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Schumer, Manchin propose corporate minimum tax and new carried interest rules

July 29, 2022 | Client Update | 11-minute read

On July 27, Sens. Schumer and Manchin announced an agreement on the Inflation Reduction Act of 2022. Key tax provisions include (1) imposing a 15% corporate AMT on the adjusted book income of corporations with over $1 billion of adjusted book income, (2) broadening the carried interest rules to extend the required holding period, require a transferor to recognize taxable phantom gain, and extend Section 1061 to apply to more types of income, and (3) increasing funding for IRS enforcement.

Background

On Wednesday, July 27, Senate Majority Leader Chuck Schumer (D-NY) and Senator Joe Manchin (D-WV) announced their agreement on an energy and healthcare bill dubbed the "Inflation Reduction Act of 2022" (the "Bill"). The Bill involves significant investments in healthcare and in energy and climate change programs that would be paid for through prescription drug pricing reform and increased tax revenue.

Although President Biden has announced his full support for the Bill, it nevertheless faces significant hurdles before it can become law. With an evenly divided Senate, and likely unanimous opposition from Republicans, Senate Democrats must be unanimous in their support. If the Bill passes the Senate, Democrats can spare only a few holdouts in the narrowly divided House.

Should the Bill become law in its current form, the tax changes will have significant implications for many taxpayers beginning in 2023. The key tax provisions are summarized below.

- A new "Corporate AMT" would impose a 15% minimum tax on the adjusted book income of corporations with over $1 billion of adjusted book income
- The Bill would broaden the scope of the carried interest rules in Section 1061 to:
  - extend the holding period requirement for individuals making more than $400,000 to at least five years and in many cases significantly longer than five years (as discussed below)
  - require a transferor of a carried interest to recognize taxable phantom gain on transfers that are otherwise treated as nontaxable under general tax principles
  - apply the longer holding period requirement to certain categories of income currently exempt from the carried interest rules, such as "qualified dividend income"
  - provide Treasury with regulatory authority to address so-called carried interest "waivers"
- The Bill would provide $80 billion over the next ten years for increased Internal Revenue Service ("IRS") enforcement, targeting taxpayers with annual taxable income above $400,000

The revenue estimates for these provisions are $313 billion (Corporate AMT), $14 billion (carried interest) and $124 billion (IRS enforcement).

Corporate Alternative Minimum Tax

Targets corporations with more than $1 billion in book income

The Corporate AMT applies to an "applicable corporation," which is any corporation that meets a $1 billion minimum book income test.[1] More specifically, the corporation's average annual "adjusted financial statement income" (or "AFSI") for three consecutive years must exceed $1 billion. A corporation's AFSI is the net income reported on its consolidated financial statement, subject to certain adjustments (discussed in more detail below).

An aggregation rule provides that, for purposes of determining whether the $1 billion test is met, the income of all corporations in a controlled group, or otherwise under common control (at a 50% threshold in each case) is aggregated.[2]

A domestic corporation that is a member of a foreign-parented group is an applicable corporation only if two separate tests are met. First, the AFSI of the group that *includes* all the foreign group members must exceed $1 billion. Second, the AFSI of the group that *excludes* all the foreign group members must equal or exceed $100 million. (In the latter test, the domestic corporation would still take into account its *pro rata* share of its CFCs' income.)

Special computational rules apply to corporations in existence for less than three years or with short taxable years.

Once an applicable corporation, always an applicable corporation

Once a corporation meets the $1 billion test, it remains an applicable corporation indefinitely, even if its AFSI drops below the $1 billion threshold.

The sole exception to this rule appears to require a determination by Treasury that continued treatment as an applicable corporation would not be appropriate.[3] Moreover, it would be available only to corporations that undergo a change of control or the AFSI of which drops below $1 billion and stays below that threshold for a specified number of years.

If Treasury determined that a corporation was no longer an applicable corporation, it would nevertheless become an applicable corporation again once its AFSI increased back above $1 billion in a later year.

Corporate AMT is calculated as 15% of AFSI

An applicable corporation must calculate its "tentative minimum tax," which is equal 15% of its AFSI, *less* the corporate AMT foreign tax credit for the year.

The Corporate AMT liability is any excess of the tentative minimum tax over the sum of the applicable corporation's regular tax liability plus its "base erosion and anti-abuse tax" (or "BEAT") liability.

A corporation that pays the Corporate AMT will receive a credit that it can use to offset its regular tax liability and BEAT liability in future tax years, but the credit cannot reduce this liability below the tentative minimum tax for any future year.

AFSI is adjusted book income

To calculate AFSI, an applicable corporation starts with the net income or loss reported on its "applicable financial statement," or "AFS." The AFS is generally a GAAP or IFRS financial statement used for reporting to the SEC or equivalent foreign agency (or, for corporations that do not report to those agencies, that is used for credit purposes or reporting to shareholders).

Special rules apply in determining AFSI, include the following: [4]

- The AFSI aggregates all items from members of the corporation's consolidated US tax group;
- The AFSI includes the group's distributive share of any partnership income and a *pro rata* share of the income of any CFC with respect to which a member is a U.S. shareholder;
- Book items related to defined benefit plans are excluded and, instead, amounts are taken into account under federal income tax principles; and
- If an applicable corporation is foreign, its AFSI takes into account only its effectively connected income, and if it is tax-exempt, its AFSI takes into account only its unrelated trade or business income.

AFSI is reduced by financial statement net operating loss carryovers, which are capped at 80% of AFSI (before the deduction). Financial statement net operating loss carryovers are net book losses incurred for a taxable year ending after December 31, 2019, and they can be carried forward indefinitely.

Corporate AMT represents another tax imposed on a different tax base

A U.S. corporation already must calculate its regular tax liability each year and, if it is subject to the BEAT, it must calculate a separate tax base and apply a different rate to determine its BEAT liability.[5] If the Corporate AMT is enacted, then a U.S. corporation would need to calculate a third tax, imposed on yet another tax base.

Moreover, if OECD "Pillar Two" is implemented as planned, then a U.S. corporation would have a fourth set of calculations to perform. Pillar Two would impose a 15% minimum tax on the book income of multinational groups with annual revenue of at least €750 million. While this tax may seem similar to the Corporate AMT, there are important differences in how the tax base would be computed under each regime. As a result, it would be entirely possible for a U.S. corporation that is subject to the Corporate AMT to be subject to additional tax under Pillar Two.

Carried interest

Section 1061 was added to the tax code as part of the 2017 tax reform legislation and generally provides that capital gain allocated under certain carried interest arrangements is eligible for the favorable 20% U.S. federal income tax rate only if the underlying asset was held for more than three years at the time of sale. The Bill includes significant changes that will generally make it more difficult for private equity sponsors to obtain long-term capital gain treatment for carried interest. The following is a summary of some of the more significant aspects of the Bill.

Five-year or longer holding period requirement

Under the Bill, in order to receive long-term capital gain treatment, the gain that is allocated to the carried interest holder must be realized by the partnership more than five years after the later of (i) the acquisition by the taxpayer of "substantially all" of his or her applicable partnership interest and (ii) the acquisition by the partnership (*i.e.*, the private equity fund) of "substantially all" of its assets.

The Bill does not define "substantially all" and it is not clear how these rules would be applied in the context of a typical private equity carried interest arrangement. It is possible that the five-year period would not start until the private equity fund makes its final portfolio investment, which could occur several years after the fund's first investment. For some private equity funds substantially all of the gain from investments could be recharacterized as short-term gain under this rule even if the investments are held for more than five years. Early investments made by the fund therefore may need to be held for significantly longer than five years in order to qualify for long-term capital gain treatment. It is also not clear how the "substantially all" test would apply to hedge funds or permanent capital vehicles that do not generally distribute proceeds from realized investments and instead use those proceeds to acquire new assets.

It is also not clear how the five-year holding period requirement would apply to applicable partnership interests that were acquired in tax-deferred exchanges, such as the contribution by an individual of his or her partnership interest to a newly formed “feeder” or “aggregator” partnership formed by the private equity sponsor. While we would expect the holding period to “tack” in this situation, the statutory language is ambiguous.

In the case of tiered partnerships, the Bill departs from the current rules by requiring the five-year holding period requirement to be met at each tier. Therefore, if the taxpayer owns an applicable partnership interest in an upper-tier partnership, which in turn owns an applicable partnership interest in a lower-tier partnership, the taxpayer can qualify for long-term capital gain treatment only if the five-year holding period requirement is met at both the upper- and lower-tier partnership levels. The current carried interest rules, by contrast, generally measure the holding period requirement only at the level of the partnership that sells the relevant asset or otherwise recognizes the relevant gain.

Three-year holding period for certain taxpayers

Under the Bill, the five-year period described above is reduced to three years (but otherwise applying the same test) for both (i) taxpayers (other than trusts or estates) who have an adjusted gross income of less than $400,000 and (ii) income that is attributable to a “real property trade or business.”

Acceleration of phantom gain on otherwise tax-free transfers of carried interests

The Bill would require any taxpayer who transfers an applicable partnership interest to recognize taxable gain (but not loss) on the transfer, even if the transfer is otherwise tax-free. Therefore gifts, estate planning transfers and other tax-deferred exchanges of applicable partnership interests that generally would be tax-free transfers in any other case would be taxable events to the transferor that generate phantom gain. The Bill would also make it difficult for private equity firms to engage in internal restructurings, as often occur in connection with spinoffs, acquisitions, third party investments and secondary transactions. Note that a similar rule was proposed by the Treasury Department in 2019 with respect to related party transfers and was ultimately rejected due to the absence of clear statutory language in current Section 1061 requiring the acceleration of gain.

Expansion to Include qualified dividend income, section 1231 gains and other income taxed at long-term capital gain rates

The Bill would apply the holding period requirement to all amounts that are either treated as capital gain or taxed at the same rates as capital gain. This would include qualified dividend income, Section 1231 gain (gain from the sale of real property and depreciable personal property held in a trade or business), and 60% of mark-to-market gains from Section 1256 contracts, all of which are not currently subject to the three-year holding period requirement.

The Bill would permit Treasury to issue regulations providing that the holding period requirement does not apply to income or gain attributable to an asset not held for portfolio investment on behalf of third party investors. This would presumably include the goodwill of a private equity firm. However, the gain acceleration rule on transfers appears to nevertheless apply to a transfer of an applicable partnership interest that has appreciated goodwill.

Regulatory authority to address carried interest waivers

The Bill directs the Treasury Department to issue regulations to prevent avoidance of the holding period requirement, including through so-called "carry waivers." Many fund sponsors include provisions in their funds' partnership agreements that permit the general partner to waive or defer capital gains from investments that do not meet the three-year holding period requirement, and receive "make-up" allocations of long-term capital gains from future profits derived by the fund. To date Treasury has not issued regulations addressing these arrangements, but noted in the preamble to the proposed Section 1061 regulations in 2019 that carry waivers may be challenged under existing law.

Increased IRS funding

The Bill would provide 10-year funding for the IRS as follows:

- $3,181,500,000 for taxpayer services
- $45,637,400,000 for enforcement
- $25,326,400,000 for operations support
- $4,750,700,000 for business systems modernization

These appropriated funds are to remain available until September 30, 2031, and no use of the funds is intended to increase taxes on any taxpayer with taxable income below $400,000.

[1] S corporations, Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs) are excluded.

[2] Under current law, portfolio companies managed by a fund operating in partnership form are generally not aggregated together for this purpose unless the fund is considered to be engaged in a trade or business. The Build Back Better Act would have broadened the aggregation rules to apply if the fund were engaged in any activity for the production of income. The Bill does not appear to contain a similar rule.

[3] It is unclear whether Treasury would make the determination on a case by case basis in response to taxpayer requests or would issue general guidance.

[4] Certain of these special rules are not taken into account for purposes of applying the $1 billion test described above.

[5] A corporation is subject to the BEAT if it meets a gross receipts test and a “base erosion percentage” test.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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