All Politics Is Local: House Dems Pass the BBBA

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When Tip O'Neill[1] reigned in the House of Representatives, legislators served their constituents by ensuring that spending bills allocated money for projects in their communities. In the 21st century, however, partisan politics sometimes takes precedence over support for legislation containing significant financial support for popular local projects. Sometimes it appears that congresswomen and men are not paying attention to what is in the legislation. Well, your ever-vigilant Mayer Brown Tax Department has been paying attention to what the House Democrats accomplished on November 19, 2021. Specifically, they passed the 2,135-page Build Back Better Act (the "BBBA").[2] This Legal Update examines the myriad proposed changes to the Internal Revenue Code (the "Code") contained in the BBBA, as passed by the House of Representatives.[3]

I. Individual Tax Changes

A. BUSINESS LOSSES

Code § 461(l), added by the Tax Cuts & Jobs Act (the "TCJA"), limits the ability of non-corporate taxpayers to claim excess business losses (i.e., business losses in excess of business income) in excess of $250,000 ($500,000 in the case of a joint return) against other types of income in any year. This limitation is scheduled to sunset after December 31, 2026. The BBBA would make it permanent. Furthermore, the BBBA would change how losses disallowed in the current year are treated in future years. Under current law, disallowed losses are carried forward as net operating losses, which can be used to offset income in future years without regard to Code § 461(l). Under the BBBA, disallowed losses would retain their character as excess business losses in future years and would be subject to the excess business loss limitation. The practical result of this change is that excess business losses that are disallowed under Code § 461(l) in a taxable year could also be limited in future taxable years.

B. STATE AND LOCAL TAX DEDUCTION

One of the more controversial provisions in the BBBA, which was not included in the Ways and Means Committee's prior version of the BBBA or the Biden administration's Green Book or BBBA framework, is a provision to increase the cap on deductions for state and local taxes (the "SALT deduction") beginning in 2021. It is expected that as the BBBA moves through the Senate, this is one provision that may change, particularly because certain Democratic senators have expressed concerns that the proposal disproportionately benefits high-income taxpayers.

Prior to the TCJA, individual taxpayers and non-grantor trusts and estates were allowed an itemized deduction for state and local real property and income taxes paid or accrued during the tax year. The TCJA imposed a $10,000 (joint filer) or $5,000 (married filing a separate return) limit on the SALT deduction through 2025.

The BBBA would extend the TCJA's temporary SALT deduction limitation through 2031 but would increase the limitation to $80,000 (joint filer) or $40,000 (estate, trust or married individual filing a separate return) for tax years 2021 through 2030. The limitation would revert to $10,000 (joint filer) or $5,000 (estate, trust or married individual filing a separate return) for tax year 2031. After December 31, 2031, the SALT deduction would not be subject to a limitation.

C. SOCIAL SECURITY TAXES/NET INVESTMENT INCOME

Under current law, S corporation members who materially participate in an S corporation's business are subject to self-employment tax only on "reasonable compensation" that they receive as employees. Similarly, limited partners who materially participate in a partnership's business are often not subject to self-employment tax. Such individuals also are exempt from the 3.8% tax on net investment income under Code § 1411, which currently applies only to certain passive income and gains.

Beginning in 2022, the BBBA would expand the 3.8% net investment income tax to cover income derived in the ordinary course of a trade or business for taxpayers with incomes greater than $250,000 (married filing separate return), $500,000 (joint filer) or $400,000 (single filers) regardless of whether the taxpayer materially participates in such business. The proposal would clarify that net investment income does not include wages taken into account in determining self-employment income. The net investment income tax would have a phase-in threshold for taxpayers whose income does not exceed the threshold by more than $100,000. This provision is intended to ensure that individuals with interests in pass-through entities will be subject to the 3.8% net investment income tax or the self-employment tax on all income (whether wages, passive income or active business income) derived from such entities.

D. HIGH INCOME SURCHARGE

Beginning in 2022, the BBBA would impose a new 5% income tax surcharge on individuals, estates and non-grantor trusts with modified adjusted gross income above a certain threshold, which would apply in addition to any other applicable income tax. This new surcharge would apply to modified adjusted gross income in excess of $10 million for taxpayers who file as single, head of household or married filing jointly; $5 million for taxpayers who file married filing separately; and $200,000 for estates and trusts. An additional 3% income tax would be imposed on modified adjusted gross income in excess of $25 million for taxpayers who file as single, head of household or married filing jointly; $12.5 million for taxpayers who file married filing separately; and $500,000 for estates and trusts. For purposes of these proposed surcharges, a taxpayer's modified adjusted gross income would be adjusted gross income reduced by any deduction (other than "above-the-line" deductions) allowed for investment interest or business interest.

E. LIMITATION ON CERTAIN SPECIAL RULES FOR CODE § 1202 GAINS

Code § 1202 permits non-corporate holders of C corporation stock to exclude a certain percentage of the "eligible gain"[4] from the sale of "qualified small business stock" held for more than five years. Generally, stock acquired after September 27, 2010, is eligible for a 100% gain exclusion.[5] The BBBA modifies this rule so that any taxpayers with an adjusted gross income[6] that equals or exceeds $400,000, as well as taxpayers that are trusts or estates, would only be permitted to exclude 50% irrespective of when a taxpayer acquired their qualified small business stock. For these taxpayers, this change reverts the Code § 1202 benefit to its state as originally enacted.[7] This change would apply to sales or exchanges made on or after September 13, 2021, other than those for which a written binding contract was in effect prior to that date (as long as the contract is not materially modified after that date).

F. ACCELERATED DEDUCTIONS FOR LAWYERS WORKING IN CONTINGENCY FEE CASES

The BBBA would change the accounting for costs incurred by lawyers working contingency fee cases to allow them to immediately deduct costs paid or incurred by them in such litigations. Under current law, lawyers working on contingency-fee cases generally cannot deduct expenses incurred for depositions, expert testimony and discovery until the conclusion of the case. The BBBA would permit lawyers to currently deduct contingency-fee case expenses, even if there is a possibility that such expenses will be reimbursed by a court order or other award in a later year.

In contingency-fee arrangements, lawyers typically advance the costs of the litigation in return for a share of the client's eventual settlement or award. Current law suspends deductions for these expenses until the lawyer receives the corresponding income at the conclusion of the case or the case otherwise concludes. Current law puts significant pressure on class action lawyers to structure litigation funding as a non-taxable advance. The change provided by the BBBA should alleviate some of the pressure to structure litigation finance transactions as non-taxable forward contracts. The proposal would generally apply to amounts paid, incurred or received in tax years beginning in 2022 (the year after the date of the enactment of the BBBA).

II. Corporate Tax Changes

A. CORPORATE ALTERNATIVE MINIMUM TAX

The BBBA includes a new corporate alternative minimum tax ("Corporate AMT") based on income reported in the corporations' financial statements. Generally, the Corporate AMT would impose a 15% tax on certain corporations' adjusted financial statement income ("AFSI"). The tax is equal to the amount by which the corporation's "tentative minimum tax"—assessed at a 15% rate on its AFSI—exceeds its regular tax liability for the applicable tax year.

The Corporate AMT applies to an "applicable corporation," defined to be any corporation other than an S corporation, regulated investment company ("RIC") or real estate investment trust ("REIT") whose three-year average annual AFSI exceeds $1 billion (the "Income Test"). For purposes of the Income Test, the AFSI of a group of corporations under common control is aggregated, and, where the parent of the group is a non-US corporation, the group's three-year annual US-related AFSI (generally, the income of domestic members of the group and ECI of foreign corporations and all income of controlled foreign corporations ("CFCs") within the group) must also exceed $100 million. Once a corporation has met the Income Test in any year ending in 2022 or later, it continues to be an applicable corporation until (i) there is a change in ownership with respect to the corporation, (ii) there is a consistent reduction in AFSI below the relevant threshold or (iii) the Internal Revenue Service ("IRS") determines it would not be appropriate to continue to treat the corporation as an applicable corporation.

The calculation of a corporation's AFSI begins with the net income or loss reported on its "applicable financial statement" ("AFS"). An AFS includes a financial statement that is prepared in accordance with GAAP or IFRS used for reporting to a governmental agency such as the Securities and Exchange Commission ("SEC") or a foreign equivalent or that is used for reporting to owners, obtaining credit or another substantial nontax purpose if no financial statement is provided to a securities regulator. If the corporation reports income in a consolidated financial statement, the financial statement is treated as an AFS of the corporation. If it is part of a consolidated group, the AFSI of each member of the group is considered part of its AFSI. A corporation's AFSI includes its distributive share of profits and losses of partnerships in which it is a partner; the income of any disregarded entities owned by the corporation; and, if it is a US Shareholder of a CFC, its pro rata share of the AFCSI of the CFC. CFC losses may offset income of other CFCs, and be carried forward to offset CFC income in future years but not the AFSI of a US corporation. As with regular corporate income tax, AFSI may be reduced by financial statement net operating losses ("NOLs") not to exceed 80% of AFSI before accounting for such NOLs.

Adjustments are made to a corporation's AFSI to (a) align the period covered by the AFS to the corporation's tax year, (b) disregard foreign taxes taken into account on the AFS to the extent the corporation elects to claim foreign tax credits and (c) disregard certain direct-pay tax credits. The bill directs the IRS to (1) provide regulations to prevent omission or duplication of items of income and loss; (2) address corporate liquidations, organizations, reorganizations and similar transactions; (3) address partnerships with income taken into account under the Corporate AMT and rules regarding partnership contributions and distributions; and (4) make other adjustments necessary to carry out the purposes of the Corporate AMT.

A corporation's tentative minimum tax can also be reduced by credits for foreign income taxes that are paid or accrued for federal income tax purposes and taken into account on an AFS. Foreign income taxes paid or accrued by CFCs are subject to an aggregate limitation of 15% of the net AFSI of all applicable CFCs. Excess foreign tax credits can be carried forward for five years. Corporate AMT is also included in a corporation's net tax liability (along with regular net income tax) that can be offset by its general business credits. Like the former Corporate AMT, and the AMT in effect for individuals, the payment of Corporate AMT gives rise to credits that can offset regular tax in excess of tentative minimum tax in future years.

B. NEW LIMITATION ON THE DEDUCTION OF INTEREST BY "SPECIFIED DOMESTIC CORPORATIONS"

Code § 163(j) already limits the amount of net business interest that most taxpayers can deduct. The BBBA proposes a new limit on net interest deductions, that is, interest expense in excess of interest income, in what would be new Code § 163(n) for tax years beginning in 2023. The Code § 163(n) limit would apply only if it disallowed more interest deductions than existing Code § 163(j).

Parsing the application of Code § 163(n) is made easier by starting with certain definitions used in the proposed Code section. First, the new limits only apply to "specified domestic corporations" (an "SDC"). An SDC is any US corporation (aggregating US affiliates) if its average annual interest expense over its average annual interest income during the current year and the two preceding years exceeds $12 million. It is unclear whether US corporations filing a consolidated federal income tax return are treated as separate corporations or a single corporation. The BBBA allows the IRS to issue regulations that treat passive interest income and expense of CFCs as incurred by an SDC.

An SDC then will only be subject to the proposed interest deduction limit if it is a member of an "international financial reporting group" (an "IFRG"). An IFRG is a group of two or more corporations, one of which is non-US, if they prepare a GAAP or IFRS financial statement for non-tax purposes, including for shareholders or creditors. A non-US corporation with a US branch is treated as a US corporation if it uses GAAP or IFRS financial statements. Excepted small businesses, RICs, REITs and S corporations are also carved out of the application of the new limitations.

An SDC that is part of an IFRG would compute the Code § 163(n) interest limitation in the following manner. First, the SDC computes the "allowable percentage." The allowable percentage is 110% of the SDC's share of the IFRG's reported net interest expense ("GRNIE") divided by the SDC's reported net interest expense (the "DCRNIE"). The SDC's share of the fraction is the ratio obtained by comparing the SDC's share of EBITDA to the IFRG's EBITDA. If the IFRG has zero or negative EBITDA, Code § 163(n) does not apply in that year. If, however, the IFRG has EBITDA but the SDC has zero or negative EBITDA, Code § 163(n) disallows all net interest expense of the SDC.

Maybe an example would help (maybe). Assume Foreign Parent ("FP") has $1,000x of EBITDA and SDC has $500x of EBITDA. The ratio of US EBITDA to IFRG EBITDA is 33.3% (500/1,500). FP has $1,000x of debt outstanding bearing interest at 5%. FP has loaned $1,000x to SDC at 6% and incurs DCRNIE of $60x. On a consolidated basis, only the $50x of interest paid by FP is reported as GRNIE (the FP-SDC loan is eliminated in consolidation). SDC's share of the $50x GRNIE is $16.65x (⅓ x $50x). SDC's allowable percentage is 27.75% ($16.65x/$60x). Proposed Code § 163(n) would limit SDC's share of interest expense to $15.26x, that is, 110% of $50x GRNIE multiplied by the 27.75%. Thus, SDC would lose the current deduction for $44.73x ($60x interest paid to FP minus the Code § 163(n) limit).

Interest that is disallowed under Code § 163(n), as a well as interest disallowed under Code § 163(j) in 2023 and thereafter, will carry forward indefinitely.

C. CORPORATE STOCK REPURCHASES

The BBBA would impose a nondeductible 1% excise tax on publicly traded US corporations (and certain US subsidiaries of publicly traded non-US corporations) for the value of any stock that is repurchased by the corporation or its "specified affiliates."[8] The repurchase amount subject to the excise tax is reduced by the value of any new issuances of stock during the year. The excise tax would apply to redemptions occurring after December 31, 2021.

In addition, the bill would create six exceptions to excise tax, including to the extent (1) the repurchase is part of a tax-free reorganization, and no gain or loss is recognized by the shareholder by reason of the reorganization; (2) the repurchased stock or its value is contributed to an employee pension plan, employee stock ownership plan or similar plan; (3) the total amount of repurchases within the year is less than $1 million; (4) the repurchase is by a dealer in securities in the ordinary course of business; (5) the repurchase is taxed as a dividend to the shareholder (as opposed to "sale or exchange" treatment); or (6) the repurchase is by a regulated investment company or a real estate investment trust.

As a general rule, redemptions of stock from small public shareholders who are not involved in the corporation's management are treated as a "sale or exchange" and not as a dividend. Even in cases where it could be theoretically possible for a repurchase of publicly traded stock to be treated as a dividend for tax purposes, the corporation likely does not have the information necessary to make this determination. The new provision may place significant stakes on the ability to obtain this information.

The excise tax would also apply to repurchases by inverted foreign corporations with stock traded on an established securities market that invert after September 20, 2021.

The term "repurchase" means (i) any acquisition of stock by a corporation from a shareholder in exchange for cash or property or (ii) any other economically similar transaction as determined by Treasury. The broad definition of "repurchase" appears to cover stock repurchases implemented through traditional open market transactions, privately negotiated purchases or registered self-tender offers. Numerous transactions could be caught up by the rule. The excise tax would extend to transactions that are treated as constructive redemptions, such as leveraged buyouts of a publicly traded target corporation. Also, a corporation's acquisition of its stock of a controlled corporation in a "split-off" may be subject to the excise tax to the extent such distribution is not tax-free. Furthermore, a corporation's acquisition of its stock in exchange for property in a distribution in complete or as part of a partial liquidation might fall into this broad definition. The BBBA would grant regulatory authority to the IRS to issue regulations addressing preferred stock (presumably, the redemption of preferred stock at maturity should not result in application of the excise tax).

D. BASE EROSION ANTI-ABUSE TAX ("BEAT") TAX CHANGES

The proposed legislation would make significant changes to the BEAT rules. BEAT was enacted as part of the TCJA and functions as a minimum tax by adding back to taxable income deductions for certain payments to related parties and applying the applicable BEAT tax rate (currently 10% or 11% for banks) to modified taxable income. BEAT currently applies to corporate taxpayers with average annual gross receipts of at least $500 million.

The proposed legislation would accelerate the imposition of the 12.5% rate for years beginning after December 31, 2022, and before January 1, 2024. The rate would be further increased to 15% for taxable years beginning after December 31, 2023, and further increased to 18% for tax years beginning after December 31, 2024.

Under current law, BEAT does not apply to a taxpayer if its base erosion percentage is less than 3%. In general, the base erosion percentage is the ratio of base eroding payments to the aggregate amount of all deductions allowable to the taxpayer. The proposed legislation would eliminate the 3% threshold for taxable years beginning after December 31, 2023. The proposal would significantly expand the number of taxpayers subject to BEAT and represents a stinging blow to many taxpayers that restructured supply chains and other intercompany transactions to eliminate base erosion payments so as to keep below the 3% threshold. Given that the elimination of the 3% base erosion threshold is not scheduled to be effective until tax years beginning after December 31, 2023, a taxpayer with average gross receipts above $500 million can avoid BEAT and delay the start of the 10-year taint (described immediately below) by keeping its base erosion percentage below 3% for the next two years.

Under current rules as modified by the proposed legislation, a taxpayer is an applicable taxpayer for BEAT purposes if the taxpayer's average annual gross receipts (tested over a three-year period) is at least $500 million. Compounding the sting of the elimination of the 3% base erosion threshold is a provision not seen in previous versions of the legislation that causes a taxpayer to remain an applicable taxpayer for 10 succeeding tax years regardless of whether the gross receipts test is met for taxable years beginning after December 31, 2021.

Under current law, a payment is not considered a base eroding payment if it is subject to the full 30% withholding tax. Where a treaty reduces the withholding tax, the payment is considered a base eroding payment for the portion of the payment not subject to withholding. The proposed legislation significantly expands the subject to US tax exclusion. Under the proposed rules, a payment that is subject to US tax in the hands of either the payor or the payee will be excluded. The exclusion for payments subject to withholding tax would continue to apply as well as payments that would be taxed as effectively connected income to the recipient.

Significantly, a payment to a CFC that is subject to global intangible low-taxed income ("GILTI") would not be considered a base eroding payment notwithstanding the Code § 250 deduction for a GILTI inclusion. This is a welcome provision and eliminates the so-called "GILTI boomerang" effect. This change will largely eliminate the application of BEAT to US multinational companies on payments made to CFCs.

The proposed legislation provides an important exception from BEAT for payments that are subject to a rate of tax equal to the lesser of 15% or the applicable BEAT rate as modified by the proposed legislation. The effective tax rate will be tested under US tax standards, namely the high-tax kickout rules in Code § 904(d)(2)(F). While not clear from the proposed legislation, Treasury personnel have indicated where the payment is subject to foreign tax under a CFC regime, an income inclusion rule or other Pillar Two mechanisms, those taxes will be considered for purposes of the foreign effective rate test.

The existing BEAT regulations contain an important exception for certain intercompany services. Under those regulations, a payment is not considered to be a base eroding payment if the payment is eligible for the services cost method (the "SCM") if it is either one of a number of specifically enumerated services or an arm's length mark-up for such service would not exceed 7%. The legislation essentially codifies the provisions in the regulations and removes any uncertainties as to the approach taken by Treasury when the regulations were finalized.

One of the most complex aspects of the proposed legislation is the expansion of base eroding payments to include certain indirect costs associated with cost of goods sold (COGS). Under current law, payments to a related foreign person for COGS are not included as base eroding payments except to the extent such payments are made to an expatriated entity. The COGS exclusion is an important exception for multinationals that acquire inventory from foreign related party manufacturers.

The proposed legislation reduces the benefit of the COGS exception in two important ways. First, any payment to a foreign related party that the US payor is required to capitalize into inventory under Code § 263A would be considered a base eroding payment. For example, if a US payor makes a royalty payment to a foreign related party for the right to manufacture inventory items, that royalty will be considered a base eroding payment. Second, the COGS exclusion for inventory acquired from a foreign related party would be limited to the (i) *direct* costs associated with acquiring the inventory and (ii) *indirect* costs of such foreign related party but only to the extent it is established that such indirect costs were paid to a US person or an unrelated foreign person or are otherwise subject to US tax in the hands of the recipient. In other words, the COGS exclusion for indirect costs is only available where inventory can be traced to third-party direct or indirect costs. To obviate the need to trace indirect costs, the legislation permits a taxpayer to elect to treat 20% of direct costs as indirect for purposes of the COGS exclusion.

The proposed legislation makes a number of changes to how NOLs interact with BEAT. Under current law, for purposes of calculating modified taxable income, NOLs are added back to the extent of any base eroding payments that contributed to the NOL. Currently, 100% of the base eroding portion of the NOL is added back even though NOLs are limited to 80% of taxable income for regular tax purposes. The proposed legislation would equalize the treatment of NOLs for regular tax and BEAT purposes by providing that the NOL add-back for BEAT purposes is limited to 80% of the base eroding portion of the NOL.

E. WORTHLESS SECURITIES AND SUBSIDIARY LIQUIDATIONS

The BBBA would modify the treatment of certain losses in a number of unrelated ways. The BBBA proposes to amend the treatment of a loss from a worthless security so that the loss is realized on the day the security becomes worthless rather than on the last day of the taxable year. Realizing a loss earlier in the year could be beneficial as it will allow some taxpayers to realize a short-term capital loss rather than a long-term capital loss. Importantly, an additional amendment would specify that abandonment is an identifiable event allowing the loss. This provision would apply for tax years beginning after December 31, 2021.

The BBBA expands the definition of a "security" for purposes of the worthless securities rules to include indebtedness issued by a partnership. This change would conform the treatment of partnership debt to corporate debt in the context of worthless securities. This change would apply for tax years beginning after December 31, 2021. Additionally, a loss from a worthless partnership interest is to be treated under the BBBA as a loss that arises from a sale or exchange of a partnership interest. Thus, the loss would be a capital loss (unless attributable to unrealized receivables and inventory items). This proposal would equate the treatment of worthless interests in partnerships without internal debt to those with debt. This provision would apply for tax years beginning after December 31, 2021.

The BBBA has a new provision under Code § 267 pursuant to which a distributee corporation cannot recognize a loss on stock or securities received from a liquidating corporation in a complete liquidation to which Code § 331 applies until the distributee corporation has disposed of *all* property received in such liquidation to unrelated persons. It is unclear how a distributee will need to establish that it has disposed of "all" property received in the liquidation, in particular as it relates to cash and other fungible assets, as well as intercompany receivables.

The BBBA targets *Granite Trust* transactions, named after the case *Granite Trust Co. v. United States*, 238 F.2d 670 (1st Cir. 1956), which held that a parent corporation could proactively sell off stock held in a subsidiary to receive taxable treatment of the subsidiary's liquidation and recognize a loss. Generally, in a *Granite Trust* transaction, a parent corporation sells a part of its interest in a to-be-liquidated subsidiary to an affiliate outside the parent's consolidated tax group, such as a foreign subsidiary or related partner, to lower the parent's stock ownership below the 80% threshold to avoid non-recognition treatment under Code § 332 and recognize a loss under Code § 331.

Although Code § 267(f) currently defers or disallows losses between corporations in the same controlled group, it does not defer any loss a parent would recognize on its remaining interest in the liquidating subsidiary. Following the passage of this provision, it would no longer be sufficient for a parent to partially sell off its interest in a liquidating subsidiary to fall below the 80% threshold to recognize a loss in the liquidation. The parent would now need to dispose of its interests in the liquidated subsidiary to recognize a loss. This provision looks to sharply curtail *Granite Trust* transactions and will apply to liquidations on or after the date of enactment.

F. ADJUSTED BASIS LIMITATION FOR DIVISIVE REORGANIZATION

In a reorganization pursuant to Code §§ 368(a)(1)(D) and 355 (i.e., spin-offs and split-offs), Code § 361(a) generally provides that the distributing corporation does not recognize gain or loss on its transfer of property to the controlled corporation in exchange for stock or securities in the controlled corporation. To the extent the distributing corporation receives property other than stock or securities (i.e., boot) from the controlled corporation, Code § 361(b)(1) generally provides that the distributing corporation does not recognize gain if the distributing corporation distributes such property pursuant to the plan of reorganization.

The transfer of boot by the distributing corporation to its creditors in connection with the reorganization is also generally considered a distribution under Code § 361(b)(1). However, under current law, nonrecognition on such distribution only applies to the extent the boot transferred to creditors does not exceed the adjusted bases of the assets transferred.

The BBBA seeks to further expand this limitation by requiring the distributing corporation to recognize gain to the extent of boot exceeding (A) the sum of (i) the total amount of liabilities assumed by the controlled corporation, (ii) the total amount of boot transferred to the creditors and (iii) the total principal amount of securities of the controlled corporation that is qualified property transferred to the creditors over (B) the total adjusted bases of the assets transferred by the distributing corporation to the controlled corporation. In other words, this proposal would further limit the distributing corporation's ability to allocate its debt to the controlled corporation on a tax-free basis since the proposed limitation would also take into account the total principal amount of securities of the controlled corporation transferred to creditors.

Under a transition rule, the BBBA's provisions would not apply to a transaction that is (i) made pursuant to a written agreement that was binding on the date the BBBA is enacted, (ii) described in a ruling request submitted to the IRS on or before such date or (iii) described on or before such date in a public announcement or in a filing with the SEC.

III. International Tax Changes

A. THE POSSESSIONS CREDIT

The BBBA creates a new general business credit (the "Possessions Credit") in respect of certain wages and fringe benefits paid to employees providing services and located in American Samoa, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, Guam and the Virgin Islands. The Possessions Credit allows a qualified domestic corporation (a "QDC") to take a credit equal to 20% of the sum of wages paid to employees performing services in the possession (subject to a wage cap of $50,000) and allocable fringe benefit expenses paid by the foreign corporation (subject to a cap of 15% of qualified possession wages).

A domestic corporation will qualify as a QDC if, for the three years preceding the year under consideration, at least 80% of its income is derived from within a possession, and at least 75% of its income is derived from the active conduct of a trade or business within a possession. Alternatively, a domestic corporation will qualify as a QDC if it is the sole shareholder of a corporation formed in a possession (a "Possessions Corporation") that meets these income requirements. If a domestic corporation wholly owns a Possessions Corporation that does not meet the income requirements referenced above, the domestic corporation may still qualify as a QDC if the Possessions Corporation has a separate and identifiable business unit (including a partnership or a DRE) that keeps its own books and records and that would meet the income requirements if such unit were treated as a separate corporation. In this case, the domestic corporation may elect to treat this unit as a separate corporation for purposes of the Possessions Credit (although how this election is made is not explained in the text of the BBBA).

The Possessions Credit is much more robust for a qualified small domestic corporation ("QSDC"). Specifically, for a QSDC, the credit is increased to 50% of the sum of wages paid to employees performing services in the possession (subject to a wage cap of $142,800) and allocable fringe benefit expenses paid by the foreign corporation (subject to a cap of 15% of qualified possession wages). A QDC will qualify as a QSDC if the QDC, or the foreign corporation of which it is the sole shareholder, has at least five, but no more than 30, full-time employees in a possession and does not have gross receipts of more than $50 million in each of the three years preceding the year under consideration.

The Possessions Credit would become effective for tax years beginning after the date of the enactment of the BBBA.

B. REDUCTION OF THE DEDUCTION FOR FDII AND GILTI

The BBBA would reduce the deduction for foreign-derived intangible income ("FDII") to 24.8% (from 37.5%) and for GILTI to 28.5% (from 50%). Considering the general corporate tax rate would remain at 21%, the BBBA's proposed reductions to the deductions for FDII and GILTI would yield an effective rate of 15.792% for FDII and 15.015% for GILTI. The 15.015% effective rate for GILTI, together with the 5% haircut on foreign tax credits (discussed below), would require an effective foreign tax rate of 15.805% to avoid residual US tax on the GILTI inclusion. The nearly 15% effective rate on GILTI and 2023 effective date appear to signal the United States' recognition of the OECD's commitment to a global minimum tax rate of at least 15% under OECD Pillar Two, which is expected to be implemented as of 2023.

In addition, the BBBA would eliminate the rule that limits the Code § 250 deduction to the current year's taxable income and, thus, would provide that the excess of the Code § 250 deduction over the current year's taxable income increases the net operating loss for the year. This taxpayer-favorable change would be effective for tax years beginning after December 31, 2022.

C. CHANGES TO SCOPE OF FDII

The BBBA would narrow the definition of "deduction eligible income" ("DEI") for FDII purposes. Notably, DEI would exclude any income treated as "passive income" under the Code § 904 foreign tax credit limitation and the regulations thereunder, that is, any income that would be "foreign personal holding company income," subject to the specific exceptions under Code § 904 (e.g., exception for active rents and royalties whether received from a related or unrelated person), and any inclusion from a "qualified electing fund" ("QEF inclusion") under the passive foreign investment company ("PFIC") rules. DEI would also exclude income and gain from the sale or other disposition of property giving rise to rents and royalties. This exclusion could operate to deny the FDII deduction for the offshoring of intangible property that is being licensed by the US taxpayer, and the wording appears to be broad enough to cover deemed royalty inclusions under the super royalty provision (Code § 367(d)). Although the Ways and Means Committee's prior version of the bill would have made the exclusions from DEI retroactive to 2018, the House version of the BBBA only makes them effective for tax years beginning after the date of enactment.

D. REPEAL OF ELECTION FOR ONE-MONTH DEFERRAL IN CFC TAX YEAR

Under current law, a CFC that is majority owned by a single US shareholder is generally required to adopt the tax year of its majority US shareholder. An exception exists, however, that allows such a CFC to elect to use a tax year that begins one month earlier than its majority US shareholder's tax year. This one-month deferral rule has often allowed taxpayers to delay the application of changes in law to their CFCs and has more generally resulted in unintended consequences in the application of newly enacted rules.

The BBBA would eliminate this one-month deferral rule for taxable years of CFCs beginning after November 30, 2022. For US shareholder-majority owned CFCs that have elected into the one-month deferral, a transition rule would conform the CFC's tax year to its majority US shareholder's tax year by ending the first tax year of the CFC beginning after November 30, 2022, at the same time as the tax year of the majority US shareholder.

E. MODIFICATIONS TO FOREIGN TAX CREDIT LIMITATIONS

The BBBA includes several substantial changes related to the calculation of foreign tax credits, substantially identical to the changes proposed in the Ways and Means Committee version of the bill.

Importantly, the BBBA would require the foreign tax credit limitation for each foreign tax credit basket to be calculated on a country-by-country ("CbC") basis. For purposes of this CbC calculation, each item of income shall be attributed to a "taxable unit" of the US taxpayer. Taxable units include (i) the US taxpayer itself, (ii) each CFC of which the US taxpayer is a US shareholder, (iii) an interest in a pass-through entity held by the US taxpayer or by any such CFC that is a tax resident in a foreign country and (iv) a branch of the US taxpayer or any such CFC that has a taxable presence in a foreign country other than its country of residence. Income of the same foreign tax credit basket earned by taxable units within the same country would be combined for purposes of calculating the taxpayer's foreign tax credit limitation for such category and country. This proposal would prevent taxpayers from cross-crediting "high" and "low" taxed income earned in different jurisdictions and, for many multinational companies, would exponentially increase their US tax compliance and reporting burden.

The BBBA would also eliminate the "foreign branch income" separate basket that had been introduced by the TCJA, thus reducing the principal foreign tax credit categories to three—passive category income, general category income and GILTI. The CbC calculation and the removal of the "foreign branch income" basket would apply to tax years beginning after December 31, 2022.

The BBBA would eliminate the one-year carryback for excess foreign tax credits. Further, the BBBA would allow a five-year carryforward for foreign taxes in the GILTI basket paid or accrued in a tax year beginning prior to January 1, 2031, and a 10-year carryforward period thereafter. Under current law, foreign taxes in the GILTI basket cannot be carried back or forward. It should be noted that, unlike the Ways and Means Committee version of the Bill, the House version would not shorten the existing 10-year carryforward period for foreign taxes in the other baskets. These changes would only apply to foreign taxes paid or accrued in tax years beginning after December 31, 2022.

Under current law, as interpreted by the IRS in regulations, interest, stewardship and R&D expenses are apportioned to GILTI, which may significantly lower the foreign tax credit limitation in the GILTI basket. In a taxpayer-favorable change, the BBBA provides that only the Code § 250 deduction and the deduction for state and local taxes, but no expenses of the US shareholder (e.g., interest expense), are allocable to the GILTI basket. The House bill clarifies that expenses that would have otherwise been allocable to GILTI income are allocable only to US source income. These changes would apply to tax years beginning after December 31, 2022.

The BBBA would apply the principles of Code § 338(h)(16) in determining the source and character of any item of income or loss in the case of a "covered asset disposition," which is defined as any transaction that is treated as a disposition of assets for US tax purposes and that is treated as a disposition of stock of a corporation (or is disregarded) for non-US tax purposes. In that case, for foreign tax credit purposes, the source and character of any item would be determined based on the source and character that the US shareholder of the target corporation would have taken into account had the sale been treated as a sale of stock for US tax purposes. This proposal would apply to covered asset dispositions occurring after enactment of the BBBA, with an exception for transactions undertaken pursuant to a binding contract in effect on September 13, 2021.

Finally, the BBBA would modify the periods during which a taxpayer may elect to claim a credit or a deduction for foreign taxes. A taxpayer may claim a foreign tax credit within five years from the date of the return for the tax year in which the taxes are paid is required to be filed. A taxpayer would only have three years to change from a credit to a deduction for foreign taxes.

F. MODIFICATIONS TO INCLUSION OF GILTI

The current GILTI regime of Code § 951A requires "US shareholders" to include the net earnings of their CFCs in their income to the extent that the CFCs earn more than a deemed 10% return on their qualified business asset investment ("QBAI"). QBAI includes tangible personal property. The BBBA would make several changes to the GILTI rules for tax years beginning after December 31, 2022.

First, the BBBA would reduce the deemed exempt QBAI earnings to 5% unless the CFC operates in a US territory. Unlike the OECD Pillar Two, the "exempt return" does not include payroll and is only based on QBAI (tangible assets).

Second, the BBBA would implement a CbC rule for determining GILTI inclusions. Under this CbC rule, instead of aggregating and netting the attributes of all CFCs of a US shareholder, the US shareholder would only aggregate the tested income, tested loss, net deemed tangible income return and foreign taxes of CFCs doing business in the same country. The resulting complexity for the distribution of previously taxed earnings and profits ("PTEP") appears to be staggering.

Third, in a significant improvement to the operation of the GILTI regime, net tested losses for a tax year would no longer disappear. Instead, net tested losses, subject to the new CbC rule, would carryforward indefinitely until fully utilized against tested income. Unfortunately, no carryback rule has been proposed.

The BBBA would also eliminate the exemption from GILTI for foreign oil and gas extraction income (FOGEI).

G. MODIFICATIONS TO DETERMINATION OF DEEMED PAID CREDIT FOR TAXES PROPERLY ATTRIBUTABLE TO GILTI TESTED INCOME

The BBBA would reduce from 20% to 5% the haircut on foreign taxes attributable to tested income under the GILTI rules. In other words, 95% of the foreign taxes attributable to tested income would be creditable. Because, as explained above, no deductions other than the Code § 250 deduction would be allocable to the GILTI basket for purposes of the foreign tax credit limitation, this should mean that a US shareholder would generally not incur residual US tax on its GILTI income so long as the income is subject to a foreign tax rate of approximately 15.805% (i.e., 15.805% * 95% = 15.015%).

The BBBA would also change the existing GILTI rules to allow a credit for foreign taxes attributable to a tested loss CFC.

Finally, the BBBA provides that, subject to regulations, a credit would be granted for the foreign taxes paid by the foreign parent of a US group that owns CFCs to the extent such foreign taxes are properly attributable to amounts of any such CFCs that are taken into account in determining the US group's tested income or loss. It appears that this provision intends to allow a foreign-parented US group to claim a credit for the foreign taxes paid by its foreign parent under an income inclusion rule in line with the OECD Pillar Two agreement.

These changes would apply to tax years beginning after December 31, 2022.

H. CHANGES TO FOREIGN BASE COMPANY SALES INCOME AND SERVICES INCOME RULES

Under current law, Subpart F income generally includes income of a CFC derived in connection with the purchase of property from, or sale of property to, a related person or on behalf of a related person (foreign base company sales income) and income of a CFC derived from performing services outside of the CFC's country of incorporation for or on behalf of a related person (foreign base company services income). The BBBA would significantly narrow the scope of these types of Subpart F income by providing that, for these purposes, a "related person" only includes a related person that is a taxable unit that is a tax resident of the United States or is subject to US tax as a result of its activities in the United States. As such, sales or services transactions between a CFC and a foreign affiliate generally would not give rise to Subpart F income and may instead result in tested income for purposes of the GILTI calculation.

In connection with this change, the BBBA would also eliminate the "branch rules" that currently apply to treat a branch of a CFC as a separate CFC for purposes of the foreign base company sales income determination. However, the BBBA would give regulatory authority to the Secretary to issue guidance to carry out the amended provisions, including to treat a branch of a CFC as a wholly owned subsidiary; it is unclear under what circumstances this would be appropriate in light of the narrowed scope of foreign base company sales income.

In addition, the BBBA would modify the same-country exceptions to foreign base company sales and services income such that the determination would no longer be whether the activity is conducted, or the customer is located, in the country of incorporation of the CFC but, rather, whether in the country of tax residence of the CFC.

These changes would apply to tax years beginning after December 31, 2021.

I. CALCULATION OF PRO RATA SHARE OF SUBPART F AND GILTI

The BBBA would substantially modify the calculation of a US shareholder's pro rata share of Subpart F and tested income items from a CFC. Under current law, a US shareholder includes its pro rata share of Subpart F and tested income only to the extent it holds stock of a foreign corporation on the last day of the year on which such foreign corporation was a CFC. In addition, the US shareholder's pro rata share with respect to stock of a CFC is reduced to the extent of dividends received by any other person during the tax year with respect to such stock (including any gains from the sale of stock recharacterized as a dividend under Code § 1248).

Under the BBBA, a US shareholder that owns stock of a CFC during the tax year may have an inclusion with respect to such stock even if they do not own such stock on the last day of the year on which the corporation was a CFC. In that case, the US shareholder's pro rata share would be based on the proportionate share of current earnings and profits ("E&P") received by the US shareholder (or by a CFC owned by such US shareholder) as a "nontaxed current dividend," that is, the portion of a dividend received from the CFC out of current year E&P that would be eligible for a Code § 245A deduction or, in case of a dividend between CFCs, that would be excluded from the recipient CFC's subpart F income under an applicable exception.

In turn, the US shareholder that owns stock of a CFC on the last day of the year in which the foreign corporation was a CFC would include its pro rata share of Subpart F income and tested income reduced by (i) the "nontaxed current dividends" received by any other US shareholder that previously owned the stock during the year and (ii) any "pre-holding period dividends," which are dividends made out of the corporation's current E&P (other than non-taxed current dividends) received by any other US person with respect to the same stock while such foreign corporation was a CFC and before such US shareholder owned the stock to the extent such dividends do not qualify for a Code § 245A deduction. Through different mechanics, these changes would address situations already tackled by Treasury in existing regulations to prevent a US buyer of CFC stock from reducing its Subpart F income or tested income inclusion by reason of dividend income recognized by a US seller that goes untaxed under Code § 245A.

While the Ways and Means Committee bill would have applied these changes retroactively to all post-TCJA years, the House bill proposed that they apply to tax years of foreign corporations beginning after December 31, 2021, and to tax years of US shareholders in which or with which such tax years end.

J. ADJUSTMENTS TO EARNINGS AND PROFITS OF CFCS

The determination of E&P of a CFC under current law generally disregards the application of certain accounting methods, such as LIFO inventory adjustments, the installment method and the completed contract method of accounting. As such, a CFC may accelerate the recognition of earnings for E&P purposes, while the corresponding income is still not otherwise recognized. The BBBA would change this result such that E&P of a CFC are computed by taking into consideration such special accounting methods. While the Ways and Means Committee would have made this change applicable for tax years beginning after December 31, 2021, the bill passed by the House would apply it to tax years of foreign corporations ending after the date of enactment. So, if the bill is enacted in 2021, it could potentially apply to transactions undertaken in the current year.

K. REINSTATEMENT OF THE "NO DOWNWARD ATTRIBUTION" RULE

The TCJA repealed Code § 958(b)(4), which prevented the downward attribution of stock ownership from a foreign person to a US person for purposes of determining whether a US person was a US shareholder or whether a foreign corporation was a CFC. This repeal was made effective for the last tax year of CFCs that began before January 1, 2018, and had the impact of significantly increasing the number of foreign corporations that were treated as CFCs because any foreign corporation that shared a foreign parent with a US subsidiary could be treated as a CFC.

Unlike the Ways and Means proposal, which would have retroactively reinstated Code § 958(b)(4) with an effective date the same as the original repeal date under the TCJA (effectively treating the repeal under the TCJA as if it had never been enacted), the effective date of the current BBBA would reinstate Code § 958(b)(4) for tax years of foreign corporations beginning after the date of enactment and tax years of US persons in which or with which such tax years of foreign corporations end. This eases the administrative burden of taxpayers who no longer need to recalculate their tax liabilities under a retroactive reinstatement of Code § 958(b)(4) but also prevents such taxpayers from obtaining refunds for taxes paid during the time Code § 958(b)(4) was repealed.

Although the reinstatement of Code § 958(b)(4) should reduce the number of taxpayers treated as owning a CFC, new Code § 951B (discussed below) has rules potentially subjecting certain US shareholders to the CFC rules despite the fact they would not be treated as CFC owners prior to the TCJA's repeal of Code § 958(b)(4).

L. FOREIGN CONTROLLED CFCS UNDER NEW CODE § 951B

Despite the reinstatement of the "no downward attribution" rule in Code § 958(b)(4) (discussed above), under the BBBA, downward attribution will still apply from a foreign parent down to its US subsidiary in certain cases under new Code § 951B.

Proposed Code § 951B introduces the concept of (i) a foreign-controlled US shareholder ("FCUSS"), where an FCUSS must own "50% or more," instead of "10% or more," of the total vote or value of a foreign corporation and (ii) a foreign-controlled CFC ("FCFC"), which are entities that are owned more than 50% by an FCUSS. For purposes of both these definitions, the downward attribution rule still explicitly applies.

Thus, if a US subsidiary shares a foreign parent with a sister foreign subsidiary and the US subsidiary directly owns less than 50% of the sister foreign subsidiary, the foreign parent's ownership in the foreign subsidiary would be attributed to the US subsidiary, potentially making the US subsidiary an FCUSS that holds an FCFC. An FCUSS treated as owning an FCFC for purposes of Code § 951B would be subject to the CFC inclusion rules.

Foreign-parented groups that have both US and non-US subsidiaries will need to reevaluate their structures to determine if the US subsidiary in the group is an FCUSS that will be subject to the CFC rules due to Code § 951B.

Code § 951B is proposed to be effective for tax years of foreign corporations beginning after the date of enactment and tax years of US persons in which or with which such tax years of foreign corporations end. Regulations will need to clarify whether an FCUSS and an FCFC will be treated as a US shareholder and CFC, respectively, under other provisions of the Code (such as under Code § 245A and the PFIC rules).

M. ELECTION TO TREAT FOREIGN CORPORATIONS AS CFCS

The BBBA would amend Code § 957(a) to allow foreign corporations to elect to be treated as a CFC. The election would need to be made by the foreign corporation and all its US shareholders, as determined at the time of the election. Once effective, the election would be binding on all future US shareholders who become shareholders after the election takes effect.

The BBBA does not contain any limitations on when this election can be made although regulations may introduce limitations in the future. For now, in situations where a foreign parent owns both a US and non-US subsidiary, which under Code § 951B causes the US subsidiary to be an FCUSS and the non-US subsidiary to be an FCFC due to downward attribution, making the election under Code § 957(a) would convert the FCFC into an actual CFC, thus turning off the downward attribution rules so that the FCUSS would no longer be a US shareholder of a CFC (assuming the US subsidiary owned less than 10% of the non-US subsidiary). Whether the regulations will limit the use of the election in this context remains to be seen.

From a practical standpoint, requiring all US shareholders to agree to the election may present difficulties in situations where there are multiple, unrelated US shareholders. However, given that once the election is made it will apply to all future US shareholders, it will be important for future owners of a foreign subsidiary to diligence whether the foreign entity has ever made an election to be treated as a CFC.

Similar to the reinstatement of Code § 958(b)(4), this provision is proposed to be effective for the last tax year of foreign corporations beginning after the date of enactment and tax years of US persons in which or with which such tax years of foreign corporations end.

N. AMENDMENTS TO CODE § 245A

Generally, subject to satisfying a minimum holding period and other requirements, the participation exemption system introduced by the TCJA allows a domestic corporation to deduct 100% of the foreign-source portion of dividends received from a foreign corporation in which the domestic corporation owns 10% or more of the vote or value.

The BBBA would limit the benefit of Code § 245A only to foreign-source dividends received from a CFC, effectively eliminating the participation exemption for any corporate US shareholder of a foreign entity that is not a CFC. It appears the drafters understand that Code § “on”?245A should only apply with respect to the residual earnings and profits of CFCs that are not captured by the subpart F and GILTI rules.

The changes to Code § 245A are proposed to be effective only after the date on which the BBBA is enacted.

O. CERTAIN CFC DIVIDENDS TREATED AS “EXTRAORDINARY DIVIDENDS” UNDER CODE § 1059

As a general matter, Code § 1059 requires a basis reduction and, thereafter, capital gain recognition with respect to shares on which a corporate shareholder receives an extraordinary dividend, provided that the shareholder has not held the stock for at least two years prior to the dividend announcement date. The BBBA would amend Code § 1059 to provide that any “disqualified CFC dividend” is treated as an extraordinary dividend without regard to the holding period. A “disqualified CFC dividend” means any dividend paid by a CFC to a US shareholder if such dividend is attributable to earnings and profits that were earned while such foreign corporation was not a CFC or such stock was not owned by a US shareholder. Importantly, the House bill abandoned the Ways and Means Committee proposal to also treat as a “disqualified CFC dividend” dividends attributable to gain on property accrued while the foreign corporation was not a CFC or the stock was not owned by a US shareholder. These changes could have an impact in M&A activity. A buyer of a foreign target from a foreign seller would need to track the history of the shares and the earnings and profits of the target. The amendments will apply to distributions made after the date of enactment of the legislation.

IV. Capital Markets Tax Changes

A. PORTFOLIO INTEREST

The portfolio interest exception allows US obligors on debt instruments to pay interest free from US withholding tax to non-US persons. When the portfolio interest exception does not apply, the US withholding tax rate on interest is 30% unless reduced by a tax treaty. Not all interest paid to non-US persons qualifies as portfolio interest. Interest that is paid by a US obligor to a non-US person who is treated as a "10% shareholder" of the US obligor (or holder of 10% or more of the capital or profits interest in a US obligor that is a partnership) is carved out of the portfolio interest exception. Under current law, a 10% shareholder is a non-US person who actually or constructively owns 10% or more of the voting stock of the obligor.

The BBBA would expand the definition of a 10% shareholder to include a non-US person who actually or constructively owns 10% or more of the vote or value of the stock of a US corporate obligor on a debt instrument held by the non-US person.

The BBBA proposes to implement this rule for debt instruments issued, or deemed reissued because of a material modification, after the date of enactment of this change. Thus, all debt instruments issued prior to this date would be grandfathered from its application. It is unclear whether a loan facility documented prior to the passage of the BBBA, but providing for drawdowns after enactment, will be considered to be "issued" prior to the passage of the act.

B. EQUITY DERIVATIVES OVER MASTER LIMITED PARTNERSHIPS ("MLPS")

Code § 871(m) treats "dividend equivalent payments" made to non-US persons in respect of dividends paid on US stocks in sale-repurchase transactions and specified notional principal contracts (a/k/a "Swaps") as dividends subject to US withholding tax. In other words, a non-US person cannot obtain a better tax result by gaining exposure to a US stock through a derivative or lending it out over a dividend record date and receiving dividend equivalent payments. The breadth with which the IRS has sought to implement this rule has made this relatively straightforward statutory mandate an extremely difficult rule to navigate in the structured product arena and for non-delta one financial products. At the current time, the rule for dividend equivalent payments only applies to delta one exposure provided to US stocks.

The BBBA would expand the reach of Code § 871(m) to include derivatives referencing US publicly traded partnerships ("PTPs") in an unusual way. Specifically, a derivative that made a payment that "is determined by reference to any income or gain in respect of an interest in a [PTP]" would be treated as a dividend equivalent payment. In the absence of an applicable income tax treaty, this rule would subject such payments to a 30% withholding tax. If the non-US recipient of the dividend equivalent payment was eligible for the benefits of an income tax treaty that provided for lower withholding tax rates on dividends, an unresolved issue arises as to whether a payment made in respect of a partnership interest would be eligible for such lower rate. If, however, the treaty contains an "Other Income" provision preventing the imposition of tax on income and gains not enumerated in the treaty, the non-US person should have a position that such Other Income provision prevents the application of the revised Code § 871(m) rule.

If enacted, the changes to Code § 871(m) would apply to payments made in 2023 or after, regardless of when the derivative was entered into.

C. CONSTRUCTIVE SALE RULES EXPANDED TO CRYPTOCURRENCIES

The constructive sale rules cause certain hedging transactions entered into with respect to "appreciated financial positions" to trigger unrealized gain with respect to such positions. Appreciated financial positions include positions in publicly traded stock and convertible debt instruments. The BBBA would treat positions in cryptocurrencies in which there is unrecognized gain for federal income tax purposes as appreciated financial positions. This change would be effective for hedges of such positions initiated after the date of enactment of the new rule. In addition, for transactions entered into after the date of enactment of the BBBA, the BBBA would expand the rule for hedging short positions by treating a contract to enter into a long position as a constructive sale.

D. UPDATING THE WASH SALE RULES

Under the wash sale rules, if a taxpayer acquires, or enters into a contract to acquire, substantially identical stocks or securities ("replacement property") that they sold at a loss within the wash sale period, the loss on the sold stock or securities is disallowed. The wash sale period is the 61-day period beginning 30 days before the sale of the loss position. The BBBA would implement several changes to the wash sale rules, all beginning in 2022.

First, the BBBA would change the rule regarding the disallowed loss itself. Under the current rules, if a loss is disallowed, the basis of the replacement property is increased by the disallowed loss. Under the BBBA rule, the basis of the replacement property is increased only if the replacement property is acquired by the taxpayer or their spouse. It appears that if the replacement property is acquired by a related person, no basis adjustment would be permitted.

Second, the BBBA would expand the list of persons acquiring replacement property that would trigger a wash sale. Under the BBBA, wash sales results are triggered if during the wash sale period replacement property is acquired by the taxpayer's spouse, the taxpayer's dependents, any entity that the taxpayer controls (generally using a 50% ownership test), the taxpayer's IRA, a Code § 529 plan or an employee annuity. This change would essentially codify existing IRS positions.

Third, the assets subject to wash sale treatment are greatly expanded to include any stock (whether or not publicly traded), a widely held partnership interest, any debt instrument, any derivative, foreign currencies, commodities and cryptocurrencies.

Fourth, the BBBA contains a provision that would exempt wash sale treatment to foreign currency and commodity transactions that are directly related to the "business needs of a trade or business" or that are part of a hedging transaction.

V. Insurance Tax Changes

Non-US insurance companies that are not closely held can avoid application of the PFIC rules if they are actively engaged in the insurance business (a "qualifying insurance company" or "QIC"). IRS regulations contain detailed rules on when a non-US insurance company will be considered to be a QIC. Under the current rules, most financial guaranty companies cannot qualify as QICs. The BBBA would expand the universe of financial guaranty companies that can qualify as QICs by allowing such companies to treat unearned premium reserves as qualifying insurance liabilities retroactively to tax years beginning in 2018.

Endnotes

[1] Thomas "Tip" O'Neill (D: Mass.) was the 47th Speaker of the House of Representatives from 1977 to 1987 and the author of a book using the same phrase as the title of our Legal Update. He served in the House from 1953 through 1987 and passed away in 1994.

[2] HR 5376 (Rule Committee Print 117-18).

[3] For our coverage of a prior iteration of this legislation, please see https://www.mayerbrown.com/en/perspectives-events/publications/2021/09/overview-of-us-tax-provisions-of-build-back-legislation-approved-by-house-ways-means-committee

[4] A taxpayer's "eligible gain" is generally the greater of (i) $10 million and (ii) 10 times the aggregate adjusted basis of the qualified small business stock issued by the corporation and disposed of by the taxpayer during the taxable year.

[5] Eligible gain on qualified small business stock acquired after February 17, 2009, and before September 28, 2010, is eligible for a 75% exclusion, and stock acquired after August 10, 1993, and before February 18, 2009, is eligible for a 50% exclusion.

[6] Determined without regard to Code §§ 1202, 911, 931 and 933.

[7] The 75% and 100% exclusions were added to the Code in 2009 and 2010, respectively.

[8] Specified affiliates include subsidiaries in which the corporation owns a 50% or greater equity interest during the taxable year.