A View from Inside the Beltway: Tax Policy – The Latest

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Latest Legislative Developments

Latest legislative developments

- After months of negotiations, the House approved the tax-and-spending Build Back Better Act (BBBA) on Nov. 19 by a 220-213 vote, setting the stage for Senate action in December
- On Dec. 19, Sen. Joe Manchin, D-WV, announced he could not support the current version of the BBBA, citing the overall cost, inflation concerns, and some policy objections. More recently, he has said the current version of the BBBA is "dead"
- In his March 1 State of the Union address, President Biden seemed to retire the "Build Back Better" brand for his signature but unveiled a new label—Building a Better America—for many of those same ideas and pitched those proposals as keys to taming the rising cost of living
- Following the State of the Union, Manchin said he could support a bill that:
    1) raises revenue by cutting prescription drug prices and raising taxes on large corporations and wealthy individuals, and
    2) uses half that revenue for deficit reduction/taming inflation and half for climate change mitigation programs and social programs in a way that is "sustainable" (i.e., not short-term funding on provisions likely to be extended but not paid for later)
- Issues including SALT cap relief and a Parliamentarian review of the House-approved BBBA are also unresolved

The President's FY 2023 Budget request tells two stories

BUSINESS TAX CHANGES (In addition to BBB)

- 28% corporate rate (GILTI would increase to 20% per interaction with the provisions in BBB)
- Tax benefits for onshoring jobs; loss of tax benefits for offshoring jobs
- End provisions cited as preferences for fossil fuel activities
- Repeal and replace BEAT with a Pillar Two conforming Undertaxed Profits Rule
- New reporting rules for digital assets
- Certain Partnership modifications

INDIVIDUAL TAX CHANGES (usually applicable only to those with incomes over $400,000)

- 20% "Billionaire" Minimum Income Tax (applicable if total income (including unrealized capital gains) exceed $100 million)
- 39.6% top income tax rate
- Estate and gift changes
- Treat carried interest as ordinary income
- Repeal like kind exchanges
- Tax capital gains as ordinary income for higher income individuals

Budget assumes as a baseline that all of the revenue raising provisions of the House-passed Build Back Better package (other than changes to SALT) have been enacted

Key Tax Proposals

Build Back Better Act – tax increases

Key business tax provisions

	Current Law	House BBB Act*
Corporate income	Taxed at 21%	No change to corporate income tax rate 15% minimum tax on companies reporting a 3-year average of “adjusted financial statement income” >$1B, effective for TYBA 12/31/22 • For foreign-parented corps, generally requires foreign income >$1B and US-related income >$100M (including income of CFCs)
Treatment of stock repurchases	No provisions	1% annual excise tax on stock repurchases of fair market value >$1M by publicly traded corporations, effective for repurchases after 12/31/21 • Excludes certain repurchases

* Unless otherwise noted, provisions are generally effective for taxable years beginning after (TYBA) 12/31/21.

Build Back Better Act – tax increases

Key international tax provisions

	Current Law	House BBB Act*
Global intangible low-taxed income (GILTI)	GILTI earned by US-based multinationals has an effective tax rate of 10.5% through 2025, then 13.125%, and is calculated on a global basis Income up to 10% of qualified business asset investment (QBAI) is exempt from US tax Taxpayers may use 80% of amount of foreign tax credits (FTCs) to offset GILTI ("20% FTC haircut")	Increase GILTI effective rate to 15.015%, calculated on a CbC basis Lower QBAI exemption to 5%, with limited exception for US territories Reduce FTC haircut by increasing to 95% the deemed paid credit for taxes attributable to GILTI Effective for TYBA 12/31/22
Base Erosion and Anti-Abuse Tax (BEAT)	US-based multinationals with $500M+ gross receipts and payments to related foreign corps of 3%+ of total deductions are subject to a 10% minimum tax (11% for certain financial institutions) for taxable years beginning before (TYBB) 1/1/26, then a 12.5% tax	12.5% for TYBA 12/31/22 and TYBB 1/1/24, 15% for TYBA 12/31/23 and TYBB 1/1/25, and 18% for TYBA 12/31/24 Extends SHIELD-like concepts, preventing application of BEAT if payment is made to jurisdiction with high enough tax rate; provides full value for all credits including FTCs Terminates BEAT exemption for low base erosion percentage: an applicable taxpayer in a single TYBA 12/31/21 is an applicable taxpayer for next 10 years

* Unless otherwise noted, provisions are generally effective for taxable years beginning after (TYBA) 12/31/21.

Build Back Better Act – tax increases

Key business tax provisions

	Current Law	House BBB Act*
Foreign-derived intangible income (FDII)	Certain export income from sales, services and intangibles for a US corporation generally has an effective rate of 13.125% 10% QBAI exemption	Increase effective rate to 15.792%
Business interest limitations	Limited to the sum of 30% of adjusted taxable income (ATI), business interest income (BII), and floor plan financing interest	Creates section 163(n) limiting interest deductions for certain domestic corps that are members of an international reporting group to the extent its reported net interest expense exceeds its allocable share of the group's net interest expense (determined on basis of relative EBITDA) by >110% Applies section 163(j) to partners or shareholders, rather than to partnerships or S corps as entities Allows 1-year carryforward of disallowed expense Effective for TYBA 12/31/22

* Unless otherwise noted, provisions are generally effective for taxable years beginning after (TYBA) 12/31/21.

Build Back Better Act – tax increases

Individual tax provisions

	Current Law	House BBB Act*
Ordinary income	• Top rate of 37% for those earning >$500k single/$600k married filing jointly (MFJ), inflation adjusted, through 2025 (>$518,401/$622,051 in tax year 2020) • Additional 0.9% Medicare income tax applies to earnings >$200k/$250k	• New 5% surtax on modified adjusted gross income (MAGI) >$10M single or MFJ/$5M married filing separately (MFS)/$200k estate or non-grantor trust • New 3% surtax on MAGI >$25M/$12.5M/$500k • Note: MAGI also includes preferential rate income, such as capital gains and qualified dividends
Capital gains and dividends	• 20% tax rate applies to long-term capital gains and qualified dividends • 3.8% net investment income (NII) tax for those earning >$200k single/$250k MFJ • Exclusion from capital gains tax for up to $250k single/$500k MFJ on qualifying home sales	• No change to tax rate on capital gains and dividends • NII tax expanded to cover NII derived in ordinary course of a trade or business for taxpayers with income >$400k single/$500k MFJ and for trusts and estates

* Unless otherwise noted, provisions are generally effective for taxable years beginning after (TYBA) 12/31/21.

Build Back Better Act – tax increases

Individual tax provisions

	Current Law	House BBB Act*
Qualified small business stock	• Special 75% and 100% exclusion rates for gains realized from certain qualified small business stock under section 1202	• The special 75% and 100% exclusion rates for gains realized from certain qualified small business stock under section 1202 would not apply to taxpayers with AGI equal or exceeding $400k • Effective for sales and exchanges after 9/13/2021, subject to a binding contract exception
Excess business losses	• Excess business losses for non-corporate taxpayers limited to $250k single/$500k MFJ), inflation adjusted, through 2025 – Current limit = $262k/$524k • Treated as NOL carryforwards in the following tax year	• Permanently disallows (currently the limitation sunsets for tax years beginning after December 31, 2025) excess business losses for non-corporate taxpayers and removes the 1-year deferral; retroactive to TYBA 12/31/20

* Unless otherwise noted, provisions are generally effective for taxable years beginning after (TYBA) 12/31/21.

Build Back Better Act – SALT cap relief

Individual tax provisions

	Current Law	House BBB Act*
State and local tax (SALT) deduction	• Taxpayers who itemize can deduct up to $10k ($5k for MFS) in property taxes plus state income or sales taxes—but but not both—paid to state and local governments, through 12/31/25; after this date, there is no cap on the deduction	• Cap on deduction is raised to $80k ($40k for MFS or estate/trust) for TYBA 12/31/20 and TYBB 1/1/31 • Then returned to $10k for TYBB 1/1/32 and repealed for TYBA 12/31/31

* Unless otherwise noted, provisions are generally effective for taxable years beginning after (TYBA) 12/31/21.

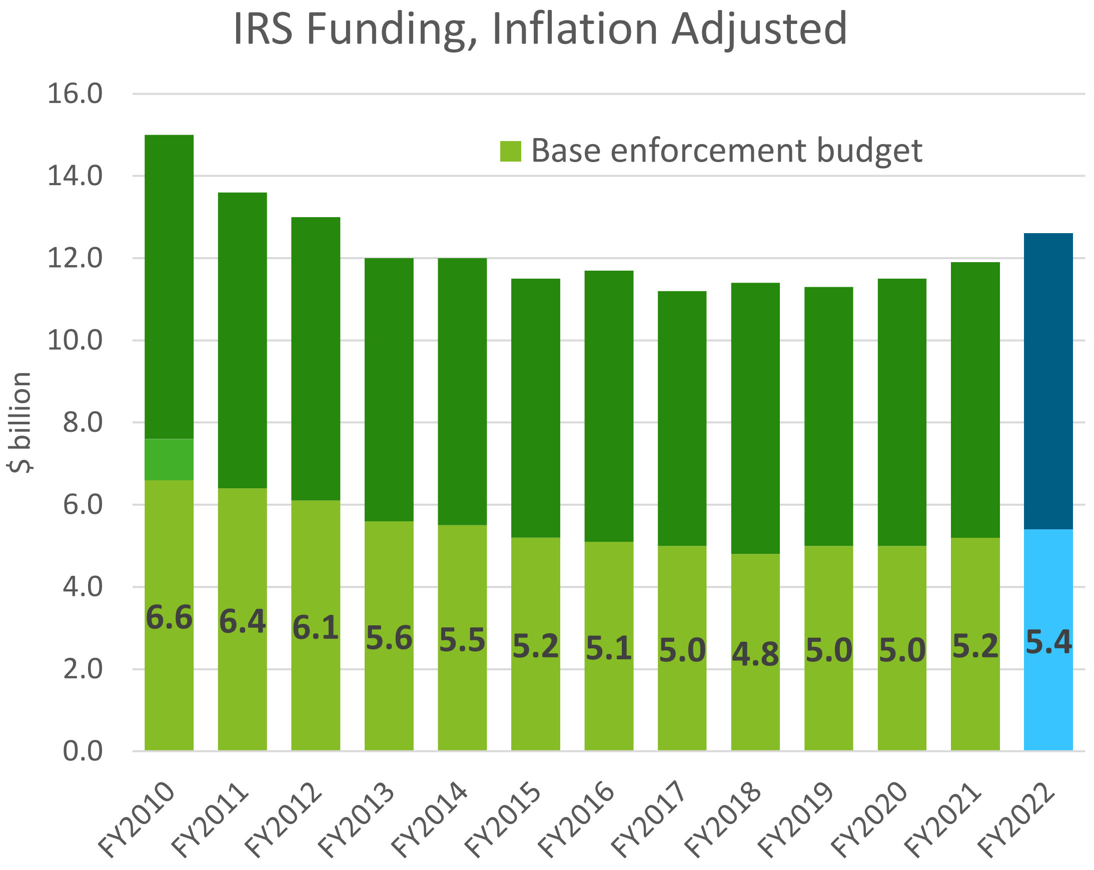
Build Back Better Act – What's left out?

Left Out

- Changes to marginal rates for individuals and corporations
- Changes to capital gains rates
- Repeal of Like Kind Exchanges
- Repeal of stepped-up basis at death
- Mark to market on assets of ultra high-net worth individuals
- Changes to section 199A deduction
- Changes to tax treatment of carried interest
- Changes to estate and gift tax rules
- Partnership tax overhaul
- Bank reporting to IRS of customer account inflows / outflows

The IRS is getting a raise for enforcement

- The FY2022 spending bill Congress passed in March – more than 5 months after the start of the fiscal year – provides a 5.7% raise for the IRS… but at $12.7B gives the agency less than the $13.2B President Biden requested
- The House-passed BBBA provides $79.6B in additional funding to the IRS over 10 years (beyond what would otherwise be available), including $44.9B for enforcement. The bill states the provision is not intended to increase taxes on taxpayers with taxable income below $400,000
- The agency's funding for FY2022 also includes $4.1B for operations support, $2.8B for taxpayer services, and $275M for business systems modernization
- The IRS typically carries 1M or fewer unprocessed returns, to include correspondence matters, into the next filing season, but as of Jan. 28, outstanding individual and business returns requiring "manual processing" came to 23.7M, including 5.8M pieces of taxpayer correspondence awaiting action



Source: "Trends in the Internal Revenue Service's funding and enforcement," Congressional Budget Office, July 2020; FY2010-FY2020 data from Congressional Budget Office; FY2021 data from Consolidated Appropriations Act, 2021 (P.L. 116-260); FY2022 data from HR 2471, the vehicle for the FY2022 Omnibus Appropriations Act, March 11, 2022

Four Tax Policy Observations

Observation #1: It just takes one…

In a 50/50 Senate, one Democratic Senator can dictate details and outcomes

- Even after bringing negotiations on the Build Back Better Act to a halt in late December, Sen. Manchin has continued to signal that he supports a number of provisions in the legislation, including tax increases to offset the cost of the roughly $1.75 trillion bill
- However, he continues to reiterate his earlier concerns about inflation, the U.S. federal debt picture and the use of “budget gimmicks” to pay for spending in the BBBA
- The answer may mean funding fewer programs over the 10-year budget reconciliation window rather than funding more programs for only a short period of time
- Also, Sen. Sinema continues to echo her concerns regarding tax rate increases and has also indicated that there may not be enough time left on the legislative calendar to complete a tax/spending package

Observation #2: Concerns are related to the spending proposals – not the tax increases

Business

- 15% corporate minimum tax based on “book income” of certain large corporations
- 1% stock buyback tax
- International reform
- Increased IRS funding with the goal of improving compliance
- Green energy tax credits
- Delay of Sec. 174 R&E amortization rules

Individuals

- 5% MAGI surcharge starting at $10 million with additional 3% of MAGI starting at $25 million
- Expanded scope of 3.8% NII tax
- Permanent disallowance of excess business losses for non-corporate taxpayers
- Repeal of special 75% and 100% exclusion rates for gains related to qualified small business stock, for taxpayers with AGI >$400,000
- Retirement savings changes (e.g., end mega-IRAs)

Observation #3: Effective dates for tax increases stick – for now

- Capitol Hill tax leaders continue to maintain that effective dates for the tax proposals included in the Build Back Better Act will remain the same, arguing that taxpayers have been on notice regarding the effective dates since last fall
- Many of the business-related tax increase proposals have prospective effective dates set to taxable years beginning on or after January 1, 2023
- The individual tax increase proposals, however, are generally effective for taxable years beginning on or after January 1, 2022 (or, in the case of qualified small business stock, September 14, 2021)
- The longer the BBBA legislative process plays out, the more difficult it may be for those dates to remain in place

Observation #4: Expiring tax provisions and newly effective tax increases have yet to be addressed

Selected provisions that expired at the end of 2021 could be retroactively extended

Pandemic assistance

- Employee retention and rehiring tax credit
- Fully refundable expanded child tax credit of up to $3600, paid monthly*; reverts to $2k maximum payment, with up to $1,400 refundable depending on earned income
- Expanded earned income tax credit*
- Refundable expanded child and dependent care tax credit
- Above-the-line charitable contribution deduction
- Increased deduction limits for charitable contributions

Traditional "extenders"

- Beginning of construction date for wind facilities eligible to claim the electricity production tax credit (PTC) [or investment tax credit (ITC) in lieu of PTC]*
- Credit for electricity produced from nonwind renewable sources*
- Credits for qualified fuel cell vehicles, alternative fuel vehicle refueling property, and two-wheeled plug-in vehicles*
- Credit for construction of new energy-efficient homes*
- Incentives for alternative fuel and alternative fuel mixtures*
- Credit for nonbusiness energy property*
- 3-year depreciation for racehorses 2 years old or younger
- Credit for mine rescue team training
- Itemized deduction for mortgage insurance premiums
- Increase in limit on cover over of rum excise tax revenues to Puerto Rico and US Virgin Islands

TCJA provisions

- Capitalization of R&E expenses*; expenses related to US R&E must now be amortized over 5 years, and those related to R&E outside the US amortized over 15 years
- Harsher limit on deduction of business interest expense begins, changing from 30% of EBITDA to 30% of EBIT

Plus… a change some hope to avoid

- TCJA's allowance of full expensing of most equipment—"bonus depreciation"—is due to begin phasing down after 2022 before expiring at the end of 2026

* Extended in House-passed version of Build Back Better Act

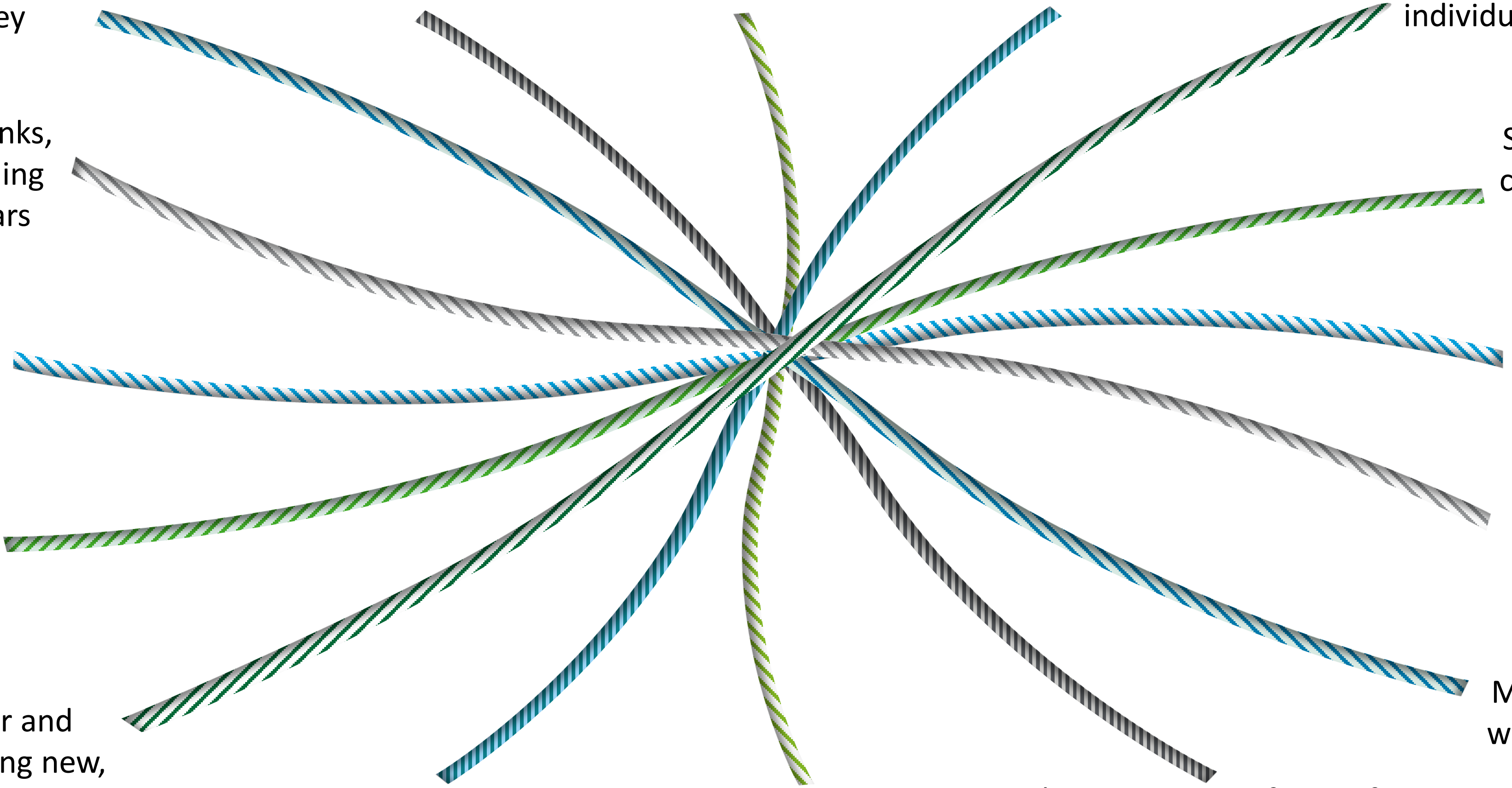
Source: JCX-1-21 List of Expiring Tax Provisions 2021-2029, Jan. 27, 2021

Note: Lists above are not exhaustive.

State of Play

Build Back Better

A game of “Tug of War” with many ropes



Let Medicare negotiate Rx prices to save money

Strong international changes are needed now

Pay for all of it with tax increases or spending cuts

Repeal of the SALT cap is critical

Raising tax rates doesn’t address the problem of individuals and businesses not paying any tax

If the bill’s total size shrinks, let’s do the same spending plans but for fewer years

Strong policies to address climate change are critical

The total cost should be only $1.5 trillion

We need to spend $3.5 trillion (or more)

We must protect oil and gas industry jobs

Let’s avoid cliffs and other budget tricks

Raising rates is simpler and more efficient than adding new, complex and untested regimes into the tax code

Medicare negotiation will reduce innovation

Repeal of the SALT cap primarily benefits the wealthiest taxpayers

We can borrow some of the short-term cost

Let’s not move too far too fast on international reform until we see what other countries will do

Can some version of Build Back Better pass?

Deal

- Budget reconciliation is a powerful tool to bypass a filibuster in the Senate and congressional Democrats will figure out a way to utilize it to pass tax-and-spending legislation
- US commitments to global efforts may also help drive action; the international tax changes included in the BBBA are seen as necessary to bring the US into compliance with the OECD/G-20 agreement on a global minimum tax that the Administration signed on to with an implementation target of 2023 (though that date may slip)
- Sen. Manchin has set general parameters for a deal (raising tax rates notwithstanding) that congressional Democrats could probably agree to provided they accept that the final bill will not be as robust as many would like
- Many Democrats think a “win” could help their party going into the November 8 elections

Can some version of Build Back Better pass?

No Deal

- The question remains as to whether there is a version of Build Back Better legislation that can garner all 50 Democratic votes in the Senate and almost every House Democrat:
  - ✓ Sen. Sinema remains opposed to tax rate increases;
  - ✓ Sen. Manchin now floating an idea of a bipartisan energy bill that could pull galvanizing policies out of BBB;
  - ✓ Others may object to the removal of enhancements to the child tax credit, some of the social safety net spending or House-passed immigration changes
- Other competing legislative priorities – China competition, Ukraine aid, COVID funding, FY23 appropriations, etc. -- could crowd out action on a tax-and-spending plan; and the calendar is rapidly tightening in an election year
- Agreement on repealing or lowering the limit on the SALT deduction – declared a red line by some Democrats – has still not emerged

Will this year’s post-election “lame duck” legislative session be productive?
Some early thoughts

Election winners generally fall into one of two camps:

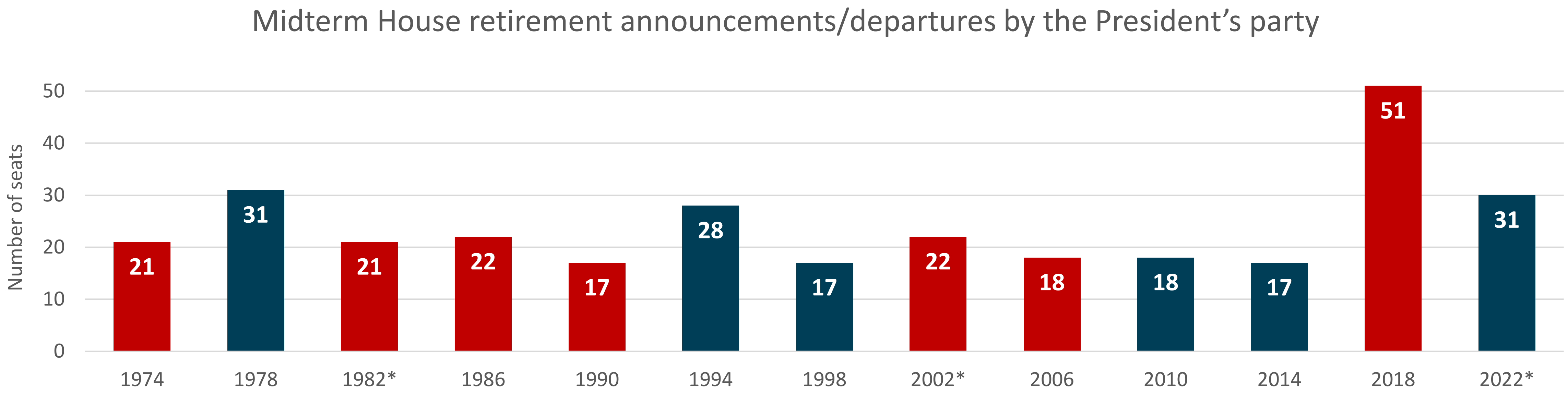
1. Desiring to clear the deck to make way for action on other priorities next year; or
2. Wanting to delay action in order to write bills next year in a manner more to their liking

Losers also generally fall into one of two camps:

1. Wanting to get done what they can while they still have some power;
2. Seeking to delay action to cause a traffic jam for the winners next year

House Democratic departures are relatively high, ahead of a potential majority loss

History is not on the side of the President's party going into the midterms



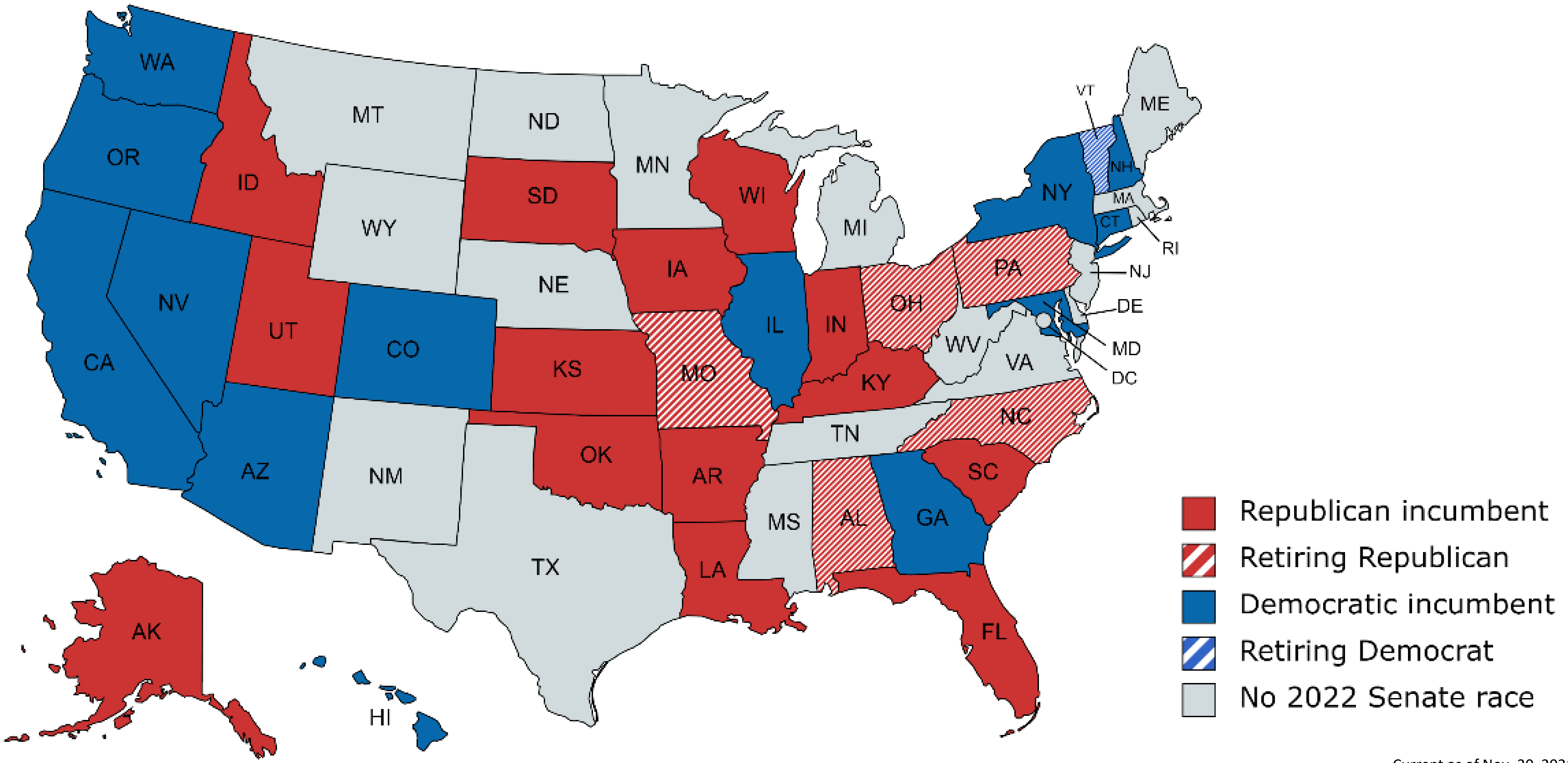
* Redistricting year
Note: Data as of Feb. 15, 2022
Source: Sabato's Crystal Ball, "Exit Stage Left or Right: Midterm Retirements and Open Seats in the House From 1974 to 2018," Geoffrey Skelley, March 22, 2018; updated by Deloitte

History suggests the House GOP may pick up seats in the 2022 midterms:

- In the 7 midterm elections of a president's first term since 1978, the president's party has lost an average of 28 House seats
- The only such election in which the president's party gained seats was in 2002 (barely one year after 9/11)
- While state-by-state maneuvering is still playing out, one bright spot for House Democrats is that their challenge will not be significantly exacerbated by the decennial Congressional redistricting process, as many in the party feared.

The 2022 Senate election map

GOP defending 20 seats, Democrats 14



Current as of Nov. 30, 2021

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