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The Proposed Build Back Better Act Moves Forward After the House Passes a Revised Version of the Bill

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Over the past year, several tax law changes have been proposed by the Biden administration and, in September 2021, draft legislative language was circulated, which set forth proposed changes to the Internal Revenue Code, that would affect many of these changes. Among the proposed tax increases introduced in the September draft legislation was an increase to the corporate income tax rate, an increase in the capital gain rate and significant changes to the tax treatment of “carried interest.”

On November 19, 2021, the House of Representatives passed a version of the Build Back Better Act, which excluded many of the tax provisions included in the version introduced in September. The expectation is that prior to passage, additional changes will be made to the tax provisions included in the Build Back Better Act.

The following is a summary of some of the more significant tax law changes that were included in the House-passed version of the Build Back Better Act.

1. ***Proposed Expansion of the Applicability of the 3.8% Net Investment Income Tax***

Under current law, the 3.8% net investment income tax does not generally apply to flow-through income from an S corporation or from other pass-through entities if the taxpayer individual is actively involved in the business.

Under the House-passed version of the Build Back Better Act, for taxpayers with taxable income over $400,000 (single filers), $500,000 (married taxpayers filing jointly or surviving spouses) or $250,000 (married taxpayers filing separately), this 3.8% tax would apply in most cases to income tax and is treated as a net investment income regardless of whether the flow-through income is from a business in which the taxpayer individual is actively involved.

This proposed change would have the effect of raising the tax rates on flow-through income from an S corporation or limited liability company. As proposed, this change would take effect on January 1, 2022.

2. *Proposed Imposition of a Tax "Surcharge" on high-income Individuals*

In the version of the Build Back Better Act that was originally proposed in September, an additional tax of 3% was imposed in the form of a surcharge on certain individuals that had adjusted gross income over a certain threshold amount. In the House-passed version of the Build Back Better Act, this surcharge concept was retained.

Under the House-passed version of the Build Back Better Act, there would be two separate surcharges imposed on high-income individuals. The first surcharge imposed would be equal to the sum of 5% of the amount of the taxpayer's adjusted gross income that exceeds $10 million ($5 million for married taxpayers filing separately; $200,000 for an estate or trust).

For taxpayers with an adjusted gross income that exceeds $25 million ($12.5 million for married taxpayers filing separately; $500,000 for an estate or trust), an additional surcharge equal to a sum of 3% would be imposed on such excess (for a total surcharge of 8%).

As proposed, this change would take effect on January 1, 2022.

3. *Proposed Changes to the Tax Benefits Applicable to Section 1202 Stock*

In the version of the Build Back Better Act that was originally proposed in September, a reduction to the amount of gain that can be excluded from the sale of certain small business stock under Section 1202 of the Code was proposed. The House-passed version of the Build Back Better Act included this tax law change and amends Section 1202 to disallow the 75% and 100% exclusion of gain from the sale of stock if the taxpayer's adjusted gross income in the year of the sale is over $400,000. This disallowance will also apply if the selling taxpayer is a trust or estate.

If passed into law, for individuals with adjusted gross income of over $400,000, this change would reduce the Section 1202 exclusion from 100% to 50% of the Section 1202 gains up to a maximum of $10,000,000 in Section 1202 gains per year/per investment. It is important to note that the gain not excluded under Section 1202 will be subject to the 28% capital gain rate. As a result, under the change to the rules of Section 1202 made by the House-passed version of the Build Back Better Act, the effective rate of capital gains tax would essentially be half the applicable capital gain rate of 28% (or 14%).

As proposed, the change would take effect retroactively to sales occurring after September 13, 2021, subject to a binding contract exception.

4. Proposed Changes to Make the Limitation Imposed on Excess Business Losses Permanent

In the version of the Build Back Better Act that was originally proposed in September, the limitations on the ability to deduct excess business losses and originally enacted in the Tax Cuts and Jobs Act of 2017 would have been made as a permanent limitation (rather than one set to expire in 2024). The House-passed version of the Build Back Better Act adopts the same proposal as set for in the September draft.

As proposed, this change would take effect on January 1, 2022

5. Proposed Changes to the Wash Sale Rules

The House-passed version of the Build Back Better Act makes commodities, foreign currencies and cryptoassets subject to the wash-sale rules. As proposed, this change would tax effect on January 1, 2022.

6. Proposed Increases to the SALT Deduction Cap

Tax Cuts and Jobs Act of 2017 imposed a limitation on an individual's ability to claim a deduction for state taxes paid by the individual. The House-passed Build Back Better Act would increase the limitation amount on the deduction for state and local taxes from $10,000 to $80,000 ($40,000 for married taxpayers filing separately and for trusts and estates).

As proposed, this change would apply for the 2021 tax year and each year thereafter through 2030. Starting in 2031, the cap on state and local tax deductions would revert back to $10,000, unless further Congressional action occurs.

7. Proposed Imposition of a 1% Surcharge on Corporate Stock Buybacks

The House-passed version Build Back Better Act imposes a tax on any domestic corporation stock that is traded on an established securities market (i.e. publicly traded corporations) in an amount equal to 1% of the fair market value of any stock of the corporation that the corporation repurchases during the year.

As proposed, this stock buy-back take would apply to repurchases of stock made after December 31, 2021.

8. Proposed Limitation on Interest Expense Deduction for Certain Corporations

The House-passed version Build Back Better Act includes a new provision that would be added to Section 163. In the proposed addition of Section 163(n), the amount of net interest expense of certain domestic corporations (or foreign corporations engaged in a U.S. trade or business) would be subject to limitation. As drafted, the limitation imposed on the interest expense deduction is described as an "allowable percentage" of 110% of the domestic corporation's net interest expense.

As proposed, these changes would apply to taxable years beginning after December 31, 2022.

9. Proposed Changes to the Rules Applicable to FDII and GILTI

The House-passed version of the Build Back Better Act reduces the applicable percentage for the foreign-derived intangible income (FDII) deduction from 37.5% to 24.8%. The House-passed version of the Build Back Better Act also reduces the applicable percentage for the global intangible low-taxed income (GILTI) deduction from 50% to 28.5%. These proposed changes result in an effective FDII rate of 15.8% and an effective GILTI rate of 15%.

A transition rule is provided for taxable years that include but do not end on December 31, 2022. Amendments related to the section 250 deductions for GILTI and FDII are effective for taxable years beginning after December 31, 2022.

10. Proposed Changes to the Foreign Tax Credit Limitation

The House-passed version of the Build Back Better Act amends the foreign tax credit rules of Section 904 to apply the foreign tax credit limitation on a country-by-country basis. The foreign tax credit limitation would also apply by taxable unit, which would include the subject corporation, each foreign corporation of which the corporation is a shareholder and interests held by the corporation in a pass-through entity. The House-passed version of the Build Back Better Act also repeals the ability to carryback of a foreign tax credit.

As proposed, this change would apply to tax years beginning after December 31, 2022.

11. Proposed Country-by-Country Minimum Tax on Foreign Profits of US corporations

The House-passed version of the Build Back Better Act changes the base erosion provisions of Section 59A by gradually increasing the applicable percentage from 10% to 12.5% in 2023, 15% in 2024 and 18% after 2024. Under these changes, amounts would not be subject to the base-erosion tax if the income was subject to an effective rate of foreign tax of at least 15% (or 18% after 2024).

Conclusion

There are several other tax-related provisions in the House-passed version of the Build Back Better Act. However, some of the tax changes that were well-publicized in the September version, such as the increase of the capital gain rates, increase to the corporate tax rate, substantial limitation of the applicability of the like-kind exchange rules of Section 1031 and changes to the taxability of carried interest have been purposefully excluded. It remains unclear if the above-referenced tax provisions will make it into the version of the Build Back Better Plan that may come out of the Senate.

James J. Wotruba also contributed to this article.

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