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Ways and Means Committee Approves $2.1 Trillion of Tax Increase Proposals that Would Have Significant Impact on Private Equity Industry

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On Wednesday, September 15, the House Ways and Means Committee approved tax increase proposals projected to raise $2.1 trillion over 10 years (the "Proposals"). If enacted in their current form as part of the broader budget reconciliation bill (the "Bill"), the Proposals would have far-reaching effects on private equity sponsors, their principals, and their portfolio companies.

The Bill faces a number of obstacles in both the House and the Senate, and material changes could be made to the Proposals (including to relevant effective dates) as the legislative process unfolds.

With those caveats, we summarize below at a high level those Proposals that are most relevant to our private equity clients. Unless otherwise noted, the Proposals generally are proposed to be effective for taxable years beginning after December 31, 2021.

Key Individual Tax Increases

- *Capital Gains Tax Rate.* Increases the top long-term capital gains tax rate from 20% to 25%, generally effective for gains and qualified dividend income recognized after September 13, 2021, subject to a binding contract exception for transactions that close in 2021.
- *Carried Interest.* Extends the three-year holding period to qualify for long-term capital gains treatment to five years, except for carried interest attributable to real

property trades or businesses. Adds rules for measuring the holding period, including for tiered entities (which in practice may significantly extend the required holding period), and modifies certain other rules. Directs Treasury to issue guidance to address carry waivers and other arrangements intended to avoid the purposes of the provision.

- *Net Investment Income Tax.* Expands the 3.8% net investment income tax to apply to active trade or business flow-through income for high-income taxpayers (above $500,000 for married filing joint and $400,000 for single).
- *Individual Tax Rate.* Increases the top individual ordinary income tax rate to 39.6%.
- *High-Income Surcharge.* Imposes a 3% surcharge on income (both ordinary income and capital gains) above $5 million.
- *SALT Deduction Cap.* The Proposals do not include any relief from the $10,000 cap on deductions for state and local taxes, though there are ongoing discussions among House Democrats to add some form of SALT relief to the Bill.

Key Corporate Tax Increases

- *Corporate Tax Rate.* Increases the corporate tax rate from 21% to 26.5% for corporations with taxable income above $5 million.
- *Interest Expense Limitation.* Limits interest deductions for certain domestic corporations that are members of an international financial reporting group and whose average excess interest expense over interest income for a three-year period exceeds $12 million.

Key International Tax Increases

- *Global Minimum Tax.* Revises the global minimum tax regime by increasing the tax rate on so-called "GILTI" income from 10.5% to about 16.5%, calculated on a country-by-country basis, and by making other technical changes to the GILTI rules (which are a mix of favorable changes, such as permitted carryforwards of GILTI losses and foreign tax credits, and unfavorable changes).
- *FDII.* Reduces the FDII deduction (which provides for a reduced tax rate for certain export income) from 37.5% to 21.875%, resulting in a 20.7% effective FDII rate.
- *BEAT*. Gradually increases the BEAT tax rate (generally a corporate minimum tax focused on "base-eroding" payments) from 10% to 12.5% to 15% and makes certain changes to the scope of the BEAT base, including the exclusion from base erosion

payments of amounts subject to foreign tax at an effective rate at least as high as the BEAT tax rate.

Other Business-Related Tax Increases

- *Qualified Small Business Stock.* Repeals the 75% and 100% exclusion rates for gains realized from certain qualified small business stock for taxpayers with income of at least $400,000 (such that the maximum exclusion rate for such taxpayers would be 50%), effective for sales and exchanges on or after September 13, 2021, subject to a binding contract exception.
- *Carryforward of Disallowed Interest Expense.* Limits the carryforward of certain disallowed interest expense to five years (rather than indefinitely as under current law).
- *Worthless Securities.* Modifies the rules related to worthless securities, including eliminating the ability to treat a loss on a worthless partnership interest as an ordinary loss.
- *Corporate Liquidations.* Defers losses with respect to certain taxable corporate liquidations involving members of the same controlled group — limiting, but not eliminating, the potential benefits associated with so-called "Granite Trust" structures — effective for liquidations on or after the date of enactment.
- *Divisive Reorganizations.* Modifies the rules related to the adjusted basis limitation for divisive reorganizations involving certain distributions to creditors (i.e., in connection with tax-free spin-offs), effective for reorganizations on or after the date of enactment.
- *Portfolio Interest Exemption.* Expands the scope of non-U.S. "10% shareholders" who are not eligible for the portfolio interest exemption by adding a value test (rather than just a vote test), effective for obligations issued after the date of enactment.
- *Common Control.* Modifies certain aggregation rules that treat multiple taxpayers as a single taxpayer for purposes of certain tax rules.
- *Executive Compensation.* Accelerates to 2022 the recently expanded limitations on the deductibility of executive compensation in excess of $1 million by publicly traded companies.

Other Individual Tax Increases

- *Excess Business Losses.* Makes permanent the disallowance of excess business losses for non-corporate taxpayers and modifies the carryforward provisions for such losses, effective for taxable years beginning after December 31, 2020.
- *Pass-Through Deduction.* Limits the maximum allowable deduction for pass-through business income ($500,000 for married filing joint, $400,000 for single).
- *IRAs.* Provides new restrictions on IRAs, including prohibiting contributions to so-called "mega" IRAs, requiring substantial minimum distributions from certain retirement accounts with more than $10 million in assets, prohibiting investment of IRA assets in entities in which the owner has a substantial interest, prohibiting IRA investments conditioned on the account holder's status (such as "accredited investor" status), and (effective January 1, 2032) prohibiting so-called "back-door" Roth IRA conversions. Provides that failure to comply with certain of these requirements may result in an IRA completely forfeiting its favorable tax status.
- *Estate and Gift Taxes.* Reverts estate and gift tax exemption amount to $5 million per individual, indexed for inflation (rather than $10 million per individual, indexed for inflation, as under current law), limits certain planning opportunities involving grantor trusts, and modifies certain estate and gift tax valuation rules.

Infrastructure Financing and Green Energy Incentives

- *Infrastructure Financing.* Makes permanent the New Markets Tax Credit, expands the Rehabilitation and Low Income Housing Tax Credits, establishes a new Neighborhood Homes Investment Act Tax Credit, and provides for tax preferred infrastructure financing.
- *Green Energy.* Extends and modifies tax incentives for renewable electricity and renewable fuels, provides green energy and energy efficiency incentives for individuals, creates and extends tax credits for electric vehicles, and reinstates the Superfund excise tax on certain products.

If you have any questions about the matters addressed in this KirklandPEN, please contact the following Kirkland authors or your regular Kirkland contact.

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Related Services

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Suggested Reading

- 02 June 2021 KirklandPEN Biden Administration Releases Budget and Green Book, Providing Details on Corporate and Individual Tax Proposals that Would Have Significant Impact on Private Equity Industry
- 19 January 2021 KirklandPEN IRS Issues Final Regulations for PE Fund Carried Interest Qualification as Long-Term Capital Gain
- 28 August 2020 KirklandPEN SEC Adopts Updated Accredited Investor and Qualified Institutional Buyer Standards