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Senate Deal Proposes Carried Interest Reform and International Tax Changes

By Matthew P. Larvick and Robbie Alipour
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On July 27, 2022, Senate Majority Leader Chuck Schumer and Senator Joe Manchin announced their agreement to move forward with tax provisions thought to have been dropped from consideration last year. Certain of these provisions are modified updates to the Build Back Better Act and the related House Ways and Means Committee proposal from 2021.

The 725-page revival, called the Inflation Reduction Act of 2022 (the "Act"), contains tax proposals that: (i) change the tax treatment of carried interests; (ii) create a new corporate minimum tax; (iii) increase the funding for the Internal Revenue Service (the "IRS) and other governmental tax functions; and (iv) increase investment in clean energy through tax credits. A vote by all 50 Senate Democrats (including the two independents who vote with them) plus Vice President Kamala Harris as the tie-breaking vote, if necessary, would be required for passage, assuming the Senate Parliamentarian certifies that the Act meets the Senate's rules for passage under its "budget reconciliation" procedures. If the budget reconciliation procedure is not available, the Act will likely fail to pass since a 60-vote supermajority of senators would then be required for passage.

Summary of Key Provisions

Set forth below is a brief summary of certain provisions of the Act.

- *Carried Interest*: The Act contains provisions that are intended to close what some have perceived as a "loophole" to the manner in which carried interests are taxed. Key changes to current law include:
  - The minimum holding period to qualify for long-term capital gains treatment for carried interests would be increased from three years to five years. The three-year period would remain applicable to taxpayers with an adjusted gross income below $400,000 and to certain real estate businesses.
  - In a significant change, the minimum holding period would not begin running until the partnership acquires "substantially all" of its assets (or, if later, the date the holder acquires "substantially all" of its carried interest). The Act does not contain a definition of "substantially all" for these purposes. Since private equity funds often make their investments over a period of years, the five-year period may not begin running until late into a fund's life. As a result, many private equity funds may find that most or all of their investment dispositions do not qualify for long-term capital gains treatment with respect to the carried interest.
  - The recharacterization rule would extend to all gross income taxed at long-term capital gains rates, unlike the current rule which applies only to long-term capital gains determined with reference to the holding period rules. Thus, unlike current law, the recharacterization rule would apply to so-called Section 1231 gains (typically generated in asset sales), qualified dividend income, and mark-to-market gains on certain futures and options contracts.

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    - Any transfer of a carried interest, including by gift, would require gain to be recognized. This rule could also apply to routine restructuring transactions where carried interests are contributed or distributed within a fund structure or where general partners seek to aggregate carried interests.
    - The Act would expressly limit the current exception for "corporations" to C corporations. Even though current Treasury Regulations already limit the exception to C corporations, the drafters of the Act apparently felt it necessary to provide a clear statutory foundation for the regulatory rule.
    - The Act would specifically authorize the Treasury Department to promulgate rules targeting so-called carried interest waivers.
- *Corporate Alternative Minimum Tax*: The Act would revive a modified version of the 15 percent minimum tax on book income that would apply to large corporate taxpayers.
    - The Act would impose a 15 percent corporate alternative minimum tax ("AMT") on adjusted financial statement income less certain AMT foreign tax credits. The AMT would apply to any corporate taxpayer (other than an S corporation, a regulated investment company, or a real estate investment trust) with book income exceeding $1 billion on average generally determined over a three-year testing period. Once a corporation meets this test for any taxable year, the AMT would continue to apply to that corporation in subsequent years even if its book income falls below the $1 billion threshold in those years, unless the Treasury Department determines that certain limited circumstances apply that make it no longer appropriate to impose the AMT on the corporation.
    - The AMT also would apply to a US subsidiary of a foreign-parented group. The AMT covers a US subsidiary with book income in excess of $100 million where the group satisfies the $1 billion income test.
    - A corporation may be subject to the AMT even though it does not satisfy the threshold on a stand-alone basis. The income test is applied by taking into account book income of highly related affiliates and controlled businesses (corporate or non-corporate).
    - Book income would be computed based on GAAP books with certain modifications prescribed by the Act. Because different standards are applied to report GAAP income and taxable income, the book income tax may exceed the regular corporate federal income tax (for example due to differences between the GAAP rules and tax rules for stock-based compensation and depreciation).
    - The AMT is distinct from the OECD's Pillar Two project, which aims to impose a 15 percent minimum tax on earnings of large multinational enterprises in each operating jurisdiction. Though the regimes may accomplish some of the same objectives, it is unclear whether the AMT will be considered Pillar Two-compliant. The Act would not increase the current 10.5 percent effective rate of tax on Global Intangible Low-Taxed Income ("GILTI") to the Pillar Two rate or otherwise make changes to conform the GILTI regime closer to certain key aspects of Pillar Two. GILTI will continued to be computed on an aggregate (one controlled foreign corporation) basis instead of a country-by-country basis.
- *IRS Funding*: The Act would appropriate approximately $80 billion to fund the IRS, Treasury Inspector General, Office of Tax Policy, US Tax Court, and Treasury departmental offices. The general purpose of this funding is to address headcount reductions and resource constraints that have adversely affected the IRS.
    - The vast majority of the additional funding will go to the IRS and would be appropriated for (among other things): (1) tax enforcement activities; (2) taxpayer services; (3) operations support; and (4) business systems modernization. The Act allocates mandatory funds to the IRS for enforcement activities such as determining and collecting taxes, supporting litigation, conducting criminal investigations, and digital asset monitoring and compliance activities.
    - With additional funds, the IRS may hire auditors and increase its capacity to perform key enforcement functions. The additional funding is expected to raise revenue and reverse the cuts that were hampering the IRS from administering and enforcing tax laws.

Effective Dates

If the Act is passed in its current form, the carried interest provisions would apply to taxable years beginning after December 31, 2022. The changes to the corporate alternative minimum tax would be effective for taxable years beginning after December 31, 2022.

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If you have questions regarding this article, please contact **Matthew P. Larvick** at +1 (312) 609-7970 or mlarvick@vedderprice.com, **Robbie Alipour** at +1 (312) 609-7782 or ralipour@vedderprice.com or the Vedder Price attorney with whom you regularly work.

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