Proskauer

A Summary of Inflation Reduction Act's Main Tax Proposals

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On July 27, 2022, Senator Joe Manchin (D-W.Va.) and Senate Majority Leader Chuck Schumer (D-N.Y.) released the Inflation Reduction Act of 2022 (the "IRA"). The IRA contains only two non-climate and non-energy tax proposals – a 15% corporate alternative minimum tax and a provision significantly narrowing the applicability of preferential long-term capital gain rates to carried interests. Each of these proposals had previously been proposed in substantially similar form.

1. 15% corporate alternative minimum tax

The IRA would impose a 15% corporate minimum tax based on the financial statement income of corporations or their predecessors with a three-year taxable year average annual adjusted financial statement income in excess of $1 billion. The corporate minimum tax would be effective for tax years beginning after December 31, 2022.

The proposal is substantially the same as the proposals introduced in the House of Representatives in November 2021 and by the Senate Finance Committee in December 2021 (in the "Build Back Better Act"). In May 2021, the Biden Administration had also proposed a 15% corporate alternative minimum tax for corporations with worldwide book income in excess of $2 billion, rather than $1 billion.

The 15% corporate alternative minimum tax would be equal to the difference between a corporation's "adjusted financial statement income" for the taxable year and the corporation's "alternative minimum tax foreign tax credit" for the taxable year. A corporation's tax liability would be the greater of its regular tax liability and the 15% alternative minimum tax.

A corporation's annual adjusted financial statement income would be based on its book income, with certain adjustments, such as to account for a corporation's activities undertaken indirectly through a consolidated group, a partnership, or a disregarded entity. The adjusted financial statement income would also be adjusted for certain taxes, such as federal income and excess profits taxes.

The average annual adjusted financial statement income of a corporation would include any other entities that are treated as a single employer with the corporation under section 52 to determine whether the corporation satisfies the $1 billion threshold.[1] This may cause corporations with less than $1 billion of adjusted financial statement income – including possibly portfolio companies of an investment fund – to be subject to the proposal. For corporations in existence for less than three years, the three-year income test would be applied over the period during which the corporation was in existence. The adjusted financial statement income of a corporation with a taxable year shorter than 12 months would be applied on an annualized basis.

Corporations would generally be eligible to claim net operating losses and tax credits against the alternative minimum tax. Adjusted financial statement income would be reduced by the lesser of (i) the aggregate amount of financial statement net operating loss carryovers to the taxable year and (ii) 80% of adjusted financial statement income (reflecting the tax rule that net operating losses are permitted to offset only 80% of taxable income). The proposed clean energy credits and other business credits would be limited to 75% of a corporation’s alternative minimum tax. In addition, a corporation would be eligible to claim a credit for corporate alternative minimum tax paid in prior years against the regular corporate tax if the regular tax liability exceeds 15% of the corporation’s adjusted financial statement income.

The corporate alternative minimum tax would apply to a foreign-parented corporation if its three-year taxable year average annual adjusted financial statement income exceeds $100 million and the international financial reporting group’s exceeds $1 billion.

The corporate alternative minimum tax would not apply to S corporations, regulated investment companies, or real estate investment trusts. In addition, the tax would not apply to corporations that have had a change in ownership or has a specified number of consecutive taxable years that will be determined by the Secretary.

The corporate alternative minimum tax does not conform to the “qualified domestic minimum top-up tax” proposed by the OECD/G20. As a result, if the OECD/G20 rules are adopted in their current form, the foreign subsidiaries of U.S. multinationals located or doing business in OECD countries could be subject to additional taxes by those jurisdictions.

2. Taxation of carried interest

Under current law, a “carried” or “profits” interest in a partnership received in exchange for services is generally not taxable when received and the recipient is taxed on their share of partnership income based on the character of the income at the partnership level. Section 1061 requires certain carried interest holders to satisfy a three-year holding period – rather than the normal one-year holding period – to be eligible for the long-term capital gain rate.

The IRA would amend section 1061 to extend the holding period for long-term capital gain treatment on all income (including dividends) from three years to five years (or longer) (the “holding period exception”). The amendments would apply to taxable years beginning after December 31, 2022.

The House Ways & Means Committee’s draft of the Build Back Better Act from September 2021 contained substantially the same carried interest proposal.

Under the IRA, the holding period exception for long-term capital gain treatment would apply to amounts realized after the date that is five years after the latest of (i) the date on which the taxpayer acquired substantially all of the carried interest with respect to which the amount is realized; (ii) the date on which the partnership in which the carried interest is held acquired substantially all of its assets; or (iii) if the partnership owns, directly or indirectly, interests in one or more other partnerships, the dates determined by applying rules similar to the rules in (i) and (ii) in the case of each other partnership.

The IRA does not define the term “substantially all” and it is unclear how these rules would apply. Many private investment funds, for example, acquire their investments over a number of years (some of which are held in partnerships which themselves may make further investments). Consequently, the five year holding period could easily be much longer in practice.

Taxpayers (other than trusts and estates) with adjusted gross income of less than $400,000 per taxable year or with income from a real property trade or business would be subject to the current holding period of three years (except determined under the rules of the IRA).

If a profits interest holder transfers its interest, the IRA would require gain recognition (even if nonrecognition would otherwise be available).

The IRA would apply only to income or gain attributable to an asset held for portfolio investment on behalf of third-party investors. The Secretary would have broad authority to issue guidance on these provisions, including to apply them to other arrangements and assets.

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[1] All references to section are to the Internal Revenue Code.

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