Senate Passes 15% Corporate Minimum Tax, 1% Tax on Stock Buybacks

August 10, 2022

On August 7, 2022, the Senate passed the Inflation Reduction Act of 2022 (the "IRA"). Although the IRA has not yet been passed by the House, it is expected to do so. The IRA introduces a broad array of provisions designed to curb climate change and lower healthcare costs. The IRA largely retains the framework for a 15% corporate minimum tax on the book income of large corporations included in prior legislation proposals and introduces a 1% excise tax on corporate stock buybacks.

Notably, the IRA does not include changes to the taxation of carried interest that were initially proposed. However, changing the taxation of carried interest remains a priority for the Democratic Party, and the treatment of carried interest under the Internal Revenue Code may still be amended in future legislation.

The tax law changes are proposed to be effective for tax years beginning after December 31, 2022.

CORPORATE ALTERNATIVE MINIMUM TAX

Corporations Subject to Tax

- The IRA imposes a minimum tax on an "applicable corporation" equal to the excess of (i) 15% of its applicable financial statement income (minus a foreign tax credit) over (ii) its regular corporate tax for the year.

- An applicable corporation is a corporation (other than an S corporation, regulated investment company or real estate investment trust) with average applicable financial statement income in excess of $1 billion for any three-year period ending with 2022 or later. Special rules apply to new corporations, short tax years and successor corporations.

Comment: The $1 billion threshold is not inflation indexed, and the IRA leaves to future IRS guidance rules that would permit corporations that experience a change in ownership or a decline in earnings to escape the minimum tax.

- The rules generally apply to a U.S. corporate subsidiary of a foreign-parent group if the group has over $1 billion in average applicable financial statement income and the U.S. subsidiary has at least $100 million in average applicable financial statement income over a three-year period.

- Aggregation rules apply to determine the $1 billion threshold across related entities.

Comment: Proposed versions of the minimum tax included additional aggregation language that would have taken into account the income of separate corporations owned by a single investment fund or other partnership. This language was dropped from the final version of the IRA.

Calculation of the Tax

- The minimum tax begins with the net income or loss shown on the "applicable financial statement." Adjustments apportion financial statement income from consolidated financial statements among members of a consolidated tax group, and require a corporation to take into account its share of book income of partnerships, disregarded entities and controlled foreign corporations ("CFCs") the taxable income of which "flow up" into its federal tax liability.

Comment: The rules adjust applicable financial statement income to include a U.S. corporation's share of the book income of its CFCs. Book losses of a CFC are not taken into account and are instead carried forward to reduce inclusions from the CFC's book income in subsequent years. The effect of these provisions may undermine the 10.5% rate under the GILTI regime and the Section 245A participation exemption.

Comment: Although the methodology used to determine the minimum tax shares some of the characteristics of the 15% global minimum tax under the OECD's Pillar Two rules, there are material differences in the way the two regimes operate. These differences could lead to attempts by other countries to impose their own Pillar Two top-up taxes against U.S. groups.

Comment: The IRA also does not include the changes to the GILTI regime, including calculating the corporate minimum tax on a country-by-country basis, and other U.S. international tax provisions that were proposed last fall in the Build Back

Better Act and that would have brought these rules more in line with the Pillar Two framework.

- The applicable financial statement used for the calculation prioritizes a taxpayer's GAAP financials used in a 10-K filing, or if not applicable, audited GAAP financials used for reporting or any other substantial non-tax purpose, or filed with a federal agency. If the taxpayer does not use GAAP financial statements then IFRS statements are prioritized. If the taxpayer uses neither GAAP nor IFRS financial reporting, financial statements filed with any other regulatory or governmental body specified by the Treasury would be used.

  Comment: While insurance groups often prepare consolidated GAAP or IFRS financials, U.S. insurance companies prepare standalone financials using statutory accounting, and taxable income generally is based on statutory income. Thus, differences between GAAP and statutory income could significantly impact the minimum tax calculation for these groups. For example, certain arrangements such as "funds withheld" reinsurance can create volatility for GAAP accounting relative to statutory income.

- The new rules provide a minimum tax credit carryforward. As a result, if an applicable corporation generates high book income relative to taxable income (causing a deferred tax liability), the corporation pays the minimum tax currently and is permitted a credit in future years if reversal of the deferred tax liability causes the effective tax rate to fall below the minimum rate.

  Comment: Applicable corporations should examine potential sources of temporary differences between book income and taxable income, which could create an unexpected cash outlay under the minimum tax and potential balance sheet strain if the corporation is required to hold a valuation allowance (or similar restriction) on any resulting deferred tax asset for the future minimum tax credit. Permanent differences between financial statement income and taxable income (such as employee stock options and the lower corporate tax rates on dividends) may result in permanent loss of tax benefits.

- If a corporation has a book loss, it is permitted to carry over the loss to reduce the financial statement minimum tax base for future years. Consistent with the usage of net operating losses against regular tax, book losses can only be used to offset 80% of book income in subsequent years. Carrybacks are not permitted.

  Comment: Only balance sheet losses from 2020 and later years are taken into account, limiting protection for taxpayers with significant historic losses and tax carryovers.

- The calculation of the minimum tax includes an adjustment to exclude the tax impact of depreciation of tangible assets, preserving the tax preference for capital investment. Intangible assets, including goodwill resulting from an acquisition, are not similarly protected with the exception of wireless spectrum acquired by wireless telecommunication carriers prior to the enactment of the IRA.

  Comment: In M&A acquisitions structured as asset purchases, partnership acquisitions or stock acquisitions that are treated as asset purchases under a Section 338 or 336(e) election, the parties generally agree to an allocation of the purchase price across acquired asset classes and goodwill. Where previously the exact allocation might only affect the time frame of depreciation for a buyer, the different treatment of depreciation of tangible assets versus goodwill and intangibles under the minimum tax could significantly affect the importance of the agreed asset values.

EXCISE TAX ON STOCK REPURCHASES

- The IRA imposes a non-deductible 1% excise tax on the fair market value of stock repurchased by publicly traded corporations or their specified affiliates. The rules cover repurchases by both U.S. public corporations and U.S. affiliates of foreign public corporations. A netting rule reduces the excise tax base by the fair market value of stock that is issued during the same taxable year, including stock issued or provided to employees.

  Comment: The excise tax applies to any repurchase transaction by a covered publicly traded corporation, even if the particular shares repurchased are not publicly traded. As a result, along with ordinary course stock redemptions, a number of corporate transactions could become subject to this excise tax.

- The excise tax does not apply to any distribution or repurchase treated as a dividend for federal income tax purposes. It also does not apply to repurchases (1) that are part of a tax-free reorganization, (2) if the repurchased stock or an equivalent value of stock is contributed to an employee retirement or stock ownership plan, (3) of less than $1 million annually, (4) under regulations, by a dealer in securities in the ordinary course of business or (5) by regulated investment companies or real estate investment trusts.

  Comment: Corporations that are subject to the excise tax could pay dividends as opposed to engaging in stock repurchases in order to avoid the excise tax. However, the impact of stock repurchases on financial metrics like earnings per share and stock price may mean that affected corporations continue to repurchase shares.

- The IRA provides for the IRS to prescribe anti-abuse rules, as well as rules designed to address special classes of stock and preferred stock.

  Comment: The regulations will be of particular interest in the market for private investments in public equity ("PIPEs"). PIPEs are commonly structured as preferred equity that will be repaid via a stock repurchase, and the rules apply without grandfathering existing investments.

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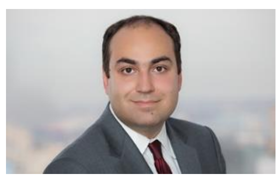

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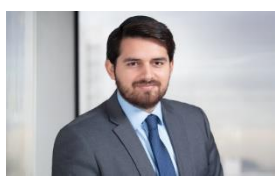

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