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Inflation Reduction Act of 2022 Would Modify the Tax Treatment of Carried Interests, Include a Corporate Minimum Tax, and Expand Clean Energy Tax Incentives

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On July 27, 2022, Senator Joe Manchin (D-West Virginia) and Senator Majority Leader Chuck Schumer (D-New York) announced an agreement on a reconciliation package entitled the Inflation Reduction Act of 2022 (the "Act") to address climate change, taxes, health care, and inflation. The Act would, among other things, (1) establish a 15 percent corporate minimum tax, (2) expand the carried interest rules under section 1061 that apply ordinary income tax rates to investment gains earned by asset managers,[1] (3) establish multi-year IRS funding with a dramatic increase in funding for tax enforcement, and (4) extend and expand available clean energy tax incentives.

Legislative Outlook

As a reconciliation bill, Democrats can avoid a Republican filibuster in the Senate and pass the Act with a simple majority of only 51 votes, rather than the usual 60 votes. With the Senate split 50-50, Democrats will need their entire caucus to remain unified, with Vice President Kamala Harris casting the deciding vote. No Republican is expected to vote for the Act.

The Act could pass both chambers of Congress as soon as August. The next step is for the nonpartisan Senate Parliamentarian to review the bill to ensure that everything within it relates directly to the budget, a robust floor debate featuring a "vote-a-rama," with votes on amendments that could extend far beyond the energy, health care, and tax issues that make up the core of the Act, and then the Senate and House will vote on the bill.

Passage of the Act in an equally divided Senate could be blocked if Democrats lose even a single member of their Caucus. Because Senator Kyrsten Sinema (D-Arizona) has blocked progress on similar issues in the past, her vote will be critical, and she has not yet announced her position. The complicating factor in the House of Representatives—where Democrats hold a narrow majority—will be whether the Progressive Caucus signs off on the Act. But Democrats understand the political reality that if either or both chambers flip in November to Republican control, the Act could be the last opportunity during the Biden Administration for Democrats to pass major legislation. So, though passage of the Act is far more likely than ever before, its passage is not guaranteed.

Corporate Minimum Tax

The Act would subject corporations with book income in excess of $1 billion to a 15 percent alternative minimum tax ("AMT"). The AMT is substantially similar to the

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revised version of the Build Back Better Act advanced by the Senate Finance Committee in late 2021. Critics of the AMT have noted that imposing a tax on book income instead of taxable income undermines certain tax benefits, such as bonus depreciation, timing benefits, and other differences between financial and tax accounting standards, and could create other unintended mismatches.

The AMT would be imposed on any corporation with average applicable financial statement income ("AFSI") in excess of $1 billion over any consecutive three-year period preceding the tax year at issue (the "Income Test"). For a corporation (including predecessors) that has been in existence fewer than three years, the Income Test would be applied on an annualized basis. AFSI would be determined by reference to the income (or loss) set forth on the corporation's audited GAAP financial statements, subject to certain adjustments, including for income from controlled foreign corporations, partnerships, and disregarded entities, corporations filing consolidated returns, and certain taxes paid. If a corporation is treated as a single employer with any other companies (corporate or non-corporate) pursuant to section 52, the AFSI of those other companies is taken into account for purposes of the Income Test. This may cause a corporation that would not otherwise satisfy the Income Test to be subject to the AMT (by reason of its relationship with other entities through disparate ownership structures, such as portfolio companies of private equity funds).

A corporation subject to the AMT generally would be eligible to claim net operating losses and tax credits against its AMT liability, with the new and extended clean energy credits discussed below (and other business credits) generally limited to 75 percent of a corporation's AMT.

The AMT would not apply to S corporations, regulated investment companies, and real estate investment trusts. Other entities that would be excluded from the AMT include (1) corporations that experience an ownership change and (2) corporations that have not met the Income Test in a to-be-specified number of consecutive taxable years. The contours of these exclusions, however, are to be determined by Treasury regulations, including what constitutes an "ownership change." A U.S. corporate subsidiary of a foreign-parented group would be subject to the AMT if that group meets the Income Test and that subsidiary has AFSI in excess of $100 million.

By incorporating financial accounting further into the tax law, the proposal would add substantial complexity to the Code. The Act leaves critical details to be provided for by guidance from the Treasury Department and IRS. That guidance will have significant tax consequences for taxpayers and will be subject to review in an era of heightened judicial scrutiny of agency rulemaking. In addition, because the creation and modification of financial statement rules is not subject to Congressional approval or the notice-and-comment requirements of the Administrative Procedures Act, the proposal would result in the calculation of tax liability being determined by decisions made by a relatively small group of unelected, unregulated decision-makers.

These proposals, if enacted, would apply to tax years beginning after December 31, 2022.

Expansion of the Carried Interest Rules Under Section 1061

The Act proposes to modify the current rules relating to the taxation of certain carried interests[2] in the same manner as the House-passed version of the Build Back Better Act (H.R. 5376), most notably:

- denying long-term capital gain rates to holders of carried interests, unless the applicable holder meets the "holding period exception," which generally would require a five year period of economic exposure to the relevant assets (three years in the case of real estate businesses or a taxpayer with adjusted gross income of less than $400,000);

- changing the manner in which the relevant holding period is determined;
- eliminating the exception from the carried interest rules for gains taxed at long-term gains rates under section 1231 and section 1256; and
- requiring full gain recognition on any transfer of an applicable carried interest, even if nonrecognition rules would otherwise apply.

The holding period exception has drawn attention for its departure from longstanding tax principles regarding holding period determinations. Specifically, the holding period exception would look to the following dates – (i) the date on which the holder of a carried interest acquired "substantially all" of its carried interest, (ii) the date on which the partnership that issued the carried interest acquired "substantially all" of its assets, and (iii) in a tiered partnership, dates determined by applying (i) and (ii) to each partnership – and then would measure the applicable five-year period from the latest of those dates.[3] The Act does not specify how the "substantially all" requirement is intended to be measured, and, because many investment funds (e.g., hedge funds and private equity funds) acquire assets at different times and have overlapping holding periods, it would be extraordinarily difficult for taxpayers to determine when these requirements have been satisfied.

The purpose of the proposed holding period exception is to ensure that ordinary income tax rates apply to any gain realized in respect of a carried interest if the gain is attributable to an asset to which the taxpayer has not been exposed economically for at least five years. As currently drafted, the proposed holding period exception could be both under- and over-inclusive, permitting gain attributable to certain assets that have been held for fewer than five years to benefit from long-term capital gains rates and subjecting long-held assets to ordinary income tax rates. Further, the proposed gain recognition rule would create a substantial trap for the unwary, particularly for indirect transfers of carried interests, including for estate planning purposes and ordinary course restructurings.

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Additional IRS Funding – Enforcement

Consistent with the House-passed version of the Build Back Better Act (H.R. 5376), the Act provides nearly $80 billion of additional IRS funding for taxpayer services, enforcement, operations support, and modernization—with more than $45 billion earmarked for IRS tax enforcement over the next nine years. Not only is the multi-year nature of the funding unique for the IRS, but the average-annual $5 billion increase to IRS enforcement also would double the IRS's enforcement budget over prior years. The art or science of estimating the revenue effects of tax legislation has led to significant disagreement recently, but per Congressional Budget Office analysis, the Senate estimates that IRS tax enforcement will generate $124 billion for the Federal fisc. Furthermore, effective tax enforcement will be critical to the realization of the revenue estimates attributable to the Act's AMT and modified taxation of carried interest provisions.

Clean Energy Tax Incentives

The Act includes numerous expansions and extensions of tax incentives for investments in clean energy by businesses and individuals. If enacted, the Act would represent a significant commitment to the development of clean energy in the United States.

Certain portions of the Act were introduced in 2021 during discussions of the Green Act, the Clean Energy for America Act, and, ultimately, the Build Back Better Act, but the Act includes additions, subtractions, and refinements that depart from the Build Back Better Act and that could have significant positive impacts on the future of clean energy project development and finance.

Notably, the Act would permit the one-time sale of credits between certain taxpayers.

Under current law, clean energy tax credits generally are not transferable, subject to a narrow exception for the investment tax credit (which is transferrable to a lessee if certain requirements are met), but the Act would expand transferability beyond passthrough leases to other structures and credit classes (including production tax credits, carbon capture and sequestration credits, and several newly proposed credits). Federal tax credit transferability could have a significant impact on the tax equity market, expanding the base of potential investors and potentially simplifying structures, although the continued non-transferability of other tax attributes (such as depreciation and amortization) means that legacy tax equity financing structures likely will continue to be relevant. As drafted, however, the Act's transferability regime raises numerous questions that likely would need to be addressed before enactment or through regulatory guidance.

In addition, the Act includes a number of significant macro-level changes to the clean energy credit system, some of which were first seen in the lead up to the Build Back Better Act, including:

- Wage and workforce eligibility requirements (applicable across clean energy credit classes) to qualify for credits at historic rates;
- Sweeteners for projects that satisfy domestic content or low-income community requirements;
- A limited direct-pay mechanism (conditioned for certain credits on phased-in domestic content requirements for projects one megawatt or greater);
- A three-year credit carryback; and
- Future transition to a technology-neutral credit regime.

In addition to these structural shifts, the Act includes the expansion of existing credits, the re-proposal of credits introduced in the discussions around the Build Back Better Act, and new credits, including:

- A new standalone investment tax credit and homeowner credit for battery storage facilities;
- Extension of the investment tax credit (and re-introduction of the production tax credit) and homeowner credit for solar projects;
- Extension of the production tax credit for on-shore and off-shore wind projects;
- A richer and broader credit regime for carbon capture and sequestration projects; and
- Extensions of legacy clean energy credits and the introduction of numerous new credits, including for clean hydrogen projects, zero-emission nuclear projects, and advanced manufacturing projects.

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[1] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code").

[2] These rules apply generally apply to any partnership interest transferred or held in connection with the performance of services in an "applicable trade or business," other than certain capital interests, interests purchased by unrelated third parties and interests held by corporations. The Act would clarify that the exception for partnership interests held by corporations would not be available for S corporations.

[3] The Act states that section 1061 "shall be applied without regard to section 83 and any election in effect under section 83(b)." The precise meaning of this portion of the proposed legislation is not entirely clear.

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