On October 28, 2021, US President Joe Biden unveiled his slimmed down $1.75 trillion infrastructure spending plan and congressional leadership released H.R. 5376 (the Build Back Better Act (BBBA)), which contains revised proposals for tax law changes to pay for the various pieces of President Biden’s new agenda. The BBBA follows a set of proposals released by the House Ways and Means Committee on September 14, 2021 (W&M Proposal), and while it incorporates some of the W&M Proposal’s tax law changes, there are notable differences (including wholesale absences of certain changes from the W&M Proposal). Following is a brief summary
of certain BBBA concepts which, if enacted in its current form, would potentially increase the overall tax burden on certain parties involved in private equity mergers and acquisitions (M&A) transactions and may have year-end planning implications as a result.

IN DEPTH

THE GOOD: NO BASE TAX RATE INCREASES, NO CARRIED INTEREST REFORM

• **No Change in Rates:** The W&M Proposal includes increases to the top individual and corporate rates, including a five percentage point increase in the rate applicable to long-term capital gains and qualified dividends. The BBBA drops any base tax rate increases on individuals and corporations, including any change to long-term capital gains rates. However, as discussed further below, this does not necessarily mean that parties engaged in M&A transactions will be free from materially higher tax bills resulting from such transactions closing next year.

• **No Carried Interest Changes:** The BBBA scraps the W&M Proposal’s increase in the holding period (to five years) applicable for carried interests to qualify for long-term capital gains rates. Thus, the existing three-year holding period (and related statutory structure of Section 1061 as originally enacted under the Tax Cuts and Jobs Act) would remain the same. There are no other explicit proposals that address carried interest arrangements, so fund managers can rest easier now that their incentive structures are, at least for the moment, no longer the subject of an attack.

• **No Income Limitation for Section 199A Deduction:** While the W&M Proposal sought to limit the application of the 20% deduction for “qualified business income” of non-corporate taxpayers under Section 199A of the Code, the BBBA drops this proposal. As a result, the “high income” caps previously proposed that could impact high-income partners of a partnership or shareholders of an S corporation are no longer on the table.

THE BAD: 3.8% MEDICARE TAX STILL APPLIES MORE BROADLY AND OTHER UNFAVORABLE CHANGES FOR SMALL BUSINESSES

• **Net Investment Income Tax Expansion:** The BBBA largely adopts without change the W&M Proposal’s expansion of the 3.8% net investment income tax starting in 2022. The proposal eliminates a perceived “loophole” by subjecting all trade or business income of individuals with earnings over $400,000 (individual) or $500,000 (married couples) to the 3.8% net investment income tax—except to the extent already subject to self-employment tax. This is an unfavorable change for owners of limited partnerships or S corporations who “materially participate” in the business and were not previously subject to the 3.8% tax or self-employment tax (other than self-employment tax on S corporation owners’ “reasonable compensation” as an employee) and, as noted
below, in particular upon a sale transaction.

- **Reduction in QSBS Benefits:** The BBBA would also retain the W&M Proposal’s changes to materially limit the benefits for owners of “qualified small business stock” (QSBS). The BBBA would reduce the 100% gain exclusion (in place since 2010) for any sales or exchanges of QSBS occurring after September 13, 2021, to 50% (unless a binding contract was entered into as of that date and is not subsequently modified in any material respect). Individual taxpayers with adjusted gross incomes of less than $400,000 would, however, continue to be entitled to the 100% exclusion. As with the W&M Proposal, there are no grandfathering rules for owners of QSBS as of the proposed effective date. Thus, all high-income current and future investors in QSBS will only be entitled to a reduced 50% gain exclusion on future sales and exchanges, significantly impacting the anticipated tax benefits of investing in such businesses.

- **No Free S Corp Exit:** The BBBA drops a provision from the W&M Proposal that would have given qualifying S corporations a limited window to reorganize into a partnership tax free. The original proposal was narrowly drafted but as with many aspects of the BBBA, there is no free lunch here.

**THE UGLY: 5 – 8% SURCHARGE ON HIGH INCOME TAXPAYERS AND 15% MINIMUM TAX ON LARGE CORPORATIONS**

- **Surcharge on High-Income Taxpayers:** The BBBA would impose new “surcharges” on individuals, estates and trusts with modified adjusted gross income (MAGI) in excess of certain thresholds. These additional taxes would apply for taxable years beginning after December 31, 2021. The surcharge is either 5% or 8% (e., the initial 5% plus an additional 3%) on the taxpayer’s income in excess of the applicable thresholds set forth in the table below. This surcharge would apply to many family or founder sellers in private equity M&A transactions.

<table>
<thead>
<tr>
<th>Surcharge</th>
<th>5%</th>
<th>8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals[1]</td>
<td>$10,000,000</td>
<td>$25,000,000</td>
</tr>
<tr>
<td>Estates or Trusts</td>
<td>$200,000</td>
<td>$500,000</td>
</tr>
</tbody>
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- **Corporate Profits Minimum Tax:** The BBBA would introduce a new Corporate Profits Minimum Tax, which would impose a 15% minimum tax on the book profits of corporations (other than S corporations, regulated investment companies and real estate investment trusts) that report an average of more than $1 billion of adjusted financial statement income over a three-year period. For this purpose, a taxpayer’s financial statement would include a financial statement on a Form 10-K filed with the US Securities and Exchange Commission.
(SEC) and, in the absence of such a financial statement, a financial statement used for a substantial non-tax purposes. The $1 billion threshold is determined after aggregating certain corporations under common ownership or control, such that the minimum tax may apply to corporations other than large multinationals (such as portfolio companies of private equity funds). The Corporate Profits Minimum Tax would apply to taxable years beginning after December 31, 2022.

YEAR-END PLANNING IMPLICATIONS FOR PRIVATE EQUITY M&A TRANSACTIONS

Several changes included in the W&M Proposal that would have adversely affected parties in common private equity M&A transactions are noticeably absent from the BBBA. Nevertheless, if the BBBA were enacted as proposed, such taxpayers would not escape unscathed. Of particular importance for sellers, the surcharge on income in excess of the applicable thresholds coupled with the expansion of the 3.8% net investment income tax to apply to gain from the sale of limited partnerships or S corporations could increase the tax liability on a portion of the gain recognized for transactions that close during 2022 or later by as much as 11.8 percentage points compared with those that close before year-end. However, for transactions where a 2021 closing is not feasible, parties might consider engaging in certain pre-closing restructuring transactions designed to accelerate gain recognition to the 2021 tax year. Sellers who would otherwise have income below the surcharge thresholds but for taxable income arising from a sale transaction may also consider structuring transactions as installment sales in order to spread the gain from the sale across two or more years in order avoid the surcharge tax.

[1] For a married individual filing a separate return, the 5% surcharge applies to the individual’s MAGI in excess of $5,000,000 and the 8% surcharge applies to the individual’s MAGI in excess of $12,500,000.

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National Law Review, Volume XI, Number 305

Source URL: https://www.natlawreview.com/article/build-back-better-act-tax-reform-implications-private-equity-ma