CHIEF INVESTMENT OFFICE

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Inflation Reduction Act of 2022: From December Shocker to July Surprise!

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In a surprise to many, including most members of Congress, the Democrats' shrinking reconciliation bill which was virtually kicked to the curb as recently as mid-July, came back to life in a stunning July surprise.

As recently as July 15, West Virginia Democrat Joe Manchin put the "kibosh" on a slimmed down version of a reconciliation bill (leaving only prescription drug costs and ACA subsidies on the table). That "kibosh" then opened the door for the Senate's passage of the CHIPS Act (Creating Helpful Incentives to Produce Semiconductors (CHIPS) for America Act HR 4346). Without the reconciliation bill being kicked to the curb, McConnell vowed not to advance the CHIPS bill. With that understanding, the CHIPS bill passed the Senate on July 27, with Republican support.[1]

Only a few hours later, Manchin and fellow Democrat Chuck Schumer announced their agreement on a narrow (but not skinny) reconciliation bill: the Inflation Reduction Act of 2022 (IRA). It appears that the Democrats only pretended a reconciliation bill was dead in order to get Republican support for the CHIPS bill. It is hard to imagine that Manchin and Schumer could have reached an agreement and then almost immediately release a 725 page bill without a prior agreement. Check mate! Whatever one wants to call it, it appears that Minority Leader Mitch McConnell and Senate Republicans were recently outmaneuvered.

We were always of the view that some form of reconciliation bill would be agreed upon, since we are mindful that Congress has never passed a budget resolution authorizing reconciliation without following through with a reconciliation bill.

What's in a name?

Build Back Better (BBB) is dead, in name only. Long live BBB. The current reconciliation bill takes on a name more appropriate for the current environment: the Inflation Reduction Act of 2022. Some of the key provisions are pulled from the original BBB bill, almost verbatim, and inserted in the proposed IRA.

Just because it is called the Inflation Reduction Act, doesn't mean it's so—at least in the near term. The Administration believes that the IRA would reduce inflation through tax increases, deficit reduction and drug pricing controls.

[1] The House passed the CHIPS bill on July 28 (243-187), with 24 Republicans joining in passing the bill despite leadership urging them to vote no. A narrower margin than originally expected.

History tells us that may not be the case. Tax increases enacted in 1968 and 1993 with the expectation of curtailing inflation did not have the desired effect. Moreover, the tax increases do not even take effect until 2023. Deficit reduction could help reduce inflation, but meaningful deficit reduction is back-end loaded and begins in earnest in 2027. Lastly, drug pricing will bring down some costs and possibly inflation, but not in the near term. Price controls do not kick in until 2026 and will not have any short-term consequences.

According to the Penn Wharton Business Model estimates, the IRA would very slightly increase inflation until 2024 and decrease inflation thereafter. However, they note that their estimates are statistically indistinguishable from zero, thereby indicating a low confidence that the IRA will have any impact on inflation.

How does the IRA contrast with earlier BBB bills?

BBB was a sweeping human infrastructure bill, with a stated price tag of about $3.5T (likely close to $5T with extensions).

Tax provisions alone in the earlier House-passed BBB bill would have raised about $2 trillion in taxes, and included surtaxes for individuals and trusts (and expanded the application of the 3.8% net investment surtax to income derived from active businesses). All of that is out. The current IRA raises $470 billion in taxes and an additional cost savings of $288 billion. Additionally, on the spending side, the current IRA also adds $57 billion in energy-related tax credits that were not in BBB.

Timing and Effective Date

With the Senate having passed the IRA on August 7, and the House having passed it on August 12, the bill advances to the White House for President Biden's signature.

Whether the bill is signed immediately or within the week, Democrats can immediately claim victory on a long-awaited centerpiece of the Biden agenda. Notwithstanding the timing around the President's signature, almost all of the provisions of the IRA do not commence until 2023, and many well after that time frame.

Overview of Bill

Tax provisions of the bill, as modified by input from Senator Kyrsten Sinema, would generate revenue of about $470 billion. That, along with cost savings ($288B), would be used to pay for (1) deficit reduction (approximately $275 billion), (2) ACA subsidies, (3) clean energy incentives and (4) climate investments (including $5 billion for drought resiliency).

TOPLINE ESTIMATES: TOTAL REVENUE RAISED $762 BILLION

Revenue Provisions	**$762 billion**
15% Corporate Minimum Tax	$222 billion*
Prescription Drug Pricing Reform	$288 billion** cost savings
Business Loss Deduction Limitation	$54 billion*
IRS Tax Enforcement (net)	$124 billion**
Excise Tax on Stock Buy-Backs	$74 billion
Revenue Provisions	**$762 billion**
Costs (Investments)	$500 billion
Energy Security/ Climate Change / Other	$402 billion**
Affordable Care Act 3-Year Extension	$64 billion**
Other Spending Provisions	$34 billion
Total Deficit Reduction	$275 billion*

* Joint Committee on Taxation estimate / ** Congressional Budget Office estimate for the 10 year budget window.

The following is an overview of the bill's revenue raising provisions:

Corporate AMT (Minimum Tax)

Certain large corporations would be subject to a 15% tax on adjusted financial statement income (so-called book income) if such tax is greater than the amount determined under general tax rules (21% of taxable income). Certain credits would be allowed to offset the tax, such as general business and foreign tax credits. Tax income and book income could significantly differ because of the variations in required tax and financial reporting rules. For instance, businesses are generally permitted to fully expense equipment and other capital improvements for tax purposes but must expense those costs over a prolonged period for financial income reporting. In an 11th hour agreement reached with Sinema, the impact of expensing was watered down, so that an even narrower set of mega corporations would be subject to this tax and about $40 billion less in revenue would be raised by this provision.

Thus, companies making significant capital investments would no longer be in the cross-hairs of this new provision. In total, an estimated 100+ mega corporations would be subject to the new 15% minimum tax, which would apply only to C Corps, with average (adjusted) financial statement income of over $1 billion for each of the three prior years .

This minimum book tax is not the same as the 15% global minimum tax that Treasury Secretary Yellen has been trying to implement with more than 130 countries—the global minimum tax would have required U.S. companies to pay a minimum tax of 15% in each country in which they report income. The global minimum tax has been jettisoned from the reconciliation bill.

The proposed minimum tax, as watered down by Senator Sinema's modifications, would still apply to taxable years beginning after December 31, 2022, but is now projected to raise $273 billion ($40 billion less than the Manchin-Schumer deal).

Excise Tax on Stock Buy-Backs

In an agreement reached with Senator Sinema in exchange for her agreement to move the reconciliation process forward, the IRA now includes a revenue raising provision imposing a 1% excise tax on stock buy-backs (repurchases) by publicly traded U.S. companies (commencing in 2023, even if the buy-back was authorized earlier). The provision mirrors the one proposed in the November BBB bill.

A number of exclusions would apply. For instance, no excise tax would be imposed on the buy-back to the extent the repurchased stock or its value is contributed to an employee pension plan, employee stock ownership plan, or similar plan or the repurchase is taxed as a dividend.

The proposed excise tax would apply to repurchases (buy-backs) of stock after December 31, 2022, and is expected to raise $73 billion. It is anticipated that some companies would accelerate repurchases into 2022 to avoid the excise tax.[2]

Loss Deduction Limitation

An undetermined amount of revenue is raised by extending, for two years, a limit on business losses that can offset an individual's non-business income. Current-year business losses cannot offset more than $270,000 of income from other sources in 2022 ($540,000 for a married couple). These amounts are adjusted annually for inflation. This is a temporary tax provision that was scheduled to expire at the end of 2025. This limitation would now expire at the end of 2027.

IRS Enforcement

The IRS would be allocated an additional $80 billion targeted at a variety of modernization, compliance and enforcement measures. According to the Congressional Budget Office, that spending is expected to result in $204 billion of additional tax collections over the 10-year budget window (a projected net revenue increase of $124 billion). Enforcement measures would be targeted to collection of taxes, legal and litigation support and specifically to digital asset monitoring and compliance activities. Funds are also specifically designated to study and explore an IRS free "Direct E-File" system.

A specific provision of the proposed bill states that the new funding is not intended to increase taxes on any taxpayer with taxable income below $400,000, but there is no legal prohibition in carrying out the IRS' general tax collection responsibilities for all taxpayers, regardless of income.

[2] As originally proposed, the IRA would have further tightened the so-called carried interest rules for certain partnership interests (e.g., hedge funds and private equity carried interests). The proposal would have treated certain partnership income as short-term capital gain, taxable at ordinary income tax rates rather than preferential long-term capital gain rates, unless a 5-year holding period was met (replacing the current 3-year holding period put in place under the 2017 Tax Act). Gain would also have been recognized upon transfer of such partnership interests. These changes would have raised about $14 billion.

ENVIRONMENTAL AND CLEAN ENERGY

The IRA contains numerous new and modified tax provisions designed to offer nearly $400 billion of clean energy tax credits for solar, wind, EVs, hydrogen, nuclear, and carbon capture among others, making the bill the single biggest climate investment in U.S. history.

The bill would provide an assortment of credits ranging from consumer home energy rebate programs, to consumer tax credits for making homes energy efficient to manufacturing incentives to on-shore clean energy initiatives. Among the multitude of tax credits, the bill includes a "clean vehicle credit" of up to $7,500 for new and $4,000 for used clean energy vehicles (EV and hybrid). Credits would be dependent on a variety of criteria including the vehicle's retail price (no greater than $80,000 for new vans, SUVs, and pickup trucks; $55,000 for other new vehicles; $25,000 for used vehicles) and subject to phase-outs based on a taxpayer's income for the current or prior year, whichever is lower (up to $300,000 for joint filers, $150,000 for single filers for new vehicles and $150,000/$75,000 for used vehicles). Only one credit would be available for each vehicle. The credit would be available to the taxpayer when filing their tax return, or through a taxpayer election, available to the vehicle dealer, which should immediately reduce the price of the vehicle. A larger credit of up to $40,000 would be available for certain commercial clean vehicles. These credits would be available to vehicles acquired after December 31, 2022.

From a non-tax perspective, the Manchin-Schumer agreement would streamline the permit process for energy infrastructure projects, the details of which would be in a promised companion bill since they cannot be included in a reconciliation bill.

OTHER

An additional $64 billion is allocated to extending Affordable Care Act subsidies for three additional years (current enhanced subsidies expire in 2023). Out-of-pocket drug costs for Medicare eligible individuals would also be capped at $2,000 per year starting in 2025.

— National Wealth Strategies, Chief Investment Office

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