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March 20, 2023

Hon. Daniel I. Werfel
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Corporate Alternative Minimum Tax Under Section 59(k)

Dear Commissioner Werfel:

Enclosed please find comments on the Corporate Alternative Minimum Tax under sections 55(b)(2)(A), 56A, 59(k), and 59(l). These comments are submitted on behalf of the Section of Taxation and have not been reviewed or approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Wells Hall

C. Wells Hall, III
Chair, Section of Taxation

Enclosure

cc: Hon. Lily Batchelder, Assistant Secretary (Tax Policy), Department of the Treasury
Thomas West, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Krishna P. Vallabhaneni, Tax Legislative Counsel, Department of the Treasury
Lindsay M. Kitzinger, Acting International Tax Counsel, Office of International Tax Counsel, Department of the Treasury
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments on the Corporate Alternative Minimum Tax

These comments ("**Comments**") are submitted on behalf of the American Bar Association Section of Taxation (the "**Section**") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Scott M. Levine and Andrew T. Davis. Primary responsibility for drafting these Comments was exercised by Andrew T. Davis, Corey Goodman, and Michael Schler (corporate-related issues), Peter Ford (accounting methods-related issues), Craig Gerson (partnership-related issues), Joseph Calianno, Jeffrey Tebbs, and Caroline Reaves (outbound-international-related issues), Sam Kaywood and Heather Ripley (inbound-international-related issues), and Daniel Reach and Alan Lederman (certain timing-related issues). Helpful comments were provided by John Bates, Didi Borden, Amie Breslow, Jack Cummings, Chris Mayer-Dempsey, Anne Devereaux, Jeff Erickson, John Franco, Tom Gaebler, Victoria Glover, Monte Jackel, Kevin Jacobs, Daniel Jose, Ted Lee, Danielle Marr, Eileen Marshall, Lauren Richards, Heather Ripley, Angela Russo, Anthony Sexton, and Valentin Van de Walle. We also thank Radhika Bora and Sicily Maleva Kiesel for their assistance in preparing these Comments. These Comments were reviewed by Ellen McElroy, Anthony Sexton, Eric Sloan, and Edward Tanenbaum of the Committee on Government Submissions for the Tax Section, Michael Desmond, Chair of the Committee on Government Submissions for the Tax Section, and Lisa Zarlenga, Vice Chair – Government Relations for the Tax Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or who is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section's diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: March 20, 2023

I. Executive Summary

Section 59(k),[1] as part of subchapter A of the Code,[2] provides rules for when an "applicable corporation" within the meaning of section 59(k) (an "**applicable corporation**") is subject to U.S. federal income tax (the "**corporate alternative minimum tax**" or "**CAMT**") on the excess of 15% of its "adjusted financial statement income" within the meaning of section 56A ("**AFSI**") over its corporate alternative minimum tax foreign tax credit for the applicable year within the meaning of section 59(l) ("**CAMT FTC**"). Section 59(k) was enacted as part of Public Law 117-169, known as the Inflation Reduction Act of 2022, on August 16, 2022.[3] On December 27, 2022, Treasury and the Service published Notice 2023-7 (the "**Notice**"), which provides taxpayers with interim guidance on certain issues related to the CAMT.[4]

Generally, a corporation is an applicable corporation if it is a C corporation (other than a regulated investment company or a real estate investment trust) that has average annual AFSI exceeding $1 billion for the three taxable years ending immediately before the applicable taxable year. A corporation is also an applicable corporation if it is a C corporation that is a member of a foreign-parented multinational group ("**FPMG**") filing the same applicable financial statement within the meaning of section 56A(b) ("**AFS**") and meets certain income thresholds. Specifically, the average annual AFSI of all members of the group must exceed $1 billion for the three taxable years ending immediately before the applicable taxable year and the corporation's average annual AFSI without regard to section 56A(d) for the three taxable years ending immediately before such taxable year must be $100 million or more.[5]

In addition, section 55(b) was amended and sections 59(l) and 56A were enacted as part of the Act. For taxable years of applicable corporations beginning after December 31, 2022, section 55(b)(2)(A) requires an applicable corporation to pay tax on the excess of 15% of its AFSI over its CAMT FTC for the taxable year, if such amount is greater than the applicable corporation's regular amount of tax (reduced by the foreign tax credit permitted under section 901) would have been for the applicable year, in a manner similar to the minimum tax imposed on individuals under section 55(b)(1) ("**AMT**"). Section 59(l) generally provides a credit in the amount of the sum of foreign income taxes paid or accrued by an applicable corporation and the applicable corporation's pro rata share of any foreign income taxes paid or accrued by a controlled foreign corporation within the meaning of section 957(a) (a "**CFC**") with respect to which the applicable corporation is a United States shareholder within the meaning of section 951(b) (a "**U.S. Shareholder**"), provided certain other requirements are met. Section 56A

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[1] Unless otherwise indicated, references to a "section" are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and all "Treas. Reg. §" references are to the Treasury Regulations promulgated under the Code, all as in effect (or, in the case of proposed regulations that remain outstanding, as proposed) as of the date of these Comments.

[2] Subchapter A consists of sections 1 through 59B.

[3] An Act to provide for reconciliation pursuant to title II of S. Con. Res. 14., Pub. L. No. 117-169, 136 Stat. 1818 (2022).

[4] Notice 2023-7, 2023-3 I.R.B. 390 ("**Notice**").

[5] I.R.C. § 59(k)(1), (k)(2).

provides rules clarifying the meaning of AFSI and AFS and makes certain adjustments to AFSI with respect to related entities, partnerships and pass-through entities, entities filing consolidated returns, and tax-exempt entities. Section 56A also provides rules for adjustments to AFSI with respect to certain items of income, deduction, and loss shown on an AFS.

We applaud the efforts of the U.S. Department of Treasury ("**Treasury**") and the Internal Revenue Service (the "**Service**") to provide taxpayers with guidance relating to the Act. As discussed in these Comments, we believe certain modifications to the application of the new rules under sections 56A, 59(k), and 59(l) are warranted under the broad authority granted to Treasury and the Service. In other cases, we recommend clarifications to the rules. These Comments focus on priority issues on which we believe guidance is needed as soon as possible. Some of these issues may affect whether a corporation is an applicable corporation. Because the CAMT is already in effect, this is important to determine as soon as possible in order to prepare financial statements, calculate taxes, and plan and execute transactions.

To provide context for our recommendations, we provide a summary of sections 56A, 59(k), 59(l), and other relevant Code sections in Part II.A of this letter.

Our recommendations are summarized below and discussed in more detail in Parts II.B through II.F of these Comments. In some instances, we do not have specific recommendations for what the rule should provide, and instead, where possible, we offer options and identify pros and cons of those options.

1. <u>General Comments</u>

   a. We support the elective safe harbor for 2023 for applicable corporation status in the Notice and recommend that a permanent simplified safe harbor be adopted. We also recommend certain refinements to the safe harbors, including rules for allocating book income on account of corporate transactions that occur during a safe harbor period.

   b. We recommend that Treasury and the Service adopt a "fresh start" date for AFSI adjustments to book income and book attributes such as basis, other than section 168 adjustments. We suggest that this date be the first day of the second taxable year before the first taxable year of the three-year lookback period.

   c. We recommend that Treasury and the Service consider providing regulatory relief to allow the carryforward of some pre-2020 AFSI losses for determining future AFSI, or support a technical amendment to allow such relief.

   d. We recommend that Treasury and the Service adopt regulations that require section 56A to be applied in a manner that will prevent duplications and omissions of book income. Absent applicable final regulations, taxpayers should be permitted to adopt any reasonable approach to preventing duplications of income and omissions of deductions, and should be required to adopt a reasonable approach to prevent omissions of income and duplications of deductions. Any approach used by taxpayers should be required to be used consistently and to clearly reflect income.

e. When taxpayers have differing accounting and taxable years, we believe that in determining status as an applicable corporation, the AFSI for a taxable year during the three-year lookback period should be equal to the AFSI of the accounting year that ends in that taxable year. In determining AFSI of an applicable corporation, we recommend that taxpayers be able to elect, on a consistent basis, between an interim closing of the books or a proration method that excludes extraordinary transactions. Similar principles should apply when there is a short taxable year.

2. Bankruptcy and Insolvency Comments

a. We recommend that guidance modify the scope of the exclusion of section 108 cancellation of debt income ("**CODI**") in the Notice. Among other things, we suggest that guidance provide an exclusion from AFSI for book CODI in excess of tax CODI, that book CODI should be excluded even if it arises in a different year than corresponding tax CODI, that attribute reduction should be made on a single-entity basis (treating a consolidated group as a single entity), that CAMT attribute reduction should be determined separately from tax attribute reduction based on CAMT CODI and CAMT attributes, that CAMT attribute reduction should not be tied to equivalent reduction of regular tax attributes, that section 108(b)(5) elections should be allowed for CAMT purposes, and that the ordering rule for section 108(b) attribute reductions should generally apply to CAMT but should be modified in respect of section 168 assets to prevent double harm to the taxpayer.

b. In connection with an emergence from bankruptcy, our members differ on whether a transaction that is taxable for regular income tax purposes should be exempt from CAMT, as the Notice provides. In any event, we believe that a Section 363 Sale, as defined below, and an insolvency workout should be treated in the same manner as an emergence from bankruptcy, and that the bankruptcy exception should apply to a member in bankruptcy even if the entire group is not in bankruptcy. We also recommend that guidance clarify that CAMT CODI does not reduce tax attributes of an acquiring entity unless the transaction is a section 381 transaction and that Section 3.07(2) of the Notice is not limited to Parties as defined in the Notice.

c. We believe that book deconsolidation arising from a bankruptcy filing should be ignored for CAMT purposes, that the bankruptcy and insolvency rules should apply to items of a member of a group that is insolvent even if other members of the group are not, and that the CAMT rules (like the regular tax rules) should look to the regarded owner of a disregarded subsidiary.

3. Corporate and Consolidated Group Comments

a. We recommend that Treasury and the Service define "change in ownership" for CAMT purposes based solely on whether a corporation joins or leaves a Section 52 Group, as defined below, and that disposition of less than substantially all the assets of a corporation should not constitute a change in ownership of the corporation.

b. When a member leaves an AFS Group, we believe that status as an applicable corporation should not depend upon the direction of the acquisition or disposition transaction. Therefore, if an applicable corporation combines with a nonapplicable corporation, the former should be the acquirer, and if neither were applicable corporations, the acquirer should be the one with the greater three-year history. In addition, we believe that the AFS Group should be able to elect among certain methodologies in allocating AFSI to a departing member, that (contrary to the Notice) a Distributing AFS Group should reduce its AFSI by the AFSI allocated to the controlled member for purposes of any retesting of its status in the future, and that CAMT carryovers should be allocated in the same manner as AFSI and should be subject to sections 382 and 383 and the SRLY rules, as defined below.

c. In connection with section 351 transactions, we believe that the CAMT nonrecognition rules should apply to all corporate transferors, that boot should be treated similarly to the regular tax treatment of boot under section 351(b), and that CAMT basis of assets should be subject to carryover basis rules similar to the tax rules.

d. In connection with corporate reorganizations, we believe that the CAMT nonrecognition rules should apply to corporate shareholders of the target corporation, that boot should be treated similarly to the regular tax treatment of boot under section 356, that CAMT basis of assets should be subject to the rules for tax basis, and that the legal form of the transaction should not matter as long as the overall transaction qualifies as a reorganization.

e. In connection with a distribution under section 355, we believe that AFSI basis should conform to tax basis principles and that AFSI gain should not include book mark-to-market gain on retained stock that is later distributed as part of the plan.

f. In connection with Covered Recognition Transactions, we believe that purchase accounting should be allowed on a taxable acquisition of stock out of a Book Group, defined below, since book gain is recognized on the assets. In a case such as a cash purchase of stock from the public, where no book gain is recognized on the assets, a majority of our members believes that purchase accounting should be allowed, while a minority believes that a carryover AFSI basis should apply. However, in any case where purchase accounting is allowed, we believe that CAMT NOLs should not carry over to the corporation with a stepped up CAMT asset basis.

g. We recommend that Treasury and the Service generally exclude from AFSI "remeasurement gain" or other income that is unrealized for regular income tax purposes.

h. In the case of transactions between entities that are part of a Book Group but not a Section 1502 Group, both as defined below, and where the transactions are not taken into account for book purposes, we recommend that notional AFSI items of income, loss, and AFSI basis of assets be created as if the entities were not part of the same Book Group. Likewise, a Section 1502 Group should be entitled to carry over its own

AFSI loss without absorption by other members of the Book Group, and should not be able to use book losses of other Book Group members against its own AFSI income.

4. Tax Accounting Comments

a. We recommend that Treasury and the Service provide guidance treating computer software, qualified films or television productions, and qualified live theatrical productions as depreciable property for purposes of section 56A(c)(13), even if a taxpayer elects to forgo the additional first-year depreciation deduction provided in section 168(k).

b. We recommend that Treasury and the Service issue guidance defining the term "net income or loss" under section 56A(a) as revenue in the AFS less associated costs and expenses reported in that AFS. The guidance should also clarify that Other Comprehensive Income ("**OCI**") is excluded from net income under section 56A(a).

c. We recommend that Treasury and the Service provide guidance clarifying that a change in determining net income for AFS purposes is a change in underlying facts and, therefore, does not constitute a change in method of accounting within the meaning of section 446 for purposes of calculating AFSI.

d. We recommend that Treasury and the Service provide guidance permitting adjustments under section 56A(c)(13) in the year amounts are capitalized into inventory under section 263A, consistent with the approach in section 163(j).

e. We recommend that Treasury and the Service provide guidance to clarify how to determine the basis of Section 168 Property ("**Section 168 Property**") for purposes of making adjustments under section 56A(c)(13). We recommend that guidance provide a simplifying assumption and a safe harbor for tracking differences in book and tax basis to ease administrative burdens.

5. Partnership Taxation Comments

a. We recommend that Treasury and the Service clarify that for purposes of determining whether a corporation is an applicable corporation, in the case of a corporate partner that includes the partnership in its Book Group, as defined below, but not in its Section 52 Group, as defined below, the corporate partner's AFSI should exclude noncontrolling interests.

b. In addition, guidance should confirm that there is no "double-counting" of AFSI under section 59(k)(1)(D), as a result of section 52(b) AFSI aggregation.

c. We recommend that taxpayers be permitted to use any reasonable approach to determine their distributive share of partnership AFSI. We further recommend that guidance acknowledge that multiple reasonable approaches may apply, including both "bottom-up" and "top-down" methods, as discussed herein.

d. We recommend that guidance provide for an adjustment to AFSI in respect of Partial Nonrecognition Transactions, as defined below. Specifically, we recommend that the percentage of financial accounting gain or loss arising from a Partial Nonrecognition Transaction that is taken into account in determining a corporate partner's AFSI should be the same as the percentage of realized tax gain or loss that is recognized.

e. We recommend that guidance provide that partnerships need only calculate and report information necessary to compute a partner's distributive share of AFSI if (i) a corporation requiring AFSI Information, as defined below, (because the corporation is or believes it may be an applicable corporation) holds an interest in the partnership directly or indirectly through one or more partnerships, and (ii) such corporation or a partnership through which such corporation indirectly owns an interest in the partnership provides timely notification, as determined by Treasury and the Service, to the partnership of the need for such information. In addition, Treasury and the Service should consider a de minimis rule to limit burdensome information reporting to the extent that a partnership is relatively small or the applicable corporation's interest in such partnership is relatively small.

6. Outbound International Taxation Comments

   a. We recommend that Treasury and the Service provide rules to prevent duplication of income by excluding any dividend from a CFC for which the taxpayer has included its pro rata share of CFC AFSI.

   b. We recommend that guidance clarify that, for purposes of making the applicable corporation determination, taxpayers should only include their pro rata share of CFC income, as determined under current Treasury guidance, including Treas. Reg. §1.951-1(b) and (e).

   c. We recommend that guidance clarify that a corporate partner may include its proportionate share of foreign taxes paid by a partnership for purposes of computing its amount of CAMT FTC. Specifically, we recommend applying the principles of section 704(b) to allocate the appropriate amount of partnership creditable foreign tax expenditures to the corporate partner for CAMT FTC purposes.

7. Inbound International Tax Comments

   a. We recommend that Treasury and the Service incorporate the aggregation rules of section 52(a) and (b) and turn off the exclusion of foreign corporations under section 1563(b)(2)(C) for purposes of determining which members are included in a FPMG for purposes of the $1 billion test. In addition, if a U.S. trade or business of a foreign corporation is treated as a domestic corporation under section 59(k)(2)(C), its AFSI should be counted for purposes of the $100 million test.

   b. We recommend that Treasury and the Service provide that the CFC adjustment rules apply to a domestic member of a FPMG for purposes of the $100 million test, but generally not to a U.S. trade or business treated as a domestic corporation if the underlying foreign owner owns stock of other foreign corporations that might be CFCs under the downward attribution rule.

c. We recommend that Treasury and the Service clarify that tax treaties should apply in determining the AFSI of a foreign corporation that has a U.S. trade or business.

8. Other Deferral Comments

a. We recommend that Treasury and the Service issue guidance addressing whether eligible gain invested in a qualified opportunity fund ("**QOF**"), and thus deferred for regular tax purposes until 2026, is likewise deferred for AFSI purposes. Similarly, Treasury and the Service should issue guidance addressing whether gains permanently excluded by reason of a taxpayer's 10-year ownership of a QOF are also permanently excluded from AFSI.

b. We recommend that Treasury and the Service issue guidance addressing whether gain deferred under section 1033 is likewise deferred for purposes of AFSI.

c. We recommend that Treasury and the Service issue guidance addressing whether gain deferred under section 1031 is likewise deferred for purposes of AFSI, consistent with long-standing Congressional policy supporting this deferral provision. We note that certain industries would likely be adversely affected by the inclusion of gain deferred under section 1031, such as large hotel and energy companies, for purposes of AFSI.

d. We recommend that Treasury and the Service issue guidance addressing whether gain deferred under sections 453 is likewise deferred for purposes of AFSI, consistent with long-standing Congressional policy supporting this deferral provision. We note that certain industries would likely be adversely affected by the inclusion of gain deferred under section 453, such as farmers and timeshare developers, for purposes of AFSI.

9. Tax-Exempt Organizations Comment

We recommend that Treasury and the Service clarify that the AFSI of a tax-exempt organization (a "**TEO**"), both for purposes of determining status as an applicable corporation and calculating the CAMT of an applicable corporation, is equal to its book unrelated business income ("**Book UBI**"), where Book UBI is the sum of (i) net income from a regularly carried on unrelated trade or business within the meaning of section 513(a) ("**UBTI**") computed with the modifications provided in subsection 512(b), and (ii) net unrelated debt-financed income as defined in section 514(a).

II. Detailed Discussion

A. Background

Section 55(b)(2)(A) requires an applicable corporation to pay CAMT on its AFSI in a manner similar to an individual's AMT under section 55(b)(1)(A) for taxable years of applicable corporations beginning after December 31, 2022.[6]

The amount of the tax imposed by section 55(b)(2)(A) is the excess of 15% of the applicable corporation's AFSI for the taxable year over its CAMT FTC for the taxable year, if such excess is greater than the sum of an applicable corporation's regular tax liability (reduced by the foreign tax credit permitted under section 901) and the tax on base erosion payments imposed under section 59A for the taxable year.[7]

1. Applicable Corporation

A subchapter C corporation (other than a real estate investment trust or a regulated investment company) is an applicable corporation if its average annual AFSI for any three consecutive preceding taxable years (the "**testing period**") ending after December 31, 2021 exceeds $1 billion (the "**$1 Billion Threshold")**.[8] In each case, for purposes of determining whether a corporation is an applicable corporation, average annual AFSI is determined without regard to the application of section 56A(d) (which would otherwise reduce AFSI by net operating loss ("**NOL**") carryovers shown on an AFS by up to 80% of AFSI).[9] In addition, for purposes of determining whether a corporation is an applicable corporation, the corporation's AFSI includes all AFSI of persons treated as a single employer under section 52(a) or (b), determined without regard to a person's distributive share of the AFSI of a partnership in which the person is a partner[10] and without regard to amounts included on an AFS in connection with certain defined benefit plans.[11]

[6] I.R.C. § 55(b)(2)(A); Pub. L. No. 117-169, § 10101(f), 136 Stat. 1818 (2022).

[7] I.R.C. § 55(a), (b)(2)(A), (c)(1).

[8] I.R.C. § 59(k)(1)(A), (B).

[9] I.R.C. § 59(k)(1)(B)(ii)(II).

[10] I.R.C. § 59(k)(1)(D). AFSI of the taxpayer with respect to a partnership is otherwise adjusted to only take into account the taxpayer's distributive share of AFSI of such partnership. I.R.C. § 56A(c)(2)(D)(i).

[11] I.R.C. § 59(k)(1)(D). AFSI is otherwise adjusted to disregard any item of income, cost or expense that would be included on an AFS in connection with a "covered benefit plan," increased by income in connection with a covered benefit plan, and reduced by deductions with respect to a covered benefit plan. I.R.C. § 56A(c)(11)(A). A "covered benefit plan" is a defined benefit plan (other than a multiemployer plan if a tax-exempt employees' trust described in section 401(a) is part of such plan, a qualified foreign plan as defined in section 404A(e), or any other defined benefit plan which provides post-employment benefits other than pension benefits. I.R.C. § 56A(c)(11)(B).

Section 52(a) treats all employees of corporations that are members of the same "controlled group of corporations" as employed by a single employer.[12] A "controlled group of corporations" is one or more chains of corporations with a common parent corporation if more than 50% of the total combined voting power of all voting stock or more than 50% of the total value of shares in each of the corporations, except the common parent corporation, is owned by one or more of the other corporations, and the common parent corporation owns stock possessing more than 50% of the total combined voting power of all voting stock or more than 50% of the total value of shares in at least one of the other corporations.[13] Section 52(b) treats all employees of trades or business (whether or not incorporated) that are under common control as employed by a single employer, based on principles of section 52(a).

In the case of a FPMG, the group's average annual AFSI for the testing period must exceed $1 billion and the corporation's average annual AFSI for the testing period must be at least $100 million in order for the corporation to be treated as an applicable corporation.[14] An FPMG is a group of two or more entities including at least one U.S. corporation and at least one foreign corporation that are included on the same AFS with respect to the taxable year, and that are deemed to have a common foreign parent under applicable federal tax rules.[15] If a foreign corporation is engaged in a trade or business within the United States, the trade or business is treated as a separate U.S. corporation that is wholly owned by the foreign corporation.[16]

Once a corporation is an applicable corporation, it continues to be treated as an applicable corporation unless such corporation either: (i) undergoes a change in ownership; or (ii) does not have average annual AFSI exceeding $1 billion for a specified number of consecutive taxable years, including the most recent taxable years; and, in both cases, the Secretary determines it would not be appropriate to treat such corporation as an applicable corporation.[17] Additionally, the three-year testing period is reduced to the period during which the corporation has existed if the corporation has been in existence for less than three taxable years.[18] In such circumstances, AFSI for any short taxable year is annualized on a monthly pro rata basis and a predecessor of an applicable corporation is treated as an applicable corporation.[19] Section 59(k) also grants the Secretary authority to promulgate regulations and other guidance to carry out this subsection,

[12] I.R.C. § 52(a).

[13] I.R.C. §§ 52(a), 1563(a). Section 1563 also treats certain insurance companies taxed under section 801 as a separate controlled group of corporations and excludes employees' trusts that are tax-exempt under section 501(a) from application of the attribution rules in section 1563(e)(3). These special rules do not apply for purposes of sections 52(a) and (b) and 59. I.R.C. § 52(a)(2).

[14] I.R.C. § 59(k)(1)(B)(ii).

[15] I.R.C. § 59(k)(2).

[16] I.R.C. § 59(k)(2)(C).

[17] I.R.C. § 59(k)(1)(C).

[18] I.R.C. § 59(k)(1)(E)(i).

[19] I.R.C. § 59(k)(1)(E)(ii), (iii).

including the application of this subsection to a corporation that experiences a change in ownership.[20]

2. AFSI and AFS

A corporation's AFSI is the corporation's net income or loss as set forth on its AFS, adjusted as provided in section 56A.[21] An AFS is generally a financial statement prepared in accordance with generally accepted accounting principles ("**GAAP**") and is a 10-K or an audited financial statement used for a substantial nontax purpose (including reporting to shareholders) or is filed with a federal agency for purposes other than federal tax purposes. An AFS may also be a financial statement made on the basis of international financial reporting standards ("**IFRS**") and filed with a foreign governmental agency that is equivalent to the U.S. Securities and Exchange Commission ("**SEC**") and has no less stringent reporting standards than the SEC, or a financial statement filed with any other regulatory or governmental body specified by the Secretary.[22]

If related entities report financial results on a single AFS, the corporation's AFS is deemed to be the group's AFS, but a member of an affiliated group filing a consolidated return only takes into account items on the affiliated group's AFS that are properly allocable to such member.[23] If a corporation is related to the taxpayer but not included on a consolidated return with the taxpayer, AFSI of the taxpayer with respect to the related corporation includes only the dividends received from such corporation and the amount includable or deductible with respect to such corporation.[24] A corporation that is a partner in a partnership must include its distributive share of the partnership's AFSI (the net income or loss set forth on the partnership's AFS) in its AFSI.[25] Additionally, if a corporation is a U.S. Shareholder of a CFC, the corporation's AFSI is increased, but not reduced, to include the corporation's pro rata share of items taken into account in computing the CFC's net income set forth on the CFC's AFS.[26] Similarly, a corporation's AFSI includes any AFSI of a disregarded entity owned by the corporation, and a foreign corporation's AFSI includes the corporation's income that is effectively connected with a U.S.

[20] I.R.C. § 59(k)(3).

[21] I.R.C. § 56A(a).

[22] I.R.C. §§ 56A(b), 451(b)(3).

[23] I.R.C. §§ 56A(c)(2)(A), (B), 451(b)(5).

[24] I.R.C. § 56A(c)(2)(C). Global intangible low-taxed income includable under sections 951 or 951A is excluded from AFSI with respect to a related corporation. I.R.C. § 56A(c)(2)(C).

[25] I.R.C. § 56A(c)(2)(D).

[26] I.R.C. § 56A(c)(3). If a corporation's pro rata share of a CFC's items taken into account in determining the CFC's net income or loss would be negative, the amount of the adjustment rolls over and reduces the corporation's AFSI adjustment for the next taxable year. I.R.C. § 56A(c)(3)(B)(ii).

trade or business ("**ECI**").[27] Finally, a TEO's AFSI includes only UBTI or income derived from debt-financed property, to the extent such income is treated as UBTI.[28]

AFSI is also adjusted to disregard any federal income taxes and income taxes with respect to a foreign country or U.S. possession taken into account on an AFS, unless the corporation elects not to receive the benefits of the foreign tax credit for the applicable year, and (without duplication) any amount treated as a payment offsetting tax pursuant to certain elections to receive a refund instead of a credit.[29] The Secretary is granted authority to promulgate regulations and other guidance to provide for adjustments with respect to current and deferred taxes.[30] Depreciation deductions with respect to 168 property reduce AFSI, and AFSI disregards depreciation expense taken into account on the corporation's AFS.[31] Thus, depreciation for AFSI purposes reflects tax rather than book depreciation. Additionally, AFSI is reduced by financial statement NOL carryovers to the current year (limited to 80% of AFSI).[32]

If an applicable corporation elects to receive the benefits of the foreign tax credit for a taxable year, the corporation is entitled to a CAMT FTC for the taxable year. The amount of the CAMT FTC is the sum of two amounts. The first amount is the lesser of (i) the applicable corporation's aggregate pro rata share (determined under section 56A(c)(3)) of the amount of foreign income taxes that are imposed by any foreign country or U.S. possession and taken into account on the AFS of, and paid or accrued for federal income tax purposes by, each CFC with respect to which the corporation is a U.S. Shareholder, and (ii) the product of 15% and the adjustment to AFSI to take into account the corporation's pro rata share of items taken into account to compute the net income or loss set forth on a CFC's AFS under section 56A(c)(3).[33] The second amount is, in the case of a U.S. corporation, the amount of income taxes imposed by a foreign country or U.S. possession that are taken into account on the applicable corporation's

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[27] I.R.C. § 56A(c)(4), (6).

[28] I.R.C. § 56A(c)(12).

[29] I.R.C. § 56A(c)(5), (9).

[30] I.R.C. § 56A(c)(5).

[31] I.R.C. § 56A(c)(13).

[32] I.R.C. § 56A(d). The NOL carryover does not apply for purposes of testing status as an applicable corporation. I.R.C. § 59(k)(1)(B)(i). Special adjustments also apply with respect to the AFSI of a cooperative to which section 1381 applies; property whose basis is determined under section 21(c) of the Alaska Native Claims Settlement Act and amounts payable under section 7(i) or 7(j) of the Alaska Native Claims Settlement Act; income in connection with a mortgage servicing contract; income, cost, or expense that would otherwise be included in connection with a "covered benefit plan;" and items of amortization expense and amortization deductions permitted with respect to "qualified wireless spectrum." Alaska Natives Claims Settlement, Pub. L. No. 29-203, I.R.C. § 56A(c)(7), (8), (10), (11), (14), 85 Stat. 688 (1971). A "covered benefit plan" is a defined benefit plan other than certain multiemployer plans if a tax-exempt employees' trust described in section 401(a) is part of such plan, a qualified foreign plan (as defined in section 404A(e)), or any other defined benefit plan which provides post-employment benefits other than pension benefits. I.R.C. § 56A(c)(11)(B). "Qualified wireless spectrum" is wireless spectrum used in the trade or business of a wireless telecommunications carrier which was acquired after December 31, 2007 and before August 16, 2022. I.R.C. § 56A(c)(14)(B).

[33] I.R.C. § 59(l)(1)(A).

AFS and paid or accrued by the applicable corporation.[34] If an applicable corporation elects to receive the benefits of the foreign tax credit for a taxable year, any excess of the amount described in (i) over the amount described in (ii) is carried over to any of the five succeeding taxable years (to the extent not taken into account in a prior year).[35]

B. General Comments

1. Simplified Determination of Status as Applicable Corporation

Section 59(k)(3) provides that the Secretary "shall" provide regulations to carry out the purposes of section 59(k) (defining an applicable corporation), including regulations providing a simplified method for determining status as an applicable corporation. Section 5 of the Notice provides an elective simplified safe harbor for avoiding status as an applicable corporation in the first taxable year ending in 2023.

Under Section 5 of the Notice, a corporation is not an applicable corporation in 2023 if (i) the average annual AFSI of the group in 2020 through 2022, as determined for purposes of the safe harbor, is $500 million (rather than $1 billion) or less, and (ii) in the case of an FPMG with group AFSI in excess of $500 million, the U.S. AFSI is no more than $50 million. For this purpose, AFSI equals reported book income but adding back federal income taxes along with certain other, albeit limited, adjustments.

We support the adoption of this safe harbor. We believe it will greatly simplify determinations for many corporations that are almost certainly not applicable corporations in 2023 under the statutory tests, but that would have needed to conduct burdensome computations to reach the same conclusion with reasonable certainty. We also believe that the government is reasonably protected by the safe harbor, because it is unlikely that many corporations that meet the safe harbor would fail the statutory test (and thus be applicable corporations) for 2023.

We have the following additional comments on this safe harbor.

a. Relationship Between the Safe Harbor for 2023 and Section 3.04 of the Notice (Concerning the Three-Year Lookback Period)

Our first comment may be best illustrated by the following example. Suppose that from 2020 through 2022, P, the parent of an AFS Group sells S, its wholly-owned corporate subsidiary, to a partnership, and S and S's corporate subsidiaries become a separate AFS Group. Under Section 3.04 of the Notice, the AFSI of the P AFS Group for the pre-sale period is not reduced on account of the disposition of S, and the S AFS Group carries with it an allocable share of the P AFS Group's AFSI for the historical period that S was in the P AFS Group.

The treatment of the P AFS Group under the safe harbor is straightforward, since the group can look at its own book income for the entire period. However, the treatment of S under

[34] I.R.C. § 59(l)(1)(B).

[35] I.R.C. § 59(l)(2).

the safe harbor is not clear. One possible treatment would be that S could be treated as a newly formed corporation upon the disposition, as it is for book purposes (the "**clean-break alternative**"). In such a case, the rules for short taxable years would apply and the history of S in the P AFS Group would be irrelevant. Alternatively, by analogy to the rules in Section 3.04 of the Notice, S could be allocated a share of the P AFS Group's book income for the pre-disposition period, and the income allocated to S would be combined with S's post-disposition book income in applying the safe harbor from 2020 through 2022 (the "**properly-allocable alternative**").

The alternative chosen also would be relevant where an unrelated AFS Group acquired S from the P AFS Group. Under the clean-break alternative, none of the P AFS Group's AFSI history would be inherited by the acquiring AFS Group for purposes of applying the safe harbor. Under this alternative, regardless of the amount of book income properly allocable to S (and its subsidiaries), provided the acquiring AFS Group separately satisfied the safe harbor (taking into account the book income of S and its subsidiaries only after the acquisition), the acquiring AFS Group would not be an applicable corporation in 2023. This would be the case under this alternative even if the amount of the P AFS Group's book income properly allocable to S and its subsidiaries averaged $500 million per year during the testing period.

Under the properly-allocable alternative, the acquiring AFS Group would be more likely to fail the safe harbor as the book income properly allocable to S and its subsidiaries would be included in the acquiring AFS Group's safe harbor calculation.

Regulations should clarify the results in these cases. The choice between the two alternatives is a choice between the simplicity of the clean-break alternative and the accuracy of the properly-allocable alternative.

We support the clean-break alternative for 2023 on the ground that it is more consistent with the terms of the Notice, on which taxpayers can rely for 2023, and we do not believe taxpayers should be given an election for an alternative method for 2023. However, as discussed in the following section, if the safe harbor is to be extended, we believe the properly-allocable alternative is the preferred approach for future years.

b. Extension of Safe Harbor

As noted above, section 59(k)(3) appears to contemplate that regulations would adopt a permanent simplified method for determining status as an applicable corporation. We support a permanent simplified method. In the absence of such a method, a significant percentage of corporations may feel compelled annually to calculate their AFSI to demonstrate that they are not applicable corporations—a costly administrative burden seemingly not intended by the statute for corporations that are virtually certain to fall below its book income thresholds.

That said, we have the following additional comments with respect to the possible extension of a safe harbor. First, if Treasury and the Service believe the existing safe harbor is too generous for a permanent safe harbor, we favor lowering the thresholds rather than eliminating the safe harbor altogether. Further, if a safe harbor is to be made permanent, we believe an anti-abuse rule should be considered to prevent using the safe harbor to avoid status as an applicable corporation when the general rule would create such status.[36]

With respect to a permanent safe harbor, we believe that in a merger and acquisition transaction involving the disposition of a subsidiary of the AFS Group, book income of the group should be allocated to the subsidiary for purposes of the safe harbor, in a manner consistent with the properly-allocable alternative. The financial accounting rules are not intended to reflect historical operations. Further, in our view, the properly-allocable alternative properly prevents reliance on the safe harbor when two corporations, each just below the safe harbor threshold, combine to create what should be an applicable corporation. Although it is implicit in the Notice, regulations should illustrate that even if a corporation avoids status as an applicable corporation in 2023 because of the safe harbor based on its book income from 2020 through 2022, that corporation might have to calculate its AFSI for one or more of 2020, 2021, or 2022 for other CAMT-related purposes. One purpose could include the need to determine status as an applicable corporation in 2024 using the corporation's AFSI for years 2021 through 2023 in the event that no safe harbor for 2024 is satisfied. Another purpose could include the need to determine the AFSI basis of assets in a future year when the corporation is an applicable corporation, based on events occurring in 2020, 2021, or 2022.

2. Lookback Period for AFSI

Section 56A(a) defines AFSI "for any corporation for any taxable year." Section 56A(d)(3), relating to AFSI loss carryovers, refers to AFSs for years ending after December 31, 2019. Absent a statutory limitation, it seems that an AFS and related AFSI can exist for earlier years. Regulations should clarify whether "retroactive" adjustments to book income to determine AFSI must be made for all prior taxable years for other purposes. This issue affects the AFSI basis of assets on a going-forward basis, and is relevant for both determining status as an applicable corporation and determining the AFSI of an applicable corporation.[37]

We note that the burden on taxpayers could last for many years. Consider the rule in Section 3.03(2) of the Notice that turns off acquisition accounting for AFSI purposes after certain nonrecognition transactions, and the rule in Section 3.06(2) of the Notice that reduces book attributes for AFSI purposes after the existence of excluded CODI. Likewise, as proposed in Part II.D.4 of these Comments, future regulations might exclude book "remeasurement gain" from AFSI, and require a carryover AFSI basis in the underlying assets. These transactions might have occurred in the distant past, but if the AFSI adjustments to book items must be made in those years, the difference between book basis (and other attributes) and AFSI basis could continue into the future.

[36] *See*, *e.g.*, Treas. Reg. § 1.304-4(b)(1) (section 304 anti-abuse rule applies if a "principal purpose for creating, organizing, or funding the acquiring corporation by any means… is to avoid the application of section 304 to the deemed acquiring corporation").

[37] These Comments do not address adjustments to Section 168 Property provided in Sections 4.06-4.08 of the Notice. This issue may be addressed in future comments.

For example, in a tax-free reorganization in 2018, acquisition accounting would have resulted in a fair market value book basis in the target assets. If AFSI adjustments such as those in Section 3.03(2) of the Notice must be made "for any taxable year," the current AFSI basis of the target assets is a carryover book basis with subsequent adjustments for notional book amortization on the reduced book basis. If AFSI adjustments only apply to transactions arising in 2020 or thereafter, the current AFSI basis would equal the initial stepped up book basis with subsequent adjustments for book amortization. In the case of an asset such as goodwill that is not amortizable for book purposes, the difference between the two approaches would persist on a permanent basis. Similar examples could be presented for excluded CODI or excluded remeasurement gain in past years.

This question is not merely a transition question. Rather, it affects the permanent operation of the CAMT. Continuing with the case of a reorganization, the question is relevant to determining the effect of a 2018 reorganization on AFSI in 2020 and all future years, and status as an applicable corporation in 2023 and all future years. It is also relevant to determining the effect of a 2025 reorganization on status as an applicable corporation in 2030 or AFSI of an applicable corporation in 2035. In all such examples, the question of how far back do you have to look to undo book basis adjustments that are disallowed for AFSI purposes will need to be addressed.

There is nothing in section 56A(a) to distinguish one prior taxable year from another prior taxable year for purposes of determining AFSI. Further, as noted above, Congress specifically limited the lookback period for loss carryovers to losses arising in 2020 and later years, with a possible negative implication for other AFSI adjustments in past years. Also, as a policy matter, Congress may well have intended that a taxpayer should initially come into the CAMT system with AFSI and tax attributes as similar as possible to prevent any such discontinuity from either increasing future CAMT liability if initial AFSI attributes are less than tax attributes or decreasing future CAMT liability if initial AFSI attributes are greater than tax attributes.

On the other hand, we believe it would be administratively difficult if not impossible for both taxpayers and the Service to require or permit an unlimited lookback period for making all adjustments to AFSI required by the statute, the Notice, and future regulations. We note that absent relief, such adjustments would be required even by corporations that at the time of the relevant transaction were not subject to the CAMT and might even have been under a safe harbor. Either every corporation, no matter how small (including S corporations that might later convert to C corporations), would be required to maintain an AFSI balance sheet in the event that it ever became subject to the CAMT or when a corporation first becomes potentially subject to the CAMT, it would have to go back to the year of formation of the corporation (or its predecessors) to make AFSI adjustments.

We, therefore, suggest a "fresh start" date for AFSI adjustments to book income and book attributes such as basis. The date might be a fixed, specified date that would apply for all future 3-year lookback periods, or a "rolling" date that would be measured back from the beginning of the applicable 3-year lookback period. On the specified date, AFSI basis and other attributes would be equal to book basis and attributes, without regard to past events.

We suggest that the specified cutoff date be the first day of the second taxable year before the first taxable year of the lookback period. For example, in testing applicable corporation status in 2024 using a lookback period from 2021 to 2023, the fresh start date would be January 1, 2019. Thus, in calculating the potential CAMT liability for 2024, there would be (absent a short taxable year) a 5-year lookback period. Likewise, for the initial calculation of status in 2023, the cutoff date would be January 1, 2018. We believe this would be a reasonable compromise between accuracy and administrability while minimizing potential distortions of AFSI.[38]

If this approach is rejected, we suggest the approach taken in Pillar 2. In general, Pillar 2 turns off acquisition accounting, but allows such treatment for transactions before December 1, 2021 if the group does not have sufficient records to determine its book income and loss with reasonable accuracy based on carryover book basis.[39] This approach alleviates some of the difficulty with an unlimited lookback period. However, it is not our preferred approach because controversies are likely to arise concerning the adequacy of books and records and the meaning of reasonable accuracy. We prefer a bright line rule, even if it involves a longer lookback period.

3. AFSI Loss Carryovers from 2019

Financial accounting does not allow for a carryover of book losses. However, section 56A(d) allows a financial statement NOL for taxable years ending after December 31, 2019, to be carried over to future years for calculating AFSI in future years. Section 59(k)(1)(B)(i) states that in determining whether a corporation is an applicable corporation, the AFSI during the three-year testing period is determined without regard to section 56A(d). Presumably the reason for this latter rule is that a negative AFSI for a taxable year in the testing period counts in determining average AFSI during the testing period, and so it should not be counted again as a carryover in order to reduce AFSI in another year in a testing period.

Therefore, under section 59(k)(1)(B)(i), a book loss in 2019 would not carry over into 2020 in determining whether a corporation is an applicable corporation in 2023. This result is arguably unfair to taxpayers and inconsistent with the purpose of section 59(k)(1)(B)(i). Absent a carryover to 2020, a book loss in 2019 provides no benefit to taxpayers under the CAMT. Thus, a carryover of such loss to 2020 would not result in a duplicated benefit, in contrast to a book loss arising in 2020 or later years. Moreover, this rule allows for a corporation to be an applicable corporation in 2023 and later years even though its total book income in 2020-2022 is no more than its total book losses in 2019 and prior years.

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[38] We note that AFSI losses arising in 2020 and later years can be carried over in determining CAMT liability, and we suggest below that regulations also allow losses from earlier years to be carried over for this purpose. If a loss, for example, in 2020 is to be carried over to future years, AFSI would be calculated in all future years to determine absorption of the loss. Therefore, we would apply all the usual AFSI adjustments in those years, including for nonrecognition transactions occurring in those years. As another example, if a corporation becomes an applicable corporation in 2028 based on its AFSI from 2025 through 2027, and calculates its CAMT liability in 2028 using loss carryovers that arose in 2021, our usual proposed cutoff date of January 1, 2023 would instead be January 1, 2021, for purposes of calculating CAMT liability.

[39] OECD, *Tax Challenges Arising From the Digitalisation of the Economy—Commentary to the Global Anti-Base Erosion Model Rules (Pillar 2),* Inclusive Framework on BEPS, Article 3.1.2.4 (2022).

For example, consider a corporation that is an applicable corporation in 2023. Section 59A(d) disregards a book loss existing in 2019 in calculating the AFSI of the corporation in 2023. The result of this rule can be illustrated with the following simple (albeit extreme) example. Suppose that corporation X: (i) breaks even for AFSI and tax purposes in all years before 2019, (ii) in 2019, has a loss of $6 billion for AFSI and tax purposes, (iii) in the years 2020 and 2021, breaks even for AFSI and tax purposes, and (iv) in 2022, has $4 billion of AFSI and taxable income (without regard to any carryover). As a result, pursuant to section 59(k)(1)(B)(i), X is an applicable corporation in 2023 based on its $4 billion of aggregate AFSI in 2020 through 2022. Further, X has an NOL carryover for regular tax purposes of $2.8 billion going into 2023,[40] but no AFSI loss carryover. This disparity may well result in significant CAMT liability in 2023 and later years because of the resulting excess of AFSI over taxable income.

The result arises even though X had a $2 billion net overall AFSI and regular tax loss in the aggregate for all years before 2023. While this is an extreme example, the result appears to be inconsistent with the intended scope of CAMT—that is, corporations that report significant and stable book earnings to their shareholders without paying a commensurate amount of tax.

Absent a special statutory or regulatory provision, nothing would allow X's 2019 AFSI loss to be carried forward because section 56A(d)(3) only allows AFSI losses in 2020 and later years to be carried forward. Moreover, allowing loss carryovers into 2020 from earlier periods for AFSI purposes would require a determination of AFSI losses and subsequent AFSI income for all pre-2020 periods. In making that calculation, it would also seem necessary to determine the amount of AFSI losses by applying the other adjustments to book income required to determine AFSI in those earlier years.[41] Query whether there is a policy justification for this result. Finally, we note that it appears inequitable from a policy perspective to apply the current AFSI rules in pre-2020 years to increase AFSI by turning off purchase accounting, but not to apply the current AFSI rules to prevent the carrying forward of an AFSI loss in those years.

We, therefore, recommend that Treasury and the Service provide regulatory relief to allow the carryforward of pre-2020 AFSI losses for determining future AFSI. We believe such relief is authorized under section 56A(c)(15) as an adjustment necessary to carry out the purposes of section 56A as we are not aware of any intentional statutory purpose to deny taxpayers the use of such losses. We acknowledge, however, the statutory interpretation challenge presented by section 56A(d). If Treasury and the Service determine that section 56A(d) must be read as the exclusive rule allowing carryovers, we recommend that Treasury support a technical amendment to allow such relief.[42] We acknowledge the administrative difficulty of an

[40] Under section 172(a), the absorption of the NOL carryforward in 2022 is limited to 80% of the $4 billion of taxable income in 2022, or $3.2 billion, leaving a $2.8 billion carryforward to 2023.

[41] *See* Part II.B.2 above for our discussion of issues related to the lookback period for AFSI adjustments and our related recommendations.

[42] Carryovers from pre-2020 years would raise two technical issues. First, AFSI carryovers from 2020 and later years can only be used to offset 80% of future AFSI, analogous to the limitation that applies to tax NOLs. In our view, if pre-2020 AFSI loss carryovers are allowed, there should be conformity between the loss years where the 80% limitation on AFSI carryovers applies and the loss years where the 80% limitation on regular income tax carryovers

unlimited lookback period for AFSI losses, just as we did in Part II.B.2 above relating to other AFSI adjustments to book income in prior years. If the lookback period for most AFSI purposes is limited as we propose above, the same limited period should be used for years from which AFSI losses can be carried forward, although we would not turn off the statutory allowance for losses arising in 2020 and later years even if a general lookback period only went back to a later date.[43]

4. Duplications and Omissions

Section 56A(c)(15)(A) authorizes regulations "to prevent the omission or duplication of any item," if the Secretary determines that such regulations are necessary to carry out the purposes of the section. As a general matter, we believe that duplications or omissions in book income should be avoided, since the apparent purpose of section 56A is to impose a minimum tax on all book income of applicable corporations once and only once.

However, in the absence of regulations, the specific rules of section 56A could require taxpayers to duplicate items of income or omit items of deduction, including, for example, the double inclusion of income of a CFC that is paid up to the U.S. Shareholder as a dividend. Similarly, the specific rules of section 56A might permit taxpayers to omit some items of book income, or duplicate some items of book deduction, in a manner that is inconsistent with the purposes of the section.

Section 9.02(8) of the Notice asks for comments on whether there can be duplication or omission as a result of the application of section 52(a) and (b) under section 59(k)(1)(D). However, we believe the issue is much broader and that it will likely never be possible for regulations to identify all cases of duplications or omissions of book income that should be corrected.

Consequently, to protect both taxpayers from inappropriate duplications of income (and omissions of deductions) and the government from inappropriate omissions of income (and duplication of deductions), we recommend that guidance provide that: (i) as a general rule, section 56A must be applied in a manner to prevent duplications and omissions of book income; (ii) in the absence of an applicable regulation, taxpayers may take any reasonable approach to prevent duplications of income and omissions of deductions, and must take a reasonable approach to prevent omissions of income and duplication of deductions, and (iii) any such approach taken by taxpayers must be used consistently, will be treated as a method of accounting, and must clearly reflect income.[44]

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applies under section 172(a). Second, again, in our view, a limitation on AFSI carryovers would be appropriate if an AFSI loss arose in a taxable year in which regular income tax NOL carrybacks were allowed.

[43] *See* note 41 above on coordinating the lookback periods for reorganizations and AFSI losses.

[44] Adopting such a rule would not preclude Treasury and the Service from adopting specific rules to govern common instances of duplication and omission (*e.g.*, the basis adjustments in respect of Covered Nonrecognition Transactions already contemplated by the Notice). But we believe that the complexity of the financial accounting rules (and the myriad of ways that the rules can vary even between GAAP and IFRS) that a general anti-duplication/omission rule

5. Differing Accounting Years and Taxable Years

Under section 59(k), a corporation is an applicable corporation to the extent its average annual AFSI over the testing period exceeds $1 billion. Likewise, an applicable corporation's CAMT liability is calculated based on that corporation's AFSI for that *taxable* year. Accordingly, we believe guidance is necessary to address how AFSI is determined in situations where a corporation's financial accounting or "fiscal" year differs from its taxable year. Although we believe that Treasury and the Service have sufficient regulatory authority to address this issue, the statute does not suggest a specific approach.[45] As discussed in this Part II.B.1 we believe the best approach differs for purposes of determining applicable corporation status and determining CAMT liability. Across the approaches we consider, there are trade-offs between administrability and the precision with which AFSI matches taxable income, and we believe that precision is comparatively more important feature for purposes of determining CAMT liability (as opposed to applicable corporation status).

a. Differing Years and Applicable Corporation Status

For purposes of determining applicable corporation status, we believe the best approach is to use AFSI for the fiscal year ending within the relevant taxable year.[46] For instance, if corporation X has a taxable year ending December 31 and a fiscal year ending June 30, X would determine applicable corporation status for its 2023 tax year by looking to its AFSI for fiscal years ending June 30, 2020, June 30, 2021, and June 30, 2022.[47] We note that, for purposes of the 2023 taxable year, the Notice's simplified method for determining applicable corporation status allows taxpayers to look to the three-year period ending during the relevant taxable year.[48]

Beyond 2023, we believe that our recommended rule is easier to implement yet just as precise for purposes of determining applicable corporation status as compared to the other potential methods described below. As we discuss below, this will mean that the relevant year for purposes of determining applicable corporation status will cover certain periods (and omit other periods) that are taken into account for purposes of determining ordinary tax liability. This

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is appropriate and necessary. For instance, as discussed in Part II.B.4, duplications and omissions may result from transactions that are not between tax consolidated group members absent further guidance.

[45] This is evident in section 56A(b)'s definition of AFS that provides that "an applicable financial statement (as defined in section 451(b)(3) or as specified by the Secretary in regulations or other guidance...." *See also* I.R.C. § 56(c)(1) ("Appropriate adjustments shall be made in [AFSI] in any case in which an applicable financial statement covers a period other than the taxable year."). We also believe that the resolution of this issue is supported by the general grant of authority in section 56A(e).

[46] As noted below, the annualization rule for short taxable years can produce unusual results (and opportunities for abuse) in some circumstances.

[47] We note that Treas. Reg. § 1.59A-2(c)(3), which governs aggregation in connection with the base erosion and anti-abuse tax rules of section 59A (*i.e.*, the "**BEAT**"), allows for aggregation within groups to be based on the group members' taxable years ending within the parent's taxable year. In our view, this is appropriate because, as is the case in determining applicable corporation status, there is no need to match the fiscal and taxable years to fulfill the purposes of the BEAT.

[48] Notice § 5.03(2)(d). *See also* Notice § 5.03(3)(b), Ex. 2.

is not problematic in the context of a status determination because the test is intended to measure the extent of the corporation's activities over the three-year period, whereas determining CAMT liability requires a year-to-year comparison of the tentative minimum tax against regular tax liability.

If Treasury and the Service allow taxpayers to use the other methods discussed below for purposes of determining applicable corporation status, we believe that a single method chosen by the taxpayer should be used consistently to determine applicable corporation status from year to year (with a change in method subject to approval by the Commissioner), so that, for example, one method cannot be used to avoid such status in 2024 if another method was used to avoid such status in 2023.

b. Differing Years and CAMT Liability

The issue of differing fiscal and taxable years in connection with the calculation of CAMT liability of an applicable corporation is challenging. Helpfully, regulations under section 451 address similar questions and allow for three possible methods of performing this allocation:[49]

- The taxpayer may compute AFS revenue based on an interim closing of the books for accounting purposes, thereby conforming the mismatching accounting years to the single taxable year;
- The taxpayer may include a pro rata portion of AFS revenue for each overlapping year (with an estimate for the most recent year if no AFS has been prepared at that time); or
- If a taxpayer's fiscal year ends five or more months after the end of its taxable year, the taxpayer may compute AFS revenue for the taxable year based on the AFS revenue reported on the AFS prepared for the fiscal year ending within the relevant taxable year.

We discuss these approaches as applied to the allocation of AFSI below.

(i) Interim Closing of the Books

Theoretically, an interim closing of the books would produce the most precise matching of AFSI and regular taxable income. That said, performing an interim closing of the books may be administratively difficult and doing so may be more appropriate for AFS revenue (a gross item) than for AFSI (a net item) — for instance, if income is included early in the year and a

[49] *See* Treas. Reg. § 1.451-3(h)(4). One could potentially read section 56A(b) as incorporating these rules by virtue of the reference to "regulations," although the better reading, in our view, is that the reference to section 451(b)(3) was included primarily to identify the relevant financial statements and not for other ancillary rules such as those concerning year mismatches. We note also that the purpose of section 451(b)(3) differs substantially from the apparent purposes of the CAMT as section 451 is concerned only with the timing of AFS revenue inclusion.

deduction is incurred late in the year, an interim closing could distort net income for the short period.[50]

(ii) Proration

A proration method has clear advantages in that it is comparatively easy to implement and allows for offsetting of income and loss that accrue at different times during the year. However, an estimate in some circumstances may be inaccurate. Presumably, in that case, the taxpayer would have to file an amended return that reflects the appropriate amount of AFSI.[51]

(iii) Fiscal Year Ending within the Taxable Year

This method is easiest to implement, but is the most inaccurate and may cause the AFSI consequences of significant, non-ordinary transactions to impact a different taxable year than under regular tax principles. It may be possible to accept this deviation if its use is restricted to fiscal years ending no more than six months prior to the end of the associated taxable year as this would minimize the possibility of an extraordinary event occurring in different taxable and fiscal years and reflect the fact that it may be more difficult to use the alternative methods where there is a shorter "stub" fiscal year ending as of the close of the taxable year. In addition, Former Treas. Reg. § 1.56-1(b)(4) limited the use of this method under the prior CAMT to circumstances where the proration method resulted in tax being shown as due.[52]

Thus, we recommend allowing taxpayers to elect to employ either the interim-closing-of-the-books method or the proration method for purposes of computing CAMT liability, but only if the proration method has an exception for extraordinary transactions.[53] Regardless of the approach Treasury and the Service take, we believe that the same method should be used consistently by the taxpayer, with a change in method subject to approval by the Commissioner.[54]

c. Short Taxable Years

(i) Applicable Corporation Status

For purposes of determining status as an applicable corporation under section 59(k)(1)(E)(ii), a short taxable year of a corporation is annualized by "multiplying the adjusted

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[50] Under the prior corporate alternative minimum tax (the "**prior CAMT**"), former Treas. Reg. § 1.56-1(b)(4) did not allow for short-period allocation based on an interim closing of the books. T.D. 8307, 55 Fed. Reg. 33,676, 33,676 (Aug. 17, 1990).

[51] The prior CAMT, under Former Treas. Reg. § 1.56-1(b)(4), permitted the proration approach with an estimate. If that estimate proved to be wrong *and correcting that estimate would increase the amount of tax due*, the taxpayer was required to amend the return and pay the additional tax.

[52] Former Treas. Reg. § 1.56-1(b)(4)(iii).

[53] *See, e.g.*, Treas. Reg. § 1.1502-76(b)(2)(ii).

[54] *See, e.g.*, Treas. Reg. § 1.451-3(l) (change requires consent under section 446 principles).

financial statement income for the short period by 12 and dividing the result by the number of months in the short period."[55] This rule can produce unusual results when a transaction creates two short taxable years in a single 12-month period. For instance, if a transaction causes a taxable year to end (*e.g.*, by virtue of joining a consolidated group), the AFSI in the year of the closing appears to count doubly for purposes of the average AFSI threshold. It is not clear to us whether this is the intent of section 59(k)(1)(E)(ii). We recommend Treasury and the Service consider issuing guidance limiting the application of the annualization rule in these circumstances.

In addition, this annualization rule could be subject to manipulation in an attempt to avoid characterization as an applicable corporation. For this reason, we believe that Treasury and the Service should consider adopting an anti-abuse rule that gives the Commissioner authority to require a different period for the determination if the corporation has more than one short year within some period (such as six years) or executes a transaction that closes its taxable year for the purposes of avoiding the CAMT.

(ii) CAMT Liability

The statute, however, does not address how short taxable years should be taken into account for purposes of calculating CAMT liability. Although section 59(k)(1)(E)(ii) does not explicitly state that it applies solely for purposes of section 59(k), applying the rule generally would produce anomalous results. For instance, if a corporation had $2 billion of AFSI for 2023 ($1 billion allocable to each half of the year), then annualizing AFSI would result in $2 billion of AFSI for each half of the year, this would effectively double the potential minimum tax liability of the corporation for 2023. Accordingly, in our view, in situations where the short taxable year is not matched by a short fiscal year, some form of allocation from the applicable AFS to the relevant taxable period should apply so that the minimum tax liability can be compared to the taxpayer's regular tax liability.

We recommend that the same principles that are adopted for purposes of differing accounting (*i.e.* fiscal) and taxable years also apply to short taxable years. Practically, this would require either an interim closing of the books or the proration method, subject to an exception for extraordinary transactions.

C. Bankruptcy and Insolvency Comments

1. Treatment of Bankrupt or Insolvent Corporations

a. CODI

We make the following incremental recommendations to the Notice's treatment of book CODI for CAMT purposes.

[55] I.R.C. § 59(k)(1)(E)(ii).

(i) CAMT CODI Where No CODI Realized for Tax Purposes

The Notice excludes, for CAMT purposes, CODI that has been realized but excluded from income for tax purposes. The Notice does not address CODI that is recognized for book purposes but is not realized for tax purposes. There are a number of situations where this may arise.

First, a debt instrument with a face amount of $100x may have an adjusted issue price of $80x for tax purposes, but be carried at $100x for book purposes. This could arise, among other reasons, as a result of a debt-for-debt exchange or the application of the investment unit rules (in a way that differs from the application of somewhat related book rules). If such debt instrument received $50x of recovery, there would be $30x of CODI (which would be excluded for tax purposes) and $50x of CODI for book purposes. Under the Notice's current approach, only $30x of the CODI would be excluded for CAMT purposes. In our view, the full $50x of book CODI should be excluded for CAMT purposes.

Second, section 108(e)(2) or (e)(6) may operate to prevent the realization of CODI in the first instance, rather than causing such CODI to be realized but then excluded from income.[56] If book CODI is attributable to CODI that goes unrealized as a result of the application of these provisions, in our view, it should be excluded from CAMT.

Consistent with the above, we recommend that any book CODI resulting from a transaction in which such CODI would be excluded from income, or simply not be realized, for regular tax purposes, be excluded from AFSI.

(ii) CODI With Respect to Obligations Not Treated as Debt for Tax Purposes, and Vice Versa

Certain kinds of instruments may give rise to book CODI where such instruments would not be treated as debt for regular tax purposes. Two approaches could be used. The regular tax characterization of the instrument could control, in which case any book CODI would be excluded from AFSI. Alternatively, the book characterization of the instrument could control, and the resulting book CODI would be excluded if another exclusion provision applies to it. If this is the approach that is taken, the instrument would need to be treated as a liability for purposes of evaluating whether any other exclusion (*e.g.*, insolvency) applies.

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[56] For instance, "future rent" obligations may be reflected as a liability on GAAP balance sheets. That type of liability essentially reflects the expected rent obligations on a long-term lease (and also is reflective of what amounts to "make-whole" provisions for an early lease termination). Because these payments are actually deductible for federal tax purposes when paid, section 108(e)(2) provides that if these obligation arise under relevant commercial law (e.g., as a result of an early lease termination), there is no CODI if they are cancelled. The same is true of discharged pension obligations. In the context of Section 108(e)(6), "shareholder loans" (i.e., loans owed by a subsidiary to its shareholder, which can arise frequently in the context of multinational groups) may be contributed to the capital of the subsidiary rather than cancelled. If certain requirements are navigated, section 108(e)(6) provides that the capital contribution is not taxable, even though the subsidiary has an accession to wealth. In both of these contexts, we do not believe that book gain should be included in the AFSI calculation.

The same issues are present in the reverse situation, where instruments are debt for regular tax purposes and equity for book purposes. We believe the same approach should be applied here as is applied to instruments that are debt for book purposes and equity for tax purposes.

(iii) Timing of CODI

CODI with respect to a particular debt instrument may be realized at different times for tax and book purposes. There are numerous situations in which this could occur. CODI may be recognized for tax purposes in a debt-for-debt exchange in Year 1—including as a result of a deemed exchange under Treas. Reg. § 1.1001-3—where the adjusted issue price of the new debt is less than the face amount of the new debt. The same substantive situation could arise as a result of section 108(e)(4). The insolvency exclusion may then apply to such exchange. The CODI generated for tax purposes may exceed CODI generated for book purposes to the extent the adjusted issue price of the new debt is less than the book carrying value of the new debt if the relevant financial accounting standard does not require a similar adjustment. Under the Notice, book income realized after Year 1 would not be excluded for CAMT purposes, because the Notice excludes CODI only when it is excluded for tax purposes. Even from a less substantive perspective, this issue presents itself where book and tax years are different.

The opposite situation could arise where the realization of CODI for regular tax purposes is deferred (*e.g.*, in certain circumstances where distributions are made over time) but realized immediately for book purposes.

We recommend that guidance provide for the exclusion of book CODI from AFSI regardless of such timing differences so long as such CODI would be excluded from income for regular tax purposes if it had been realized at such time or it is attributable to the same event that gave rise to CODI that was excluded for regular tax purposes in a different period.

(iv) CAMT Attribute Reduction in Consolidated Groups in General

Treas. Reg. § 1.1502-28 sets forth a complex hybrid approach to attribute reduction for consolidated group members, pursuant to which CODI first reduces attributes of the debt issuer, and then a variety of mechanical rules apply to reduce certain tax attributes, including tax basis, elsewhere in the consolidated group. These rules put significant weight on the entity-by-entity location of tax attributes, intercompany stock basis, and intercompany claims. In the tax context, all of this information is relevant to complying with other consolidated tax rules, but for financial accounting purposes, this information is not relevant.

We recommend that attribute reduction for CAMT purposes should, like other CAMT determinations, be made on a purely single-entity basis (within the tax consolidated group with respect to which the book CODI arises). As illustrated below, this issue is particularly prevalent under the Notice's methodology for determining how many CAMT attributes are subject to reduction.

This general approach could result in some distortions of CAMT outcomes in subsequent asset and entity dispositions. The hybrid approach was adopted under Treas. Reg. § 1.1502-28 rather than a full single-entity approach for this reason. Our recommendation here hinges on administrability. Following Treas. Reg. § 1.1502-28 principles for CAMT purposes would essentially require the imposition of a completely separate consolidated book/tax regime (which the Notice otherwise, properly in our view, declines to do). We believe that creating a similar approach for CAMT purposes is not worth the accompanying administrability challenges and taxpayer compliance costs.

(v) Amount of CAMT Attribute Reduction

Under the Notice, CAMT attributes are reduced by excluded CODI in an amount that is equal to the amount of attributes that were reduced for tax purposes (the "**Section 108(b) Reduction Amount**"), rather than on an independent CAMT basis amount. This leads to a number of potential distortions.

First, this may result in a situation where CAMT tax attributes that would otherwise be subject to reduction are not reduced. The deviation could be attributable to, among other things: (i) application of the principles in Treas. Reg. § 1.1502-28, including entity-by-entity calculations of the liability floor rule under section 1017 or the location of assets within the consolidated group; or (ii) situations where tax basis in assets is less than book basis in assets because of differences in depreciation and amortization schedules of a kind that are not otherwise equalized by section 56A(c).

Second, attribute reduction for regular tax purposes could exceed the amount that would be determined on a single-entity basis. This could happen, for example, if third-party debt is issued by subsidiaries of the entity that incurs CODI. For CAMT purposes, the issuer's own debt and the debt of its subsidiaries would be taken into account for determining the liability floor. However, for regular tax purposes, only the issuer's own debt would be taken into account in determining the liability floor at the issuer level, with the subsidiary's liability determining its separate liability floor amount. If the subsidiary has allocable attributes other than asset tax basis, the subsidiary's liabilities will not shield those attributes for tax purposes, with the net result being a tax attribute reduction amount that exceeds the attribute reduction that would occur for book purposes.

Third, under the Notice, it is possible that CAMT attributes would be reduced by an amount that exceeds CAMT CODI. For example, in a scenario where $100x face of debt is satisfied for $80x of new debt that has a $50x issue price for tax purposes, there may be $50x of regular tax attribute reduction, but there is only $20x of CODI for CAMT purposes. In such a circumstance, only $20x of CAMT attributes should be reduced, not $50x.

We recommend that, rather than grappling with these anomalous results, CAMT attribute reduction be determined separately from regular tax attribute reduction. As a consequence, CAMT attributes would generally be subject to reduction in an amount equal to the amount of CODI excluded for CAMT purposes, subject to book basis in assets being protected by the CAMT liability floor.

If Treasury and the Service decline to depart from the Section 108(b) Reduction Amount construct, the definition should be clarified to avoid duplicated amounts attributable to the application of Treas. Reg. § 1.1502-28. As the Notice is currently drafted, if P incurs $100x of CODI that reduces stock basis in S by $100x, and S has $100x of inside attribute reduction, the Section 108(b) Reduction Amount could be interpreted to be $200x because P has $100x of CODI that reduces tax attributes (the stock of S) and S is deemed to have another $100x of CODI pursuant to Treas. Reg. § 1.1502-28(a)(3)(ii). This seems to be unintentional under the Notice.

If Treasury and the Service choose to depart from the Section 108(b) Reduction Amount construct, in our view, additional guidance will be necessary to apply the insolvency exclusion from a financial accounting perspective. One approach could be to strictly follow financial accounting, compare book assets to book liabilities, and use that comparison to determine the extent of the insolvency. However, we believe the better approach would be to rely on the amount of insolvency that is determined for regular tax purposes. There are several reasons in our view, that support this approach. The main reason is that distinctions between the treatment of various items (*e.g.*, "future" obligations, contingent obligations, mismatches on the treatment of an instrument as debt or equity for book and tax purposes, inconsistent treatment of an item as a liability for book and tax purposes, and the treatment of deferred tax assets and liabilities) could render "book insolvency" determinations more challenging. Additionally, book valuations are typically "trailing" based on the timing of impairment analyses, contrary to tax insolvency determinations that are made on a "real time" basis, making book value a difficult proxy to use for real-time insolvency determinations. Ultimately, in our view, the difficulty in making insolvency determinations based on financial accounting values outweighs the benefits that may exist to using the book "base" for this purpose.

(vi) CAMT Attributes Subject to Reduction

Rather than enumerating a specific list of CAMT attributes subject to reduction, we recommend a qualitative approach that provides for the reduction of any tax attributes that are of a similar nature to attributes subject to reduction under section 108. Together with this qualitative rule, specific illustrative attributes could be listed, including financial statement NOLs, CAMT basis in assets, and CAMT FTC. We recommend specifically excluding certain items that do not have a section 108 analogue, including cash, current and deferred tax assets, and similar items.

We recommend that CAMT attribute reduction *not* be tied to equivalent reductions of regular tax attributes. For example, suppose (i) a debtor has $200x of excluded CODI for regular tax and CAMT purposes; (ii) the debtor has $100x of NOL and $100x of tax basis for regular tax purposes, but $50x of NOL and $150x of book basis for CAMT purposes; and (3) for regular tax purposes, the debtor's NOL and tax basis is each reduced to $0. In this situation, we recommend that, for CAMT purposes, the debtor's NOL and tax basis be reduced fully to $0, rather than limiting the reduction in book basis to $100x (because the reduction of tax basis was limited to $100x). These determinations would, of course, be subject to the separate tax and book liability floor determinations referenced above.

For regular tax purposes, attribute reduction does not flow down into the "inside" attributes of non-consolidated entities (either partnerships or corporations), except in the case of an electing partnership. While in our view imperfect, we recommend that for CAMT purposes, any attribute that is included in the consolidated book results of the entity that incurred CODI should be subject to reduction for CAMT purposes, even if the entity is not consolidated for tax purposes, unless the entity is included in a separate consolidated tax group. As an example, assume that P owns 80% of the vote and 60% of the value of S, resulting in consolidation for book but not tax purposes. S necessarily would not be a member of any other consolidated tax group. In this situation, book CODI arising in P would reduce book attributes of S on a consolidated basis. By contrast, assume foreign P owns 100% of domestic S1 and 100% of domestic S2. Book CODI arises in S1. The attributes of S2 would not be subject to reduction. In our view, this approach generally preserves the balance between (i) generally making CAMT determinations on a single-entity basis; and (ii) respecting that CAMT groups that have multiple tax consolidated groups generally must make bifurcated determinations among the tax consolidated groups.

This approach is somewhat unfavorable to the minority owners of entities that are part of an AFS Group but not a tax consolidated group. However, that distortive economic effect already exists (in that the entity essentially generates CAMT liability that it might not generate on a standalone basis) and can be addressed through tax sharing agreements.[57]

(a) Availability of Section 108(b)(5) Election

We recommend that section 108(b)(5) apply for purposes of the CAMT. Various approaches to this could be taken, and will need to address: (i) the fact that for regular tax purposes, section 108(b)(5) is elective as to amount and the election can be made separately for separate entities; and (ii) basis in depreciable asset basis for CAMT purposes may be significantly different from basis in depreciable assets for regular tax purposes.

With respect to (i), we believe, to the greatest extent possible, conformity between financial accounting and tax treatment should be required. As an initial matter, that would require that section 108(b)(5) apply for CAMT purposes if it is elected for regular tax purposes. From there, one potential approach would be a percentage-based approach, *i.e.*, if the section 108(b)(5) election is made for a specific percentage of regular excluded CODI in a given year (taking into account all excluded CODI for all entities in the group) then the section 108(b)(5) election must also be made for that same percentage of CAMT CODI. Alternatively, a gross amount approach could be applied.

With respect to (ii), if a particular approach would result in the CAMT section 108(b)(5) amount exceeding available CAMT basis in depreciable assets, any remaining CAMT CODI would proceed through the remaining CAMT CODI attribute reduction waterfall.

(b) Ordering of Section 108(b) Attribute Reduction

As discussed above, the amount and type of attributes that could be reduced under section 108 for regular tax and CAMT purposes could vary. For purposes of CAMT, there are two potentially relevant sets of asset basis for Section 168 Property: tax basis (for purposes of

[57] This is similar to the current distortive economic effects of CODI that "tiers down" into a consolidated, non-wholly-owned subsidiary under the regular tax rules, though agreements often do not address this issue.

calculating depreciation deductions) and "modified CAMT book basis," for purposes of calculating AFSI gain or loss on the disposition of property. This modified basis may, of course, deviate from actual book basis because of the application of the CODI rules and the approach taken to purchase accounting, redetermination gain, fresh start accounting, and others.

Because a taxpayer may never dispose of Section 168 Property, under the normal attribute reduction ordering rules, a taxpayer could be "harmed twice" for CAMT purposes by a single dollar of CODI where it reduces basis in Section 168 Property for regular tax purposes but it reduces another attribute, such as CAMT NOL, for CAMT purposes. For example, if a taxpayer has $100x of CODI for book and tax purposes, and that CODI reduces $100x of section 168 basis for regular tax purposes and $100x of CAMT NOL for CAMT purposes, the taxpayer would lose $100x of AFSI depreciation *and* $100x of CAMT NOL. While the taxpayer in this scenario does have $100x of book basis in the Section 168 Property, if that property is never sold (and perhaps even if that property is sold if the rule in Section 4.07 of the Notice is retained), the taxpayer would never receive a benefit from that book basis.

One way to resolve this potential "double counting" issue would be to modify the general attribute reduction ordering rules. Under this approach, CAMT basis reduction could apply first to Section 168 Property (regardless of whether a section 108(b)(5) election is made) to the lesser of (i) the book basis in such property and (ii) the amount of basis reduction in Section 168 Property for regular tax purposes. This approach may provide taxpayers with inappropriate timing benefits under certain circumstances. For example, it could result in basis being reduced in a comparatively long-lived section 168 asset instead of CAMT NOL that could be used more quickly. Although such a scenario is possible with a section 108(b)(5) election in place, our recommendation with respect to section 108(b)(5) could limit this type of planning. In any case, if a CAMT section 108(b)(5) election was made, it is possible that assets with shorter lives would be subject to reduction.

Alternatively, AFSI could be adjusted to "back out" the reduced AFSI depreciation resulting from the regular tax reduction in Section 168 Property to the extent a different CAMT attribute (such as CAMT NOLs or the book basis in a different asset) is reduced. This could be overly favorable where the separate asset is itself book basis in an asset that is not sold, so there would likely need to be a corresponding reduction to the AFSI depreciation with respect to the alternative asset.

While we make no specific recommendation for how to address this double counting issue, we do believe that Treasury and the Service should publish guidance to address the issue.

b. Bankruptcy Emergence Issues

Subject to the discussion in Part II.C.1.b(iv) below around a potential technical glitch attributable to the incorporation of the definition of "Party," Section 3.07 of the Notice broadly exempts book income or loss attributable to bankruptcy emergence transactions and requires corresponding adjustments to asset basis for CAMT purposes.

(i) Taxable Transactions and "G" Reorganizations with Gain Recognition

A bankrupt corporation's emergence from bankruptcy is often structured as a taxable disposition of assets to its creditors—*i.e.*, a "Bruno's transaction." In such cases, book income might exceed taxable income, or available book attributes may be less than available tax attributes. For example, if assets with a book and tax basis of $0 and value of $40x are transferred in satisfaction of $100x of recourse debt, there will be $40x of taxable gain and $60x of CODI. However, for book purposes, there might be $100x of reflected book income without allocating between book gain on the assets and book CODI. In somewhat less frequent situations, a debtor engaged in a "G" reorganization (whether acquisitive or divisive) might recognize income with respect to a part of the emergence transaction.[58]

Under the Notice, it would appear to be the case that, even though the transaction (or part of the transaction) was taxable for regular tax purposes, it is not taxable for CAMT purposes. Going forward, the emerged entity (and subsequent acquiring entities) would have transferred basis for CAMT purposes but exchanged basis for regular tax purposes. Members of the Section have different views on whether this is the proper outcome. Certain members believe that, under the "don't kick a person while they're down" theory that often informs bankruptcy-specific tax rules, all such transactions should be excluded from AFSI. Moreover, these members highlight that the policy drivers behind the CAMT were not aimed at bankrupt companies.

Other members believe that, as a general matter, bankrupt companies are not excluded from the tax consequences of transactions that are partially or wholly taxable, and there is not a compelling reason to deviate from those consequences for CAMT purposes. Further, if transactions that are taxable for regular tax purposes are not taxable for CAMT purposes, an issue arises as to whether it is appropriate for book assets to avoid CAMT attribute reduction as a result of CODI when they are transferred to a new entity in a manner other than a section 381 transaction.[59] Finally, applying the rule would increase the number of circumstances in which an applicable corporation could be found to have a negative AFSI basis in its assets, though this is an issue that extends beyond the restructuring space and, in our view, will need to be addressed more broadly.

For "G" reorganizations, the rules otherwise applicable to certain specified nonrecognition transactions under the Notice where gain or loss is exempt in full from the regular tax calculation ("**Covered Nonrecognition Transactions**") would then be applied to determine how much of any book gain would be included in AFSI determinations.

[58] In one particularly well-known example that was subject to a private letter ruling, a debtor consummated a divisive spinoff that was generally tax-free, but, as part of the emergence transactions, transferred certain assets in a nonqualifying section 351 exchange. *See* P.L.R. 201644018 (Oct. 28, 2016). In other situations, gain might be recognized where most but not all assets are transferred in an acquisitive "G" reorganization and the remaining assets are disposed of in a taxable transaction.

[59] As we note below, as a general matter, we recommend that CAMT follow the regular tax rule that CODI does not follow to a new entity that is not a section 381 successor, even if such entity otherwise carries CAMT history forward under the general CAMT successor rules.

If final rules do subject taxable emergence transactions to CAMT, guidance should make it clear that, even if book income in this case is not "bifurcated" between book gain on the assets (*i.e.*, the difference between book basis and fair market value), on the one hand, and book CODI, on the other hand, taxpayers are permitted to do that allocation, assuming that the transaction is one in which such an allocation occurs for tax purposes. In other words, if the bankruptcy emergence involves a situation triggering "*Tufts* gain" for regular tax purposes,[60] then there should be no bifurcation between book asset gain and CODI.

(ii) Clarifications of "Emergence from Bankruptcy" Exception

"Emergence from bankruptcy" is not defined in the Notice, nor is it clear whether the Notice intended to incorporate the concept specifically from GAAP. Bankruptcy practitioners would generally treat this as a term of art that specifically applies to the debtor consummating a bankruptcy plan of reorganization. However, there are other transactions that colloquially constitute "emergence from bankruptcy." A debtor may dispose of some or all of its assets, either to creditors or to a third-party purchaser, in a transaction under section 363 of the Bankruptcy Code ("**Section 363 Sale**"), with the debtor's plan of reorganization providing that the proceeds of such disposition will be distributed to creditors and the debtor entity itself will be wound down. As discussed above, there is some question about the general application of the "emergence from bankruptcy" exception and whether it applies to taxable transactions.

Regardless of how that question is addressed, we generally believe that Section 363 Sales should be treated the same as transactions consummated under a bankruptcy plan of reorganization. Accordingly, if Treasury and the Service exclude taxable transactions under a bankruptcy plan of reorganization from AFSI (with the corresponding carryover AFSI basis), we believe the same treatment should apply to Section 363 Sale transactions. We also believe the same result should occur where a Section 363 Sale is followed by a so-called "structured dismissal," where the debtor does not confirm a bankruptcy plan of reorganization and is simply wound down under state law, or a conversion to a liquidation under Chapter 7 of the Bankruptcy Code.

Where such transactions are tax-free, we do not believe there is any policy reason to exclude them from a "bankruptcy emergence exception." As a general matter, whether a bankruptcy transaction is consummated pursuant to a bankruptcy plan of reorganization or a Section 363 Sale has no federal tax consequences—it all comes down to whether a transaction is taxable or tax-free. Indeed, many "G" reorganizations are consummated as Section 363 Sales.[61]

Additionally, Section 3.07 of the Notice is defined by reference to a group of entities whose financial results are reported on a single AFS (an "**AFS Group**"). It is relatively common for some, but not all, entities of a corporate group to file for bankruptcy or to emerge from

[60] *Commissioner v. Tufts*, 461 U.S. 300 (1983) (holding that gain equal to the amount of outstanding debt will be recognized on the disposition of an asset subject to a nonrecourse liability, regardless of the value of the relevant asset, rather than recognition of gain up to the value of the asset with CODI for the residual amount).

[61] *See, e.g., In re GMC*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009).

bankruptcy. The parent of an AFS Group is not always the entity filing for bankruptcy protection. In some cases, a subsidiary of an AFS Group, rather than the parent corporation, may file for bankruptcy. In other cases, a parent may file for bankruptcy but one or more subsidiaries that are part of an AFS Group do not file (for non-tax reasons). Further, in other cases, some members of an AFS Group may be disposed of while other members emerge from bankruptcy or are liquidated. Thus, we recommend that the bankruptcy exception apply if it is attributable to one or more members of an AFS Group filing for bankruptcy protection—even if the other members of the group have not filed for bankruptcy.[62] In the event that Treasury and the Service do not provide guidance consistent with this recommendation, we recommend that if the parent corporation of an AFS Group is in bankruptcy, any book implications should be subject to the bankruptcy exception.

(iii) Application of CODI to Emerged Entity

We recommend guidance to clarify that, as is the case for regular tax CODI, CAMT CODI does not reduce tax attributes of an acquiring entity unless the transaction is a section 381 transaction (*e.g.*, an acquisitive "G" reorganization).

(iv) Clarifications With Respect to Application of Section 3.07(2) to a "Party"

Section 3.07(2) of the Notice, in our view, appropriately requires that adjustments be made to the applicable AFS of an entity emerging from bankruptcy to take account of the effect of Section 3.07(1) of the Notice going forward. However, Section 3.07(2) operates by reference to the "property of a Party" emerging from bankruptcy. Party is defined elsewhere in the Notice and generally applies to a participant or participant group (each a "**Party**") in a "covered transaction" under the Notice (a "**Covered Transaction**"). We recommend modifying Section 3.07(2) of the Notice so that it does not rely on the definition of Party and instead applies under any circumstance where an entity subject to the CAMT consummates a bankruptcy insolvency workout.[63]

Similarly, because the provision currently applies only to the bankrupt company that is a Party, the conformity achieved under Section 3.07(2) of the Notice does not currently appear to apply if the bankrupt entity subsequently participates in a Covered Transaction. In other words, an acquirer would *not* be required (or permitted) to make the adjustments called for under

[62] The CODI bankruptcy exclusion under section 108 applies so long as the corporate entity with CODI is in bankruptcy (subject to some complexity where disregarded entities are implicated). In the context of section 382(l)(5) and (6), the Service has issued several private letter rulings indicating that those special rules can be applied where the consolidated parent company is in bankruptcy but some or all of its subsidiaries are not. *See*, *e.g.*, P.L.R. 201051019 (Sept. 14, 2010); P.L.R. 201306003 (Oct. 25, 2012); P.L.R. 201435003 (May 21, 2014). Notably, these section 382-related rulings have not addressed a situation where a parent company is *not* in bankruptcy.

[63] It is somewhat unclear whether a "standalone" reorganization, pursuant to which creditors of a company receive equity in exchange for their claims and no assets are transferred, is a "Covered Transaction" under the current definitions. Though these transactions are often thought of as recapitalizations under section 354 and no gain or loss is recognized by a relevant corporation under section 1032, these transactions do give rise to income (albeit income that is either potentially or actually excludable under section 108(b)), and often do not satisfy the requirements of section 354 from the perspective of some or all of the creditors.

Section 3.07(2) of the Notice. In our view, this would result in the kind of "whipsaws" that the other Covered Transaction provisions are intended to avoid.

(v) Extension of "Emergence from Bankruptcy" Exception to Insolvent Out-of-Court Workouts

As a general matter of bankruptcy policy, debtors should not be encouraged to file for bankruptcy instead of doing out-of-court workouts. The income tax rules deviate from this principle in a variety of ways (*e.g.*, section 368(a)(1)(G), section 382(l)(5) and (l)(6)). In our view, where possible, regulatory guidance should be crafted in a way that does not favor in-court workouts over out-of-court workouts.

Accordingly, we recommend that the bankruptcy emergence exclusion—however it is ultimately scoped with respect to the issues discussed above—also apply to insolvent workouts. For purposes of determining insolvency for this purpose, a safe harbor could be adopted pursuant to which debtors are entitled to presume a workout is an insolvency workout if pre-transaction equity holders hold less than a threshold amount of pro forma equity of the company (or an acquiring entity) after the transaction and the transaction results in partial or full satisfaction of creditor claims (whether in company equity or in other consideration provided by an acquirer). This threshold should be low, but enough to acknowledge that existing equity holders commonly do preserve some of their equity in out-of-court workout transactions. Debtors should also be entitled to rely on the exclusion if they can demonstrate, through an applicable valuation analysis, that the debtor was insolvent before the relevant transaction and was rendered solvent (or released from all of its liabilities and wound down) by the transaction.

If Treasury and the Service choose to not apply the bankruptcy emergence exception to taxable transactions (as discussed above), then we would limit our proposal to any redetermination gain or loss that might occur as a result of an out-of-court insolvency workout involving an equitization of creditors (which equitization might be accomplished through a recapitalization or section 351 transaction in which the company's assets are not disposed of at all).[64] The same result could be reached by treating equitization of this nature as a Covered Nonrecognition Transaction.

c. General Issues

(i) Book Deconsolidation Resulting from a Bankruptcy Filing

When a subsidiary or group of subsidiaries in an AFS Group files for bankruptcy but the reporting entity does not, that subsidiary generally is deconsolidated from the non-debtor parent AFS Group, at least during the pendency of the bankruptcy. If the subsidiary ultimately remains in the book group, the subsidiary will be re-consolidated for financial accounting purposes.

We believe that this AFS Group deconsolidation should be ignored for all CAMT purposes while the Chapter 11 proceedings of the subsidiary is pending, with the adjustment to

[64] We understand that fresh-start accounting itself does not apply to out-of-court transactions.

AFSI ignoring any resulting book gains or losses and to continue to include the subsidiary's financial results for AFSI determinations. We further believe that if the subsidiary ultimately leaves the relevant book group, the rules generally applicable to deconsolidations should be applied at that later point.

(ii) Treatment of Disregarded Entities, and Debtor Subsidiaries with Non-Debtor Reporting Entities

The CAMT as a general matter is applied on a single-entity basis. A question could arise with respect to how the bankruptcy and insolvency provisions apply where a member of an AFS Group is bankrupt or insolvent but other members of the AFS Group, potentially including the parent reporting entity, are not. We believe the proper approach is that the bankruptcy and insolvency rules should apply to any item that is attributable to a bankruptcy or insolvency workout, even if other members of the AFS Group are not in bankruptcy or insolvent.

With respect to entities that are disregarded for federal tax purposes, one of two approaches could apply. The general rule discussed above could apply, without regard to whether the disregarded entity's owner is itself bankrupt or insolvent. Alternatively, the rule that applies for regular tax purposes could be applied—that is the bankruptcy and insolvency rules look to the regarded owner of the disregarded entity. Though there are virtues to both approaches, we believe applying different rules for CAMT and regular tax purposes would unnecessarily deviate from the policy decisions that have already been made with respect to the appropriate treatment of disregarded entities and would result in unnecessary administrative complexity for taxpayers and the Service.

D. Corporate and Consolidated Group Comments

1. Consolidation/Deconsolidation Issues

a. Overview

Corporations frequently join and leave corporate groups as a result of merger and acquisition transactions, which can impact income and tax attributes. These issues are typically associated with affiliated groups of corporations filing a consolidated return under section 1502 ("**Section 1502 Group**"). However, in a CAMT environment, these issues can arise when corporations join or leave a controlled group of corporations under section 52(a) or (b) (a "**Section 52 Group**") or a group of corporations that are consolidated for book purposes (a "**Book Group**"). Below, we identify certain issues related to the interaction of the CAMT and the joining and leaving of a Section 52 Group or a Book Group, as the case may be.[65]

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[65] Many of the examples discussed below in this Part II.D discuss the accounting treatment of transactions based on GAAP principles. We note that many corporations (especially FPMGs) will report on the basis of IFRS, which may account for transactions in a substantially different way than GAAP and, in certain circumstances, lead to inappropriate results (to the taxpayer or the U.S. fisc, as the case may be) that may need to be addressed with targeted guidance.

b. Changes in Ownership

(i) Background

Under section 59(k)(1)(C), an applicable corporation ceases to be an applicable corporation if it either: (i) has a "change in ownership"; or (ii) has a specified number (to be determined by the Secretary and which shall, as appropriate, take into account the facts and circumstances of the taxpayer) of consecutive taxable years, including the most recent taxable year, in which the corporation does not meet the average annual AFSI threshold, and the Secretary determines it would be appropriate to cease treating the corporation as an applicable corporation. It is unclear what constitutes a "change in ownership" for purposes of the first prong of the section 59(k)(1)(C) test. Treasury and the Service have requested comments as to which transactions should be treated as a "change in ownership" for purposes of this rule.[66]

(ii) Recommendation

We believe that a "change in ownership" should be determined solely with respect to whether a corporation joins or leaves a Section 52 Group. This rule is appropriately broad and easier to implement than corresponding rules under section 355(e) or section 382. Finally, in our view, a disposition of assets (other than a disposition of substantially all of an applicable corporation's assets) should not constitute a "change in ownership" with respect to that corporation.

(iii) Discussion

A variety of tests are possible for purposes of determining when a corporation has a "change in ownership," such as:

- a test based solely on whether the corporation joins or leaves a Section 52 Group—rules that are consistent with those set forth in Section 3.04 of the Notice regarding Covered Transactions;[67]

- a 50% ownership change within three years under section 382, a determination that does not depend upon the existence of a "plan," only takes account of five percent shareholders, and treats a "public group" as a single shareholder; or

- a 50% ownership change under section 355(e)—a provision that requires a plan and takes account of all shareholders no matter how small, and which could be applied with or without the various presumptions and safe harbors in that section and related regulations.

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[66] Notice § 9.02(4).

[67] Under these rules, applicable corporation status terminates when a Target AFS Group or Target is acquired by an Acquirer AFS Group and the acquisition creates a Test Group composed of the two groups. The terms Target AFS Group, Target Acquirer AFS Group, and Test Group are each defined in Part II.D.1.c(ii).

We believe that a corporation joining or leaving a Section 52 Group should have a "change in ownership," even if there is only a very small actual change in ownership (*e.g.*, even from 50% to 50.1% ownership by another party). Section 59(k)(1)(D) generally provides that the AFSI of persons that are treated as a single employer under section 52(a) or section 52(b) is aggregated for purposes of determining whether those persons are applicable corporations.[68] Accordingly, we believe that "change in ownership" should likewise be defined by reference to section 52.[69]

Moreover, we do not think it is necessary or appropriate to determine whether a "change in ownership" has occurred based on the tests of sections 382 and 355(e). Indeed, these provisions are targeted at tracking shareholder ownership to prevent certain abuses. Section 382 is aimed at preventing loss corporations from trafficking their losses while section 355(e) is aimed at ensuring that historical shareholders retain control of the corporation. By contrast, section 59(k)(1)(C), in our view, only should be implicated if the AFSI profile of the relevant corporate entity has changed. This is frequently the case when an entity joins or leaves a group but not in the case of a sale from one passive shareholder to another. In addition, defining "change in ownership" solely by reference to section 52 is more administrable it does not require tracking ownership over a multiple-year period.

Finally, we believe that an applicable corporation should not have a "change in ownership" solely on account of its disposition of an asset. Indeed, an applicable corporation will remain part of a Section 52 Group following an asset disposition unless its stock is also transferred directly or indirectly by the parent of that group. That said, consistent with section 59(k)(1)(E)(iii),[70] we believe it is appropriate to treat a corporation that acquires substantially all of an applicable corporation's assets (whether pursuant to a section 381 transaction or otherwise) as having acquired such assets in a Covered Transaction.

c. Joining or Leaving a Section 52 Group

The remainder of this Part discusses the rules applicable to Covered Transactions set forth in section 3.04 of the Notice. We begin with a summary of the applicable provisions of the Notice and then discuss a few potential refinements to the Notice.

(i) Background

Under Section 3.04 of the Notice, if a corporation or one or more chains of entities connected through common ownership that acts as an acquirer (an "**Acquirer AFS Group**")

[68] The section 52 aggregation rules apply only for purposes of determining applicable corporation status and *not* for purposes of determining the entities' CAMT liabilities.

[69] We note that the Secretary has flexibility to limit the circumstances under which a change in Section 52 Group ownership results in a loss of applicable corporation status, because it may determine under section 59(k)(1)(C)(i)(1) the factors under which termination of status as an applicable corporation is appropriate. We discuss in Part II.D.1.b the circumstances under which a change in ownership should terminate applicable corporation status.

[70] Section 59(k)(1)(E)(iii) provides that references to an applicable corporation in section 59(k) shall include references to any predecessor of that corporation.

acquires a corporation or one or more chains of entities that acts as a target as described in the Notice (a "**Target AFS Group**") (or a single target that is within a Target AFS Group or comprises one such group (a "**Target**")) and creates a single Section 52 Group or FPMG (a "**Test Group**"), the applicable corporation status of the Target AFS Group or the Target, if any, will terminate.[71] For purposes of testing applicable corporation status in the future (including the year of the acquisition), the Test Group includes the AFSI of the Target AFS Group or, in the case of a Target exiting a Target AFS Group, the Target's allocable portion of the group's AFSI.[72] Any income allocated to Target by the Target AFS Group does not reduce the Target AFS Group's AFSI in future periods.[73]

Similar rules apply to a corporation or one or more chains of entities connected through common ownership that acts as a distributing corporation (a "**Distributing AFS Group**") in a section 355 or similar taxable transaction. If the corporation or one or more chains of entities whose stock is distributed by a Distributing AFS Group ("**Controlled**") is distributed out of the Distributing AFS Group, its applicable corporation status, if any, ceases and it is allocated a portion of the Distributing AFS Group's AFSI. The Distributing AFS Group's AFSI is not reduced by the AFSI allocated to Controlled nor is it otherwise affected by the distribution of Controlled stock.

(ii) Recommendations

We make the following recommendations regarding the Notice's treatment of entities joining or leaving a Section 52 Group:

- *Legal Form of Acquirer and Directionality*: The Covered Transaction rules should be adjusted so that applicable corporation status is not dependent on the direction of an acquisition or disposition transaction.

- *Allocation Methodology*: The Notice requests comments on how to allocate AFSI to a Target exiting the Target AFS Group or Controlled exiting the Distributing AFS Group.[74] We believe that proposed regulations should allow taxpayers to select from certain enumerated allocation methodologies, which include those based on: (i) AFSI as determined on a separate entity basis, (ii) book income, and (iii) taxable income.

- *Reduction of Acquirer AFS Group AFSI*: Contrary to the Notice, we believe that a Distributing AFS Group should be permitted to reduce its AFSI by the AFSI allocable to Controlled as part of a section 355 transaction.

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[71] Notice § 3.04(1)(a), (2)(a).

[72] Notice § 3.04(1)(b), (2)(c).

[73] Notice § 3.04(2)(d).

[74] Notice § 9.01(1)(e), (f).

- *Treatment of AFSI Attribute Carryforwards*: We believe that CAMT attributes other than AFSI should be allocated according to the same method used to allocate AFSI, and that those attributes should be subject to limitation, for example under principles similar to the principles of sections 382 and 383 or the "separate return limitation year" (or "**SRLY**") rules.[75]

We discuss each of these topics in turn.

(iii) Discussion

(a) Legal Form of Acquirer and Directionality

We begin with the following example:

> **Example 1:** X, an individual that does not conduct any trade or business, owns all of the stock of corporation C, an applicable corporation. X sells all of corporation C's stock to Y, an individual that does not conduct any trade or business.

Under the rules of the Notice and our proposed definition of "change in control," the acquisition by Y would not have any CAMT implications, as C does not join or leave a Section 52 Group as a result of the sale. Accordingly, C would remain an applicable corporation after the sale, and Y would look to C's prior AFSI history for purposes of assessing when and whether it ceases to be an applicable corporation in the future.[76] As discussed above, we believe this approach is reasonable given that (i) C's CAMT profile has not changed as a result of the sale and (ii) section 59(k) generally provides that, once a corporation becomes an applicable corporation, it will remain so indefinitely until section 59(k)(1)(C) provides otherwise.

One initial tension with this approach is that it is somewhat formalistic, as demonstrated by the following example:

> **Example 2:** X, an individual that does not conduct any trade or business, owns all of the stock of corporation C, which is an applicable corporation. Y forms a new corporation B, which purchases all of X's C stock.

In many cases, Y can easily form a new corporation to serve as acquirer in a transaction, and effecting a transaction through that entity is economically equivalent to Y purchasing C directly. If Y does so, C will join B's group and, under the Notice, C's applicable corporation status will cease. However, because C's AFSI history will solely be relevant for purposes of the Acquirer AFS Group's history, the Acquirer AFS Group will generally be in the same CAMT position as C was pre-acquisition. The one exception is where C's status as an applicable corporation is based on qualification in a prior three-year period, so the Acquirer AFS Group might avoid such status based on the most recent three-year period of C.

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[75] Notice § 9.02(13).

[76] I.R.C. § 59(k)(1)(E)(iii).

Similarly, under the Notice, the direction of an acquisition can affect the AFSI result.

Example 3: X, an individual that does not conduct any trade or business, owns all of the stock of corporation C, which is an applicable corporation. Corporation B, which is not an applicable corporation, acquires all of X's C stock for B stock.

Under the facts of Example 3, the applicable corporation status of C would terminate, but its AFSI would be included in B's CAMT calculation going forward (which may cause B to be an applicable corporation). By contrast, had C acquired B for C stock, C would have remained an applicable corporation by virtue of section 59(k)(1)(A) regardless of the combined AFSI profile of B and C.[77]

We believe that the CAMT consequences of C and B combining should be the same regardless of the direction of the acquisition, since the economic consequences are the same in both cases. Likewise, we believe that the results in Examples 1 and 2 should be the same. Consequently, we would provide that, when an applicable corporation and a non-applicable corporation combine, the applicable corporation should be deemed the Acquirer AFS Group for purposes of applying the rules of the Notice. This would likely result in the Acquirer AFS Group being an applicable corporation.[78] Adopting this rule would harmonize the results in Example 1, Example 2, and Example 3. For the same reason, we believe if both combining corporations are applicable corporations, the Acquiring AFS Group should be the corporation with the greater three-year history.[79]

(b) Allocation Methodology

As discussed above, the Notice requests comment on how to allocate AFSI to a Target exiting the Target AFS Group or Controlled exiting the Distributing AFS Group. Helpfully, section 1552 already provides certain permitted methodologies for the similar exercise of allocating the consolidated tax liability of a group among members for purposes of their earnings

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[77] In this circumstance, we note that the accounting rules applicable to reverse acquisitions may produce this result. This is because "Acquirer AFS Group" is defined as the entity treated as the acquiring entity on its AFS, and the reverse acquisitions rules generally deem the acquirer to be the entity whose former equity holders receive more than 50 percent of the equity of the combined venture. Directionality could be just as relevant in situations where cash is the sole (or a significant) form of consideration in the transaction. In such situations, although the planned transaction and its "reverse" are different economically in that a different set of shareholders owns the combined enterprise, the *combined enterprise* is identical no matter the transaction's direction.

[78] The above discussion focuses on transactions where an entire Acquirer AFS Group and Target AFS Group combine as part of an acquisition transaction. We also propose a similar approach to transactions involving a Distributing AFS Group and Controlled entity in Part II.D.1.c(iii)(c) below. That said, we do not believe that it is necessary or appropriate to apply a rule governing directionality to a transaction where a Target is acquired out of a Target AFS Group—in that circumstance, the Target AFS Group retains the relevant transaction consideration, so it will not be reduced in size as a result of the transaction. Accordingly, consistent with the existing treatment of these transactions under the Notice, the Target AFS Group should remain an applicable corporation and Target should be treated as an applicable corporation if it has sufficient AFSI as determined on a pro forma basis with the Acquirer AFS Group.

[79] In this context, directionality remains relevant in that it may affect the application of the section 59(k)(1)(A) look back (*e.g.,* one of the two applicable corporations may have different periods before which they are permitted to be retested).

and profits determinations. These methodologies include allocating tax liability: (i) to each member as if such member filed a separate return, (ii) based on the taxable income of each member as determined under Treas. Reg. § 1.1502-12, and (iii) based on each member's relative contribution to the aggregate tax liability of the Section 1502 Group.

By analogy, we propose adopting three similar methods to allocate AFSI:

- *Separate Return Principles*. We believe that the most precise method of determining the AFSI allocable to Target or Controlled is to calculate its AFSI as if it had been an entity separate from the remainder of the Target AFS Group or Distributing AFS Group, as applicable. Performing this calculation in practice, however, may be difficult. It will require the Target AFS Group or the Distributing AFS Group to construct pro forma separate financial statements for Target or Controlled and then adjust the net income reflected on those statements under section 56A. While these determinations should be done in a manner consistent with the group's prior reporting practices, it will need to give effect to intercompany transactions that were previously disregarded as between financially consolidated entities. Accordingly, it may be a difficult burden in many circumstances, especially where no separate AFS is prepared in connection with the disposition.

- *Book Income*. A simpler, but less precise, method for determining the AFSI allocable to the exiting Target or Controlled entity is to calculate the net book income of both the Target AFS Group and Target (or the Distributing AFS Group and Controlled) for the relevant years and then allocate AFSI between the two groups according to net income. This still requires the construction of pro forma separate financial statements for Target or Controlled, but without the further step of adjusting under section 56A.

- *Taxable Income*. An even simpler, but even less precise, method for determining the AFSI allocable to the exiting Target or Controlled entity is to look to that entity's share of the Section 1502 Group's taxable income. This is obviously a simplification in that it ignores differences between taxable income and book income, but information regarding each entity's taxable income will be more readily calculable under the consolidated return rules.

Consistent with the principles of section 1552 and Treas. Reg. § 1.1502-33(d), we believe that taxpayers should generally be permitted to select one of these specified methods for this purpose. Certain of these methodologies (especially, a transaction that requires a pro forma, separate-return calculation for Target or Controlled) will be difficult to apply and, therefore, inappropriate for ordinary-course dispositions where the Target or Controlled does not approach the $1 billion applicable-corporation threshold. If Treasury and the Service are concerned about giving taxpayers a choice between methodologies in all circumstances, an alternative approach would be to mandate a single approach based on separate-return principles or book income, but provide taxpayers a safe harbor based on taxable income if the group's taxable income falls below a lower threshold (*e.g.*, $200 million or $500 million).

(c) Reduction of Distributing AFS Group AFSI

Under Section 3.04(2)(d) and (3)(c) of the Notice, AFSI allocated to a Target leaving a Target AFS Group, or Controlled leaving a Distributing AFS Group, does not reduce the AFSI of the Target AFS Group or Distributing AFS Group, respectively. In effect, then, transactions in which entities join or leave a Section 52 Group result in the duplication of AFSI for purposes of testing status as an applicable corporation.

We believe this is the appropriate result for the Target AFS Group as part of the sale transaction. In such a circumstance, the Target AFS Group receives an amount of cash or other consideration that is equal to the value of the Target; accordingly, the Target AFS Group does not shrink as a result of the sale transaction. Even if the Target AFS Group decides to distribute some or all of the transaction consideration to its shareholders, a distribution generally would not be taken into account for purposes of testing applicable corporation status.

We believe that this is not the correct treatment, however, in the context of a transaction involving a Controlled and Distributing AFS Group. Consider the following example, modeled after Example 7 of the Notice:

> **Example 4:** Corporation D, the parent of a Distributing AFS Group, owns all of the stock of corporation C; D distributes all of the stock of C on December 31, 2022. Distributing AFS Group has AFSI of $1.1 billion, $1.1 billion and $1.1 billion, for taxable years 2020, 2021, and 2022, respectively; $500 million, $500 million and $500 million of AFSI is allocable to Controlled for taxable years 2020, 2021, and 2022, respectively. The Distributing AFS Group remains a group of applicable corporations after the distribution, even though its retained business only accounts for $600 million of AFSI annually from 2020 through 2022.

We agree that as a general matter (subject to Example 5 below), if the Distributing AFS Group is a group of applicable corporations before the distribution, it should remain so immediately after the distribution, as would be the case for any applicable group that made a large dividend distribution to its shareholders. However, the policy of section 355 is to facilitate the division of a single corporation into two corporations on a tax-free basis, with a division of many of the tax attributes. We therefore believe it would be most consistent with the policies of both section 355 and the CAMT to provide that if and when the status of the Distributing AFS Group is retested after the distribution, that group can then reduce its AFSI for the pre-distribution period by the AFSI allocated to Controlled under any applicable allocation rule. This rule would apply, for example, if the group was not already an applicable corporation at the time of the distribution and was being retested thereafter, or if the group was then an applicable corporation and regulations allow retesting either after a spinoff or on account of a reduction in AFSI.[80]

[80] Regulations under section 59(k)(1)(C) could allow the Distributing AFS Group to retest its status as an applicable corporation as of the date of the section 355 transaction, and if so, we see no reason to prevent them from doing so unless some of the AFSI allocated to Controlled was eliminated. Such an approach, in our view, is consistent with section 355 principles but is in tension with the general "once an applicable corporation, always an applicable corporation" rule. Such a retesting would increase concerns about spinoffs for the primary purpose of avoiding CAMT.

As a possible exception to the rule in the preceding paragraph, consider the following example where Controlled is larger than the remainder of the Distributing AFS Group:

> **Example 5:** Corporation D, the parent of a Distributing AFS Group, owns all of the stock of corporation C. Distributing AFS Group has AFSI of $1.1 billion, $1.1 billion and $1.1 billion, for taxable years 2020, 2021, and 2022, respectively; $1 billion of AFSI is allocable to Controlled for each of taxable years 2020, 2021, and 2022. The Distributing AFS Group remains a group of applicable corporations after the distribution on December 31, 2022, even though its retained business only accounts for $100 million of AFSI annually from 2020 through 2022 and Controlled will be an applicable corporation based on the AFSI allocated to it by the Distributing AFS Group.

Here, had the Distributing AFS Group retained Controlled's business assets and instead distributed all of its other assets in a section 355 transaction, the smaller of the two businesses (now a Controlled corporation) would not have been an applicable corporation, and, in our opinion, rightfully so given that it had average annual AFSI of $100 million over the preceding three-year period. To avoid having the CAMT results of that transaction be dependent on which business is distributed, we would treat the entity with the higher average AFSI as the "Distributing AFS Group" for purposes of the foregoing rules notwithstanding the transaction form. Under this approach, for example, if the Distributing AFS Group had been an applicable corporation, the "once an applicable corporation, always an applicable corporation" rule would apply to the larger of the two groups, and that larger group would keep the entire AFSI history of the Distributing Group until a retesting of such status occurred.[81] The smaller of the two groups would retain its allocated AFSI in all cases.

(d) Treatment of Other CAMT Attributes

Under section 56A(d), AFSI losses carry forward to offset AFSI in future taxable years. Similarly, if minimum tax is paid in a given taxable year, that payment will result in a credit that will carryforward to future taxable years to offset regular tax.[82] These components of the CAMT raise at least two questions in the mergers and acquisitions context. First, how should these attributes be allocated upon a member's separation from a Section 52 Group (if at all)? Second, should attributes be subject to limitation when one Section 52 Group, or a member of such a group, joins another Section 52 Group or becomes a stand-alone group, and if so, how should that limitation be calculated?

On the other hand, the greater the CAMT tax benefit from the spinoff, the harder it might be to establish that the spinoff had a valid nontax business purpose. In all, the multiple safeguards embedded in section 355 and the regulations thereunder to protect against tax avoidance may be sufficient to allay any concerns over taxpayers engaging in divisive reorganizations to avoid the application of the CAMT.

[81] *See* Treas. Reg. § 1.7874-10(g) (similar rule for purposes of testing section 355 transactions as "non-ordinary course distributions" under the anti-inversion rules).

[82] I.R.C. § 53(a).

On the first question, we believe that the same method used to allocate AFSI should also apply to AFSI loss carryforwards and CAMT FTCs. In our view, the methodologies described above apply equally as well to other CAMT attributes and taxpayers should *not* have flexibility to apply different allocation methodologies for AFSI and other CAMT attributes. That said, as discussed in Part II.D.3, we believe that no AFSI loss carryforwards or CAMT FTCs should be allocated to a Target/Target AFS Group if there is a step up in the AFS basis of its assets as a result of purchase accounting.

On the second question, we believe that it is appropriate to apply section 382, section 383, and (where otherwise applicable) SRLY principles to the carryforward of CAMT attributes to the Acquirer AFS Group. This would prevent "trafficking" of AFSI loss carryforwards or AFSI credits, consistent with the restrictions on the use of such items for regular tax purposes; indeed, we believe that these principles should apply more broadly than the "change in ownership" definition under section 59(k)(1)(C) so that transactions like Example 1 result in the limitation of CAMT attributes.[83]

2. Corporate Organizations, Reorganizations, and Separations in Subchapter C

Part III of subchapter C of the Code provides for nonrecognition treatment for certain specific corporate organization, reorganization, and separation transactions. These nonrecognition rules have been a part of the U.S. tax system, in one form or another, for over a century. There is often little parallel between the parameters of these nonrecognition rules and the treatment of such transactions for book reporting purposes. Accordingly, Congress authorized Treasury and the Service in section 56A(c)(15)(B) to harmonize the new CAMT with these tax nonrecognition rules:

> The Secretary shall issue regulations or other guidance to provide for such adjustments to adjusted financial statement income as the Secretary determines necessary to carry out the purposes of this section, including adjustments— . . . (B) to carry out the principles of part II of subchapter C of this chapter (relating to corporate liquidations), part III of subchapter C of this chapter (relating to corporate organizations and reorganizations), and part II of subchapter K of this chapter (relating to partnership contributions and distributions).

In the Notice, Treasury exercised this authority by providing for an exemption from AFSI financial statement gain or loss directly resulting from Covered Nonrecognition Transactions. Within the universe of corporate tax, these Covered Nonrecognition Transactions include

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[83] We note that, in some circumstances, it will be difficult to translate regular tax principles into the CAMT regime. For instance, to apply section 382 to AFSI loss carryforwards, one would need to adapt (or disregard) the section 382(h) rules governing built-in gains and built-in losses for purposes of the CAMT. For this reason, it may be more appropriate to base the limitation framework for AFSI loss carryforwards on SRLY principles as compared to section 382.

transactions that qualify for nonrecognition under sections 332, 337, 351, 354, 355, 357, 361, 368, and 1032.[84]

The Notice does not address all issues related to nonrecognition transactions, and, in our view, some issues that the Notice addresses need to be clarified or corrected. These Comments highlight five key issues that we believe need to be addressed in priority guidance, which are summarized here and further discussed in Parts II.D.2.a-c. However, we expect that additional issues and inconsistencies will likely surface as taxpayers begin to apply the rules to specific fact patterns and on tax returns, and further guidance may be required.

First, the Notice does not address the treatment of transactions in which gain or loss is recognized only in part. The Notice has requested comments on this issue, which we address below in Part II.D.2.a. In brief, we believe Section 3.03(1) of the Notice should be extended to apply an exemption from AFSI for the nonrecognition portion of a partial nonrecognition transaction in which some gain is recognized (a "**Partial Noncognition Transaction**").

Second, under the Notice, only a "Party" to a Covered Nonrecognition Transaction is eligible to exclude book gain or loss resulting directly from that Covered Nonrecognition Transaction. But while the Notice's definition of "Party" includes many principal entities in the Covered Nonrecognition Transaction, it does not include non-book consolidated shareholders of Targets. We believe that the definition should be expanded to include such shareholders.

Third, the exemption from AFSI provided by the Notice only applies to the "direct" consequences of a Covered Nonrecognition Transaction. Although this can result in an exemption from AFSI for book gain or loss in a nonrecognition transaction where the event or item on which book gain or loss is triggered is the same event or item as the nonrecognition transaction for tax purposes, it is unclear how this rule is meant to apply in other situations, and further clarification and expansion of the rule would be welcome. For instance, although we believe the exemption ought to apply where either (i) the form of the transaction reflected on a company's AFS differs from the actual or deemed form of the transaction for tax purposes,[85] or (ii) book gain or loss is triggered by the transaction but not on the precise element of the transaction that triggers the tax gain,[86] it would be helpful to have explicit confirmation that it does by regulation. In our view, clarification and expansion of the scope of this exemption would be appropriate. We believe that the exemption should be interpreted broadly for a number of reasons. One key reason is that the failure to conform book treatment to tax treatment can result in unusual timing differences, where the same gain can be triggered in one year for tax purposes and a different year for book purposes, and thus potentially subject that gain to tax twice as a result.

[84] Outside of the corporate context, the Notice also includes nonrecognition transactions under sections 721 and 731, which are addressed in Part II.F.3 of these Comments.

[85] Such an example may be a transaction treated as a transfer of stock for tax purposes that is treated as a transfer of assets for book purposes.

[86] Such an example may be where, as a result of a transfer of property in a nonrecognition transaction for tax purposes, a company is required to mark-to-market property other than the transferred property for book purposes.

Fourth, the Notice addresses a potential disparity between the tax and book basis rules in certain nonrecognition transactions where tax basis carries over but book basis might be stepped up. Similar to the approach to exchanged basis and transferred basis under regular tax principles, Section 3.03(2) of the Notice provides that, for purposes of computing the AFSI of a Party receiving transferred property in a Covered Nonrecognition Transaction, such Party should not take into account any increase or decrease in book basis of such property. This rule was presumably included to incorporate tax principles into the CAMT calculation, with the intent of preserving the built-in gain or loss that was not recognized by deferring it until a later event with respect to such property. However, we do not believe Section 3.03(2) of the Notice functions appropriately in a number of circumstances. We believe that further refinement and clarification of these book basis adjustment rules are necessary to ensure that these adjustments apply in the appropriate circumstances. As drafted in the Notice, the new rule appears to prevent AFSI basis step ups in circumstances where regular tax principles would allow them. And the AFSI basis rules may be applied inconsistently under the Notice to similar types of transactions. At a minimum, we believe that the rule turning off AFSI basis adjustments in Section 3.03(2) of the Notice should only apply to the extent that the relevant property receives exchanged basis or transferred basis under regular tax principles. Additionally, we believe that the rule should be expanded to apply to all corporate parties to a transaction, rather than just the "Parties" as defined in the Notice. And finally, the rule should clarify that property, for this purpose, includes equity issued in connection with a transaction.

Fifth, the Notice and section 56A more generally present the possibility that the same gain may be subject to taxation twice, if taxable gain and book gain arise in different periods and with respect to different transactions involving the same property. Double taxation could arise over a period of years, for example, where a transaction is fully or partially taxable for regular tax purposes but involves companies that are part of the same Book Group. The basis adjustment rules addressed in the previous paragraph address this issue to some degree, but additional rules would be required to address this concern fully, including in respect of full recognition transactions. There are multiple potential approaches to this issue, which we address in Part II.D.5 below.

Each of the issues described above present themselves differently depending on the type of nonrecognition transaction in question. These issues are discussed in Parts II.D.2(a)-(c) below.

a. Corporate Organizations Under Section 351

(i) Background

Section 351 was enacted to facilitate business adjustments by allowing taxpayers to transfer property and assets into controlled corporate entities while permitting the transferor to defer the recognition of gain on the transferred property.

Nonrecognition treatment is available under section 351 if the transferors of property to a corporation are in "control" of the transferee corporation, within the meaning of section 368(c)

("**Section 368(c) Control**"), immediately after the exchange.[87] Under these rules, nonrecognition can apply where:

- A single transferor transfers property to a wholly owned corporate subsidiary, whether the subsidiary is newly formed or preexisting, and whether or not the subsidiary issues new equity in exchange;

- A single transferor transfers property to a non-wholly owned corporation, so long as after the transfer, the transferor owns stock in the corporation constituting Section 368(c) Control. This result would obtain regardless of whether the corporation is newly formed or preexisting, regardless of whether the corporation issues new equity in the exchange, and regardless of whether the transferor owned stock constituting "control" in the transferee prior to the exchange; or

- Multiple transferors transfer property to a newly formed or preexisting corporation, and after the exchange these transferors *collectively* own stock of the transferee corporation constituting Section 368(c) Control (again, whether or not they owned sufficient "control" in the corporation prior to the transfer).

Under section 351, if a transferor in a transaction that otherwise qualifies for nonrecognition treatment receives, in addition to stock of the transferee corporation, money, or property other than stock of the transferee corporation, the exchange will still qualify as a section 351 transaction; but the transferor will recognize gain (but not loss) to the extent of the amount of the money and the fair market value of the property other than transferee stock.[88] There are also a number of exceptions to section 351 treatment, including, for example: (i) transfers to "investment companies";[89] (ii) transfers of property to a debtor in Chapter 11 proceedings, where

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[87] I.R.C. § 351(a). For this purpose, "control" is the ownership of stock possessing (i) at least 80% of the total combined voting power of all classes of the corporation's voting stock and (ii) at least 80% of the total number of shares of each class of the corporation's non-voting stock. This definition is found in section 368(c), as interpreted by the Service in Rev. Rul. 59-259, 1959-2 C.B. 115.

[88] I.R.C. § 351(b). For this purpose, "money or property" includes so-called "nonqualified preferred stock," which, generally, is preferred stock that is likely (or required) to be converted into cash or other property by its terms.

Additionally, liability assumptions in connection with a section 351 transaction can sometimes be treated as money or other property for this purpose. Section 357(a) provides that, for purposes of section 351, if a transferee corporation assumes a liability of the transferor as part of the consideration for the transferred assets, such assumption will generally not be treated as money or other property, and will not prevent the exchange from qualifying under section 351. However, section 357(b) provides that if, taking into account "the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the transferor with respect to the assumption" was a purpose to avoid federal income tax on the exchange or was not a bona fide business purpose, then such assumption shall, for purposes of section 351, be considered as money received by the transferor on the exchange. Section 357(c) provides that if the liabilities assumed exceed the total amount of adjusted tax basis of property transferred in the underlying 351 exchange, the excess of the liabilities assumed over such total adjusted basis will be recognized as gain, subject to certain exceptions.

[89] *See* I.R.C. § 351(e)(1); Treas. Reg. § 1.351-1(c)(1).

the stock received is used to satisfy such debtor's indebtedness;[90] and (iii) the issuance of stock in exchange for services, indebtedness of the transferee (other than indebtedness evidenced by a security), or certain interest on such indebtedness.[91]

The relevant accounting rules applicable to transfers of property to a corporation are not parallel with the rules of section 351. There are meaningful differences in when (and with respect to which assets) book income can arise. As described above, the Notice attempts to align AFSI rules and section 351 in the case of Covered Nonrecognition Transactions. However, as discussed below, the CAMT rules provided by the Code and the Notice still result in significant differences in exclusions from taxable income under AFSI and section 351, and in some cases with respect to basis.

(ii) Recommendations

We believe that a guiding principle for further guidance should be to preserve nonrecognition treatment under particular sections of the Code referred to in section 56A(c)(15)(B) and the Notice where the tax law already provides for it. In addition to the exclusion of gain for fully nonrecognition transactions set forth in the Notice, we believe future guidance should establish exclusions from AFSI in the case of Partial Nonrecognition Transactions involving section 351 and extend treatment as Covered Nonrecognition Transactions to applicable corporations that do not consolidate for book purposes with corporations to which they make section 351 contributions. Specifically, we recommend that Treasury issue the following guidance under the authority granted to it in section 56A(c)(15)(B) with respect to section 351 transactions:

- *Extend Application of Covered Nonrecognition Transactions to All Corporate Contributors to Controlled Corporations.* Due to the definition of "Party" in Section 3.02(9) of the Notice, the exemption for Covered Nonrecognition Transactions does not apply to all taxpayers involved in the nonrecognition transaction. We believe that the rules of the Notice should be extended to include any corporate taxpayer that is eligible for nonrecognition treatment under section 351 under regular tax principles.

- *Conform AFSI with Partial Nonrecognition of Boot in a Section 351 Transaction.* If there is taxable boot paid in a section 351(a) transfer, we believe the CAMT should adopt a "boot-within-book-gain" rule similar to that of section 351(b).

- *Broadly Interpret the Exemption for Covered Nonrecognition Transactions*. The scope of the exemption from AFSI provided to Covered Nonrecognition Transactions should be clarified to ensure that book gain or loss is eligible for the exemption regardless of the legal form of the transaction, and the number and order of steps, so long as the transaction overall qualifies as a Covered Nonrecognition Transaction (or a Partial Nonrecognition Transaction) for regular tax purposes.

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[90] I.R.C. § 351(e)(2).

[91] I.R.C. § 351(d).

- *Book Basis Adjustments Should be Applied Consistently Across Transactions and Conform to Regular Tax Principles for Exchanged Basis and Transferred Basis Transactions*. If a transaction qualifies for nonrecognition treatment in full or in part under section 351, then we believe book basis in the transferred property should be preserved for future AFSI calculations (or adjusted for partial gain recognition, as necessary) in conformity with the tax transferred basis rules. Additionally, the transferor's basis in stock received in such nonrecognition transactions should have exchanged basis for book purposes to the extent it receives exchanged basis for tax purposes.[92]

(iii) Discussion

(a) Partial Nonrecognition Transactions

Because the Notice's definition of "Covered Nonrecognition Transaction" applies only to a transaction that is not treated as resulting in "any amount" of gain or loss for federal tax purposes, section 351 transactions that include boot are not Covered Nonrecognition Transactions as the term is currently defined. However, we do not believe it would be appropriate for a transaction that is partially eligible for nonrecognition treatment for regular tax purposes to be fully includable in book income for AFSI purposes, merely because some portion (but not all) of the gain is recognized. Such a position would be inconsistent with the clear intent of Congress in providing for nonrecognition treatment under section 351 in the first instance. Section 56A(c)(15)(B) expressly authorizes Treasury to integrate these longstanding principles of section 351 into the new CAMT regime, which the Notice has done in part. Further action from Treasury would be necessary to align the two regimes completely. Example 6 below illustrates our recommendation for how the calculation of AFSI can account for boot in the section 351 context.

(b) Scope of Parties Eligible for the Exemption

The Notice's definition of "Party" may not include an applicable corporation that does not consolidate for book purposes with a corporation to which it contributes property in a section 351 transaction. For example, in a situation where there are multiple corporate transferors of property to a single jointly-owned corporation, and where none of the contributors owns 50% of the transferee, accounting principles may require the inclusion of gain on the transferred property while section 351 provides for nonrecognition for regular tax purposes. The Notice permits the *transferee* to avoid including book income in AFSI for this transaction, because that entity is a "Party" as defined in Section 3.02(9) of the Notice. But the transferors are not in the list of Parties, because they are not the "Controlled" or "Distributing" companies in a spinoff or splitoff, or a member of its AFS Group, Target or a member of the Target AFS Group or, as per the above, a member of the acquirer's AFS Group. As such, the Notice does not generally

[92] The considerations for basis preservation are more complex in the case of transactions that are taxable for tax purposes but do not result in book income inclusions. Additionally, there are a number of other issues related to basis, including section 362(e) loss importation and loss duplication transactions, which are complex and require further consideration for how they might be adapted to account for book principles. Those issues are not addressed in these Comments.

address the treatment of nonconsolidated corporate shareholders of the corporate parties in a Covered Nonrecognition Transaction, even if those transferors are themselves potentially "applicable corporations" calculating their own AFSI.

In our view, there does not appear to be a principled reason to require an inclusion for AFSI purposes on such facts similar to those in the above paragraph, where the taxpayers are engaging in an otherwise fully or partially tax-deferred transaction for regular tax purposes, and especially where the assets will receive a carryover AFSI basis. Doing so would unnecessarily discourage the formation of corporate joint ventures between multiple parties, as well as post-formation transfers to such joint ventures. It would also draw an unnecessary distinction between contributions to wholly owned corporations and contributions to partially owned corporations, when Congress had already made a judgment in enacting section 351 about which partially-owned scenarios merit a tax deferral. Finally, it would potentially treat multiple parties to the same transaction differently, if an AFSI exemption applies to the corporate transferee but not the corporate transferor, in transactions that are otherwise treated as nonrecognition transactions (fully or partially) for both parties under regular tax principles.

(c) Book Basis

Section 3.03(2) of the Notice provides that with regard to property transferred to a "Party" as part of a Covered Nonrecognition Transaction, any increase or decrease in the financial accounting basis of that property on the AFS of the Party resulting from that Covered Nonrecognition Transaction is not taken into account solely for purposes of computing the AFSI of the Party receiving the transferred property with regard to any taxable year of that Party. Under a literal reading, in the context of a section 351 transaction where an applicable corporation transfers property to a Party, the Party receiving the property would adjust its AFS basis in the property for purposes of determining AFSI in later transactions. However, the rule does not appear to extend to the stock in the Party received by the transferor. We believe that it should, to the extent that such stock is reflected as an asset on the transferor's AFS. This is most relevant in the case of transfers of transferred property to transferees that are not members of the same Book Group. Additionally, it is not clear how the book basis adjustment rules in the Notice are intended to apply to a transaction where one party recognizes gain but the other does not.[93] Special considerations also apply in the case of basis adjustments due to liability assumptions under section 358(d).

(iv) Examples and Recommendations

The following examples illustrate our recommendations for further guidance on section 351 transactions, illustrating the issues described above. The relevant book considerations are described in the examples.

(a) Partial Nonrecognition Transactions

[93] An example of such a circumstance is where an issuer of stock may be exempt from gain in respect of assets received pursuant to section 1032, but where the transferor of those assets in exchange for the stock is not eligible for nonrecognition treatment under another Code section.

Example 6A: *Partial Nonrecognition Transaction Between Entities that are Not Consolidated for Book Purposes.*

> Corporation A transfers property valued at $200x, with a $50x tax basis, to corporation B in exchange for (i) $100x worth of stock in corporation B and (ii) cash consideration of $100x. Assume the transaction qualifies under section 351, and that B and A are not part of the same Book Group. A includes taxable income from the transfer equal to the lesser of $100x (the total value of boot consideration) and $150x (the amount of built-in gain in the transferred property). Further, assume that for book purposes, the transferred property has book basis of $0 or $150x. Book income in respect of the transferred property would be either $200x or $50x, respectively.

This fact pattern raises two potential issues described above: (i) the treatment of nonconsolidated transferors for book purposes; and (ii) the treatment of Partial Nonrecognition Transactions.

With respect to the first issue, as noted above, we believe that the definition of Parties for purposes of Section 3.02(9) of the Notice should be expanded to include corporate transferors that transfer property to corporate transferees, regardless of whether the transferor and transferee are consolidated or part of the same AFS Group for book purposes.

With respect to the second issue, there are two potential approaches the CAMT could take to allow for a partial exclusion of book gain from AFSI in this example. On the one hand, the AFSI calculation could import the "boot within book gain" principle from section 351(b) and subject A to an AFSI inclusion of either $50x of book income (the lesser of $100x boot and $50x gain, if book basis were $150x), or $100x of book income (the lesser of $100x boot and $200x gain, if book basis were $0). On the other hand, the AFSI calculation could adopt a "lesser of" principle, and cause A to include in AFSI the lesser of its taxable income inclusion of $100x or book income ($50x or $200x, depending on basis). We believe that both of these alternatives would fall within Treasury's authority under section 56A(c)(15). In this particular example, the results under either approach are the same. But if, for example, the cash consideration paid were $175x, then the results would differ. Taxable income would be $150x (the lesser of $175x of boot and $150x of gain). In the fact pattern where book basis is $0, the first approach would result in $175x of book income (the lesser of $175x of boot and $200 of book gain). But the second approach would result in only $150x of book income (the lesser of $200x of book gain and $150x of taxable income). In a more extreme case, if tax basis were $200x, book basis was $0, and cash was $100x, there would be no taxable gain, the first approach would result in $100x of book gain and the second approach would result in $0 book gain.

Arguably, the strongest support for the "lesser-of" approach is that where a transaction is otherwise eligible for nonrecognition treatment for tax purposes, it makes little sense to only partially exclude book income where the book results are substantially different in amount, because doing so could place a penalty on the nonrecognition transaction by subjecting it to a higher amount of taxation. That said, the "boot-within-book-gain" approach benefits from being a more familiar concept, and more consistent with the framework of subchapter C itself, and we believe on balance, these factors outweigh the benefit of avoiding additional book tax costs in a relatively rare set of circumstances.

Under either approach, if A has a book *loss* in the transferred asset rather than taxable gain, we do not believe it is appropriate to include the book loss in AFSI. It would not be logical and could lead to abuse to allow book losses but not book gains in AFSI.

In respect of basis, consistent with the rules for Covered Nonrecognition Transactions set forth in the Notice, we believe that adjustments should be made to book basis for AFSI purposes to reflect the partial nonrecognition nature of the transaction. The rule in Section 3.03(2) of the Notice turns off all book basis adjustments in the case of a Covered Nonrecognition Transaction but only for the transferee of the property. It would need to be modified in this case in two respects. First, similar to transferred basis rules under section 351 for regular tax purposes, Section 3.03(2) of the Notice should be expanded to permit a portion of such book adjustments to be respected, in the amount of any book gain that is included in AFSI under the principles above (similar to the application of section 362(a)) or would be included in AFSI if the relevant transferors were each applicable corporations. Second, if the corporate transferor of assets receives equity in the transferee corporation in the section 351 transaction, its book basis in the equity received should reflect "exchanged basis" in the transferred property, plus any gain included in AFSI on the transfer.

> **Example 6B:** *Partial Nonrecognition Transaction Between Entities that are Consolidated for Book Purposes*
>
> Same as Example 6A, except that corporation B is in the same Book Group as A. In this example, we would not expect the transfer to give rise to any book gain regardless of the amount of built-in gain, because A and B are part of the same Book Group.[94] However, A still recognizes $100x of taxable income on the transfer.

This fact pattern, involving transactions between the U.S. tax group and the larger book group, is discussed in Part II.D.5 below.[95] As described in that section, we believe that it would be appropriate to create notional AFSI income items, even if there is no book income on the taxpayer's AFS so that the timing of book income and taxable income in the same transaction is aligned. Failing to align the timing could result in subjecting a taxpayer to tax in two different periods with respect to the same built-in gain. This fact pattern could also arise in the context of a transfer to a subsidiary in a transaction where section 351 does not apply due to the application of section 351(e)(1) (transfers to investment companies), section 351(e)(2) (certain transfers to companies in Chapter 11 proceedings, where the stock issued is in satisfaction of debt), and other circumstances addressed later in these Comments.

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[94] This may be an example where there are significant difference between U.S. GAAP and IFRS. This example assumes that the group reports their AFSs under U.S. GAAP.

[95] We are assuming for simplicity that there is no remeasurement gain (*i.e.*, mark-to-market gain) on B's assets resulting from this transfer, but if there were, that too would raise concerns that apply more broadly than simply to nonrecognition transactions. Issues relating to the book concept of "remeasurement gain" are described in Part II.D.4 below.

(b) Transactions Involving Non-Cash Boot: Other Property

The examples above involve boot that was paid in cash, which would not have given rise to taxable income or book income for B. However, if the boot paid by B in the exchange were instead an asset with built-in gain, B would be required to include taxable gain, if any, with respect to that asset under section 1001. To the extent that transfer gives rise to book income as well, we do not think an exemption from AFSI would be appropriate for the built-in gain in that asset. We believe that the principles of the Notice are already consistent with this approach, because they prescribe analyzing separate components of each transaction separately. In this case, the component of the transaction relating to the transferee's consequences of delivering built-in gain property in exchange for transferred property are analyzed under section 1001, rather than section 351, which applies to the transferor. The components should be analyzed separately for AFSI purposes as well.

However, in our view, the Notice is somewhat ambiguous on this point, because although it instructs taxpayers to analyze each "component" of a transaction separately, here, the two "components" are just the opposite perspectives of a single exchange (the perspective of the transferee versus that of the transferor). It is not clear to us what Treasury and the Service had in mind in this situation. We believe that the transferee should be required to recognize book gain on the built-in gain in property it delivers in consideration for transferred property, to the extent that recognition of gain is otherwise consistent with the taxpayer's financial reporting position.

Example 6C: *Issuance of Common and Nonqualified Preferred Stock*

> Corporation A (an applicable corporation) transfers property with built-in gain to corporation B in exchange for stock in B in a transaction that qualifies for section 351(a) treatment. B issues both common stock and nonqualified preferred stock to A in the exchange. The nonqualified preferred stock is treated as "other property" for purposes of section 351(b),[96] and as a result, a portion of A's gain is required to be recognized.

This fact pattern raises similar issues to Examples 6A and 6B in respect of both the recognition of book income and treatment of book basis. If the entities are not part of the same Book Group (both before and after the transaction), then we believe that this example should be treated the same as Example 6A above. Doing so would require expanding the definition of Parties from the Notice to include corporate transferors that are not consolidated for book purposes with the corporate transferee. Also, because both the boot and common stock are stock interests, in order to adapt the "boot within book gain" rule or the "lesser of" approach for AFSI purposes, it may be necessary to value and reflect the nonqualified preferred stock and common stock separately on the taxpayer's AFS (if they are not separately reflected under the taxpayer's AFS methods to begin with), so that the book basis in each class of stock can properly reflect the book gain or loss that was recognized in respect of that particular series under section 358(a)(1) and (a)(2).

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[96] *See* I.R.C. § 351(g)(1) (treating nonqualified preferred stock as boot in a section 351 transaction).

The example is far more complicated if A and B are part of the same Book Group. In that case, it is possible that there is no book gain inclusion even though there would be taxable gain in respect of the nonqualified preferred stock. These issues are addressed in Part II.D.5 below, which deals more generally with circumstances involving the recognition of regular taxable income but, due to book consolidation, no book income.

Additionally, if A and B are part of the same Book Group, the AFSI adjustments, including book basis adjustments, required to be made by the transferor in this example may be complicated by the fact that B's stock (including the nonqualified preferred stock it issues) may not be reflected at all on A's AFS. As a result, although it would appear to be straightforward to adjust the basis in the transferred assets to properly account for the nonrecognition and recognition components of the transaction under principles similar to section 362, it may not be possible to reflect corresponding adjustments to the newly issued stock (under principles similar to section 358) using items that are currently reflected on the companies' respective books.

This distinction between how tax rules treat equity and how book rules treat equity could present a disconnect upon a later disposition of the equity. If A later disposes of the B nonqualified preferred stock but not the B common stock, then a portion of the original gain which was triggered for regular tax purposes on the Partial Nonrecognition Transaction may be included in book income, and therefore AFSI, in a subsequent year if the disposition of nonqualified preferred stock is, for book purposes, viewed instead as a disposition of a portion of the underlying assets held by B. We do not believe it was Congress's intention to tax the same gain twice, even if it formally appears in different items—in this case, the transferred assets for tax purposes. To avoid this issue, it may be necessary at the time of the original transaction to reflect a form of tracing of the book basis from B's assets to the transferred stock, so that the treatment of the subsequent disposition transaction for AFSI purposes can still be viewed as a transfer of assets with stepped up basis (to align with the tax treatment of the transfer of nonqualified preferred stock with stepped up basis), rather than assets with adjusted transferred basis. We believe this may be an important issue to address but likely not as urgently as certain other issues addressed by these Comments.[97]

Example 6D: *Issuance of Only Nonqualified Preferred Stock*

> Same as Example 6C, except that all of the stock delivered by corporation B is nonqualified preferred stock.

In this case, the transaction is a fully taxable transaction whereby all of the built-in gain in the transferred as assets must be recognized for regular tax purposes.[98] If the entities are part of the same Book Group, it is possible that no book gain is triggered even though there is taxable gain. These issues are addressed in Part II.D.5 below. If the entities are not part of the same Book

[97] This issue applies more broadly than just a section 351 transaction involving nonqualified preferred stock. It can arise in any fact pattern where, for regular tax purposes, a shareholder could have different bases in different shares of stock of the same issuer, since a later disposition of some (but not all) of that stock would require the taxpayer to determine the tax basis of the particular transferred shares of stock. *See*, *e.g.*, Treas. Reg. §§ 1.358-2(a)(2), 1.1012-1(c).

[98] I.R.C. § 351(g)(1)(A), (B).

Group, then we believe that no exemption from AFSI should be available because the transaction is not a nonrecognition transaction at all for tax purposes. However, we note that with respect to B, the issuance of stock is part of a section 1032 exchange, and, therefore, technically part of a Covered Nonrecognition Transaction for purposes of the Notice.

As described above, we do not believe that the basis rule in Section 3.03(2) of the Notice functions properly on these facts. Under that rule, because B is a Party receiving transferred property in a Covered Nonrecognition Transaction, it would not be permitted to take into account book basis adjustments resulting from that transaction on its AFS. However, under section 362(a), B's tax basis in the transferred property would be adjusted to reflect any gain recognized by A on the transfer. We believe that Section 3.03(2) of the Notice should conform to the rules of section 362(a) in this situation, by ensuring that B's book basis in its assets can be adjusted to take into account the book gain recognized by A on the exchange. Likewise, A's stock interest in B received in the exchange should have a stepped up basis for AFS purposes.[99]

(c) Transactions Involving Non-Cash Boot: Section 357

In the event that a section 351 transaction gives rise to taxable income to the transferor resulting from the application of section 357(b) or (c), we believe that "boot within book gain" principles similar to those applicable to Example 6A should apply. Additionally, regardless of whether liability assumption gives rise to taxable income, we believe that the basis adjustment rules under Section 3.03(2) of the Notice should take into account the impact of liability assumption on shareholder tax basis set forth in section 358(d)—*i.e.*, that the shareholder's basis in the transferred stock is reduced by the amount of the liability assumed. We note that, due to potential differences between tax basis and book basis, it is possible that these liability assumption rules could give rise to additional AFSI gain in circumstances where there would not be tax gain, including specifically if the book basis in the transferred property is lower than the amount of liability assumed, but the tax basis is not. We believe this fact pattern requires further consideration from Treasury, and we do not at this time have a specific view on the appropriate way to resolve this issue under the CAMT.

(d) Separate Transactions vs. a Single Transaction

There are variations on the simple example of a Partial Nonrecognition Transaction from Examples 6A and 6B that can involve two separate components for regular tax purposes. If, under book principles, the two separate components are not treated as separate, then the question arises as to which particular gain, for book purposes, should be exempt from AFSI, and how to adjust book asset basis.

[99] There is considerable complexity in this area. If A and B are part of the same Book Group, the issues associated with book basis are addressed in Part II.D.5 below. Additionally, in a fully taxable transaction involving a transfer of property to a corporation in exchange for the issuance of new stock, section 1032 would also apply to the stock issuance and, as with this example, there would similarly be no reason in that circumstance to override book basis adjustments on the transferred assets as those assets would receive a tax basis step up as well.

Example 7: *Multiple Transactions: Section 351 Contribution and Sale to Subsidiary*

Corporation A, an applicable corporation, transfers property with built-in gain to corporation B in exchange for stock in B in a transaction that qualifies for section 351(a) treatment. A sells other property to a subsidiary of B for cash in a transaction that would be a taxable sale under section 1001.

Under regular tax principles, the two components of the transactions in Example 7 are viewed separately. Therefore, under the Notice, the section 351 transaction between A and B in Example 7 would be viewed as a Covered Nonrecognition Transaction, while the taxable sale would not be so designated. A would receive an exemption under the Notice from book gain, if any, solely with respect to the section 351 transaction.

In comparing Example 7 to Example 6A above, the regular tax treatment differs. In Example 6A, A is taxed on the lesser of the built-in gain in all of the transferred property and the amount of cash boot it receives. In Example 7, A must first divide its basis in the transferred property between that which it transfers to B in a nonrecognition transaction with no gain or loss recognized, and that which it sells to the subsidiary in a fully taxable transaction. Assuming all of the transferred property has built-in gain to some degree, the gain recognized in Example 7 will be lower overall than that in Example 6A.

Although the basis adjustments and nonrecognition treatment in Example 6A are straightforward to apply for AFSI purposes, the approach is not as simple in Example 7. First, assuming that B and its subsidiary in Example 7 are part of the same Book Group, it is not clear how the relevant financial accounting principles would apply to A and whether financial accounting principles even recognize two different transactions or just a single transaction. If financial accounting principles only recognize a single transaction, then A's choice as to which assets it transfers to B versus which assets it transfers to B's subsidiary would not be reflected anywhere on either corporation's AFS. Nevertheless, we believe it would be appropriate in this circumstance to align the AFSI treatment with regular tax principles.

Thus, the gain that A defers in the section 351 transaction should be preserved and deferred for AFSI purposes as well, while the gain that A recognizes in the section 1001 transaction should result in a book basis step up on B and its subsidiary's AFS (as well as A, if they are in the same AFS Group). As such, at least to the extent that the relevant financial accounting principles would result in gain inclusion for property transferred to B, to B's subsidiary, or both, AFSI should be determined such that A is treated as transferring the same assets for book purposes to the particular entity that it is treated as transferring such assets for regular tax purposes. Appropriate basis adjustments should also be made, such that the assets transferred to B receive transferred book basis, while those transferred to the subsidiary have their book basis stepped up.

(e) Other Section 351 Issues

There are other variations on section 351 transactions that should be addressed by guidance. One important clarification for future guidance is to clearly delineate which elements of a transaction, as reflected on a taxpayer's AFS, are eligible for an exemption under the nonrecognition rules. We believe the guidance should apply the exemption broadly, to ensure that if a transaction is subject to nonrecognition treatment for tax purposes, it does not inadvertently result in book gain merely because the transaction is reflected differently on a taxpayer's AFS. The example below is intended to illustrate this issue.

Example 8. *Merger Regarded as Contribution for Tax Purposes*

As part of a plan to transfer a line of business to corporation B, corporation A undertakes the following steps: first, A transfers the assets to newly formed entity C, which elects to be treated as a disregarded entity for tax purposes. Second, B forms entity D, a disregarded entity for tax purposes. Third, entity C merges with and into entity D, with entity D surviving. In exchange, B stock is issued to A. Alternatively, if applicable under the meaningless gesture doctrine, no stock is issued.

This transaction may be viewed (among other potential characterizations) as a transfer by A of the assets it transferred to C into B in exchange for B equity that, together with other transfers to B, may qualify under section 351. In effect, the contribution to C, and the merger of C into D, are ignored. From a tax perspective, there would be a single nonrecognition transaction under section 351, *i.e.*, the deemed transfer of assets from A to B, even though there is never any actual transfer of assets from A to B. As a result, each company's AFS may reflect an entirely different form of transaction (or multiple transactions). Indeed, there is no guarantee that the separate formal steps of this arrangement will be viewed together for book purposes as they are for tax purposes, as those steps may be given separate effect (or may be ignored entirely) depending on the facts.

Regardless, it seems clear that because the transaction overall gives rise to no gain or loss under section 351 for regular tax purposes, the exemption for Covered Nonrecognition Transactions should be interpreted in a way that exempts from AFSI any book gain on any of the steps. There may be valid nontax reasons for a company or companies to adopt a particular form of transaction, and achieve the same tax result, and, in our view, it would be appropriate for the CAMT to be interpreted in a way that does not eliminate that flexibility.

b. Corporate Reorganizations under Section 368

(i) Background

The "reorganization" rules of subchapter C of the Code provide an exception to gain recognition in certain corporate combination and separation transactions. Section 368(a) defines the term "reorganization," and for transactions that are included in that category, section 354, section 356, and section 361 provide rules for the tax treatment of exchanges of property by target shareholders and corporations that are "parties to the reorganization" made in connection with the reorganization. These provisions have been in the Code almost since its inception, and, relative to many other Code provisions, have not been substantially amended in the ensuing time (the predecessor to section 368 was enacted in 1918). When the rules apply, a shareholder in a corporation undergoing a reorganization is permitted to receive, tax-free, new stock in a second corporation that substantially continues the first corporation's business enterprise.[100]

The nonrecognition of gain or loss in connection with reorganizations applies to three specifically described exchanges. The first is an exchange by shareholders of stock or securities in a corporation, a party to a reorganization, for stock or securities of the other party.[101] The second (applicable to some forms of reorganization) is an exchange in which a corporation party to the reorganization exchanges property in pursuance of a plan of reorganization for stock or securities (and potentially other property) in another corporation that is also a party to the same reorganization.[102] The third (again applicable to some forms of reorganization) is the mirror of the first—the distribution by Target of stock or securities (or other property) it received from the other party to its own shareholders completing the reorganization transaction.[103] Subject to certain adjustments for gain recognized on boot, the acquiring corporation generally takes a transferred basis in property it receives in a section 368-qualifying reorganization,[104] and

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[100] *See, e.g.*, Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders*, ⁋ 12 (Nov. 2020).

[101] *See* I.R.C. § 354. Section 354 generally provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization. This rule applies to the target corporation's shareholders, in both stock reorganizations and asset reorganizations. *See also* Treas. Reg. § 1.354-1(a).

If boot is exchanged in addition to qualified property, section 356 can subject the shareholder to partial recognition on the lesser of the amount of boot or the total amount of gain in the exchanged stock or securities. Section 356 generally provides that if section 354 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient is recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. *See also* Treas. Reg. § 1.356-1(a).

[102] *See* I.R.C. § 361(a), (b). Under section 361(a), no gain or loss is recognized by a corporation party to a reorganization that exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation, also a party to the reorganization. It applies to the corporate transferor in asset reorganizations. Section 361(b) applies if the conditions of section 361(a) are only partially met—if the target corporation receives other property from the acquirer in addition to stock or securities of the issuing corporation, it can still avoid the recognition of gain or loss in the transaction by distributing such other property in pursuance of the plan of reorganization. Finally, section 361(c) provides that no gain or loss is recognized by a party to a reorganization on the distribution to its shareholders of qualified property (defined to include stock of another corporation that is a party to the reorganization and which is received by the distributing corporation in an exchange described in section 361(a)) in pursuance of the plan of reorganization.

Additionally, section 357 provides special rules for a transfer of property with a liability in connection with a reorganization. If the transferee assumes liabilities of the transferor in connection with a reorganization, section 357 generally provides that the transferor will not recognize gain upon the assumption, as long as the amount of the liabilities assumed does not exceed the total adjusted basis of the property transferred in the exchange. However, under section 357(b), if "the principal purpose" of a liability assumption is tax avoidance, the amount of the liability assumed in the transaction will be treated as money received by the transferor and will result in the recognition of gain by the transferor. Finally, under section 357(c), if the liabilities assumed exceeds the total amount of adjusted tax basis of property transferred in the underlying 361 exchange, the excess of the liabilities assumed over such total adjusted basis will be recognized as gain, with certain exceptions applying.

[103] *See* I.R.C. § 361(c), described in note 102 above.

[104] *See* I.R.C. § 362. Section 362 provides that if property, other than stock or securities in a corporation a party to a reorganization, is acquired by a corporation in connection with a reorganization described under section 361, then the

Target's shareholders generally take an exchanged basis in the stock or securities they receive in the acquiring corporation.[105]

There are several disparities between how business combination transactions are viewed for financial accounting purposes and for regular tax purposes, and the various forms of reorganization transactions authorized by the Code are treated differently from each other on financial statements. Moreover, due to substance-over-form principles, reorganization transactions can take multiple different forms.[106] Some forms of reorganization could give rise to book income, and other forms with identical economic terms might not, even where the tax treatment of such transactions under general tax principles is identical. In our view, treating such transactions differently for CAMT purposes likely would chill the (albeit limited) flexibility taxpayers currently have to adopt transaction structures that may be beneficial for non-tax reasons, while still maintaining nonrecognition treatment for tax purposes. The rules for Covered Nonrecognition Transactions set forth in the Notice only apply to the direct consequences of those transactions. However, it is not clear how they are supposed to apply to transactions that are deemed to occur for tax purposes, but which are not reflected in a similar fashion in a company's AFS.

(ii) Recommendations

As described further below, guidance is needed to ensure that the longstanding principles described above are not overridden by section 56A. The issues we recommend addressing here largely align with those described above for section 351 transactions, and, in our view, similar principles should apply in resolving them. However, because there are multiple corporations involved in certain section 368 reorganizations, as opposed to the single corporate transferee in a section 351 transaction, the application of those principles to reorganizations differs. Additionally, as with section 351 transactions, the potential for gain duplication can result in the case of Partial Nonrecognition Transactions between entities that are part of the same Book Group. Those issues are addressed in Part II.D.5.

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basis to the acquiring corporation shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

[105] *See* I.R.C. § 358. Section 358 provides that a shareholder's basis in the property that it receives on a tax-deferred basis in connection with a reorganization in exchange for its target corporation shares will be equal to the basis of the target corporation shares at the time of the exchange, decreased by the sum of the amount of any money and the fair market value of any other property (other than money) received in the exchange, and increased by the amount of any gain that the shareholder recognized on the exchange.

[106] There are seven different types of reorganization transactions under section 368. Some involve stock transfers and some involve actual or deemed asset transfers. Even within these categories, the formal legal steps of a transaction can differ from one transaction to another, and substance-over-form principles can apply to treat them the same as one another. One such example is a reverse subsidiary merger immediately followed by a merger of the acquired target into the parent corporation. That transaction is analyzed as if the target corporation merged directly into the parent corporation. *See*, *e.g.*, Rev. Rul. 2001-46, 2001-2 C.B. 321. Similarly, a reverse subsidiary merger could also be viewed as a share-for-share exchange. *See, e.g.*, Rev. Rul. 67-448, 1967-2 C.B. 144. Further, a transfer of stock in a target corporation followed by a liquidation of that corporation into its acquirer can qualify under the asset transfer reorganization rules, as if the steps were reversed and the target transferred its assets for the relevant consideration and then liquidated. *See* Rev. Rul. 2004-83, 2004-2 C.B. 157.

The exemption from AFSI provided by Section 3.03(1) of the Notice for Covered Nonrecognition Transactions is a helpful start, but as with section 351 transactions, we recommend guidance be issued on the following issues.

- With respect to the target corporation shareholders in a reorganization:
  - *Extend Application of Covered Nonrecognition Transactions to All Corporate Shareholders of the Target.* Due to the definition of "Parties" in the Notice, the exemption for Covered Nonrecognition Transactions does not apply to all taxpayers whose taxes are affected by the reorganization, including corporate transferors of stock or securities in an exchange of target corporation stock that qualifies under section 354 and section 356. We believe that the rules of the Notice should be extended to include any corporate taxpayer that is eligible for nonrecognition treatment under regular tax principles.
  - *Conform AFSI with Partial Nonrecognition of Boot in a Reorganization.* To the extent section 356 applies to an exchange resulting in recognition of gain with respect to the receipt of taxable boot, the same principles described above with respect to Partial Nonrecognition Transactions for section 351 should apply to the shareholder consequences of a reorganization.
- With respect to the corporate parties to a reorganization:
  - *Conform AFSI with General Tax Principles for Section 357 Assumptions of Liability.* To the extent that a corporation, a party to a reorganization, assumes liabilities of a transferor corporation, we believe that the AFSI calculation should take into account the liability assumption for purposes of the transferor's gain or loss, and each party's basis, in a similar manner to section 357. However, as with section 351 transactions, we believe this treatment could raise additional complexities that must be explored further in future guidance, and we do not currently have a view on the best approach.
  - *Maintain General Tax Principles for the Treatment of Boot in Reorganizations.* To the extent that a corporation, a party to a reorganization, retains boot in a transaction to which section 361(a) otherwise applies, the AFSI of that corporation should include the book income, if any, attributable to the receipt of the retained boot.
- With respect to shareholders and corporate parties to the reorganization:
  - *Book Basis Adjustments Should be Applied Consistently Across Transactions and Conform to Regular Tax Principles for Exchanged Basis and Transferred Basis Transactions*. If a transaction qualifies for nonrecognition treatment in full or in part under section 354, 356, or 361, then we believe book basis in the transferred property should be preserved for future AFSI calculations in conformity with the tax transferred basis rules, to the extent that book income would otherwise have

been included but is exempt from AFSI. Additionally, a shareholder's basis in stock received in such nonrecognition transactions, under section 354 or 356, as applicable, should have exchanged basis for book purposes to the extent it has exchanged basis for tax purposes, adjusted as necessary to the extent book gain is recognized.

- *Broadly Interpret the Exemption for Covered Nonrecognition Transactions*. The scope of the exemption from AFSI provided to Covered Nonrecognition Transactions should be clarified to ensure that book gain or loss is eligible for the exemption regardless of the legal form of the transaction, and the number and order of steps, so long as the transaction overall qualifies as a Covered Nonrecognition Transaction for regular tax purposes.

(iii) Discussion

We recommend that guidance under section 56A(c)(15)(B), carrying out the principles of Part III of subchapter C of the Code, exclude from AFSI income or gain from transactions described in Part III to the extent that income or gain would not be recognized under those provisions. Similar to the section 351 principles discussed above, we do not believe it would be appropriate for a transaction that is partially eligible for nonrecognition treatment for regular tax purposes to be fully includable in book income for AFSI purposes, merely because some portion (but not all) of the gain is recognized. In our view, such a position would be inconsistent with the intent of Congress in providing for nonrecognition treatment under sections 354, 356, 361, and 368.

Additionally, in our view, it would be appropriate to expand the exemption for Covered Nonrecognition Transactions that are "reorganizations" to nonconsolidated shareholders of Target companies in a reorganization. Currently, although the Notice includes section 354 as one of the Code sections that can be a Covered Nonrecognition Transaction, that reference has a very limited function under the Notice as currently drafted. Specifically, only "Parties" are eligible for the exemption, which does not include Target shareholders who exchange their target stock for issuing corporation stock in a transaction governed by section 354.[107] In addition, Covered Nonrecognition Transactions do not include a Partial Nonrecognition Transaction under section 356.[108]

For Target shareholders that are consolidated with Target (and part of its "Target AFS Group" under the Notice), there is no book equivalent to a section 354 transaction. Target's stock is not reflected as an asset on the shareholder's books and, therefore, there is no share-for-share exchange for financial accounting purposes equivalent to the section 354 transaction that is reflected for regular tax purposes. This may be the case even if Target becomes deconsolidated as a result of the transaction.

[107] Notice § 3.03(1)(a).

[108] Notice § 3.02(5)(a).

In an asset reorganization where Target is deemed to transfer its assets to the acquirer for tax purposes, and then distribute the acquirer stock to its shareholders in completion of the reorganization, the exemption in the Notice for section 361 transactions ought to apply to a corporate shareholder of Target that is, prior to the transaction, consolidated with Target because, for book purposes, Target's transfer of its assets would be reflected on the shareholder's books as an asset transfer as well. However, in stock reorganizations, like reverse subsidiary mergers and "B" reorganizations, there is no transfer of Target assets for tax purposes, even though the transaction may be reflected on the Target AFS Group's AFS as a disposition of Target's assets. It is important for guidance to clarify that the exemption from gain for Covered Nonrecognition Transactions applies to this asset-level gain as well, even though the character of the transaction for tax purposes (as a transfer by parent of its subsidiary stock) differs from the character for book purposes (as a disposition of the underlying assets).

The following examples illustrate some of the key areas of misalignment between measurement of book income and taxable income in transactions that qualify as reorganizations under section 368.

> **Example 9A:** *Type "C" Asset Reorganization with a Shareholder that is Not Consolidated for Book Purposes and No Gain or Loss is Recognized*
>
> Corporation A (an applicable corporation) acquires in a single exchange 100% of the assets of corporation B (an applicable corporation), the parent of its Book Group, in exchange for voting stock of A. B then distributes the A stock received to its shareholders in complete liquidation and B shares are cancelled. Corporation C owns a minority interest in B and does not consolidate with B for book purposes. Assume that this transaction otherwise satisfies all the requirements for reorganization treatment as a type "C reorganization."

For federal tax purposes, the transaction is characterized as an asset reorganization. None of A, B, or B's shareholders recognize any gain or loss on the exchanges of shares and exchange of assets, as the case may be. A's transfer of its assets to B and A's distribution of B stock to its shareholders qualifies for nonrecognition under section 361, while C qualifies for nonrecognition on its share-for-share exchange under section 354.

We understand that under financial accounting rules, there are two potential income events. First, B may be required to include income on the disposition of its assets to A in exchange for A's voting stock.[109] Second, B's shareholders may be required to include income on the exchange of B shares for A shares in the liquidation transaction.

Under the Notice, B would be a Party to the transaction and exclude from AFSI any book income recognized on the disposition of its assets to A and subsequent distribution of A stock, because both the disposition of assets and distribution of stock separately qualify as Covered Nonrecognition Transactions under section 361. However, C would not be a Party to the

[109] Depending on the timing, it is possible under GAAP rules that B's income event never is reflected on any financial statements, since B liquidates as part of the transaction. However, we are assuming for purposes of this example that the asset-level book gain is reflected on a financial statement.

transaction and therefore could not exclude from AFSI any book gain recognized on the exchange of B shares for A shares. We believe that the definition of Parties for purposes of Section 3.02(9) of the Notice should be expanded to include corporate transferors of stock or securities of Target, regardless of whether the transferor and Target are consolidated or part of the same AFS Group for book purposes. In our view, appropriate basis adjustments should also be made, such that the A stock transferred to C, as well as the B assets transferred to A, each have a substituted book basis for AFSI purposes.

> **Example 9B:** *Alternative Form of Type "C" Reorganization and No Gain or Loss Recognized*
>
> Assume the same facts as in Example 9A, except that corporation A acquires 100% of the stock of corporation B from its shareholders in exchange for A stock, and then B immediately completely liquidates into A by converting to a limited liability company. Assume that this transaction qualifies as a type "C" reorganization, although in the form described it might also qualify as one or more other types of reorganization.

The tax treatment of A, B and B's shareholders is identical to that in Example 9A. However, for book purposes, due to the form of this transaction, there is no asset transfer between unrelated parties and, therefore, B would have no book income (even though B's corporate shareholders may have book income). We believe that guidance should treat these two transactions the same, and provide exemptions from AFSI for corporate shareholders and the corporate parties to the reorganization with respect to any income recognized for book purposes.[110] Similarly, A's AFSI basis in the assets it acquires (in the complete liquidation of B) and C's AFSI basis in the A stock it receives should in each case be identical to that in Example 9A, and follow exchanged basis and transferred basis tax principles under section 358 and 362, as the case may be.

We believe that similar principles should apply with respect to acquisitive "D" reorganizations and "G" reorganizations.

> **Example 10A:** *Stock Reorganization with Minority Corporation Shareholder*
>
> Corporation A (an applicable corporation) acquires in a single exchange 100% of the stock of corporation B (an applicable corporation), the parent of its Book Group, from B's shareholders. Corporation C owns a minority interest in B and does not consolidate with B for book purposes. Assume that this transaction otherwise satisfies all the requirements for reorganization treatment as a type "B" reorganization.

There are several potential disparities between the book and tax treatment of this transaction. For federal tax purposes, the transaction is characterized as a stock reorganization, so none of A, B, or B's shareholders recognize any gain or loss on the share-for-share exchanges.

[110] We note that, if B actually transferred its assets to A in complete liquidation, there would still likely be no book consequences because the transfer is between members of a Book Group.

However, for B shareholders that are not consolidated with either B or A for book purposes, we understand that there is potential book income on the share-for-share exchanges.

Under the Notice, C would not be a Party to the transaction and, therefore, could not exclude from AFSI any book gain recognized on the exchange of B shares for A shares. Thus, we believe that the definition of Parties should be expanded as explained in our analysis of Example 9A.

With respect to basis, for book purposes, A might reflect B's assets with a stepped up basis, even though for tax purposes there would be no adjustment to B's asset basis. Additionally, A would not reflect B's stock on its AFS once they are consolidated after the transaction, even though such stock is recognized as an asset of A for tax purposes. In order to avoid a misalignment between current and future book and tax income, we believe it is necessary in this circumstance to adjust B's asset basis for AFSI purposes after the transaction, so that it is the same as B's asset basis prior to the transaction. Additionally, in the event that for tax purposes A has different tax bases in different shares of its B stock under Treas. Reg. § 1.358-2(a), we believe that a tracing rule—similar to that described above with respect to our discussion on nonqualified preferred stock in Example 6C—may be needed to properly account for book gain or loss when there are subsequent partial transfers of such stock to avoid recognizing the same gain twice.

In our view, similar principles should apply to a reorganization that takes the form of a reverse subsidiary merger or a forward subsidiary merger.

> **Example 10B:** *Stock Reorganization with a Consolidated Applicable Corporation Shareholder Treated as an Asset Disposition for Book Purposes and a Stock Disposition for Income Tax Purposes*
>
> Assume the same facts as in Example 10A except that corporation B is wholly owned by corporation C and consolidates with C for book purposes.

The tax treatment of each party and the shareholders is identical to that in Example 10A. We understand that under financial accounting rules, the transaction is viewed as a disposal of assets by B (part of the Target AFS Group) to A. We believe that guidance should clarify that any book gain reflected on Target AFS Group's AFS on the disposition of B's assets should be excluded from Target AFS Group's AFSI. It is important for guidance to clarify that the exemption from gain for Covered Nonrecognition Transactions applies to this asset-level gain as well, even though the character of the transaction for tax purposes (as a transfer by parent of its subsidiary stock) differs from the character for book purposes (as a disposition of the underlying assets). Appropriate basis adjustments should also be made, such that the stock of A transferred to C as consideration, is reflected with exchanged book basis from the B assets that were deemed transferred. Although we believe this treatment is what was intended by the Notice, further clarification would be helpful.

> **Example 11A:** *Partial Nonrecognition Transaction Structured as a Forward Merger with Minority Applicable Corporation Shareholder*

Corporation A (an applicable corporation) forms a merger subsidiary. Corporation B merges with and into the merger subsidiary, with the merger subsidiary surviving the merger. The consideration received by B shareholders is 60% A stock and 40% cash. Corporation C owns a minority interest in B and does not consolidate with B for book purposes. Assume that this transaction otherwise satisfies all the requirements as a reorganization under section 368(a)(1)(A) by virtue of section 368(a)(2)(D).

Except for the boot paid to the shareholders, none of A, B, or B's shareholders recognize any gain or loss for federal tax purposes on the exchanges of shares and assets, as the case may be. B does not recognize gain on the cash received and distributed to its shareholders under section 361(b). B shareholders will recognize taxable income on the cash they receive as boot under section 356(a), in an amount equal to the lesser of their built-in gain in their B stock and the amount of boot received. To the extent that B recognizes book gain on the assets it transfers to A and its receipt of cash, the guidance should exclude this book income from the calculation of AFSI, consistent with the Notice's treatment of Covered Nonrecognition Transactions without boot. Similar rules should apply if this transaction takes the form of a type "C," "D," or "G" asset reorganization.

We believe that the definition of Parties should be expanded as explained in Example 9A such that it would include C. With regard to partial nonrecognition by C, this transaction presents the same issues as those described in Example 6A in the discussion above on section 351 transactions, with respect to the application of the boot-within-gain rule. We believe guidance should adopt a similar boot-within-book-gain approach here. In our view, appropriate basis adjustments should also be made, such that the stock transferred to C receives exchanged book basis increased by any book gain recognized on the receipt of boot and reduced by cash received by C, and the assets transferred to B receive transferred basis.

Example 11B: *Partial Nonrecognition Transaction Structured as a Forward Merger with a Consolidated Applicable Corporation Shareholder*

Assume the same facts as in Example 11A except that, prior to the transaction, corporation B is wholly owned by corporation C and consolidates with C for book purposes.

The tax treatment of each party and the shareholders is identical to that in Example 11A. To the extent that B recognizes book gain on the assets it transfers to A and its receipt of cash, the guidance should exclude this book income from the calculation of AFSI, consistent with the Notice's treatment of Covered Nonrecognition Transactions without boot. For federal tax purposes, this transaction is characterized as an asset reorganization, with B's transfer of property qualifying for nonrecognition under section 361 on the cash it receives and distributes to its shareholders. Thus, for federal tax purposes, the Target AFS Group recognizes gain only at the shareholder level, and such gain is determined with reference to the B shares exchanged.

We understand that, for financial accounting purposes, the Target AFS Group is viewed as having disposed of assets (rather than stock) in connection with the reorganization. As discussed above in Example 10B, we believe that guidance should clarify that any book gain reflected on B's Target AFS Group's AFS as a disposition of B's assets should be excluded from Target AFS Group's AFSI (including the AFSI of C). With regard to C, the same issues that arise under Example 11A apply here, except that C is treated for book purposes as having disposed of property rather than B stock. For tax purposes, C is viewed as engaging in a Partial Nonrecognition Transaction with respect to its gain in its B stock. In order to properly reflect such a Partial Nonrecognition Transaction on C's AFS after the transaction, we believe that a notional item of gain may need to be created, and asset level gain should be ignored. Additionally, after the transaction, assuming C and A are not consolidated for book purposes, C will have stock in A reflected as an asset on its AFS. In our view, C's book basis in the stock should be adjusted, for AFS purposes, to reflect its asset level basis in the assets it was deemed to transfer, but adjusted upwards to reflect any partial gain recognition and downward to reflect cash received, under principles similar to section 358.

> **Example 12A:** *Partial Nonrecognition Transaction Structured as a Reverse Subsidiary Merger with a Minority Applicable Corporation Shareholder*
>
> Corporation A (an applicable corporation) forms a merger subsidiary. A acquires corporation B (an applicable corporation) for 90% A stock and 10% cash in a reverse triangular merger. B is the parent of its Book Group. The merger subsidiary merges with and into B, with B surviving. Corporation C owns a minority interest in B and does not consolidate with B for book purposes. Assume that this transaction otherwise satisfies all the requirements as a reorganization under section 368(a)(1)(A) by virtue of section 368(a)(2)(E).

Except for the boot paid to the shareholders, none of A, B, or B's shareholders recognize any gain or loss for federal tax purposes on the deemed share-for-share exchanges as a result of the merger. B shareholders will recognize taxable income on the cash they receive as boot under section 356(a), in an amount equal to the lesser of their built-in gain and the amount of boot received. We understand that there may be income recognition on the share-for-share exchange for book purposes. In our view, the guidance should adopt a similar approach here for shareholders as with Example 6A boot-within-book-gain.

We also believe that the definition of Parties should be expanded as explained in Example 9A such that it would include C. In our view, appropriate basis adjustments should also be made, such that the stock transferred to C receives exchanged book basis, increased by book gain recognized on the boot, and reduced by cash received.

> **Example 12B:** *Partial Nonrecognition Transaction Structured as a Reverse Subsidiary Merger with a Consolidated Applicable Corporation Shareholder*
>
> Assume the same facts as in Example 12A except that corporation B is wholly owned by corporation C and consolidates with C for book purposes.

The tax treatment of each party and the shareholders is identical to that in Example 12A. With regard to C, this transaction presents the same issues as those described in Example 6A in the discussion above on section 351 transactions, and we believe guidance should adopt a similar boot-within-book-gain rule approach here.

For federal tax purposes, the transaction is characterized as a stock reorganization. We understand that, for financial accounting purposes, the Target AFS Group is viewed as having disposed of assets (rather than stock) in connection with the reorganization, at least to the extent that C and A are not consolidated for book purposes after the transaction. We believe that guidance should clarify that any book gain reflected on B's Target AFS Group's AFS as a disposition of B's assets should be excluded from Target AFS Group's AFSI. As discussed above in Example 10B, in our view, it is important for guidance to clarify that the exemption from gain for Covered Nonrecognition Transactions applies to this asset-level gain as well. We also believe that C's basis, for AFSI purposes, in the A stock it receives should be determined under principles similar to those described in Example 11B.

c. Corporate Distributions Under Section 355

(i) Background

Section 355 is the primary Code section governing nonrecognition treatment for spinoff and splitoff transactions. Congress provided some flexibility to corporations effecting a spinoff or splitoff by permitting nonrecognition treatment both when the distribution of a controlled subsidiary is made *pro rata* with respect to all of the shareholders of the distributing corporation, and where it is distributed on a non-*pro rata* basis. Congress first enacted rules to provide for nonrecognition in certain spinoff-type transactions in 1918 and, subject to numerous amendments, continues to provide for nonrecognition on certain corporate distributions of subsidiary stock.[111]

Nonrecognition treatment is available under sections 355 and 361 if a corporation, Distributing, distributes to its shareholders stock of another corporation, Controlled, and certain conditions are satisfied. [112] At a high level, under these rules, nonrecognition can apply under section 355 where:

- Distributing contributes an active trade or business to a newly-formed Controlled (or Distributing historically held the stock of Controlled and Controlled has an active trade or business) and distributes all of its Controlled stock to its shareholders on a pro rata basis (a "**spinoff**"), or

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[111] Revenue Act of 1918, Pub. L. No. 65-254, § 202(b), 40 Stat. 1057, 1060 (1919). *See* Revenue Act of 1921, Pub. L. No. 67-98, § 202(c), 42 Stat. 227, 230 (1921). *See also* Revenue Act of 1924, Pub. L. No. 68-176, § 203(h)(1)(B), 43 Stat. 253, 257 (1924). Congress partly repealed section 355 in 1934 but reinstated and amended it in the 1950s. *See* Revenue Act of 1951, Pub. L. No. 82-183, § 317, 65 Stat. 452, 493 (1951). *See also* Internal Revenue Code of 1954, Pub. L. No. 83-591, § 355(b), 68A Stat. 3, 114 (1954).

[112] Among others, these conditions are that (i) Distributing distributes section 368(c) "control" of Controlled to its shareholders under section 355(a)(1)(A), (ii) the distribution is not used principally as a device for the distribution of earnings and profits under section 355(a)(1)(B), (iii) Distributing and Controlled are engaged in valid active trades or businesses immediately after the distribution under section 355(b), (iv) the distribution does not constitute a disqualified distribution under section 355(d), and (v) section 355(e) does not apply to the distribution as a result of a 50% change of control of Distributing or Controlled as part of a plan with the distribution.

- Distributing contributes an active trade or business to a newly-formed Controlled (or Distributing historically held the stock of Controlled and Controlled has an active trade or business) and delivers all of the stock of Controlled to certain shareholders of Distributing corporation in exchange for their Distributing stock on a non-pro rata basis (a "**splitoff**").

When Distributing transfers assets to Controlled as part of the plan of the distribution of Controlled to Distributing shareholders, such transactions are also known as "divisive D reorganizations," and these transactions are effected pursuant to section 368(a)(1)(D) and section 355.

Both spinoffs and splitoffs can still qualify for nonrecognition treatment where Distributing retains stock in Controlled constituting less than 20% of the voting power and 20% of each class of non-voting stock, and subsequently exchanges the retained Controlled stock for Distributing debt or stock, or otherwise disposes of such Controlled stock in certain transactions undertaken with the permission of the Service.

The relevant accounting rules take an entirely different approach to separation transactions. At a high level, we understand that spinoff transactions (that is, those that are *pro rata* distributions to Distributing's shareholders) do not result in gain for financial accounting purposes, while splitoff transactions can trigger such gain based on the difference between the fair market value of Controlled's stock at the time of distribution and its book value. Additionally, in circumstances where Distributing delivers Controlled stock or securities to creditors of Distributing, financial accounting rules may require an income inclusion even where the strict conditions necessary for nonrecognition treatment under section 355 have been met.

The Notice exempts from AFSI financial statement gain or loss directly resulting from either spinoff or splitoff transactions eligible for nonrecognition transaction under section 355. In order to qualify for exemption from AFSI, such spinoff or splitoff transactions must qualify for nonrecognition in full, except to the extent one component of the larger transaction constitutes a Covered Nonrecognition Transaction even though gain is recognized with respect to another such component.[113] For any Covered Nonrecognition Transaction eligible for the exemption described above, increases and decreases to the financial accounting basis of property that would otherwise have been taken into account for financial reporting purposes are not taken into account for AFSI purposes by the party receiving the transferred property.

(ii) Recommendations

The guidance issued under the Notice helpfully aligns the treatment of splitoff transactions with those of spinoff transactions for AFSI purposes. We believe some further clarification is necessary with respect to the following issues:

- The AFSI basis consequences of Covered Nonrecognition Transactions that are spinoffs and splitoffs should follow the federal tax basis consequences.

[113] *See* Notice §§ 3.03(1)(a); 3.02(5)(b).

- Distributing's book gain with respect to retained stock should not result in AFSI in certain circumstances.

(iii) Discussion

(a) Basis

As with section 351 transactions and reorganizations, the basis rule in Section 3.03(2) of the Notice does not align well with the substitute basis rules (*i.e.*, exchanged basis and transferred basis) under regular tax principles. We believe the two should be aligned. Thus, for example, Controlled's asset basis should be preserved for AFSI purposes in a spinoff or splitoff, regardless of whether the relevant book rules treat the spinoff or splitoff as triggering book gain (and, therefore, regardless of whether or not the Covered Nonrecognition Transaction rule in Section 3.03(1) of the Notice is needed to exempt such book gain, subject only to the adjustments that may be required under section 362 (including, for example, in connection with a "boot purge" transaction).

Additionally, we believe that Example 4 in Section 3.03(3)(d) of the Notice incorrectly applies both the rules of the Notice and tax basis principles. Under the example, in an otherwise tax-free spinoff transaction, Distributing recognizes taxable income with respect to a debt-for-debt exchange. The Example concludes that, because of this recognition event, an asset basis adjustment is required for Controlled's assets. Section 362 does not provide for such an adjustment, nor does section 355, and we do not believe it would be appropriate for CAMT purposes either. We do not believe that Example 4 properly applies the basis adjustment rule in section 3.03(2) of the Notice, and recommend modifying the example to do so.

(b) Multi-Step Transactions

In the case of a multi-step spinoff or splitoff, where Distributing retains a portion of the Target stock for a period and then subsequently disposes of such stock in completion of the spinoff or splitoff, the gain in respect of such subsequent disposition is exempt from federal taxation assuming that it is distributed in completion of the relevant spinoff or splitoff and was undertaken with the permission of the Service. We believe that this result is also what should occur under the Notice. In that regard, we believe that the rule exempting the direct book consequences of a Covered Nonrecognition Transaction arguably already applies on these facts. However, further clarification on this point would be helpful.

Additionally, we believe that guidance should clarify that Distributing should not be required to include in AFSI any book income attributable to its ownership of the retained Controlled stock, during the period Distributing retains such stock, other than income in respect of distributions of assets from Controlled to Distributing during that period. We understand that it is possible under financial accounting rules that certain adjustments and other book gain (including, for example, "remeasurement" or mark-to-market gain) could occur during that period with respect to transactions between Distributing and Controlled (or Distributing's mere ownership of Controlled equity). However, we do not see a rationale for applying the CAMT to such income and gain, where the gain inherent in those retained shares would otherwise be eligible for nonrecognition treatment under the spinoff and splitoff tax rules. Arguably, Example 3 in Section 3.03(3)(c) of the Notice suggests that such gain is eligible for the exemption under the Notice, because it provides that Distributing does not take into account *any* financial accounting gain that would otherwise result from the application of the taxpayer's accounting standards. However, confirmation of this treatment would be welcome.

In addition to the points above, we have considered whether guidance is needed in situations where a spinoff or splitoff *and* an acquisition of a 50% or greater interest in either Distributing or Controlled is acquired as part of the same plan or arrangement as set forth in section 355(e). Such transactions could, years after the separation transaction, result in an imposition of corporate-level taxable income on Distributing. In this case, we recommend that guidance require gain recognition for AFSI purposes in an amount that is equal to the gain that Distributing recognized under book principles without regard to the exemption from AFSI otherwise provided in Section 3.03(1) of the Notice. In a spinoff, this should not result in any additional AFSI inclusions, because as described above, the financial accounting rules generally do not require remeasurement gain to be taken into account in a pro rata spinoff transaction.

We had also considered adopting a lesser-of principle, where the gain included in AFSI as a result of a section 355(e) transaction could be capped at the amount of section 355(e) gain. However, in our view, this approach would encourage adopting a two-step transaction structure (distribution followed by a pre-agreed upon sale) to avoid any AFSI in excess of section 355(e) gain, and does not appear to be justified from a policy perspective. Section 355(e) was intended to put Distributing in the same tax position as if it had done a taxable distribution, and we do not believe there is a reason that the CAMT result to Distributing should be different if the spinoff or splitoff fails section 355 altogether, or if it satisfies section 355 but is fully taxable on account of section 355(e).

3. Purchase Accounting of Covered Recognition Transactions

The Notice generally provides that, in the event of a Covered Nonrecognition Transaction, any increase or decrease in the book basis of a Party's assets will not be taken into account for purposes of calculating AFSI.[114] The Notice, however, does not address and requests comments on whether similar rules should apply to transactions under the Notice that result in gain or loss recognition for tax purposes ("**Covered Recognition Transactions**"),[115] which are equally as capable of providing an asset basis step up for book purposes as Covered Nonrecognition Transactions even though there is no book or taxable gain recognized on the assets. The Notice also provides for no AFSI adjustments in respect of differences in book and tax amortization resulting from the purchase accounting of taxable asset acquisitions. In this Part, we discuss these situations and whether, in our view, AFSI should be adjusted to conform with regular tax principles in such situations.

[114] Notice § 3.03(2).

[115] Notice § 9.01(1)(d).

a. Background[116]

"Purchase accounting," "acquisition method accounting," or "business combination accounting" applies when a transaction or other event occurs pursuant to which an acquirer obtains control of one or more businesses.[117] A business is any "integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return."[118] Thus, a simple asset sale would not qualify for purchase accounting if, together, those assets do not constitute a business. Purchase accounting applies regardless of whether the legal form of the acquisition is a stock sale or an asset sale.[119]

The consequences of a business combination are, for book purposes, essentially those that would result in a transaction characterized as an asset sale for regular tax purposes. First, the acquirer must "recognize the identifiable assets acquired,[120] the liabilities assumed and any noncontrolling interest" in the target business.[121] Identified assets include both tangible assets and intangible assets other than goodwill.[122] Identified assets and liabilities are recognized at fair value on the acquisition date. Mechanically, this requires the acquirer to allocate value across the identified assets in a manner similar to section 1060.[123] This allocation will affect the depreciation and amortization with respect to those assets, as well as any gain or loss upon their eventual disposition.

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[116] This summary reflects the GAAP rules of purchase accounting. We note that the IFRS rules will apply in circumstances where the relevant financial statement is under IFRS and that the rules may different.

[117] Financial Accounting Standards Board ("**FASB**") ASC 805-10-25-1.

[118] *Id*.

[119] FASB ASC 805-10-55-3. Certain transactions are excluded from the purchase accounting rules, such as formations of joint ventures and combinations involving entities or businesses under common control.

[120] The acquirer in a business combination is defined based on the consideration being paid. In a business combination where the consideration is cash or other assets (or the assumption of seller liabilities), the acquirer is usually the party transferring that consideration (or assuming those liabilities). FASB ASC 805-10-55-11. In a business combination where the consideration is equity, the acquirer is usually the "entity that issues its equity interests." FASB ASC 801-10-55-12. That said, the "acquirer for accounting purposes may not be the legal acquirer" and "all pertinent facts and circumstances should be considered in determining the acquirer in a business combination that primarily involves the exchange of equity interests." PricewaterhouseCoopers, *Business Combinations and Noncontrolling Interests*, § 4.2, available at https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/business_combination/assets/pwcbuscombguide0922v2.pdf. (Sept. 30, 2022).

[121] FASB ASC 805-20-25-1.

[122] To be identified separately from goodwill, an intangible asset must either "arise from contractual or other legal rights" or be "capable of being separated or divided from the acquired business and sold, transferred, licensed, rented, or exchanged." PricewaterhouseCoopers, *US Business Combinations Guide*, § 4.2, *available at* https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/business_combination/business_combination__28_US/chapter_4_intangible_US/42_intangible_assets_US. (May 31, 2022).

[123] FASB ASC 805-20-30-1.

Then acquirer must establish the value of the cash or other consideration being paid in exchange for the business. To the extent the value of the consideration exceeds the fair value of the identified assets and liabilities of the target business, the acquirer will record an amount of goodwill as an asset; that asset is not amortizable and, instead, subject to annual impairment tests based on Accounting Standards Codification ("**ASC**") 350.[124] In the unlikely event that the value of the consideration is *less* than the fair value of the identified assets and liabilities, ASC 805 recognizes this as a "bargain purchase" and requires the immediate recognition of gain equal to the shortfall.[125]

b. Recommendations

We recommend that Treasury and the Service issue the following guidance on the AFSI consequences of purchase accounting basis step ups in Covered Recognition Transactions:

- Purchase accounting should be allowed on a taxable acquisition of stock out of an AFS Group, since book gain is recognized on the assets.

- In the case of a cash purchase of stock from the public, where no book gain is recognized on the assets, a majority of our members believes that purchase accounting should be allowed, while a minority believes that a carryover AFSI basis should apply.

- In any case where purchase accounting is allowed, CAMT NOLs should not carry over to the corporation with a stepped up CAMT basis.

- If Treasury and the Service decide to adjust AFSI to eliminate the purchase accounting step up resulting from a taxable stock purchase, they should not adjust AFSI so that all accounting goodwill resulting from a taxable asset purchase is amortizable under section 197's straight-line amortization schedule.

c. Discussion

(i) Taxable Stock Sales

In a Covered Recognition Transaction that is a taxable stock purchase, the Acquirer AFS Group will generally not receive any basis step up in Target's assets for regular tax purposes.[126]

[124] PricewaterhouseCoopers, *US Business Combinations Guide*, § 2.6, *available at* https://viewpoint.pwc.com/dt/us/en/pwc/accounting_guides/business_combination/business_combination__28_US/chapter_2_acquisitio_US/26_recognizing_and_m_US.html (May 31, 2022). Impairment is tested on an annual basis or more frequently, if the circumstances require it.

[125] *Id.*

[126] This assumes that the target is a corporation for U.S. tax purposes and no section 338 or 336(e) election is made. Transactions involving the sale of a disregarded entity or partnership or a corporation with a section 338 or 336(e) election raise the same considerations as a taxable asset sale.

However, purchase accounting will cause an asset basis step up for book purposes. This has the following consequences:

- *Depreciation.* Under section 56A(c)(13), AFSI is reduced for depreciation expense under section 167 with respect to Section 168 Property and increased by the amount of any corresponding book items of depreciation. This is intended to adjust AFSI so that it applies tax, and not book, rules for depreciation. Accordingly, section 56A(c)(13) should eliminate any AFSI depreciation resulting from a purchase accounting step up given the lack of tax depreciation. Upon disposition of depreciable property, the Notice requires the taxpayer to adjust AFSI to redetermine gain or loss by "adjusting the AFS basis of such property to take into account all current and prior section 56(c)(13) adjustments," including those that would have been made in years prior to the effectiveness of the CAMT; this provision does not specify whether those "current and prior section 56(c)(13) adjustments" are inclusive of those occurring prior to the purchase accounting step up.[127]

- *Amortization.* Unlike depreciation, there is no general AFSI adjustment for section 197 amortization.[128] Thus, purchase accounting is favorable to the Acquirer AFS Group in two respects. First, specified (non-goodwill) intangibles with a limited life will produce amortization that reduces AFSI. Second, although goodwill will not result in any predictable amortization, it may trigger loss upon impairment, which carries forward into future years under section 56A(d).

- *Sale of Target Stock.* A disposition of Target will result in deconsolidation for book purposes. Accordingly, the disposition will trigger book gain to the extent of: (i) the appreciation in Target's assets since initial purchase; and (ii) any depreciation or amortization taken prior to sale.[129] For regular tax purposes, however, there will be gain only to the extent of appreciation in Target's stock since the buyer's purchase.

- *Sale of Target Assets*. A disposition of some or all of Target's assets will result in recognition of gain and loss, as the case may be, for book purposes. Accordingly, the disposition will trigger book gain to the extent of: (i) the appreciation in those assets since the initial purchase; and (ii) any depreciation or amortization taken prior to sale. By contrast, for regular tax purposes, gain and loss will be calculated based on the historical tax basis of the relevant assets, which is unaffected by the purchase accounting step up.

There are three key implications to the above discussion. First, prior to a sale, purchase accounting results in differences between book and tax depreciation and amortization to the extent the purchase price is allocable to intangibles with a limited life. This will generally be most relevant where there are valuable "specified" intangibles, because those items will be amortizable currently. In the usual case, this will result in an excess of book deductions over tax deductions that will reduce the potential CAMT liability. Second, any amortization that is

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[127] Notice § 4.07.

[128] Under section 56A(c)(14), AFSI is adjusted to follow section 197 principles for qualified wireless spectrum.

[129] FASB ASC 810-10-40-4.

allowed for AFSI purposes, but not for regular tax purposes, is unwound upon a sale of Target stock. Third, in the event of a sale of Target assets, purchase accounting will create a permanent AFSI benefit relative to tax by reducing AFS gain on that sale.

Moreover, allowing purchase accounting on a taxable stock purchase (assuming no allowance of amortization of goodwill for AFSI purposes, as discussed below) may result in taxpayer behavior aimed at maximizing the AFSI benefit of intangibles that are specifically identifiable for book purposes. As occurred prior to the enactment of section 197 in 1993, applicable corporations will be incentivized to allocate as much value as possible to identifiable intangibles (amortizable) rather than goodwill (nonamortizable). Moreover, in the event Service auditors have the authority to challenge aggressive book positions that had been approved by company auditors for GAAP purposes, the Service frequently may find itself in litigation on this issue. Similarly, taxpayers may have the incentive to selectively trigger impairment of their goodwill to offset AFSI. Although any such impairment would have to be approved by auditors, this planning would be available to taxpayers unless the straight-line amortization schedule under section 197 were adopted. While these concerns could possibly be ameliorated with anti-abuse rules, it may not be so clear that such taxpayer behavior is "abusive."[130]

To better conform AFSI with regular tax principles (including the repeal of the *General Utilities* Doctrine), Treasury and the Service could adjust AFSI to eliminate the benefit of purchase accounting in cases where the underlying assets are not subject to book gain ("**purchase accounting adjustment**"). [131] We note that a purchase accounting adjustment would have far-reaching consequences for the Acquirer AFS Group—because book basis is fundamental to the reporting of many transactions, it would be very burdensome to completely eliminate the benefit of a purchase accounting step up in AFSI basis. Further, while the Notice's treatment of Covered Nonrecognition Transactions raises similar reporting complexities, taxable stock sales are likely to be much more commonplace for Acquirers, compounding the practical impact of the purchase accounting adjustment.

If a purchasing accounting adjustment is adopted, in our view, it should have the following features:

- *Scope*. The purchase accounting adjustment should apply to taxable stock sales in which (i) the acquiring corporation obtains the benefit of a purchase accounting step up but (ii) the selling corporation does not recognize any book gain on the assets, and (iii) the sale does not also result in a deemed sale of assets for regular tax purposes. Practically, this means that purchase accounting should be allowed on a taxable stock sale of a consolidated Target because this would trigger book gain to the Target AFS Group and on a transaction involving a section 338

[130] Of course, in doing so, companies will need to take into account the potential tax benefits alongside the financial accounting impact of the recognition of additional book expense. We do not have any expertise in whether those financial reporting considerations may moderate the impulse to maximize CAMT benefits.

[131] We likewise note that, as discussed above, the Pillar 2 rules disregard purchase accounting except in limited circumstances.

election because that election results in a deemed asset sale for regular tax purposes.

- *Basis.* If the purchase accounting adjustment applies to taxable stock sales, the Acquirer AFS Group should be treated as acquiring Target's underlying assets with a carryover AFS basis, which would be taken into account for purposes of all of the Acquirer AFS Group's AFSI determinations going forward.

- *Notional AFS Item for Stock Basis*. If the Acquirer AFS Group subsequently disposes of Target's stock in a taxable sale, AFS gain or loss would normally be based on the Acquirer AFS Group's AFS basis in Target's assets. If a purchase accounting adjustment had previously been made, this would inappropriately eliminate the Acquirer AFS Group's purchased basis in its Target stock. Accordingly, the Acquirer AFS Group should be permitted to maintain that purchased stock basis as a separate, notional AFS item, which would offset gain or generate a loss upon a taxable sale of its Target stock. This item should equal the purchase accounting step up (or step down) allocable to the Target assets (before taking into account any purchase accounting adjustment), without regard to any subsequent depreciation or amortization of that stepped up (or stepped down) basis.

We acknowledge that the administrative complexity associated with a purchase accounting adjustment has to be balanced against the adjustment's policy justification. We therefore recommend that guidance provide the following rules:

that:

- In the case where a subsidiary is purchased from a Target AFS Group and gain or loss is reported on the assets for book purposes, *General Utilities* repeal is not implicated and purchase accounting should be followed.

- If gain on the assets is not recognized for book purposes, such as on a purchase of stock from the public, a majority of our members believes that purchase accounting should be allowed on the basis that the policy justification for a purchase accounting adjustment does not outweigh its administrative complexity as applied to the full universe of Covered Recognition Transactions; these members also recognize that the CAMT is fundamentally based on book principles and that purchase accounting is an established accounting principle. However, a minority of our members believes that carryover AFSI basis should apply under *General Utilities* principles.

- In any cases where purchase accounting is followed, any existing CAMT NOLs of the Target AFS Group should be eliminated or, in the case of a Target being acquired out of a Target AFS Group, retained by the Target AFS Group—this ensures that the book "asset sale" framework applies for both carrying value *and* loss carryforward purposes.

- When purchase accounting is allowed, Treasury and the Service should also consider adopting a rule that retroactively disallows a purchase-accounting step up for CAMT purposes if the Acquirer AFS Group disposes of the assets of the Target or the Target AFS Group (as the case may be) within a given period after the acquisition.

Similarly, if purchase accounting is followed, regulations should clarify the interaction between purchase accounting and the adjustment for depreciable assets under Section 4 of the Notice; in particular, regulations should address how an Acquirer must take into account items such as Tax COGS Depreciation, Deductible Tax Depreciation, Covered Book COGS Depreciation, Covered Book Depreciation Expense and Covered Book Expense (as each term is defined under the Notice) to the extent those items are attributable to the assets' ownership in the hands of the Target AFS Group.

(ii) Taxable Asset Sales

A related, but distinct, inquiry is whether AFSI should be conformed with general tax principles in connection with a taxable asset purchase. Following such a purchase, there is no, or comparatively little, upfront difference between book and tax: both result in a full basis step up. However, in addition to the built-in statutory differences between book and tax on section 168 assets, an asset purchase may result in a significant difference between book and tax amortization if a significant amount of the purchase price is allocable to goodwill. In that circumstance, the taxpayer will likely be *worse off* applying financial accounting principles than tax principles. The tax goodwill will be amortizable under section 197, while the book goodwill will only create an AFSI benefit upon impairment, which may or may not ever occur.

To address this gap between book and tax treatment, Treasury and the Service would have to adjust AFSI so that goodwill amortization follows section 197 principles. At the outset, we note that, it is not clear whether Treasury has authority to adopt such a proposal. Although there is a general grant of authority in section 56A(c)(15), the statute already includes provisions specifically aligning book depreciation and amortization with respect to qualified wireless spectrum with tax principles.[132] The fact that all amortization under section 197 was not adjusted for in this manner, in our view, suggests that Congress did not intend for a general amortization adjustment to apply. It is also not obvious that, as a policy matter, goodwill amortization for tax but not book purposes should receive more favorable relief from Treasury and the Service than other discontinuities between tax and book treatment.

On the other hand, failure to allow AFSI amortization for goodwill under section 197 principles may result in taxpayer behavior similar to that discussed above in connection with purchase accounting following a stock acquisition. Applicable corporations may be incentivized to allocate as much value as possible to identifiable intangibles (amortizable) rather than goodwill (nonamortizable), with the attendant complexities described above.

Although there are various competing considerations, our recommendation is that no special adjustments to the AFSI treatment of intangibles should be applied in the context of asset

[132] I.R.C. § 56A(c)(1) and (c)(14)

sales. That said, Treasury and the Service could adopt such an adjustment only if purchase accounting is disregarded in connection with taxable stock purchases. The intent behind such an approach would be to provide that, in all circumstances, regular tax rules should govern the tax attributes resulting from an acquisition transaction, whether or not those tax rules end up being more favorable to taxpayers than the book rules. Nevertheless, we do not recommend adopting such an approach, as it is not clear that Treasury has authority for such an approach, and because the basic tax principle that supports disregarding purchase accounting in the context of stock purchases (namely, the repeal of the *General Utilities* Doctrine) has no bearing on asset purchases.

4. Remeasurement Gain and the Realization Principle

As noted above in Part II.D.1 there is a significant disconnect between tax and accounting principles in circumstances involving transactions with an entity that is not consolidated with the counterparty for financial statement purposes, or for transfers of property between corporations that were not previously consolidated for financial statement purposes, but become consolidated, or vice versa. In addition to the realization versus recognition questions raised in the sections above, such transfers can oftentimes result in "remeasurement gain" for GAAP purposes, with respect to the *preexisting* investment reflected on the parent's balance sheet before and after the transaction. The circumstances in which the book income is triggered are not limited to realization transactions, and we believe that rules should address whether book income arising out of non-realization transactions can have AFSI consequences. The examples below highlight certain situations in which this issue can arise.

In many cases, the resulting book income bears no relation to taxable gain, or even to the particular transferred assets.

> **Example 13A:** Corporation A (an applicable corporation) and other transferors transfer property with built-in gain to corporation B (an applicable corporation). B is not part of the same Book Group as A, and A owned an equity interest in B prior to the transfer described here. For book purposes, A recognizes book income on the transferred property. However, in some cases A also may need to take into account remeasurement gain for book purposes on its historically held equity in B, to the extent the book value of that equity is less than its implied value from this transfer (*i.e.*, if A's preexisting equity in B has appreciated in value since it was originally booked). Effectively, A is marking its B equity to market for book purposes at the time of this transfer.

> **Example 13B:** Same as Example 13A, except that B was part of the same Book Group as A before the transfer, but not after the transfer. In addition to the book consequences resulting from the gain in the transferred asset itself, the deconsolidation of B for book purposes can give rise to additional book income attributable to the inherent book gain in A's historically held equity in B that remains A's equity in B (*i.e.*, those assets besides the property being transferred). The reason is that B's assets would have been reflected on A's balance sheet before the transfer but are taken off of A's balance sheet as a result of the transfer

and are effectively converted into a non-controlled equity interest in B for book purposes.

> **Example 13C:** Same as Example 13B, except that B is part of the same Book Group as A after the transfer but not before the transfer. In addition to the book consequences resulting from the gain in the transferred asset itself, A may again need to take into account remeasurement gain for book purposes on its preexisting equity in B, to the extent the book value of that equity is less than its implied value from this transfer.

The transactions described in Examples 13A through 13C may be section 351 transactions, or they may not be. That classification relates to the *taxation* of built-in gain in the property A transferred to B, and can be addressed by the nonrecognition rules described above for that purpose. If instead the transactions are section 1001 events, book gain on the transferred property can be included in AFSI under the general principles set forth in section 56A (*i.e.*, because no nonrecognition override would apply).

But in each of these fact patterns, there is a second type of book gain that has no corollary under federal tax principles. That second type of gain is the gain A or B may need to include for book purposes on assets or equity interests that are *not* being transferred. Although the imposition of remeasurement gain is on different types of assets in the three versions of this example (B's equity in two examples, B's assets in another), it is in each case effectively mark-to-market gain the inclusion of which is inconsistent with the realization principle. It is possible in many circumstances that this unrealized book gain is accounted for under OCI and, as we recommend in Part II.E.2.b below, should be excluded from AFSI on that basis. But we understand that in many circumstances it would be treated as net income for financial reporting purposes, and therefore included in AFSI absent a separate basis for excluding it.

Importantly, these issues can arise in myriad forms of taxable and tax-free transactions. For example, if A owned 100% of B and sold 51% of it for cash, A may need to take into account remeasurement gain on the remaining 49% for book purposes. The same concept would appear to apply if A owned 49% of B's equity, and acquired the remaining 51% in a taxable or nonrecognition transaction.

This treatment may have no connection to a company's actual income on a realization basis, as illustrated by the following example:

> **Example 13D:** In year 1, corporation A and two individuals transfer property to corporation B in exchange for one-third of B's equity each. At the time of the transfer, each transferor transfers property valued at $1 billion ($3 billion in total) and receives B equity valued at $1 billion. In year 2, the value of B's assets has increased to $6 billion, reflecting $1 billion of unrealized and untaxed gain per shareholder. Additionally, A transfers a smaller amount of additional property to B for a small amount of additional equity.

It is possible that because the implied value of B's equity issued to A in the second transaction was significantly higher than the value at which A carried the equity it already owned in B on its balance sheet, relevant book principles might require A to take into account remeasurement gain on its original $1 billion of B's equity. In that case, A could have $1 billion of book income triggered by a relatively small transfer of assets. It would be inconsistent with realization principles, and we believe inconsistent with the principles behind CAMT, to take that book income into account for AFSI and require A to pay tax on that unrealized gain.

We also understand that remeasurement gain can arise in dilution transactions, for example if a corporation or partnership issues new equity to a new or existing investor, diluting the equity investments of the other owners. In this latter fact pattern, we understand that the diluted owner(s) may be required, in some circumstances, to recognize book income as if the owner had sold a portion of its equity interest (representing the difference between the pre-dilution and post-dilution investment percentages) for its then-current value and report book gain attributable to such deemed sale. In this case, the person recognizing book income has not engaged in a transaction at all.

We recommend that guidance exclude the book income amounts from AFSI in each of the circumstances illustrated by Examples 13A though 13D above, because they appear to be inconsistent with the purposes of the CAMT and would in many cases result in duplicate taxation of the same items of gain except to the extent book gain results in a corresponding asset basis step up. In many of these cases, we believe the exclusion of remeasurement gain is suggested by section 56A(c)(2)(C), which provides that, in the case of a non-consolidated corporate subsidiary of a taxpayer, the AFSI of the taxpayer with respect to such subsidiary will be determined by only taking into account dividends received from such subsidiary and other items includable in gross income with respect to such subsidiary. Nevertheless, we believe it is critical that Treasury and the Service clarify that pure remeasurement gain is not includable in AFSI, regardless of the specific circumstances in which it arises and regardless of whether they technically fall within section 56A(c)(2)(C).

We acknowledge that there are numerous ancillary consequences that would result from this characterization that would need to be addressed, including, importantly, ensuring that book income that is excluded by such a rule would not be permanently exempt from the book calculation, including, for example, on a later disposition of the equity or assets. This might be addressed by requiring adjustments to AFSI basis, for purposes of future AFSI calculations in respect of the relevant equity or assets, in a way that will already be necessary for dealing with the consequences of bankruptcy and insolvency transactions as well as Covered Transactions.

For example, we believe that the same principles that apply to Examples 13A through 13D above should apply equally if the transferred property consists of equity in a subsidiary (*i.e.*, if A wholly owns C, and transfers 51% of C's equity into B, deconsolidating C for book purposes and triggering remeasurement gain on the 49% retained stake). In this fact pattern, we believe that additional guidance should consider adopting principles analogous to Treas. Reg. § 1.1502-13, relating to the triggering of deferred gain in a consolidated tax return. Under those principles, remeasurement gain initially excluded from AFSI might be included in AFSI when the retained stake leaves the book group or when the member owning the retained stake leaves the book group. This would make sense if, absent application of Treas. Reg. § 1.1502-13 principles, the economic appreciation in that retained stake would go permanently unrecognized for AFSI purposes.[133]

5. Transactions Between a Section 1502 Group and a Larger Book Group

This Part discusses cases where there is a transaction between an applicable corporation, or group of applicable corporations, and a corporation that is not in the Section 1502 Group but is in the Book Group (*i.e.*, included in the same AFS). These transactions raise questions if the AFS disregards transactions between entities within the Book Group. These transactions could arise, for instance, if a U.S. group has a foreign parent (or other foreign affiliate) or owns more than 50% (but less than 80%) of a domestic corporation.

We note that Section 9.01(1)(C) of the Notice asks for comments on whether adjustments to AFS gain or loss should be made to Covered Recognition Transactions carried out solely between or among members of a single AFS Group. Our approach is broader, because Covered Recognition Transactions are limited to taxable dispositions of assets, while we also discuss other items of income or loss from payments between group members.

For simplicity, we will consider four fact patterns where a single domestic corporation C engages in a transaction with either: (i) a 60% owned domestic subsidiary or a wholly owned foreign subsidiary (in either case "S"); or (ii) a foreign parent corporation "P." Consider the following fact patterns:

Example 14A: C receives \$100x of interest or royalties from P or S.

Example 14B: C pays \$100x of interest or royalties to P or S.

Example 14C: C sells an asset (basis \$0, value \$100x) to P or S for \$100x in cash.

Example 14D: C buys an asset (existing basis \$0, value \$100x) from P or S for \$100x in cash.

Since P, C, and S are included in the same AFS, transactions between them may be disregarded on the AFS. The transactions should generally be disregarded in determining whether C is an applicable corporation, since that test is intended to be based on the income of the group as a whole and should not be affected by intra-group transactions.[134] The core question

[133] Although the above discussion focuses on the adverse consequences resulting from remeasurement gain being respected for AFSI purposes, remeasurement principles also may give rise to book loss. Thus, we suggest that Treasury and the Service clarify that loss is not includable in AFSI. Absent this clarification, taxpayers may take the position that such a loss offsets AFSI even though no loss is realized for tax purposes. Further, the ancillary consequences of this approach also would need to be addressed, in our view, in the same manner as for remeasurement gain.

[134] To be sure, in the case of an FPMG that reports under GAAP, while intragroup transactions do not affect the AFSI of the group as a whole, the treatment of transactions between the domestic subgroup and the rest of the group may

is how these transactions should be treated in determining AFSI if C is in fact an applicable corporation and the transactions are disregarded on the AFS.

We believe there are three possible alternative approaches to the treatment of these transactions for AFSI purposes: (i) disregard the transactions altogether, just as we are assuming they are disregarded for book purposes; (ii) create notional book items, and resulting notional AFSI items as if C filed separate financial statements; or (iii) in the case of sales, apply deferral principles similar to the consolidated return rules in Treas. Reg. § 1.1502-13. We believe any of these methods would be authorized by the grant of authority in section 56A(c)(15) and section 56A(e) for regulations that the Secretary determines are necessary to carry out the purposes of section 56A. However, as discussed below, we believe the second alternative, to create notional book items, best carries out those purposes.

a. Disregarding Intragroup Transactions

Disregarding the transactions would be consistent with the premise that the CAMT is intended to be imposed on reported book income and should not be imposed on hypothetical book income. However, this would have a number of anomalous consequences.

- In Example 14A, C's taxable income would not come with corresponding AFSI, allowing it to "shelter" from potential CAMT liability an equal amount of AFSI in excess of taxable income.

- In Example 14B, C would get a tax deduction but not an AFSI deduction for the payment, meaning that it could owe the CAMT solely on account of a deductible payment to a related party.

- In Example 14C, C would be replacing an appreciated asset with cash without ever having any AFSI. No AFSI would be taken into account on a resale of the asset by P (since it is foreign) or S if it is foreign. In this case, even if S was domestic and received a $0 AFSI basis in the asset, this approach would allow the shifting of AFSI between C and S in an uneconomic manner that would permit tax planning to minimize CAMT liability.

- In Example 14D, the asset would retain its $0 book basis. If C sold the asset to an unrelated party for $100x, it would have no taxable gain but would have $100x of AFSI and potential CAMT liability.

These fact patterns, and others, involve duplication or omission of AFSI and, in our view, do not seem consistent with the purpose of the statute.

b. Notional AFSI Items

The second approach would be to create notional book items, and resulting notional AFSI items in all cases involving transactions with non-tax-consolidated members of the Book Group.

affect the domestic subgroup's AFSI and, accordingly, whether the subgroup meets the separate $100 million threshold for status as an applicable corporation.

On the one hand, this approach has the benefit of reaching the economically correct determination of AFSI for C, without the anomalous results that arise from disregarding intragroup transactions. This approach, in our view, is also consistent with section 56A(c)(2)(C), which states that the AFSI of a Section 1502 Group shall be determined by only taking into account dividends and "other amounts which are includable in gross income or deductible as a loss under this chapter... with respect to such other corporation." Arguably that language includes income or deduction on transactions with the other corporation.

On the other hand, we recognize that, in enacting the CAMT, Congress might have reasonably been concerned about intragroup transactions (*e.g.*, intragroup royalties or indebtedness) that may be designed to reduce a group's U.S. tax liability while not impacting book income. Creating notional AFSI items for these transactions would effectively unwind the CAMT's application with respect to these strategies.

c. Deferred AFSI Items

A third approach would be to apply the principles of the consolidated return regulations relating to intercompany transactions in Treas. Reg. § 1.1502-13. Under this approach, items of income and deduction are reported currently (Examples 14A and 14B), but gain or loss on sales transactions are reported on a deferred basis (Examples 14C and 14D). Under these rules, if C sold an asset to P or S, C would not have immediate AFSI, but rather C would have AFSI equal to its initial notional AFSI gain at the time the buyer of the asset (P or S) resold the asset to a third party, or when the buyer of the asset was no longer in the same group as C for financial reporting purposes.

However, this approach would be complex, as are the intercompany transaction rules under Treas. Reg. § 1.1502-13. Such a regime would have to require, for example, partial recognition of AFSI by C if the asset had a positive tax basis, was a depreciable asset for book purposes, and P or S took such depreciation. Moreover, in the consolidated return context, there is a single taxpayer for tax purposes and therefore no ability to shift reported income or AFSI from one Section 1502 Group to another. If those principles are applied to a Book Group, tax planning would allow the shifting of AFSI from one Section 1502 Group to another. C would also need to know the actions taken by P or S with respect to the asset, which would not always be possible. Finally, the logic is not clear for applying deferral principles to sales in Examples 14C and 14D and either disregarding income and deduction in Examples 14A and 14B altogether or else requiring current recognition of income or deduction in those cases.

d. Recommendations

We believe the preferable alternative is the creation of notional AFSI items. We acknowledge that this approach would itself not be simple, but we believe it is most consistent with the purposes of the statute and the best way to avoid anomalous results.

Whatever approach is adopted, we believe that the book basis of assets for AFSI purposes should be conformed to the rules for book recognition of gain or loss for AFSI purposes. This will avoid duplication or omission of income. If C is treated as having positive or negative AFSI on account of a sale of an asset to domestic S that is disregarded for GAAP purposes, then in our view S should receive a cost basis for AFSI purposes even though there is a carryover basis for GAAP purposes. Likewise, if C buys an asset from P, we believe that C should get a cost basis for AFSI purposes even though there is a carryover basis for GAAP purposes.

Moreover, a similar issue arises, even in the absence of intercompany transactions, if the Book Group has positive AFSI but, on a standalone basis, C has an AFSI loss. In that case, failure to treat C as a stand-alone Book Group would mean that it would not have an AFSI loss to carry forward. If Treasury and the Service adopt our view to create notional book items of income and loss as if the C group was a separate group, logically it should also allow the C group to have a notional NOL on a stand-alone basis that could be carried forward, and, in our view, the notional NOL should not be absorbed elsewhere to reduce AFSI within the book group.[135]

Finally, to the extent regulations adopt the approach of creating notional AFSI for C as if it had separate book financials, the issue arises as to whether the principles of section 267(f) should apply. Section 267(f) defers recognition of a loss for tax purposes under principles similar to the consolidated return rules. We believe there would be merit to conforming the AFSI rules to the tax rules. There is a question of whether a sale to a related party should result in an allowable AFSI loss as a policy matter, especially since it is not realized for book purposes due to the consolidation of the members. Moreover, allowing such an AFSI loss before the tax loss is recognized could result in an AFSI loss that provides no tax benefit, but AFSI in excess of taxable income in the later year, with resulting CAMT liability, solely because of the timing difference. However, we do not consider this issue an immediate priority, and this could be considered further in the future.

E. Tax Accounting Comments

1. Treatment of Computer Software, Qualified Films or Television Productions, and Qualified Live Theatrical Productions for Section 56A(c)(13) Purposes

a. Background

Section 168(k) provides a special allowance for depreciation of certain property. Section 168(k)(1) provides that in the case of any qualified property, the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property. The term "qualified property" in section 168(k)(2) includes computer software, qualified film or television production, and qualified live theatrical productions placed in service before January 1, 2027. Section 168(k)(7) permits a taxpayer to elect out of the special allowance for depreciation under section 168(k) with respect to any class of property for any taxable year. If a taxpayer makes such an election with regard to computer software, qualified film or television productions, or qualified live theatrical productions, the property is subject to cost recovery under section 167 or section 181, as applicable, rather than section 168(k) depreciation. Section 56A(c)(13) provides "adjusted financial statement income shall be reduced by depreciation

[135] For example, if a foreign parent owns two U.S. tax groups in the same book group, an actual or notional AFSI loss of one tax group should not be required to offset actual or notional AFSI income of the parent or the other group.

deductions allowed under section 167 with respect to property to which section 168 applies to the extent of the amount allowed as deductions in computing taxable income for the taxable year."

In Section 4.04(1)(b) and (c) of the Notice, the government specifies that for purposes of the reduction provided for under section 56A(c)(13), the term Section 168 Property includes "[c]omputer software that is qualified property . . . and depreciated under [section] 168" and "[o]ther property depreciated under [section] 168 that is (i) qualified property . . . and that is (ii) described in [Treas. Reg.] § 1.168(k)-2(b)(2)(i)(E), (F), or (G)" (related to qualified films or television productions, qualified live theatrical productions, and specified plants). In addition, the Notice provides that depreciation adjustments under section 56A(c)(13) are not available to the extent that a taxpayer elects to forgo bonus depreciation for such property.

b. Recommendation

We recommend that Treasury and the Service issue guidance to provide that computer software, qualified films or television productions, and qualified live theatrical productions remain a class of property to which section 168 applies and, as such, remains Section 168 Property for purposes of the adjustment in section 56A(c)(13)(A), even if a taxpayer elects to forgo the additional first-year depreciation deduction provided in section 168(k).

c. Discussion

Taxpayers are permitted depreciation adjustments under section 168(k) for computer software, qualified film or television production, and qualified live theatrical productions. Such property is amortized under section 167 if the taxpayer elects to forgo the additional first-year depreciation deduction available under section 168(k) for the class of property for the taxable year in which the property is placed in service. Section 56A(c)(13) explicitly states that the adjustment is the amount allowed as depreciation deductions under section 167 with respect to *property* to which section 168 applies. That is, the adjustment under section 56A(c)(13) is available with respect to specific types of property. Therefore, in our view, an election out of bonus depreciation should not change the characterization of the property as Section 168 Property. In these circumstances, the taxpayer should be entitled to a depreciation adjustment under section 56A(c)(13).

For this reason, we suggest that the government reconsider the position set forth in the Notice that depreciation adjustments under section 56A(c)(13) are not available to the extent that a taxpayer elects to forgo bonus depreciation for certain property. Instead, we believe that Section 168 Property remains unchanged in its characterization even if a taxpayer elects to forgo the additional first-year depreciation deduction with respect to such property. As such, the adjustment provided in section 56A(c)(13) should similarly remain available to the taxpayer.

For all other purposes, depreciation is determined based on the specific class of property so that all taxpayers holding the same class of property receive similar depreciation treatment. Further, the class of property remains unchanged even if a taxpayer elects to forgo available bonus depreciation. Our recommendation also aligns the CAMT provisions with the treatment of depreciable property and, as such, ensures that disparate treatment does not arise under the CAMT for property that is within the same class of property for depreciation purposes.

2. Meaning of "Net Income or Loss" under Section 56A(a)

a. Background

Section 56A(a) defines AFSI as the net income or loss reported in the taxpayer's AFS as defined in section 451(b)(3) or specified in regulations or other guidance, with adjustments for certain items. However, section 56A does not explicitly define AFS net income or loss. Section 56A(b) defines an AFS with reference to section 451 and related regulations. Section 451(b)(3) and Treas. Reg. § 1.451-3 each define an AFS but neither provision defines net income or loss. In addition, the Notice regularly refers to net income or loss but does not provide further clarification regarding the meaning of the term.[136] Instead, the Notice requests comments on the extent to which, if any, items included in OCI in a taxpayer's AFS should be included in AFSI.[137]

b. Recommendation

We recommend that guidance clarify that the term net income or loss set forth on the taxpayer's AFS refers to a taxpayer's income from operations and that the term excludes items included in OCI reported on the taxpayer's AFS.

c. Discussion

In financial accounting, there is a significant distinction between net income and OCI. Net income is a measure of the utility of the entity's operating assets and is generally computed as sales less cost of goods sold and other expenses.[138] In contrast, OCI includes items of unrealized gain or loss. The FASB establishes the rigorous standards for U.S. GAAP, which are set forth as ASCs. The list of items included in OCI is set forth in ASC 220-10-45-10A and includes, but is not limited to: foreign currency translation adjustments; gains and losses on foreign currency transactions that are designated as economic hedges; gains and losses on derivative instruments that are designated as cash hedges; and changes in fair value attributable to instrument-specific credit risk of certain liabilities.[139] Further, the definition of net income for GAAP purposes excludes OCI.

Despite the lack of legislative history, a colloquy between Senate Finance Committee Chairman Ron Wyden and Senator Ben Cardin suggests that the CAMT was intended to be

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[136] *See, e.g.*, Notice § 4.02(1) (defining "**Covered Book COGS Depreciation**" as depreciation expense, impairment loss, or impairment loss reversal that is taken into account as cost of goods sold in the "net income or loss set forth on the taxpayer's AFS.").

[137] Notice § 9.02(16).

[138] FASB, Accounting Standard Update No. 2011-05, Comprehensive Income (Topic 220). Under ASC 220-10-45-7, net income may also include income from discontinuing operations and extraordinary items.

[139] *Id.*

limited to net income from the taxpayer's operations, and that OCI was not to be included in net income for purposes of the CAMT.

During the colloquy, Senator Cardin stated: "I want to ask for a clarification of the provision in the underlying bill regarding the corporate book minimum tax. Is it the Chairman's understanding and intent that, because the corporate alternative minimum tax is based on financial statement income, it does not include Other Comprehensive Income?" In response, Senator Wyden stated that, "I thank the Senator for his inquiry and can clarify that, for purposes of the corporate alternative minimum tax, Other Comprehensive Income is not included in financial statement income."[140] Accordingly, it appears that Congress did not intend for income from investments, derivatives, hedges, and similar items that are included in OCI to be included in the definition of net income or loss on an AFS. Additionally, as it appears that OCI was not intended to be included in the definition of net income, comprehensive income (or earnings), which includes OCI, also likely was not intended to be included in the definition of net income for purposes of CAMT. The colloquy between Senators Wyden and Cardin clarifies that Congress likely intended the term net income to be applied narrowly, limited to income from operations and excluding OCI and comprehensive income. Including OCI in a taxpayer's net income would increase fluctuations in net income.

We recommend that guidance define revenue in an AFS as the starting point in calculating a taxpayer's net income, less adjustments for cost of goods sold and associated expenses. In our view, and likely consistent with Congressional intent, OCI and similar items should be excluded from the definition of net income or loss because such amounts are not associated with the entity's operating assets.

3. Whether Methods for Determining Net Income on an AFS Constitute Methods of Accounting for Tax Purposes in Determining a Taxpayer's AFSI

a. Background

Section 446(a) provides that taxable income must be computed using the method of accounting on the basis of which the taxpayer regularly computes its income in keeping its books.[141] If no method of accounting has been regularly used by the taxpayer or if the method used does not clearly reflect income, the taxpayer must use a method of accounting that does clearly reflect income.[142] A method of accounting determines when an item is taken into account

[140] Congressional Record, S. 4166 (2023), https://www.congress.gov/congressional-record/volume-168/issue-133/senate-section/article/S4165-3.

[141] *See also* Treas. Reg. § 1.446-1(a)(1). The requirement that a taxpayer compute taxable income under the methods of accounting used to compute its income in keeping its books is generally satisfied if the taxpayer reconciles the results obtained under the methods of accounting used for books and the methods used for federal tax purposes and maintains sufficient records to support that reconciliation. Rev. Proc. 2015-13, 2015-5 I.R.B. 419, § 2.01(4).

[142] I.R.C. § 446(b).

for tax purposes and includes both a taxpayer's overall plan of accounting and also its accounting treatment of any material item.[143]

A taxpayer establishes a method of accounting by treating the item properly on its first federal income tax return that reflects the item or, alternatively, by treating the item the same way on at least two consecutively filed federal income tax returns (*i.e.*, consistent treatment), regardless of whether the method is permissible or impermissible.[144]

Once a method has been established for an item, a taxpayer may not change that method without first securing the consent of the Commissioner.[145] A change in method of accounting occurs when the method of accounting used by the taxpayer for an item in computing its taxable income for a particular year is different than the taxpayer's established method of accounting used to compute the taxpayer's taxable income for the immediately preceding taxable year.[146] A method change includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan.[147] When a taxpayer changes its method of accounting, section 481(a) generally requires the taxpayer to make any adjustments necessary to prevent the duplication or omission of income or expense that may result from computing taxable income using a method different from the one used in the preceding taxable year.[148]

Not all changes in computing taxable income constitute a change in method of accounting under section 446. That is, when a taxpayer continues to apply its current method of accounting to different facts following from a change in its business practices, contractual arrangements, or transaction economics, both court rulings and the applicable regulations provide that a change in the underlying facts is not a change in method of accounting.[149]

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[143] Treas. Reg. § 1.446-1(a)(1). *See also* Treas. Reg. § 1.446-1(e)(2)(ii)(a).

[144] Treas. Reg. § 1.446-1(e)(1); Rev. Proc. 2015-13, § 2.01(1), (2); Rev. Rul. 90-38, 1990-1 C.B. 57; *Thrasys, Inc. v. Commissioner*, T.C. Memo. 2018-199; *Greiner v. United States*, 122 Fed. Cl. 139, 149 (2015) *aff'd* 651 F. Appx. 1000 (Fed. Cir. 2016).

[145] I.R.C. § 446(e); Treas. Reg. § 1.446-1(e)(2)(i); Rev. Proc. 2015-13, § 2.03.

[146] Rev. Proc. 2015-13, § 2.02(1).

[147] Treas. Reg. § 1.446-1(e)(2)(ii)(a).

[148] I.R.C. § 481(a); Rev. Proc. 2015-13, §§ 2.06(1), 3.15.

[149] Treas. Reg. § 1.446-1(e)(2)(ii)(B); Treas. Reg. § 1.446-1(e)(2)(iii), Ex. (3) (finding that a change in the deduction of vacation pay was a change in facts rather than a change in method of accounting because the change was driven by a change in the type of plan (vested as opposed to unvested) used by the taxpayer). *See also Decision, Inc. v. Commissioner*, 47 T.C. 58 (1966), *acq*. 1967-2 C.B. 2 (holding that a change in business contracts that resulted in a deferral of income was a change in facts); *Hallmark Cards, Inc. v. Commissioner*, 90 T.C.26, 35 (1988) (finding a change in treatment of an item of income resulting from a change in underlying facts does not constitute a change in method of accounting; holding that "as to merchandise sold by petitioner pursuant to its deferred Valentine program, the all-events test is not satisfied until January 1, and that income from those sales is not accruable by petitioner until that date."); *Federated Dep't Stores v. Commissioner*, 426 F.2d 417 (6th Cir. 1970) (holding that a change in the treatment of the sale of receivables created a legal relationship materially different from that involved in borrowing on the receivables, which was a change in facts); *Angelus Funeral Home v. Commissioner*, 43 T.C. 391 (1967), *acq*.

b. Recommendations

We recommend that guidance be issued to provide that a change in determining net income for AFS purposes is a change in underlying facts and, therefore, does not constitute a change in method of accounting within the meaning of section 446 for purposes of determining AFSI. Further, we recommend that guidance address the possible omission or duplication of income resulting from a change in determining the income on an AFS for purposes of calculating AFSI.

c. Discussion

Guidance should be issued under the CAMT to clarify that a change in the AFS treatment of an item that is included in the AFSI computation under the CAMT does not constitute a change in method of accounting for tax purposes within the meaning of section 446. Rather, we believe that such a change constitutes a change in the underlying facts to which tax principles are being applied.

A change in determining net income for AFS purposes depends on a taxpayer's reasonable judgment, and this discretion may result in disparate outcomes for similarly situated taxpayers. More importantly, a taxpayer's determinations are made applying U.S. GAAP, which is subject to the governance of the FASB, or IFRS, whose standards are determined by the International Accounting Standards Board or the International Sustainability Standards Board. Consequently, changes made in the determination of net income for AFS purposes are driven by a range of business and administrative factors other than the principles of tax administration and the collection of revenue. As a result, in our view, a change in the determination of net income for AFS purposes should be characterized as a change in facts rather than a change in method of accounting.

When a taxpayer continues to apply its current method of accounting to different facts following from a change in its business practices, contractual arrangements, or transaction economics, both court decisions and the applicable regulations provide that a change in the underlying facts is not a change in method of accounting. For example, in *Decision, Inc. v. Commissioner*,[150] the Tax Court found that taxpayer's change in its contracts that resulted in the deferral of income recognition from advertising activities was not a change in accounting method because it was a change in policy affecting business operations. The court concluded that the contract revisions were not unlike "a decision to lower prices or halt production. To sustain [the Service's argument that the change is an accounting method change] would have the effect of denying a business the right to determine the terms of sale of its product without clearing the matter with the Commissioner of Internal Revenue…."[151]

1969-2 C.B. 20, *aff'd* 407 F.2d 210 (9th Cir. 1969) (finding a change of facts results from a change in contract that changes when income is recognized).

[150] 47 T.C. 58 (1966), *acq*. 1967-2 C.B. 2.

[151] *Id*. at 64.

Further, in *Hallmark Cards v. Commissioner*,[152] the Tax Court considered whether the taxpayer utilized a proper method of accounting for recognizing income in relation to its sale of Valentine merchandise. Historically, the taxpayer recognized income from the sale of its merchandise at the time the merchandise was shipped to customers, however, as its business grew, it faced challenges in meeting the demands of a compressed holiday time frame.[153] The taxpayer changed the terms of its Valentine merchandise sales contracts to indicate that title did not transfer until January 1 of the year following the year of receipt of the merchandise.[154] As a result, customers did not include Valentine merchandise in their inventories until the year following receipt of the merchandise and the taxpayer did not recognize income from the sale of the Valentine merchandise until the year following shipment of the merchandise.[155] The Tax Court explained that such a change in the timing of income recognition following from a change in underlying facts or business practice does not constitute a change in method of accounting.[156] Citing to *Decision, Inc.*, the court continued that "[t]o hold otherwise would effectively give respondent the right to dictate to petitioner the terms under which it may sell its merchandise, clearly an 'odious propagation of the tentacles of the government anemone.'"[157]

Treas. Reg. § 1.446-1(e)(2)(ii)(B) explicitly provides that a change in underlying facts is not a change in method of accounting and includes as an example of a change in facts an operational change involving a change in the taxpayer's treatment of vacation pay.[158] In the example, vacation pay has been deducted when paid because the taxpayer did not have a completely vested vacation pay plan, and as such, the payment liability did not accrue until that year. The taxpayer adopts a completely vested vacation pay plan, which changes its year for accruing the deduction. The regulations conclude that the plan change is not a change in method of accounting because the change in the timing of the deduction results from the change in the company's vacation pay policy. That is, the change results from a change in underlying facts or business practice.

Consistent with the case law and related regulations, we believe that a change in financial accounting reporting is not a change in method of accounting and should not be subject to the Service's approval. To characterize such a change as a change in tax method of accounting would, as the Tax Court noted, expand the Service's power to include the determination of taxpayers' financial reporting policies.

Previously, the government has taken the position that certain changes in a taxpayer's AFS constitute changes in method of accounting when an AFS item directly impacts taxable

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[152] 90 T.C. 26, 35 (1988).

[153] *Id.* at 28–29.

[154] 90 T.C. at 29–30.

[155] *Id.* at 30.

[156] *Id.* at 35.

[157] 90 T.C. at 35.

[158] Treas. Reg. § 1.446-1(e)(2)(iii), Ex. (3).

income. Treas. Reg. § 1.451-8(g)(2) provides that a change in the manner of recognizing advance payments in revenue (*e.g.*, electing to apply the deferral method under section 451(c)(1)(B)), which is taken into account in an AFS that changes, or that could change, the timing of the inclusion of income for U.S. federal tax purposes, is a change in accounting method. With respect to the changes addressed in the regulations as interpreted in procedural guidance,[159] the change in the treatment is an explicit change in income recognition for tax purposes. With the CAMT, the effect of a change in financial reporting for AFS purposes is akin to a change in business practice, which both the Service and the courts have found to be a change in facts. Moreover, when the government addressed the change to deferral treatment, the only available remedy to correct resulting omissions and duplications of income was through an accounting method change implemented with a section 481(a) adjustment to correct any omission or duplication of income. Here, to the extent that there is concern that a change in reporting practices may result in an omission or duplication of income, section 56A(c)(15) may be used to address any omission or duplication of income.

We believe that guidance is needed to provide a rule for preventing the duplication or omission of income. That said, in our view, an accounting method change and a section 481(a) adjustment is not required; rather, the guidance should provide a rule for handling adjustments on the AFS for purposes of calculating AFSI.

4. Tax COGS Depreciation Adjustments to AFSI

a. Background

Section 4.03 of the Notice provides that, for purposes of the depreciation adjustments in section 56A(c)(13), AFSI is reduced by Tax COGS Depreciation to the extent of the amount recovered as part of cost of goods sold in computing taxable income for the taxable year, reduced by Deductible Tax Depreciation to the extent of the amount allowed as a deduction in computing taxable income for the taxable year, adjusted to disregard Covered Book COGS Depreciation, Covered Book Depreciation Expense, and Covered Book Expense, and adjusted for other items as provided in published guidance. Tax COGS Depreciation includes depreciation deductions allowed under section 167 with respect to Section 168 Property that is capitalized to inventory under section 263A and recovered as part of cost of goods sold in computing gross income under section 61.[160]

Section 9.01(2) of the Notice requests comments regarding how a taxpayer with Tax COGS Depreciation should make the adjustments described in Section 4.03 of the Notice to ensure that: (i) AFSI is reduced by only the amount of Tax COGS Depreciation, which is recovered as part of cost of goods sold in computing taxable income for the taxable year; and (ii)

[159] *See* Rev. Proc. 2022-14, 2022-7 I.R.B. 502, § 16.08 (describing automatic accounting method changes available for changes in AFS for purposes of applying certain revenue recognition methods); § 16.09 (describing changes in the timing of recognition of income due to new standards).

[160] Notice 2023-07, § 4.02(6), (7).

Covered Book COGS Depreciation is appropriately disregarded in determining AFSI for the year in which it is recovered as part of cost of goods sold.

b. Recommendation

We recommend that Treasury and the Service provide guidance permitting taxpayers to make the Tax COGS Depreciation adjustments using the approach provided in the regulations under section 163(j). Specifically, taxpayers should make the adjustments in the year of the depreciation allowance to avoid the administrative complexity of tracking COGS depreciation and to facilitate compliance with these provisions.

c. Discussion

The Notice provides that the depreciation adjustment under section 56A(c)(13) includes Tax COGS Depreciation to the extent of the amount recovered as part of cost of goods sold in determining taxable income for the taxable year. Thus, AFSI is not adjusted by the full amount of tax depreciation attributable to inventory, for example, under the Notice, the depreciation attributable to work in process and ending inventory is not included in the adjustment. Similar guidance was initially proposed in the context of section 163(j) but modified when final regulations were issued under section 163(j).

Section 163(j) limits the amount allowed as a deduction for business interest expense to the sum of (i) the business interest income of such taxpayer for such taxable year, (ii) 30% of the adjusted taxable income ("**ATI**") of such taxpayer for such taxable year, plus (iii) the floor plan financing interest of such taxpayer for such taxable year. Section 163(j)(8)(A)(v) defines ATI as the taxable income of the taxpayer computed without regard to certain items, including any deduction allowable for depreciation for taxable years beginning before January 1, 2022.

Under Prop. Treas. Reg. § 1.163(j)-1(b)(1)(iii), the government provided that an amount capitalized into inventory under section 263A was not a depreciation deduction that was to be added back in computing ATI. However, after commentators raised questions and concerns regarding the treatment of depreciation in the proposed regulations and suggested that depreciation deductions should also include amounts capitalized into inventory, Treasury and the Service issued final regulations permitting depreciation amounts that are capitalized into inventory to be considered depreciation for purposes of computing ATI. Specifically, the preamble to the final regulations provided:

> The Treasury Department and the [Service] have reconsidered [Prop. Treas. Reg.] § 1.163(j)-1(b)(1)(iii). Accordingly, under the final regulations, the amount of any depreciation . . . that is capitalized into inventory under section 263A during taxable years beginning before January 1, 2022, is added back to tentative taxable income as a deduction for depreciation . . . when calculating ATI for that taxable year, *regardless of the period in which the capitalized amount is recovered through cost of goods sold*. For example, if a taxpayer capitalized an amount of depreciation to inventory under section 263A in the 2020 taxable year, but the inventory is not sold until the 2021 taxable year, the entire capitalized amount of depreciation is added back to tentative taxable income in the 2020 taxable year,

and such capitalized amount of depreciation is not added back to tentative taxable income when the inventory is sold and recovered through cost of goods sold in the 2021 taxable year. Under such facts, *the entire capitalized amount is deemed to be included in the calculation of the taxpayer's tentative taxable income for the 2020 taxable year, regardless of the period in which the capitalized amount is actually recovered.*[161]

Consistent with the approach taken in section 163(j), we recommend that Treasury and the Service provide guidance permitting adjustments under section 56A(c)(13) in the year amounts are capitalized into inventory under section 263A and the regulations thereunder ("**UNICAP**").

Section 263A and the regulations thereunder govern the cost accounting of property produced and acquired for resale. The UNICAP rules require the allocation of certain direct costs and a proper share of indirect costs, including depreciation, attributable to such property.[162] Allocable costs are limited to those costs which are "otherwise deductible" in the taxable year,[163] and such allocable costs are included in inventoriable costs.[164] As a result, to the extent that depreciation is allocated to inventory, such amounts are capitalized and subsequently recovered through cost of goods sold, which reduces taxable income in the year that associated inventory is sold.

In interpreting section 56A(c)(13), there is a question whether the application of section 263A changes the treatment of an amount allowed for depreciation to something else, other than an adjustment to the computation of AFSI. Although there is no statutory limitation to the adjustment for depreciation deductions, the Notice provides that the depreciation adjustment under section 56A(c)(13) is limited to Tax COGS Depreciation to the extent of the amount recovered as part of cost of goods sold in determining taxable income for the taxable year. This approach is not only inconsistent with section 56A(c)(13) but at odds with the underpinnings of section 263A, which does not change the deductible treatment of an item.

The UNICAP rules were enacted as part of the Tax Reform Act of 1986. The legislative history reflects that Congress changed the capitalization rules to better match the timing of the reduction in taxable income for otherwise deductible amounts with the income that the costs were incurred to generate.[165] In fact, the legislative history refers to depreciation that is subject to

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[161] Preamble to Treas. Reg. § 1.163(j)-1 through -11, 85 Fed. Reg. 56,686, 56,691 (Sept. 14, 2020) (emphasis added).

[162] I.R.C. § 263A(a); see also Treas. Reg. § 1.263A-1(c)(3)(ii)(I).

[163] Treas. Reg. § 1.263A-1(c)(2).

[164] I.R.C. § 263A(a)(2).

[165] H.R. Rep. No. 99-426, at 625 (1985) (identifying as a principal reason for the change the fact that the then-current rules for capitalizing tangible property production costs produced "a mismatching of expenses and related income, which may result in offsetting the expenses against unrelated income of the taxpayer" and stating the change was made "to more accurately reflect income and make the income tax system more neutral"). *See also General Explanation of The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity*, May

the UNICAP rules (and therefore would be capitalized in inventory) as "depreciation deductions." [166] As the Service subsequently noted, section 263A "does not change the character of any expense from 'nondeductible' to 'deductible,' or vice versa."[167]

Treasury and the Service have consistently interpreted other sections of the Code referencing "deductions" for depreciation as including depreciation taken into account in inventory under UNICAP. For example, section 1016(a)(2) provides for the reduction of basis to account for depreciation to the extent the depreciable amounts are "allowed as deductions in computing taxable income . . . but not less than the amount allowable."[168] As such, the basis of depreciable property is reduced even if the depreciation is capitalized under the UNICAP rules rather than taken as a deduction on the taxpayer's return.[169] Indeed, the preamble to the section 163(j) regulations favorably referred to arguments that section 163(j) should be read consistently with 1016(a)(2).[170]

We believe the treatment of depreciation capitalized into inventory as indicated in the Notice treats taxpayers subject to UNICAP unfairly as compared to taxpayers not subject to UNICAP. Taxpayers subject to UNICAP would not be able to take a full adjustment for their depreciation allowances, and would therefore be subject to increased AFSI and, as a result, increased CAMT liability. We do not see a clear policy reason to justify this disparate treatment between those taxpayers subject to the UNICAP rules (generally including manufacturers, retailers, utilities and defense companies) and those taxpayers that are not subject to UNICAP (service industries and certain small taxpayers).[171]

1985, at 201-02, in which the President's budget proposal sketched out the Tax Reform Act generally, and section 263A, in particular.

[166] H.R. Rep. No. 99-841, at II-304 (1986) (Conf. Rep.). *See also* S. Rep. No. 100-445 at 104 (1988); I.R.C. § 263A(a) (flush language) ("any cost (which but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.").

[167] CCA 201504011 (Dec. 10, 2014). When section 263A was amended by the Technical and Miscellaneous Revenue Act of 1988, Congress reiterated that UNICAP should not be interpreted as making a change to existing law regarding whether an item is deductible.

[168] Notably, the regulations under section 1016 do not deviate from the statutory references to deductions allowed or allowable. *See* Treas. Reg. § 1.1016-3(b), (e). *See also* the recapture provisions of sections 1245(a) and 1250(a) and the regulations thereunder, which consistently reference deductions "allowed or allowable" for depreciation and cross-reference the section 1016 regulations.

[169] See *Commissioner v. Idaho Power*, 418 U.S. 1, 10 (1974), which makes it clear that capitalized depreciation reduces basis. Section 263A codifies the primary holding of *Idaho Power*, that construction equipment depreciation must be capitalized into constructed property, and extends it to all produced property, including manufactured inventory. As such, the portion of the depreciable bases attributable to facilities and equipment are allocated to the manufactured goods and become inventory expenses.

[170] 85 Fed. Reg. at 56,691.

[171] *See* AM 2008-012 (Dec. 9, 2008) (concluding that Congress would not have drafted section 172(f) in a way that was discriminatory to manufacturers, and if they had, they would have stated so explicitly).

In addition, we believe that the approach in the Notice is unnecessarily complex and administratively burdensome to taxpayers subject to section 263A. For example, a taxpayer using a standard costing method would allocate an appropriate amount of direct and indirect costs to property produced through the use of pre-established standard allowances.[172] To the extent that actual costs vary from the standard costs, the variances are allocated among the property produced, assuming the variances are significant. If section 56A(c)(13) included Tax COGS Depreciation to the extent of the amount recovered as part of COGS, then a taxpayer on the standard cost method would be required to remove depreciation from its standard costs for purposes of the adjustment in section 56A(c)(13). Doing such would require additional standard costing determinations taking into account variances, which would be unnecessarily complex and administratively burdensome.

Moreover, the Notice's approach is at odds with fundamental cost accounting principles that costs are to be allocated to inventory throughout the production process, recovered through cost of goods sold, to determine taxable income. Taxpayers subject to sections 263A and 471 may choose to use one of several allocation methods (e.g., simplified production method, specific identification, standard cost) to allocate costs to inventory. To the extent that depreciation may only be taken into account with respect to Tax COGS Depreciation, taxpayers will be required to segregate depreciation from other inventories (e.g., raw materials, finished goods, work in process, ending inventory) for purposes of determining AFSI, which will affect application of the CAMT and taxable income determinations. The inventory costs methods rely on a consistent allocation of costs throughout a taxpayer's inventories, and the approach in the Notice is at odds with this fundamental concept. A proper application of the inventory provisions requires that the full depreciation allowance be allocated to all items of inventory and not limited to the amount recovered as part of cost of goods sold.

For all these reasons, we recommend that Treasury and the Service instead provide a simplifying convention, which, consistent with the regulations under section 163(j), deems the entire amount of capitalized depreciation to be included in determining taxable income in the year in which it is capitalized under section 263A, rather than limiting the adjustment to inventory that is sold and recovered through cost of goods sold. This approach would greatly ease the administrative burden of compliance on taxpayers subject to the CAMT, while adhering to the broader objectives of the AFSI depreciation adjustment provisions.

In the event Treasury and the Service do not permit taxpayers to adjust AFSI to take into account its full depreciation allowance, in light of the short period of time taxpayers have to comply with these new provisions and the fact that few, if any, taxpayers currently have systems in place to track costs already allocated to inventory, the government should consider providing transition guidance or a simplified approach for taxpayers to implement this new requirement.

[172] *See generally* Treas. Reg. § 1.263A-1(f).

5. Differences in Book and Tax Depreciation

a. Background

There are substantial differences between depreciation principles for financial reporting purposes and for federal tax purposes. These differences largely stem from the disparate purposes for which income and revenue is tracked under each system. The Supreme Court recognized these differences in *Thor Power v. Commissioner*:

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested. . . .The primary goal of the income tax system, in contrast, is the equitable collection of revenue. . . . Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism.[173]

As the Supreme Court noted, these divergent purposes often result in the different treatment of items where many assets that are capitalized for book purposes are expensed for tax purposes, and vice versa. For example, repairs are capital assets for book purposes, but are generally expensed for tax purposes. Therefore, for book purposes, an applicable corporation would have basis in, and take depreciation on, repairs while no corresponding basis or depreciation exists for tax purposes. Further, as a general rule, capital assets are depreciated more quickly for tax purposes than they are for book purposes.

Section 56A(c)(13)(A) provides that AFSI is reduced by the depreciation deductions allowed under section 167 with respect to property to which section 168 applies to the extent allowed as a deduction in computing taxable income. Section 56A(c)(13)(B) provides that AFSI is also adjusted to disregard any amount of depreciation expense that is taken into account on the taxpayer's AFS with respect to such property.

b. Recommendations

We recommend that guidance clarify how taxpayers determine the basis of Section 168 Property on which book depreciation is computed for purposes of making the adjustments under section 56A(c)(13). Further, we recommend guidance providing a simplifying assumption and a safe harbor for tracking differences in book and tax basis to ease administrative burdens for taxpayers arising from inconsistencies in book and tax accounting practices. Specifically, we recommend guidance to provide a safe harbor under which a taxpayer only makes the adjustments for Covered Book COGS Depreciation, Covered Book Depreciation Expense, Tax COGS Depreciation, and Tax Depreciation (as identified in Section 4.02(1), (2), (6), and (7) of the Notice) if its unadjusted book basis for Section 168 Property exceeds 10% of its unadjusted tax basis for the same property. Additionally, we believe that the guidance should provide that no adjustment is made for Covered Book COGS Depreciation, Covered Book Depreciation Expense, Tax COGS Depreciation, and Tax Depreciation if the unadjusted book basis for

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[173] *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-43 (1979) (concluding that "given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.").

Section 168 Property is less than or equal to 10% of its unadjusted tax basis for the same property.

Finally, we recommend that guidance include specific examples to illustrate the intended application of the rules in various situations (*e.g.*, basis differences resulting from interest capitalization, purchase accounting, and operating leases compared to capital leases). The examples should demonstrate whether there is a tax equivalent to Covered Book Expense.

c. Discussion

The many differences between determining book basis and determining tax basis may lead to confusion over how to apply the depreciation adjustments to AFSI under the CAMT. In light of these many differences, we believe that guidance should clarify for taxpayers how to determine book basis for Section 168 Property for purposes of the depreciation adjustments to AFSI under section 56A(c)(13). Examples illustrating application of these adjustments would help taxpayers to better understand the provision and promote compliance.

Differences in the timing of capital and ordinary expenses may result in year-over-year omissions or duplications of income or expense. Taxpayers generally do not have systems in place to track differences in book and tax depreciation. Tracking these differences in basis for book versus tax will be a significant administrative burden on taxpayers. To ease this administrative burden, and to promote compliance with the provision, we recommend guidance to provide safe harbors and simplifying conventions for taxpayers seeking to comply with the CAMT rules. For example, we recommend that the government provide a safe harbor whereby a taxpayer whose unadjusted book basis for Section 168 Property is less than 10% of its unadjusted tax basis for Section 168 Property not be required to make adjustments under section 56A(c)(13).

F. Partnership Taxation Comments

1. Determining the Amount of AFSI for Purposes of the Applicable Corporation Status Test

a. Background

Under section 56A(c)(2)(D)(i) (the “Distributive Share Limitation”), the AFSI of a corporate partner is adjusted to take into account only the corporate partner’s distributive share of partnership AFSI (except to the extent determined by the Secretary).

Section 59(k)(1)(D), however, provides in pertinent part that, “solely for purposes of determining whether a corporation is an applicable corporation [under section 59(k)(1)], all AFSI of persons treated as a single employer with such corporation under section 52(a) or 52(b) is treated as AFSI of the corporation, and AFSI of the corporation is determined without regard to [the Distributive Share Limitation].” Section 7.02 of the Notice provides that based on the language of section 59(k)(1)(D), AFSI of a corporate partner is in all cases determined without regard to the Distributive Share Limitation for purposes of determining applicable corporation status (*i.e.*, regardless of whether the corporate partner and the partnership are part of a Section 52(b) Group).

The Notice provides welcome clarification that the Distributive Share Limitation does not apply for purposes of determining applicable corporation status. However, additional prescriptive guidance is necessary to address the manner in which a corporate partner determines its AFSI from a partnership in which it owns an interest but which is not included in the corporation's Section 52(b) Group. We recommend that this guidance specify that corporations that include partnerships in their Book Group (but not as part of a Section 52(b) Group) will for purposes of the applicable corporation status include the consolidated AFSI of the partnership net of income attributable to noncontrolling interests ("**NCI**"). Further, we recommend that guidance clarify that there is no "double-counting" when a corporate partner and partnership are part of a Section 52(b) Group. These two issues and our recommendations are discussed below.

b. Corporate Partners that Are Part of the Same Book Group But Not Part of Section 52(b) Group with those Partnerships

(i) Recommendation

We believe guidance should clarify that the corporate partner's AFSI for purposes of testing whether it is an applicable corporation excludes NCI (*i.e.*, $440 million in the example below). As a policy matter, the non-application of the Distributive Share Limitation for purposes of determining whether a corporation is an applicable corporation might be justified, because it permits a potential CAMT taxpayer to determine whether it is subject to the regime without having access to information about the AFSI of any partnerships in which it is a direct or indirect partner. This policy, however, would not justify the inclusion of NCI, which will almost certainly be excluded for purposes of determining actual tax liability.

(ii) Discussion

We agree with the interpretation of section 59(k)(1)(D) in Section 7.02 of the Notice.[174] That said, the Notice does not affirmatively address how a corporate partner determines its AFSI from a partnership. In particular, as discussed in more detail below, uncertainty may still arise in some situations, including when a corporate partner that is not part of a Section 52(b) Group with a partnership joins in a Book Group with the partnership (*i.e.*, the corporation's financial statement reflects all of the partnership's financial statement net income or loss).

> **Example 15.** USP, a domestic corporation, owns one asset, a 40% capital and profits interest in PRS, a partnership. PRS has its own financial statement reflecting $1.1 billion of net income in the taxable year. USP and PRS are not part of a Section 52(b) Group but they are part of a Book Group.[175] Thus, USP's consolidated net income is $1.1 billion for the taxable year, all of which is derived

[174] We understand that some congressional tax staff have stated publicly the Distributive Share Limitation was intended to be turned off only in situations in which a corporate partner and partnership are part of a Section 52(b) Group (rather than in all cases). However, there is no legislative history to section 59(k)(1)(D) to support this intent, and we believe the approach in Section 7.02 of the Notice is appropriate and consistent with the plain language of section 59(k)(1)(D).

[175] This could occur if USP is the managing member or general partner of PRS and is treated as owning a controlling interest for financial statement consolidation purposes.

from PRS. Of that amount, only $440 million is economically attributable to USP; the remaining $660 million is economically attributable to other unrelated partners in PRS (in financial accounting terms, the $660 million is attributable to NCI, which is effectively an adjustment made to consolidated income to arrive at the net income attributable to just the corporate partner).

As clarified in Section 7.02 of the Notice, the Distributive Share Limitation does not apply for purposes of determining applicable corporation status, and USP's AFSI with respect to PRS is not limited to USP's distributive share of the AFSI of PRS ($440 million). For purposes of determining whether USP is an applicable corporation, however, it is unclear whether USP's AFSI is $1.1 billion (*i.e.*, including the $660 million of income attributable to the NCI), $440 million (*i.e.*, excluding the $660 million of income attributable to the NCI), or another amount.[176] We believe that USP's net income attributable to the NCI should not be included in AFSI for purposes of determining whether USP is an applicable corporation.

There is support for an adjustment to remove the NCI under section 56A(c)(2)(A) and the principles of section 451(b)(5) and Treas. Reg. § 1.451-3(h) when multiple entities are included on the same AFS. In addition, section 56A(a) defines AFSI as the net income or loss "of the taxpayer," and a consolidated financial statement may include net income or loss of other taxpayers to the extent there is an NCI. Thus, removing net income or loss attributable to NCI in this context is consistent with section 56A(a).[177]

c. Double Counting of AFSI Where Corporate Partners are Part of Section 52(b) Group with One or More Partnerships

(i) Recommendation

The grant of regulatory authority in section 56(c)(15) makes it clear that Congress intended that Treasury adopt rules to eliminate double counting. For this reason, we recommend that regulations confirm that, when a corporate partner and a partnership are part of a Section 52(b) Group, the AFSI of the partnership is counted only once.

[176] It may be possible to apply rules similar to section 451(b)(5) and Treas. Reg. § 1.451-3(h) to justify other amounts.

[177] Although not addressed in these comments, additional questions on the scope of Section 7.02 of the Notice may arise in other situations as well. Specifically, if a corporate partner owns a minority interest in a partnership and there is no Section 52(b) Group and no Book Group, it is unclear whether the corporate partner may apply any section 56A adjustments to the financial statement income or loss it reflects with respect to an investment in the partnership (*e.g.*, a corporation in this circumstance may use a mark-to-market method for financial accounting purposes when the partnership itself only owns stock and has no AFSI for the relevant taxable year). Section 7.02 of the Notice could be read to provide that no section 56A adjustments may apply in these situations, and, although this approach may be more administrable for taxpayers and the government, there is uncertainty whether this is consistent with the plain reading of the statute, which provides that only taxable income or loss items with respect to an interest in an unconsolidated corporate subsidiary are included in AFSI.

(ii) Discussion

If a corporate partner and a partnership are part of a Section 52(b) Group, there is a potential for "double-counting" of AFSI as a result of section 59(k)(1)(D). The issue is illustrated by the following example:

> **Example 16**. USP, a domestic corporation, owns one asset, a 60% interest in the capital and profits of PRS. PRS has its own financial statement reflecting $700 million of net income for the taxable year. Assume for purposes of the example that PRS's AFSI is $700 million. USP and PRS are part of a Section 52(b) Group and part of the same Book Group. Thus, USP's consolidated net income is $700 million for the taxable year, all of which is derived from PRS. Of that amount, only $420 million is economically attributable to USP; the remaining $280 million is attributable to NCI.

Because USP and PRS are part of a Section 52(b) Group, all AFSI of PRS is treated as AFSI of USP for purposes of determining whether USP is an applicable corporation under section 59(k)(1)(D). But if this amount is simply added to USP's AFSI calculated without regard to the special rule under section 59(k)(1)(D), some or all of PRS's AFSI of $700 million may be included more than once. For instance, if USP included $420 million of PRS's income under the general rule, the addition of another $700 million would result in a total inclusion of at least $1.12 billion (or more if the NCI were not eliminated), exceeding PRS's total income.

2. Determination of "Distributive Share" of Partnership AFSI

a. Background

Section 56A(c)(2)(D)(i) provides that if a taxpayer is a partner in a partnership, AFSI of the taxpayer with respect to the partnership is adjusted to take into account only the taxpayer's distributive share of the partnership's AFSI. Section 56A(c)(2)(D)(ii) provides that partnership AFSI is the "partnership's net income or loss set forth on the partnership's applicable financial statement (adjusted under rules similar to the rules of this section)."

Section 56A, however, does not define "distributive share" for this purpose, and, given the emphasis of section 56A on financial statement, rather than section 704(b) book or taxable income, the meaning of "distributive share" is not obvious in this context.[178] It is left to regulations to provide a definition a partner's "distributive share" of partnership AFSI.

b. Recommendation

We recommend that taxpayers be permitted to use any reasonable approach to determine their distributive share of partnership AFSI. We further recommend that guidance acknowledge that multiple reasonable approaches may apply, including but not limited to the approaches

[178] As discussed more fully in Part II.F.2 below, although section 56A does not contain an express policy statement, it is clear that its starting point is the AFS, which generally is prepared in accordance with GAAP or IFRS and not under federal tax principles.

described above, and including both "bottom-up" and "top-down" methods. The approach used should be determined by the partnership in the case of a bottom-up method and by the partner in the case of a top-down method. Any method for determining a partner's distributive share of AFSI should be consistently applied by the taxpayer and all parties related to the taxpayer, until the chosen approach is no longer reasonable for that taxpayer. Any guidance on this issue should apply to any transfers after the effective date of the guidance.

c. Discussion

A definition of the partner's "distributive share" of partnership AFSI is necessary to allow applicable corporations with interests in partnerships to calculate their AFSI.[179] In the discussion that follows, we outline four potential methodologies, including both "bottom-up" and "top-down" approaches. A bottom-up approach is an approach to determining a partner's distributive share of partnership AFSI that begins with a partnership's AFSI and allocates it among the partners (*e.g.*, the section 704(b) book allocation methodology, a taxable income methodology, or applying hypothetical liquidation at book value ("**HLBV**") concepts to a partnership's financial accounting income, as discussed below). A "top-down" approach would allow a partner to determine its distributive share by making determinations based on its own financial statements.[180] Examples of each of these approaches are discussed below. In general, we recommend that taxpayers be permitted to elect any reasonable method, including any of the four methods described here, so long as such method is consistently applied.

(i) Calculate in Accordance with Financial Accounting Rules

Arguably, the approach to determining distributive share best aligned with section 56A's emphasis on financial statement income is to apply the financial accounting rules applicable to the partner (*e.g.*, where appropriate, the consolidation rules for controlled entities or the equity method) to determine a partner's distributive share of partnership AFSI. More specifically, a corporate partner would look to its own AFS to determine its distributive share of partnership AFSI, and its financial statement income inclusion with respect to its partnership investment would be used to determine its distributive share.

Although in line with the financial accounting principles of section 56A, concerns have been raised that a top-down approach such as calculating AFSI in accordance with the corporate partner's financial statement inclusion is inconsistent with section 56A(c)(2)(D)(ii). Section 56A(c)(2)(D)(ii) provides that partnership AFSI is the "partnership's net income or loss set forth on the partnership's applicable financial statement (adjusted under rules similar to the rules of this section)." This language suggests that partnership AFSI is determined at the partnership rather than the partner level, at least if the partnership itself has an AFS. Nevertheless, the statute

[179] I.R.C. §56A(c)(2)(D)(i).

[180] As has been widely noted, the structure of the statute, and in particular section 56A(c)(2)(D)(ii), may suggest that Congress intended a bottom-up approach. However, Congress also gave the Secretary broad discretion that appears to give authority to permit a top-down approach should Treasury and the Service determine that such approach is the better one for policy, administrability, or other reasons. *See* I.R.C. § 56A(c)(2)(D)(i), (c)(15), (e).

gives the Secretary discretion to deviate from determining a partner's AFSI by reference to its distributive share of partnership AFSI.[181] In addition, section 56A(b) provides broad authority to the Secretary to define a partnership's AFS (for example, by looking to the AFSs of its partners). For these reasons, we believe there is sufficient authority for an approach that does not begin with the partnership's AFSI.

Note that is possible that a partnership might not have its own AFS.[182] In that circumstance at least, it would make sense to allow a corporate partner of the partnership to utilize its own AFS to determine its distributive share of partnership AFSI in accordance with the financial accounting rules it otherwise uses, even if Treasury and the Service felt compelled to adopt a different general rule to define "distributive share."[183]

(ii) Calculate in Accordance with Section 704(b) Allocations

An alternative approach would permit partnerships to allocate their AFSI among the partners in proportion to each partner's share of partnership section 704(b) items for the year. This approach makes the most sense in the context of partnerships that generally make "bottom-line" allocations of each item of income, gain, loss deduction, and credit comprising overall net section 704(b) income or loss. In the case of such partnerships, an allocation of AFSI in accordance with a partner's share of section 704(b) items has the advantage of being generally consistent with subchapter K principles and relatively easy to administer. However, section 704(b) allocations might not always align with the partnership's underlying economics for that tax year,[184] and could cause a corporate partner's distributive share of partnership AFSI in a given year to deviate from the amount reflected on its AFS.[185]

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[181] *See* I.R.C. § 56A(c)(2)(D)(i) ("*Except as provided by the Secretary*, if the taxpayer is a partner in a partnership, AFSI of the taxpayer with respect to such partnership shall be adjusted to only take into account the taxpayer's distributive share of AFSI of such partnership." (emphasis added)).

[182] If the statute was estimated to apply to less than 200 taxpayers when it was enacted, as has been reported, it seems counterintuitive that its provisions would be interpreted to burden tens of thousands of partnerships by requiring partnerships that could potentially have an applicable corporation as a partner to start preparing an AFS to the extent they are not already doing so.

[183] One objection to allowing corporate partners to determine partnership AFSI has been a concern that this approach could cause the partners' aggregate distributive share of AFSI to be greater or less than 100% of partnership AFSI. We do not believe that this should be a material concern if the exception were limited to partnerships without their own AFS; any partnership with significant value or multiple partners subject to the CAMT is likely to have its own AFS. *See* section 56A(c)(15) ("The Secretary shall issue regulations or other guidance to provide for such adjustments to AFSI as the Secretary determines necessary to carry out the purposes of this section, including adjustments … to prevent the omission or duplication of any item….").

[184] Allocations under section 704(b) may not align with the partnership's underlying economics due to, *e.g.*, the impact of certain mandatory regulatory allocations required for federal tax purposes, including deficit restoration requirements, qualified income offsets, and minimum gain chargebacks.

[185] These distortions may occur, for example, where a partner receives an allocation of an item (*e.g.*, amortization related to section 197 intangibles) that reduces taxable income but does not reduce AFSI, or there is section 704(b) loss and positive AFSI.

Applying this AFSI allocation rule to partnerships that make special allocations of particular items of section 704(b) income, gain, loss, deduction, or credit is more challenging.[186] An allocation of partnership AFSI in accordance with an annual section 704(b) percentage also could be distortive if the partnership has preferred interests or has other allocation provisions that change partners' bottom-line sharing over time.

(iii) Calculate in Accordance with Federal Taxable Income

A third allocation approach would permit partnerships to allocate partnership AFSI in proportion to each partner's distributive share partnership taxable income or loss. This approach is similar to an allocation in proportion to section 704(b) items but requires the partnership to take into account partners' relative section 704(c) gains and losses.[187] As a policy matter, however, this methodology may be less preferable than other suggested methodologies if financial accounting principles are intended to apply to the allocation of AFSI, as it looks to the partners' shares of taxable income rather than financial statement income. In addition, many problems identified with respect to an allocation of AFSI in proportion to a partner's share of section 704(b) items would be equally applicable to allocations in accordance with a partner's share of taxable income. For example, special allocations would be problematic as would allocations that change over time.

(iv) Calculate Using HLBV

As a fourth allocation method, a taxpayer's distributive share of AFSI could be calculated by applying a system similar to the equity accounting method's HLBV calculation with respect to partnership AFSI.[188] Applying an HLBV method, a corporate partner would determine its share of partnership AFSI by calculating the amount it would receive or be obligated to pay if the partnership were to liquidate and sell all of its assets at book value and distribute the resulting cash to its partners and creditors in accordance with the partnership agreement and applicable law. The difference in a partner's beginning and ending HLBV would represent the partner's distributive share of partnership AFSI for the year if partnership AFSI is defined as the change in aggregate hypothetical liquidation value from the beginning to the end of the period. Such an approach has the virtue of being familiar to tax practitioners insofar as it is consistent with the

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[186] Although it might be possible to tie a partnership's section 704(b) allocation of an item to a partner's share of a corresponding item of partnership AFSI, such an approach would seem to be extraordinarily complex, and for that reason we do not recommend it.

[187] This approach would be consistent with the safe harbor for allocations of creditable foreign tax expenditures ("**CFTE**s") under Treas. Reg. § 1.704-1(b)(4)(viii), which provides that an allocation of a CFTE will be deemed to be in accordance with the partners' interests in the partnership only if the CFTE is allocated to the partners in proportion to the partners' shares of net U.S. taxable income attributable to the particular CFTE category to which the CFTE relates.

[188] HLBV is a balance sheet-oriented methodology for allocating pre-tax financial statement income or loss of a partnership to a partner by calculating the amount each partner would receive if the partnership were liquidated at book value at the end of each measurement period. The change in the allocated amount to each partner during the period is the amount of book income or loss allocated to that partner (adjusted for distributions and contributions).

manner in which allocations of section 704(b) book items are made by many partnerships under the "partners' interest in the partnership" standard, including "targeted allocation" provisions.

3. Adjustments to AFSI to Take Into Account the Rules and Principles of Subchapter K

a. Background

Section 56A(c)(15)(B) provides that the Secretary shall issue regulations or other guidance to provide for adjustments to AFSI necessary to carry out the purposes of section 56A, including adjustments to carry out the principles of part II of subchapter K (relating to partnership contributions and distributions).[189]

(i) Principles of Subchapter K

In general, the intent of subchapter K is to permit taxpayers to conduct joint business (including investment) activities through a flexible economic arrangement without incurring an entity-level tax.[190] Under section 721(a), if a partner contributes property to a partnership in exchange for an interest in the partnership, neither the partner nor the partnership recognizes any gain or loss. Instead, the realized gain or loss is deferred through sections 722 and 723, the latter of which provides the contributing partner a basis in its partnership interest equal to the amount of money and the adjusted tax basis of any property contributed.

Similarly, section 731(a) and section 731(b) generally provide that if a partnership makes a distribution to a partner, neither the partner nor the partnership will recognize gain or loss.[191] Again, the potential for gain is generally deferred through section 732, which provides for carryover basis in the distributed property (in non-liquidating distributions of property other than money). Thus, sections 721 and 731, and their correlative basis provisions, further the intent of subchapter K by generally permitting taxpayers to contribute capital to, and withdraw capital from, a partnership without recognizing gain or loss.

(ii) The Notice

Section 3.03(1)(a) of the Notice provides that any financial accounting gain or loss resulting from the application of the accounting standards used to prepare the AFS of a Party[192] to a Covered Nonrecognition Transaction is not taken into account solely for purposes of

[189] Part II of subchapter K governs contributions to partnerships (sections 721 through 724); partnership distributions (sections 731 through 737); transfers of partnership interests (sections 741 through 743); and provisions common to other parts of part II (sections 751 through 755).

[190] Treas. Reg. § 1.701-2(a).

[191] The partner recognizes gain only to the extent that any money distributed exceeds the adjusted tax basis of such partner's entire interest in the partnership immediately before the distribution A partner recognizes a loss only upon a liquidating distribution where the partner receives only money or property described in section 731(a)(2)(B).

[192] A "Party" includes a corporate partner transferring property to, or receiving property from, a partnership in a Covered Transaction. Notice § 3.02(9). A "Covered Transaction" refers to a Covered Recognition Transaction or a Covered Nonrecognition Transaction. *Id*.

calculating the AFSI of the Party for the one or more taxable years in which the AFS of the Party takes into account the Covered Nonrecognition Transaction. A Covered Nonrecognition Transaction is a transaction that, solely with regard to a corporation or a partnership (as appropriate), qualifies for nonrecognition treatment for federal tax purposes under enumerated[193] provisions of the Code – including sections 721 and 731.[194] Accordingly under Section 3.03(1)(a) of the Notice, no GAAP income or loss should be taken into account in determining the AFSI of an Applicable Corporate Partner that contributes property to a partnership, or that receives a distribution from a partnership, provided that no tax gain or loss is recognized under an exception to section 721(a) or section 731, respectively.

By contrast, it appears that if any tax gain or loss is recognized under any such exception (*e.g.,* if even a penny of gain is recognized for federal tax purposes), the transaction would be treated as a Covered Recognition Transaction, and there would be no adjustment to the Applicable Corporate Partner's AFSI arising from the transaction.[195] Section 3.03(3)(e) of the Notice contains an example in which a partner contributes property to a partnership and simultaneously receives a distribution of cash from the partnership.[196] In the example, the disguised sale rules of section 707(a)(2)(B) and Treas. Reg. § 1.707-3 apply to treat the transaction as a part taxable exchange under section 1001, and a part nontaxable exchange under section 721(a), the example concludes that the transaction as a whole is treated as a Covered Recognition Transaction. The apparent result of this treatment is that all of the GAAP gain reportable in respect of the transaction is includable in the partner's AFSI, even though a portion of the exchange treated as a taxable sale may require the recognition of an insignificant amount of tax gain relative to the total amount of realized tax gain. Section 9.01(1)(b) of the Notice requests comments regarding Covered Transactions in which, for federal tax purposes, gain or loss is recognized in part.

b. Recommendation

We agree that if a nonrecognition provision of subchapter K applies to a transaction between an Applicable Corporate Partner and the partnership, the Applicable Corporate Partner's AFSI should be adjusted to exclude all GAAP income or loss that arises from such transaction. Further, in response to Sections 9.01(1)(b) and 3.03(3)(e) of the Notice, we recommend that future guidance provide for an adjustment to AFSI in respect of Partial Nonrecognition Transactions. Specifically, we recommend that the amount of GAAP gain or loss arising from a Partial Nonrecognition Transaction that is taken into account in determining an Applicable Corporate Partner's AFSI should be adjusted to reflect the principles of subchapter K, using the Proportionate Approach, described below.

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193 Sections 332, 337, 351, 354, 355, 357, 361, 368, 721, 731, or 1032, or a combination thereof.

194 Notice § 3.02(5)(a).

195 A "Covered Recognition Transaction" is a transfer, sale, contribution, distribution, or other disposition of property treated as resulting in gain or loss for federal tax purposes (*i.e.*, a disposition of property that does not qualify as a Covered Nonrecognition Transaction). Notice § 3.02(6).

196 Notice § 3.02(3)(e), Ex. 5.

c. Discussion

Nothing in the statute suggests an adjustment to AFSI is required only when a nonrecognition provision applies in full, and we believe sound tax policy supports adjustment in connection with Partial Nonrecognition Transactions. Permitting an adjustment to AFSI under section 56A(c)(15)(B) in connection with Partial Nonrecognition Transactions would "carry out the principles of part II of subchapter K." Those principles recognize that where an exception to a nonrecognition provision applies, the result is the recognition of a portion of the tax gain or loss that is realized, instead of converting the transaction to a fully taxable one. By contrast, the "all or nothing" approach of Section 3.03(1)(a) of the Notice would lead to results that seem to contravene the principles of subchapter K. For instance, compare the example from Section 3.03(3)(e) of the Notice (described above), with the following:

> **Example 17.** Partner A contributes property with FMV of $100 and tax basis of zero to Partnership in exchange for an interest in the partnership worth $99x and $1x of cash. The contributed property has a GAAP basis of $60x, and Partner A recognizes $40x of GAAP gain as a result of the Contribution, resulting in a GAAP equity method investment (or basis) of $100x.[197] The contribution generally qualifies for non-recognition treatment under section 721 except that $1x of the contributed property is deemed sold in a disguised sale under section 707. Accordingly, Partner A recognizes $1 of gain under section 707(a)(2)(B) and Treas. Reg. § 1.707-3.
>
> Under Section 3.03 of the Notice, because Partner A recognizes $1x of tax gain, the Contribution and Distribution are treated as a Covered Recognition Transaction, and Partner A must take into account the full $40x of GAAP gain in determining its AFSI.

As an exception to nonrecognition under section 721(a), the disguised sale rules take a proportionate approach to recognizing the unrealized tax gain in the transferred property. They do not require Partner A to recognize the $100 of realized tax gain merely because she receives a $1 distribution. If guidance under section 56A(c)(15)(B) is to carry out the principles of subchapter K, we recommend that it take a similar approach.

In that regard, we recommend adopting the Proportionate Approach or the Substitution Approach, as defined below. Under the Proportionate Approach, the Applicable Corporate Partner would include in AFSI the portion of the GAAP gain or loss that is taken into account for financial accounting purposes, multiplied by the ratio (expressed as a percentage) of the tax gain or loss that is recognized, over the tax gain or loss that is realized.

Under the Substitution Approach, the GAAP income or loss from a Partial Nonrecognition Transaction would be includable in AFSI of the Applicable Corporate Partner only to the extent of the amount determined by applying the relevant rules for computing

[197] The $40 of GAAP gain would result from the derecognition of the property. The $100 equity method investment would subsequently be reduced by the $1 distribution.

recognition of tax gain or loss, but replacing the relevant tax inputs (*e.g.*, FMV, adjusted tax basis) with the correlative GAAP inputs (*e.g.*, fair value, GAAP basis, carrying amount).[198]

Both of these approaches can be illustrated by the following variation of the above example:

> **Example 18**. Assume the same facts as Example 17, except that the adjusted tax basis of the property is $10x (instead of zero) and the Partnership distributes $25x (instead of $1x) to Partner A. Under section 707(a)(2)(B) and Treas. Reg. § 1.707-3, Partner A is considered to have sold a portion of the property with a value of $25x in exchange for cash. Accordingly, Partner A must recognize $22.5x of tax gain ($25 amount realized less $2.5x adjusted tax basis ($10x multiplied by $25x/$100x)).[199]
>
> Under the Substitution Approach, the amount of GAAP gain taken into account in Partner A's AFSI as a result of the exchange would be determined in the same manner as the amount of tax gain that Partner A recognizes under section 707(a)(2)(B) and Treas. Reg. § 1.707-3, but by substituting the GAAP basis of the property for the tax basis. Accordingly, Partner A's AFSI from the exchange would be limited to $10x ($25x cash distribution, less $15x ($60x GAAP basis multiplied by $25x/$100x)).
>
> Under the Proportionate Approach, the amount of GAAP gain taken into account in Partner A's AFSI as a result of the exchange would be the GAAP gain that is reportable for financial accounting purposes ($40x), multiplied by the ratio of Partner A's recognized tax gain ($22.5x) over its realized tax gain ($90x, or $100x amount realized *less* $10x tax basis in the contributed property). Accordingly, under the Proportionate Approach, Partner A's AFSI from the exchange would be limited to 25% of the GAAP gain that is taken into account for financial accounting purposes, or $10x.[200]

As illustrated by Example 18, both the Proportionate Approach and the Substitution Approach achieve the same result with respect to disguised sales because the gain recognition

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[198] Overlaying tax concepts on GAAP accounting as required by a Substitution Approach would require addressing corresponding tax issues raised by provisions such as section 704(c) (addressing value-basis differences) and section 752 (addressing the treatment of partnership liabilities). Those issues are not addressed in the examples and discussion that follows but would need to be considered further if a Substitution Approach were adopted.

[199] *Cf.* Treas. Reg. § 1.707-3(f), Ex. 1

[200] Under Treas. Reg. § 1.707-3(c), a contribution and distribution that occur within a two-year period are generally presumed to be a sale of the property (or a portion thereof). It is possible for a distribution in a subsequent year to result in a partner recognizing gain under the disguised sale rules in a prior year. This may present a challenge to a partner that is determining whether it is an Applicable Corporate Partner based on the prior year (but before the subsequent distribution occurs to trigger the disguised sale rules). Accordingly, we recommend that in this fact pattern, any GAAP gain or loss that would be taken into account by the partner in the prior year (based on the approaches discussed in Part II.F.1) would not be taken into account until the year of the distribution, when the exception to nonrecognition under section 731 applies.

provision takes a proportionate share of the realized gain into account. However, for exceptions to nonrecognition that determine gain in another manner, the Proportionate Approach and the Substitution Approach may lead to different results.

The Proportionate Approach is more administrable than the Substitution Approach because it is based upon computations that an Applicable Corporation will have already made for federal tax purposes. In contrast, the Substitution Approach would require partnerships to maintain parallel sets of GAAP 704(b), GAAP 704(c), and GAAP basis books. For this reason, we recommend that Treasury and the Service adopt the Proportionate Approach as the default approach to adjustments under section 56A(c)(15)(B) to Partial Nonrecognition Transactions. The Substitution Approach is intrinsically neither more nor less taxpayer favorable, potentially yielding either greater or lesser gain amounts than the Proportionate Approach depending on the particular facts. Similarly, the Substitution Approach is intrinsically neither more nor less correlated to the tax principles of subchapter K. However, to the extent one believes it is important to align the treatment of Partial Nonrecognition Transactions between subchapter C and subchapter K, the Substitution Approach offers an alternative that is functionally similar to the "boot within book gain" approach recommended in Part II.D.2.a(iv) above.

If an adjustment to AFSI is made in connection with a Covered Nonrecognition Transaction or a Partial Nonrecognition Transaction, then appropriate adjustments are needed to avoid any double counting or omission issues. For example, if the partnership in Example 16 subsequently sold the property for $100x, then for purposes of determining the amount of GAAP gain allocable to Partner A, the property's GAAP basis should be reduced by the amount of GAAP gain that was not taken into account in Partner A's AFSI from the transaction.[201]

4. Information Reporting Issues

We recommend that Treasury and the Service provide guidance to partnerships specifying which partnerships will be required to provide AFSI information and what information must be provided. We recommend that this guidance balance the information needs of the small number of taxpayers that will require partnership AFSI information with the burden on partnerships of producing that information.

a. Background

Temp. Treas. Reg. § 1.6031(b)-1T provides that any partnership required to file a return under section 6031 "shall furnish to every person who was a partner . . . at any time during the taxable year a written statement" containing the partner's distributive share of income, gain, loss, deduction, or credit required to be shown on the partnership return and to "the extent provided by form or the accompanying instructions, any additional information that may be required to apply

[201] Under the Substitution Approach only $10x of the $40x of GAAP gain from the transaction was taken into account for determining Partner A's AFSI from that transaction; thus for purposes of determining A's share of AFSI from the partnership's subsequent sale of that property, the GAAP basis of the property should be reduced by $30x. Similarly, under the Proportionate Approach, only $10x of the $40x of GAAP gain from the transaction was taken into account for determining Partner A's AFSI from that transaction; thus, for purposes of determining A's share of AFSI from the partnership's subsequent sale of that property, the GAAP basis of the property should be reduced by $30x.

particular provisions of subtitle A of the Code to the partner with respect to items related to the partnership."[202]

As discussed above, under the Distributive Share Limitation, if a taxpayer is a partner in a partnership, the AFSI of the taxpayer with respect to the partnership is adjusted to take into account only the taxpayer's distributive share of the partnership's AFSI. Likewise, under section 56A(c)(2)(D)(ii), the AFSI of a partnership is the partnership's net income or loss set forth on such partnership's AFS adjusted under rules similar to the rules of section 56A. Thus, for purposes of determining CAMT liability—at least under the bottom-up approach suggested by a narrow reading of the statue—an applicable corporation that is a partner in a partnership determines its AFSI by taking into account its distributive share of the net income or loss set forth on the AFS of the partnership. Similarly, if a partnership (an upper-tier partnership) is a partner in another partnership (a lower-tier partnership), the upper-tier partnership determines its AFSI by taking into account its distributive share of AFSI of the lower-tier partnership.

Although a partnership may be able to determine whether a direct partner is or is likely to be an applicable corporation, in our experience partnerships often have limited information about their indirect partners. A partnership with partners that are themselves partnerships may have information relevant to the CAMT calculations of an applicable corporation but may not know that the information is relevant. Further, although many partnerships have financial statements, it seems unlikely to us that they will calculate AFSI unless they are required (by regulation or contract) to do so. In this regard, we note that although many partnerships maintain three sets of books (tax, section 704(b), and GAAP) a fourth set of books will almost certainly be required to track AFSI. Moreover, depending on how Treasury and the Service interpret the term "distributive share" in this context, a partnership may be required to undertake additional analysis to determine a partner's distributive share of AFSI. This accounting and analysis have the potential to be significantly burdensome.

b. Recommendation

Given the relatively small number of corporations likely to be subject to the CAMT,[203] we recommend that Treasury and the Service issue guidance providing that partnerships need only calculate and report information necessary to compute a partner's distributive share of AFSI ("**AFSI Information**") if a corporation requiring AFSI Information (because the corporation is or believes it may be an applicable corporation) (i) holds an interest in the partnership directly or indirectly through one or more partnerships, and (ii) the corporation or the partnership through which the corporation indirectly owns its partnership interest provides timely notification, in the manner determined by Treasury and the Service, to the partnership of the need for such

[202] Temp. Treas. Reg. § 1.6031(b)-1T(a) (written statement requirement); Temp. Treas. Reg. § 1.6031(b)-1T(c)(3) (detailing the contents of the statement).

[203] *See* Joint Committee on Taxation Memorandum, *Proposed Book Minimum Tax Analysis by Industry* (Jul. 28, 2022) ("As we project that only approximately 150 taxpayers annually will be subject to the proposed book minimum tax…"), available at https://www.finance.senate.gov/imo/media/doc/jct_analysis_book_minimum.pdf.

information.[204] We further recommend that three groups of corporations be required to request AFSI from a partnership: (i) any corporation that knows or should know that it is subject to the CAMT, (ii) any corporation that has reason to believe that it may be subject to the CAMT if its distributive share of the partnership's AFSI were taken into account, and (iii) any corporation that had more than $1 billion of revenue (or gross receipts) in the preceding taxable year (including, for this purpose, the book revenue (or gross receipts) of all person related to the corporation (applying principles of the section 448(c)(2) aggregation rules for purposes of determining relationship).[205]

In addition, we recommend that Treasury and the Service consider adopting a *de minimis* rule to limit burdensome information reporting for small partnerships (*e.g.*, partnerships with gross receipts less than the amount specified in section 448(c)(1), adjusted for inflation (currently $26 million). We further recommend that if the *de minimis* rule applies, the applicable corporation should be required to substitute its direct or indirect share of the partnership's taxable income for the unreported distributive share of AFSI.

If our recommendation is adopted, information reporting will begin with the best informed and most sophisticated taxpayers reaching out for information rather than with a blanket requirement for all partnerships to create and distribute information that might not be required by any of its direct or indirect partners. In order to permit affected taxpayers to comply with the requirements of the CAMT, we urge Treasury and the Service to provide guidance addressing partnership information reporting requirements as promptly as possible. We request that, consistent with prior guidance providing penalty relief for partnership tax capital reporting and reporting on Schedule K-3 in the first applicable year, a partnership should not be subject to penalties with respect to 2023 AFSI information reporting if it makes a reasonable good faith effort to comply with the applicable reporting requirements.

G. Outbound International Taxation Comments

1. Duplication of CFC Income

a. Background

A U.S. Shareholder's AFSI is adjusted to take into account its pro rata share of CFC AFSI under section 56A(c)(3).

Section 56A(c)(2)(C) provides additional rules for calculating AFSI from corporations excluded from the taxpayer's Section 1502 Group. Under section 56A(c)(2)(C), the taxpayer's AFSI with respect to that excluded corporation is determined by "only taking into account"

[204] If a partnership uses a "bottom-up" approach, discussed above, in calculating its distributive share of AFSI, then AFSI Information may be reported by the partnership to the ultimate corporate partner. Alternatively, if a top-down approach to calculating and reporting distributive share were adopted, the necessity of reporting information from the bottom-up could be further limited.

[205] Since partnerships with gross receipts in excess of $5 million are currently required to report gross receipts determined under section 448(c)(2) to their partners on the Schedule K-1, line 20AG, imposing a gross receipts test cross-referencing section 448(c) would not increase the administrative burden on partnerships in a tiered structure.

dividends the taxpayer receives and other amounts which are includable in the taxpayer's gross income, other than amounts required to be included under sections 951 and 951A, or deductible as a loss. The amount of any dividend may be "reduced to the extent provided by the Secretary in regulations or other guidance."[206] In addition, Treasury and the Service are authorized to prevent the omission or duplication of any item in determining AFSI.[207]

Under section 1504(b)(3), foreign corporations cannot be included in a taxpayer's Section 1502 Group. Accordingly, any CFC, regardless of the interest held by the U.S. Shareholder, is subject to the dividend inclusion rule in section 56A(c)(2)(C), in addition to the pro rata share rule in section 56A(c)(3).

b. Recommendation

We recommend that Treasury and the Service provide rules to prevent duplication of income by excluding any dividend from a CFC for which the taxpayer has included its pro rata share of CFC AFSI.

c. Discussion

The CAMT by its terms does not prevent duplication of income arising from inclusions of CFC AFSI and inclusions of CFC dividends. Instead, the Code provides that dividends may be included in AFSI, authorizes guidance to reduce certain dividends and to prevent duplication, and seeks to ensure that gains and deductible stock losses are not ignored in determining AFSI. We believe that guidance should prevent the duplication of CFC income arising from the concurrent application of section 56A(c)(2)(C) and (c)(3).

The risk of CFC income duplication is apparent when examining CFCs included in a taxpayer's Book Group AFS. For financial statement purposes, intercompany dividends from consolidated subsidiaries are eliminated and do not affect consolidated financial statement income, consistent with the purpose of ensuring that consolidated statements reflect the economic performance of a single entity.[208] To determine a U.S. Shareholder's pro rata share of CFC AFSI for purposes of section 56A(c)(3), the CFC's AFSI is calculated on a standalone basis and included in the taxpayer's AFSI.[209] Although the CFC's standalone AFSI is reduced for intercompany transaction expense, CFC AFSI is not reduced for dividends issued from the CFC to its owner(s). If a taxpayer was required to include both its pro rata share of CFC income and dividends from that CFC, the taxpayer's AFSI would exceed economic income of the

[206] I.R.C. § 56A(c)(2)(C).

[207] I.R.C. § 56A(c)(15)(A).

[208] For example, for initial consolidation of a subsidiary, U.S. GAAP provides that "in the preparation of consolidated financial statements, intra-entity balances and transactions shall be eliminated. This includes intra-entity open account balances, security holdings, sales and purchases, interest, dividends, and so forth." FASB ASC 810-10-45-1.

[209] The CFC's pro rata share rule does not contain any exclusions, such as a substance-based carveout similar to the deemed tangible income return in section 951A.

consolidated enterprise and exceed the amount properly recognized for financial accounting purposes.

Including CFC dividends in the base of the CAMT would also yield persistent asymmetry with the regular tax. Standing alone, the CFC inclusion rule generally exceeds parity with the regular tax system, with CFC AFSI taxed at a 15% rate, as opposed to the 10.5% GILTI rate, and with the entire pro rata share of CFC income subject to inclusion, with no substance-based carveout. The dividend inclusion rule in section 56A(c)(2)(C), if not restricted, would further eclipse the regular tax system. For federal tax purposes, CFC distributions generally do not increase tax, as distributions are typically sourced either (i) from previously taxed earnings and profits excluded from gross income under section 959 or (ii) from section 959(c)(3) earnings and profits eligible for the 100% dividends-received deduction under section 245A.[210]

Consistent with canons of statutory construction, if a conflict exists between a general and a specific provision, the specific provision should prevail. The rule governing dividends in section 56A(c)(2)(C) applies not only to CFCs, but to the broad set of entities excluded from a taxpayer's federal consolidated group.[211] By contrast, the pro rata inclusion rule applies only to CFC owners. The rules in section 56A(c)(2)(C) and (c)(3) may be harmonized by allowing the general application of the dividend inclusion rule, with an exclusion for dividends from CFCs, which are instead governed by the CFC inclusion rule. We recommend that Treasury and the Service exercise their authority to exclude dividends from any CFC for which the taxpayer has included its pro rata share of CFC AFSI.

In offering this recommendation, we are mindful that Treasury and the Service considered a similar issue for prior CAMT from 1987 through 1989 and adopted a tracking system to prevent duplication of income from CFC dividends, rather than a *per se* exclusion. In particular, Treasury and the Service issued regulations allowing taxpayers to exclude CFC dividends from "net book income" if the taxpayer could demonstrate that the dividend was sourced from an amount previously included in "adjusted net book income."[212]

In our view, significant differences between the prior CAMT and the CAMT counsel a different approach here. Under the prior CAMT, the taxpayer included an adjustment to book income equal to the amount required to be included in the taxpayer's gross income under subpart F in the regular tax system.[213] The targeted inclusion of subpart F amounts was significantly narrower than the CFC inclusion rule in current section 56A(c)(3), which applies to all of a CFC's income without exception. Moreover, because the prior CAMT was calculated by reference to identifiable amounts determined for regular tax purposes, taxpayers were able to track whether such amounts had previously been included in adjusted net book income. By contrast, the CFC inclusion rule in the CAMT does not map onto existing groups of previously

[210] *But see*, *e.g.*, Treas. Reg. § 1.245A-5; I.R.C. § 245A(e).

[211] *See generally* I.R.C. § 1504.

[212] Former Treas. Reg. § 1.56-1(d)(4)(v), (viii) (1990).

[213] Former Treas. Reg. § 1.56-1(b)(2)(iv) (1990).

taxed earnings and profits,[214] because the CFC inclusion rule is not limited to amounts subject to anti-deferral rules in the regular tax system. We believe that any type of "tracking" rule would require an intricate set of procedures to identify items previously included in CAMT AFSI, introducing complexity and imposing administrative burden on the Service and taxpayers.

2. CFCs in Section 52 Group

a. Background

As discussed above, for purposes of determining applicable corporation status, all AFSI of persons treated as a single employer with such corporation under subsection (a) or (b) of section 52 is treated as AFSI of such corporation.[215] Section 52(a) incorporates the controlled group rules of section 1563(a), substituting a 50% test for the 80% test.[216] Section 52(b) aggregates all trades or businesses under common control.

Under section 56A(c)(3), a U.S. Shareholder of a CFC must adjust its AFSI to take into account its pro rata share of items taken into account in computing the net income or loss set forth in each CFC's AFS.[217] If the overall CFC adjustment is negative, it cannot reduce AFSI of U.S. members of the group but that amount is carried forward to offset positive CFC AFSI in future years.[218] The U.S. Shareholder's pro rata share is determined under rules "similar to the rules under section 951(a)(2)."[219] Section 951(a)(2) provides rules for determining a taxpayer's pro rata share of subpart F income.

b. Recommendation

We recommend that guidance clarify that, for purposes of making the applicable corporation determination, taxpayers should only include their pro rata share of CFC income, as determined under current Treasury guidance, including Treas. Reg. § 1.951-1(b) and (e).

c. Discussion

We believe that guidance is needed to confirm how the pro rata share rule applies with respect to CFCs that are within the Section 52 Group of the U.S. Shareholder for purposes of determining applicable corporation status of the U.S. Shareholder. Specifically, if a CFC is part of the Section 52 Group, the wording of the aggregation rule under section 59(k)(1)(d) could be interpreted to suggest that all of the CFC AFSI should be included. This result would conflict

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[214] Treas. Reg. § 1.960-3(c).

[215] I.R.C. § 59(k)(1)(D). *See* Part II.A.1 of these Comments.

[216] I.R.C. § 1563(b)(2)(C); *See* Part II.A.1 of these Comments.

[217] Specifically, CFC's AFS should be adjusted under rules similar to those that apply in determining AFSI. I.R.C. § 56A(c)(3)(A).

[218] I.R.C. § 56A(c)(3)(B).

[219] I.R.C. § 56A(c)(3)(A).

with the statutory rules in section 56A(c)(3), which provides that only the pro rata share of the CFC's net income should impact the taxpayer's AFSI. Furthermore, if such a result was intended, the statute could have turned off the CFC pro rata rule, as is contemplated in the test for FPMGs under section 59(k)(2)(A). As such, we recommend guidance clarifying that taxpayers may use the guidance that Treasury and the Service have issued under section 951(a)(2) to determine their pro rata share of CFC income for purposes of making the applicable corporation determination.

3. CAMT FTCs: Foreign Taxes Paid by Partnerships

a. Background

Section 55(b)(2) imposes a 15% AMT on the AFSI of corporations that have an average AFSI of $1 billion over a three-year period. Generally, the taxes of a corporate taxpayer are disregarded in calculating AFSI. Payments of foreign taxes, however, are creditable against a taxpayer's corporate AMT liability. The amount of available CAMT FTC equals the sum of (i) the amount of foreign taxes paid by the domestic corporate taxpayer and (ii) the lesser of: (A) the domestic corporate taxpayer's pro rata share of the amount of foreign taxes paid by a CFC of the corporate taxpayer, and (B) 15% of a CFC's financial accounting income included in the corporate taxpayer's AFSI.[220]

b. Recommendation

We recommend that guidance clarify that a corporate partner may include its proportionate share of foreign taxes paid by a partnership for purposes of computing its amount of CAMT FTC. Specifically, we recommend applying the principles of section 704(b) to allocate the appropriate amount of partnership creditable foreign tax expenditures (as defined above, "CFTEs") to the corporate partner for CAMT FTC purposes.

c. Discussion

The language of the statute does not address CAMT FTCs paid by a partnership, though section 56A(c)(2)(D) is clear that a corporate taxpayer that is a partner in a partnership takes into account in AFSI its distributive share of the partnership's net income. Because corporate partners bear the economic burden associated with their distributive share of the partnership's AFSI for purposes of computing the corporate AMT, as well as their share of foreign taxes paid by the partnership, it is appropriate that they receive a proportionate share of such taxes for purposes of computing the CAMT FTC.

We propose to apply the principles of section 704(b) to allocate the appropriate amount of partnership CFTEs to the corporate partner for CAMT FTC purposes. Under the Treasury Regulations promulgated under section 704(b), partnership allocations are respected if they have substantial economic effect within the meaning of the regulations or are allocated in accordance

[220] I.R.C. § 59(l). *See* Part II.A.2 of these Comments.

with the partners' interest in the partnership.[221] Allocations that are compliant with the applicable Treasury Regulations will generally have substantial economic effect. On the other hand, allocations that are in accordance with the partners' interest in the partnership may or may not correspond to the overall economic arrangement of the partners.[222] The Treasury Regulations provide for a facts and circumstances analysis and list four non-exclusive factors to consider: (i) the partners' relative contributions to the partnership (ii) the interests of the partners in economic profits and losses; (iii) the interests of the partners in cash flow and other non-liquidating distributions; and (iv) the rights of partners to distributions of capital upon liquidation.[223] The Treasury Regulations provide a special rule for foreign tax credits, which provides that allocations of CFTEs are made in accordance with the partners' interest in the partnership if: (i) the CFTEs is allocated to each partner and reported on the partnership tax return in proportion to their category shares of income to which the CFTEs relates; and (ii) allocations of all other partnership items in the aggregate that have a material effect on the amount of CFTEs allocated to a partner are valid.[224] Compliance with these Treasury Regulations ensures that any CFTEs allocated to a corporate taxpayer would correlate with any net income allocated and included in a corporate taxpayer's AFSI.

In our view, applying the principles of section 704(b) to allocate a partnership's foreign taxes to its corporate partner is essential to avoid double taxation. Further, tax practitioners are already familiar with the Treasury Regulations promulgated under section 704(b) and would likely not need further guidance on its application to the CAMT FTC. Moreover, corporate taxpayers would not be burdened in complying with this solution, given that any partnership in which they are a partner should already be compliant with section 704(b). Lastly, this solution streamlines the CAMT FTC with the partnership tax rules.

H. Inbound International Taxation Comments

1. Determining AFSI of Members of an FPMG

a. General Background

As discussed above, a corporation is an applicable corporation for a taxable year if it has average annual AFSI of $1 billion for the testing period.[225] A corporation that is a member of an FPMG is an applicable corporation if (i) the overall FPMG meets the $1 Billion Threshold (after applying certain adjustments), and (ii) the corporation has average annual AFSI of $100 million

[221] Treas. Reg. § 1.704-1(b)(1)(i).

[222] Treas. Reg. § 1.704-1(b)(3)(i).

[223] Treas. Reg. § 1.704-1(b)(3)(i)-(ii).

[224] Treas. Reg. § 1.704-1(b)(4)(viii)(a).

[225] I.R.C. § 59(k)(1)(B)(i).

for the same testing period.[226] An FPMG consists of two or more entities if: (i) at least one entity is a domestic corporation and another entity is a foreign corporation; (ii) such entities are included in the same AFS with respect to the taxable year; and (iii) either the common parent of such entities is a foreign corporation, or if there is no common parent, the entities are treated as having a common parent under rules to be prescribed by Treasury.[227]

b. Applying the Aggregation Rules to FPMGs

For purposes of determining whether a corporation is an applicable corporation, the AFSI of all persons treated as a single employer under section 52(a) or section 52(b) is treated as AFSI of that corporation.[228] Section 52(a) broadly incorporates the controlled group rules of section 1563, which exclude foreign corporations.[229] Section 52(b) would aggregate all trades or businesses under common control.

For purposes of the $1 Billion Threshold, an FPMG would include the AFSI of "all members of such group."[230] This rule, contained in section 59(k)(2)(A), does not expressly incorporate (or turn off) the aggregation rules of section 52(a) and (b). Nevertheless, the statute gives Treasury the authority to prescribe regulations for the determination of "the entities to be included in a foreign-parented multinational group."[231] Consequently, we think such regulations could incorporate the aggregation rules of section 52(a) and (b) but turn off the exclusion of foreign corporations.[232] That would promote simplicity and put U.S. and foreign multinational groups on similar footing.

In addition, the rules concerning the $100 million test do not count the AFSI of "all members" of the FPMG as the "all members" aggregation rule applies "solely for purposes" of the $1 Billion Threshold.[233] Although there is no specific rule that turns off the aggregation rules of section 52(a) and (b) for purposes of applying the $100 million test, the AFSI of foreign members is not counted as noted above.

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[226] I.R.C. § 59(k)(1)(B)(ii). Consequently, the corporation is tested first taking into account the AFSI of all members of the FPMG under section 59(k)(2) (for purposes of the $1 Billion Threshold) and then the separate income of that member without regard to section 59(k)(2) (for purposes of the $100 Million Threshold).

[227] I.R.C. § 59(k)(2)(B).

[228] I.R.C. § 59(k)(1)(D).

[229] I.R.C. § 1563(b)(2)(C). The original draft of the bill would have removed the exclusion for foreign corporations. *See* Amendment in the Nature of a Substitute to provide for reconciliation pursuant to title II of S. Con. Res. 14, Pub. L. 117-169, § 10101 (Aug. 16, 2022) (amending section 59(k)(1)(D)(iii)) (the "**Thune Amendment**"). But the exclusion was ultimately retained in the law, as enacted, as a result of the Thune Amendment. *Id*. at § 13904.

[230] I.R.C. § 59(k)(2)(A).

[231] I.R.C. § 59(k)(2)(D).

[232] *See* I.R.C. § 1563(b)(2)(C).

[233] I.R.C. § 59(k)(2)(D).

Additionally, a U.S. trade or business of a foreign corporation is treated as a separate domestic corporation that is wholly owned by the foreign corporation.[234] Given this treatment, the foreign corporation exception contained in section 1563(b)(2)(C) would not apply to exclude a U.S. trade or business, which is considered a domestic corporation. Consequently, our interpretation of the statute is that an FPMG with one or more domestic subsidiaries and one or more foreign corporations with a U.S. trade or business would aggregate the AFSI of such domestic subsidiaries and the U.S. branches of the foreign corporations for purposes of the $100 million test.[235] However, the income of any foreign members of the FPMG other than U.S. business income would be excluded. We recommend issuance of regulations to clarify that this is the correct interpretation.

c. Application of the CFC Adjustment Rules to U.S. Members of an FPMG

There are special rules for counting the AFSI of CFCs whereby a U.S. Shareholder of a CFC must count its pro rata share of items taken into account in computing the net income or loss set forth in the AFS, with certain adjustments, of each such CFC.[236] As noted above, the AFSI of all members of an FPMG is counted for purposes of the $1 Billion Threshold.[237] That test for FPMGs carves out the CFC adjustment rules since the AFSI of all members of the group is counted anyway.[238] There is no similar carve out for purposes of the $100 million threshold. Thus, we believe that the CFC adjustment rules should apply to a domestic corporation that is a member of an FPMG for purposes of testing whether such corporation meets the $100 million threshold and for purposes of calculating the CAMT itself.

We believe further clarification is needed where a foreign corporation whose U.S. trade or business is treated as a domestic corporation. As noted above, the U.S. trade or business of a foreign corporation is treated as a separate domestic corporation wholly-owned by the foreign corporation.[239] If the foreign corporation with a U.S. trade or business also has foreign subsidiaries, it may well be possible that those foreign subsidiaries would be treated as CFCs under the downward attribution rule of section 958(b) by virtue of the presence of "real"

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[234] I.R.C. § 59(k)(2)(C).

[235] We believe this is so because, as mentioned, nothing turns off the aggregation rules of section 52(a) and (b) for purposes of the $100 million test. But some take the view that the AFSI of deemed corporations are not to be aggregated with one another or with a "real" domestic corporation because the $100 million test is to be applied without regard to section 59(k)(2), which is where the U.S. trade or business rule resides.

[236] I.R.C. § 56A(c)(3)(A). If the overall CFC adjustment is negative, it cannot reduce AFSI of U.S. members of the group but may be carried forward to offset positive CFC AFSI in future years. I.R.C. § 56A(c)(3)(B).

[237] I.R.C. § 59(k)(2)(A).

[238] *Id.* ("solely for purposes of this subparagraph [which pertains to the $1 Billion Threshold], applicable financial statement income shall be determined without regard to paragraphs … (3) … of section 56A(c)").

[239] I.R.C. § 59(k)(2)(C).

domestic subsidiaries in the FPMG.[240] It is unclear whether the CFC adjustment rules would apply to the deemed domestic corporation that is a section 958(a) shareholder of foreign subsidiaries now treated as CFCs due to the construct of section 59(k)(2)(C), such that the deemed domestic corporation must include the AFSI of such foreign subsidiaries.

Section 56A(c)(4) provides that a foreign corporation must determine AFSI "under principles similar to section 882." This would apply where a foreign corporation has a branch and that branch is treated as a domestic corporation. Section 882 provides rules for when gross income and deductions are effectively connected with the conduct of a trade or business. In particular, foreign corporation must use the "asset use test" and the "business activities test" to determine whether dividends received should be ECI for purposes of section 882.[241] Under these tests, dividends received from wholly-owned subsidiaries are generally not ECI.[242]

We recommend that the regulations consider a hypothetical dividend test. If a dividend received by a foreign corporation would be ECI under either the asset use or business activities test, then the stock of that corporation should be deemed to be owned by the deemed domestic corporation.[243] If such a dividend would not be ECI, as we expect in most cases, then the stock of that foreign corporation would be excluded and the CFC adjustment rules would not apply.

2. Interaction of Section 56A(c)(4) and Tax Treaties

Section 56A(c)(4) provides that to determine the AFSI of a foreign corporation, the "principles of section 882 shall apply." Section 882(a)(1) provides that a foreign corporation is subject to corporate tax on "income which is effectively connected with the conduct of a trade or business within the United States," or ECI. U.S. income tax treaties generally provide that business income of a foreign resident cannot be taxed in the U.S. unless it is attributable to a U.S. permanent establishment.[244] Section 894(a)(1) provides that "the provisions of *this title* shall be applied to any taxpayer with due regard to any treaty obligation of the United States which

[240] We do not believe that the downward attribution rule should be applied to a "deemed" domestic subsidiary because that status applies only "for purposes of this paragraph."

[241] *See* I.R.C. § 864(c)(2).

[242] *See* Treas. Reg. § 1.864-4(c)(2)(iii)(a). In the case of insurance companies, stock is viewed as held for the conduct of the trade or business under the asset use test unless the foreign corporation owns 10% or more of the voting of value of that stock (directly or constructively). Treas. Reg. § 1.864-4(c)(2)(iii)(b). Under the business activities test, the focus is generally whether dividends and capital gains on stock are derived in the active conduct of a trade or business by dealers in securities and investment companies. Treas. Reg. §1.864(c)(3)(i). Dividends from wholly or majority owned subsidiaries would generally not give rise to ECI under the business activities test.

[243] This hypothetical dividend approach is similar to approach taken in Treas. Reg. §§ 1.865-1 and 1.865-2 on how to allocate losses on stock and debt instruments for purposes of determining foreign source net income.

[244] *See, e.g*., Art. 7(1) of the Convention between the United States of America and the Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes; Art. 7(1) of the Tax Convention with the Netherlands. Every U.S. Model Income Tax Treaty since 1977 has contained this rule. *See, e.g*., Art. 7(1) of the United States Model Income Tax Treaty (1977) and Art. 7(1) of the United States Model Income Tax Convention (2016).

applies to such taxpayer."[245] Consequently, treaty benefits apply for purposes of section 882. As a result, income that would otherwise be taxed under section 882 as ECI is exempt from tax if it is not attributable to a permanent establishment in the United States.[246]

Section 7852(d)(1) provides that, for purposes of determining the relationship between a treaty provision and any U.S. law affecting revenue, neither the treaty nor the law has preferential status to the other. Enacted together with section 894(a), section 7852(d) codified the general "later in time" rule, whereby the later of a treaty or a statute would control.[247] Courts generally try to construe treaties and statutes harmoniously to avoid applying the later in time rule unless it is clear that Congress intended for the statute to take priority.[248] Consequently, the later in time rule only applies where there is a clear conflict between the law and the treaty and no indication of Congressional intent.[249]

We believe that the later in time rule of section 7852(d)(1) should not apply to overrule applicable treaty provisions in determining AFSI of a foreign corporation. First, in our view, there is no conflict between section 56A(c)(4) and U.S. income tax treaties because section 56A(c)(4) refers to the "principles of section 882," which already apply with "due regard to any treaty obligation" under section 894(a). In addition, there is no indication either in section 56A itself or in legislative history that Congress intended that the provisions of the CAMT would be imposed on income that is otherwise exempt from tax under a tax treaty. Consequently, we

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[245] Emphasis added.

[246] *See, e.g.*, *Taisei Fire and Marine Insurance v. Commissioner*, 104 T.C. 535 (1995); *National Westminster Bank v. United States*, 44 Fed Cl. 120 (1999).

[247] *See* Senate Report to Accompany S. 2238, S. Rep. 100-445, 100th Cong., 2d Sess. at 316 (1988) (the "**Senate Finance Committee Report**"); *see also Lindsey v. Commissioner*, 98 T.C. 672, *aff'd* 15 F.3d 1160 (D.C. Cir. 1994) (section 59(a)(2)'s limitation on the availability of alternative minimum tax foreign tax credits overrides a contrary treaty provision); Rev. Rul. 80-201, 1980-2 C.B. 221 (regarding an amendment to section 904 and stating "The courts do not favor repudiation of an earlier treaty by implication and require clear indications that Congress, in enacting subsequent inconsistent legislation, meant to supersede the earlier treaty…An example of such a clear indication is the presence of subsequent inconsistent legislation together with a committee report indicating that Congress intended such legislation to supersede the earlier treaty" (citation omitted)).

[248] *See, e.g.*, *Whitney v. Robertson*, 124 U.S. 190, 194 (1988) ("When [a statute and treaty] relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either; but if the two are inconsistent, the one last in date will control the other...."); *Cook v. United States*, 288 U.S. 102 (1933). *See also* Rev. Rul. 80-223, 1980-2 C.B. 217 ("The courts do not favor repudiation of an earlier treaty by implication and require clear indications that Congress, in enacting subsequent inconsistent legislation, meant to supersede the earlier treaty.) (citing *Head Money Cases*, 112 U.S. 580, 597-99 (1884); *United States v. Payne*, 264 U.S. 446, 448 (1924); *Menominee Tribe of Indians v. United States*, 391 U.S. 404, 413 (1967)).

[249] The Senate Finance Committee Report states: "It is a proper function of the courts to carry out the process of harmonization, that is, to construe earlier and later provisions in a way that is consistent with the intent of each and that results in an absence of conflict between the two." S. Rep. 100-445, 100th Cong., 2d Sess. at 317 (1988). The Senate Finance Committee Report further provides: "Courts may find convincing evidence that the purpose of the later statute was completely unrelated to the earlier provision purported to be repealed, and that therefore the earlier provision continues to apply without change." *Id*. (citing *Watt v. Alaska*, 451 U.S. 259 (1981); *United States v. United Continental Tuna Corp*, 425 U.S. 164 (1976)).

believe that income tax treaties should be taken into account in determining the AFSI of a foreign corporation that has a U.S. trade or business.

I. Deferral Comments

1. Overview

There are certain provisions in the Code that defer or exclude income from tax. These provisions impact the computation of AFSI for applicable corporations. We recommend that Treasury and the Service consider issuing guidance under the authority granted under section 56A(c)(5) and (e) with regard to the computation of AFSI with respect to the following exclusion and deferral incentives:

- Deferral of eligible gain contributed to QOFs and exclusion of gain on QOF interests after 10 years;
- Deferral of gain from involuntary conversions;
- Deferral of gain from like-kind exchanges; and
- Deferral of gain from installment sales.

2. Qualified Opportunity Funds

We believe that Treasury and the Service should consider issuing regulations under authority granted under section 56A(c)(5) or 56A(e) with regard to whether AFSI incorporates the QOF exclusion and deferral rules for applicable corporations subject to the CAMT.

Some large C corporations have created, or have considered creating, QOFs described in section 1400Z-2 in order to make investments of eligible gain in qualified opportunity zone businesses ("**QOZBs**"). Similarly, some governmental economic development authorities seek to attract large C corporation employers to establish QOZBs in their jurisdictions through QOFs by stressing the tax benefits.

Section 1400Z-2(a)(1)(A) generally requires that a C corporation invest its eligible gains in a QOF within 180 days to achieve these deferral benefits. Accordingly, applicable C corporations that have recently reorganized or anticipate recognizing in the near future eligible gains that would be deferred upon reinvestment in a QOF would benefit from prompt guidance on the status of QOF investments under the CAMT.

The principal federal tax benefit of a QOF is the permanent exclusion of gain on sale after ten years of ownership. A smaller potential tax benefit is the deferral until 2026 of inclusion of eligible gain invested in a QOF during 2023, 2024, or 2025.

The QOF program is a socially-oriented, anti-poverty tax incentive. Its social goals are similar to those of general business tax credits such as the certified historic tax credit, low-income housing tax credit, new markets tax credit, and work opportunity credit. Indeed, many

QOZBs also generate such general business credits. Credits are allowed against the CAMT under section 38(c)(6)(E)(i) up to 75% of the combined regular tax and CAMT.

AFSI under section 56A does not expressly incorporate the section 1400Z-2 favorable exemption and deferral tax incentives for investments in QOFs. Applicable corporations whose marginal financial statement income from QOF exit and entry transactions would be subject to the CAMT and would see their immediate marginal federal tax benefits from participating in the QOF program evaporate. In addition, large corporations with foreseeable possible exposure to CAMT throughout the mid-to-late 2030s may find their federal tax incentive to form QOFs, before the QOF program's 2027 expiration date, eliminated, or reduced.

As noted above, one might analogize the QOF program to other socially motivated general business tax credit programs, which would be creditable against up to 75% of the combined regular tax and CAMT. One might also analogize the CAMT to the individual AMT, which favorably and fully incorporates the QOF deferral and permanent exemption rules into the calculation of AMT income. Moreover, there is no indication of legislative intent to exclude these deferral and permanent exemption rules for purposes of applying the CAMT. Accordingly, modifications to the general AFSI computation should be considered to encompass, completely or a substantial portion of, the QOF exclusion and deferral rules. In our view, Treasury and the Service could contemplate such action through the authority provided for under section 56A(c)(5) or 56A(e).

3. Involuntary Conversions

We recommend that Treasury and the Service consider issuing a regulation under authority granted under section 56A(c)(5) or 56A(e) with regard to the computation of AFSI to preserve the section 1033 deferral rules for involuntary conversions of applicable corporations subject to the CAMT.

We believe section 1033 reflects long-standing Congressional policy that qualifying corporations should be able to reinvest their earnings in order to maintain their business activities, without adverse tax liabilities, despite some of their business premises having suffered compensable destruction, eminent domain proceedings, or similar involuntary conversions. Because of the involuntary nature of section 1033 transactions, we believe that there is no significant opportunity for abuse.

4. Like-Kind Exchanges

We recommend that Treasury and the Service consider issuing a regulation under authority granted under section 56A(c)(5) or 56A(e) with regard to the computation of AFSI to preserve the section 1031 deferral rules for like-kind exchanges.

Section 1031 reflects long-standing Congressional policy that qualifying corporations should be able to reinvest their earnings in order to maintain their business activities, without adverse corporate tax liabilities.

On January 19, 2023, the Congressional Research Service issued a report on the CAMT that it emphasized the need for guidance on whether book-tax differences for like-kind exchanges should be eliminated for purposes of calculating AFSI:

> Capital gains are treated differently for book purposes than for tax purposes. Some companies are required to (or elect to) include unrealized gains on assets under GAAP accounting. Gains on some transactions are deferred for tax but not for book purposes. One example is like-kind exchanges, which applies to exchanges of real property. Guidance appears needed to determine whether gains are reduced on adjusted financial statement income if not realized for tax purposes.[250]

In addition, certain industries, such as large hotel and energy companies, may be adversely affected by the inclusion of gain deferred under section 1031 for purposes of calculating AFSI, possibly suggesting that deferral under section 1031 should receive more favorable relief than other discontinuities between book and tax treatment. Accordingly, some members believe that Treasury and the Service should consider issuing a regulation under section 56A(c)(5) or 56A(e) to incorporate the section 1031 deferral rules into the computation of AFSI.

5. Installment Sales

We recommend that Treasury and the Service consider issuing a regulation under authority granted under section 56A(c)(5) or 56A(e) with regard to the computation of AFSI to preserve the installment sale treatment under sections 453 and 453A.

Sections 453 and 453A allow taxpayers, including qualifying corporations, to defer gains on installment sales in certain circumstances. For example, deferral of gains on nondealer installment sales is generally permissible, provided that the obligation is not pledged. This reflects long-standing Congressional policy that taxpayers generally should be able to match their ability to pay cash taxes on installment obligations with the cash generated from those same obligations, irrespective of whether the corporation might have other cash resources to pay the tax on the deferred gain. In addition, sections 453 and 453A have specific rules that enable taxpayers in certain industries to elect installment method reporting, even if they are dealers.[251]

Installment sale deferral is the largest timing difference in the CAMT and therefore merits special attention by Treasury and the Service.[252] In the nondealer situation and the timeshare situation, sections 453A(a)(1) and 453(l)(3), respectively, compensate the U.S. fisc for the tax deferral through an interest charge. If both the interest charge and the CAMT apply, the government may be viewed as receiving a windfall. The interest charge is based on the deferred regular corporate income tax rate, currently 21%. If the 15% CAMT applies currently on a taxpayer's gain from an installment sale, the interest charge is applied based on a 21% rate,

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[250] Jane G. Gravelle, CRS Report, R47328, *The 15% Corporate Alternative Minimum Tax*, at 18 (Jan. 19, 2023.

[251] *See* I.R.C. § 453(l)(2) (farming, timeshares, unimproved residential lots, and campground rights).

[252] *See* Congressional Research Service, Report R4687, *Minimum Taxes on Business Income: Background and Policy Options*, Page 4, Table I. Corporate Tax Expenditures (Nov. 16, 2021).

despite only a 6% current tax savings rate. Thus, a CAMT taxpayer would bear an interest charge that is three and a half times larger than that of a regular taxpayer.[253]

Certain industries, such as farming and timeshare developers, may be more adversely affected than others by the inclusion of installment gain deferred under section 453 for purposes of calculating AFSI. Some Section members thus believe that deferral under section 453 should receive more favorable relief than other discontinuities between book and tax treatment. Accordingly, we recommend Treasury and the Service consider issuing regulations under section 56A(c)(5) or 56A(e) to determine how the section 453 deferral rules should be treated when computing AFSI.[254]

Depending upon how Treasury and the Service address such computations, they could consider, under the authority granted in sections 453A(e) and 453(j), issuing regulations that turn off the interest charge discussed above, or impose a reduced interest charge, in appropriate circumstances where installment sale gain is otherwise subject to the CAMT.

J. Tax-Exempt Organizations Comments

Section 56A(c)(12) provides that "in the case of an organization subject to tax under section 511, AFSI shall be appropriately adjusted to only take into account any AFSI either (i) of an unrelated trade or business, as defined in section 513, of such organization, or (ii) derived from debt-financed property, as defined in section 514, to the extent that income from such property is treated as UBTI.

We recommend that guidance make clear that section 56A(c)(12)(A) is not intended to take into account any income (or associated expenses) excluded from UBTI under section 512(b). Rather, pursuant to section 56A(c)(12)(B), items described in section 512(b) should only give rise to the AFSI of an applicable TEO to the extent such items are income derived from debt-financed property, as defined in section 514. The intent of Congress to exclude items described in section 512(b) other than debt-financed income is evident in the fact that section 56A(c)(12)(B), which specifically includes income from debt-financed property, would be unnecessary if section 56A(c)(12)(A) already included such income.

Therefore, guidance should clarify that the AFSI of a TEO, both for purposes of determining status as applicable corporation and calculating the CAMT of an applicable corporation, is equal to its Book UBI, where Book UBI includes: (i) net income from a regularly

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[253] OECD Pillar Two allows deferred taxes that will reverse within five years to be currently taken into account at the 15% minimum tax rate. This allows, in effect, installment obligations that mature within five years to be excluded from the Pillar Two minimum tax. This Pillar Two exclusion is available even without regard to an interest charge, such as those imposed under sections 453A(a)(1) and 453(l)(3). Given the U.S. interest charge rules, Treasury and the Service may wish to consider an exemption for certain installment sale payment obligations.

[254] For purposes of the prior CAMT rules applicable to the 1987-1989 book-tax preferences, and to the post-1989 adjusted earnings tax preference, installment sale deferral was unavailable for obligations deferrable for regular corporate income tax, even for those obligations subject to the statutory interest charge. We note that the repealed 1987-1989 book-tax preferences, and the post-1989 adjusted earnings tax preference, unlike section 56A(c)(5), did not contain specific regulatory authority to address deferred taxes.

carried on unrelated trade or business within the meaning of section 513(a), computed with the modifications provided in subsection 512(b), plus (ii) net unrelated debt-financed income as defined in section 514(a).