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Report No. 1473
March 20, 2023

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

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

The Honorable William M. Paul
Principal Deputy Chief Counsel
and Deputy Chief Counsel
(Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

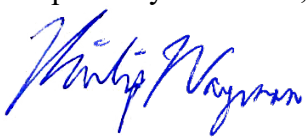
Re: Report No. 1473 - Report on Selected Issues Relating to the Corporate Alternative Minimum Tax

Dear Ms. Batchelder and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1473 of the Tax Section of the New York State Bar Association discussing selected issues relating to the corporate alternative minimum tax, including issues relating to Notice 2023-7.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,



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Report No. 1473

New York State Bar Association Tax Section

Report on Selected Issues Relating to the Corporate Alternative Minimum Tax

March 20, 2023

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Report on Selected Issues Relating to the Corporate Alternative Minimum Tax

I. Introduction

This report (the "**Report**")[1] analyzes and provides recommendations regarding new Section 56A and accompanying amendments to Sections 53, 55 and 59,[2] which were enacted as part of the law commonly known as the "**Inflation Reduction Act of 2022**," or "**IRA**."[3] These provisions impose a new corporate alternative minimum tax ("**CAMT**") on corporations that meet a specified size threshold.

Part II summarizes our principal recommendations for guidance from the Department of the Treasury ("**Treasury**," including as applicable the Internal Revenue Service, or "**IRS**") with respect to selected aspects of CAMT, including in response to Notice 2023-7 (the "**Notice**").[4] In particular, our recommendations focus on topics for which we believe prompt guidance is especially important: the impact of acquisitions and other corporate transactions on a corporation's "**adjusted financial statement income**" ("**AFSI**") and its basis in its assets as determined for CAMT purposes; the impact of such transactions on testing for whether corporate participants in those transactions meet the size threshold to be subject to CAMT; safe harbors for determining whether a corporation meets such size threshold; application of Section 56A(c)(13) to determine depreciation expense and related basis adjustments for CAMT purposes; application of the CAMT rules to distressed taxpayers; and selected partnership issues. Part III provides background on CAMT and related procedural rules. Part IV analyzes potential topics for Treasury guidance related to CAMT, presents different approaches that Treasury guidance could take in certain areas, and in some cases offers our recommended approaches.

II. Summary of Principal Recommendations

Guiding Principles for Making Regulatory Adjustments to AFSI

1. We recommend that Treasury be judicious in providing for adjustments to a corporation's AFSI to conform it more closely to taxable income, but we did not reach

[1] The principal authors of this Report are Shane Kiggen, Kara Mungovan, Sara Zablotney, and Libin Zhang. Substantial research and drafting assistance was provided by William Liang, Yixuan Long, Janine Mesina, and Albert Park. Helpful comments were received from Jennifer Alexander, William Alexander, Daniel Altman, Eric Behl-Remijan, Kimberly Blanchard, Robert Cassanos, Peter Connors, Tijana Dvornic, Lawrence Garrett, Stuart Goldring, Kevin Jacobs, Jiyeon Lee-Lim, Michael Mollerus, Richard Nugent, Deborah Paul, Jason Sacks, Michael Schler, David Schnabel, Jodi Schwartz, Stephen Shay, Patrick Sigmon, Eric Sloan, Joseph Toce, Shun Tosaka, Philip Wagman, Andrew Walker, and Gordon Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of NYSBA's Executive Committee or its House of Delegates.

[2] Except as otherwise indicated, all references to "**Sections**" refer to the Internal Revenue Code of 1986, as amended (the "**Code**"), or the Treasury Regulations promulgated thereunder, as applicable.

[3] An Act To provide for reconciliation pursuant to title II of S. Con. Res. 14, Pub. L. No. 117-169 [hereinafter IRA], § 10101, 136 Stat. 1818, 1818-28 (2022).

[4] 2023-3 I.R.B. 390. The Notice is described in Part III.C below.

a consensus on a more specific guiding principle for when tax principles should override financial accounting principles in computing AFSI.

AFSI and Basis Determinations in Corporate Transactions

2. When a target corporation is acquired by a member of an AFS Group (defined below) in an M&A transaction, the acquirer AFS Group, in preparing its consolidated AFS (defined below), generally must apply "purchase accounting," under which it adjusts the financial accounting basis of the target assets to fair value and records the excess of the purchase price over the aggregate fair value of target assets as goodwill. Additionally, if the target issues standalone financial statements following the transaction, the target sometimes may elect to apply "push-down accounting" (*i.e.*, to reflect the acquirer AFS Group's new financial accounting basis in the target assets). We urge Treasury to clarify whether, in a wholly taxable M&A transaction, purchase accounting and similar adjustments to the financial accounting basis of the target assets are taken into account in computing AFSI. We are unanimous that such financial accounting basis adjustments should be taken into account where the financial accounting gain or loss with respect to the target assets is included in the AFSI of the target or a member of its AFS Group. However, the Executive Committee of the Tax Section (the "**Executive Committee**") did not reach complete agreement as to whether the same result should obtain in a taxable transaction where neither the target nor a member of its AFS Group recognizes financial accounting gain or loss, and thus AFSI, with respect to the target assets (*e.g.*, where the target in a stock acquisition is the parent of an AFS Group). While a majority would take into account purchase accounting and similar adjustments in computing AFSI in such circumstances, a minority would not.

3. We urge Treasury to provide guidance as to the treatment of CAMT attributes following taxable M&A transactions. While a comprehensive discussion of CAMT attributes is beyond the scope of this Report, we believe that the treatment of any FSNOL carryovers (defined below) attributable to the target should depend on whether the AFSI basis of the target assets is stepped up (or down) to fair value. If there is a step-up (or step-down), then:

    a. In the case of a carve-out acquisition of a target from an AFS Group, any FSNOL carryovers attributable to the target should generally be available to offset AFSI with respect to its assets. The seller should inherit any remaining FSNOL carryovers attributable to the target, if the seller is a corporation that is in the same tax consolidated group as the target.

    b. In the case of an acquisition of an entire AFS Group, if the acquirer AFS Group obtains a stepped-up (or stepped-down) AFSI basis in the target AFS Group's assets, then one reasonable approach would be to eliminate any FSNOL carryovers of the target or its AFS Group. Another reasonable approach would be to reduce such FSNOLs by the amount of the step-up (if any). It also may be appropriate to allow the target and acquirer to jointly elect to forego a step-up, and instead preserve the target's FSNOLs.

4. We recommend that Treasury confirm that Section 56A(c)(2)(C) applies for purposes of determining whether, and to what extent, the AFSI of a taxpayer reflects amounts with respect to its ownership or disposition of stock of a subsidiary not in its tax consolidated group. We believe that the text and history of the provision establish that the AFSI of a taxpayer includes amounts arising in respect of events resulting in the recognition of items of income, gain, deduction, or loss for income tax purposes. However, under Section 56A(c)(2)(C), (i) the AFSI of a taxpayer does not include mark-to-market unrealized gains and losses with respect to stock of a nonconsolidated subsidiary (unless taken into account under Section 475), and (ii) it appears AFSI also may not include gains and losses with respect to such stock arising from nonrecognition exchanges. We urge Treasury to clarify how the amount of items income, gain, loss, or deduction with respect to such stock are determined under Section 56A(c)(2)(C) when there is a taxable event.

5. Consistent with the Nonrecognition Rule (defined below) set forth in the Notice, we believe that if a corporation undertakes a transaction that qualifies as wholly tax-free under Sections 332, 337, 351, 354, 355, 357, 361, or 1032, any financial accounting gain or loss resulting from that transaction should be excluded from its AFSI. As a consequence, however, the corporation should take a transferred AFSI basis in any equity it receives in the transaction, so that any such gain or loss is merely deferred, rather than eliminated. However, the Executive Committee did not reach a consensus as to whether, in a transaction that qualifies for nonrecognition treatment for AFSI purposes, any increase or decrease in the financial accounting basis in the transferred property in the hands of the transferee should be taken into account for purposes of computing the transferee's AFSI. One subset believes that such adjustments should always be taken into account in computing AFSI. A second subset believes the opposite: financial accounting basis adjustments resulting from transactions that are wholly tax-free for U.S. federal income tax purposes should never be taken into account in computing AFSI. And a third subset of the Executive Committee favors an intermediate position, under which such financial accounting basis adjustments would be taken into account in computing AFSI except where the Treasury has excluded the gain with respect to the transferred property from the AFSI of the transferor pursuant to its regulatory authority. However, there is a consensus among the Executive Committee that if the Acquirer AFS Group obtains a stepped-up AFSI basis in the assets of the Target or Target AFS Group, any FSNOL of the Target or Target AFS Group should be eliminated or at least reduced by the amount of the step-up. As in the case of a taxable acquisition, it may also be appropriate to allow the target and acquirer to jointly elect to forego a step-up and instead preserve the target's FSNOLs.

6. We recommend that Treasury expand the scope of the Nonrecognition Rule to cover transactions that qualify as partially tax-free. Doing so would require rules for determining the amount of the transferor's financial accounting gain or loss that is included in its AFSI, the transferor's AFSI basis in any equity interests received, and the transferee's AFSI basis in the transferred property (assuming that the transferee in a nonrecognition transaction is generally required to take a transferred AFSI basis in the property received in such a transaction). We recommend that such rules generally parallel the rules set forth in the applicable Code provisions.

7. We recommend that Treasury provide guidance that if a taxpayer recognizes gain for U.S. federal income tax purposes with respect to an asset in one step of a multistep transaction and financial accounting gain with respect to the same asset in a different step, then a portion of the financial accounting gain should be included in AFSI, with the portion being determined in a manner consistent with the determination where the tax and financial accounting gain are recognized on the same step. Further, to the extent that the financial accounting gain with respect to the applicable asset is included in AFSI, the AFSI basis of the applicable asset should be adjusted to reflect any book basis step-up.

8. We recommend that Treasury issue regulations providing that where a taxpayer recognizes financial accounting gain or loss on the consolidation or deconsolidation of a subsidiary member of its consolidated group or the dilution of its ownership interest, the taxpayer's AFSI will be adjusted to the extent that it realized no gain or loss on the transaction for U.S. federal income tax purposes.

9. If Treasury declines to confirm that mark-to-market unrealized gains and losses with respect to corporate stock are generally excluded from AFSI under Section 56A(c)(2)(C), we urge Treasury to clarify that any mark-to-market unrealized gains and losses with respect to corporate stock are excluded from AFSI under the Nonrecognition Rule.

10. We recommend that Treasury clarify that the Basis Adjustment Rule (defined below) applies with respect to property acquired in a transaction subject to the Nonrecognition Rule only to the extent that financial accounting gain or loss with respect to that property is excluded from the AFSI of the transferor under the Nonrecognition Rule.

11. Treasury should provide guidance under the Basis Adjustment Rule regarding how far back an acquirer needs to look, in order to identify historical transactions that involved an asset owned by the target and determine the impact of those transactions on the target's AFSI basis in that asset.

Determining Applicable Corporation Status and AFSI History after Corporate Acquisitions and Divisions

12. The Notice provides interim guidance on determining applicable corporation status and AFSI history following an extraordinary transaction, such as the combination of two AFS Groups or the division of a single AFS Group into two or more separate corporations. However, we recommend that Treasury modify that guidance in the following respects:

    a. In the case of a combination of two AFS Groups, if either of the combining AFS Groups was an applicable corporation prior to the combination, the combined AFS Group should be an applicable corporation after the combination. If neither of the combining AFS Groups was an applicable corporation prior to the combination, the combined AFS Group should inherit the applicable corporation status and AFSI history of one of the two combining groups, generally based on

whichever group's AFSI history over the three-year period preceding the year of the combination is greater.

b. In the case of a separation of a subsidiary corporation from the parent of an AFS Group, our recommendations depend on whether the parent was an applicable corporation prior to the separation.

   i. If the parent AFS Group was not an applicable corporation prior to the separation, neither the parent AFS Group nor the subsidiary should be an applicable corporation after the separation. Further, the parent AFS Group and the subsidiary should determine their respective AFSI histories under one of two alternative approaches.

      1. Under the first alternative, each of the parent's AFS Group and the subsidiary would be required to prepare *pro forma* historic financial statements and compute its hypothetical AFSI history accordingly.

      2. Under the second alternative, the larger of the parent's AFS Group and the subsidiary, as of immediately after the separation, would inherit the parent AFS Group's AFSI history, while the smaller of the two would be treated as a newly formed corporation.

   ii. If the parent of the AFS Group was an applicable corporation prior to the separation, the larger of the parent of the AFS Group and the subsidiary, as of immediately after the separation, should inherit the parent's applicable corporation status. Further, the smaller of the parent's AFS Group and the subsidiary, as of immediately after the separation, should generally be treated as newly formed corporation, unless it meets a specified size threshold, generally based on its AFSI history.

c. Where, as part of a plan, a subsidiary leaves its parent's AFS Group and combines with another AFS Group, the rules governing separation transactions described above should be applied to determine the subsidiary's applicable corporation status and AFSI history, and then the rules applicable to combination transactions described above should be applied to determine the combined AFS Group's applicable corporation status and AFSI history.

Simplified Procedure for Computing AFSI for Purposes of Determining Applicable Corporation Status

13. We agree that there should be a simplified method of calculating AFSI for corporations that are small enough to clearly not be applicable corporations, and we recommend that Treasury make the Safe Harbor Method (defined below) available to all corporations indefinitely, albeit with potentially different thresholds than outlined in the Notice, and subject to an anti-abuse rule.

14. Treasury should provide guidance as to how a corporation that makes use of the Safe Harbor Method to determine that it is not an applicable corporation in a particular tax year should apply the AFSI Test (defined below) in any subsequent year for which the Safe Harbor Method is not available and, in particular, whether the corporation must go back and calculate its AFSI for prior years for which it had previously only calculated its Modified AFSI (defined below).

15. Treasury should provide guidance as to whether an applicable corporation that has previously relied on the Safe Harbor Method to determine it was not an applicable corporation in a prior year, can carry forward FSNOLs arising in such prior year that are determined using the methodology for calculating Modified AFSI, rather than the regular rules for computing AFSI.

16. Treasury should provide guidance clarifying whether the calculation of a corporation's Modified AFSI under the Safe Harbor Method requires the corporation to include income or loss of persons that are not consolidated with the corporation for financial accounting purposes but are treated as a single employer with that corporation under Section 52(a) or (b).

Adjustment to AFSI for Depreciation of Section 168 Property

17. Treasury should clarify the definition of "Tax Depreciation" in the Notice by explicitly including Section 743(b) adjustments in respect of Section 168 property.

18. We recommend that Treasury provide guidance as to whether purchase accounting and similar adjustments made to the basis of Section 168 property for financial accounting purposes are taken into account in determining the AFSI basis of the Section 168 property.

19. Treasury should determine whether Congress intended for Section 56A(c)(13) to apply to Section 168 property acquired or placed in service (i) in tax years beginning before January 1, 2020 (*i.e.*, the first year in which a taxpayer's AFSI is taken into account in an AFSI Test) or (ii) in tax years beginning on or after January 1, 2020, but in which the relevant corporation was not an applicable corporation. If it determines that Congress did not intend for Section 56A(c)(13) to apply in such circumstances, we recommend that Treasury require taxpayers to use book depreciation with respect to such property for purposes of computing AFSI or, alternatively, provide taxpayers with a one-time election to do so for all such property (as long as, in the case of Section 168 property acquired or placed in service in a year in which the relevant corporation was not an applicable corporation, the corporation has not derived, and will not derive, any CAMT benefit from accelerated depreciation with respect to the property).

Application of CAMT to Distressed Taxpayers

20. Treasury should consider whether Distressed Taxpayers (defined below) should be entitled to relief in determining whether they continue to constitute applicable corporations within the scope of CAMT after a Title 11 Case (defined below), or whether instead the testing period should be "reset" for such taxpayers.

21. We recommend that Treasury reevaluate its position in the Notice on the amount of excluded CODI (defined below) that a Distressed Taxpayer may exclude from AFSI, particularly given the different scope and identity of balance sheet liabilities that can give rise to income upon modification under applicable accounting standards. In particular, for a Distressed Taxpayer in a Title 11 Case, we recommend that all income from liability relief be excluded from AFSI whether or not it is consistent with the amount of exclusion for regular tax purposes. We also recommend that Treasury consider the applicability of concepts like those in Section 108(e) to calculating CODI for AFSI purposes, and/or specifically exempt AFS income items from relief from financial statement liabilities that do not have a regular tax analogue.

22. Treasury should reconsider its position in the Notice regarding the scope and applicability of the "insolvency" exception to the exclusion of CODI for CAMT purposes. We recommend four possible alternatives including (i) a proportional approach, (ii) a separate calculation of insolvency for CAMT purposes, (iii) an approach that excludes CODI to the extent of the regular tax exclusion plus the amount of income from discharge of "hybrid" items like preferred stock, and (iv) an approach that permits the exclusion of AFS CODI to the extent of regular tax *insolvency* (rather than a limitation to the amount of the regular tax CODI exclusion).

23. We recommend that Treasury reconsider the position in the Notice that AFSI CODI must arise in the same taxable year as regular tax CODI in order to benefit from the bankruptcy or insolvency exclusions, as there could be significant timing differences between recognition of income as a result of liability relief for AFSI purposes and the recognition of CODI for regular tax purposes. We suggest a tracing and matching approach.

24. For tax consolidated groups, we generally do not support special rules that would create separate entity accounting with respect to computations of insolvency, attribute reduction, etc., in a Distressed Taxpayer context. Instead, we support the treatment of the consolidated group as a single entity for such purposes. However, we recommend clarifications to address (i) situations where there is not complete identity between members in an AFS Group and entities in the group that file a Title 11 Case, (ii) application of the insolvency exclusion and (iii) deconsolidations and reconsolidations of subsidiaries from the AFS Group.

25. We recommend that Treasury promulgate additional guidance regarding the application of rules similar to the attribute reduction rules of Section 108(b) with respect to CODI excluded from AFSI. A minority of members of the Executive Committee believe that, other than a reduction of the FSNOL, no adjustment should be made to CAMT attributes as a result of excluded CODI. The majority of the members of the Executive Committee support a more detailed attribute reduction regime but urge Treasury among other things to (i) coordinate any reduction in the basis of Section 168 property for regular tax purposes with a reduction of AFSI basis in such property, in order to prevent double counting of the effects of such basis reduction in the calculation of AFSI in future years, (ii) specify the application of Section 108(b) tax concepts to an AFS balance sheet, including the methodology by which any future income (or

reduction in loss) for CAMT purposes is taken into account, (iii) address the common situation where CAMT balance sheet items differ in kind and extent from regular tax attributes and (iv) address the application of the rules to a taxpayer that is consolidated for AFS purposes but not for tax purposes.

26. We also recommend that additional guidance be provided with respect to transactions incident to a Distressed Taxpayer's Title 11 Case, including (i) the extent to which a Distressed Taxpayer that reorganizes without a Covered Transaction (defined below) takes into account "fresh start" accounting (or the equivalent), (ii) coordinating the Covered Nonrecognition Transaction (defined below) rules with reorganizations described in Section 368(a)(1)(G), and (iii) the consequences to a Distressed Company and any purchasing person of transactions treated as taxable asset sales for regular tax purposes. In general, we recommend that a taxpayer benefitting from "fresh start" accounting be permitted to exclude the fresh start income and use its post-adjustment balance sheet for CAMT purposes at the price of eliminating its FSNOLs and that there be no wholesale exclusion of actual asset sale gain for CAMT purposes.

AFSI of Corporate Partners in a Partnership

27. A corporate partner's AFSI should include gain or loss on the sale or other taxable (as determined under regular tax principles) disposition of its interest in the partnership.

28. A partner's "distributive share" of a partnership's AFSI should be equal to the partner's financial accounting percentage of the partnership's financial accounting income.

29. We recommend that a partner be able to elect, at least in some circumstances, to use the fair value or measurement alternative methods of accounting for CAMT purposes if those methods are used for financial accounting purposes.

30. If an applicable corporation undertakes a transaction that qualifies as tax-free under Section 721 for regular tax purposes, then any financial accounting gain or loss resulting from that transaction should be excluded from its AFSI.

31. When an applicable corporation transfers property to a partnership in a transaction meeting the requirements of Section 721, we believe that CAMT rules akin to Section 704(c) should apply, in order to allocate back to the transferring partner the consequences of the difference between the asset's fair value and the partner's AFSI basis in the asset at the time of the transfer. We discuss two approaches that could be followed in such rules. Under the first approach, an applicable corporation could generally choose among the existing Section 704(c) methods, plus a new method similar to the deferred sales method in prior proposed regulations. Under the second approach, the applicable corporation would be required to use the deferred sales method, on the theory that it operates in a manner similar to the financial accounting treatment of a partner's transfer of property to a partnership in exchange for a partnership interest.

32. If an applicable corporation receives a distribution from a partnership that qualifies as tax-free under Section 731 for regular tax purposes, then any financial accounting gain

or loss resulting from that transaction should be excluded from its AFSI. We recommend that adjustments similar to those under Section 734(b) apply for CAMT purposes.

33. For CAMT purposes, a partner should take into account equity method basis differences arising as a result of its acquisition of a partnership interest. These adjustments are broadly similar to Section 743(b) adjustments made for regular tax purposes. In addition, consistent with recommendation 17 above, a partner should be entitled to use, for purposes of computing its AFSI, Section 743(b) adjustments for assets such as Section 168 property and qualified wireless spectrum.

34. A majority of the Executive Committee recommends the Full Section 752 Approach, under which the Section 752 regulations governing allocation of liabilities apply for both regular tax and CAMT purposes. The justification for the Full Section 752 Approach is that a partner should not obtain a better or worse result by contributing encumbered property to a partnership than the partner would by receiving a cash distribution from the partnership. By comparison, a minority of the Executive Committee favors the No Section 752 Approach, under which Section 752 is not incorporated into the CAMT regime. Under this approach, a partner would recognize CAMT gain when it contributes property to a partnership with debt in excess of basis.

35. If a partner uses the equity method of accounting under GAAP, the partner's ability to deduct its distributive share of partnership losses for purposes of computing its AFSI should be subject to the GAAP Loss Limitation (defined below), which provides that a partner's share of a partnership's losses generally cannot reduce the partner's equity investment in the partnership below zero. We did not reach a consensus on whether Section 704(d) should apply to limit AFSI losses.

36. A majority of the Executive Committee recommends that for purposes of applying the AFSI Test, a corporation's AFSI should include all of the AFSI of partnerships that are consolidated with the corporation for financial accounting purposes, without any subtraction for non-controlling interests in such partnerships. A minority believes that non-controlling interests in such partnerships should be subtracted, when applying the AFSI Test.

III. Background and Overview of CAMT

A. A Brief History of Alternative Minimum Taxes

Under U.S. federal income tax law, the base on which tax is levied is taxable income, "a term whose content not only reflects accounting principles and economic concepts but also embodies numerous legislative judgments about fairness, administrative convenience, and the desirability of encouraging or not impeding a host of social, personal, and business activities."[5] Examples of these legislative judgments can be found in various tax benefits afforded corporations (sometimes referred to as "tax expenditures"), including accelerated or "bonus"

[5] Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts ¶2.1 (WG&L) [hereinafter Bittker & Lokken].

depreciation for tangible assets,[6] exclusion of cancellation of indebtedness income from the taxable income of insolvent or bankrupt corporations,[7] and amortization of various non-wasting acquired intangible assets (including goodwill).[8] A taxpayer that is able to take advantage of these types of tax benefits (particularly in combination with each other) may be able to reduce its tax liability far below the product of the statutory rate and its economic income.

An alternative minimum tax (an "**AMT**") sets limits on those benefits by ensuring that taxpayers pay at least a minimum rate of tax applied to a broader base that excludes some of these tax benefits. In other words, an AMT allows Congress to cut back on the use or combined use of various Congressionally enacted tax benefits by taxpayers who would otherwise reduce their income below a specified threshold, while leaving those same tax benefits intact and available for use by taxpayers who do not reduce their income "too much." Central to any AMT regime is the question of how the broader tax base should be defined—that is, which tax benefits should be retained, and which should be excluded from the AMT base? In the discussion that follows, especially in cases where there is an absence of statutory guidance or legislative history, this Report will examine the CAMT in light of this (and other) objectives as a way to help identify suggested approaches to implementation of the CAMT in the areas discussed.

Congress enacted the first corporate minimum tax in the Tax Reform Act of 1969 as a corporate add-on minimum tax.[9] It imposed a 15% tax on certain corporate tax preferences that was paid in addition to the regular corporate income tax. In the 1980s, Congress was concerned that, notwithstanding the existence of the corporate add-on minimum tax, many corporations that reported substantial financial accounting income paid little or no tax.[10] Congress focused on two reasons for this perceived failure. First, the add-on minimum tax was not designed to define a comprehensive income base. Second, the tax failed to adequately measure economic income.[11]

The Tax Reform Act of 1986 repealed the corporate add-on minimum tax and replaced it with a corporate AMT. According to both the House Ways and Means Committee Report and the Senate Finance Committee Report, the corporate AMT was designed to "serve one overriding objective: to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits. Although these provisions may provide incentives for worthy goals, they become counterproductive when taxpayers are allowed to use them to avoid virtually all tax liability. . . . With respect to corporations, . . . [t]he minimum tax cannot successfully address concerns of both real and apparent fairness unless there is certainty that whenever a company publicly reports substantial earnings (either pursuant to public

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[6] *See* Section 168(k).

[7] *See* Section 108(a)(1)(A) and (B).

[8] *See* Section 197.

[9] Tax Reform Act of 1969, Pub. L. No. 91-172, § 301, 83 Stat. 487 (1969). Congress wanted to prevent corporations from escaping tax on all or a large portion of their economic incomes through the use of various deductions and exclusions. S. REP. No. 91-552, at 111, *as reprinted in* U.S.C.C.A.N. 2142.

[10] S. REP. No. 99-313 at 519 (1986) [hereinafter 1986 SENATE REPORT]; H.R. REP. No. 99-426, at 306–07 (1985) [hereinafter 1985 HOUSE REPORT].

[11] *See* 1986 SENATE REPORT at 519; 1985 HOUSE REPORT at 306.

reporting requirements, or through voluntary disclosure for substantial non-tax reasons), that company will pay some tax."[12]

Under the 1986 corporate AMT regime, a corporation paid the excess (if any) of its tentative minimum tax over its regular tax. To compute its tentative minimum tax, the corporation would (i) calculate its "alternative minimum taxable income," (ii) subtract its exemption amount, (iii) apply a 20% rate and then (iv) reduce the result by the alternative minimum tax foreign tax credit. The starting point for alternative minimum taxable income was taxable income, subject to a number of adjustments, and then increased by various tax preferences. One of those adjustments is known as the "Business Untaxed Reported Profits" ("**BURP**") adjustment, which applied only to taxable years beginning in 1987, 1988 and 1989. In particular, the BURP adjustment was an increase of 50% of the amount (if any) by which the corporation's "adjusted net book income" ("**ANBI**," as defined under former Section 56(f)) exceeded the corporation's alternative minimum taxable income (calculated without the BURP adjustment and without any net operating loss carryforwards otherwise allowed). For taxable years beginning in 1990 and later, the BURP adjustment no longer applied and, instead, taxable income was increased by 75% of the amount (if any) by which the corporation's adjusted current earnings exceeded the corporation's alternative minimum taxable income (calculated without the adjusted current earnings adjustment and without any net operating loss carryforwards otherwise allowed).[13]

The temporary reliance on book income adjustments was intended to restore public confidence in the fairness of the tax system before moving to a "broad based system that is specifically defined by the Internal Revenue Code."[14] Congress intended this system to "generally be at least as broad as book income" and should "rely on income tax principles in order to facilitate its integration into the general minimum tax system."[15]

The Omnibus Reconciliation Act of 1993 ("**1993 Act**") and the Taxpayer Relief Act of 1997 ("**1997 Act**") made changes to the applicable depreciation adjustments.[16] In addition, the 1997 Act repealed the corporate AMT for "small corporations."[17] In the House Report for the 1997 Act, the corporate AMT was found "to inhibit capital formation and business enterprise and [was] too administratively complex."[18] By the mid-2000s, changes to the corporate AMT's depreciation adjustment, the exemption for small corporations and the enactment of bonus

[12] *See* 1986 SENATE REPORT at 518, 520; 1985 HOUSE REPORT at 305-06.

[13] *See* Sections 55 through 59 (1986 version).

[14] STAFF OF THE JOINT COMM. ON TAX'N, 99TH CONG., GENERAL EXPLANATION OF PUBLIC LAW 99-514 435-36 (1987).

[15] *Id.* at 436.

[16] *See* Pub. L. No. 103-66, §13115, 107 Stat. 312, 432; Pub. L. No. 105-34, §402, 111 Stat. 788, 844.

[17] In general, a small business corporation is a corporation that had average gross receipts of less than $5 million for the three-year period beginning after December 31, 1994. *See* Pub. L. No. 105-34, §401, 111 Stat. 788, 843-44.

[18] H.R. REP. NO. 105-148, at 351-52 (1997); H.R. Rep. No. 105-220, at 390-91 (1997) (Conf. Rep.).

depreciation rules all reduced the number of companies subject to the corporate AMT and the amount of corporate AMT payments.[19]

The Tax Cuts and Jobs Act ("**TCJA**") repealed the corporate AMT regime beginning after December 31, 2017.[20] The version of that bill that passed the House of Representatives would have repealed both the individual and corporate AMT.[21] The House Report explained that:

> The requirement that taxpayers compute their income for purposes of both the regular income tax and the AMT is one of the most far-reaching complexities of the Code. The AMT is particularly burdensome for individuals with small businesses, because they often do not know whether they will be affected until they file their taxes and therefore must maintain a reserve that cannot be used to invest in their businesses.[22]

However, the final text of the TCJA repealed only the corporate AMT and instead retained the individual AMT with modifications.[23]

In May 2021, the Biden administration proposed a 15% minimum tax on the worldwide "book earnings" of corporations with book earnings of more than $2 billion (the "**Green Book Proposal**").[24] Treasury explained the Green Book Proposal as follows:

> The proposal would work to reduce the significant disparity between the income reported by large corporations on their federal income tax returns and the profits reported to shareholders in financial statements by requiring them to pay a minimum amount of tax based on their reported financial income. The proposal is a targeted approach to ensure that the most aggressive corporate tax avoiders bear meaningful federal income tax liabilities. The proposal would also provide a backstop for the proposed new international tax regime since highly profitable multinational corporations would no longer be able to report significant profits to shareholders while avoiding federal income taxation entirely.[25]

The "Build Back Better Act" bill, H.R. 5376, was introduced on September 27, 2021 by Rep. John A. Yarmuth and was passed by the House of Representatives on November 19, 2021. The Build Back Better Act included a 15% corporate minimum tax proposal that applied to

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[19] *See* Carlson, Curtis P., *The Corporate Alternative Minimum Tax Aggregate Historical Trends* (Dep't of the Treas., Office of Tax Analysis Paper No. 93, 2005), https://home.treasury.gov/system/files/131/WP-93.pdf.

[20] Pub. L. No. 115-97, §12001, 131 Stat. 2054, 2092-94 (2017).

[21] *See* H.R. 1, 115th Cong. § 2001 (as passed by House, Nov. 16, 2017).

[22] H.R. Rep. No. 115-409, at 224 (2017).

[23] *See, e.g.,* H.R. REP. NO. 115-466, at 319-23 (2017). Commentators believe the individual AMT was retained for revenue-related reasons. *See, e.g.*, Leonard E. Burman & Joseph Rosenberg, *The Senate Would Keep The Individual AMT, But Turn It Into A Very Different Tax*, TAX POLICY CENTER (December 6, 2017), https://www.taxpolicycenter.org/taxvox/senate-would-keep-individual-amt-turn-it-very-different-tax.

[24] DEP'T OF THE TREAS., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2022 REVENUE PROPOSALS 21 (2021), https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf.

[25] *Id*. at 21.

corporations with average AFSI of more than $1 billion over a three-year period.[26] The new proposal, while incorporating elements of the BURP adjustment, deviated from the BURP adjustment in a number of ways as described below.

The House bill was amended, renamed as the Inflation Reduction Act, and passed by the Senate on August 7, 2022. The Senate amendments were agreed to by the House of Representatives on August 12, 2022, and the IRA was signed into law by President Biden on August 16, 2022.

B. Overview of CAMT

The IRA imposes a new 15% CAMT on "applicable corporations," which are corporations that have an average annual AFSI in excess of $1 billion over a three-taxable-year period.[27] A corporation's AFSI is the net income reported on its "**applicable financial statement**" (or "**AFS**"), [28] with certain adjustments.[29] The CAMT is a true alternative minimum tax: an applicable corporation must calculate its "**tentative minimum tax**," which is 15% of its AFSI, less CAMT foreign tax credits, and then pay any excess of the tentative minimum tax over the sum of its regular U.S. federal income tax liability plus its liability for the base erosion anti-abuse tax ("**BEAT**").[30]

1. Applicable Corporation

The term "applicable corporation" generally includes any corporation, other than an S corporation, a regulated investment company, or a real estate investment trust, that meets an "average annual adjusted financial statement income test" (the "**AFSI Test**") in one or more taxable years (i) before the current taxable year and (ii) ending after Dec. 31, 2021.[31]

A domestic corporation meets the AFSI Test for a particular taxable year if its average annual AFSI (determined as described below) for the three-taxable-year period ending with that taxable year exceeds $1 billion.[32] However, if that domestic corporation is a member of a foreign-parented multinational group—*i.e.*, if it is included on an AFS of a group that has a foreign parent—then it must meet two tests: (1) the regular $1 billion test, taking into account for this purpose essentially all the AFSI of all the members of the group, and (2) a $100 million

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[26] *See* H.R. 5376, 117th Cong. § 138101 (as passed by House, Nov. 19, 2021).

[27] *See* Sections 55, 56A and 59(k)(1)(B)(i).

[28] AFS means, with respect to any taxable year, an applicable financial statement (as defined in Section 451(b)(3) or as specified by the Secretary in regulations or other guidance) that covers that taxable year. Section 56A(a). Under Section 451(b)(4), an applicable financial statement includes a financial statement prepared in accordance with U.S. Generally Accepted Accounting Principles ("**GAAP**"), a financial statement made on the basis of International Financial Reporting Standards ("**IFRS**"), or a financial statement filed with any other regulatory or governmental body or used for credit purposes or reporting to shareholders.

[29] *See* Section 56A.

[30] Section 55(a).

[31] Section 59(k)(1)(A).

[32] Section 59(k)(1)(B)(i).

average annual AFSI test (computed over the same period), taking into account for this purpose only the AFSI of the domestic members of the group and the "effectively connected" AFSI of each foreign member (as determined pursuant to Section 56A(c)(4)).[33]

As a result, for a calendar year corporation, the 2023 calendar year is the first year in which it may be an applicable corporation, and the determination for this year will be based on whether it met the AFSI Test for the 2022 calendar year, which, in turn, will be based on the corporation's AFSI in 2020, 2021 and 2022.

Once a corporation meets the AFSI Test, it remains an applicable corporation indefinitely, unless it meets two criteria.[34] First, it must either undergo a change in ownership or its AFSI must drop below $1 billion and stay below that threshold for a number of years to be specified by Treasury.[35] Second, Treasury must determine that it would not be appropriate to continue to treat the corporation as an applicable corporation.[36]

2. CAMT Liability

An applicable corporation must calculate its "tentative minimum tax," which is equal to 15% of its AFSI, less its CAMT foreign tax credit for the year.[37] The CAMT liability is any excess of the tentative minimum tax over the sum of the applicable corporation's regular tax liability plus its BEAT liability.[38]

A corporation that pays the CAMT will receive a credit that it can use to offset its regular tax liability and BEAT liability in a future tax year, to the extent such liabilities exceed the tentative minimum tax for that future tax year.[39] Business credits can be used to offset up to 75% of CAMT liability.[40]

3. AFSI[41]

AFSI serves two purposes: (i) determining whether the AFSI Test is met and, therefore, whether the corporation in question is an applicable corporation ("**scope**" purposes) and (ii)

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[33] Section 59(k)(1)(B)(ii) and (k)(2).

[34] Section 59(k)(1)(C).

[35] Section 59(k)(1)(C)(i).

[36] *See* Section 59(k)(1)(C)(ii).

[37] Section 55(b)(2)(A).

[38] Section 55(a).

[39] *See* Section 53.

[40] *See* Section 38.

[41] As described in detail below, the starting point for computing AFSI is financial accounting income. We do not have expertise on financial accounting matters but have consulted with various accounting experts in the course of preparing this Report.

computing the CAMT liability ("**liability**" purposes). AFSI is calculated somewhat differently, depending on the purpose for which it is being calculated.

To calculate AFSI for liability purposes, an applicable corporation starts with the net income or loss[42] reported on its AFS, and makes a series of adjustments, including the following:[43]

- If the applicable corporation is included on an AFS for a group of entities, rules similar to the rules of Section 451(b)(5) apply;

- If the applicable corporation is a member of a consolidated U.S. tax group, AFSI for that group takes into account items on the group's AFS that are properly allocable to members of the group;

- For other corporations that are not members of the corporation's consolidated U.S. tax group, only dividends and various other specified items are included;

- The group's distributive share of any partnership AFS income and its *pro rata* share of the AFS income of any "**controlled foreign corporation**" (or "**CFC**") with respect to which a member is a U.S. shareholder are included;

- Financial accounting items related to defined benefit plans are excluded and, instead, amounts are taken into account under U.S. federal income tax principles; and

- If an applicable corporation is foreign, its AFSI takes into account only its effectively connected income, and if it is tax-exempt, its AFSI takes into account only its unrelated trade or business income.

In addition (and in a departure from the version of the CAMT included in the Build Back Better Act and an earlier version of the IRA), two categories of tax benefits are preserved:

- AFSI does not take into account financial accounting depreciation expense attributable to tangible assets to which Section 168[44] applies and, instead, takes into account depreciation attributable to those assets used in computing taxable income; and

- AFSI does not take into account financial accounting amortization attributable to wireless spectrum acquired after December 31, 2007, and before the date of enactment, and, instead, takes into account amortization deductions attributable to those assets used in computing taxable income.

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[42] GAAP "comprehensive income" includes "net income" and "other comprehensive income." AFSI appears to include only "net income" and not "other comprehensive income." This point was confirmed by Senator Wyden in a colloquy with Senator Cardin. *See* 168 Cong. Rec. S4166 (daily ed. Aug. 6, 2022).

[43] *See* Section 56A(c).

[44] Section 168 provides for accelerated cost recovery deductions and bonus depreciation.

If an applicable corporation incurs a net financial accounting loss for a taxable year ending after December 31, 2019, this creates a "**financial statement net operating loss**" or "**FSNOL**" carryover that can be carried forward indefinitely and used to offset up to 80% of AFSI in a future year.[45]

For scope purposes, AFSI is calculated in the same manner as for liability purposes, subject to the following modifications:

- Each corporation includes in its AFSI the AFSI of each other person treated as a single employer with that corporation;[46]
- The adjustments related to partnership income and defined benefit pension plans do not apply;[47] and
- FSNOL carryovers from prior years are not taken into account.[48]

4. Treasury's Authority for Regulations and Other Guidance

The IRA grants Treasury broad authority to prescribe regulations or other guidance that are necessary or appropriate to carry out the provisions of CAMT, including:

- Under Section 59(k) (defining applicable corporation):
  - For carrying out the purposes of Section 59(k), including guidance providing a simplified method for determining applicable corporation status and addressing ownership changes;[49] and
  - For rules addressing foreign-parented multinational groups;[50]
- Under Section 56A (determining AFSI):
  - To provide for proper treatment of current and deferred taxes;[51]
  - To "appropriately" adjust AFSI to disregard book depreciation expense for "Section 168 property" (defined below);[52]

[45] *See* Section 56A(d).

[46] Section 59(k)(1)(D).

[47] Section 59(k)(1)(D).

[48] Sections 56A(d) and 59(k)(1)(B).

[49] Section 59(k)(3).

[50] Section 59(k)(2)(D).

[51] Section 56A(c)(5).

[52] Section 56A(c)(13).

- To prevent omission/duplication of any item, and to carry out principles of subchapter C part II (liquidations), part III (corporate organizations and reorganizations) and subchapter K part II (partnership contributions and distributions);[53] and

- As necessary to carry out purposes of Section 56A, including relating to the effect of the rules of Section 56A on partnerships with income taken into account by an applicable corporation;[54] and

As is necessary to carry out the purposes of the corporate AMT foreign tax credit.[55] These grants of authority are in addition to Treasury's general authority[56] and give Treasury broad latitude to provide guidance and clarification.

C. Notice 2023-7

On December 27, 2022, the IRS released its first piece of interim guidance interpreting the CAMT in the form of the Notice. The Notice describes proposed regulations that the IRS intends to issue and states that taxpayers may rely on these descriptions until the proposed regulations are issued. The Notice addresses the following topics:

- Adjustments to AFSI to disregard financial accounting income and loss, and related basis adjustments, resulting from combination and separation transactions involving corporations and partnerships;[57]

- Application of the AFSI Test when the corporation has engaged in combination and/or separation transactions within the three-year testing period;[58]

- Treatment of a tax consolidated group for purposes of calculating AFSI;[59]

- Adjustments to AFSI to exclude certain financial statement income from the discharge of indebtedness, and adjustments to CAMT attributes;[60]

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[53] Section 56A(c)(15).

[54] Section 56A(e).

[55] Section 59(l)(3).

[56] *See* Section 7805(a) ("the Secretary shall prescribe all needful rules and regulations for the enforcement of this title").

[57] Section 3.03 of the Notice, discussed in Part IV.B.

[58] Section 3.04 of the Notice, discussed in Part IV.C.

[59] Section 3.05 of the Notice, which states that a tax consolidated group is treated as a single entity for purposes of calculating AFSI for determining applicable corporation status and for purposes of calculating AFSI for CAMT liability.

[60] Section 3.06 of the Notice. Issues related to Sections 3.06 and 3.07 of the Notice are discussed in Part IV.F.

- Adjustments to AFSI to exclude certain financial statement income when a corporation emerges from bankruptcy, and basis adjustments;[61]

- Adjustments to AFSI to implement Section 56A(c)(13) relating to Section 168 property (defined below);[62]

- A simplified safe harbor method for determining applicable corporation status for the first tax year to which the CAMT applies;[63]

- Adjustments to AFSI to disregard financial statement items relating to certain transferrable or refundable tax credits;[64] and

- Clarification as to how corporate partners in partnerships calculate their AFSI for scope purposes.[65]

IV. Discussion of Recommendations

A. Guiding Principles for Making Regulatory Adjustments to AFSI[66]

The starting point for AFSI is net income or loss reported on an AFS.[67] This amount is then subjected to various adjustments. Some of these adjustments neutralize differences in the

[61] Section 3.07 of the Notice.

[62] Section 4 of the Notice, discussed in Part IV.E.

[63] Section 5 of the Notice, discussed in Part IV.D.

[64] Section 6 of the Notice.

[65] Section 7 of the Notice. This and other issues related to partnerships are discussed in Part IV.G.

[66] In considering which adjustments should be made to financial accounting income to determine the base for a minimum tax, one obvious reference point is the Pillar 2 rules. However, the Inclusive Framework has described its approach as follows: "the income (or loss) is calculated based on financial accounts, which provides a base that is harmonised across all jurisdictions. Certain adjustments are needed to better align the financial accounts with tax purposes. These have been kept to a minimum and are made where necessary to reflect common permanent differences, such as to remove most dividends and equity gains so that the minimum tax does not apply to such income, or to remove expenses disallowed for tax purposes such as bribes and to correct prior year errors. There is also an exclusion for international shipping income." *See The Pillar Two Rules in a Nutshell*, OECD/G20 Inclusive Framework on BEPS (Dec. 20, 2022) https://www.oecd.org/tax/beps/pillar-two-model-rules-in-a-nutshell.pdf. In light of the fact that Congress appears to have chosen financial accounting income as the starting point for AFSI specifically because it is not taxable income, as well as the fact that concerns around uniformity across jurisdictions are not present in the CAMT regime, we have not generally cited the Inclusive Framework's approach to adjusting financial accounting income.

[67] Unless otherwise specified, this Report assumes that the GAAP is the relevant accounting standard. We acknowledge that certain foreign parented groups report on IFRS and that IFRS is therefore also relevant to the CAMT, but a detailed discussion of IFRS is beyond the scope of this Report.

We note that GAAP permits a number of alternative accounting methods, and subjective judgment is often necessary in applying GAAP. For example, several acceptable methods are allowed for the valuation of inventory and cost of goods sold. As another example, GAAP requires a loss contingency to be recorded if (i) it is probable that an asset has been impaired and (ii) the amount of the loss can be reasonably estimated. *See* ASC 450-20-25-2. As a result, similarly situated companies may have different book income because of the accounting choices and the subjective (….continued)

financial accounting and tax treatment of certain items, thereby preventing the CAMT from undermining certain policy objectives reflected in the Code. In some cases, Congress has clearly specified when to follow tax rather than financial accounting in computing AFSI—like replacing financial accounting depreciation with tax depreciation in the case of certain tangible assets, for example. But in other cases, Congress has provided Treasury with considerable discretion. In particular, Section 56A(c)(15) directs Treasury to issue regulations or other guidance "as necessary to carry out the purposes of [Section 56A]," and, more specifically, to provide for such adjustments to AFSI as Treasury determines necessary "to carry out the purposes of [Section 56A]," including adjustments to "prevent the omission or duplication of any item" and "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 determining how to exercise the authority delegated to it by Congress to adjust AFSI relative to financial accounting income, Treasury should be guided by the policy goals underlying CAMT. Although it is difficult to discern Congress' policy goals because there is no official legislative history to the CAMT itself, the CAMT was based on the financial accounting AMT proposal included in the Build Back Better Act, which, in turn, was apparently inspired by the Green Book Proposal from the spring of 2021. Treasury's comments explaining the Green Book Proposal are therefore instructive,[68] as are comments made at various times by President Biden[69] and by lawmakers[70] involved in crafting the CAMT legislation. As these comments

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judgments of their accountants. Problems and complexities inherent in relying on book income, including the challenges it presents to tax audits and the pressure it exerts over accounting system generally, are beyond the scope of this Report.

[68] *See supra* text accompanying note 25.

[69] DEP'T OF THE TREAS., THE MADE IN AMERICA TAX PLAN 13 (2021), https://home.treasury.gov/system/files/136/MadeInAmericaTaxPlan_Report.pdf ("Corporations are simultaneously able to signal large profits to shareholders and reward executives with these returns, while claiming to the IRS that income is at such a low level that they should be freed from any federal tax obligation. The President's minimum book tax proposal would work to eliminate this disparity.").

[70] *See, e.g.*, 168 Cong. Reg. S4169 (2022) (Senator Merkley: "Americans know that billionaire companies one after the other—some of the most profitable companies in our entire country, companies like Amazon—don't pay a single cent in tax. They use our legal system. They use our road system. They use our education system. They use it all in vast quantities and don't contribute a single dime. One single ordinary worker does more to pay for all of the infrastructure these massive companies utilize than the company does. It is about time corporations that make massive profits pay something, and 15 percent isn't even their fair share. And it is part of a global agreement to hold corporations accountable, so they don't skip from one country to another, to another, to another, evading everyone everywhere."); *id.* at S4211 (Senator Cardin: "In 2020, 50 of the biggest corporations paid $0 in Federal corporate income tax, despite recording substantial profits. Some of these companies effectively had a negative Federal income tax because they received more in credits and rebates than they paid in taxes. The AMT makes the existing corporate tax structure fairer, especially for smaller businesses that often pay their taxes at higher rates than the largest corporations. Consider that many small businesses pay taxes through the individual tax code, where the highest tax rate is as much as 37 percent. Setting a baseline of taxes to be paid by the largest corporations gives small businesses a better chance to compete and succeed."); Press Release, Elizabeth Warren, Senator, U.S. Senate, *Senators Warren, King, and Wyden Announce Updated Proposal To Prevent The Biggest And Most Profitable Corporations From Paying Nothing In Federal Taxes* (Oct. 26, 2021), https://www.warren.senate.gov/newsroom/press-releases/senators-warren-king-and-wyden-announce-updated-
(….continued)

indicate, the CAMT is intended to ensure that large corporations that report high earnings to shareholders but substantially lower taxable income to the IRS pay a minimum amount of tax.[71]

However, these sources do not provide a single rationale for imposing a minimum tax on the financial accounting income of large corporations. Some comments indicate that the CAMT was motivated by concerns about the basic fairness of a tax system in which large profitable corporations pay little to no U.S. federal income tax,[72] suggesting that the substantial gap between the financial accounting and taxable incomes of large companies is problematic *per se*. On this view, the CAMT serves as a counterweight, by narrowing the gap between what such companies report on their financial statements and what they report to the IRS. However, certain comments are couched in language evoking fault or blameworthiness, thus implying that large financial accounting-tax gaps must often result from corporate tax avoidance or evasion.[73] As these latter comments imply, the policy problem at which CAMT is directed is not necessarily financial accounting-tax differences in and of themselves but rather the "excessive" tax planning that is believed by some of the CAMT's proponents to drive those large financial accounting-tax differences. And, of course, as the CAMT was enacted as part of a reconciliation bill, the need to raise revenue to fund spending initiatives inevitably must have formed the backdrop for Congressional negotiations around its scope and reach.

These ambiguities notwithstanding, the Executive Committee believes that Treasury should be judicious in providing for adjustments to financial accounting income to conform

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proposal-to-prevent-the-biggest-and-most-profitable-corporations-from-paying-nothing-in-federal-taxes ("United States Senator Elizabeth Warren (D-Mass.), Senator Angus King (I-Maine), and Senate Finance Committee Chair Ron Wyden (D-Ore.) announced an updated proposal that prevents America's largest corporations from paying nothing in federal taxes. The Corporate Profits Minimum Tax is a new corporate minimum tax that would strengthen our economy and create a fairer tax system. The lawmakers will include the proposal as a pay-for in the Build Back Better plan.").

[71] Notably, these concerns echo concerns raised in the legislative history for prior corporate AMT regimes. *See supra* notes 10 - 12 (and the accompanying text). Furthermore, in contrast to the 1986 corporate AMT regime that was only ever intended to be based on book income for three years, CAMT is based on book income permanently, and CAMT's AFSI threshold means that it will apply (at least initially) to fewer corporations. These differences suggest Congress may be less concerned with building a new, comprehensive tax base for all taxpayers and is more focused on ensuring profitable companies pay taxes on the amount of book income they purport to be earning.

[72] *See* Press Release, *supra* note 70 (quoting Senator King: "Corporations should not be able to access America's wealthy consumer market, talented labor pool, and other benefits without paying to support the conditions that make the U.S. the world's premier place to do business – but many profitable, U.S.-based corporations pay zero federal corporate income tax. Our proposal is about simple fiscal sense and common fairness, creating a reasonable floor on tax payments to make sure profitable corporations with profits over $1 billion pay their fair share.").

[73] *Id.* (quoting Senator Wyden: "The most profitable corporations in the country are often the worst offenders when it comes to paying their fair share. Year after year they report record profits to shareholders and pay little to no taxes. Our proposal would tackle the most egregious corporate tax dodging by ensuring the biggest companies pay a minimum tax."); OFF. OF SEN. ELIZABETH WARREN, TAX DODGERS: HOW BILLIONAIRE CORPORATIONS AVOID PAYING TAXES AND HOW TO FIX IT 1 (2021) ("The [predecessor to the CAMT] would end tax-rigging schemes by requiring giant companies that report more than $1 billion in profits to pay a minimum 15% tax rate"); *id.* at 2 ("It will apply to roughly 200 corporations that have three-year-average annual book earnings exceeding $1 billion and that use loopholes and accounting gimmicks to pay little to nothing in taxes, like getting a tax break for exorbitant executive compensation"); DEP'T OF THE TREAS., *supra* note 25, at 21 ("The proposal is a targeted approach to ensure that the most aggressive corporate tax avoiders bear meaningful federal income tax liabilities.").

AFSI more closely to taxable income for two reasons. First, Congress made financial accounting income the starting point for AFSI specifically because financial accounting income is not taxable income. Indeed, Congress' intention seems to have been that the CAMT would apply when the taxpayer's taxable income was substantially below its financial accounting income. Said differently, AFSI's entire *raison d'etre* appears to be that it is not taxable income. The more tax principles are incorporated into the determination of AFSI, the closer AFSI will come to taxable income. Presumably, then, incorporating too many tax principles would bring AFSI too close to taxable income and frustrate Congressional intent. Second, the more adjustments to financial accounting income that must be made to calculate AFSI, the more complex the calculation will become—particularly with respect to adjustments that affect attributes, such as basis, that must be tracked over multiple taxable years. Accordingly, in determining how to exercise the authority delegated to it by Congress to adjust AFSI relative to financial accounting income, Treasury should give careful consideration to the administrability of the resulting system.

Nevertheless, the Executive Committee did not reach a consensus on a more specific guiding principle for determining when tax principles should override financial accounting principles in computing AFSI. Some members are of the view that AFSI should deviate from financial accounting principles only in narrow circumstances—in particular, (i) when there is specific statutory direction (*e.g.*, for depreciation) or (ii) when there is specific statutory authority to prevent a distortion in amount (*e.g.*, omissions and duplications) or timing (*e.g.*, implementing specific nonrecognition principles to prevent "bunching up" income) of financial accounting income and not exercising that statutory authority would result in clearly unfair or anomalous results. Other members of the Executive Committee, however, favor a more flexible approach, which would allow adjustments to AFSI for differences between financial accounting and taxable income in a broader range of circumstances. While acknowledging that such an approach would present difficult line-drawing problems, these members nonetheless stress that it is fully consistent with the expansive authority granted by Congress to Treasury to issue regulations or other guidance "as necessary to carry out the purposes of [Section 56A]."[74] Furthermore, in certain circumstances not envisioned by Congress, rigidly adhering to financial accounting principles may frustrate the purposes behind the CAMT.

B. AFSI and Basis Determinations Relating to Corporate Transactions

1. Key Differences between Tax and Financial Accounting Treatment

Although the tax and financial accounting systems both purport to measure "income," they do so for different purposes. The purpose of taxable income is to facilitate the determination of a taxpayer's tax liability, and ultimately, the collection of tax revenues. Although taxable income reflects accounting and economic considerations, it also intentionally deviates from economic income in important ways because of various Congressional judgments concerning fairness or administrative convenience, or, in some cases, a desire to encourage certain activities.[75] By contrast, the purpose of financial accounting income is to provide investors with

[74] Section 56A(c)(15).

[75] Bittker & Lokken, ¶2.1.

clear, consistent, and comparable information regarding the reporting entity's financial condition. These different purposes drive a number of important differences in how each system accounts for corporate transactions.

First, while both systems require gains and losses with respect to property to be realized before being recognized, the two systems define realization differently. For tax purposes, gain or loss is generally realized only upon a disposition of the property. But the financial accounting system allows gain or loss to be realized in the absence of a disposition. For instance, suppose a parent corporation owns a noncontrolling interest in the stock of a subsidiary, which it accounts for under the equity method of accounting. [76] If the subsidiary issues stock to a new investor, the parent realizes financial accounting gain or loss as a result of the dilution of its ownership interest in the subsidiary, even though it realizes no gain or loss for tax purposes.

Second, the Code defers the recognition of realized gains and losses in certain circumstances. As one example, no gain or loss is recognized on certain property exchanges pursuant to a corporate reorganization. The policy behind granting nonrecognition to transactions that continue a taxpayer's investment in modified form is that "the new enterprise or the new corporate structure that may hold the corporate assets, and the new stock or securities received in exchange for old stock or securities, are substantially continuations of, and interests in, the old corporation, still alive but in different form."[77] In addition, the taxpayer may not have sufficient liquidity to pay tax on its realized gains and, in the absence of a liquidity event, the investment may be difficult to value. The financial accounting system, by contrast, currently has no comparable nonrecognition regime.

Third, for tax purposes, the treatment of a transaction depends crucially on its legal form. For financial accounting purposes, however, legal form is typically irrelevant. The acquisition of a corporate target, for instance, illustrates this point. If the transaction is structured as a taxable stock acquisition for tax purposes, the target retains its historical tax basis in its assets. But if it is structured as a taxable asset acquisition, then the acquirer takes a tax basis in the target assets equal to their cost. By contrast, for financial accounting purposes, in any form of business combination, whether a stock acquisition or an asset acquisition, the acquirer generally adjusts the financial accounting basis of the acquired assets on its consolidated financial statements to fair value and records the excess of the purchase price over the aggregate fair value of the acquired business assets as goodwill (*i.e.*, purchase accounting adjustments). [78]

Fourth, in the tax system, there is an essential connection between the transferor's recognition of gain or loss on a property transfer and the transferee's initial basis in the property. If a person transfers property to a corporation in a transaction to which Section 1001 applies, the

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[76] Under GAAP, an investor uses the equity method when the investor holds significant influence over the company. The threshold for "significant influence" is typically ownership of between 20% and 50% of the voting interests in the company. Where an investor does not have significant influence, it may elect to use the fair value method, under which the investment is marked to market on a quarterly basis.

[77] Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, ¶12.00[1].

[78] In addition, if the target issues standalone financial statements following the transaction, the target may elect to apply "push-down accounting" (*i.e.*, to reflect the acquirer's new basis in the target assets) under GAAP. However, push-down accounting is not available under IFRS.

transferor generally recognizes any gain or loss realized on the property, and the transferee corporation takes an initial tax basis in the property equal to its cost. But if a person transfers property, say, to a corporation solely in exchange for stock of the transferee corporation in transaction to which Section 351(a) applies, the transferor recognizes no gain or loss and takes a substituted tax basis in the stock received. Additionally, the transferee corporation takes a transferred tax basis in the property received. The built-in gain or loss in the transferred property is thus not only preserved in the stock of the transferee corporation in the hands of the transferor; it is duplicated in the transferred property in the hands of the transferee corporation. The effect is to shift gain or loss that economically accrued during the transferor's ownership period to the transferee corporation. By contrast, there is no connection in the financial accounting system between gain reported by the transferring reporting entity and the transferee reporting entity's initial financial accounting basis. In fact, as discussed below, it is common for the financial accounting basis of property to be reset to fair value in the hands of the transferee regardless of whether the transferor recognizes financial accounting gain or loss on the transfer. Consequently, financial accounting does not permit the shifting of built-in gains and losses between reporting entities.

Lastly, while the tax and financial accounting systems both allow certain groups of entities to report income on a consolidated basis, the two systems employ materially different consolidation models. Under the Code, consolidation is elective and is generally available only to certain types of corporations connected through a chain of at least 80% stock ownership (by vote and value) with a parent corporation. By contrast, under financial accounting principles, consolidation is generally mandatory for most types of entities that are connected through voting control with a parent. The tax and financial accounting systems also conceive of consolidated groups differently. While the consolidated return regulations treat members of a tax consolidated group as a single entity for some purposes and as separate corporations for others, the financial accounting system applies full single-entity treatment. Thus, under financial accounting principles, when a subsidiary leaves a financial accounting consolidated group, the group generally recognizes financial accounting gain or loss with respect to the assets of the subsidiary, regardless of how the deconsolidation is effectuated.

In the discussion below, we highlight examples of common corporate transactions that are treated differently under tax and financial accounting principles, and consider whether, and to what extent, tax principles should override otherwise applicable financial accounting principles for purposes of determining the AFSI of the parties to these transactions. Selected issues with respect to transactions involving partnerships are discussed separately in Part IV.G.

2. Wholly Taxable Transactions

Below we discuss whether, in the case of a wholly taxable acquisition of one corporation by another, the acquirer should take into account any resulting step-up (or step-down) in the financial accounting basis of the target assets on its AFS for purposes of computing its AFSI. We also analyze the treatment of FSNOL carryovers attributable to the target corporation.

i. Carve-out Acquisition from AFS Group

Consider first a case where the acquired corporation is a subsidiary member of a group of entities that prepare a consolidated AFS (an "**AFS Group**").

> **Example 1:** Parent, an applicable corporation, is the parent of an AFS Group and a tax consolidated group that include Target. Acquirer is the parent of an unrelated AFS Group. Parent sells 100% of the stock of Target to Acquirer for cash in a taxable transaction in which no election under Section 338 is made.

For tax purposes, Parent recognizes gain with respect to the Target stock, Acquirer takes a cost basis in the Target stock, and Target's basis in its assets is unchanged. For financial accounting purposes, however, the Parent AFS Group recognizes gain with respect to the Target assets on its consolidated AFS, and the financial accounting basis of the Target assets is stepped up to fair value on the Acquirer AFS Group's consolidated AFS.

Under the statute, absent guidance from Treasury, the AFSI consequences to the parties generally track the financial accounting consequences: the AFSI of the Parent AFS Group includes the financial accounting gain it recognized with respect to the Target assets on the sale (subject to certain adjustments),[79] and the Acquirer AFS Group takes a stepped-up AFSI basis in the Target assets.[80] The Executive Committee believes that it is appropriate to permit the Acquirer AFS Group a stepped-up AFSI basis in the Target assets whenever the financial accounting gain with respect to the Target assets is included in the Parent AFS Group's AFSI. Moreover, we believe that a step-up is appropriate regardless of whether the sale occurs in a taxable year in which Parent is an applicable corporation subject to the CAMT. Accordingly, we recommend that Treasury confirm that purchase accounting and similar adjustments are taken into account in this fact pattern for purposes of determining the AFSI basis of the Target assets.

In addition, we urge Treasury to provide guidance as to whether any CAMT attributes (*e.g.*, FSNOL carryovers) of the Parent AFS Group are allocated to Target as a result of the sale, and if so, the method of allocation. While a comprehensive discussion of CAMT attributes is beyond the scope of this Report, we believe that the treatment of FSNOL carryovers attributable to Target should depend on whether or not the AFSI basis of the Target assets is stepped-up to fair value. If there is an AFSI basis step-up in Example 1, then, for purposes of determining the treatment of any FSNOL carryovers attributable to the Target, one reasonable approach would be to treat the transaction as a sale of the Target assets followed by a liquidation of the Target.

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[79] *See* Section 56A(a), (c)(1), and (c)(2)(B). Under Section 56A(c)(2)(B), if Parent and Target are members of a consolidated group, it appears they are treated in essence as a single corporation, as discussed further in Part IV.C.3.i below. Under that approach, Parent's sale of Target's stock logically is treated as an asset sale. By comparison, if Parent did not include Target in a consolidated group, then under Section 56A(c)(2)(C), it appears Parent would include in AFSI gain or loss with respect to its sale of Target's stock and would not include in AFSI financial accounting gain with respect to Target's assets. Section 56A(c)(2)(C) is discussed further below.

[80] Note that, to the extent the Target assets consist of Section 168 property, the Acquirer AFS Group would not get the benefit of this basis step-up for purposes of calculating depreciation, and, depending on guidance from Treasury, may not get the full benefit of the basis step-up upon a subsequent sale of the property. For a discussion of the interplay between purchase accounting and the CAMT depreciation adjustment rules applicable to Section 168 property, see Part IV.E.3.

Under this approach, in Example 1, any FSNOL carryovers attributable to the Target should generally be available (together with any of the Parent AFS Group's other FSNOLs) to offset AFSI recognized with respect to the Target's assets. Further, since Parent is a corporation that meets the 80% stock ownership requirements of Section 332(b) with respect to Target, a liquidation of Target into Parent would have qualified as a complete liquidation of Target within the meaning of Section 332(a), and thus a transaction to which Section 381 applies. Accordingly, Parent should inherit any remaining FSNOL carryovers attributable to the Target.[81]

ii. Acquisition of Entire AFS Group

Different considerations come into play when the Target is a standalone corporation or the parent of an AFS Group.

> **Example 2:** Target is a publicly traded applicable corporation whose stock is owned 25% by Investor, a corporation that accounts for its investment in Target under the equity method of accounting, and 75% by various individuals and noncorporate entities that are not aggregated with any corporation under Section 52. Acquirer is the parent of an unrelated AFS Group. The Target shareholders sell 100% of the stock of Target to Acquirer for cash.

For tax purposes, the Target shareholders recognize gain with respect to the Target stock, Acquirer takes a cost basis in the Target stock, and Target's basis in its assets is unchanged. For financial accounting purposes, Investor recognizes gain with respect to the Target stock. Additionally, even though Target recognizes no financial accounting gain with respect to its assets, the financial accounting basis of the Target assets is stepped up to fair value on the Acquirer AFS Group's consolidated AFS.

Does Section 56A(c)(2)(C) apply to Investor?

The first issue presented by Example 2 is whether the financial accounting gain recognized by Investor on the sale of Target is subject to adjustment under Section 56A(c)(2)(C). That provision states:

> In the case of any corporation which is not included on a consolidated return with the taxpayer, AFSI of the taxpayer with respect to such other corporation shall be determined by only taking into account the dividends received from such other corporation…and *other amounts which are includible in gross income or deductible as a loss under this chapter (other than amounts required to be included under Sections 951 and 951A or such other amounts as provided by the Secretary) with respect to such other corporation*. (Emphasis added).

The italicized text is ambiguous. On one hand, it could refer solely to items of income or loss generated by the nonconsolidated corporation that "tiers up" and is reflected in the financial

[81] The result that the FSNOLs remain with Parent in Example 1 also is consistent with a view that under Section 56A(c)(2)(B), Parent and Target are treated as a single corporation prior to the sale, with Parent being treated for CAMT purposes as selling Target's assets; a corollary is that attributes such as FSNOLs stay behind with the single corporation in which those attributes have been generated, *i.e.*, Parent.

accounting income of the taxpayer under applicable financial accounting standards (such items, "**corporate-level items**"). Under this interpretation, Section 56A(c)(2)(C) would have no application to the financial accounting gain recognized by Investor with respect to its Target stock; that gain would simply be included in Investor's AFSI without adjustment. On the other hand, "other amounts…with respect to such other corporation" may include not just corporate-level items but also items of income or loss generated by the taxpayer from transactions with respect to the stock of the nonconsolidated corporation (such items "**shareholder-level items**"). Under this latter interpretation, Section 56A(c)(2)(C) would apply for purposes of determining Investor's AFSI from the transaction.

The text of Section 56A(c)(2)(C) tends to support this latter interpretation. It indicates that the AFSI of the taxpayer is reduced by amounts which are "deductible as a loss" for U.S. federal income tax purposes with respect to the nonconsolidated corporation. However, a taxpayer cannot claim a deduction for losses incurred by its nonconsolidated corporation. Generally, the only way for a taxpayer to claim a deduction with respect to a nonconsolidated corporation is to dispose of the corporation's stock. Therefore, the reference to amounts which are "deductible as a loss" for U.S. federal income tax purposes only makes sense if such amounts refer to shareholder-level items.

The evolution of Section 56A(c)(2)(C) lends further support to the notion "other amounts…with respect to such other corporation" includes both corporate- and shareholder-level items. When the CAMT was originally introduced in the House of Representative's "Build Back Better Act" proposal in November 2021, it included a version of Section 56A(c)(2) drawn from the 1986 corporate AMT regime.[82] Like the final version, the original version of Section 56A(c)(2) consisted of four rules intended to clarify how items reflected on an AFS of an entity related to the taxpayer are taken into account in determining the taxpayer's AFSI. Among them were Sections 56A(c)(2)(C) and (D), which addressed situations where (i) a taxpayer owns an interest in a corporate or partnership subsidiary that is not consolidated with the taxpayer for tax purposes and (ii) the subsidiary's financial accounting income is reflected (in whole or in part) in the financial accounting income of the taxpayer under the consolidation or equity methods of accounting. The original versions of these provisions generally removed any undistributed financial accounting income of the subsidiary from the AFSI of the taxpayer. For example, the original version of Section 56A(c)(2) provided that the taxpayer's AFSI would be adjusted as necessary to disregard the *earnings* of corporations that are not in the taxpayer's consolidated return except to the extent those earnings were received as dividends or otherwise required to be included in gross income. Because the original version of these provisions did not provide for any adjustments to the AFSI of the taxpayer for financial accounting gain or loss with respect to the equity of such subsidiaries, it was clear that any such gains or losses would be included in its AFSI.

In the course of Congressional negotiations, however, the text of Section 56A(c)(2)(C) changed. Instead of adjusting AFSI of the taxpayer with respect to a nonconsolidated corporation by reversing out earnings not distributed to the taxpayer as a dividend, the final version reverses out all amounts with respect to the subsidiary other than dividends and "other amounts which are includible in gross income or deductible as a loss under this chapter…with respect to such other

[82] *See* H.R. 5376, 117th Cong. § 138101 (as passed by House, Nov. 19, 2021).

corporation." Although there is no legislative history clearly indicating the reason for the change, the surrounding circumstances suggest that it was intended to exclude from AFSI mark-to-market unrealized gains or losses with respect to corporate investments from AFSI (other than those that would be taken into account for tax purposes — for example, by securities dealers under Section 475). Thus, while the original version of Section 56A(c)(2)(C) applied solely to corporate-level items, it was changed to exclude from AFSI a specific type of shareholder-level item, namely, mark-to-market unrealized gains and losses.[83] While the mark-to-market unrealized gains and losses may have been the catalyst for this change, the final text of the provision does not distinguish such gains and losses and other types of shareholder-level items, including realized gains and losses from actual dispositions.

Accordingly, we urge Treasury to provide guidance clarifying that Section 56A(c)(2)(C) applies to corporate- and shareholder-level items taken into account by a taxpayer with respect to a nonconsolidated corporate subsidiary.

How is Investor's Gain Adjusted under Section 56A(c)(2)(C)?

Assuming Section 56A(c)(2)(C) is relevant to determining Investor's AFSI from the transaction, the next issue is how that provision acts to adjust Investor's financial accounting gain for purposes of computing its AFSI. Once again, the statutory text admits of multiple interpretations.

One possibility is that Section 56A(c)(2)(C) requires a taxpayer to determine AFSI with respect to stock of a corporation that is not consolidated for tax purposes by reference to tax principles full stop. On this reading, Investor would use its tax basis in the Target stock to determine the amount of AFSI resulting from the disposition of that stock. Although this is a natural reading of the statutory text, it is unclear whether this result was intended. A taxpayer's tax basis and AFSI basis in a nonconsolidated subsidiary are liable to differ significantly. Where they do, using tax basis to determine the taxpayer's AFSI on the disposition of a nonconsolidated subsidiary may distort the taxpayer's "true" AFSI with respect to its investment.

A second interpretation of Section 56A(c)(2)(C) is that tax principles apply only for purposes of determining whether, in principle, a given item of income or loss with respect to a nonconsolidated corporation is taken into account in AFSI; if the item is includible in gross income or deductible as a loss for tax purposes, the amount of the inclusion or deduction for AFSI purposes is generally determined with reference to financial accounting principles. Under this interpretation, Investor would use its AFSI basis in the Target stock to determine the amount of AFSI resulting from the disposition of that stock. We note that this interpretation would enhance the coherence of the CAMT system. The function of attributes such as basis is to accurately measure a taxpayer's lifetime income (however defined) within an annual accounting regime. Because AFSI is the relevant measure of income under the CAMT, using AFSI basis, rather than tax basis, to determine the amount of gain or loss from the disposition of a

[83] IRS Notice 2023-20, 2023-10 I.R.B. 523, which provides interim guidance to insurance companies regarding the application of CAMT, is consistent with this interpretation. It implies that mark-to-market unrealized gains and losses with respect to nonconsolidated corporate stock and partnership interests are disregarded from AFSI. *See* Section 2.02(3) of Notice 2023-20.

nonconsolidated subsidiary is apt to reflect more clearly a taxpayer's lifetime AFSI with respect to an investment.

A third interpretation is that Section 56A(c)(2)(C) requires a taxpayer to take into account in its AFSI any financial accounting income or loss with respect to a nonconsolidated corporation to the extent the income or loss is includible or deductible for tax purposes. Under this interpretation, Investor would use the greater of its AFSI basis or tax basis in the Target stock to determine the amount of AFSI resulting from the disposition of that stock. While we believe that that the statutory text is susceptible of this interpretation, we do not believe that it has merit as a policy matter.

We urge Treasury to clarify which of the foregoing interpretations is correct.

How is Acquirer's AFS Group's Financial Accounting Basis in the Target Assets Determined for AFSI Purposes?

The third issue presented in Example 2 concerns the determination of Acquirer AFS Group's AFSI basis in the Target assets. Considering that neither Target nor any other party recognized any gain or loss with respect to the Target assets for financial accounting, and therefore AFSI, purposes, should the step-up in the Target assets be taken into account for purposes of computing the AFSI of the Acquirer AFS Group?

Allowing the Acquirer AFS Group an AFSI step-up can be defended on three grounds. *First*, Congress chose to determine the base of the CAMT with reference to financial accounting principles rather than tax principles. Under financial accounting principles, the income of a particular reporting entity generally reflects only the income that economically accrued by that entity. Denying the Acquirer AFS Group a step-up in the Target assets for AFSI purposes would contravene this principle by effectively importing the built-in gain in the Target assets to the Acquirer AFS Group. To be sure, Congress granted Treasury authority to deviate from financial accounting income in computing AFSI. However, it is arguably reasonable to assume that in designing the CAMT, Congress was aware of fundamental aspects of the financial accounting system, such as purchase accounting. Under this assumption, Treasury does not need to increase the AFSI of the Acquirer AFS Group above its financial accounting income in order to accomplish Congress' policy goals.

Second, purchase accounting is a two-way street: if Target had built-in losses in its assets for financial accounting purposes, purchase accounting would eliminate those losses, as the assets' financial accounting bases would be stepped down to fair value on the Acquirer AFS Group's consolidated AFS. Disregarding purchase accounting adjustments for AFSI purposes in such a case would allow the shifting of built-in losses among reporting entities for AFSI purposes, and so consideration would need to be given to the potential distortions to AFSI that would attend such a regime.

Third, denying the Acquirer AFS Group an AFSI basis step-up in the Target assets may distort the Acquirer AFS Group's AFSI upon a future disposition of the Target stock. Upon such a disposition, the Acquirer AFS Group would recognize for financial accounting purposes gain on the Target *assets* as opposed to the Target stock. Assuming Target and Acquirer were

members of a consolidated group, it appears the Acquirer AFS Group would recognize gain on the assets (rather than the stock) of Target for AFSI purposes as well, as mentioned above. Indeed, in such a case, even if the Acquirer AFS Group went on to sell the Target stock for exactly the same price it paid for the Target stock (such that it had no tax gain or economic income), it would still recognize AFSI gain on all Target's assets.

On the other hand, it could be argued that allowing the Acquirer AFS Group to obtain a "free" AFSI basis step-up would be inconsistent with fundamental U.S. federal income tax principles in general and (in this context) the repeal of *General Utilities* ("**GU repeal**") in particular. Because Congress delegated authority to Treasury to adjust AFSI to carry out the principles of part II of subchapter C (relating to corporate liquidations)—which presumably include GU repeal—Treasury arguably has authority to adjust the Acquirer AFS Group's AFSI to neutralize the effects of purchase accounting and similar adjustments, even in a non-liquidation context. The case for incorporating GU repeal is strongest where Target, before being acquired, was an applicable corporation subject to CAMT: permitting a step-up to the Acquirer AFS Group in that scenario would potentially allow built-in gains that were already within the base of the CAMT to escape the CAMT.

More specifically, allowing this "free" AFSI basis step-up would permit—and, in fact, encourage—certain tax planning strategies that could be considered abusive.

First, buying the stock of a standalone corporation with appreciated assets for cash and thereby obtaining an AFSI basis step-up would permit an applicable corporation to use the basis step-up as a shield to reduce its future AFSI and therefore its CAMT liability. If it reduced its CAMT liability low enough, it could escape the CAMT altogether and resume paying regular income tax. Of course, reducing AFSI in this way would be accomplished by actually acquiring assets, which is a transaction that, unlike most tax shelters, clearly has substance. In addition, the counterweight to this incentive is the fact that reducing AFSI by inflating AFSI deductions comes at the cost of reducing the company's financial accounting income, and most companies seek to do just the opposite.

Moreover, the effectiveness of this strategy would be mitigated in certain circumstances depending on the nature of the target corporation's assets and the acquirer's method of accounting. For the reasons described below, acquiring goodwill or Section 168 property (defined below) would not confer much (if any) AFSI benefit at all.

Goodwill is not generally amortizable by public companies (instead, it is periodically tested for impairment), while private companies may elect to amortize goodwill. To the extent the target's assets consisted of goodwill, therefore, a public company acquirer would not get any benefit from the AFSI step-up unless and until it re-sold the target (or the target business) or determined that the goodwill had become impaired. Further, a financial accounting basis step-up in Section 168 property would produce no AFSI benefit because financial accounting depreciation deductions with respect to Section 168 property are not taken into account in computing AFSI under Section 56A(c)(13). Whether the step-up could produce a benefit upon a sale of the Section 168 property would depend on future guidance from Treasury (discussed below in Part IV.E.3).

In light of the financial accounting treatment of goodwill and the AFSI treatment of Section 168 property, the only category of assets that would reliably produce an AFSI benefit while held by a public company acquirer group is definite life intangible assets. The fact that the benefit of the AFSI basis step-up would be restricted to this category of assets would lessen the value of the tax planning strategy described above. It would, however, create an incentive to allocate the basis step-up away from goodwill and to definite life intangibles, which is exactly the incentive that Congress sought to eliminate when it enacted Section 197.[84] As noted above, though, the counterweight to this incentive is the incentive companies typically have to maximize financial accounting income.

Second, if Acquirer in Example 2 were subject to CAMT and received an AFSI basis step-up in Target's assets, then it could re-sell those assets at no additional AFSI gain. It would recognize gain for regular tax purposes, and the buyer in that subsequent transaction would get a basis step-up in the assets for both regular tax purposes and AFSI purposes. If Acquirer paid regular tax on the asset gain on the subsequent sale, then the basis step-up to the buyer would seem justified, but if Acquirer continued to be a CAMT taxpayer even with the incremental gain from the subsequent sale, then the buyer in the subsequent sale would have received a basis step-up in the assets for both regular tax and AFSI purposes with the only corresponding tax cost to Acquirer being a reduction in its CAMT credit. If Treasury views this result as abusive or otherwise undesirable, it could issue an anti-abuse rule that would deny Acquirer the benefit of an AFSI basis step-up for Target's assets if it re-sold all or a substantial portion of those assets in a taxable transaction within a prescribed period of time.

In considering any recommendation in this area, it is important to consider administrative burden. As regards this particular issue, adjusting AFSI to carry out the principles of GU repeal would amplify the complexity of determining the Acquirer AFS Group's AFSI. For one, it would increase the already significant burdens of maintaining and auditing a third set of CAMT-specific books and records. It would also probably necessitate a Section 382-like regime for preventing trafficking in built-in losses. However, because AFSI computations already require tracking and applying FSNOL carryovers and substituting tax depreciation for financial accounting depreciation with respect to Section 168 property, the computation of AFSI under the statute is already an inherently complex exercise. Moreover, the Notice requires adjustments to use transferred AFSI basis in certain nonrecognition transactions. Adjusting AFSI to incorporate GU repeal principles would merely add incremental complexity to an area where Congress and Treasury have already chosen to tolerate considerable complexity.

On balance, the Executive Committee believes that allowing the Acquirer AFS Group the benefit of a step-up in this circumstance is appropriate. Accordingly, we recommend that Treasury not adjust AFSI to neutralize the basis step-up (or step-down) in Target's assets that the Acquirer AFS Group would receive for financial accounting purposes.

[84] By allowing most intangible assets to be amortized using a single method under Section 197, Congress sought to eliminate the growing number of disputes between taxpayers and the IRS regarding the allocation of basis between definite lived intangible assets and previously non-amortizable assets like goodwill. *See* H.R. REP. NO. 103-111, at 760 (1993).

The presence or absence of a step-up in the assets' AFSI basis should inform the treatment of any FSNOL carryovers of the Target AFS Group in Example 2. Where there is no step-up, the Target AFS Group should retain its FSNOL carryovers. By comparison, if the AFSI basis of the Target assets is stepped-up (or down) to fair value, one reasonable approach would be to eliminate any FSNOL carryovers of the Target AFS Group. This result can be seen as particularly appropriate to the extent the loss carryovers are attributable to depreciation or amortization deductions with respect to the Target assets: stepping up the asset basis for AFSI purposes without removal of the FSNOL would confer a double benefit on taxpayers. Eliminating the Target AFS Group's FSNOL carryovers when the Acquirer AFS Group obtains a step-up under purchase accounting can also be viewed as appropriate as a broader policy matter. The effect of purchase accounting and similar adjustments is to treat a transaction as an acquisition of the Target assets from the perspective of the Acquirer AFS Group. To the extent FSNOL carryovers of the Target AFS Group would be eliminated by reason of an actual acquisition of the Target assets, consistency arguably requires that such losses be eliminated in a stock acquisition where the Acquirer AFS Group obtains a stepped-up (or stepped-down) basis in the Target assets for AFSI purposes.

Alternatively, another approach would be to eliminate Target's FSNOLs to the extent of the step-up in the basis of Target's assets in Example 2. This would ensure there is no double benefit from depreciation and amortization deductions and would also achieve fair results for taxpayers with large FSNOLs and little or no basis step-up. In this connection, we note that, while the statute does not mandate purchase accounting for AFSI purposes, it does specifically contemplate FSNOL carryovers. Thus, while an adjustment to prevent a double benefit would be appropriate, complete elimination of FSNOLs as a result of purchase accounting treatment arguably is not.

Finally, if Treasury decides to eliminate FSNOL carryovers in a case where the AFSI basis of Target's assets is adjusted on a stock acquisition, Treasury could consider allowing Target and the Acquirer AFS Group to jointly elect for Target to retain any loss carryovers attributable to it in lieu of the Acquirer AFS Group obtaining any step-up in the AFSI basis of the Target assets. We believe that such an election may be necessary to reach the right policy result in a way that is consistent with the statutory language, which, as noted above, expressly contemplates FSNOL carryovers.

3. Wholly Tax-Free Transactions

i. Guidance under the Notice

As mentioned, the Code provides for nonrecognition of gain or loss in certain transactions, while the financial accounting principles do not. For purposes of computing the AFSI of a "**Party**" to a "**Covered Nonrecognition Transaction**", the Notice generally conforms the CAMT treatment of the Covered Nonrecognition Transaction to its tax treatment. Section 3.03(1)(a) of the Notice generally provides that if a Party engages in a Covered Nonrecognition Transaction, it does not take into account in its AFSI for the year of the transaction any financial accounting gain or loss resulting from the Covered Nonrecognition Transaction (the

"**Nonrecognition Rule**").[85] In addition, Section 3.03(2) of the Notice generally provides that if property is transferred to a Party as part of a Covered Nonrecognition Transaction described in the Nonrecognition Rule and that Party gets a basis step-up or step-down for financial accounting purposes, it does not take into account that basis step-up or step-down in its AFSI for any year (the "**Basis Adjustment Rule**").[86]

A Covered Nonrecognition Transaction is a transaction that, solely with regard to a corporation or a partnership, qualifies as *wholly* tax-free under Section 332 or 337 (liquidation of a subsidiary into its parent corporation), Section 351 (transfer of property to a controlled corporation), Section 354, 357, 361 or 368 (reorganization), Section 355 (spin-off/split-off/split-up), Section 1032 (issuance of corporate stock), or Section 721 or 731 (contribution to or distribution from a partnership). Partially tax-free transactions thus do not qualify as Covered Nonrecognition Transactions. For this purpose, each component transaction of a larger transaction is examined separately for qualification as a Covered Nonrecognition Transaction. Thus, if a distributing corporation contributes property to a controlled corporation and then distributes the stock of the controlled corporation to its shareholders in a transaction described in a Sections 368(a)(1)(D) and 355 (a "**D/355 Transaction**"), the contribution and the distribution are tested separately from the perspective of each party for Covered Nonrecognition Transaction status.

A Party includes most principal parties to these transactions—for example, the target and acquirer corporations in an acquisitive reorganization, and the distributing and controlled corporations in Section 355 transactions—as well as any shareholders or partners of such parties that are members of the same AFS Group. Notably, it does not include shareholders who are not members of the same AFS Group as the principal parties, though.

ii. Carve-out Acquisition from AFS Group

Example 3: Parent, an applicable corporation, is the parent of an AFS Group and a tax consolidated group that include Target. Acquirer is the parent of an unrelated AFS Group. Target merges with Acquirer, with Acquirer surviving, and Parent receiving

[85] The Nonrecognition Rule in the Notice refers to "financial accounting gain or loss." In the absence of the rule, however, in many cases an applicable corporation would take into account gain or loss items in its AFSI computation that are different from its financial accounting gain or loss. This is because an applicable corporation must adjust the financial accounting basis of its property for purposes of its AFSI computation in a variety of circumstances (specifically, under the Basis Adjustment Rule and the basis adjustment rules that apply to Section 168 property and in situations involving cancellation of debt income and emergence from bankruptcy in Sections 4.07, 3.06 and 3.07 of the Notice, respectively). As a result, the gain and loss items that an applicable corporation disregards under the Nonrecognition Rule will often differ from the applicable corporation's financial accounting gain and loss items.

[86] The Basis Adjustment Rule purports to disregard for AFSI purposes "any increase or decrease in the financial accounting basis" of the property to which it applies. As noted above in footnote 87 with respect to the Nonrecognition Rule, an applicable corporation's basis in property for AFSI purposes can be different from its financial statement basis for a variety of reasons. When the basis of that property is adjusted to fair value for financial accounting purposes and the Basis Adjustment Rule does not apply, such that the basis is also adjusted for AFSI purposes, the size of the adjustment for AFSI purposes will differ from the size of the adjustment for financial accounting purposes. The size of the basis adjustment for a piece of property that is disregarded under the Basis Adjustment Rule is therefore different from the size of the financial accounting basis adjustment.

solely Acquirer stock representing 49% of the Acquirer's total outstanding voting stock in a transaction that qualifies as a reorganization under Section 368(a)(1)(A) (an "**A Reorganization**").

For tax purposes, the merger is treated as if Target transferred its assets to Acquirer in exchange for Acquirer stock and the assumption of Target's liabilities (if any), and Target then distributed the Acquirer stock to Parent in cancellation of its stock. Parent recognizes no gain or loss on the exchange of Target stock for Acquirer stock and takes a substituted tax basis in the Acquirer stock. Target recognizes no gain on its deemed transfer of its assets to Acquirer, and Acquirer takes a transferred tax basis in its assets. However, for financial accounting purposes, the Parent AFS group recognizes gain with respect to the Target assets on its consolidated AFS and takes a financial accounting basis in the Acquirer stock equal to the fair value of the Target stock. The financial accounting basis of the Target assets is stepped up to fair value on the Acquirer AFS Group's consolidated AFS.

As mentioned, for purposes of computing the AFSI of a Party to a Covered Nonrecognition Transaction, the Notice generally conforms the CAMT treatment of the transaction to its tax treatment. Here, Acquirer's acquisition of Target from Parent is a Covered Nonrecognition Transaction, and each of the Parent AFS Group and the Acquirer AFS Group is a Party to that Covered Nonrecognition Transaction. Therefore, under the Nonrecognition Rule, the Parent AFS Group does not take into account in its AFSI any of the financial accounting gain resulting from the Covered Nonrecognition Transaction. Further, under the Basis Adjustment Rule, solely for purposes of determining its AFSI, the Parent AFS Group takes an AFSI basis in the Acquirer stock equal to its financial accounting basis in the Target stock exchanged therefor (*i.e.*, a substituted AFSI basis).

We support Treasury's decision to provide for nonrecognition treatment for AFSI purposes in Covered Nonrecognition Transactions such as Example 3. Congress delegated authority to Treasury to issue regulations adjusting AFSI as necessary to "carry out the purposes of [the definition of AFSI]," including to "carry out the principles of various parts of the tax Code relating to (i) liquidations, (ii) corporate organizations and reorganizations and (iii) partnership contributions and distributions."[87] We believe that, in delegating Treasury this authority, Congress intended to permit Treasury to narrow the base of the CAMT relative to financial accounting income as appropriate by exempting financial accounting gain recognized in specified nonrecognition transactions.[88] We believe that exempting such gain from the base of the CAMT in appropriate cases is sound tax policy: as Congress has recognized in the context of the regular U.S. federal income tax system, mere changes in the form of a taxpayer's investment

[87] Section 56A(c)(15). Note that if Target is not a member of the same consolidated group as Parent, Parent's nonrecognition of gain or loss may be provided for by the terms of Section 56A(c)(2)(C), rather than being dependent on an exercise by Treasury of its regulatory authority under Section 56A(c)(15). In view of the policy considerations described in the text as to Parent, this result under Section 56A(c)(2)(C) appears to be a clearly appropriate one.

[88] We do acknowledge, however, that it is not at all certain based on the text of the statute that Congress intended to exempt gain from all of these transactions. On one hand, if Congress intended such a sweeping exclusion, one might expect Congress to have more clearly articulated its intentions. On the other hand, Congress was quite specific in that it referenced certain types of nonrecognition transactions, while leaving out others." *See, e.g.,* Section 1400Z-2 (deferral related to investments in "qualified opportunity zones"); Section 1031 (like-kind exchanges).

are not an appropriate occasion for the imposition of tax, because the new corporate structures are substantial continuations of the old corporation, just in a different form. In addition, the taxpayer may not have sufficient liquidity to pay tax and the investment may be difficult to value. Furthermore, we believe that failure to incorporate these nonrecognition provisions into the CAMT in these appropriate cases would frustrate these policies and could cause corporations whose average AFSI from ordinary course operations is well below the $1 billion threshold to become applicable corporations on account of a single extraordinary nonrecognition transaction, enlarging the set of taxpayers subject to the CAMT in unintended ways. In addition, we understand that when companies engage in these types of extraordinary transactions and must report the resulting gain in their GAAP income, they typically report "adjusted GAAP income" alongside their GAAP income and exclude the gain from those results. As a result, we do not believe that discrepancies between taxable income and GAAP income arising as a result of these types of transactions were included in the discrepancies that motivated Congress to enact the CAMT.

We also support the application of the Basis Adjustment Rule to the Acquirer voting stock received in the exchange. If AFSI is reduced for financial accounting gain recognized on the exchange of property for equity in a nonrecognition transaction, the transferor should take a substituted financial accounting basis in the equity received for purposes of computing its AFSI, so that the transferor's financial accounting gain is merely deferred, rather than exempted from the CAMT.

However, we did not reach a consensus as to whether the Acquirer AFS Group should take into account the step-up to the financial accounting basis of the Target assets for purposes of computing its AFSI in Example 3. Some members of the Executive Committee would allow the step-up to the Acquirer AFS Group in Example 3 for many of the same reasons as in Example 2. There, the Executive Committee concluded that, notwithstanding that the financial accounting gain with respect to the Target assets is not included in the AFSI of any corporation or partnership, the Acquirer AFS Group should be allowed a step-up for AFSI purposes for three reasons. *First*, since Congress intended for the base of the CAMT to be determined generally with reference to financial accounting income, Treasury should only alter the base of the CAMT relative to financial accounting income by adjusting AFSI to the extent necessary to vindicate a particularly compelling policy objective. Moreover, to the extent a particular policy objective compels a regulatory adjustment to AFSI, the adjustment should be narrowly tailored to achieve that objective. In Example 3, there are compelling reasons to defer recognition of the Parent AFS Group's financial accounting gain with respect to the Target assets and to require the Parent AFS Group to take a transferred financial accounting basis in the Acquirer stock. However, this group argues, such adjustments are sufficient to ensure that the inherent gain in the Target AFS Group's assets is ultimately clearly reflected; there is no need to go further and require the Acquirer AFS Group to take a transferred financial accounting basis in the Target assets for purposes of computing its AFSI. *Second*, disregarding purchase accounting and similar adjustments would open up potential for abuse in cases where Target had built-in losses in its assets. *Third*, denying Target the benefit of a step-up could distort Acquirer's AFSI upon a subsequent taxable disposition of the Target stock.

Other members of the Executive Committee, however, oppose allowing a step-up in Example 3, contending that the Acquirer AFS Group should be required to take a transferred

financial accounting basis in the Target assets for purposes of computing its AFSI. According to these members, Examples 2 and 3 are distinguishable: while the result in Example 2—a step-up without gain recognition—follows directly from the application of financial accounting principles, the result in Example 3 does not. Instead, it results from Treasury's exercise of its authority to conform the CAMT treatment of the transaction to its tax treatment by incorporating the nonrecognition provisions of subchapter C. It is one thing to consistently apply financial accounting principles to determine the AFSI of both parties to a transaction as in Example 2; it is quite another to selectively "turn off" those principles as to one party but not the other.[89] As these members reason, if Treasury exercises its authority to adjust AFSI to carry out the principles of subchapter C by providing for nonrecognition of the Parent AFS Group's financial accounting gain or loss, it should also incorporate all the basis provisions that are integrally related to the nonrecognition provisions. This approach, its supporters argue, is faithful to the grant of legislative authority to carry out the principles of corporate reorganizations, which presumably extend to the rules under Section 362(b) for determining of the acquiring corporation's basis in property received in a corporate reorganization.

Some members also note that allowing the Acquirer AFS Group the "free" AFSI basis step-up in cases, such as Example 3, where the transferor is an applicable corporation and has not included any gain with respect to the Target assets in its AFSI would raise the same concerns regarding potential abuse as Example 2.

The members who support allowing a financial accounting asset basis step-up in Example 3, however, counter that such concerns could be addressed more economically through an anti-abuse rule — for instance, by triggering the transferor's deferred financial accounting gain if the transferee disposes of all or a substantial portion of the transferred assets within a specified time period following an otherwise qualifying nonrecognition transaction. A targeted approach such as this, they argue, would be preferable to the distortions and additional compliance burdens that would accompany a regime in which the transferee is required to take a transferred financial accounting basis in the transferred assets.

Among the group of members who support a transferred financial accounting basis in the Target assets in Example 3, there is some disagreement as to the importance of the Parent AFS Group's status as an applicable corporation to the analysis. Some would come out differently if the Parent AFS Group were not an applicable corporation. These members view that situation as analogous to one in which Target is owned solely by individuals or other CAMT-indifferent persons, since in that situation there would be no CAMT liability in respect of Target's asset gain, regardless of the application of the regulatory exclusion to the financial accounting of gain or loss from AFSI. Others point out the practical difficulties that would arise in tracking the status of the various shareholders and determining whether the AFSI gain would have caused a transferor AFS group that was otherwise not an applicable corporation to become an applicable corporation, as well as questions that would arise in circumstances where some shareholders are applicable corporations and others are not.

[89] As discussed more fully below in Part IV.B.3.iii, if Parent is not part of the same tax consolidated group as Target, then there is arguably no "selective" turning off of nonrecognition principles: Section 56A(c)(2)(C) appears to mandate nonrecognition at the shareholder level, while leaving it open what happens at the Target level.

Finally, as discussed in the previous Examples, we believe that the determination of the Acquirer AFS Group's basis should inform the treatment of any FSNOL carryovers attributable to Target. If the Acquirer AFS Group is permitted a stepped-up basis in the Target assets for purposes of computing its AFSI, then any FSNOL carryovers should be eliminated, or at least reduced, as discussed at Example 2 above. [90] But if the Acquirer AFS Group takes a transferred financial accounting basis in the Target assets for this purpose, then Target should be allocated the portion of the Parent AFS Group's loss carryovers attributable to it and these carryovers should be available for use by Acquirer AFS Group.

iii. Acquisition of Entire AFS Group

> **Example 4:** Target is a publicly traded applicable corporation whose stock is owned 25% by Investor, a corporation that accounts for its investment in Target under the equity method under GAAP, and 75% by various individuals and noncorporate entities that are not aggregated with any corporation under Section 52. Acquirer is the parent of an unrelated AFS Group. The Target shareholders transfer 100% of the stock of Target to Acquirer solely in exchange for Acquirer voting stock in a B Reorganization.

For tax purposes, the Target shareholders recognize no gain or loss on the exchange of Target stock for Acquirer voting stock and take a substituted basis in the Acquirer voting stock. Acquirer takes a transferred basis in the Target stock. Target's basis in its assets is unchanged. For financial accounting purposes, Investor recognizes gain with respect to the Target stock and takes a financial accounting basis in the Acquirer stock equal to the fair market value of the Target stock exchanged therefor. Target recognizes no gain or loss with respect to its assets. Nevertheless, the financial accounting basis of the Target assets is stepped up to fair value on the Acquirer AFS Group's consolidated AFS.

Under the Notice, Investor's exchange of Target stock for Acquirer voting stock is a Covered Nonrecognition Transaction. However, because Investor does not consolidate with Target for financial accounting purposes, Investor is not a Party to the Covered Nonrecognition Transaction within the meaning of the Notice. Therefore, the Nonrecognition Rule does not apply to Investor.

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[90] Although Example 3 is similar to Example 1 in that, in both cases, Parent is disposing of a consolidated Target, we believe a different treatment of the Parent AFS Group's FSNOL carryovers is warranted. In Example 1, the Parent AFS Group recognized AFSI gain or loss on Target's assets, so there was no justification to eliminate or transfer to Acquirer AFS Group any portion of the Parent AFS Group's FSNOL carryovers. By contrast, in Example 3, the Parent AFS Group does not recognize AFSI gain or loss on Target's assets. As noted in the discussion of this point in relation to Example 2, if the Acquirer AFS Group were to receive an AFSI basis step-up in Target's assets, then preserving FSNOL carryovers allocable to Target would produce a double benefit. (To be sure, if Treasury adopts our recommendation that Parent should receive a substituted basis in the Acquirer stock it receives in the transaction, it would eventually recognize AFSI gain on the stock, but only in the future upon a taxable disposition of the Acquirer stock.) A more reasonable result in this case would be to eliminate a portion of the Parent AFS Group's FSNOL carryovers.

If, on the other hand, the Acquirer AFS Group does not receive an AFSI basis step-up in Target's assets, we do not see any logic in either permitting the Parent AFS Group to continue to use the portion of its FSNOL carryovers that are allocable to Target or eliminating them. Instead, a more reasonable result would be for the Acquirer AFS Group to inherit them.

Nevertheless, depending on the interpretation of Section 56A(c)(2)(C), Investor may not need to avail itself of the Nonrecognition Rule to exclude the financial accounting gain with respect to its Target stock from its AFSI. As noted above in the discussion of Example 2, Section 56A(c)(2)(C) could be interpreted to say that, with respect to a nonconsolidated corporation, AFSI does not include any item of financial accounting income or loss derived by the corporation itself or generated on a sale or exchange of the corporation unless there is a corresponding item of taxable income or loss. Under this interpretation, because Target does not file a consolidated return with Investor, Investor's AFSI with respect to Target will take into account the financial accounting gain recognized on the Target stock only if gain was recognized for tax purposes. Investor's exchange of Target stock for Acquirer voting stock qualifies for nonrecognition treatment, and so no financial accounting gain would be included in Investor's AFSI.

For the reasons discussed above, the text, structure, and history of Section 56A(c)(2)(C) indicate that it applies for purposes of determining the AFSI of a taxpayer from transactions with respect to the stock of the nonconsolidated corporation. Although this provision was specifically intended to provide for nonrecognition of mark-to-market unrealized gains and losses with respect to nonconsolidated corporations, it also by its terms provides for nonrecognition for realized gains and losses on actual dispositions of stock in such corporations. If Treasury determines that Section 56A(c)(2)(C) does not provide for nonrecognition upon actual dispositions, however, we urge Treasury to extend the Nonrecognition Rule to cover such situations. Further, we recommend extending the Basis Adjustment Rule to the determination of the exchanging shareholder's basis in the stock received in the nonrecognition transaction, so that any such gain is merely deferred, not eliminated from AFSI entirely.

Turning to the consequences to the Acquirer AFS Group, the Executive Committee is again divided as to whether the Acquirer AFS Group should be allowed an AFSI basis step-up in the Target assets. Those members who would allow the Acquirer AFS Group an AFSI step-up in Example 3 would also allow the Acquirer AFS Group an AFSI step-up in Example 4 for the same reasons. In addition, these members contend that the case for allowing a step-up in Example 4 is stronger than in Example 3: conditioning an asset basis step-up to the transferee on gain recognition by the transferor specifically in the context of a nonrecognition transaction within a broader system that does not generally adhere to a GU repeal principle seems arbitrary.

However, among those members who would deny the Acquirer AFS Group an AFSI step-up in Example 3, views as to Example 4 differed. While a subset of these members would deny the Acquirer AFS Group a step-up in Example 4 for the same reasons as in Example 3 (including the arguments outlined in the discussion of Example 2 and echoed in the discussion of Example 3 alluding to consistency with the principles of GU repeal), another subset would distinguish the two examples. As this latter subset argues, where, as in Example 3, Treasury exercises its authority under Section 56A(c)(15)(B) to provide for nonrecognition of gain or loss in certain transactions, it should fully conform the financial accounting treatment of those transactions to their tax treatment by incorporating the applicable basis adjustments. Example 4, however, does not involve the exercise of Treasury's authority under Section 56A(c)(15)(B) or otherwise; neither Target nor any other party recognizes any gain or loss on Target's assets under applicable financial accounting principles. Accordingly, where, as in Example 4, Treasury is not

exercising its regulatory authority to exclude financial accounting gain or loss from AFSI, it need not make any corresponding basis adjustments.

There are practical reasons for distinguishing Examples 3 and 4, as well. Where the target is a subsidiary member of an AFS Group, as in Example 3, nonrecognition treatment is liable to have a direct effect on that AFS Group's CAMT liability. Where the target is a standalone entity or the parent of an AFS Group, however, no party will recognize financial accounting gain or loss on the target assets, so even in the absence of a statutory or regulatory exclusion, no applicable corporation will include any gain or loss attributable to the target assets in its AFSI simply because of how the financial accounting rules work. It could be argued that where one of the target shareholders—like Investor in Example 4—recognizes gain for financial accounting purposes, and that gain is excluded from AFSI either under Section 56A(c)(2)(C) or as a result of Treasury guidance, then that situation is somewhat analogous to Example 3. The stakes in this case are typically much lower, though. Gain or loss recognized on Target's stock by any noncorporate Target shareholders that are not aggregated under Section 52 with any corporation will not be included in any corporation's AFSI. Only the gain or loss on Target's stock recognized by Target shareholders that are themselves corporations or that are aggregated under Section 52 with a corporation could ever be relevant to an AFSI calculation. And even those shareholders, as noted above, may have nonrecognition of gain or loss pursuant to Section 56A(c)(2)(C), a shareholder-level provision that by its terms applies automatically, without a connection to the AFSI consequences (if any) to the target corporation. Denying an asset basis step-up in full merely because a minority shareholder in the target corporation enjoys nonrecognition treatment for AFSI purposes under Section 56A(c)(2)(C) or even Treasury guidance is arguably a disproportionate response.

Finally, we believe that the same principles as were discussed in Example 2 as regards the treatment of any FSNOL carryovers attributable to Target should apply to Example 4. Just like in Example 2, if the Acquirer AFS Group is permitted a stepped-up basis in the Target assets for purposes of computing its AFSI, then any FSNOL carryovers should be eliminated, at least to the extent of the step-up (subject to a joint election to forego the AFSI basis step-up and preserve the FSNOL carryovers). However, if the Acquirer AFS Group takes a transferred financial accounting basis in the Target assets for this purpose, then Target AFS Group should retain its FSNOL carryovers.

iv. Summary

The Executive Committee believes that if a corporation undertakes a transaction that qualifies as wholly tax-free under Sections 332, 337, 351, 354, 355, 357, 361, or 1032, any financial accounting gain or loss resulting from that transaction should be excluded from its AFSI (including in cases where Section 56A(c)(2)(C) does not provide for that result). As a consequence, however, the corporation should take a substituted AFSI basis in any equity it receives in the transaction, so that any such gain or loss is merely deferred, rather than

eliminated. Accordingly, we recommend that Treasury expand the scope of the Nonrecognition Rule and the Basis Adjustment Rule to the extent necessary to achieve this result.[91]

However, the Executive Committee did not reach a consensus as to whether, in such a transaction, any increase or decrease in the financial accounting basis in the transferred property in the hands of the transferee should be taken into account for purposes of computing the transferee's AFSI. In general, members of the Executive Committee divide into three distinct camps:

- The first camp believes that the transferee should always take into account such financial accounting basis adjustments in computing AFSI, and thus, for instance, would permit the Acquirer AFS Group a step-up in Examples 3 and 4;

- The second camp believes that when property is transferred in a transaction that qualifies as nonrecognition treatment to the transferor(s) for tax purposes, the transferee should never take into account the resulting financial accounting basis adjustments in computing its AFSI, and thus would deny the Acquirer AFS Group a step-up in Examples 3 and 4; and

- The third camp believes that the transferee should take into account financial accounting basis adjustments except where the Treasury has excluded the gain with respect to the transferred property from the AFSI of the transferor under Section 56A(c)(15)(B), and thus would deny the Acquirer AFS Group a step-up in Example 3 (provided Parent and Target are in the same consolidated group, such that Section 56A(c)(2)(C) does not apply) but not in Example 4.

Finally, the Executive Committee believes that any FSNOL of the Target or Target AFS Group should be eliminated (or at least reduced by the amount of the step-up) if the Acquirer AFS Group obtains a stepped-up financial accounting basis in the assets of the Target or Target AFS Group for purposes of computing its AFSI.

[91] Section 3.03(1)(a) of the Notice includes transactions that are tax-free under Sections 721 or 731 in its list of Covered Nonrecognition Transactions. These types of transactions are discussed further in Part IV.G below. We note that in the partnership context, there are considerations that would counsel refining or modifying the principles discussed above for tax-free reorganizations under Section 368 or other corporate transactions. For example, since a partnership is a flow-through entity, if it received an AFSI basis step-up in assets it acquired from an applicable corporation in a Section 721 transaction, then the applicable corporation potentially would enjoy a pro rata share of that step-up while also getting tax-free treatment for its transfer of assets to the partnership, absent rules preventing that result.

4. Partially Tax-Free Transactions

The Nonrecognition Rule applies only with respect to a Covered Nonrecognition Transaction — that is, a transaction that, solely with regard to a corporation or partnership (as appropriate), qualifies as wholly tax-free under certain enumerated Code provisions with regard to the corporation or partnership (as appropriate). For purposes of the Nonrecognition Rule, each component transaction of a larger transaction is tested separately for qualification as a Covered Nonrecognition Transaction. In the discussion below, we first consider whether the scope of Covered Nonrecognition Transactions should be expanded to include property transfers that qualify as tax-free only in part. We then consider whether, in the case of an integrated transaction with multiple steps, some of which qualify as tax-free (in whole or in part) and others which do not, the Nonrecognition Rule should apply separately to each of the individual steps (as under the Notice) or rather to the transaction as a whole.

i. Partially Tax-Free Transfers

We see little reason to limit the scope of the Nonrecognition Rule to transactions that are wholly tax-free. As discussed in connection with Example 3, we believe that Congress intended for Treasury to issue regulations adjusting AFSI as necessary to "carry out the purposes of [the definition of AFSI]," including to "carry out the principles of various parts of the tax Code relating to (i) liquidations, (ii) corporate organizations and reorganizations and (iii) partnership contributions and distributions."[92] Further, we believe that incorporating the principles of these Code provisions would be sound tax policy. A partially tax-free transaction represents a mere change in the form of an investment to the extent it is tax-free, and the same valuation and liquidity concerns that arise in fully tax-free transactions can arise in partially tax-free transactions as well. For this reason, nonrecognition treatment under the Code is generally not an "all or nothing" proposition; as long as a transaction meets certain definitional requirements, a taxpayer may qualify for nonrecognition treatment on the exchange property of certain qualifying types of consideration but not for others. We believe a similar approach should apply for purposes of determining AFSI. Moreover, if an "all or nothing" approach were adopted, then the Nonrecognition Rule and the Basis Adjustment Rule would in many circumstances be entirely elective because a taxpayer could quite easily turn transaction in which no gain or loss was recognized for tax purposes into a transaction in which some gain or loss was recognized for tax purposes by including a *de minimis* amount of cash "boot." This change would not interfere with the tax treatment under the regular income tax rules (other than the recognition of a de minimis amount of gain and the inability to qualify as a B Reorganization) but would cause the Nonrecognition Rule and the Basis Adjustment Rule to not apply. Accordingly, we recommend that Treasury expand the concept of a Covered Nonrecognition Transaction to include partially tax-free transfers.

We acknowledge that expanding the definition of Covered Nonrecognition Transaction would create additional complexity: because a taxpayer may realize different amounts of gain or loss for financial accounting purposes in a partially tax-free transfer, Treasury would need to provide rules for determining the amount of the transferor's financial accounting gain or loss that is included in its AFSI, the transferor's financial accounting basis in any equity interests received

[92] Section 56A(c)(15).

for AFSI purposes, as well as the transferee's financial accounting basis in the transferred property for AFSI purposes. However, we believe that these rules can and should parallel the rules set forth in the applicable Code provisions. We believe that this approach is workable in practice and consistent with Congressional intent implicit in the grant of regulatory of authority in Section 56A(c)(15)(B). The following example illustrates the application of this approach in the context of a Section 351 exchange with boot.

> **Example 5:** Parent is an applicable corporation. JV Partner is the parent of an unrelated AFS Group. Parent and JV Partner form JV, a corporation with a single class of stock, with Parent contributing three operating assets[93]—A, B, and C—to JV in exchange for $800 of JV stock and $200 cash, and JV Partner contributing $801 in exchange solely JV stock, in a transaction to which Section 351 applies. Because JV Partner obtains voting control over JV, JV joins the JV Partner AFS Group.

For tax purposes, Parent is treated as though it separately exchanged assets A, B, and C for a pro rata portion of the JV stock and cash,[94] and thus computes its gain or loss as follows:

Asset	FMV	Tax Basis	Allocated Stock	Allocated Boot	Tax Gain/(Loss) Recognized
A	500	250	400	100	100
B	400	350	320	80	50
C	100	150	80	20	-
Total	**1,000**	**750**	**800**	**200**	**150**

Under Section 358(a), Parent takes a transferred basis in the JV stock received, decreased by the cash received, and increased by the gain recognized. Under Section 362(a), JV takes a transferred basis in assets A, B, and C, increased by the gain recognized by Parent.

For financial accounting purposes, Parent computes its gain or loss as follows:

[93] For simplicity, we have assumed that none of assets A, B, C is the stock of a member of the Parent AFS Group. If any of the assets were stock in such a subsidiary, the Parent AFS Group's financial accounting gain or loss would be determined with respect to the subsidiary's assets. In that case, the calculation of gain or loss for AFSI would likewise be made with respect to the assets of the subsidiary, as if those assets had been directly transferred, assuming the subsidiary and Parent were members of a tax consolidated group (such that Section 56A(c)(2)(C) did not apply).

[94] *See* Rev. Rul. 68-55, 1968-1 C.B. 140.

Asset	FMV	Book Basis	Book Gain/(Loss) Recognized
A	500	300	200
B	400	350	50
C	100	150	(50)
Total	**1,000**	**800**	**200**

Parent takes a financial accounting basis in the Acquirer stock equal to the fair value of the Target stock. Further, the financial accounting basis of the Target assets is stepped up to fair value on the JV Partner AFS Group's consolidated AFS.

By contrast, under our recommended approach, the transaction would qualify as a Covered Nonrecognition Transaction, and thus would qualify for nonrecognition treatment to Parent in part. To determine the amount of financial accounting gain included in its AFSI, Parent would apply the same principles used to compute its tax gain, except that it would substitute financial accounting basis for tax basis in the calculation:

Asset	FMV	Book Basis	Allocated Stock	Allocated Boot	AFSI Gain/(Loss) Recognized
A	500	300	400	100	100
B	400	350	320	80	50
C	100	150	80	20	-
Total	**1,000**	**800**	**800**	**200**	**150**

The Executive Committee is divided as to a recommendation for the AFSI basis consequences to the parties. Those members that would recommend that Acquirer AFS Group in Example 3 should retain the AFSI benefit of the financial accounting basis step-up in the Target assets would advocate for the same approach here with respect to the JV Partner AFSI Group.

Those members that would argue for a carryover basis in Example 3 would recommend that the AFSI basis consequences to the parties would likewise follow tax principles. Consistent with the principles of Section 358(a), for purposes of determining its AFSI, Parent would take a substituted financial accounting basis in the JV stock received, decreased by the cash received, and increased by the gain recognized. Consistent with the principles of Section 362(a), for purposes of determining its AFSI, the JV Partner AFSI Group would take a transferred financial accounting basis in assets A, B, and C, increased by the financial accounting gain included in Parent's AFSI. The overall result of this approach would be to use tax principles to determine gain recognition for CAMT purposes, even though the amounts of tax gain and financial accounting gain would be different.

We note that depending on the type of partially tax-free transfer involved, the exact application of the above-described approach may differ. For instance, and depending on how

Section 721 principles are applied in the context of CAMT (an issue discussed further in Part IV.G), if an applicable corporation transfers assets to a partnership in a transaction that is in part a nontaxable Section 721 transaction and in part a sale under Section 707 (similar to Example 5 in Section 3.03(3)(e) of the Notice), then the transaction would generally be bifurcated in accordance with the disguised sale regulations with the applicable corporation recognizing gain for CAMT purposes with respect to the same transferred assets, and in the same manner, as under such regulations. As to the basis consequences, those members that would advocate for the JV Partner AFSI Group in Example 5 to reflect its financial accounting basis step-up in the transferred assets in its AFSI calculation would likewise argue that AFSI basis should follow financial accounting basis here. Those members that argued in favor of following tax principles in Example 5 would likewise argue in favor of the same approach here.

ii. Multistep Transactions

For purposes of the Nonrecognition Rule, each component of a larger transaction is tested separately for qualification as a Covered Nonrecognition Transaction. Thus, within a larger transaction, some components may qualify for nonrecognition treatment for AFSI purposes, even though others do not. This approach can yield questionable results where the steps of such a transaction that result in taxable gain or loss are not the same ones that result in financial accounting gain or loss.

> **Example 6:** Distributing is a publicly traded applicable corporation and the parent of an AFS Group. On December 31, Year 1, Distributing forms Controlled, contributes appreciated assets to Controlled in exchange for Controlled stock and Controlled's assumption of certain Distributing liabilities (the "**Contribution**"), then distributes 100% of the stock of Controlled to its public shareholders in exchange for their Distributing stock (the "**Split-off Distribution**") in a transaction that qualifies as a D/355 Transaction. The amount of Distributing liabilities assumed by Controlled exceeds the aggregate tax basis of the assets contributed to Controlled in the Contribution.[95]

For tax purposes, the excess of the liabilities assumed by Controlled over the aggregate tax basis of each asset contributed to Controlled is treated as taxable boot under Section 357(c). Distributing thus recognizes part of the gain in the assets contributed to Controlled under Section 361(b) and, under Section 362(b), Controlled takes a carryover basis in each contributed asset, increased by the amount of gain recognized by Distributing with respect to that asset. The Split-off Distribution qualifies for nonrecognition treatment for Distributing under Section 361(c)(3). For financial accounting purposes, though, the situation is reversed: the Distributing AFS Group recognizes no financial accounting gain on the Contribution, but it recognizes financial accounting gain with respect to the Controlled assets as a result of the Split-off Distribution. Accordingly, if the AFSI of the Distributing AFS Group is separately determined for each component of the transaction (as it is under the Notice), then the Distributing AFS Group recognizes no AFSI on the transaction whatsoever: it recognizes no AFSI on the Contribution because it recognizes no gain for financial accounting purposes on the Contribution, and it

[95] *Cf.* Example 4 in Section 3.03(3) of the Notice.

recognizes no AFSI on the Split-off Distribution because the Split-off Distribution qualifies for nonrecognition treatment under the Nonrecognition Rule.

To resolve this issue, we recommend that Treasury provide guidance to the effect that if a taxpayer recognizes tax gain with respect to an asset in one step of a multistep transaction and financial accounting gain with respect to the same asset in a different step, then a portion of the financial accounting gain should be included in AFSI, with the portion being determined in a manner consistent with the determination where the tax and financial accounting gain are recognized on the same step. Further, to the extent that the financial accounting gain with respect to the applicable asset is included in AFSI, the AFSI basis of the applicable asset should be adjusted to reflect any book basis step-up.

We think it is instructive to compare our recommended approach in Example 6 with Treasury's analysis of Example 4 in Section 3.03(3)(d) of the Notice. There, Distributing, the parent corporation of an AFS Group (the Distributing AFS Group), contributed property to Controlled in exchange for Controlled stock, Controlled's assumption of certain Distributing liabilities, Controlled cash, and Controlled securities (collectively, the Contribution). Distributing then distributed the Controlled stock to certain of its shareholders in a series of distributions (collectively, the Staggered Split-off Distribution) and transferred the Controlled Cash and Controlled debt securities to its creditors (the Cash for Debt Exchange and Debt for Debt Exchange, respectively). Although the Contribution and Staggered Split-off Distribution each qualified for nonrecognition treatment under the Code, the Debt for Debt Exchange did not, and so the Distributing AFS Group included in its AFSI any financial accounting gain or loss recognized on the Debt for Debt Exchange. The example goes on to say that any such gain results in a step-up in the financial accounting basis of the Controlled assets for purposes of computing its AFSI, even though gain was recognized with respect to the Controlled securities, rather than the Controlled assets.

This result is puzzling because all the financial accounting gain on the contributed property is disregarded for AFSI purposes, and yet part of the financial accounting basis step-up with respect to the contributed property is taken into account. It would seem more logical to analyze Example 4 of the Notice as follows. There is no financial accounting gain on the Contribution, but there is financial accounting gain on the Staggered Split-off Distribution and, as a result, a financial accounting basis step-up on the contributed property. However, there is no tax gain recognized on that property on any step of the multistep transaction because both the Contribution and the Staggered Split-off Distribution are tax-free. As a result, both the financial accounting gain recognized, and the financial accounting basis step-up, with respect to the contributed property are disregarded for AFSI purposes. By contrast, tax gain is recognized with respect to the Controlled securities in the Debt for Debt Exchange, so any financial accounting gain or loss on Controlled Securities and (to the extent relevant) any financial statement basis step-up on the Distributing debt acquired in exchange therefor should also be taken into account for AFSI purposes.

5. Consolidation/Deconsolidation and Dilution Gains and Losses

Another area where guidance is needed is the treatment of financial accounting gains and losses resulting from the consolidation or deconsolidation of subsidiary members of an AFS

Group or the dilution of an investor's interest in a company that it accounts for under the equity method.

> **Example 7:** Parent is an applicable corporation and the parent of an AFS Group that includes Subsidiary. Investor, the parent of an unrelated AFS Group, contributes cash or property to Subsidiary in exchange for 51% of the Subsidiary stock, causing Subsidiary to deconsolidate from the Parent AFS Group and join the Investor AFS Group.

For tax purposes, neither Parent nor Subsidiary realizes any gain or loss from the transaction. However, for financial accounting purposes, the Parent AFS Group is treated as a single entity, and so when Subsidiary leaves the Parent AFS Group, the Parent AFS Group recognizes gain or loss with respect to Subsidiary's assets rather than the Subsidiary stock on its consolidated AFS. Absent guidance from Treasury to the contrary, any deconsolidation gain or loss is potentially included in the AFSI of the Parent AFS Group.

As discussed above, Section 56A(c)(2)(C) appears to limit a shareholder's recognition of gain or loss for AFSI purposes to circumstances where the shareholder also recognizes gain or loss for tax purposes. In Example 7, if Parent and Subsidiary are not members of the same consolidated group, then this provision would logically apply and would prevent Parent from including its financial accounting gain or loss in AFSI.

Moreover, apart from Section 56A(c)(2)(C), the regulatory authority granted to Treasury in Section 56A(c)(15) specifically sanctions adjustments to AFSI to "carry out the principles of various parts of the tax Code relating to (i) liquidations, (ii) corporate organizations and reorganizations and (iii) partnership contributions and distributions."[96] It makes no mention of adjustments for nonrealization events. Still, the logic that compels adjusting AFSI to exclude financial accounting gain with respect to nonrecognition transactions applies with equal to force to financial accounting gain taken into account in similar nonrealization events. Parent's investment in Subsidiary is, in form and substance, unchanged; all that has happened is that Subsidiary has obtained fresh capital from a new investor.

Further, in situations such as Example 7, the distinction between a nonrealization event and a nonrecognition transaction enumerated in Section 56A(c)(15) is purely a matter of form. For example, in Example 7, the parties could have formed a new corporation, with Parent contributing all of its Subsidiary stock and Investor contributing cash, in each case for stock of the new corporation in a Section 351 exchange. In fact, this is broadly consistent with how financial accounting rules, with their robust single-entity view of consolidated groups, conceive of the deconsolidation in Example 7. If Parent's financial accounting gain from that Section 351 exchange is exempted from AFSI (under Section 56A(c)(2)(C) or Section 56A(c)(15)), then it does not seem logical that it would not also exempt gain from a substantively similar nonrealization event.

A similar issue arises when an investor that accounts for an investment using the equity method has its interest reduced through dilution. To illustrate, suppose that following the transaction in Example 7, Investor invested additional capital to increase its ownership

[96] Section 56A(c)(15).

percentage in Subsidiary by 10 percentage points, thereby reducing Parent's ownership percentage from 49% to 39%. For financial accounting purposes, Parent accounts for the dilution of its interest as if it had sold 10% of its interest, and therefore recognizes financial accounting gain or loss.

We recommend that Treasury issue regulations providing that where a taxpayer recognizes financial accounting gain or loss on the consolidation or deconsolidation of a subsidiary member of its AFS Group or the dilution of its ownership interest, the taxpayer's AFSI will be adjusted to the extent that it realized no gain or loss on the transaction for tax purposes. Consistent with Example 3, we recommend that Parent take a substituted AFSI basis in its Subsidiary stock, so that the gain in that stock is deferred rather than eliminated. As to whether Subsidiary should still benefit for AFSI purposes from the financial accounting asset basis step-up, we note that the same considerations that were discussed in relation to Example 3 apply here as well.

6. Other Issues

i. Basis Determinations with respect to Pre-Effective Date Transactions

The Notice indicates that if a Party received property in a Covered Nonrecognition Transaction occurring before the effective date of the CAMT, it must redetermine its financial accounting basis in that property for purposes of computing its AFSI pursuant to the Basis Adjustment Rule.[97] The Notice is silent as to whether the obligation to make such redeterminations applies to property acquired in taxable years ending before January 1, 2020—*i.e.*, years in which the taxpayer's AFSI has no potential effect on its future CAMT liability (such years "**Pre-CAMT Years**").[98]

The Notice requires adjustments to the basis of Section 168 property[99] and, in this context, the Notice is explicit that the adjustments are required for Section 168 property placed in service in a Pre-CAMT Year.[100]

The Notice also requires basis adjustments in connection with the exclusion of cancellation of indebtedness income and emergence from bankruptcy, respectively (collectively, "**Distressed Company Transactions**").[101] The Notice is silent as to whether these adjustments

[97] Section 3.03(a) of the Notice includes an example where a taxpayer acquires a target in 2022 in a Covered Nonrecognition Transaction. Financial accounting gain and corresponding basis increases as a result of the acquisition are not taken into account for the party's AFSI calculations.

[98] While the CAMT is effective for tax years beginning after December 31, 2022, a taxpayer's AFSI for the preceding three tax years is relevant to determining whether and when it is an applicable corporation, and thus subject to the CAMT.

[99] Section 4 of the Notice.

[100] Section 4.08 of the Notice includes an example that involves Section 168 property that was purchased and placed into service on January 1, 2018 and, in determining its basis in the property, the taxpayer must take into account tax financial accounting items from 2018 and 2019.

[101] Sections 3.06(2) and 3.07(2) of the Notice.

should apply with respect to transactions that occurred before the effective date of the CAMT or in Pre-CAMT Years.

Treasury should provide guidance as to how far back taxpayers need to look in order to apply these principles. We believe it may appropriate to limit the lookback period in some circumstances because requiring taxpayers to reconstruct their financial accounting basis from transactions that occurred many years prior will impose substantial compliance burdens on taxpayers. In fact, in many cases, it will be practically impossible for taxpayers to comply with a requirement to look back many years because they (or counterparties to their transactions) may no longer possess the historical books and records required to recompute their financial accounting basis.[102] We consider three alternatives below.

First, Treasury could provide guidance to the effect that any assets held by a taxpayer as of the first day of the first calendar year taken into account in the taxpayer's first AFSI Test (*i.e.*, January 1, 2020, for a calendar year taxpayer) should have a basis for AFSI purposes as of that time equal to its financial accounting basis as of that time, and AFSI basis adjustments with respect to the assets are made only from that date forward. There is some logic to this rule, as the treatment of transactions in Pre-CAMT Years will have no CAMT relevance to any taxpayer. Moreover, this rule would create symmetry with the statutory rule that permits FSNOL carryovers generated in tax years ending after December 31, 2019 to be carried forward.[103] However, always requiring taxpayers to look all the way back to 2020 will become increasingly burdensome as time goes by and Treasury should consider how to address situations where the books and records to support a basis computation simply do not exist.

Second, Treasury could instead require a taxpayer to look back some specified number of years. This approach has the advantage of limiting the burden on taxpayers, as it never requires looking back beyond a specified number of years. However, this would create an asymmetry for any taxpayer seeking to offset AFSI with FSNOL carryovers from years pre-dating the lookback.

Third, Treasury could provide a rule that links the lookback to the taxpayer's individual status. For example, it could say that a taxpayer's AFSI basis in its assets is equivalent to its financial accounting basis as of the first day of the first taxable year (i) for which the taxpayer is an applicable corporation, (ii) included in the taxpayer's first AFSI calculation that resulted in applicable corporation status or (iii) for which the taxpayer does not qualify for the Safe Harbor Method. This rule would alleviate what could otherwise be a substantial (and, in many cases, unrealistic) burden on non-applicable corporations to maintain records of their AFSI basis just in case they ever engaged in a nonrecognition transaction with an applicable corporation or became

[102] We observe that a longer "lookback" rule would have a lesser impact as regards Section 168 property compared to other property received in a Covered Nonrecognition Transaction or involved in a Distressed Company Transaction. By its nature, the basis of Section 168 property will be reduced to zero in a discrete period of time, which will mean that eventually the lookback rule will have no further relevance as regards this category of property. For example, suppose Treasury imposed an indefinite lookback rule. By 2023, any Section 168 property with a useful life of 10 years or less that was placed in service by 2013 now has a basis of zero, meaning that the lookback rule will not have any effect on it. By contrast, if a taxpayer had acquired a piece of non-depreciable property in a nonrecognition transaction at any time since 1913, it would need to go back and reconstruct its financial accounting basis over the prior 110-year period.

[103] *See* Section 56A(d).

an applicable corporation themselves. It would, however, also create an asymmetry for any taxpayer seeking to offset AFSI with FSNOL carryovers from years pre-dating the lookback.

Regardless of the lookback period Treasury chooses, it will need to consider a situation where a taxpayer acquires assets in a Covered Nonrecognition Transaction from a party that does not prepare an AFS. In this case, we recommend that Treasury permit the taxpayer to use its financial accounting basis without adjustment for purposes of computing its AFSI. While this result could be viewed as a windfall to acquirers in this situation, it would be difficult to require carrying over a financial accounting basis that had never been calculated simply because it had never been relevant. An anti-abuse rule in this context would perhaps be appropriate to police exploitation of the rule.

ii. Mark-to-Market Unrealized Gains and Losses with respect to Retained Stock in a D/355 Transaction

> **Example 8:** Distributing is a publicly traded applicable corporation and the parent of an AFS Group. On January 1, Year 1, Distributing forms Controlled, contributes appreciated assets to Controlled, and then distributes 81% the stock of Controlled to its public shareholders in a transaction that qualifies as a D/355 Transaction. On December 31, Year 1, Distributing uses the remaining 19% of the Controlled stock to retire its historical debt in a transaction that qualifies for nonrecognition treatment under Section 361(c)(3) (*i.e.*, a "debt-for-equity exchange").

From January 2 through December 31 of Year 1, Distributing accounts for its 19% investment in Controlled under the fair value method for financial accounting purposes. It therefore marks the Controlled stock to market on a quarterly basis, recognizing financial accounting gains and losses based on the difference between the stock's fair value and its financial accounting basis at the end of each quarter of its fiscal year.

Arguably, these mark-to-market unrealized gains and losses are excluded from the AFSI of the Distributing AFS Group under Section 56A(c)(2)(C), which, as discussed in Part IV.B.3.ii above, provides that the AFSI of a taxpayer with respect to a nonconsolidated corporation is determined only taking into account dividends received from the corporation and other amounts includible in gross income or deductible as a loss under the Code with respect to that corporation. However, the Notice requests comments on the extent to which guidance should provide adjustments to AFSI to disregard mark-to-market unrealized gains and losses that are otherwise included in AFSI, raising the possibility that Section 56A(c)(2)(C) does not apply to such items.

Assuming such gains and losses are not generally excluded from AFSI under Section 56A(c)(2)(C), it is unclear whether Distributing's mark-to-market unrealized gains and losses with respect to the retained Controlled stock arising during the three quarters between the distribution of Controlled at the end of Year 1 and the debt-for-equity exchange would be excluded from Distributing's AFSI under the Nonrecognition Rule. Section 3.03(1)(b) provides that the Nonrecognition Rule applies "solely to the AFSI consequences that result directly from Covered Nonrecognition Transaction for "the Party's taxable year in which the AFS of the Party takes into account that transaction." It is uncertain whether the mark-to-market unrealized gains

or losses in Example 8 result "directly" from the Covered Nonrecognition Transaction. On one hand, it could be argued that those gains or losses are directly from the Covered Nonrecognition Transaction in that there is a causal link between gains or losses and the Covered Nonrecognition Transaction: the gains or losses would not arise but for the D/355 Transaction. On the other hand, Section 3.03(1)(b) could be read more narrowly as limiting the scope of the Nonrecognition Rule to items resulting from the Covered Nonrecognition Transaction itself. According to this narrower reading, the Nonrecognition Rule would extend only to Distributing's financial accounting gains and losses resulting from the distribution of Controlled stock and the debt-for-equity exchange; it would not apply to Distributing's mark-to-market unrealized gains and losses with respect to the Controlled stock because those items are merely collateral consequences of a Covered Nonrecognition Transaction.

We believe that the latter restriction would undermine the policy concerns that prompted Treasury to provide nonrecognition treatment for Covered Nonrecognition Transactions. Accordingly, if mark-to-market unrealized gains and losses with respect to corporate stock are not generally excluded from AFSI under Section 56A(c)(2)(C), we urge Treasury to clarify that any mark-to-market unrealized gains and losses with respect to corporate stock occurring during the course of a multistep Covered Nonrecognition Transaction such as Example 8 are excluded from AFSI under the Nonrecognition Rule.

iii. Basis Determinations in Section 1032 Transactions

> **Example 9:** Parent, an applicable corporation, is the parent of an AFS Group that includes Target. Acquirer is the parent of an unrelated AFS Group that includes Acquirer Subsidiary. Parent transfers 100% of the stock of Target to Acquirer Subsidiary solely in exchange for Acquirer Subsidiary nonvoting preferred stock.

For tax purposes, the transaction is fully taxable to Parent. As to Acquirer Subsidiary, however, the transaction is tax-free under Section 1032(a). It is therefore a Covered Nonrecognition Transaction, and the Acquirer AFS Group is a Party to that transaction. Because the Target stock is transferred to the Acquirer "as part of" a Covered Nonrecognition Transaction, it could be argued that, under the Basis Adjustment Rule, the Acquirer AFS Group must take a transferred financial accounting basis in the Target assets for purposes of computing its AFSI. We recommend that Treasury clarify that the Basis Adjustment Rule applies only to the extent that financial accounting gain or loss was excluded from the AFSI of the transferor under the Nonrecognition Rule (unless Treasury determines more generally that purchase accounting adjustments in target assets in connection with taxable stock acquisitions should be disregarded AFSI purposes). This recommendation is similar, in principle, to our recommendation regarding partially tax-free transactions in Part IV.B.4.i above.

iv. Basis Determinations in Transactions Not Covered by the Notice

It is clear from the statute that, except as otherwise provided in the statute or in guidance from Treasury, the starting point for the AFSI computation is financial statement income. As described above, the Notice describes various situations where an applicable corporation must adjust its AFSI basis in its property. Presumably if an applicable corporation engages in a transaction before additional guidance is issued, and the Notice does not require a basis

adjustment in the property acquired in the transaction, then the applicable corporation can take an AFSI basis that property that is equal to its financial accounting basis, even if subsequent guidance provides for a different result for property acquired after the issuance of that future guidance. Treasury should confirm this point.

C. Determining Applicable Corporation Status and AFSI History After Corporate Combinations and Divisions

If a corporation or AFS Group undertakes an extraordinary transaction, such as a combination with another corporation or AFS Group or a division into two or more separate corporations (or AFS Groups), it will be important for that corporation (or AFS Group) to be able to evaluate the impact that extraordinary transaction will have on its applicable corporation status. We describe below certain common fact patterns and make recommendations as to how applicable corporation status should be determined with respect to each resulting corporation in each fact pattern.

1. Guidance under the Notice

The Notice provides guidance for determining the applicable corporation status and AFSI history of a corporation following three categories of transactions. The first is the acquisition by an AFS Group (an "**Acquirer AFS Group**") of the stock or assets of an entire AFS Group (a "**Target AFS Group**"). In such a case, the applicable corporation status of the Target AFS Group terminates, and the applicable corporation status and AFSI history of the combined group (the "**Test Group**") is generally determined by aggregating the AFSI of the Acquirer AFS Group and the Target AFS Group for each of the three preceding taxable years. We refer to this approach as the "**Aggregate Approach**".

The second category of transactions is the distribution by one AFS Group (the "**Distributing AFS Group**") of the stock of a controlled corporation ("**Controlled**") to the shareholders of the Distributing AFS Group's parent corporation. In that situation, the applicable corporation status of Controlled terminates, and the AFSI history of Controlled is determined based on Controlled's allocated portion of the Distributing AFS Group's AFSI. Pending the issuance of forthcoming proposed regulations, the allocation may be made based on "any reasonable allocation method," though the Notice does not provide any examples of reasonable allocation methods or any criteria for evaluating the reasonableness of a particular method. Significantly, the AFSI of the Distributing AFS Group is not reduced by the allocation of AFSI to Controlled.

The final category of transactions addressed by the Notice is a carve-out or similar acquisition by an Acquirer AFS Group of a subsidiary member of a Target AFS Group ("**Target**"), creating a new Test Group comprised of the Target and the Acquirer AFS Group. There, the applicable corporation status and AFSI history of the Target terminates, and the applicable corporation status and AFSI history of the Test Group comprised of Target and the Acquirer AFS Group is determined using a blend of the principles applicable to acquisitions and divisions described above. First, the AFSI history of Target is determined based on Target's allocated portion of its Target AFS Group's AFSI (the "**Target AFS Group**"), using any reasonable method. Then, the applicable corporation status and AFSI history of the Test Group is

determined by aggregating the AFSI of the Acquirer AFS Group and an allocated portion of the Target AFS Group's total AFSI for each of the three preceding taxable years. Again, the AFSI of the parent's AFS Group is not reduced by the allocation of AFSI to the Target.

For purposes of these rules, the Notice indicates that financial accounting principles, rather than legal form, control which entity is the Acquirer and which is the Target, and which is Distributing and which is Controlled.

2. Combinations of Entire AFS Groups

When an Acquirer AFS Group acquires an entire Target AFS Group—whether by way of a taxable stock purchase, a taxable merger, or a tax-free reorganization—the resulting Test Group will need to determine its applicable corporation status and AFSI history. As discussed below, there are various possible approaches for making such determinations. We first consider the policy considerations relevant to determining the purpose of the AFSI Test in the context of combinations of AFS Groups. We then evaluate the Aggregate Approach set forth in the Notice along with two alternatives: the *Pro Forma* Approach and the Successor Approach.

i. Policy Considerations

The premise underlying the Aggregate Approach appears to be that, in the case of a combination of AFS Groups, the AFSI Test should be applied so as to approximate the historical size of the Test Group as if it had been a single group during the three taxable years preceding the combination. This premise is debatable. In general, the purpose of the AFSI Test is to limit the scope of the CAMT to large, profitable corporations. Consistent with this purpose, the AFSI Test generally looks to the AFSI historically generated by a particular corporation, rather than the AFSI historically generated by any of its businesses. In light of this, one could question whether Congress intended that the applicable corporation status and AFSI history of a Test Group would be determined by constructing a counterfactual in which the Target AFS Group and Acquirer AFS Group belonged to the same corporate group for the three-taxable-year period before the combination when the two groups were in fact separate and unrelated during that period.

Applying the AFSI Test by reference to such a counterfactual may cause the Test Group to be an applicable corporation even if it never itself generates AFSI in excess of $1 billion in any year following the combination. For example, suppose that an Acquirer AFS Group and a Target AFS Group each had an average of $550 million of AFSI during the three taxable years preceding a combination. In connection with the combination, the Test Group divests of certain unwanted assets of the historical Target AFS Group, and the slimmed-down Test Group generates less than $1 billion in AFSI in every year following the combination. Aggregating the pre-combination AFSI histories of the Acquirer AFS Group and the Target AFS Group will cause the Test Group to be an applicable corporation as of the first year after the combination unless and until it is able to meet the status-shedding requirement of Section 59(k)(1)(C), even though the Test Group itself never meets the Congressionally specified size threshold for the CAMT. Significantly, this situation can materialize even in the absence of a divestiture, as the Test Group may have a very different capital structure and amount of leverage, such that it may expect to generate different amounts of income than the sum of its historic parts. In addition,

aggregating the pre-combination AFSI histories of the Acquirer AFS Group and the Target AFS Group for purposes of the AFSI Test will result in economically similar transactions having dramatically different CAMT consequences. To illustrate, assume the same facts as in the previous example, except that the target is a partnership. As a noncorporate entity, target is not a member of a Target AFS Group, and therefore its historical financial accounting income is not aggregated with the historical AFSI of Acquirer AFS Group for purposes of determining whether the combined company is an applicable corporation. Thus, unlike in the previous example, the combined company is not an applicable corporation following the transaction.

We note that Treasury has addressed similar issues in the context of other Code provisions with retrospective gross receipts tests. For example, the BEAT regime imposes a $500 million gross receipts test and, for this purpose, aggregates group members and looks back three years.[104] Regulations under the BEAT provide that a corporation will include in its calculations only those gross receipts of the other members of its group for periods during which those entities were group members.[105] In other contexts, though, Treasury has imported gross receipts history of joining members. For example, old regulations under a prior version of Section 263A included a three-year lookback for a gross receipts test. For this purpose, each group included three years of gross receipts of each entity that was a member of the group as of the first day of the applicable taxable year, regardless of whether each such entity had been a member for the entire three-year period.[106]

However, the AFSI Test implicates additional issues not relevant to the foregoing gross receipts tests because AFSI, unlike gross receipts, can be negative. As a result, aggregating the pre-combination AFSI of the Target AFS Group and the Acquirer AFS Group for purposes of the AFSI Test could also encourage acquisitions of loss companies, as a corporate group that was about to become an applicable corporation based on its own AFSI history could avoid this status simply by acquiring another corporate group with FSNOL carryovers over the three prior years (or significant built-in losses in its assets). Of course, Treasury may attempt to address this concern by applying principles similar to Section 382 principles to the use of FSNOL carryovers or by adding CAMT-specific principal purpose presumptions to the Section 269 regulations.

ii. The Aggregate Approach

If the purpose of the AFSI Test is to approximate the historical size of the Test Group as if it had been a single group preceding the combination, the logic of the Aggregate Approach is obvious, as it aggregates the AFSI histories of corporations that are, in fact, combining. Moreover, aggregating the AFSI histories of the Target AFS Group and Acquirer AFS Group is a relatively straightforward way of approximating the hypothetical size of the Test Group prior to the combination.

However, we note that Aggregate Approach would permit an applicable corporation that has experienced a recent decline in its average AFSI below the $1 billion threshold to shed its

[104] Section 59A(e)(1)(B) and (3).

[105] Treas. Reg. § 1.59A-2(c)(4)(i).

[106] Treas. Reg. § 1.263A-3(b)(3) [prior version].

status as an applicable corporation simply by combining with a corporation in a transaction in which it is the target under financial accounting principles. While a persistent decline in a corporation's AFSI may be grounds for terminating its status as an applicable corporation under generally applicable rules issued pursuant to Section 59(k)(1)(C), it does not appear appropriate to permit such a termination to be engineered by completing a combination transaction. Accordingly, if Treasury decides to retain the Aggregate Approach, we recommend supplementing it with a rule providing that in the case of an acquisition of an entire Target AFS Group, if either the Acquirer AFS Group or the Target AFS Group is an applicable corporation prior to the transaction, the Test Group will be treated as an applicable corporation after the transaction.

iii. The *Pro Forma* Approach

As an alternative to the Aggregate Approach set forth in the Notice, the parties could be required to construct a *pro forma* AFSI history for the combined group based on its members immediately after the combination transaction and their individual histories (the "***Pro Forma* Approach**"). Consistent with this principle, if any of the entities included in the combined group was an applicable corporation before the combination transaction, the combined group would inherit that status.

The *Pro Forma* Approach is similar to the Aggregate Approach in that it aggregates pre-combination AFSI of certain members of combining groups. But it differs from the Aggregate Approach in that it would not take into account entities that had previously been affiliated with one of the combining groups but that had been disposed of before the combination transactions. By taking into account only those entities that actually are part of the combined group immediately after closing, the historical data would more accurately approximate the current value of the combined group, but the applicable corporation status determination would still be based on a purely hypothetical group that never existed. This approach could be viewed as having a statutory basis if Section 59(k)(1)(D) is interpreted to aggregate all entities within the combined group together at the end of the year of the combination transaction, and references to the "corporation" throughout the AFSI Test in Section 59(k)(1) are interpreted to refer to that group of entities and its *pro forma* history. However, by requiring *pro forma* calculations that group together entities that were, in fact, never together, it would often introduce significant additional complexity.

iv. The Successor Approach

If Treasury determines that, in the case of a combination of AFS Groups, the AFSI Test should not be applied so as to approximate the historical size of the Test Group as if it had been a single group during the three taxable years preceding the combination, then the Test Group could inherit the applicable corporation status and AFSI history of one of the two combining groups (the "**Successor Approach**").

Under this approach, Treasury would need to determine a method for identifying which combining group's history would be inherited. One option would be to look to the rules under which the AFS is prepared, which, in most cases of U.S.-parented groups, will be GAAP. As we understand, the rules for determining acquirer status under GAAP are complex, nuanced, and

require significant discretion in their administration. We also understand that they take into account factors that are irrelevant here.[107] Therefore, we do not believe it would be appropriate to look to the rules under which the AFS is prepared.

In this connection, we note that the Notice determines the identity of the acquirer in a Covered Transaction combining groups and terminates the applicable corporation status (if any) of the target, based on the GAAP treatment of the transaction by the parties. We believe this is inappropriate and, as indicated above, believe a corporation should not cease to be an applicable corporation (other than by becoming part of the AFS Group of another applicable corporation) as a result of a combination transaction.

Instead of using the Notice's approach, a more logical alternative would be to compare each combining group's AFSI history and whichever group's AFSI history over the three-year period preceding the year of the closing is higher would generally be the AFSI history for the Test Group. However, this rule would be subject to an exception for cases where the group with the lower AFSI history was already an applicable corporation and the group with the higher AFSI history was not. In that case, the Test Group should be an applicable corporation, with the normal status-shedding rule under Section 59(k)(1)(C) determining when the Test Group ceases to be an applicable corporation. Treasury would need to provide guidance as to which combining group's AFSI history would be taken into account when applying Section 59(k)(1)(C) in such a case.

The Successor Approach just described would be administratively simple, as it would not require hypothetical or *pro forma* calculations; all it would require would be a comparison between each corporate group's AFSI history, which each corporate group should have readily available for purposes of making its own applicable corporation status determination.[108] There is also logical appeal to identifying one of the combining companies as the acquirer and continuing to test that (now larger) group, while no longer testing the acquired group. The concern about encouraging acquisitions of loss companies that was identified with respect to the Aggregate Approach and the *Pro Forma* Approach would not be present here; under those other two approaches, a corporation that had high enough AFSI to be on the verge of becoming an applicable corporation would be able to reduce its three-year AFSI history by acquiring a loss company. By contrast, under the Successor Approach, the corporation's AFSI history would be unaffected by acquiring a loss company.

Lastly, compared to the Aggregate Approach and the *Pro Forma* Approach, the Successor Approach produces results that more closely align with an acquisition by one combining group of the assets of the other combining group. While it is true that in an asset deal the parties can choose which group is the acquirer and therefore which group's AFSI history is relevant going forward, in most cases it is the larger of the two companies that is acquiring the assets of the smaller. While that choice is not technically available here because the approach requires the larger of the two groups to be the predecessor, in many cases, the larger group would

[107] *See, e.g.,* ASC 810-10, 805-10-55-11, and 805-10-55-12.

[108] If Treasury permits a corporation to use a simplified method of determining applicable corporation status, and either of the combining companies uses that method, it should be entitled to also use that method for purposes of determining its AFSI history under the Successor Approach.

be the logical choice for acquirer in an asset deal anyway, so the results of the two approaches, while not identical, are a reasonably close fit.

v. Comparison of Alternatives

Below we compare alternative approaches described above in the context of two examples. For the sake of simplicity, we focus on the Aggregate Approach and the Successor Approach. The application of the *Pro Forma* Approach is not illustrated because it would require detailed facts regarding the corporate histories of the two combining groups.

> **Example 10:** Target is the parent of an AFS Group and Acquirer is the parent of another unrelated AFS Group. Neither is an applicable corporation. The Target AFS Group generates $200 million of AFSI losses in each of Years 1 through 3. The Acquirer AFS Group generates $900 million of AFSI in years 1 and 2 and $1.3 billion of AFSI in Year 3. On the last day of Year 3, Acquirer acquires Target. The combined entity ("**CombinedCo**") generates $1.1 billion and $1.2 billion of AFSI in Years 4 and 5, respectively.

	Acquirer	Target	Acquirer + Target	CombinedCo
Year 1	900	(200)	700	
Year 1	900	(200)	700	
Year 3	1,300	(200)	1,100	
Year 4				1,100
Year 5				1,200

In the absence of a combination transaction, Acquirer would have become an applicable corporation in Year 4 because its average AFSI in Years 1 through 3 exceeds $1 billion. Under the Successor Approach, CombinedCo likewise would become an applicable corporation in Year 4. Under the Aggregate Approach, however, CombinedCo would not become an applicable corporation until Year 6 because (absent guidance from Treasury applying Section 382 principles) Target's standalone losses would "shelter" Acquirer's income in the years before the combination transaction. Acquirer could thus delay its applicable corporation status for two years simply by acquiring a loss company. This approach therefore arguably incentivizes acquisitions of loss companies.

> **Example 11:** Assume the same facts as Example 10, except that the Target AFS Group generates $100 million of AFSI in Years 1 through 3 and the Acquirer AFS Group generates $950 million of AFSI in Years 1 through 3. After the combination, CombinedCo generates $1.05 billion of AFSI in Year 4 and $1.2 billion of AFSI in Year 5.

	Acquirer	Target	Acquirer + Target	CombinedCo
Year 1	950	100	1,050	
Year 1	950	100	1,050	
Year 3	950	100	1,050	
Year 4				1,050
Year 5				1,200

Under the Aggregate Approach, CombinedCo would be an applicable corporation in Year 4 since Acquirer and Target's combined average AFSI in Years 1 through 3 exceeds $1 billion. In other words, CombinedCo would be an applicable corporation in the very first year that the combined group existed because the aggregate of the two combining group's histories exceeded the threshold, even though those groups were, in fact, separate in those prior years. Under the Successor Approach, by contrast, CombinedCo would not be an applicable corporation until Year 6, which is the first year where the AFSI history of a corporate group that actually existed exceeded the threshold.

Under the Successor Approach, even if both Acquirer and Target were very close to meeting the AFSI Test before the combination, as long as neither Acquirer nor Target was an applicable corporation before the combination, the combined company will never be an applicable corporation in Year 4; Year 5 will always be the first year CombinedCo could be an applicable corporation. If, in Example 11, Target had had much more income in Years 1-3—say, for example, $900 million—then under the Successor Approach, CombinedCo would still not be an applicable corporation in Year 4. It may be an applicable corporation in Year 5, though, if it generates sufficient AFSI in Year 4 to meet the AFSI Test. Notably, these results are entirely consistent with the results that would obtain if Acquirer were to acquire Target's assets, rather than the Target itself. In that case, the only impact on Target's applicable corporation status would be that Target's AFSI in years after the acquisition would reflect the income or loss generated by the acquired business.

vi. Recommendation

On balance, the Executive Committee believes that the Successor Approach is the best approach for determining the applicable corporation status and AFSI history of a Test Group following a combination of two AFS Groups.

3. Divisions of an AFS Group

In the discussion that follows, we consider approaches for determining applicable corporation status and AFSI history of the resulting entities and groups when a subsidiary member of an AFS Group leaves that group in a divisive transaction — that is, a tax-free or taxable distribution of the subsidiary's stock, an issuance of stock by the subsidiary that results in its deconsolidation, or a taxable or tax-free disposition of the subsidiary's stock to a non-corporate acquirer. However, because we believe that different rules should apply depending on whether the subsidiary (or the tax consolidated group of which it is a member) is an applicable corporation prior to the division, we begin with a brief discussion of the rules for determining

which entities within a corporate group meeting the AFSI Test are considered applicable corporations.

i. Determining Applicable Corporation Status Prior to a Division

A corporation's AFSI for a particular taxable year is the net income or loss of the corporation set forth on its AFS for the taxable year, subject to certain adjustments.[109] A special rule provides that, solely for purposes of determining whether a corporation is an applicable corporation, all AFSI of each entity treated as a single employer with that corporation under Section 52(a) or (b) will be treated as AFSI of that corporation.[110] Arguably, therefore, if a group of corporations that are collectively treated as a single employer have sufficient AFSI in the aggregate to meet the AFSI Test, then each entity within that group could be considered an applicable corporation because each entity within that group will be attributed the income of each other entity in the group and will therefore itself meet the AFSI Test.

With respect to members of a tax consolidated group, however, the analysis is different. The statute provides that if a corporation is part of a consolidated group in a particular tax year, the AFSI for the group takes into account items on the group's AFS for that year that are properly allocable to members of the group.[111] The reference to the group's AFSI suggests that the AFSI—and, therefore, applicable corporation status—applies to the group as a whole, rather than to any individual entity. The Notice confirms this result: a tax consolidated group is treated as a single entity for purposes of determining applicable corporation status and for purposes of calculating AFSI.[112] Thus, when a tax consolidated group breaks apart, the question arises as to which members (or groups of members) continue to be applicable corporations.[113]

ii. Divisions Not Involving an Applicable Corporation

> **Example 12:** Parent, a publicly traded corporation that is not an applicable corporation, is the common parent of an AFS Group that includes Subsidiary. Parent distributes all the stock of Subsidiary to its shareholders.

Because Parent was not an applicable corporation immediately before the division, neither Parent nor Subsidiary should be an applicable corporation after the division.[114] However,

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[109] Section 56A(c)(2)(A).

[110] Section 59(k)(1)(D).

[111] Section 56A(c)(2)(B). Congress specified that Treasury may define exceptions to this rule in regulations.

[112] Section 3.05 of the Notice.

[113] Likewise, when new members join a group that is already an applicable corporation, those members can also take on that status even though they have not previously been applicable corporations. Combination transactions are discussed above in Part IV.C.2.

[114] We note that if, on a standalone basis, the Parent AFS Group had $1 billion of AFSI losses over the three-year period preceding the division, and Subsidiary had $1.5 billion of AFSI over the same period, under this approach, neither Parent nor Subsidiary would be an applicable corporation in the first year after the division. The second year after the division would be the first year either company could be an applicable corporation.

each must determine its AFSI history to assess whether it will be an applicable corporation in future years.

The approach adopted in the Notice for determining Subsidiary's AFSI history is to allocate a portion of the Parent AFS Group's total AFSI to Subsidiary. We believe that allocating Subsidiary a portion of the AFSI of the Parent AFS Group is a reasonable approach for determining Subsidiary's AFSI history. Regarding basis for the allocation, one plausible option would be to require each of Parent and Subsidiary to prepare its *pro forma* historical financial statements and compute its hypothetical AFSI history accordingly. While this may produce results that more accurately capture the financial history of each group, the administrative and computational costs and complexities may be significant, and some members of the Executive Committee question the fairness of requiring the Parent and Subsidiary groups to shoulder those burdens when the combined Parent-Subsidiary group was not an applicable corporation immediately before the division. Notably, the administrative burden may be particularly heavy if the composition of Subsidiary's assets changes significantly during the three taxable years preceding the division.

Under the Notice, the AFSI of the Parent AFS Group is not reduced by the allocation of AFSI to Subsidiary. Thus, the allocated portion of the Parent AFS Group's AFSI is duplicated in the AFSI history of the Parent AFS Group and Subsidiary. We question whether this duplication is appropriate.

While an allocation-based approach may be a reasonable approach for determining the AFSI history of Parent and Subsidiary, other alternatives are possible. For instance, in lieu of an allocation, Parent and its remaining subsidiaries could inherit the AFSI history of Parent, and Subsidiary could be considered newly formed. This approach has the benefit of simplicity and would work logically when a small subsidiary leaves a large group. However, it would reach counterintuitive results where a large subsidiary leaves behind a smaller group.

To address this concern, Treasury could adopt a rule that would require the parties to compare the relative sizes (based on value) of Parent and the Subsidiary group immediately after the division, and, regardless of the form of the division, the larger of the two groups would inherit the historic Parent Tax Group's AFSI history. The other group would be considered newly formed for purposes of determining applicable corporation status.[115] Treasury would need to specify acceptable methods for determining the value of each group. For example, the Parent AFS Group and Subsidiary could compare their enterprise value at the time of the division based on stock price or (if relevant) as implied by deal terms.[116] Methods that require Parent and Subsidiary to compare their historical value over a specified period of time may run into similar administrative and computational difficulties discussed above. Proponents of this approach point to the fact that no *pro forma* calculations would need to be done, and no analysis would need to be done around hypothetical groups that did not exist as separate groups before the division.

[115] If either Subsidiary or Parent becomes an ineligible entity (an S corporation, a regulated investment company, or a real estate investment trust) after the division, Treasury should consider whether the other group (assuming it is an eligible corporation) should automatically assume that entity's AFSI history.

[116] Some members expressed a concern that comparing enterprise value at a single time point may be distortive.

iii. Divisions Involving an Applicable Corporation

Example 13: The facts are the same as in the previous example, except that Parent was an applicable corporation prior to the division.

We believe that if Parent was an applicable corporation immediately before the disposition, at least one of Parent or the Subsidiary should inherit the applicable corporation status, and then continue to be subject to the normal status shedding rules under Section 59(k)(1)(C). Had the division not occurred, Parent would have remained an applicable corporation—even if its AFSI had recently dipped below the $1 billion threshold—unless and until the normal shedding rule applied. We do not see any reason there should be a greater opportunity to shed applicable corporation status simply because of a divisive transaction.

This approach would require two rules. First, there would need to be a rule for identifying, as between Parent and the Subsidiary, which one inherits the applicable corporation status. One plausible basis would be for Parent to retain its applicable corporation status in all cases. Following the "direction" of the transaction would produce a logical result in a case where the business being separated from a group is smaller than the remaining business. However, it would produce an odd (and unfair) result in a case where Parent disposed of a very large business and retained a smaller business (in a reverse spin, for example); in that case, the Subsidiary should take on the applicable corporation status. In light of this, we believe that the larger of Parent and the Subsidiary, as of immediately after the division, should inherit the applicable corporation status. As above, relative sizes could be determined based on enterprise values.

By comparison, we note that under the approach in the Notice, if Parent is an applicable corporation prior to the distribution and is treated as the distributor for GAAP purposes, then Subsidiary does not inherit Parent's applicable corporation status; instead, it appears Parent automatically continues to possess that status. We believe an approach based on relative size or other relevant objective characteristics of the distributing and distributed corporation should be considered, as an alternative to the Notice's approach.

Second, there would need to be a rule for determining whether the smaller of Parent and the Subsidiary is also an applicable corporation immediately after the division. The smaller group could be considered a newly formed entity. This approach has some logical appeal where the smaller group is truly small, but it is less appealing where the smaller group is enormous and clearly large enough to satisfy the AFSI Test in its own right. In this latter case, treating the smaller group as a new corporation would essentially give that smaller group one "free" year where it was not an applicable corporation. To illustrate, suppose that Parent had over $100 billion in AFSI in every year in recent memory, roughly half of which is attributable to Subsidiary. We think it is clear that both Parent and Subsidiary should be applicable corporations immediately after the division. By contrast, if Subsidiary represents a small division valued at less than $10 million, we think it is equally clear that Subsidiary should not be an applicable corporation. Accordingly, we think a rule that provides that the smaller group is newly formed unless it meets a specified size threshold, in which case it would be an applicable corporation, would be appropriate.

In order to determine the size threshold, one approach would be to presume that the AFSI Test would have been met had the smaller group been a standalone group for the prior three years, unless the smaller group prepares *pro forma* historic financial statements that demonstrate that the AFSI Test would not have been met.[117] However, for reasons similar to those discussed above, it may be impractical to determine the *pro forma* AFSI history.

Another approach would be to presume that the AFSI Test would have been met had the smaller group been a standalone group for the prior three years if the smaller group's AFSI exceeds $1 billion (or another specified threshold) in the first taxable year ending after the division, in which case the smaller group would also be an applicable corporation for that first tax year. This approach has the benefit of simplicity. But using only a single year could be somewhat distortive, particularly if that single year were a short tax year and the corporation in question operated a seasonal business. While taxpayers would be incentivized to artificially depress AFSI in that first year, the strong incentives reporting entities typically have to increase their book income would in many circumstances act as a counterweight to this incentive but may of course fall short in certain circumstances — including, for example, where the short year was so short as to be of little consequence to investors or where the reporting entity was a private company not subject to the same pressure to report high earnings as public companies. It would be prudent, therefore, to include an anti-abuse rule targeting this type of manipulation and to potentially limit the availability of this rule to situations where abuse is unlikely.

We think the latter approach strikes a better balance between compliance burden and policy concerns over inappropriate shedding of the applicable corporation status. We acknowledge that a rule based on the AFSI of the first tax year ending after the closing of the division may produce different results compared to an approach based on historic AFSI in tax years leading up to the closing of the transaction (which was the approach when two AFS Groups combine, as discussed in Part IV.C.2 above). However, we believe the application of the CAMT regime needs to be balanced with administrative feasibility when a standalone AFSI history does not otherwise exist.

In the event both Parent and the Subsidiary are applicable corporations in the first tax year ending after the closing of the division, Treasury should consider rules for allocating Parent's CAMT attributes between Parent and the Subsidiary.

4. Carve-outs from AFS Groups

When a subsidiary member of the Target AFS Group (*i.e.*, Target) leaves the Target AFS Group and joins another AFS Group (*i.e.*, the Acquirer AFS Group), Treasury should prescribe rules that would determine the applicable corporation status of the resulting Test Group consistent with the principles discussed in Parts IV.C.2 and IV.C.3. Specifically, we recommend first using rules described in Part IV.C.3 to determine whether Target would be an applicable corporation if it were a standalone corporation, then applying rules described in Part IV.C.2 above to determine the applicable corporation status and AFSI history of the Test Group.

[117] Presumably if Treasury makes available a safe harbor for determining AFSI on a simplified basis for scope purposes, that safe harbor should be available for purposes of this calculation.

To illustrate this approach, suppose that Distributing, an applicable corporation and the parent of an AFS Group, spins off Controlled, a member of the Distributing AFS Group, and Controlled then merges with a third party, Acquirer, which is not an applicable corporation and is the parent of an unrelated AFS Group, as part of a plan that includes the spin-off. If the Distributing AFS Group is larger than Controlled, the Distributing AFS Group will continue to be an applicable corporation and the Distributing AFS Group's AFSI history will continue to be its AFSI history. If Controlled is even slightly below the applicable size threshold described above, Controlled will be considered newly formed. If Controlled is also larger than Acquirer, then the Test Group composed of Controlled and the Acquirer AFS Group will inherit Controlled's AFSI history and will, therefore, be considered newly formed. As a result, the Test Group will test for applicable corporation status for the first time in the second year after the transaction.

D. Simplified Procedure for Computing AFSI for Purposes of Determining Applicable Corporation Status

As noted above, AFSI must be calculated for two separate purposes: scope purposes—*i.e.*, determining whether a corporation is an applicable corporation—and, if it is an applicable corporation, liability purposes. As noted above, the starting point for computing AFSI is net income or loss reflected on an AFS, and then various adjustments are made.[118] AFSI is therefore not equivalent to taxable income and not equivalent to book income. Just how different it is from book income—and therefore the administrative burden that will likely be associated with computing AFSI—will depend on additional guidance Treasury ultimately issues but, even based on the statute and Notice alone, there will be meaningful differences between book income and AFSI. For example, AFSI will be reduced by tax—rather than book—depreciation deductions attributable to Section 168 property (defined below).[119]

Certain differences between book income and AFSI will need to be tracked year-to-year.[120] In those cases, AFSI computations will necessitate the creation and maintenance of a separate set of books and records, which may require significant system build and will be impractical for many companies to accomplish in the short term, particularly growing companies that are active in acquisitions. Some of these differences can arise even before a corporation becomes an applicable corporation.

If a corporation calculates its AFSI and determines it is an applicable corporation, then it will need to recalculate its AFSI in order to compute its CAMT liability. If, however, the corporation determines that it is not an applicable corporation, then the entire burden of calculating AFSI will have been in aid of determining that the CAMT does not apply to it. By definition, therefore, the CAMT regime will impose an administrative burden on a subset of

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[118] As described in more detail in Part II.B.3 above, these various adjustments differ somewhat, depending on whether AFSI is calculated for scope purposes or liability purposes.

[119] Section 56A(c)(13).

[120] For example, in Part IV.E.3 below, we discuss adjustments required by the Notice to AFSI on the sale (or deemed sale) of Section 168 property to account for accelerated depreciation deductions previously included in AFSI, and in Part IV.B above we discuss the possibility of adjustments to AFSI to preserve gain or loss where the financial accounting basis in assets is increased with no corresponding AFSI gain or loss inclusion.

corporations that fall outside of its intended reach.[121] An important question for Treasury to consider will be which corporations should fall within that subset and which should be entitled to some form of relief.

Based on the statute as drafted, every corporation—*no matter how small and how clearly it is not an applicable corporation*—must compute its AFSI for purposes of determining whether it is an applicable corporation. For small enough corporations, the administrative burden of undertaking this exercise hardly seems worthwhile. Moreover, it is clear that Congress expected only a small number of corporations to actually pay tax under CAMT. It is hard to imagine Congress also intended to add significant compliance burdens to *all* corporations, regardless of size.[122] Further, Congress appears to have intended that AFSI calculations for scope purposes could be a simplified version of the full AFSI determination, as it directed Treasury to issue regulations or other guidance providing a simplified method for determining whether a company is an applicable corporation.[123] In other areas of the Code, Treasury has also permitted simplified assumption rules based on readily available information.[124] Notably, the OECD/G20 Inclusive Framework on BEPS has likewise provided certain safe harbors for purposes of Pillar 2 based on simplified determinations.[125]

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[121] Not only will an administrative burden fall on corporations, but certain partnerships whose income is included by corporate partners will also need to compute their AFSI. In addition, certain individuals could even need to compute AFSI as a result of the aggregation rules under Section 52(b) that are incorporated by Section 59(k)(1)(D). For purposes of simplicity, however, this part of the Report references only the burden placed on corporations.

[122] On August 1, 2022, the Joint Committee on Taxation, working with a prior version of the Senate bill, projected that "only approximately 150 taxpayers annually will be subject to the proposed book minimum tax." Letter from Thomas A. Barthold, Chief of Staff, Joint Comm. on Tax'n, to Ron Wyden, Chairman, S. Comm. on Fin. (Aug. 1, 2022), https://www.finance.senate.gov/imo/media/doc/CAMT%20JCT%20Data.pdf. It is suggested that Senate Democrats lowered the estimate to 125. *See* Jasper L. Cummings, Jr., *The 2022 Corporate AMT*, TAX NOTES (Oct. 11, 2022), https://www.taxnotes.com/tax-notes-today-federal/alternative-minimum-tax/2022-corporate-amt/2022/10/11/7f5rg?. Some commentators estimated 90. *See* Martin. A. Sullivan, *Tax Credits and Depreciation Relief Slash Burden of New Corporate AMT*, TAX NOTES (Aug. 22, 2022), https://www.taxnotes.com/tax-notes-federal/corporate-alternative-minimum-tax/tax-credits-and-depreciation-relief-slash-burden-new-corporate-amt/2022/08/22/7dypn.

[123] Section 59(k)(3).

[124] *See, e.g.*, Treas. Reg. § 1.897-2(b)(2)(i) (the fair market value of a corporation's U.S. real property interests is presumed to be less than 50% of the fair market value of the aggregate assets if, on an applicable determination date, the total book value of the U.S. real property interests held by the corporation is 25% or less of the book value of the aggregate of the corporation's assets).

[125] *See* OECD (2020), *Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two)*, OECD/G20 Inclusive Framework on BEPS (Dec. 20, 2022) https://www.oecd.org/tax/beps/safe-harbours-and-penalty-relief-global-anti-base-erosion-rules-pillar-two.pdf. As noted above in note 66, we have not generally cited the Inclusive Framework's approach, but we do think it is instructive to observe that the Inclusive Framework has clearly acknowledged the complexity associated with the computations under Pillar 2's minimum tax regime and has found it appropriate to provide relief to smaller taxpayers. Of course, the usefulness of this comparison is limited by the fact that the Pillar 2 and CAMT regimes are very different and therefore present different practical and computational challenges.

1. Guidance under the Notice

The Notice provides that, for the first taxable year beginning after December 31, 2022 (*i.e.*, the first taxable year to which the CAMT applies), a corporation may choose to apply a simplified safe harbor method described in the Notice (the "**Safe Harbor Method**") in lieu of the statutory AFSI Test for purposes of determining whether it is an applicable corporation.[126]

Under the Safe Harbor Method, the corporation applies the AFSI Test with the following four modifications:

1. The $1,000,000,000 threshold in Section 59(k)(1)(B)(i) (including for purposes of Section 59(k)(1)(B)(ii)(I)) is lowered to $500,000,000;[127]

2. The $100,000,000 threshold in Section 59(k)(1)(B)(ii)(II) is lowered to $50,000,000;[128]

3. In determining AFSI, many of the adjustments to book income normally required under Section 56A(c) and (d) are ignored;[129] and

4. If a corporation's AFS year is different from its taxable year, it may apply the AFSI Test on the basis of its AFS year, rather than its taxable year.[130]

A corporation's AFSI computed under the Safe Harbor Method is referred to in this Report as its "**Modified AFSI**." If a corporation's Modified AFSI exceeds the relevant thresholds specified in the Notice, then the corporation will determine its applicable corporation status under the statutory AFSI Test.[131]

2. Commentary

We agree that there should be a simplified method of calculating AFSI for corporations that are small enough to clearly not be applicable corporations, and we have the following suggestions aimed at refining the approach.

i. Indefinite Safe Harbor

We recommend that Treasury make the Safe Harbor Method available to all corporations indefinitely. The basis for this recommendation is a concern for the administrative burden that will be imposed on small corporations in the absence of such a safe harbor. As a practical matter, small enough corporations that are clearly not applicable corporations are not likely to go to the

[126] Section 5.03(1) of the Notice.

[127] Section 5.03(2)(a) of the Notice.

[128] Section 5.03(2)(b) of the Notice.

[129] Section 5.03(2)(c) of the Notice.

[130] Section 5.03(2)(d) of the Notice.

[131] Section 5.03(4) of the Notice.

trouble of engaging in detailed AFSI calculations to prove they are not applicable corporations. Likewise, while some IRS agents may require those calculations in all circumstances, we expect that many IRS agents will likely not require those calculations where the outcome is obvious enough in advance—although different agents will likely apply different criteria for determining whether the outcome is obvious enough. Moreover, any public company that determines it is not an applicable corporation will need its financial accounting auditors to sign off on that determination.[132] In the absence of a safe harbor, it is likely that the accounting firms that serve in this role will develop their own standards for when AFSI must be calculated precisely and when a company is small enough that it need not engage in those calculations. In light of these practicalities, it would seem odd to deliberately create a situation where enforcement of the rules is highly likely to be uneven, and where a large number of smaller corporations—and their IRS auditors—are inevitably going to operate outside of the technical requirements of the rules simply because doing otherwise would be impractical. It would seem more sensible for Treasury to provide that corporations that are "small enough" do not need to do detailed AFSI calculations but instead can use the Safe Harbor Method on an ongoing basis, and to clearly define what "small enough" means for this purpose.

We understand that Treasury performed detailed statistical analyses to determine the thresholds for the Safe Harbor Method and acknowledge that different thresholds may be appropriate if the Safe Harbor Method were made available indefinitely.

We also acknowledge that permitting indefinite use of the Safe Harbor Method may create incentives for corporations to manipulate their reported book income to avoid applicable corporation status; this risk is greatest for privately held corporations that are not under as much pressure as public companies to reflect high earnings for shareholders.[133] We think this concern could be adequately addressed by setting the threshold low enough and by including a general anti-abuse rule.

ii. Applying the AFSI Test in Post-Safe Harbor Years

If a corporation makes use of the Safe Harbor Method to determine that it is not an applicable corporation in a particular tax year, then that corporation will need guidance as to how to apply the AFSI Test in any subsequent year for which the Safe Harbor Method is not available.

Example 14: Corporation is a domestic corporation that is a calendar year taxpayer. Corporation generated $450 million of Modified AFSI in each of 2020, 2021 and 2022.

[132] Many private companies also must prepare audited financial statements for a variety of reasons; these companies would also need auditor approval of any determination as to applicable corporation status.

[133] Private companies are, of course, still motivated to report high earnings to their existing and potential future creditors and, in some cases, equity investors. However, this motivation is often not as strong as for public companies (for example, although creditors may consider reported earnings, they also focus upon the soundness of the borrowing corporation's cash flow statements, projections, and balance sheet).

Applicable corporation status in 2023. Corporation's average annual Modified AFSI over the 2020-2022 period is $450 million. As a result, Corporation can apply the Safe Harbor Method to determine it is not an applicable corporation for 2023.

Applicable corporation status in 2024. If Treasury does not make the Safe Harbor Method available for 2024, then Corporation will need to apply the statutory AFSI Test to determine its applicable corporation status for 2024. Even if Treasury does make the Safe Harbor Method available for 2024, if Corporation had, say, $630 million of Modified AFSI in 2023, then its average annual Modified AFSI over the 2021-2023 period would be $510 million, which exceeds the $500 million threshold. In either case, Corporation would then need to apply the statutory AFSI Test, which would require calculating its AFSI for 2021 and 2022, but Corporation would not have previously done these calculations, as it had taken advantage of the Safe Harbor Method for its 2023 applicable corporation determination.

Treasury could provide that, where a corporation makes use of the Safe Harbor Method to determine that it is not an applicable corporation for a particular tax year, then it does not have to calculate its AFSI for any year included in the three-year reference period for that year. Instead, it is entitled to continue to use the modified AFSI for each of those years when applying the AFSI Test for any subsequent year. It could further provide that the thresholds for any year where Modified AFSI is used for at least one year in the three-year reference period are a weighted average of the statutory thresholds and the thresholds specified in the Safe Harbor Method under the Notice. In Example 14, Corporation used the Safe Harbor Method to determine it was not an applicable corporation for 2023. Under this approach, Corporation would be entitled to continue to use the Modified AFSI for 2021 and 2022 in its AFSI Test for 2024, and the applicable threshold would be $667 million. Likewise, Corporation would be entitled to continue to use the Modified AFSI for 2022 in its AFSI Test for 2025, and the applicable threshold would be $833 million.

The benefit of this approach is that a corporation that qualified to use the Safe Harbor Method could take comfort in not performing a full AFSI calculation for the years at stake. If, by contrast, Treasury required a full AFSI calculation for the three prior years as soon as a corporation did not qualify for the Safe Harbor Method, then the Safe Harbor Method's usefulness would be substantially curtailed. We do acknowledge, though, that this approach would incentivize a corporation that currently qualified for the Safe Harbor Method but that expected to soon cease to qualify to engage in transactions that would provide a CAMT benefit once it no longer qualified.

iii. Transition Rules for Operating Losses

If a corporation that has been using an AFSI Safe Harbor to determine it is not an applicable corporation then becomes an applicable corporation, it would then need to calculate its AFSI for the current year in order to calculate its CAMT liability for that year. In calculating its CAMT liability, its AFSI would be reduced for any FSNOL carryovers. If the corporation's Modified AFSI for a prior year reflected a loss, and if the corporation had relied on the Safe Harbor Method in that loss year to determine it was not an applicable corporation in a future year, then it would never have calculated its AFSI for that loss year. Treasury should consider whether the corporation could use its Modified AFSI loss to determine its FSNOL carryover, or

whether it would need to go back and compute its AFSI under the regular rules for purposes of determining its carryover.

On one hand, one could argue that if the corporation wants the benefit of an attribute, it is not at all unreasonable to expect that corporation to go to the trouble of calculating the attribute precisely. On the other hand, the purpose of the Safe Harbor Method presumably is to reduce the compliance burden for a corporation that is clearly not an applicable corporation. It would be significantly less useful to tell a corporation that it need not compute its AFSI to determine that it is not an applicable corporation, but to go on to tell that same corporation that it may, in fact, need to compute its AFSI for that year at a later date in order to benefit from its loss.

We note that Treasury should coordinate its guidance on this issue with its guidance on how far a taxpayer must look back to determine the AFSI basis in its assets discussed above in Part IV.B.6.i. For example, one potential approach discussed in regard to the latter issue was to permit a taxpayer to assume its AFSI basis in its assets was equal to its financial accounting basis in those assets as of the first day of the first taxable year for which the taxpayer does not qualify for the Safe Harbor Method. If Treasury adopted this approach, then Treasury should not permit FSNOL carryovers to be carried forward from years during which the taxpayer qualified for the Safe Harbor Method.

3. Scope of Entities Included in Safe Harbor Method Calculation

As noted above, the statutory AFSI Test is based on the AFSI of the relevant corporation, adjusted in various ways to take into account income and loss items attributable to certain related entities.

First, Section 56A(a) provides that a corporation's AFSI for a particular taxable year is the "net income or loss of the taxpayer set forth on the taxpayer's AFS for such taxable year,"[134] Section 56A(b) defines AFS by reference to Section 451(b)(3),[135] and Section 56A(c)(2)(A) provides that if the taxpayer's financial results are reported on the AFS for a group of entities, rules similar to the rules of Section 451(b)(5) will apply.[136] Section 451(b)(5) provides generally that if a taxpayer's financial results are reported on the AFS for a group of entities, the AFS will be treated as the AFS of the taxpayer, and the Treasury Regulations thereunder specify how to determine the amount of AFS revenue reflected on the group's AFS that is allocated to the taxpayer (the "**AFS Determination Rule**").[137] Section 56A(c)(2)(B) provides an aggregation principle for members of a U.S. tax consolidated group (the "**Consolidated Group Aggregation Rule**"), while Sections 56A(c)(2)(C) and (D) and Section 56A(c)(2)(3) provide inclusion rules for items attributable to non-consolidated corporations, partnerships and controlled foreign corporations, respectively (together, the "**Related Entity Rules**"). Taken together, therefore, these rules prescribe how to isolate the taxpayer's AFS revenue on the AFS for its AFS Group,

[134] Section 56A(a).

[135] Section 56A(b).

[136] Section 56A(c)(2)(A).

[137] Treas. Reg. § 1.451-3(h)(1)-(3).

and which income and loss items attributable to various other entities are also included in the taxpayer's AFSI calculation.

Second, Section 59(k)(1)(D) provides that, solely for purposes of computing AFSI for scope purposes, a corporation takes into account the AFSI of all persons treated as a single employer with that corporation under Section 52(a) or (b).[138] This rule is referred to as the **"Employer Aggregation Rule**."

The AFS Determination Rule, Consolidated Group Aggregation Rule, Related Entity Rules, and Employer Aggregation Rule, taken together, mean that a corporation's AFSI for scope purposes includes all the income and loss of that corporation and of any other person that is treated as a single employer with the corporation under Section 52(a) or (b), and various items attributable to certain other related entities.

As noted above, Section 5 of the Notice outlines the Safe Harbor Method in which certain adjustments to AFSI continue to apply, but certain others do not. In particular, the Notice first says that a corporation may choose to apply the Safe Harbor Method in lieu of the rules in Section 59(k)(1) and (2) for purposes of determining whether it is an applicable corporation,[139] but then goes on to say that under the Safe Harbor Method, a corporation determines whether it is an applicable corporation by applying the rules of Section 59(k)(1) and (2) with certain modifications, including that the AFS Determination Rule and the Consolidated Group Aggregation Rule continue to apply, but the Related Entity Rules do not.[140] Instead, the Notice provides that the financial accounting journal entries that are made for AFS purposes in order to present the financial results of the AFS Group as a single company (including journal entries to eliminate transactions between members of the AFS Group) are taken into account, other than any such entries that eliminate transactions between persons not treated as a single employer under Section 52(a) or (b).[141] It appears, therefore, that the income and loss items of each entity that is both consolidated with the taxpayer for book purposes and treated as a single employer with the taxpayer under Section 52(a) or (b) are included in the AFSI Test for purposes of the Safe Harbor Method. However, it is not entirely clear whether that computation must take into account the AFSI of persons that are not consolidated with the corporation for book purposes, but that are treated as a single employer with that corporation under Section 52(a) or (b). Although we believe that to be the better reading, it also appears possible to read Section 5.03(2)(c) as indicating the income of such entities is not taken into account for purposes of the Safe Harbor Method. We recommend that Treasury clarify its intent here.

E. Adjustment to AFSI for Depreciation of Section 168 Property

Book and tax use different methods to depreciate tangible property. While book typically uses the straight-line method,[142] Section 168 provides for the modified accelerated cost recovery

[138] Section 59(k)(1)(D).

[139] Section 5.03(1) of the Notice.

[140] Section 5.03(2)(c)(i) of the Notice.

[141] Section 5.03(2)(c)(ii) of the Notice.

[142] *See* ASC 360-10-35-4.

deduction method and bonus depreciation (*i.e.*, accelerated depreciation), which together allow eligible tangible property to be depreciated over a shorter period and, in some cases, at a faster rate early in its useful life. Section 56A(c)(13) provides that AFSI shall be reduced by depreciation deductions allowed under Section 167 with respect to "property to which Section 168 applies" ("**Section 168 property**") to the extent of the amount allowed as deductions in computing taxable income for the tax year, and "appropriately adjusted" (i) to disregard any amount of depreciation expense that is taken into account on the taxpayer's AFS with respect to that property, and (ii) to take into account any other item specified by the Secretary in order to provide that Section 168 property is accounted for in the same manner as it is accounted for under "this chapter," which refers to Sections 1 through 1400Z-2.[143]

1. Guidance under the Notice

The Notice represents Treasury's first statement as to which adjustments are appropriate under Section 56A(c)(13). In particular, Section 4 of the Notice provides for four adjustments to AFSI:

1. First, AFSI is reduced by "Tax COGS Depreciation," but only to the extent of the amount recovered as part of costs of goods sold in computing taxable income for the year.[144] "Tax COGS Depreciation" is "Tax Depreciation" that is capitalized into inventory under Section 263A and recovered as part of cost of goods sold in computing gross income under Section 61,[145] and "Tax Depreciation" is depreciation deductions allowed under Section 167 with respect to Section 168 property.[146]

2. Second, AFSI is reduced by "Deductible Tax Depreciation," but only to the extent of the amount allowed as a deduction in computing taxable income for the year.[147] "Deductible Tax Depreciation" is Tax Depreciation that is allowed as a deduction in computing taxable income.[148]

3. Third, AFSI is adjusted to disregard "Covered Book COGS Depreciation," "Covered Book Depreciation Expense," and "Covered Book Expense."[149] "Covered Book COGS Depreciation" is 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

[143] In addition, Section 56A(c)(14) reduces AFSI for amortization deductions allowed under Section 197 for qualified wireless spectrum, which is generally not amortizable for book purposes. "Qualified wireless spectrum" is defined as wireless spectrum that is used in the trade or business of a wireless telecommunications carrier and was acquired after December 31, 2007, and before the date of enactment of the IRA. *See* Section 56A(c)(14)(B).

[144] Section 4.03(1) of the Notice.

[145] Section 4.02(4) of the Notice.

[146] Section 4.02(7) of the Notice.

[147] Section 4.03(2) of the Notice.

[148] Section 4.02(4) of the Notice.

[149] Section 4.03(3) of the Notice.

taxpayer's AFS with respect to Section 168 property.[150] "Covered Book Depreciation Expense" is depreciation expense, impairment loss, or impairment loss reversal other than Covered Book COGS Depreciation that is taken into account in the net income or loss set forth on the taxpayer's AFS with respect to Section 168 property.[151] "Covered Book Expense" is an amount, other than Covered Book COGS Depreciation and Covered Book Depreciation Expense, that is (i) recognized as an expense or loss in the net income or loss set forth on the taxpayer's AFS and (ii) reflected in the adjusted depreciable basis of Section 168 property for federal income tax purposes.[152]

4. Last, AFSI is adjusted for other items as provided in guidance published in the Internal Revenue Bulletin.[153] As of the date of this Report, no such items have been so published.

Put simply, the Notice provides that all tax depreciation items taken into account in taxable income for a particular year with respect to Section 168 property reduce AFSI, while all book expense items taken into account in book income for that year with respect to Section 168 property are eliminated from AFSI. This principle applies whether the tax depreciation deductions arise and reduce taxable income in the current year or, alternatively, have arisen in a prior year and been capitalized into inventory and are recovered in the current year as part of cost of goods sold.

The Notice also provides for adjustments to AFSI upon dispositions of Section 168 property. These adjustments are discussed in Part IV.E.3 below.

2. Section 743(b) Basis Adjustments

The Notice does not explicitly address Section 743(b) adjustments in respect of Section 168 property.

> **Example 15:** Assume A and B jointly operate a business through a limited liability company, LLC, that is treated as a partnership for U.S. federal income tax purposes and CAMT purposes.[154] LLC owns a piece of Section 168 property, among other properties. C (who is not related to A or B) purchases a portion of A's LLC units from A for cash.

For regular tax purposes, C's purchase would be treated as a purchase of a partnership interest and C would take a fair market value cost basis in its acquired partnership interest. As long as the partnership had in effect an election under Section 754, C would get the benefit of a Section 743(b) basis adjustment, which would be allocated among LLC's assets under Section 755. With respect to the portion of the basis adjustment allocated to C's pro rata portion of the

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[150] Section 4.02(1) of the Notice.

[151] Section 4.02(2) of the Notice.

[152] Section 4.02(3) of the Notice.

[153] Section 4.03(4) of the Notice.

[154] As discussed in Part IV.G, we recommend that the treatment of an entity as a partnership for CAMT purposes match its treatment for regular tax purposes.

Section 168 property, C would get to reduce its taxable income by the resulting depreciation deductions.

Although C's deductions are as a result of a Section 743(b) adjustment and not, strictly speaking, depreciation deductions attributable to Section 168 property, we see no reason why there should be a different consequence under Section 56A(c)(13) than if C had purchased Section 168 property directly and depreciated it itself. After all, Section 743(b) embodies the "aggregate approach," which seeks to treat a partnership as an aggregate of its partners, as opposed to as an entity.[155] In furtherance of that principle, depreciation deductions resulting from a Section 743(b) adjustment that is allocable to Section 168 property should be considered "Tax Depreciation" under Section 4.02(7) of the Notice to the same extent as depreciation deductions attributable to the Section 168 property would have been.

While we believe this result is appropriate under Section 56A(c)(13) for the purpose of taking into account regular tax Section 743(b) adjustments in respect of Section 168 property owned by a partnership, we recognize that treating a partnership solely as an aggregate in all respects for purposes of computing AFSI would create complexities, and our particular recommendation here does not extend to that broader point.

Issues related to adjustments for CAMT purposes corresponding to regular tax Section 743(b) adjustments are discussed further in Part IV.G.6 below.

3. Gain / Loss on Sale of Section 168 Property

As described above, the Notice provides that, when a taxpayer disposes of Section 168 property, it must adjust AFSI to redetermine any gain or loss taken into account in its book income with respect to the disposition by adjusting the AFS basis of the property to take into account all *current and prior* "Section 56A(c)(13) adjustments," including those that would have been made in taxable years prior to the effective date of the CAMT had the CAMT applied in those years.[156] The term, "Section 56A(c)(13) adjustments" is not defined in the Notice, but presumably refers to the four adjustments required by Section 4.03 of the Notice and described in Part IV.E.1 above. This rule is referred to in this Report as the "**Gain Redetermination Rule**." The Notice includes a single example similar to the following to illustrate this rule.[157]

> **Example 16:** Taxpayer is a calendar year taxpayer and an applicable corporation for the 2023 taxable year. Taxpayer reports its financial results under U.S. GAAP. On January 1, 2018, Taxpayer purchases for $1,000 and places in service a piece of Section 168 property.

For tax purposes, Taxpayer claims 100% "bonus" depreciation for the property and thus deducts the full $1,000 cost in 2018. For book purposes, Taxpayer depreciates the property over

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[155] *See, e.g.,* McKee, Nelson & Whitmire, Federal Taxation of Partnerships & Partners ¶24.01 (WG&L): "If the partnership makes a valid election under § 754, or if the partnership has a substantial built-in loss, the general entity rule of § 743(a) gives way to the aggregate approach under § 743(b)." (footnotes omitted).

[156] Section 4.07 of the Notice.

[157] Section 4.08 of the Notice.

40 years on a straight-line method, thus recognizing $25 book depreciation expense—which is Covered Book Depreciation Expense—per year.

Assume Taxpayer then sells the property for $900 on January 1, 2024. At the time of the sale Taxpayer's book basis in the property is $850 ($1,000 cost, *less* $25 expense per year for 6 years). As a result, Taxpayer recognizes $50 book gain ($900 amount realized, *less* $850 book basis).

AFSI result for 2023: For tax purposes, Taxpayer deducted its entire cost basis in 2018 and, as a result has no Deductible Tax Depreciation or Tax COGS Depreciation in 2023. Taxpayer's $25 book expense for 2023 is Covered Book Depreciation Expense; Taxpayer must adjust its AFSI to disregard this $25 of Covered Book Depreciation Expense.

AFSI result for 2024: When Taxpayer sells the property on January 1, 2024, Taxpayer will have to adjust its AFSI for 2024 to apply the Gain Redetermination Rule. In particular, Taxpayer will adjust its book basis in the property (which, as noted above, is $850) to take into account the cumulative Section 56A(c)(13) adjustments, starting from the date the property was placed in service. Notably, this timing principle is articulated only in the example and not in the rule in Section 4.07 of the Notice itself. Accordingly, the book basis is reduced to $0 ($850 book basis, *reduced by* the $1,000 of Covered Tax Depreciation taken in 2018, and *increased by* $150 of Covered Book Depreciation Expense taken from 2018-2023), and Taxpayer must therefore take into account $900 of gain in its AFSI calculation ($900 amount realized, *less* $0 basis).

The Gain Redetermination Rule thus applies to increase Taxpayer's AFSI gain from its $50 of book gain to $900. If we ignore for the moment the fact that CAMT was not in effect in 2018,[158] then this is a logical result because Taxpayer invested $1,000 in the property in 2018 and recovered the full $1,000 by reducing AFSI in 2018 by $1,000. When the property is sold for $900 in 2024, the full $900 amount realized represents economic gain and should be taken into account.

This rule appears to reach a reasonable result where the property was purchased, placed in service and sold by the same taxpayer and same book consolidated group. But where the property undergoes a change in ownership, the Notice is difficult to interpret and may reach an illogical result.

> **Example 17:** Assume the same facts as Example 16, except that Taxpayer is a GAAP consolidated subsidiary of a public parent corporation and, before Taxpayer sells the property on January 1, 2024, Taxpayer's parent sells 100% of the stock of Taxpayer to another GAAP consolidated group on January 1, 2023, at a time when the property is valued at $1,000. Assume no election under Section 338 is made.

For tax purposes, the analysis is the same. Taxpayer claims $1,000 "bonus" depreciation under Section 168(k) in 2018, and Taxpayer is entitled to no further tax depreciation with respect

[158] Part IV.E.4 below includes a discussion of the merits of including pre-CAMT adjustments.

to the property. When Taxpayer is sold in 2023, it continues with its historic $0 tax basis in the property.

Under GAAP, however, when Taxpayer joins a new consolidated group on January 1, 2023, the basis of all its assets, including the property, are stepped up to fair value, which, in the case of the property, is $1,000.

The acquirer GAAP group then depreciates the property over a new 40-year period and therefore reflects $25 depreciation expense in its 2023 GAAP income and reduces its GAAP basis to $975. As a result, when the acquirer GAAP group sells the property on January 2, 2024, it has a $75 GAAP loss ($900 amount realized, *less* $975 basis).

As noted above, the Gain Redetermination Rule requires the GAAP gain to be adjusted to take into account all current and prior Section 56A(c)(13) adjustments, including those that would have been made in taxable years prior to the effective date of the CAMT had the CAMT applied in those years, and the example in the Notice specifies that the taxpayer must start from the date the property was placed in service.

The GAAP basis of the property at the time of the sale on January 1, 2024, is $975. The property was placed in service on January 1, 2018, and since that time there have been the following Section 56A(c)(13) adjustments:

1. The $1,000 bonus depreciation Taxpayer took in 2018 would have reduced AFSI in 2018 had CAMT applied in that year and is therefore Deductible Tax Depreciation;

2. Taxpayer's original GAAP group reflected $125 in GAAP depreciation expense between January 1, 2018, and December 31, 2022, all of which is therefore Covered Book Depreciation Expense; and

3. The acquirer's GAAP group reflected $25 in GAAP depreciation expense in 2023, which is also therefore Covered Book Depreciation Expense.

The Gain Redetermination Rule requires that the GAAP basis in the property be decreased by the $1000 Deductible Tax Depreciation and increased by the $25 Covered Book Depreciation Expense that represents the 2023 GAAP depreciation expense. It is unclear whether the Notice also requires an increase in respect of the $125 Covered Book Depreciation Expense that represents the 2018-2022 GAAP depreciation expense. A plain reading of the language suggests that it may, since it requires taking into account all current and prior Section 56A(c)(13) adjustments, and the example identifies the starting date as the date the relevant property was placed in service. Under this reading, the AFSI basis would be $125 ($975 GAAP basis, *less* $1,000 Deductible Tax Depreciation, *plus* $125 Covered Book Depreciation Expense from 2018-2022, *plus* $25 Covered Book Depreciation Expense from 2023) and, therefore, the AFSI gain would be $775 ($900 amount realized, *less* $125 AFSI basis).

However, the GAAP basis at the time of the sale of the property does not reflect any GAAP depreciation that precedes the purchase accounting adjustment; indeed, the GAAP depreciation from the period before the purchase accounting adjustment is completely irrelevant to the GAAP analysis of the sale of the property. If we are seeking to eliminate the effect of the

GAAP depreciation on the GAAP basis, then it does not make sense to include an adjustment for any Covered Book Depreciation Expense that represents this pre-purchase accounting adjustment book expense.

Consistent with this view, the language of the Notice could be read to not require adding back Covered Book Depreciation Expense that was reflected before a purchase accounting adjustment, as one could argue that the amount required to "take into account" this book expense is $0. Under this reading, the AFSI basis would be $0 ($975 GAAP basis, *less* $1,000 Deductible Tax Depreciation, *plus* $25 Covered Book Depreciation) and, therefore, the AFSI gain would be $900 ($900 amount realized, *less* $0 AFSI basis). This approach represents a hybrid book-tax approach because it begins with book basis and makes certain adjustments to reverse the book expense and incorporate tax deductions, but it does not eliminate the effects of purchase accounting adjustments, so it is referred to in this Report as the "**Hybrid**" approach.

An alternative approach would be to simply say that the AFSI basis of Section 168 property always equals its tax basis. Under this approach, the AFSI basis of the property before its sale would be equal to the tax basis ($0), and the AFSI gain on the sale of the property would be equal to the tax gain on the sale ($900). This approach is referred to in this Report as the "**Follow Tax**" approach.

Under either approach, the AFSI gain in Example 17 would be $900 because the value of the property at the time of the purchase accounting adjustment equaled its initial cost basis. If however, the value differed from the initial cost basis, the two approaches would reach different results.

The below table illustrates the AFSI basis and AFSI gain under each approach in three scenarios. Scenario 2 represents the facts of Example 17, and Scenarios 1 and 3 represent variations on Example 17 where the property is valued at $1,100 and $900, respectively, at the time of the purchase accounting adjustment.

	Scenario 1		**Scenario 2**		**Scenario 3**	
	Tax	**Book**	**Tax**	**Book**	**Tax**	**Book**
Initial basis on January 1, 2018	1,000	1,000	1,000	1,000	1,000	1,000
Depreciation 2018 -- 2022	(1,000)	(125)	(1,000)	(125)	(1,000)	(125)
Purchase accounting basis on January 1, 2023	N/A	**1,100**	N/A	**1,000**	N/A	**900**
Depreciation 2023	-	(28)	-	(25)	-	(23)
Opening basis on January 1, 2024	-	1,073	-	975	-	878
Amount realized on sale on January 1, 2024	900	900	900	900	900	900
Gain	900	(173)	900	(75)	900	23
	Follow Tax	**Hybrid**	**Follow Tax**	**Hybrid**	**Follow Tax**	**Hybrid**
AFSI basis	-	100	-	-	-	(100)
AFSI gain	**900**	**800**	**900**	**900**	**900**	**1,000**

In Scenario 1, because the property is valued at $1,100 at the time of the purchase accounting adjustment, the adjustment results in a "stepped up" book basis that exceeds the initial cost basis by $100. This $100 purchase accounting step-up is "free" to the taxpayer in that it has not been included in income but serves to shelter $100 of gain on the ultimate sale of the

property. As a result, under the Hybrid approach, the AFSI gain on that sale of $800 is lower than the tax gain by $100.

In Scenario 2, because the property is valued at $1,000 at the time of the purchase accounting adjustment, there is no step-up or step-down vis-à-vis the initial cost basis of the property, so the Hybrid approach and the Follow Tax approach both result in the same AFSI gain of $900.

In Scenario 3, because the property is valued at $900 at the time of the purchase accounting adjustment, there is a $100 purchase accounting "step down" vis-à-vis the initial cost basis of the property. Under the Hybrid approach, the taxpayer bears the cost of this step down in the form of AFSI gain that exceeds tax gain by $100.

More generally, both the Follow Tax approach and the Hybrid approach ensure that any Deductible Tax Depreciation that has reduced AFSI is included in AFSI basis, such that the taxpayer does not "double dip." The difference between the two approaches is that, under the Follow Tax approach, purchase accounting adjustments to book basis are entirely irrelevant, whereas they are taken into account under the Hybrid Approach.

Under the Hybrid approach, if there is a purchase accounting adjustment that results in book basis in Section 168 property that exceeds the initial tax cost basis, then the taxpayer benefits from that basis "step-up." By contrast, if there is a purchase accounting adjustment that results in book basis in the Section 168 property that is lower than the initial tax cost basis, then that basis "step-down" will be to the detriment of the taxpayer. In the latter case, the AFSI basis could even turn negative, as illustrated by Scenario 3.

In thinking about whether these should be so taken into account, it is perhaps instructive to consider what would be the results to AFSI calculations in the absence of the rule in Section 56A(c)(13) requiring book expense items related to Section 168 property to be replaced by tax depreciation deductions. In that case, AFSI would follow book in all cases. If there were a purchase accounting step-up, the taxpayer's AFSI calculations would reflect the correspondingly higher GAAP expense items for so long as it continued to hold the property, and the correspondingly lower GAAP gain upon a sale. Likewise, if there were a purchase accounting step-down, the taxpayer's AFSI calculations would reflect the correspondingly lower GAAP expense items for so long as it continued to hold the property, and the correspondingly higher GAAP gain upon a sale.

Section 56A(c)(13) forces AFSI to reflect tax depreciation items instead of GAAP expense items, so it follows logically that AFSI basis should reflect tax depreciation items instead of GAAP expense items. The question is therefore whether, because AFSI reflects tax depreciation items instead of GAAP expense items, AFSI basis should reflect purchase accounting step-ups and step-downs.

The benefits of the Follow Tax approach are simplicity and consistency with tax principles. After all, Congress specified in the statute that tax depreciation deductions with respect to Section 168 property were to replace book expense, so it is not unreasonable to take that approach to its logical conclusion and account for Section 168 property entirely consistently

with tax. Moreover, perhaps this is what Congress had in mind when it drafted a statute that requires Section 168 property to be "accounted for in the same manner as it is accounted for under [sections 1 through 1400Z-2]."[159]

On the other hand, if that is what Congress intended, Congress could have clearly and specifically said so and it did not, so perhaps the cryptic language in the statute requires a more nuanced approach than simply basis following tax in all cases. After all, the entire CAMT regime is a hybrid book-tax system, and it is consistent with that for AFSI basis in Section 168 property to be a hybrid book-tax basis, as in the Hybrid approach. Under the CAMT regime, taxpayers generally bear the consequences of purchase accounting adjustments, and there is no clear direction from Congress to make an exception to this treatment for Section 168 Property.

4. Potential Adjustments to AFSI for Accelerated Depreciation Claimed Before a Taxpayer Became an Applicable Corporation

The apparent intent of Section 56A(c)(13) is to preserve the incentive for capital investment created by accelerated depreciation by replacing book depreciation with tax depreciation with respect to Section 168 property. However, if Section 56A(c)(13) were to apply to Section 168 property that was acquired or placed in service by a corporation before it became an applicable corporation subject to the CAMT, it could have the effect of increasing a taxpayer's CAMT liability.[160] The Notice provides that Section 56A(c)(13) does apply to Section 168 property placed in service in any taxable year, including taxable years before 2023,[161] but it is unclear whether Congress intended this result and debatable whether this result is sound tax policy.

Below we consider whether, and under what circumstances, Treasury should exercise its authority to adjust AFSI to neutralize the effect of accelerated depreciation on the CAMT. We focus first on situations involving taxpayers that claimed accelerated depreciation for Section 168 property placed in service in Pre-CAMT Years. We then turn to situations involving taxpayers that claim accelerated depreciation for Section 168 property placed in service in tax years beginning on or after the last Pre-CAMT Year (such years, "**CAMT Years**") but in which it was not an applicable corporation.

Accelerated Depreciation Claimed in Pre-CAMT Years

Example 18: Assume that X corporation purchases equipment with a useful life of 10 years for $1,000 at the beginning of 2019.

The equipment is eligible for 100% bonus depreciation under Section 168(k), and so in computing its taxable income for 2019, X claims a $1,000 tax depreciation deduction for the

[159] Section 56A(c)(13)(B)(ii).

[160] The discussion that follows focuses on book-tax differences attributable to depreciation methods (*e.g.*, straight-line depreciation versus accelerated depreciation). However, we note that book-tax differences in other aspects of depreciation besides the "method"—for example, depreciation period/useful life and in conventions for property placed into service partway through a year—can also affect CAMT liability.

[161] Section 4.06 of the Notice.

equipment. For book purposes, however, X depreciates the equipment on a straight-line basis, recording $100 of book depreciation in 2019 and each of the subsequent nine years. Assuming Section 56A(c)(13) applies, however, X cannot use book depreciation for the equipment when computing its AFSI in 2020 and beyond, even though X fully depreciated the equipment for tax purposes in a Pre-CAMT Year.

As mentioned, Section 56A(c)(13) provides that AFSI shall be "appropriately adjusted" to disregard any amount of depreciation expense that is taken into account on the taxpayer's AFS with respect to that property, suggesting that there may be cases in which adjusting AFSI to disregard book depreciation expense would not be "appropriate." Because there is no official legislative history to the CAMT, however, it is unclear whether Example 18 is such a case.

On one hand, denying X book depreciation expense could be defended on the basis that, for Section 168 property, Congress intended for AFSI to be computed with reference to tax rather than book depreciation, and the result in Example 18 is consistent with that intent. In CAMT Years, X's AFSI deductions with respect to the equipment ($0) will equal its tax deductions ($0); tax depreciation and AFSI expense will match in each relevant year. To allow X to claim, for purposes of computing its AFSI, deductions in excess of tax deductions would be a windfall to X, allowing it to shelter from CAMT other tax deductions where no book/AFSI deduction is allowed.

Further, it could be argued that the text of Section 56A(c)(13) reflects a deliberate policy choice to deny transition relief for Section 168 property acquired or placed in service prior to the effective date of the CAMT. After all, book-tax differences relating to accelerated depreciation in pre-CAMT tax years are just one of many types of pre-CAMT book-tax differences, and with respect to some such differences, Congress explicitly denied transition relief. For example, take the strict transition rule for FSNOL carryovers: while the IRA allows taxpayers to deduct FSNOLs, it defines "financial statement NOL" as the net loss on the corporation's applicable financial statement for tax years ending after December 31, 2019. Thus, tax net operating losses ("**NOLs**") arising in Pre-CAMT Years and carried forward to CAMT Years can give rise to a CAMT liability. If tax NOLs from Pre-CAMT Years can affect a taxpayer's CAMT liability, then arguably so too should accelerated depreciation from Pre-CAMT Years.

On the other hand, it could be argued that Example 18 is just the type of situation that Congress presumably had in mind when it limited the denial of book depreciation to "appropriate" circumstances. To begin with, denying X the ability to use book depreciation when computing its AFSI arguably violates an even more fundamental matching principle, namely that expenses should be appropriately matched against revenue to clearly reflect income. When computing its AFSI in CAMT Years (*i.e.*, tax years beginning after December 31, 2020), X must include the income from the equipment earned, but it cannot claim a deduction for the depreciation expense related to that income because for regular income tax purposes that deduction was claimed in a Pre-CAMT Year (*i.e.*, 2019). Thus, in tax years relevant to determining X's status as an applicable corporation or its CAMT liability, X's AFSI from the equipment will not be clearly reflected. As noted above, the apparent *raison d'etre* of the CAMT is to design a tax base that more clearly reflects economic income. Allowing the book expense in this case avoids creating a mismatch between economic income and expense and thereby honors

the purpose of the CAMT, even though it creates a divergence between AFSI and tax depreciation.

Additionally, there is no indication that Congress specifically considered transition issues with respect to accelerated depreciation claimed in Pre-CAMT Years. In fact, public statements regarding the effect of Section 56A(c)(13) made by the lawmakers who introduced it focus instead on preserving the benefits of accelerated depreciation.

Moreover, adjusting AFSI to disregard book depreciation expense in Example 18 arguably would not be "appropriate" because X did not derive any CAMT benefit from accelerated depreciation relating to the equipment placed in service in 2019. To permit X to use book depreciation deductions in computing its AFSI in CAMT Years would not provide X with a duplicative CAMT benefit; it would instead ensure that X got to recover its full cost basis in the equipment for CAMT purposes. For all practical purposes, allowing X to use book depreciation deductions in computing its AFSI in CAMT Years would place X in the same position with respect to the equipment as if Section 56A(c)(13) had not been adopted and it had consistently computed its AFSI using book depreciation with respect to the equipment. As some members of the Executive Committee argue, Section 56A(c)(13) was intended to provide taxpayers with a benefit; where it does not in fact provide a benefit, allowing taxpayers to waive the provision is consistent with the Congressional intent.

Allowing taxpayers to compute AFSI using book depreciation with respect to Section 168 property acquired or placed in service in Pre-CAMT Years would affect the administrability of the CAMT in different ways. On one hand, it would be necessary to separately track Section 168 property, depending on whether it was acquired or placed in service in a Pre-CAMT Year or in a CAMT Year. All else equal, this would tend to increase the burden of complying with and administering the CAMT. On the other hand, the adjustments to AFSI required by Section 56A(c)(13) will likely be a source of significant complexity, and so by reducing the need to make such adjustments—even to a limited extent—the election may reduce overall complexity of the system.

If Treasury determines that Congress did not intend for Section 56A(c)(13) to apply to Section 168 property acquired or placed in service in tax years ending before January 1, 2020, we recommend that it use its authority to require taxpayers to use book depreciation with respect to such property when computing AFSI (or, alternatively, to provide taxpayers with a one-time election to do so for all such property). However, if Treasury determines that Congress intended Section 56A(c)(13) to apply to Section 168 property acquired or placed in service in tax years ending before January 1, 2020, we recommend that Treasury consider whether to allow taxpayers to retroactively elect out of Section 168, either by filing an amended tax return or a change in accounting method.[162]

[162] Treasury provided similar relief following retroactive changes to Section 168(k) in the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, 134 Stat. 337 (2020). *See* Rev. Proc. 2020-25, 2020-19 I.R.B. 785.

Accelerated Depreciation Claimed in CAMT Years but Before a Taxpayer becomes an Applicable Corporation

Example 19: Assume the same facts as the previous example except that X purchases the equipment at the beginning of 2020.

For tax purposes, X claims a $1,000 depreciation deduction for the equipment in 2020, while for book purposes, X records $100 of depreciation expense in each of 2020 through 2029. In its 2024 tax year, X becomes an applicable corporation.

The key difference between Example 18 and Example 19 is that in Example 19, X's tax depreciation deduction for the equipment is taken into account in computing its AFSI in a tax year for which X's AFSI is relevant to determining its status as applicable corporation. However, as in Example 19, that AFSI deduction accrues in a year in which X is not an applicable corporation. Again, in the absence of any official legislative history to the CAMT, it is unclear whether Congress intended that Section 56A(c)(13) would deny X book depreciation expense with respect to the equipment when computing its AFSI in this circumstance.

On one hand, there are several credible reasons for believing that Congress intended Section 56A(c)(13) to operate precisely in this way. First, as discussed in connection with Example 18, for each year, X's AFSI deductions will equal its tax deductions, which is arguably the scheme that Congress intended. Second, X's aggregate AFSI in CAMT-relevant tax years is clearly reflected. Third, even though X's tax depreciation deduction is not taken into account in a year in which X is subject to the CAMT, it still has potential significance for X's CAMT liability. For example, suppose that, but for the reduction in AFSI for the accelerated depreciation deduction in 2020, X would have satisfied the AFSI Test and thus qualified as an applicable corporation in 2023. In such a case, Section 56A(c)(13) would provide X with a potentially significant benefit—the ability to avoid the CAMT for the 2023 tax year—and so to allow X to use book depreciation in computing its AFSI in post-2023 tax years would be to duplicate the benefit of accelerated depreciation for CAMT purposes.

On the other hand, while X's aggregate AFSI in CAMT-relevant tax years is clearly reflected, X's AFSI from the equipment that is subject to the CAMT (*i.e.*, X's post-2023 AFSI) arguably is not: when computing its AFSI in post-2023 tax years, X must include the income earned from the equipment in AFSI, but it cannot claim a deduction for the depreciation expense related to that income, because the deduction was claimed in a tax year prior to the year in which X became an applicable corporation.

Further, allowing X to use book depreciation in computing its post-2023 AFSI will not necessarily result in any duplicative CAMT benefit to X. As one example, suppose X's average annual AFSI for 2020 through 2023, determined without the adjustments in Section 56A(c)(13), was less than $1 billion. In that case, the reduction in AFSI for the accelerated depreciation deduction in 2020 would make no difference to when X becomes an applicable corporation. As another example, even if X would have become an applicable corporation in 2023 but for the adjustments in Section 56A(c)(13), X's regular tax liability in 2023 may have been sufficiently great to avoid CAMT liability for that year. In circumstances such as these, where a taxpayer derives no CAMT benefit from accelerated depreciation relating to the equipment placed in

service before the taxpayer becomes an applicable corporation, the logic of allowing the taxpayer to use book depreciation is similar to that of allowing the taxpayer to use book depreciation with respect to assets acquired or placed in service in Pre-CAMT Years.

As mentioned in the discussion of Example 18, allowing a taxpayer to use book depreciation for Section 168 property acquired or placed in service before the taxpayer becomes an applicable corporation would create the need to separately track this category of Section 168 property. However, for taxpayers that are not subject to the CAMT, it would greatly simplify their computation of AFSI (for scope purposes), as they would be relieved of the obligation to make the Section 56A(c)(13) adjustments.

If Treasury determines that Congress did not intend for Section 56A(c)(13) to apply to property acquired or placed in service by a taxpayer prior to it becoming an applicable corporation, we recommend that Treasury either require taxpayers to use book depreciation with respect to such property when computing AFSI or, alternatively, to provide taxpayers with a one-time election to do so for all such property, provided, in each case, that the taxpayer has not derived, and will not derive, any CAMT benefit from accelerated depreciation with respect to the property. This could be established by showing that, for each relevant tax year, the taxpayer's actual CAMT liability is no greater than it would have been had its AFSI been computed without the adjustments set forth in Section 56A(c)(13) (*i.e.*, as if the taxpayer had consistently used book depreciation in computing AFSI in such years).

If Treasury determines that Congress intended Section 56A(c)(13) to apply to Section 168 property acquired or placed in service in tax years during which it was not an applicable corporation, we recommend that Treasury consider whether to allow taxpayers to retroactively elect out of Section 168(k), either by filing an amended tax return or a change in accounting method, for the reasons set forth above.

F. Application of CAMT to Distressed Companies

This portion of the Report discusses several of the issues raised by the CAMT and the Notice that are peculiar to corporations and AFS Groups suffering from financial distress ("**Distressed Taxpayers**"). It is not intended to be exhaustive. In addition, several of the issues raised in the Distressed Taxpayer context are the same issues that arise in other contexts and are discussed elsewhere in this Report. With limited exceptions, we generally think that where CAMT applies to a Distressed Taxpayer, the taxpayer should be treated in basically the same manner in the distressed context as in the non-distressed context.

A Distressed Taxpayer (even one that that is so deeply distressed that it has filed for relief in a bankruptcy proceeding under Title 11 of the United States Code (the "**Bankruptcy Code**")) might show significant amounts of income or gain on an AFS as a result of cancellation or modification of its liabilities, the application of "fresh start accounting" or equivalent under the applicable accounting standard or otherwise. The CAMT provisions of the Code do not provide any rules that provide explicit relief to Distressed Taxpayers. However, for regular tax purposes, Congress determined that Distressed Taxpayers should be granted relief in certain circumstances (i) from taxation on certain cancellation of indebtedness income ("**CODI**") as described in Section 108, and subject to attribute reduction as described in Section 108(b) and Section 1017,

(ii) by applying more lenient standards to tax-deferred reorganizations under Section 368(a)(1)(G), and (iii) with respect to limitations on the use of historic tax attributes following changes of control under Section 382. Without relief in the CAMT context, the policy decisions to provide tax relief to such taxpayers for regular tax purposes could be rendered a nullity as a result of a CAMT liability. Importantly, the ability of such taxpayers to successfully reorganize as ongoing businesses would be jeopardized as a result of a large CAMT liability, even if the Distressed Taxpayer had not previously constituted an applicable corporation. Therefore, we support the decision in the Notice to provide relief to distressed taxpayers for CAMT purposes that is generally analogous to the relief available to such taxpayers for regular tax purposes.

However, while we think that the Notice is a step in the right direction, we think that it does not entirely capture the reality of the AFS impact of bankruptcy or workout transactions to both a Distressed Taxpayer and its stakeholders and leaves many unanswered questions regarding the application of the CAMT provisions to them. Our preliminary questions and recommendations with respect to Distressed Taxpayers are discussed below. There are additional issues that this Report does not discuss that may be covered in a later report; for instance, the application of Section 382 principles for CAMT purposes, including in a Title 11 Case, issues applicable to the taxation of stakeholders in a Distressed Company, and detailed consolidated return comments.

1. Distressed Taxpayers in General

We think that it is most urgent for Treasury to propose more comprehensive rules for Distressed Taxpayers that have filed a petition for relief under the Bankruptcy Code (a "**Title 11 Case**"). Certainty regarding the CAMT consequences to such Distressed Taxpayers is important so that a Distressed Taxpayer can determine the value available to be distributed to its creditors and other stakeholders in the Title 11 Case as well as whether it can even confirm a bankruptcy plan of reorganization. Under Section 503(b)(1)(B) of the Bankruptcy Code, taxes incurred by Distressed Taxpayers during the pendency of a Title 11 Case are treated as "administrative expenses" that have priority over payments to other creditors. Thus, if the Distressed Taxpayer incurs a CAMT liability while in a Title 11 Case, such tax must be paid in priority to the claims of other creditors, even if such CAMT liability arises solely as a result of accounting entries rather than realization events as commonly understood for regular tax purposes. There are also issues that apply to Distressed Taxpayers that are "insolvent" for purposes of Section 108(a)(1)(B) and that exclude CODI for regular tax purposes. While not as urgent as guidance for Distressed Taxpayers in a Title 11 Case, there are also important issues for these taxpayers that should be addressed in guidance, particularly as tax considerations are currently one of the important factors Distressed Taxpayers consider when determining whether it is advantageous to file for Bankruptcy Court protection in a Title 11 Case.

2. Application of CAMT to a Distressed Taxpayer in a Title 11 Case in General

In many cases, a Distressed Taxpayer might have never constituted an applicable corporation, but either as a result of substantial income on its AFS arising from the modification or elimination of liabilities on its balance sheet in bankruptcy, fresh start accounting, or as a result of asset sales in connection with the resolution of the Title 11 Case, might recognize a

significant amount of AFSI during its Title 11 Case. This could result in the Distressed Taxpayer constituting an applicable corporation for the year of such transactions and/or for the year subsequent to such transactions. Treasury should consider whether a corporation (or AFS Group) that has never been an applicable corporation should become an applicable corporation solely as a result of AFSI arising from the transactions in connection with its Title 11 Case. Such transactions are (hopefully) a one-time event in the life of the taxpayer and do not necessarily measure the corporation's on-going profitability profile.

CAMT's policy is presumably similar to Treasury's description of the Green Book Proposal, *i.e.*, generally, to reduce the disparity between what large corporations report as taxable income and the profits they report to shareholders in financial statements.[163] To that end, we think there is a legitimate question whether a Distressed Taxpayer's income incurred in connection with a bankruptcy or workout transaction is what Congress had in mind in enacting CAMT. In addition, Treasury should consider whether it is appropriate to provide a special rule to "reset" the three-year testing period for a Distressed Taxpayer that is an applicable corporation before commencing a Title 11 Case, in situations where the taxpayer emerges from the Title 11 Case with new ownership. In our experience a significant change in ownership typically accompanies a Distressed Taxpayer's emergence from a Title 11 Case. In such instances, given the changes in a business and a balance sheet that tend to occur as a result of a Title 11 Case, a new measurement period may be appropriate.

Some members of the Executive Committee support exempting Distressed Taxpayers (particularly those in a Title 11 Case) from CAMT altogether. These members acknowledge that there would be difficulties in identifying which taxpayers should be eligible for such relief absent a Title 11 Case, and the countervailing policy goal of limiting the situations in which tax considerations encourage recourse to the Bankruptcy Court system. However, if CAMT indeed was intended to function as a minimum tax to ensure that companies showing AFS profit pay a minimum amount of tax, then under this line of argument, a truly Distressed Taxpayer should be outside the scope of CAMT. However, the majority of the Executive Committee believes that while some relief for Distressed Taxpayers is appropriate, neither the statute nor the policy support such a complete exemption.

3. Distressed Taxpayer CODI Issues

If a Distressed Taxpayer has CODI that is excluded from income for regular tax purposes, Section 3.06(1) of the Notice excludes from AFSI the financial accounting income or gain from cancellation or compromise of the Distressed Taxpayer's debt in an amount equal to the amount of CODI that is excluded for regular tax purposes. This exclusion applies only if such CODI is recognized both for CAMT and for regular tax purposes in the same year. While we appreciate the Notice's exclusion for CODI in a Title 11 Case, we believe that the Notice does not provide adequate relief to a Distressed Taxpayer. We also have some suggestions as to the application of attribute reduction concepts for CAMT purposes where there is excluded CODI.

[163] *See* DEP'T OF THE TREAS., *supra* note 24.

i. Items that Constitute CODI

In general, Section 61(a)(11) provides that a taxpayer's gross income for regular tax purposes includes income from the discharge of indebtedness. Under Section 108(a) a taxpayer in a Title 11 Case may exclude 100% of its CODI for regular tax purposes, and an insolvent taxpayer may exclude CODI to the extent of its insolvency. In addition, Section 108(e) provides several other exceptions and rules that classify and define certain transactions as being excluded from CODI, giving rise to CODI, or defining the amount of such CODI. In particular, under Section 108(e)(2), CODI does not include the discharge of indebtedness to the extent payment of the liability would give rise to a deduction (*e.g.*, most operating lease liabilities, pension liabilities, etc.). Section 108(e)(6) provides that if a shareholder contributes indebtedness to capital (not in exchange for equity), the corporation is treated as satisfying the indebtedness with an amount equal to the shareholder's basis in the indebtedness. Section 108(e)(4) causes a debtor to recognize CODI if its debt is purchased by a related party at a discount. Section 108(e)(8) and Section 108(e)(10) measure the amount of CODI recognized by a debtor if its debt is satisfied with its equity or by another debt instrument issued by it.

The Notice limits the CODI exclusion for AFSI purposes to the amount of CODI that is excluded for regular tax purposes. We believe that final guidance should clearly define what sorts of liability relief constitute taxable AFSI in a Distressed Taxpayer scenario, taking into account the purposes of CAMT, the CODI exclusions and the significant differences between the conception of regular tax and AFS liabilities. There are many items on an AFS that are listed as "liabilities," the cancellation or modification of which might give rise to AFS income or gain, but that are either not liabilities for regular tax purposes or do not give rise to cancellation of debt income under other exceptions under Section 108. Common examples include operating lease liabilities, preferred equity that is treated as debt under an applicable accounting standard[164], deferred tax liabilities, deferred revenue, certain customer deposit type items, pension obligations, obligations to remediate environmental sites, litigation liability, and liabilities related to certain warrants and options.[165]

In evaluating the proper balance to strike in applying CAMT to Distressed Taxpayers, we think the policy choices that the government made in enacting the CODI exceptions for bankrupt and insolvent taxpayers in Section 108 are instructive. The legislative history indicates that, in enacting the insolvency and bankruptcy exceptions, Congress sought to preserve a debtor's "fresh start" by allowing a debtor emerging from bankruptcy or an insolvent debtor outside bankruptcy to avoid an immediate income tax liability, and in exchange requiring a taxpayer that excludes CODI under either of these exceptions to reduce the taxpayer's tax attributes (*e.g.*, net operating losses and tax asset basis) in the manner provided in Section 108(b).[166] We think the statutory regime in Section 108 evidences a Congressional determination that debt cancellation

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[164] See, *e.g.*, ASC 480. The concern equally applies to an instrument denominated as "debt" for corporate law purposes but that is treated as equity for regular tax purposes under Section 385 principles and/or applicable common law.

[165] Another disconformity is caused as a result of forgiveness of payroll protection loans under the CARES Act of 2020 as the forgiveness is excluded under Section 1106 of the CARES Act and not Section 108. This should be addressed in guidance in order to preserve the policy objectives of the CARES Act.

[166] *See* S. REP. NO. 96-1035, at 9-10 (1980).

income realized by a taxpayer in a Title 11 Case or while the taxpayer is insolvent generally should not give rise to an immediate cash tax liability.[167] Indeed, even the law that predated the statutory exceptions in Section 108 contained some exceptions to the recognition of CODI for discharged indebtedness if the taxpayer was insolvent or in a bankruptcy proceeding.[168]

Without additional relief, as a result of the modification of the AFS "liabilities" listed above, a Distressed Taxpayer could have a significant amount of AFSI in an amount that far exceeds its excluded CODI under Section 108(a) for regular tax purposes, leading to the same problems presented by AFSI arising from the cancellation of liabilities that are debt for tax purposes. In addition, the failure to exclude from AFSI these items could cause a Distressed Taxpayer to become an applicable corporation when it has a long history of actually losing money, hand over fist.

Example 20: X Corporation filed for a Title 11 Case in Year A as debtor-in-possession under Chapter 11 has the following simplified balance sheet:[169]

Assets	(in $ millions)	Liabilities	(in $ millions)
Cash	500	A/P, net	500
Prepaid Expenses	100	Deferred Revenue	400
A/R, net	100	Current Lease	800
PP&E, net	6,000	Long Term Lease	15,000
Lease Right of Use	12,000	Long Term Debt	6,000
Intangible assets	1,000	Preferred Equity Liability	500
Equity Method Investments	100	Shareholder's Equity (Accumulated Deficit)	(3,500)

[167] We have previously recommended relief from alternative minimum tax for Distressed Taxpayers. *See* New York State Bar Association Report No. 608, Alternative Minimum Tax Committee Report on the Application of the Corporate Alternative Minimum Tax in Bankruptcy Settings (Mar. 17, 1989).

[168] See, *e.g.*, *Lakeland Grocery Co. v. Comm'r*, 36 B.T.A. 289 (1937) (applying an insolvency exception); 11 U.S.C. §§ 268, 270, 395, 396, 520, 522 and 679 prior to enactment of Pub. L. No. 95-598, 92 Stat. 2549 (1978) (establishing a bankruptcy exception).

[169] We are aware that the accounting presentation would change somewhat for X as a result of the Chapter 11 filing. This table is simplified to illustrate the issue.

Goodwill	0		
Total	19,800	Total	19,800

X Corporation has AFSI net operating losses of $2,500 million that have accumulated since December 31, 2019. X Corporation has been an "applicable corporation." X reorganizes under Chapter 11, and in the reorganization, (i) $1,000 million of its long term debt remains in place without change (likely its debtor in possession financing which converted into an exit facility at par on the same terms), (ii) $5,000 million of its long term debt is exchanged for equity that has a value of $1,000 million (so CODI of $4,000 million), (iii) X terminates its underwater long-term leases and renegotiates several others such that it reduces the lease liability on its balance sheet to $12,000 million (*i.e.*, the value of its right of use asset), recording a gain of $3,000 (the difference between the $15,000 liability and the $12,000 right of use asset previously on the books) and (iv) claims of general unsecured creditors (including the landlords in respect of the rejected leases), and historic equity, including its outstanding preferred equity are cancelled for no consideration.

For regular tax purposes, X has $4,000 of excluded CODI. For AFSI purposes (excluding the effects of "fresh start" accounting, discussed below), X has gain from the extinguishment of long-term debt of $4,000 million, gain from the lease termination of $3,000 million, and a $500 million gain from the extinguishment of the liability associated with the preferred stock. Under the Notice, it is clear that X could exclude $4,000 of any AFSI related to liability relief. However, if the $3,500 million of other liability relief is treated as AFSI, X will be an applicable corporation (barring other loss items) and have a CAMT liability of about $150 million (*i.e.*, AFSI of $3,500 million, less X's $2,500 million AFSI NOL carryforward, multiplied by 15%). This CAMT liability could prevent X from reorganizing successfully.

To address these issues, we propose a few solutions:

- Treasury should consider a very simple approach for Distressed Taxpayers in a Title 11 Case and exclude from AFSI all income items related to liability relief.[170] At least in the context of a Title 11 Case, where 100% of CODI of a Distressed Taxpayer is excluded under Section 108(a), this would align the CAMT result with the regular tax result in line with the overall policy of relief for Distressed Taxpayers in a Chapter 11 Case, while providing significant administrative simplicity. The taxpayer would have substantially more certainty regarding its ability to emerge from the Title 11 Case. In the context of a Title 11 Case, we do not think that this proposal has significant opportunity for abuse (though there may be different considerations outside of the Title 11 Case context), and we believe it aligns with overall policy goals to support a Distressed Taxpayer's reorganization as a going concern.

[170] As noted below, it is possible that the Notice attempts to achieve this result in Section 3.07; however, we are not certain that was the intent of that portion of the Notice.

- If Treasury does not take a full exclusion approach, Treasury should consider incorporating the principles of Section 108(e)(2) so that income items related to modifications of "liabilities" for AFS purposes that would otherwise give rise to a deduction (or put differently relate to liabilities that did not create "basis" in an asset in the classic tax sense) are excluded from AFSI, at least in circumstances where the taxpayer is in a Title 11 Case (and potentially in the case of insolvency). Conceptually, if a cancelled liability would not give rise to income for regular tax purposes because of the application of Section 108(e)(2), then it should not give rise to AFSI. We appreciate that this rule may not be appropriate outside the context of a Distressed Taxpayer, but particularly if Treasury continues to apply the framework of the Notice that limits the amount of excluded AFS CODI to the amount of regular tax excluded CODI, then such a rule is critical to ensure that the Distressed Taxpayer does not have a large CAMT liability as a result of the rationalization of its balance sheet in a bankruptcy or workout transaction. If Treasury takes this approach, guidance and examples applying the concepts of Section 108(e)(2) to AFS items would be appreciated.

- Treasury should also consider exempting from a Distressed Taxpayer's AFSI items arising from liability relief associated with AFS concepts that do not have a tax analogue or could give rise to double counting. This would apply to items like reductions in deferred tax liabilities (which would at best be circular if included), and potentially also to AFSI liability relief related to preferred equity and similar items.

- Treasury should consider whether and how to implement concepts like Section 108(e)(4), Section 108(e)(6) and Sections 108(e)(8) and 108(e)(10), particularly in circumstances where the financial accounting result might be quite different than the tax result. For instance, debt contributed to the capital of a company may or may not give rise to AFSI under the applicable accounting standards depending on the judgment of the preparer of the AFS and the facts and circumstances.[171] Purchases of debt by a person that is related for tax purposes may or may not give rise to AFSI under the applicable standard. And, while exchanges of debt for equity and debt for debt might give rise to AFSI by applying a similar standard, the result may not align. For instance, the determination of fair value of equity for AFS purposes might be different than the determination of fair market value for regular tax purposes. Alternatively, the application of the "issue price" rules for regular tax purposes, as applied to the calculation of CODI might give rise to a result that differs from the AFS result in the exchange of debt context.

We think that there are additional considerations that should be taken into account with respect to the application of the insolvency exclusion of Section 108(a)(1)(B) for CAMT purposes. We are more sympathetic to the Notice's approach to matching the amount of regular tax excluded CODI to the amount of AFSI excluded CODI in the case of the insolvency exclusion, particularly if Treasury adopts our recommendations to exclude AFSI items that are analogous to Section 108(e)(2) items, and items that do not have a tax analogue. This approach would eliminate difficult questions regarding the amount of AFS insolvency and greatly simplify

[171] *See* ASC 470-50-40.

the administration of the exception. However, particularly if these recommendations are not adopted, we think that other approaches might yield a more equitable result.

- One possibility is a proportional approach. For instance, if a taxpayer is permitted to exclude 80% of its realized CODI under Section 108(a)(1)(B), then the taxpayer would be permitted to exclude 80% of its AFS CODI (however defined). This would tie the determination of insolvency to tax concepts (rather than accounting standard concepts) and create a proportional exclusion such that if there is a difference between AFS CODI and regular tax CODI in amount, the taxpayer is not required to pay a large CAMT liability as a result of an out-of-court restructuring that otherwise would not have given rise to significant tax. However, this proposal does not make any inquiry into whether the Distressed Taxpayer is insolvent (however defined) for AFS purposes. Some members of the Executive Committee think this approach would therefore inappropriately benefit a company that was insolvent for regular tax purposes but solvent for AFS purposes.

- A second possibility is an approach that simply measures AFS insolvency separately and excludes AFSI CODI from AFSI only to the extent that the Distressed Taxpayer is insolvent for AFS purposes. This approach would be very complex and would require Treasury to define the parameters of AFS insolvency applying different accounting standards and the items that are included both in the solvency calculation and AFS CODI with specificity.

- A third possibility would focus on the potential distortions created by "hybrid" items (*e.g.*, preferred stock that is treated as equity for regular tax purposes but as debt for AFS purposes). Under this proposal, the amount of excluded AFS CODI would be limited to the amount of regular tax AFS CODI plus the amount of AFS income from liability discharge in respect of such hybrid items, without further inquiry into whether the Distressed Taxpayer is solvent for AFS purposes. Because hybrid items like preferred stock are likely to be the most junior capital in the system, it will almost always be the case that income items arising from a cancellation of such an instrument would be emblematic of insolvency. We do note that there could be modifications to such instruments (or other events in such instruments' lives) that could give rise to AFSI. We also note that this would require Treasury to identify the scope of such hybrid items. Because of this possibility the AFSI exclusion for such hybrid items should only be available if the Distressed Taxpayer is insolvent for regular tax purposes (though realization of regular tax CODI would not be required).

- A fourth possibility would permit a Distressed Taxpayer to exclude AFSI CODI to the extent of regular tax insolvency (even if regular tax CODI is lower). This is not a perfect fix because of the hybrid instrument risk described above, but it does give Distressed Taxpayers more room to manage the impact of income items arising as a result of the different systems and standards used to prepare an AFS.

ii. Timing Issues

The Notice limits the AFS CODI exclusion for a Distressed Taxpayer to taxable periods where CODI is also recognized for regular tax purposes. While we appreciate the desire for

simplicity, we believe that there are circumstances where this could cause distortions in the calculation of AFSI and cause a taxpayer to pay CAMT when such income would otherwise have been excluded for regular tax purposes. For instance, it is possible that in one taxable period, a Distressed Taxpayer could recognize CODI that is excluded under the insolvency exception as a result of a purchase of the debt instrument by a related party at a discount, but the AFS of the Distressed Taxpayer does not yet reflect the CODI (*e.g.*, because the outstanding carrying value of the debt has not been reduced under applicable accounting standards).[172] Then, in a later transaction in a Title 11 Case, if the debt instrument (which is a new debt instrument for tax purposes, but the same debt instrument for AFS purposes) is modified or compromised, the Distressed Taxpayer could have CODI for AFSI purposes in excess of the CODI calculated for regular tax purposes.

> **Example 21:** Assume that Corporation Y has $5,000 million of debt outstanding. In Year 1, A, an individual who is "related" to Corporation Y within the meaning of Section 267, purchases $2,000 million of Y's debt for $800 million. Y recognizes CODI of $1,200 million for regular tax purposes, which is less than or equal to Y's current "insolvency" for purposes of Section 108 and is therefore excluded from Y's income. Y is deemed to reissue the debt to A with an issue price of $800 million and a stated redemption price at maturity of $2,000 million under Treas. Reg. § 1.108-2(g). No gain or loss with respect to such debt is recorded on Y's AFS. Y files a Title 11 Case under Chapter 11 of the Bankruptcy Code as debtor in possession in Year 2. Y emerges from its Title 11 Case in Year 2 when the adjusted issue price of such repurchased debt is $900 million. In the reorganization, all $5,000 million of Y's debt is exchanged for $1,000 million of equity in reorganized Y. A's $2,000 million of debt is exchanged for $400 million of equity in reorganized Y. Y recognizes an additional $500 million of CODI for regular tax purposes for A's debt and $2,400 million of CODI for regular tax purposes on the remaining debt, for a total of $2,900 million, all of which is excluded under Section 108(a)(1)(A). For AFSI purposes, Y may or may not have gain of $4,000 million, depending on the judgment of the preparer of the AFS. If the preparer determines that the transaction is a capital transaction, then our understanding is that Y would not have CODI, but instead would derecognize the liability and there would be a credit to equity. If the preparer does determine that there should be gain, then Y may exclude $2,900 million of such income under the Notice. Assuming Y is an applicable corporation, and depending on the existence and availability of Y's FSNOLs, in such case Y could have a CAMT tax liability of up to $165 million (*i.e.*, the remaining $1,100 million of AFS CODI multiplied by 15%).

We note that this timing issue does not exist for a taxpayer in a Title 11 Case if Treasury determines to exclude all AFS CODI that is realized in a Title 11 Case. This would be true even in cases where Y's Year 1 CODI was fully or partially taxable because it exceeded Y's

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[172] *See* ASC 470-50-40. Note that debt owed to related parties (as defined for AFS purposes) might be reflected on the balance sheet differently than debt owed to true third parties.

This could also arise in a first step out-of-court restructuring where tax CODI is recognized as a result of a debt amendment or exchange and excluded under the insolvency exception. *See, e.g.*, guidance under ASC 470-60.

insolvency.[173] We believe that where Y is under the protection of a Bankruptcy Court in a Title 11 Case, this result is consistent with the policy objective of permitting Distressed Taxpayers to reorganize efficiently and effectively, rather than having to liquidate because the available reorganization plan on the table would give rise to a cash tax and administrative expense in excess of what is sustainable by the plan's economics.

However, if Treasury is concerned about the inconsistent result that would occur where Y's earlier CODI is not excluded for regular tax purposes (and does not adopt a Title 11 Case exclusion rule), then Treasury could consider a suspense or carryforward concept for AFSI purposes. This concept would track the amount of excluded CODI attributable to a particular debt instrument that is carried on an applicable corporation's AFS so that if there is a timing mismatch between regular tax CODI and AFS CODI for any reason with respect to a particular debt instrument, a Distressed Taxpayer could at least have access to the same amount of exclusion for AFSI purposes that it previously excluded for regular tax purposes. This would be much more complex than the exclusion approach, but the approach would provide some relief to a Distressed Taxpayer like Y in Example 21.[174]

The timing question is more difficult with an insolvent Distressed Taxpayer that never files a Title 11 Case. The Notice's approach again has the benefit of simplicity and clarity where such taxpayer recognizes CODI, and it avoids questions regarding the amount of AFSI insolvency and the timing of any AFS CODI recognition. However, like in the case where the Distressed Taxpayer files for Title 11 protection, a tracing approach could be considered. In that case, the AFS CODI should be excluded from AFSI if it would have been excluded from income for regular tax purposes if it had been realized at such time or is attributable to the same event that gave rise to the excluded CODI in a different period.

a. Certain Consolidated Return CODI Calculation Considerations

Under Section 3.05 of the Notice, a tax consolidated group is treated as a single entity for determining applicable corporation status and for purposes of calculating AFSI for CAMT liability. In general, this simplicity is welcome, and eliminates difficult questions regarding, for instance, CODI on intercompany obligations. However, it does give rise to certain additional considerations in the CODI context.

- With respect to Distressed Taxpayers involved in a Title 11 Case, the Notice is generally unclear as to the results where all members of the AFS Group are not also in the regular tax consolidated group and do not file a Title 11 Case. Example 8 of the Notice assumes that there is complete identity between the AFS Group and the consolidated group, and

[173] We also think that there may be areas, like those involving related parties, where a judgement call will be required by the financial statement preparer as to the proper presentation of the transaction on the AFS. This rule would have the benefit of not subjecting the tax result to the financial statement preparer's judgement in classifying certain kinds of items.

[174] Note that because of the fiction of Treas. Reg. § 1.108-2(g), there might not be complete alignment in the amount of CODI. All of these concepts would also have to be harmonized with the CAMT rules regarding accounting periods that differ for regular tax and AFS purposes.

that all of the members have filed such a case. Since the facts are often quite different, taxpayers need additional guidance to clarify whether and how the relief in the Notice (as modified in regulations) applies outside the context of Example 8. We generally believe that the proposals in the Notice should be clarified to provide that notwithstanding Section 3.05 of the Notice, AFS CODI should only be excluded by the AFS Group if it relates to a debt or other liability as to which CODI is excluded from income by an entity (as determined for regular tax purposes) because the debt or other liability was discharged in a Title 11 Case.

- For regular tax purposes, the ability to access the Section 108(a) insolvency exclusion is determined on a separate company basis. For instance, assume a subsidiary of a consolidated parent (but not any other member of the group) is insolvent and has a significant amount of CODI that it is able to exclude from income. The parent entity remains extremely profitable and certainly is not insolvent. The Notice provides that only the amount of excluded CODI for tax purposes may be excluded from AFSI. It thus appears that the AFS Group would be permitted to exclude the CODI of the subsidiary for CAMT purposes up to the amount of the regular tax exclusion. It is not completely obvious to us that this is appropriate if the CAMT liability of an AFS Group is determined on an aggregate basis and as a policy matter. However, it is consistent with the Notice's position that a taxpayer may exclude an amount of CODI for CAMT purposes up to the amount of the CODI excluded for regular tax purposes without inquiry as to the AFS solvency of the AFS Group.

- If a subsidiary (or group of subsidiaries) within an AFS Group files a Title 11 Case, it is possible that under the applicable accounting standard, the subsidiary deconsolidates from the AFS Group (even though it has not deconsolidated from the consolidated group). Leaving aside the AFS consequences of such deconsolidation, whether and how the results of CODI realized by such subsidiary should be taken into account in the parent's CAMT calculations is unclear. Exactly how this would work (and exactly how any reconsolidation of the entity at a later time would be treated) in order to prevent double counting should be clarified.

b. Attribute Reduction

Section 3.06(2) of the Notice requires that if financial accounting gain resulting from a discharge of indebtedness is excluded under the Notice, the AFS Group's CAMT attributes (whatever those are) must be reduced by the amount of regular tax attribute reduction, "taking into account the ordering provided by Section 108(b) and Section 1017." This rule currently leaves a lot to the imagination, and this section provides our comments on the concept.

In the first instance, a minority of the members of the Executive Committee question whether attribute reduction is an appropriate concept to import into CAMT. If the purpose of CAMT is to measure taxable income against the profits reported on financial statements, it is not clear that preserving future CAMT taxation potential through financial statement attribute reduction (that will not show up on a financial statement except as a deferred tax liability) is

appropriate. Attribute reduction in the CAMT context will create significant complexity, and there is a reasonable likelihood that double- or under-counting of attributes will arise.[175]

That said, the statutory framework of CAMT does not look purely to financial statement results (*e.g.*, importation of a tax depreciation concept for fixed assets). Further, in the regular tax context, Congress clearly evidenced a desire to combine debt cancellation relief for Distressed Taxpayers with attribute reduction that would result (hopefully) in the rehabilitated taxpayer paying additional taxes in the future. Therefore, the majority of the members of the Executive Committee believes that if a Distressed Taxpayer excludes AFS CODI from AFSI, its tax attributes for CAMT purposes (however ultimately defined) should also be reduced. The rubric for any CAMT attribute reduction should have the same result as for regular tax purposes (*i.e.*, to preserve for future taxation the amount of CODI that is not permanently excluded), but also should be carefully considered to make sure that the attribute reduction does not cause a duplicative reduction in attributes.

First, the Notice currently provides that the Distressed Taxpayer's "CAMT attributes" should be reduced "to the extent of" the amount of attribution reduction under Section 108(b) for regular tax purposes.[176] We recommend that Treasury reconsider this position. Depending on how "attributes" are defined for this purpose, the Notice's position could raise difficult questions in situations where a taxpayer's existing CAMT attributes are less than its regular tax attributes that are being reduced (i.e., would immediate CAMT tax result?). Similar issues and distortions arise where a Distressed Taxpayer has more or fewer tax attributes of a certain type (*e.g.*, NOLs for regular tax purposes versus NOLs for CAMT purposes). If Treasury adopts the suggestion to implement rules that could permit the amount of AFS CODI to differ from the amount of regular tax CODI (*e.g.*, as a result of a difference in timing, adoption of the Title 11 Case exclusion recommendation, as a result of the proportionality proposal or otherwise), then both the amount of attribute reduction and, potentially the determination of the liability floor under Section 1017 should likewise be harmonized so that a taxpayer's CAMT assets are reduced by the correct amount of excluded AFS CODI. If Treasury continues with the Notice's approach, it should more carefully define the scope of the amount of attribute reduction in the consolidated context to eliminate any potential duplication in the amount of such CODI as a result of the "push down" and "fan-out" rules of Treas. Reg. § 1.1502-28 that, for instance, create deemed items of CODI as a result of consolidated subsidiary stock basis reduction (not a concept for CAMT purposes under the current rules) to push the attribute reduction into the basis of subsidiary assets.

Once the amount of attribute reduction is identified for CAMT purposes, it is important to identify what attributes exist for CAMT purposes that are available for reduction and the order in which such reduction should occur. There are many items that are carried on the asset side of a balance sheet of an enterprise that do not have a tax analogue and are maintained and adjusted in a manner that is foreign from a regular tax perspective.[177] And, conversely, there are CAMT

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[175] In addition, if fresh start reporting is permitted for CAMT purposes (as described *infra*), a full scope of attribute reduction may not be appropriate.

[176] Section 3.06(2) of the Notice.

[177] For example, it can be asked what it would mean to adjust "goodwill" for AFSI purposes, where "goodwill" is not an amortizable asset but can be adjusted in accordance with relevant accounting principles.

attributes created by the statute that exist, if at all, for AFS purposes only in the deferred tax asset account of an applicable corporation (*e.g.*, the FSNOL). In particular, because CAMT attributes may be different in kind and extent than regular tax attributes, it is possible that attribute reduction could affect one category of regular tax attributes (*e.g.*, regular tax basis), but a different category of CAMT attributes (*e.g.*, a FSNOL carryovers). It is also unclear how to overlay the concepts of Section 108(b) onto an AFS for CAMT purposes.

Initially, there are three assets that exist solely for CAMT purposes that should be available for reduction: (1) the FSNOL carryovers under Section 56A(d)(2), (2) the CAMT foreign tax credit described in Section 59(a), and (3) AFSI asset basis in depreciable and amortizable assets as further described in Section 4 of the Notice (which, as discussed, is a separate basis account maintained for CAMT purposes, and is in several respects quite different than the carrying value of an applicable corporation's assets on its AFS, including in the manner that income and deduction items related to the property are taken into account for AFSI purposes and how gain is computed upon the disposition of such an asset). Leaving aside the order in which CAMT attributes should be reduced, the first two categories are relatively straightforward as they have clear analogues to the regular tax system (and in fact are not really attributes that exist for AFS purposes, even though they exist for CAMT purposes). Ordering aside, the Executive Committee recommends that if attribute reduction is adopted for CAMT purposes, these CAMT attributes should be available for reduction.

Whether and to what extent other assets carried on the asset side of an applicable corporation's AFS balance sheet should be reduced is a much harder question. Treasury could take the view that all "assets" (or most – the rules should probably exclude items that do not have a tax analogue or would give rise to double counting) on the balance sheet of an AFS are available for reduction for CAMT purposes unless specifically excluded. This would require the applicable corporation to maintain indefinitely a "shadow" balance sheet and income statement for CAMT purposes and determine the timing for any income recognition (or adjustment to loss recognition) as a result of the adjustments. One possibility is to provide that if and when the applicable accounting standard required any adjustment to, or recognized income with respect to, either the asset in question, or in certain circumstances its paired liability (*e.g.*, prepaid expenses and deferred revenue, lease right of occupancy and lease liability, etc.) the taxpayer would have a different amount of CAMT income or loss than is shown on its AFS. However, tracking these amounts and coordinating them with the calculation of AFSI would be very complex.

If this approach is taken, there would be an adjustment to the CAMT carrying value of an asset to a value that is different than the value reflected on the actual AFS, but there could be no income statement item associated with the adjustment (as that would lead to immediate taxation). This approach is slightly odd if viewed from a financial accounting perspective. Usually, when the value of an asset (or liability) is adjusted on a balance sheet, the differential is reflected on the income statement. Since balance sheet assets are generally carried at fair value and adjustments are made for impairments or (under certain accounting standards, and for certain assets) appreciation, the timing of any recapture of this amount would not necessarily be linked to a realization event as understood for tax purposes. Instead, there would need to be rules that identified the moment for CAMT purposes to take into account these items, and the tax results would depend on management's selection and application of AFS standards. In addition, in this approach, we recommend that Treasury explicitly exclude balance sheet assets that would create

immediate gain or would create duplication or circularity. In particular, cash and deferred tax assets[178] generally should not be available for reduction, and Treasury should consider as a policy matter whether assets such as pension assets should be available for reduction for CAMT purposes. For all these reasons, we think that Treasury should create guidelines to help taxpayers determine which sorts of AFS line items correspond to tax items described in Section 108(b).

As described above, guidance should also address scenarios where the Section 108(b) Reduction Amount is greater than the amount of the attributes deemed available for CAMT purposes in any particular class or in the aggregate. We believe that no CAMT asset should be reduced below zero (creating immediate taxation) for these CAMT purposes. Treasury should also consider whether available assets should be "paired," that is, should similar classes of assets be reduced even if the amount available in the CAMT class is greater or less than the amount available for regular tax purposes?

Alternatively, Treasury could limit the reduction to the CAMT tax assets of the applicable corporation (*i.e.*, FSNOLs, CAMT foreign tax credits, and basis as computed for AFSI purposes, taking into account the double counting point discussed above). This approach would be much simpler than the first approach, would tie to assets that have a clear existence for tax purposes and are not dependent on management's discretion with respect to the application of accounting standards. However, as described below, this approach might limit the availability of attributes available to reduce for CAMT purposes, meaning that the amount of black hole CODI for CAMT purposes could exceed the amount of black hole CODI for regular tax purposes.[179]

Finally, with respect to property depreciable under Section 168 (for this purpose including qualified wireless spectrum), special rules would have to apply to clarify both to which basis the reduction applies, and also how such reduction interacts with the adjustments required by CAMT such that only the CAMT-calculated basis is available for reduction; and adjustments would need to be made in applying the principles of Section 4 of the Notice. If the basis of assets is reduced for regular tax purposes, this appears to affect the amount of depreciation available to the taxpayer for CAMT purposes as well (and also the gain on sale of the asset taken into account for CAMT purposes as a result of the application of the Gain Redetermination Rule). Because of this symbiosis, we recommend that notwithstanding the ordering in Section 108(b),

[178] Deferred tax assets and liabilities are tricky concepts to apply in the context of the CAMT, and the issues extent far beyond Distressed Taxpayers. Such items can relate to attributes like NOLs or capital loss carryforwards, tax credits, timing differences between book and tax income, and likely the CAMT attributes themselves. These are subject to adjustment as a result of reserves based on the AFS preparer's view as to the usability of such attributes given projections, and also as a result of the use or reduction for regular tax purposes. Thus, a reduction in a regular tax NOL would create an adjustment to the deferred tax asset for regular tax purposes that could then affect the FSNOL. Or a reduction in regular tax basis could increase a deferred tax liability and thus affect the FSNOL or another CAMT attribute. The full scope of potential issues with respect to such assets and liabilities for AFS purposes is beyond the scope of this section of the Report.

[179] As described in Section 2.02 of the Notice, for regular tax purposes, attributes are reduced under Section 108(b), and, in the case of the basis of property, under Section 1017 (subject to the liability floor further described in Section 1017). Any debt discharge in excess of attribution reduction is not includible in income and is commonly referred to as "black hole" CODI.

basis reduction that occurs for regular tax purposes should automatically be credited as attribute reduction for CAMT purposes and be treated as occurring first.

Example 22: Corporation C is a standalone corporation that has filed for the protection of a court in a Title 11 Case. Corporation C has historically been an applicable corporation and has the following balance sheet:

Assets	$ million	Liabilities	$ million
Cash	100	Accounts Payable	500
Inventory	1,200	Long Term Debt	5,000
Accounts Receivable (net)	150	Operating Lease Liability	1,600
Prepaid Expenses	300	Deferred Revenue	100
Operating Lease Assets	1,400	Gift Card Liabilities	400
PP&E (net)	600		
Goodwill	1,000		
Trademark	250		
Franchise (net)	450		
Other Assets	250	Shareholder's Equity (accumulated deficit)	(1,900)
	5,700		5,700

In the Title 11 Case, $4,000 million of C's long-term debt is converted into equity of $1,000 million, C rejects its underwater leases and the landlords holding the unsecured claim in respect of such leases receive a recovery of $0, and C emerges with debt of $1,000 million. Assume C has regular tax NOLs of $2,500 million, basis in its fixed assets of $0, basis in its trademark and franchises of $500 million and basis in amortizable goodwill of $750 million. Assume C has FSNOLs of $1,500 million and AFSI basis in its fixed assets of $0.

For regular tax purposes, C has CODI of $3,000 million that is excluded under Section 108(a)(1)(A). Under Section 108(b) and Section 1017, for regular tax purposes C must reduce its tax attributes and the basis in its assets by the amount of its excluded CODI, subject to the limitation of Section 1017(b)(2). Thus, C reduces its NOL balance by $2,000 million to $0, and its basis in its amortizable intangibles by $1,000 million to $250 million. Likewise, under the Notice, C may exclude up to $3,000 million of AFS CODI, and C also must reduce its CAMT attributes (however defined) by $3,000 million. C reduces its FSNOL to $0. However, there is

still $1,500 million of potential attribute reduction available. C has depreciable AFSI basis in its fixed assets of $0 (but is carrying such assets at $600 million on its AFS). Query how C's fixed asset carrying value should be adjusted (assuming that all such assets are Section 168 assets) if at all. In addition, should C notionally adjust the value of items like AFS goodwill, franchise, and other intangible assets (the adjustment of which is somewhat at the discretion of the AFS preparer), inventory, or lease assets, for CAMT purposes, and if so, should the amount of any such reduction be tied to the amount of the reduction as calculated for regular tax purposes? Query also the order in which to adjust such assets and the timing of the CAMT income to be realized in respect of such adjustments.

The application of these concepts where an AFS Group and a tax consolidated group are not coterminous also raises difficult issues. AFSI takes into account items from non-wholly-owned entities and CFCs that are members of the AFS Group in a manner that may differ from the manner in which the applicable accounting standard takes such items into account for AFS purposes as described elsewhere in this Report. In general, we recommend that attributes attributable to wholly-owned entities within an AFS Group be available for reduction. However, how any reductions should be taken into account for CAMT purposes with respect to non-wholly-owned entities is less clear. A reasonable answer is that a class of attributes attributable to such entities and allocable to the relevant AFS Group should be created and tracked, but we recognize the complexity of such an endeavor.

There are many other difficult issues related to CAMT attribute reduction that should be addressed in guidance but that this Report does not address in depth, as the Tax Section's position on such items will depend on the approach taken in additional guidance. For instance:

- Because Section 3.05 of the Notice calculates income of a consolidated group that is part of an AFS Group on a consolidated basis, we believe that attribute reduction should also occur on a consolidated basis, and that concepts like Treas. Reg. § 1.1502-28 should be irrelevant. We believe this is true even where the amount of excluded CODI is determined on a separate entity basis (*e.g.*, if a single subsidiary of a consolidated group and an AFS Group realizes CODI in a Title 11 Case, for CAMT purposes, the CAMT attributes of the entire AFS Group should be available for reduction). We believe this is a necessary simplification and is consistent with our other recommendations. In particular, the provisions of Treas. Reg. § 1.1502-28 that push down attribute reduction through subsidiaries (including intercompany items) simply do not have an AFS analogue, and Treasury should resist creating an entirely separate consolidated return regime based on accounting principles. We recognize that this could cause distortions that the Treas. Reg. § 1.1502-28 regime was designed to fix. However, given the extreme amount of complexity a similar regime would require for CAMT purposes we do not recommend trying to construct such an approach.

- We are unsure whether permitting the equivalent of a Section 108(b)(5) election makes sense in the CAMT context. However, if this is permitted, we believe that it should only be permitted if the election is also made for regular tax purposes, and that the reduction should be applied proportionately to the consolidated asset basis of depreciable assets as determined for CAMT purposes (rather than to AFS basis) proportionately and to the

same assets as for regular tax purposes. We think this is necessary to prevent duplication or improper electivity.

4. Issues Particular to a Title 11 Case

Our general understanding is that at least under GAAP, an AFS Group emerging from bankruptcy must apply "fresh-start reporting" upon emergence from bankruptcy if the reorganization value of the emerging entity immediately prior to the emergence is less than the total of all post-petition liabilities and allowed claims, and holders of voting shares immediately prior to the confirmation hold less than 50% of the voting shares of the emerging entity. If fresh start reporting does not apply, then the applicable AFS generally would only reflect the effects of the reorganization. Our further understanding is that if such reporting applies, the fresh start reporting is effective as of the later of the confirmation of the plan and when all material conditions precedent to the plan becoming binding are resolved.[180] The effects of the plan are generally recorded on the Distressed Taxpayer's AFS as of such date (subject to a convenience rule if emergence is very close to the end of a reporting period), and are based on the valuation of the estate approved by the court as part of the confirmation process (which is usually a range, with the Distressed Taxpayer having significant discretion to pick the appropriate value within the range for AFS purposes).[181] This will generally cause the Distressed Taxpayer to record gain or loss applying purchase accounting principles to report net assets at fair value, recorded as a "fresh-start adjustment."

Section 3.07(1) of the Notice provides that if the emergence from bankruptcy of an AFS Group results in AFS gain or loss, such financial accounting gain or loss "resulting from application of the accounting standards used to prepare the AFS" is not treated as AFSI for the taxable year in which the emergence occurs. We believe that this provision is intended to exclude from AFSI any income or gain recognized on the AFS Group's AFS as a result of "fresh start" accounting under GAAP or any equivalent standard as described above. However, as drafted, the exclusion is incredibly broad and could be read to apply to any of the accounting standards that could cause income recognition in connection with the emergence transactions, including standards with respect to cancellation of debt or as a result of asset sales or other transactions in connection with emergence. We suggest that Treasury clarify the types of accounting standards eligible for this rule, because as drafted we believe the Notice is over-inclusive and this broad scope may not have been intended.

In addition, because the Notice does not define "emergence" from bankruptcy, it is not clear whether transactions such as asset sales under Section 363 of the Bankruptcy Code that might be precedent to an emergence from a Title 11 Case qualify for relief. Consistent with regular tax principles, we do not believe that actual taxable asset sales should receive any particular preference for CAMT purposes just because a Distressed Taxpayer is in a Title 11 Case. We recommend that final guidance clarify that such transactions are not covered by Section 3.07 of the Notice and are simply treated like any other asset sale for CAMT purposes. We think this should equally be the case where the transactions that conclude the bankruptcy are

[180] S*ee* ASC 852-10-45-17.

[181] S*ee* ASC 852-10-45-17, -18.

structured as a full asset sale followed by a structured dismissal of the Title 11 Case. In such transactions, the Distressed Taxpayer would be calculating its regular tax due (if any) in determining whether such transaction was value maximizing. If the taxpayer is an applicable corporation, then it is unclear that the statute should permit an exception to such corporation also taking into account the potential of application of the CAMT just because it is in a Title 11 Case. Put differently, if there is a regular tax realization event, it is not clear there should be any special rule preventing it from being a CAMT realization event as well; a more generous rule might at the margins encourage a Distressed Taxpayer to seek protection of a Bankruptcy Court in a Title 11 Case rather than trying to resolve its case out-of-court.

We also believe that the application of Section 3.07(1) of the Notice to an AFS Group is improper. As discussed above, it is often the case that all members of an AFS Group do not file a Title 11 Case (*e.g.*, where members of an AFS Group are controlled foreign corporations). In line with our recommendation regarding the clarification over "fresh start" accounting, we believe that the income exclusion should apply where such accounting standard applies (so, *e.g.*, where the parent of an AFS Group has filed a Title 11 Case, upon emergence of the parent, or where a subsidiary, but not the parent has filed, to the extent that creditors end up owning more than 50% of the equity of the subsidiary, directly or indirectly, and the other conditions for fresh start reporting are met). While this could cause an AFS Group to recognize AFSI in connection with an emergence from a Title 11 Case where fresh start accounting does not apply, we think that is not improper as in such transactions, only the effects of the reorganization itself (and not a fresh start adjustment) apply, and the entity is plainly in better financial health.

Section 3.07(2) of the Notice further provides that with respect to any property of a "Party" emerging from bankruptcy, any increase or decrease in the financial accounting basis of the Party's property on the AFS resulting from emergence from bankruptcy (other than in respect of adjustments for excluded CODI) is not taken into account for purposes of computing AFSI with regard to any taxable year of that Party and the Party's AFSI basis carries over. Under the Notice, the term "Party" is limited to persons that engage in Covered Transactions. A "**Covered Transaction**" includes Covered Non-Recognition Transactions (*i.e.*, transactions that qualify for non-recognition treatment for federal income tax purposes) and Covered Recognition Transactions (*i.e.*, transactions resulting in gain or loss for federal income tax purposes). Neither term appears to include a standalone AFS Group emerging from a Title 11 Case. Indeed, as drafted, such a Distressed Taxpayer could interpret the Notice to permit it to exclude 100% of its income items recorded on its AFS in connection with its bankruptcy emergence as a result of fresh start adjustments and also to enjoy the benefit of fresh start accounting on its AFS and AFSI basis.

We do not think this wholesale exclusion was the intent of the Notice. However, it may not be a wholly unreasonable result and the Executive Committee is divided as to whether the Notice should be clarified to support this interpretation or should be clarified to require carryover AFSI basis in the standalone single party reorganization context. Supporters of a system that would both exclude the fresh start adjustment income items from AFSI and permit the post-emergence entity to use the fresh start balance sheet of the applicable corporation for CAMT purposes note that post-emergence an AFS Group that has applied fresh start principles is generally treated as a new reporting entity for applicable financial statement purposes. In fact, applicable guidance under GAAP provides that presentations of predecessor financial statements

"shall not be viewed as a continuum because the financial statements are those of a different reporting entity and are prepared using a different basis of accounting, and therefore are not comparable. Attempts to disclose and explain exceptions that affect comparability would likely result in reporting that is so unwieldy that it would not be useful."[182]

The preservation of the entity's historic balance sheet for CAMT purposes results in just such unwieldy reporting and raises difficult questions as to what it means to preserve basis in CAMT assets particularly where such "assets" do not necessarily have a tax analogue as understood. We thus think that it would not be improper in the case of a single party reorganization to permit the post-emergence AFS Group to benefit for CAMT purposes (or suffer a detriment, depending on valuations and the pre-emergence carrying value of the assets) from the fresh-start adjustments required under a fresh start principles. If adopted, we recommend that this approach clarify that any FSNOL carryover is eliminated and does not carry over into future periods. The approach would have the benefit of more closely aligning the reorganized AFS Group's AFSI for CAMT purposes with the net income shown on its applicable financial statements. We note that this approach is in tension with the idea that in the CAMT regime there is attribute reduction for excluded CODI under principles similar to Section 108(b) as described above, and if this approach is taken, it would need to be coordinated with the approach to attribute reduction.

Some members of the Executive Committee support the contrary position and believe that the approach in the Notice should be clarified instead to provide that in the standalone reorganization context where fresh start adjustments are excluded, the AFS Group should maintain its pre-reorganization AFS values for purposes of calculating AFSI for CAMT purposes on a go-forward basis. This position would cause the AFS Group to take into account for CAMT purposes any built in gain or loss that existed as of immediately prior to the emergence transaction with respect to its AFS items in the future. If this approach is taken, AFSI would be even further decoupled from the financial statement income reported by the AFS Group for AFS purposes. Like in the other approach, the treatment of attribute reduction would need to be specified. Furthermore, as discussed with respect to attribute reduction, because the CAMT values (and potentially accounting methods) of the AFS Group will differ from the AFS Group's actual results under applicable accounting standards, rules will need to be provided with respect to timing and amount of AFSI recognition with respect to this shadow balance sheet.

The Notice is also unclear regarding the CAMT treatment of other common transactions in connection with the emergence from a Title 11 Case.

- Emergence transactions are often structured as a taxable sale of assets to a new entity formed by creditors (*e.g.*, in a so-called "Bruno's" transaction). In that transaction, for regular tax and often for book purposes, the acquirer is a newly formed entity. We believe that the Notice should be interpreted as providing, and final guidance should confirm, that Section 3.07(2) of the Notice does not apply to such transaction because it applies solely to property of the Party emerging from bankruptcy. If there is a new taxpayer for all purposes, we read this provision of the Notice as not applying to such new taxpayer. However, we understand that other commentors believe that the provision

[182] S*ee* ASC 852-10-45-27.

does apply, and there is ambiguity in cases where there is an accounting successor but not a tax successor. As described above, we recommend that final guidance provide that gain as a result of taxable asset sales, even if in connection with an emergence transaction and recorded on the Distressed Taxpayer's AFS under an accounting standard, should not be excluded from a Distressed Taxpayer's AFSI and that there should be no carry over of the Distressed Taxpayer's AFSI basis to the acquirer's basis for CAMT purposes. Furthermore, if the transaction is structured as a stock transaction for regular tax purposes, but an asset sale for tax purposes (*e.g.*, as a result of a Section 338 election), we recommend that the same result apply.

- The Notice is unclear how the provisions of Section 3.07 of the Notice should be reconciled with the Covered Nonrecognition Transaction Rules in the case of a reorganization described under Section 368(a)(1)(G). We recommend that a G reorganization should be treated for CAMT purposes as a Covered Nonrecognition Transaction and not under Section 3.07 of the Notice.

- Similarly, if the emergence transaction takes the form of a business combination that is also a Covered Transaction (whether or not a G reorganization) and in which there is not a fresh start adjustment as commonly understood, we believe that the general rules applicable to a Covered Transactions should apply.

- If the emergence transaction is structured as an equitization transaction in which creditors acquire more than 50% of a Distressed Taxpayer, and purchase accounting rather than fresh start accounting type concepts apply, we recommend that such transaction be treated as a Covered Transaction.

5. Other Issues

There are a number of other issues applicable to Distressed Taxpayers that we also think merit clarification in final guidance.

- Deconsolidation of a subsidiary for financial accounting purposes raises multiple issues:

    - If a subsidiary (or subgroup) within an AFS Group, but not the whole AFS Group, files for bankruptcy, it may be required to deconsolidate from the AFS Group under applicable accounting standards, and the parent would recognize gain or loss as a result of the deconsolidation.[183]

    - We generally recommend that any such items be excluded from AFSI unless such items are recognized for tax purposes because recognition of such items is not consistent with the realization requirement of the income tax. In such cases, it may be necessary to separately state intercompany accounts at the subsidiary level

[183] *See, e.g.*, ASC 810-10-15-10, but also see ASC 852-14 where bankrupt entities are separately reported on condensed consolidating financials within an AFS.

for applicable financial statement purposes. It is unclear how Section 3.05 of the Notice should be applied in these circumstances.

- Additional adjustments may be necessary in situations where such subsidiaries reconsolidate with the AFS Group.

- Alternatively, some members of the Executive Committee support an approach where (i) the gain or loss with respect to such subsidiary is taken into account by the AFS Group upon the deconsolidation, (ii) the portion of the FSNOL carryover attributable to such subsidiary is allocated back to such subsidiary and limited in use to income generated by such subsidiary under rules similar to the SRLY rules, (iii) any further separate company items of such subsidiary would be taken into account under the general rules applicable to entities that are not part of the AFS, and (iv) any items associated with the reconsolidation of the entity (if it occurs) also are taken into account.

- Rules for CODI allocated from partnerships should be coordinated with partnership guidance as discussed elsewhere in this Report.

- In an out-of-court restructuring, if the balance sheet of an AFS Group is adjusted in connection with a transaction where creditors acquire more than 50% of the stock of AFS Group, we recommend that such transaction be treated as a Covered Transaction if not otherwise addressed by the proposals above.

G. AFSI of Corporate Partners in a Partnership

In developing our comments and recommendations for the application of CAMT to partnerships, we are guided by several general principles. First, although the number of applicable corporations that meet the AFSI Test may be few, those corporations own, directly or indirectly, interests in a large number of partnerships. A key goal of the CAMT rules dealing with partnerships should be to minimize administrative complexity and compliance burdens for these partnerships that otherwise would be outside the intended scope of CAMT, particularly where applicable corporations own, directly or indirectly, only a relatively small interest in a partnership. An even greater number of partnerships are owned by corporations that need to apply the AFSI Test, including with respect to income from their partnership investments, further underscoring the importance of administrable rules.

Second, we believe that to achieve administrative simplicity, the best approach generally will be to follow the relevant financial accounting rules, when the statute permits a choice as to whether tax concepts or financial accounting concepts should apply for purposes of CAMT. We understand that partnerships often will be relying on financial accounting professionals for CAMT compliance, and as a result in our recommendations related to partnerships, we try to be judicious in making tax adjustments to financial statement income. The use of financial accounting rules is also consistent with the general purpose of CAMT, which is to impose a tax based on economic income (measured by financial accounting principles for most purposes) rather than taxable income.

Third, where the statute expressly provides for the incorporation of principles from income tax provisions (for example, in Section 56A(c)(15)(B), which provides for incorporation of the principles of Sections 721 and 731 into CAMT), Treasury must consider to what extent adopting those specific income tax provisions in the CAMT regime then necessitates incorporating other conceptually related income tax rules designed to prevent distortion or shifting of income among taxpayers. For example, in our view Section 721 is conceptually intertwined with Sections 704(c) and 752, which prevent shifting and deferral of income and gain away from the contributing partner; as we discuss below, if Treasury adopts Section 721 principles in the CAMT regime it appears reasonable also to incorporate the principles of these two companion provisions. As another example, also discussed below, Section 731 is conceptually related to adjustments under Section 734(b), and Treasury could decide whether to incorporate these types of adjustments in the CAMT regime. To the extent the basic structure and operation of rules imported from the regular tax system into the CAMT system corresponds to their structure and operation for normal income tax purposes, that would help to reduce administrative complexity.

As we believe the discussion below illustrates, importing income tax rules and principles from Subchapter K into the CAMT regime inevitably entails complexity and increases administrative burden. It is also potentially at odds with Congress' evident purpose in enacting CAMT of adopting a way to measure income that is different than the regular income tax regime. In cases where Treasury believes it is obligated to incorporate income tax rules related to partnerships into CAMT, including rules viewed as generally taxpayer-favorable such as Sections 721 and 731, Treasury may wish to consider adopting, as an elective regime (with sufficient time limits on and other requirements for making the election to ensure the election cannot be manipulated), rules that allow a taxpayer instead to opt to follow financial accounting principles.[184]

Developing CAMT rules for cases where an applicable corporation is consolidated for financial accounting purposes with a partnership in which it owns an interest would appear to involve additional considerations beyond those applicable to investments in nonconsolidated partnerships. Although there is no concept of partnership consolidation in the income tax rules, we believe some of the issues related to the treatment of transactions between an applicable corporation and a partnership that is consolidated for financial accounting purposes, may be conceptually related to issues concerning the treatment under CAMT of transactions between an applicable corporation and a corporate subsidiary that is consolidated for income tax and financial accounting purposes, including where the subsidiary has an unrelated minority owner.[185] Such issues also are, to an extent, conceptually related to treatment of transactions between an applicable corporation and a corporate subsidiary consolidated for financial accounting but not income tax purposes.[186] In all these cases, income, gain or loss may not arise or may be eliminated in consolidation for financial accounting purposes, with respect to (for

[184] The deferred sales method described in Part IV.G.4 below, while not completely aligning the CAMT consequences of partner's contribution of property to a partnership with those under financial accounting principles, would move at least partway toward bringing them into alignment.

[185] *See* Section 56A(c)(2)(B) and Section 3.05 of the Notice.

[186] *See* Section 56A(c)(2)(C).

example) a sale of property between the applicable corporation and the subsidiary or other intercompany transactions. It would appear appropriate to develop rules that address these related but distinct situations in a logically coherent way. Treasury may conclude that it is appropriate to cause the CAMT treatment of transactions between an applicable corporation and a subsidiary that is a consolidated partnership to correspond to the treatment that would apply within a tax consolidated group (including possible elimination of income from intercompany transactions), or to correspond to the treatment where a corporate subsidiary is consolidated for financial accounting but not tax purposes. If a parent applicable corporation consolidates a subsidiary partnership for financial accounting purposes and another applicable corporation holds a minority interest in that partnership, Treasury will need to consider the extent to which the minority owner's consequences under CAMT of its investment in the partnership (for example, the computation of the minority owner's distributive share of income or loss the partnership derives from transactions with its consolidated parent) should be tied together with the parent's treatment of those transactions under CAMT. The potential complexities arising when an applicable corporation owns an interest in a consolidated partnership, and the differences in treatment of an investment in such a partnership (as opposed to an investment in a nonconsolidated partnership) that may be appropriate under CAMT in order to address these complexities, are beyond the scope of this Report. The discussion below does not address consolidated partnerships, except to a limited extent where expressly indicated.

1. Classification as a Partnership

Entities may have inconsistent classifications for financial accounting and regular tax purposes. The "check-the-box" regulations allow non-corporate entities, such as a limited liability company (LLC) or a partnership formed under state law, to elect to be classified as either a corporation or a pass-through entity for U.S. federal tax purposes,[187] including (apparently) for CAMT purposes. In contrast, the financial accounting rules are not elective, do not permit a state law partnership to be treated as a corporation, and classify an LLC as either a corporation or a partnership based on its organizational structure.[188] Insofar as CAMT is intended to apply a minimum tax based on a different "income" base rather than an alternative, entirely separate tax regime for applicable corporations, we believe it makes sense to maintain parity between the classification of an entity as a corporation or a partnership for regular tax purposes and for CAMT purposes. As a result, the CAMT partnership rules may apply to an LLC that is treated as a partnership for U.S. federal income tax purposes but as a corporation for financial accounting purposes, while the CAMT corporation rules may apply to an LLC or state law partnership that has elected to be a corporation for U.S. federal income tax purposes. We believe these results are appropriate.

2. Scope of Section 56A(c)(2)(D)

The statute is not entirely clear regarding which categories of partnership-related taxable income should be taken into account for AFSI purposes. Section 56A(c)(2)(D)(i) provides that, except as provided by Treasury, the AFSI of a partner in a partnership "with respect to such

[187] Treas. Reg. § 301.7701-3.

[188] *See* ASC 323-30-35-3.

partnership shall be adjusted to only take into account the taxpayer's distributive share of [AFSI] of such partnership." (The partnership's AFSI is the partnership's net income or loss set forth on such partnership's applicable financial statement, adjusted under rules similar to Section 56A's rules.[189]) Read literally, this language arguably only addresses "flow-through" income allocated to a partner based on its distributive share.

The language of Section 56A(c)(2)(D)(i), which provides that a partner takes into account only its distributive share of the partnership's AFSI except as otherwise provided, differs from the otherwise analogous language in Section 56A(c)(2)(C) that applies to subsidiary corporations that are not members of an applicable corporation's tax consolidated group. Section 56A(c)(2)(C) generally provides that a parent corporation of a non-consolidated subsidiary corporation takes into account not only the dividends received from the subsidiary corporation, but also other amounts which are includible in gross income or deductible as a loss for regular tax purposes with respect to the subsidiary corporation. Accordingly, the parent corporation's AFSI should generally include gain or loss from the sale, worthlessness, or other taxable disposition of the stock of the subsidiary corporation, as discussed in Part IV.B.2.ii above.

The language difference between the adjacent Sections 56A(c)(2)(C) and 56A(c)(2)(D)(i) creates a negative inference that a corporate partner's AFSI does not include any gain or loss on the sale or other disposition of a partnership interest. We do not think the language difference was intentional. Nor do we see a compelling policy reason to treat an applicable corporation's corporate and noncorporate investments differently for this purpose. We recommend that guidance under Section 56A(c)(2)(D)(i) provide that a partner's AFSI also includes any gain or loss recognized on a sale or other taxable disposition of the partnership interest.

Consistent with the discussion in Part IV.B.2.ii, above, however, we believe that a partner's AFSI generally should not include any mark-to-market unrealized gains and losses taken into account for financial accounting purposes, although we do think it would be reasonable in certain circumstances for a partner to be able to use the fair value or measurement alternative methods to account for its investment in a partnership as discussed in Part IV.G.2 below. Further, when determining the amount of any recognized CAMT gain or loss with respect to the sale or other disposition of a partnership interest, it would seem reasonable to measure gain or loss by reference to the partner's AFSI basis, rather than its income tax basis, in the partnership interest, for reasons corresponding to those discussed above in Part IV.B.2.ii in the context of measuring CAMT gain or loss on the sale of the stock of a nonconsolidated corporate subsidiary.

> **Example 23:**[190] Corporation A owns a 40% interest in partnership PRS. Corporation A has a tax basis of $200 and an AFSI basis of $100 in its PRS interest. PRS has no liabilities. Corporation A sells its interest in PRS for $300 of cash. Under Section 741, Corporation A recognizes $100 of gain for regular tax purposes. For purposes of computing its AFSI, Corporation A would generally recognize $200 of gain if it applies

[189] Treas. Reg. § 301.7701-3.

[190] In all of the examples in Part IV.G, Corporation A is an applicable corporation.

Section 741 principles but measures its gain by reference to its AFSI basis in its PRS interest. In our view, this is a reasonable result.

3. What is "Distributive Share"?

Section 56A(c)(2)(D) uses the term "distributive share" but does not define it. The same term is used in many other Code provisions such as Section 108(e)(8), 163(j)(4), and 168(h)(6)(B), 702(b), and 704(b), all of which generally apply rules under the Section 704(b) regulations to allocate a partnership's taxable income and items thereof among the partners,[191] subject to special rules such as those under Section 704(c) and Treas. Reg. § 1.704-3 for contributed properties. This might suggest that the same Section 704(b) principles were intended to apply in determining CAMT "distributive share."

Nevertheless, we are mindful of the administrative burdens on partnerships that are imposed by transplanting tax rules into the financial accounting sphere. AFSI is generally based on financial accounting income, which is allocated under the financial accounting rules instead of Section 704(b). We believe it would be simpler administratively to follow those allocations of financial accounting income rather than applying a modified Section 704(b) distributive share percentage to AFSI. Section 704(b) distributive share rules also include distortions (such as the value-equals-basis presumption in Treas. Reg. § 1.704-1(b)(2)(iii)(d) or the fact that revaluations under Treas. Reg. § 1.704-1(b)(2)(iv)(f) are optional) that would be inconsistent with the purpose of the CAMT rules and their reliance on financial accounting income as the presumptive measure of "economic" income. We therefore do not believe, on balance, that Section 704(b) distributive share principles generally should apply in allocating a partnership's AFSI among its partners. We recommend that financial accounting items should be allocated by the partnerships among the partners according to the partner's share of such items for financial accounting purposes, such as under either (i) the sharing ratio under the equity method of accounting or (ii) by fully consolidating and then subtracting for non-controlling interests.[192]

If the partnership makes adjustments in determining AFSI under Section 56A(c), such as adding back foreign income taxes under Section 56A(c)(5)), we believe that the same financial accounting distributive share percentage should apply to allocate the adjustments. In other words, the ratio that the financial accounting distributive share of income bears to the partnership's financial accounting income should be used for CAMT allocation purposes, even if the financial accounting distributive shares might theoretically have been different had the partnership instead earned the AFSI amount for financial accounting purposes. It would be extremely burdensome to require a partnership and its partners to run the AFSI adjustments through the partnership waterfall in order to recompute new financial accounting distributive shares for every partner. In addition, many of the AFSI adjustments are timing differences, which should tend to even out over time.

In order to reduce the compliance burdens on partnerships that have relatively small interests held directly or indirectly by applicable corporations, we recommend that a partner (at least in such a case) be allowed to elect to use the fair value or measurement alternative methods

[191] Treas. Reg. § 1.704-1 ("Partner's distributive share").

[192] We understand that the two methods are economically equivalent in arriving at the same net number.

of accounting for CAMT purposes if those methods are being used by the partner for financial accounting purposes. The fair value or measurement alternative methods would allow the partner to determine its partnership-related AFSI solely at the partner level, thereby eliminating the need to inquire into the partnership's financial accounting records and make onerous adjustments to reconcile the financial accounting numbers, tax numbers, and AFSI numbers of the partnership (and potentially also its lower-tier partnerships). The ability for a small partner in a partnership to determine its partnership-related AFSI solely at the partner level arguably is analogous to how a shareholder that owns less than 80% of a subsidiary corporation, or a shareholder that owns less than 10% of the stock of a controlled foreign corporation, generally only needs to recognize dividends and other tax items under Section 56A(c)(2)(C) without having to inquire into the subsidiary corporation's financial accounting items and make AFSI adjustments.

A CAMT fair value election, based on Treasury's discretionary authority pursuant to Section 56A(c)(2)(D)(i), would be consistent with the general statutory approach of reducing the burden of complex AFSI calculations for entities with small interests held by applicable corporations and thereby reduce the administrative burden of CAMT on entities (non-applicable corporations) outside the intended scope of the CAMT regime. Such an election is also consistent with the general goal of CAMT to impose a minimum tax based on a taxpayer's financial accounting income. The Executive Committee was not in complete agreement on the circumstances, if any, in which the election should be available. Some members of the Executive Committee believe that an election to use fair value for CAMT purposes should be available whenever the partner is using fair value for financial accounting purposes, to ensure simplicity and consistency. Other members of the Executive Committee oppose any electivity by a taxpayer that may result in a lower tax burden, especially if the election is not irrevocable with respect to all of the taxpayer's partnership interests and binding in all future taxable years and on all related taxpayers. If the election is perceived as being too favorable to taxpayers to be adopted as a general rule, the election could be limited to small partnerships or to partnerships that are owned below a certain percentage threshold directly or indirectly by one or more applicable corporations.

The use of financial accounting distributive shares that we suggest can be illustrated by the following examples for different levels of ownership by the applicable corporation of interests in the partnership, which implicate three different financial accounting regimes.

> **Example 24 (consolidation):** Corporation A owns an 80% interest for financial accounting purposes in partnership PRS, which has $100 of financial accounting income after deducting $50 of foreign income taxes. Due to a multi-tier distribution waterfall in PRS's partnership agreement, assume that Corporation A would have a 70% interest in PRS for such purposes if PRS had $150 of financial accounting income. PRS has no other CAMT adjustments. Corporation A elects to credit foreign income taxes for regular tax and CAMT purposes. Corporation A has control over PRS and therefore consolidates PRS for financial accounting purposes.[193] Corporation A's financial statements have $100 of income from PRS and a $20 subtraction for non-controlling interests. The Section 56A(c)(5) adjustment for foreign taxes would cause Corporation A to have $150 of income from PRS (due to an increase of $50) and a $30 subtraction for non-controlling

[193] *See* ASC 805-10-25-5.

interests (due to an increase of the noncontrolling 20% interest multiplied by $50). Under our suggested approach, Corporation A therefore has $120 of AFSI from PRS and a $40 CAMT foreign tax credit.

	Consolidated Amount	Noncontrolling Interest	AFSI
Financial Accounting Income	$100	($20)	$80
Section 56A(c)(5) adjustment for foreign taxes	$50	($10)	$40
Total	$150	($30)	$120

Example 25 (equity method): Corporation A owns a 40% interest for financial accounting purposes in partnership PRS, which has $100 of financial accounting income after deducting $50 of foreign income taxes. Due to a multi-tier distribution waterfall in PRS's partnership agreement, assume Corporation A would have had a 60% interest in PRS if PRS had $150 of financial accounting income. PRS has no other CAMT adjustments. Corporation A elects to credit foreign income taxes for regular tax and CAMT purposes. Since Corporation A is presumed to have significant influence over PRS's operating and financial policies by owning more than 20% of PRS's equity,[194] Corporation A uses the equity method of accounting for PRS. Corporation A's financial statements show $40 of income from PRS. The $20 Section 56A(c)(5) adjustment causes Corporation A to have $60 of AFSI from PRS (due to an increase of 40% of $50) and a $20 CAMT foreign tax credit.

Example 26 (mark-to-market): Corporation A owns a 10% interest in partnership PRS, which has $100 of financial accounting income after deducting $50 of foreign income taxes. Due to a multi-tier distribution waterfall in PRS's partnership agreement, Corporation A would have had a 20% interest in IRS if PRS had $150 of financial accounting income. PRS has no other CAMT adjustments. Corporation A uses the fair value method of accounting for its PRS interest, and assume that the fair value of its interest in PRS increases by $12 and it records $12 of income on its financial statements corresponding to that increase. For CAMT purposes, we recommend that Corporation A be allowed to use either the equity method of accounting or the fair value method of accounting for its PRS interest. If Corporation A uses the equity method for CAMT purposes, then after applying the Section 56A(c)(5) adjustment, Corporation A has $15 of AFSI from PRS (equal to 10% of the sum of $100 and $50) with a $5 CAMT foreign tax credit (equal to 10% of $50). Alternatively, if Corporation A makes the fair value election for CAMT purposes, Corporation A may elect to use the same fair value method of

[194] *See* ASC 323-10-15-11.

accounting for its PRS interest that it uses for financial accounting purposes, so that Corporation A has $12 of AFSI from PRS with no CAMT foreign tax credit.

Example 27 (mark-to-market CAMT election): Corporation A owns a 40% interest for financial accounting purposes in partnership PRS, which has $100 of financial accounting income after deducting $50 of foreign income taxes. PRS has no other CAMT adjustments. Corporation A elects to credit foreign income taxes for regular tax and CAMT purposes. Corporation A makes an election under the financial account rules to report its PRS interest at fair value.[195] Assume that the fair value of Corporation A's interest in PRS increases by $48 and it records $48 of income on its financial statements. For CAMT purposes, we recommend that Corporation A may use either the equity method of accounting or the fair value method of accounting for its PRS interest. If Corporation A uses the equity method for CAMT purposes, then after applying the Section 56A(c)(5) adjustment, Corporation A has $60 of AFSI from PRS (equal to 40% of the sum of $100 and $50) with a $20 CAMT foreign tax credit (equal to 40% of $50). Alternatively, if Corporation A makes the fair value election for CAMT purposes, Corporation A may elect to use the same fair value method of accounting for its PRS interest that it uses for financial accounting purposes, so that Corporation A has $48 of AFSI from PRS with no CAMT foreign tax credit.

A partnership has to adjust its AFSI under Section 56A(c)(13) for tax depreciation on Section 168 property and under Section 56A(c)(14) for qualified wireless spectrum amortization. A majority of the Executive Committee recommends that the financial accounting distributive share percentage should also apply to these items. The use of a single financial accounting distributive share percentage for AFSI and its adjustments would be administratively simpler and is more consistent with the general approach of using financial statement income as the base for computing AFSI. For the Section 56A(c)(13) depreciation adjustment and Section 56A(c)(14) amortization adjustment, it would be administratively burdensome and may create inconsistencies if the financial accounting distributive share of book depreciation and amortization is subtracted and then the Section 704(b) distributive share of tax depreciation and amortization is added for each partner.

A minority of the Executive Committee recommends that Section 704(b) distributive share should be used for Section 56A(c)(13) tax depreciation and Section 56A(c)(14) qualified wireless spectrum tax amortization, even if the financial accounting distributive share is used for all other AFSI items. This method ensures consistency between a partner's regular tax allocation of such depreciation and amortization expense and its CAMT allocation of the same expenses. Section 56A(c)(13) may be read as attempting to ensure that a taxpayer should always have the same CAMT depreciation on Section 168 property as its regular tax depreciation on the same property, and Section 56A(c)(14) may be read similarly for CAMT qualified wireless spectrum amortization. However, this method is administratively more complex and requires a partnership to disaggregate its AFSI into component items that are subject to different distributive share percentages.

[195] S*ee* ASC 825-10-15.

Example 28: Corporation A owns a 40% interest in partnership PRS for financial accounting purposes and a 50% interest in partnership PRS for Section 704(b) purposes. PRS has $100 of financial accounting income after claiming $50 of book depreciation on Section 168 property. PRS has $10 of depreciation on the Section 168 property for regular income tax purposes. PRS has no other CAMT adjustments. Corporation A uses the equity method of accounting for PRS, so its financial statements have $40 of income from PRS. The Section 56A(c)(13) adjustment for depreciation causes PRS to have $140 of AFSI, after adding back $50 of book depreciation and subtracting $10 of tax depreciation.

Under the majority view, Corporation A has $56 of AFSI allocated from PRS, equal to 40% of $140. The same 40% financial accounting distributive share thus applies to all of PRS's AFSI adjustments.

Under the minority view, PRS's $140 of AFSI is separated into two components: $10 of tax depreciation on its Section 168 property and $150 of other AFSI items. Corporation A is allocated a 50% Section 704(b) distributive share of the $10 of tax depreciation and is allocated a 40% financial accounting distributive share of the $150 of other AFSI items, to arrive at $55 of AFSI allocated from PRS's AFSI (equal to 40% of $150 minus 50% of $10). Corporation A effectively has a blended 39.3% distributive share of PRS's $140 of AFSI. It should be noted that for the Section 168 property, Corporation A is effectively allocated 50% of the tax depreciation but 40% of income and all other expenses with respect to the property. It is also necessary to consider whether gain on a sale of the Section 168 property should be allocated 50%, rather than 40%, to Corporation A for CAMT purposes, to the extent of the CAMT depreciation expense previously allocated to it in that ratio.

Some taxpayers use other financial accounting methods to account for their investments, such as the proportional amortization method available since 2014 for investments in partnerships that generate the low-income housing tax credit.[196] The proportional amortization method effectively causes the taxpayer to account for its investment purely based on the tax credits and other tax benefits from the investment, without regard for the investment's economic profits or losses. Treasury and the IRS should evaluate whether the same method would count as "distributive share," or whether taxpayers using the proportional amortization method for financial accounting purposes must use the equity method or some other method for CAMT purposes. We recommend that taxpayers be permitted to use the proportional amortization method for CAMT purposes because the method is consistent with the taxpayer's financial accounting income, after taking into account the AFSI adjustments.

4. Section 721 Transactions and Section 704(c)

When property is contributed to a partnership, either by an applicable corporation or by another partner, a number of complex issues arise in the CAMT regime. Under normal financial

[196] *See* ASU 2014-01, *Investments—Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. The proportional amortization method may become available for more types of tax credits in the future.*

accounting rules, the contributor generally recognizes gain (or loss) with respect to the contribution, and the partnership has a fair value basis in the contributed property. The partnership then allocates depreciation, amortization, and gain with respect to the contributed property in the same manner as similar items with respect to other property. In contrast, Section 56A(c)(15)(B) authorizes regulations for CAMT to conform to the regular tax nonrecognition provision in Section 721, which provides that the contributor typically does not recognize any gain or loss upon contributing property to a partnership.[197] We believe that Section 721 nonrecognition rules should apply to partnerships, for the same reasons described in Part IV.B.3 above for corporate nonrecognition transactions.

When an applicable corporation transfers property to a partnership in a transaction meeting the requirements of Section 721, we believe that special CAMT rules akin to Section 704(c) are necessary, in order to allocate back to the contributing partner some or all of the consequences of the difference between the asset's fair value and the partner's AFSI basis in the asset at the time of the transfer. We believe it would similarly be appropriate to adopt a CAMT analogue of "reverse" Section 704(c) gain or loss when the partnership redetermines the fair value of its assets for financial accounting purposes, which results in financial accounting gain or loss that is disregarded for CAMT purposes while the partnership assets' AFSI basis remain the same. Without Section 704(c) principles, partners could artificially shift CAMT gain, loss, or other tax items amongst themselves, the same concern that led to Section 704(c) becoming mandatory for regular tax purposes in the Deficit Reduction Act of 1984 (P.L. No. 98-369).[198]

In determining the Section 704(c) book-tax difference that is the deferred CAMT gain or loss, the financial accounting fair value of the contributed asset is akin to the asset's Section 704(b) book value, while the contributed asset's AFSI basis is akin to the asset's tax basis. We suggest two different approaches for a partnership and its partners to handle the deferred CAMT gain.

The first approach ("**Section 704(c) Methods Approach**") would require taxpayers to apply Section 704(c) principles and would permit them to use any one of the methods described in the Section 704(c) regulations. This approach would provide flexibility for taxpayers to use their existing tax methodologies and workpapers and simply apply them to CAMT amounts – an approach similar to how individuals compute amounts relevant for the AMT and how corporations before 2018 computed their pre-TCJA CAMT.

> **Example 29:** In 2023, Corporation A contributes an intangible asset with an AFSI basis of $4 and a fair value of $40 to partnership PRS, in exchange for a 40% interest in PRS. Corporation B contributes $60 of cash to PRS. The intangible asset has a financial accounting useful life of four years and is stepped up to a fair value of $40 for financial accounting purposes in the hands of PRS. PRS has $100 of financial accounting income in its first year, after deducting $10 of amortization from the contributed intangible asset, and the financial accounting income is allocated $40 (40%) to Corporation A and $60 (60%) to Corporation B. The $10 of financial accounting amortization is effectively

[197] *See* Sections 3.02(5)(a) and 3.03(1) of the Notice.

[198] *See* H. Rep. 98-432 Part 2, at 1209 ("special rules are need to prevent an artificial shifting of tax consequences between the partners with respect to pre-contribution gain or loss").

allocated $4 (40%) to Corporation A and $6 (60%) to Corporation B. Since Corporation A has deferred its gain of $36 in the contribution for CAMT purposes under Section 721(a), PRS has a AFSI basis of $4 in the intangible property and is allowed only $1 of amortization deductions for CAMT purposes. The discrepancy between financial accounting amortization and CAMT amortization can be addressed under Section 704(c) principles. Under the traditional method, PRS allocates the $1 of amortization to Corporation B and none to Corporation A, which would have $44 (equal to 40% of $110 of pre-amortization income) of allocated income for CAMT purposes. Alternatively, PRS can use the remedial method under Section 704(c) principles (or the traditional method with curative allocations) to allocate $6 of amortization to Corporation B (consisting of $1 of CAMT amortization plus $5 of notional amortization) and create a notional $5 of CAMT income to Corporation A, which would have $49 of allocated income for CAMT purposes.

In addition, under the Section 704(c) Methods Approach, we recommend that partners and partnerships be permitted to choose to adopt for CAMT purposes the deferred sales method that was set forth in the Section 704(c) proposed regulations.[199] The deferred sales method would reduce the administrative burden on the partnership by causing all the calculations associated with built-in gain or loss for a contributed asset to be computed at the contributing partner level. The partnership would continue to compute its financial accounting income without adjustment for that built-in gain or loss (although subject to other AFSI adjustments) and would allocate that income to its partners. The contributing partner would amortize its deferred gain or loss over time, while the partnership would treat the contributed property as if it had a AFSI basis step-up (or step-down) to fair value. The non-contributing partners would be in the same position, with the same share of income, as would be the case if the contributed property had not had any built-in gain or loss at the time of contribution. Specifically, in the above example, the contributing partner (Corporation A) could be permitted to amortize the deferred $36 of unrealized gain in the intangible property over its four-year useful life to be $9 per year, which would be added to the $40 of financial accounting income allocated by PRS to A, to arrive at $49 of allocated income for CAMT purposes. Corporation B as the non-contributing partner would not need to make any adjustments to its $60 of allocated financial accounting income in order to determine that it has $60 of CAMT income from PRS.

We did not reach a consensus on whether the Section 704(c) method a taxpayer adopts must be consistent for CAMT purposes and regular tax purposes. Supporters of consistency believe that permitting inconsistent elections will enable taxpayers to manipulate their Section 704(c) CAMT deductions in a taxpayer advantageous manner. The risk of method manipulation is less likely if the rules provide that a partnership and its partners may always use either (i) the same method for CAMT purposes as for regular tax purposes, or (ii) the deferred sales method

[199] 57 Fed. Reg. 61353 (Dec. 24, 1992). The deferred sales method was replaced by the remedial method when the Section 704(c) regulations were finalized in T.D. 8500 (Dec. 22, 1993). Treasury appeared to believe that the deferred sales method was unreasonable because it increased the basis of property contributed to the partnership. We believe this concern is not warranted in the CAMT context, because the deferred sales method ensures that the contributing partner's gain is properly taken into account and is consistent with the fact that (outside of consolidation) the partnership is increasing the contributed property's basis to fair value for financial accounting purposes.

for CAMT purposes. Supporters of inconsistency believe that it provides more flexibility and reduces the administrative burdens on partnerships. For instance, a partnership may continue to use the traditional method for regular tax purposes if that is the method it is accustomed to using, while adopting a deferred sales method for CAMT purposes that is closer to the financial accounting results. In addition, consistency in methods may not provide much consistency in results when an asset has a different basis and useful life for regular tax and CAMT purposes. However, when the CAMT Section 704(c) amount is determined by reference to the regular tax Section 704(c) amount due to a specific CAMT adjustment such as under Section 56A(c)(13) for Section 168 property or Section 56A(c)(14) for qualified wireless spectrum, consistency in Section 704(c) methods may be more appropriate in order to generate the same results for regular tax and CAMT purposes.

The second approach ("**Mandatory Deferred Sales Approach**") would require all partners and partnerships to use the deferred sales method when a partner contributes property to a partnership in a Section 721 contribution. This reduces the administrative burdens on partnerships by mandating that all the calculations be done at the partner level, and it reduces complexity by eliminating the variety of Section 704(c) methods for CAMT purposes. It reduces the potential for shifting CAMT gain or loss between partners due to the application of the ceiling rule under the traditional method. The method is also more consistent with the financial accounting rules (outside of consolidation) by providing an asset basis step-up (or step-down) to fair value for CAMT purposes when the asset is contributed to the partnership, as well as crystallizing a gain or loss for the contributing partner at that time (although the timing for inclusion of that gain or loss in income would be deferred until future periods, unlike the financial accounting income items). On the other hand, this method reduces taxpayer choice, and may increase burdens on some partnerships.

The Mandatory Deferred Sales Approach may be more challenging to implement at the partner level when the partnership has a financial accounting book-up event with reverse Section 704(c) gain for some of its partners. The partners would be deemed to contribute their share of all of the partnership's assets to the partnership and may be required to make computations using information in the possession of the partnership and not the partners. In contrast, the Section 704(c) Methods Approach provides more flexibility for the partnership to make the reverse Section 704(c) computations with partnership-level calculations.

Under either approach, the CAMT rules could provide that Section 704(c) principles do not apply if there is a small disparity between the financial accounting fair value of a contributed (or deemed contributed) partnership asset and the AFSI basis of the partnership asset.[200]

5. Section 731 Asset Distributions

When a partnership distributes property to a partner, Section 731 should normally apply to prevent gain (or loss) recognition for the partnership and the partners for CAMT purposes, under Section 56A(c)(15)(B), for reasons similar to those discussed in Parts IV.B.3 and IV.G.4 above. To the extent the distributee partner would have a stepped up basis for financial accounting purposes in the distributed assets, we believe that it would be reasonable for Section

[200] *See* Treas. Reg. § 1.704-3(e)(1) for a small disparity exception for regular tax purposes.

732 principles to apply when determining the AFSI basis of the distributed assets and of its partnership interest, in order to ensure that the distributee partner does not receive an increase in the AFSI basis of the property it holds (the distributed assets and partnership interest, in aggregate) without a corresponding inclusion of income for CAMT purposes.

In this regard, although the partner usually takes a carryover basis in the distributed property equal to the partnership's AFSI basis in that property,[201] the distributed property's AFSI basis may change if the partner does not have sufficient AFSI basis in its partnership interest or if the distribution is a liquidating distribution.[202] We recommend that adjustments similar to those under Section 734(b) apply for CAMT purposes.

> **Example 30:** Corporation A owns a 40% interest in partnership PRS. Corporation A has a tax basis of $400,000 and a AFSI basis of $600,000 in its PRS interest. PRS has no liabilities and has not made a Section 754 election. PRS distributes an asset with a tax basis of $100,000 and a AFSI basis of $200,000 to Corporation A in full redemption of Corporation A's PRS interest. The distribution does not result in gain recognition under the regular tax under Section 731 or CAMT under Section 56A(c)(15)(B), and Corporation A takes the distributed property with a tax basis of $400,000 and a AFSI basis of $600,000 under the principles of Section 732(b). If the distribution is subject to the principles of Section 734 for CAMT purposes, then the basis reduction rule in Section 734(d) will apply. As a result, PRS will be required to reduce the income tax basis of its remaining assets by $300,000 and the AFSI basis of its remaining assets by $400,000.[203]

It may also be appropriate to import other income tax rules related to Section 731 into the CAMT regime in order to prevent shifting and distortions of CAMT income and loss, such as the seven year waiting periods in Sections 704(c)(1)(B) and 737.[204] Those rules were enacted in order to reduce the ability to shift unrealized taxable gain between taxable and tax-exempt partners, which is of concern for CAMT purposes given that the vast majority of taxpayers are not subject to the CAMT.

We recognize that the above results can lead to complexity for partnerships that distribute appreciated or depreciated properties to their partners. We have evaluated two other approaches. The first alternative is to turn off Section 731 entirely for CAMT purposes, whether universally or by a taxpayer-specific election. This simplifies matters by aligning CAMT gain or loss with financial accounting gain or loss. However, it creates a discrepancy with the gain or loss recognized in the regular tax system and seems inconsistent with Congressional intent in enacting Section 56A(c)(15)(B), which authorizes regulations to carry out the principles of Section 731. It also provides partnerships with the ability to recognize CAMT losses on

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[201] Section 732(a)(1).

[202] Sections 732(a)(2) and 732(b).

[203] Treasury should provide guidance as to how Section 734(d) and Section 743(d) apply if the basis reduction is more than $250,000 for regular tax purposes but less than $250,000 for CAMT purposes, or vice versa.

[204] We see less need for Section 751(b) to apply for CAMT purposes. In addition to its significant complexity, Section 751(b) addresses transactions motivated by the differences in tax rates between ordinary income and capital gain, which is a difference that does not exist for CAMT purposes or for corporations generally.

distributions of depreciated property to their partners, which can reduce the AFSI of the partnership and its partners.

Another alternative is to permit (or require) the partnership to use a deferred sales method, in a manner similar to the deferred sales method described in Part IV.G.4 above for Section 721 contributions. The partnership would effectively defer for CAMT purposes, at the partnership level, the partnership's financial accounting gain in the distributed property. The partnership does not need to make any Section 734(b) adjustments. The distributee partner receives the property with a fair value basis for CAMT purposes. The difficulties with this approach are that it still requires partnership-level computations, and it introduces significant mismatches with the regular tax system. The partnership ultimately recognizes the deferred gain for CAMT purposes under this approach, whereas the partner often recognizes the deferred gain for regular tax purposes after a Section 731 distribution. The partnership could in theory make a special allocation of the deferred gain for CAMT purposes to only the distributee partner, but that partner might have been fully redeemed out of the partnership by the time the deferred gain is taken into account and allocated. A system of rules also would need to be devised to determine what events trigger the partnership's deferred gain, whether the deferred gain is amortized over time in the absence of a trigger event, and how the amortized gain is allocated between the partners. These rules would not have a close counterpart in the applicable regular tax rules, and administration of such rules could prove complicated.

While both of these two alternatives thus raise significant issues, they also both would make it more difficult for partners to use partnership distributions as a means to shift CAMT gain or loss among themselves. By comparison, Section 731 and its related income tax provisions do often permit shifting of basis and gain or loss between assets and partners, so long as the partners can wait a certain amount of time and bear some administrative complexity.

6. Section 743(b) Adjustments

We recommend that guidance provide that AFSI is computed taking into account equity method basis differences, which we understand to be the financial accounting equivalents of Section 743(b) adjustments. If a partner's purchase of a partnership interest does not result in an equity method basis difference for financial accounting purposes, we further recommend that the partnership should be permitted to elect (akin to a Section 754 election) to compute and amortize equity method basis differences for CAMT purposes.

The equity method basis differences should be computed based on the partnership's AFSI basis in its assets instead of its financial accounting basis in the assets. For partnership assets that are Section 168 property that generates tax depreciation for CAMT purposes under Section 56A(c)(13) and qualified wireless spectrum that is amortized under Section 56A(c)(14), we recommend that for CAMT purposes the equity method basis differences should be replaced by the regular tax Section 743(b) adjustments as described in Part IV.E.2 above.

> **Example 31:** Corporation A owns a 40% interest in partnership PRS, which owns an intangible asset X with tax basis of $20 and financial accounting fair value of $50 as its sole asset. Corporation B acquires all of the stock of Corporation A at a time when asset X is worth $200. Pushdown accounting causes PRS to have a basis of $200 in asset X for

financial accounting purposes, but it is assumed that the AFSI basis remains unchanged at $50. Unrelated Corporation C then purchases Corporation A's 40% interest in PRS for $120. PRS makes a Section 754 election. For regular tax purposes, Corporation C has a $112 Section 743(b) adjustment (equal to the excess of $120 over 40% of PRS's $20 tax basis in asset X), which is amortized over asset X's tax useful life. For financial accounting purposes, Corporation C has a $40 equity method basis differences item (equal to the excess of $120 over 40% of PRS's $200 financial accounting basis in asset X), which is amortized over asset X's financial accounting useful life. We recommend that for CAMT purposes, Corporation C has a $100 equity method basis differences item (equal to the excess of $120 over 40% of PRS's original $50 financial accounting basis in asset X before the pushdown accounting), which is amortized over asset X's financial accounting useful life.

We did not reach a consensus on whether the CAMT equity method basis differences should apply only when a Section 743(b) adjustment would apply for regular tax purposes (*e.g.*, when the partnership makes a Section 754 election), or whether the CAMT equity method basis differences should apply whenever equity method basis differences arise for financial accounting purposes. The former provides more consistency with the regular tax rules and may be administratively simpler for some partnerships, while the latter provides more consistency with the financial accounting rules. We also recommend Treasury provide guidance as to how the Section 743(d) built-in loss rule applies for CAMT purposes when the loss may be different for regular tax purposes.

Section 743(b) adjustments and similar items may also arise in other contexts, with effects on both the regular tax and the CAMT. We recommend that the pending regulations address the fact that discharged CAMT liabilities may give rise to CAMT CODI, which if excluded under Section 108 could reduce the taxpayer's AFSI basis in a partnership interest and the partnership's AFSI basis in its assets, including Section 168 property.[205]

7. Section 752 and Liabilities

Section 752 treats the allocation of partnership liabilities to, or away from, a partner as a deemed contribution, or distribution, for regular tax purposes. It ensures that transactions between a partnership and its partners do not have different results depending on whether the transactions involve cash payments or liability assumptions.

We considered two different options to address Section 752 for CAMT purposes: a "Full Section 752 Approach" and a "No Section 752 Approach."

A majority of the Executive Committee recommends the Full Section 752 Approach, under which the Section 752 regulations governing allocation of liabilities apply for both regular tax and CAMT purposes. The justification for the Full Section 752 Approach is that a partner should not obtain a better or worse result by contributing encumbered property instead of receiving a cash distribution from the partnership. Without Section 752, the application of

[205] *See* Treas. Reg. § 1.1017-1(g).

Section 721 (and Section 731) to partnerships for CAMT purposes (as the statute contemplates) may result in distortions and the potential for tax avoidance.

> **Example 32:** Corporation A owns an asset with a tax basis of $100, AFSI basis of $50, and gross fair market value of $300. The asset is encumbered by $200 of nonrecourse liabilities. Corporation A contributes the encumbered asset to partnership PRS in exchange for a 10% interest in PRS. Section 752 causes PRS to allocate all $200 of the asset's liabilities to Corporation A for regular tax purposes. Under the Full Section 752 Approach, Section 752 applies in the same manner for CAMT purposes. Thus, the contribution is subject to Section 721(a) for both regular tax and CAMT purposes, which permits Corporation A to defer all of its $200 of unrealized regular tax built-in gain and $250 of unrealized CAMT built-in gain. The $200 of liability allocation to Corporation A causes Corporation A to have a $100 tax basis and $50 AFSI basis in its partnership interest.
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> If the $200 of liabilities is subsequently shifted to another partner in a later transaction, the $200 deemed distribution to Corporation A under Section 752 would result in Corporation A recognizing $100 of taxable gain for regular tax purposes and $150 of taxable gain for CAMT purposes. (The recognized $150 of CAMT gain is the same amount of CAMT gain that was deferred in the original contribution.)

The Section 752 rules make a distinction between recourse and nonrecourse liabilities, which under the Full Section 752 Approach would be maintained for CAMT purposes. Thus, in the above example, the $200 liability shift may have occurred because another partner guaranteed the debt or because the lender acquired an interest in the partnership. The liability shift may also occur because of a distribution of the encumbered property by a partnership to a partner, such as in a Section 731 transaction. If the CAMT did not generally follow the Section 752 rules in this respect, taxpayers may have a significant potential for tax avoidance by manipulating the timing of regular tax gain recognition without corresponding CAMT gain recognition, or vice versa.

We recommend that Treasury clarify whether a partnership's liabilities for CAMT purposes are all of the liabilities shown on the partnership's AFS. A partnership's financial accounting liabilities may not exist for regular tax purposes, such as if the partnership is the lessee under a lease and has to report as a liability the amounts owed under the lease agreement.[206] It is not clear if those liabilities exist for CAMT purposes. (We discuss similar issues above in the distressed context, in connection with Example 20.)

In adopting a Full Section 752 Approach, Treasury may consider simplifications that preserve the basic objectives of Section 752 in the regular tax rules, without importing all the intricacies of those rules into the CAMT regime. We would be glad to consider further the possibility for such simplifications if that would be helpful to Treasury.

A minority of the Executive Committee prefers the No Section 752 Approach, which completely eliminates the effects of Section 752 for CAMT purposes. This has the benefit of

[206] *See* ASU 2016-02.

administrative simplicity and is more consistent with how liabilities are treated for financial accounting purposes. However, under this approach, a taxpayer would recognize CAMT gain when it contributes property with debt in excess of basis to a partnership, even if Section 752 would defer the gain for regular income tax purposes. The taxpayer could have a CAMT liability in the absence of a corresponding regular tax liability, which gives rise to a minimum tax credit that can be used when the deferred regular tax gain is later recognized. The No Section 752 Approach would take away one of the principal, and much-utilized, benefits of the partnership structure compared to corporations, which is the flexibility to have debt in excess of basis in many circumstances.

> **Example 33:** Corporation A owns an asset with a tax basis of $100, AFSI basis of $50, and gross fair market value of $300. The asset is encumbered by $200 of liabilities. Corporation A contributes the encumbered asset to partnership PRS in exchange for a 10% interest in PRS. Under the No Section 752 Approach, Section 752 causes PRS to allocate all $200 of the asset's liabilities to Corporation A for regular tax purposes but not for CAMT purposes. The contribution is subject to Section 721(a), which permits Corporation A to defer all of its $200 of unrealized regular tax built-in gain. But Corporation A recognizes $150 of CAMT gain in the contribution and defers only $100 of CAMT built-in gain. Corporation A has a $100 tax basis in its PRS partnership interest (same as in Example 32) but a $0 AFSI basis in its PRS partnership interest.
>
> If the $200 of liabilities is subsequently shifted to another partner in a later transaction, such as a partnership distribution of the encumbered property to another partner, the $200 deemed distribution to Corporation A under Section 752 would result in Corporation A recognizing $100 of taxable gain for regular tax purposes but would be ignored for CAMT purposes. Under the No Section 752 Approach, a partner would not be allocated any of the partnership's liabilities for AFSI basis purposes. The partner's lower AFSI basis in its partnership interest might cause the partnership's AFSI losses to be more likely to be limited as described in Part IV.G.8, below.

8. Partnership Interest AFSI Basis and Loss Limitations

For regular tax purposes, a partner in a partnership is generally subject to two partnership-level limitations on allocations of partnership tax losses to the partner. First, the Section 704(b) loss limitation rule provides that partnership tax losses typically cannot cause a partner to have a negative Section 704(b) book capital account, unless the partner has a deficit restoration obligation or in certain other circumstances.[207] Second, partnership tax losses cannot cause a partner to have a negative tax basis in its partnership interest under Section 704(d).

The Section 704(b) loss limitation rule has a GAAP analogue for partners in partnerships (and shareholders in corporations) that use the equity method of accounting for their partnership interest. The rule ("**GAAP Loss Limitation**") provides that a partner's share of a partnership's GAAP losses generally cannot reduce the partner's equity investment in the partnership below zero.[208] When the equity investment reaches zero, the partner stops using the equity method for

[207] Treas. Reg. § 1.704-1(b)(2).

[208] *See* ASC 323-10-35-19.

the partnership interest and ceases taking into account the partnership's GAAP losses. The equity investment is carried at zero on the partner's financial statements until the partnership earns sufficient profits to reverse the unrealized losses. However, this GAAP Loss Limitation does not apply if the partner has guaranteed the partnership's debts or has otherwise committed to provide further financial support for the partnership, in which case the partner reports the negative equity investment as a liability.

Treasury and the IRS should consider whether the CAMT should have loss limitations based on the GAAP Loss Limitation (and similar rules under other financial accounting regimes), the regular tax rules, or both. The GAAP Loss Limitation can be imported into the CAMT regime as a substitute for the Section 704(b) loss limitation rule that applies for regular tax purposes. In other words, a partnership's AFSI losses allocated to a partner are limited for CAMT purposes if the corresponding GAAP losses are limited under the GAAP Loss Limitation. The use of the GAAP Loss Limitation maintains consistency between CAMT and financial accounting principles, consistent with Congress' evident purpose in enacting CAMT. Appropriate adjustments would be required to ensure that the GAAP Loss Limitation applies properly to AFSI losses, such as by taking into account the Section 56A(c) adjustments to AFSI in quantifying the amount subject to the GAAP Loss Limitation.

In addition to the GAAP Loss Limitation, a majority of the Executive Committee recommends that the principles of Section 704(d) apply to limit a partner's distributive share of a partnership's AFSI losses to the partner's AFSI basis in its partnership interest. This aligns the CAMT with the regular tax system, is consistent with the other AMT rules, and reduces the potential for CAMT tax avoidance.

> **Example 34:** Corporation A owns a 40% interest in partnership PRS with a tax basis of $60 and a AFSI basis of $50. PRS has a $200 loss for regular tax purposes, which is allocated $80 to Corporation A. PRS also has a $150 AFSI loss, which is allocated $60 to Corporation A and is not limited by the GAAP Loss Limitation. Corporation A is allowed only a $60 regular tax loss under Section 704(d), which reduces its tax basis in its PRS interest to $0, and the remaining $20 tax loss is suspended until the next taxable year. Corporation A is allowed only a $50 AFSI loss under Section 704(d), which reduces its AFSI basis in its PRS interest to $0, and the remaining $10 AFSI loss is suspended until the next taxable year.

Other members of the Executive Committee recommend that Section 704(d) should not apply at all to a partnership's AFSI losses; rather, a partner's share of those AFSI losses would be limited only to the extent that the GAAP Loss Limitation or similar financial accounting rules apply. This approach enables the CAMT to follow more closely financial reporting income. However, this approach may allow more AFSI losses to be allocated to a partner than regular tax losses and may result in negative AFSI basis in partnership interests. In the above example, Corporation A would be allowed a $60 AFSI loss that reduces its AFSI basis in its PRS interest to negative $10. If the AFSI contains tax depreciation on Section 168 property, the partner can effectively deduct more of such tax depreciation for CAMT purposes than for regular tax purposes.

Yet other members of the Executive Committee suggest some type of hybrid approach, such as Section 704(d) applying only to regular tax items such as tax depreciation on Section 168 property that are allowed for CAMT purposes. This approach ensures a conformity with Section 56A(c)(13) that CAMT does not allow more tax depreciation on Section 168 property than the amount allowed for regular tax purposes. Another hybrid approach is for Section 704(d) to permit current deduction of AFSI losses in either the same dollar amount or in the same proportion that Section 704(d) is allowing current deduction of regular tax losses. In Example 34, since Corporation A is allowed $60 of its regular tax loss allocated from PRS, it would be allowed the same $60 of AFSI loss allocated from PRS and end up with a negative $10 AFSI basis in its PRS interest. Alternatively, since Corporation A is allowed 75% of its regular tax loss allocated from PRS ($60 out of an allocation of $80 of regular tax loss), it would be allowed the same 75% of AFSI loss allocated from PRS ($45 out of an allocation of $60 of AFSI loss), which reduces its AFSI basis in its PRS interest to $5, and the remaining $15 AFSI loss is suspended until the next taxable year. These approaches may result in additional complexity for partnerships and their partners as they disaggregate the components of the partnership's AFSI loss and determine the proper amount of each component loss allowed to each partner in each year for CAMT purposes.

9. Covered Nonrecognition Transactions

The Notice requests comments as to whether any exceptions should apply to the Covered Nonrecognition Transaction rule for partnership transactions. Section 704(c)(2) is called "special rule for distributions where gain or loss would not be recognized outside partnerships." Section 704(c)(2) was enacted by the Omnibus Budget Reconciliation Act of 1989 (P.L. No. 101-239), and the Senate Finance Committee noted in its legislative history that: "The committee also believes that, in limited circumstances, where multiple properties of a like kind are distributed to partners, and the transaction would have been treated as a like-kind exchange had it occurred outside the partnership, the partners should receive treatment similar to like-kind exchange treatment."[209] It permits taxpayers to use partnerships to engage in transactions similar to Section 1031 like-kind exchanges, complete with similar requirements of 180 days to generally complete the exchange and that the properties be of 'like kind.' Section 704(c)(2) does differ from Section 1031 in some ways, such as the lack of a requirement that the properties be held for productive use in a trade or business or for investment. Nevertheless, given that Section 1031 like-kind exchanges are not themselves Covered Nonrecognition Transactions, Treasury and the IRS should consider whether Section 704(c)(2) transactions are sufficiently similar to warrant not being Covered Nonrecognition Transactions either.

10. Distributive Share for Scope Determination

In the Notice, Treasury confirmed that a corporation's AFSI for scope purposes shall be determined under Section 59(k)(1)(D) without regard to the rule in Section 56A(c)(2)(D)(i) about AFSI taking into account only the corporation's distributive share of the partnership's AFSI. We believe that this is the correct reading of the statutory provision, despite some commentator claims that the provision is ambiguous and perhaps should only apply to partnerships that are

[209] STAFF OF S. COMM. ON FIN., 101ST CONG., REVENUE RECONCILIATION ACT OF 1989 196 (Comm. Print 1989).

treated as a single employer with the corporation under Section 52(b) as described earlier in the provision.

A majority of the Executive Committee recommends that a corporation's AFSI for scope purposes includes all AFSI of partnerships that are consolidated with the corporation for financial accounting purposes, without any subtraction for non-controlling interests that would otherwise apply in computing AFSI for liability purposes. This majority believes that a subtraction for non-controlling interests in determining AFSI for scope purposes would be the same as using distributive share for AFSI for scope purposes and would render the Section 59(k)(1)(D) clause meaningless.

The effective result of the Section 59(k)(1)(D) clause is that a partner has 100% inclusion of a partnership's AFSI if the partner controls the partnership and consolidates the partnership for financial accounting purposes,[210] regardless of how much the partner owns of the partnership's capital or profits. The 100% inclusion results in parity between corporations and partnerships. The single employer rule in Section 52(a) effectively results in 100% inclusion of a subsidiary corporation's AFSI when a shareholder controls a corporation by owning more than 50% of the corporation's stock by vote, even if the shareholder does not own more than 50% of the corporation's stock by value. Similarly, the 59(k)(1)(D) clause effectively results in 100% inclusion of the partnership's AFSI when a partner controls a partnership, even if the partner does not own more than 50% of the capital or profits of the partnership. This consistency also ensures that entities such as LLCs do not change their controlling members' AFSI for scope purposes by having the LLC make an entity classification election for U.S. income tax purposes.

The table below summarizes the results of this approach for subsidiaries that are corporations as opposed to partnerships.

	Subsidiary is a Corporation	**Subsidiary is a Partnership**
Shareholder/partner owns more than 50% of vote (or controls) and more than 50% of value of subsidiary corporation/partnership	100% inclusion under Section 52(a)	100% inclusion under Section 52(b)
Shareholder/partner owns 50% or less of vote but more than 50% of value of subsidiary corporation/partnership	100% inclusion under Section 52(a)	100% inclusion under Section 52(b)
Shareholder/partner owns more than 50% by vote (or controls) but 50% or less by value of subsidiary corporation/partnership	100% inclusion under Section 52(a)	**100% inclusion under Section 59(k)(1)(D) clause, due to consolidation of the partner and the**

[210] S*ee* ASC 805-10-25-5.

		partnership for financial accounting purposes
Shareholder/partner owns 50% or less by vote and 50% or less by value of subsidiary corporation/partnership	Less than 100% inclusion under Section 56A(c)(2)(C)	Less than 100% inclusion under equity method of accounting, fair value method, or other financial accounting method

A minority of the Executive Committee believes that a corporation's AFSI for scope purposes should be reduced by non-controlling interests in consolidated partnerships. This outcome would be consistent with general statutory language in Section 56A(a) that AFSI is the "net income or loss" set forth on the taxpayer's AFS, which is reduced by non-controlling interests under the financial accounting rules. This minority takes the view that such a reading does not render the Section 59(k)(1)(D) clause meaningless, because a corporation could use different percentages in determining its share of a partnership's AFSI for scope purposes and its distributive share of a partnership's AFSI for liability purposes. For instance, AFSI for scope purposes may use the financial accounting percentage of a partnership's AFSI, while AFSI for liability purposes may use the blend of Section 704(b) distributive share and financial accounting distributive share that is the minority view described in Part IV.G.3 above.

This approach would reduce the AFSI for scope purposes for many corporations that control partnerships in which they own minority economic interests and thereby reduce the number of applicable corporations subject to the CAMT, but it would require most partnerships to undertake two separate percentage calculations to allocate its AFSI among its partners for two different purposes.

> **Example 35:** Corporation A owns a 40% interest in partnership PRS for financial accounting purposes and a 50% interest in partnership PRS for Section 704(b) purposes. Corporation A controls PRS and is consolidated with PRS for financial accounting purposes. PRS has $100 of financial accounting income after claiming $50 of book depreciation on Section 168 property. PRS has $10 of depreciation on the Section 168 property for regular income tax purposes. PRS has no other CAMT adjustments. The Section 56A(c)(13) adjustment for depreciation causes PRS to have $140 of AFSI, after adding back $50 of book depreciation and subtracting $10 of tax depreciation.
>
> Under the majority view, Corporation A has $140 of AFSI for scope purposes from PRS, because Corporation A and PRS are consolidated for financial accounting purposes. Corporation A has $56 of AFSI for liability purposes allocated from PRS, equal to 40% of $140 (same as the majority view in Example 28).
>
> Under the minority view, Corporation A has $56 of AFSI for scope purposes from PRS, equal to a 40% financial accounting percentage of PRS's $140 of AFSI. Corporation A has $55 of AFSI for liability purposes allocated from PRS, equal to 40% of $150 of AFSI

(without tax depreciation on Section 168 property) minus 50% of $10 of tax depreciation on Section 168 property (same as the minority view in Example 28).

The minority view would involve two separate calculations of AFSI for scope purposes and AFSI for liability purposes for most partnerships, even if a partner does not consolidate with the partnership for financial accounting purposes.

Example 36: The facts are the same as in Example 35, except that Corporation A does not control PRS and uses the equity method of accounting for its PRS interest.

Under the majority view, Corporation A has $56 of AFSI for both scope purposes and liability purposes allocated from PRS, equal to 40% of $140.

Under the minority view, Corporation A has $56 of AFSI for scope purposes from PRS, equal to a 40% financial accounting percentage of PRS's $140 of AFSI. Corporation A has $55 of AFSI for liability purposes allocated from PRS, equal to 40% of $150 of AFSI (without tax depreciation on Section 168 property) minus 50% of $10 of tax depreciation on Section 168 property. These results are the same as in Example 35.