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IRS issues interim guidance on the corporate alternative minimum tax

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On Tuesday, December 27, 2022, the IRS released a notice that describes proposed regulations that the IRS intends to issue addressing the application of the new corporate alternative minimum tax (CAMT). The notice contains guidance on a number of issues pertaining to the determination of whether a corporation is subject to the CAMT and the computation of liability under the CAMT. This update describes the new guidance and highlights important considerations for taxpayers.

Background

On Tuesday, December 27, 2022, the Internal Revenue Service (IRS) released Notice 2023-7 (the "Notice"), which describes proposed regulations that the IRS intends to issue addressing the application of the corporate alternative minimum tax (CAMT) that was enacted as part of the Inflation Reduction Act of 2022. The IRS also released interim guidance on the 1% stock repurchase excise tax, and we recently circulated a separate update on that guidance.

The Notice provides much-needed, albeit limited, guidance on certain fundamental issues in applying the CAMT. This update summarizes the guidance and highlights important considerations for taxpayers in implementing it.

The CAMT is intended to apply only to the largest corporate taxpayers—dubbed "applicable corporations"—that meet an "AFSI Test." To meet the AFSI Test, a corporation[1]— must have average annual adjusted financial statement income (AFSI) of over $1 billion during a three-consecutive-year period ending before the current year, taking into account for this purpose the AFSI of all persons treated as a single employer under Section 52.[2] If a corporation is a member of a foreign-parented multinational group,[3] it must also meet a separate, but similar, $100 million test, this time taking into account only the AFSI of the domestic members of the group and the "effectively connected" AFSI of each foreign member over the same three-year period.

The CAMT is a 15% alternative minimum tax on the AFSI of applicable corporations. A corporation's AFSI is the net income or loss reported on its applicable financial statement (AFS, generally prepared under U.S. GAAP or IFRS standards), adjusted in various ways.[4] These adjustments differ depending on whether AFSI is calculated for "scope" purposes—that is, determining whether a corporation is an applicable corporation—or for "liability" purposes—that is, computing the CAMT liability of an applicable corporation. For example, if a corporation incurs an AFSI loss in a particular year, this loss creates a "financial statement net operating loss carryover" that can be used in future years to offset AFSI for liability purposes, but not for scope purposes.

The Notice provides interim guidance on the below time-sensitive issues and provides that taxpayers may rely on this interim guidance until proposed regulations adopting the guidance are issued.

– Certain scoping rules simplifying and clarifying the definition of "applicable corporation," including:
  - A simplified safe harbor method for determining applicable corporation status, relying primarily on unadjusted financial statement income, for the first taxable year beginning after December 31, 2022.

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- Rules identifying how to determine applicable corporation status for corporations involved in certain transformative “Covered Transactions,” such as corporate separations and combinations.
- Rules for determining the applicable corporation status of a corporation that is a partner in a partnership.

– Certain rules applicable to other aspects of the calculation of AFSI, including:
  - Limited relief for troubled corporations, including with respect to cancellation of indebtedness income and emergence from bankruptcy proceedings.
  - Limited guidance for calculating AFSI and corresponding adjustments to book items in respect of so-called “Covered Nonrecognition Transactions” involving corporations and partnerships. Notably, the proposed rules provide favorable guidance aligning the treatment of corporate separations structured as spinoffs with those structured as splitoffs.
  - The treatment of tangible depreciable property.
  - The treatment of payments in respect of certain transferrable or refundable tax credits.

The Notice announces that the IRS will issue additional interim guidance addressing, among other issues, certain issues related to the treatment under the CAMT of items that are marked-to-market for financial statement purposes (such as life insurance company separate account assets and certain financial products), the treatment of certain items reported in other comprehensive income on a company’s AFS, and the treatment of embedded derivatives arising from certain reinsurance contracts. The additional interim guidance will be intended to help avoid substantial unintended adverse consequences to the insurance industry and certain other industries.

The Notice also solicits comments on specific topics related to guidance contained in the Notice and certain other issues. Prior to the issuance of the proposed regulations, taxpayers may rely on the guidance provided in the Notice.

Scoping issues

Simplified safe harbor method for determining applicable corporation status

Section 5 of the Notice provides limited relief in the form of a simplified safe harbor method for a corporation to determine whether it is an “applicable corporation” for the first taxable year beginning after December 31, 2022—that is, 2023 for a calendar year taxpayer. As noted above, under the regular rules for determining applicable corporation status, a corporation starts with the income or loss reflected on its AFS and applies a number of adjustments to arrive at its AFSI. The simplified safe harbor method, where it applies, permits a corporation to determine its applicable corporation status based on the income or loss reflected on its prior years’ AFSs, without incorporating most of the usual adjustments.

More specifically, under this simplified safe harbor method, a corporation starts with the income or loss reflected on its AFS and, instead of all the usual adjustments, it simply applies the same aggregation rules that are used to calculate AFSI and disregards federal and foreign income taxes. The corporation then applies a modified version of the AFSI Test to this “unadjusted AFSI”: the corporation will not be an applicable corporation as long as its average annual unadjusted AFSI over the prior three-year period does not exceed $500 million and, if the corporation is a member of a foreign-parented multinational group, the average annual unadjusted AFSI of the group’s domestic members and the “effectively connected” unadjusted AFSI of its foreign members over the same period is less than $50 million. If a corporation cannot conclude it is not an applicable corporation under the simplified safe harbor method, that does not necessarily mean it is an applicable corporation; in that case, it must determine its AFSI and apply the AFSI Test under the regular rules to determine its applicable corporation status.

In addition, if the corporation’s AFS covers a period that differs from its taxable year, it may apply the simplified safe harbor method on the basis of the periods covered by its AFS, rather than taxable years.

While this simplified safe harbor method will likely provide relief to many taxpayers, a number of important issues remain to be addressed, two of which are highlighted below.

– Further guidance is necessary to determine how to coordinate this simplified safe harbor method with the rule described in the Covered Transactions section below regarding the impact of transformative transactions (for example, the acquisition of a corporation by another corporation) on applicable corporation status. Absent relief, a full AFSI calculation may be necessary even for taxpayers that meet the simplified safe harbor method in the event of a

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transformative transaction.

- If a corporation that has a financial statement loss in 2020, 2021 and/or 2022 uses the simplified safe harbor method to determine that it is not an applicable corporation in 2023 and later determines that it is an applicable corporation in a subsequent year, further guidance should clarify how the corporation computes its financial statement net operating loss carryovers. For example, must it go back to the earlier years and calculate its AFSI loss under the regular rules, or can it use the loss calculated under the simplified safe harbor method?

Covered Transactions: Determining applicable corporation status after corporate combinations and divisions

Section 3.04 of the Notice provides guidance for determining the AFSI and applicable corporation status of a corporation after certain transformative corporate actions (referred to as "Covered Transactions" in the Notice). Specifically, the guidance addresses when and how the historic AFSI of a target corporation (or controlled corporation, in the case of a separation) is taken into account in the determination of whether it or its acquirer (or distributing corporation, in the case of a separation) is an applicable corporation after a Covered Transaction. As defined in the Notice, Covered Transactions include (i) a nonrecognition transaction with regard to a corporation or a partnership (described in further detail in the Covered Nonrecognition Transactions section below), and (ii) a transfer, sale, contribution, distribution or other disposition of property that results in gain or loss for tax purposes. Treasury requested comments on whether Covered Transactions should be expanded to include additional transactions.

The Notice provides three sets of rules for determining the AFSI history of a corporation that has engaged in different forms of Covered Transactions in the past, depending on the identity of the acquirer and acquiree under U.S. GAAP, and whether the acquiree was part of an AFS Group before the transaction.

Acquisition of a stand-alone target group. If an acquiring company acquires a stand-alone target AFS Group to form a new group that is treated as a single employer under Section 52 or a single foreign-parented multinational group, the target AFS Group ceases to be an applicable corporation (if it was an applicable corporation to begin with). The acquirer AFS Group takes into account the AFSI of the target AFS Group for the three taxable year period ending with the taxable year in which the acquisition takes place (the "three-year lookback period").

Acquisition of a company (or its assets) from a larger group. If an acquiring company purchases a target in a carve-out transaction from another AFS Group, the target is allocated a portion of the target AFS Group's AFSI for the three-year lookback period based on any reasonable allocation method. The acquirer AFS Group takes into account the allocated AFSI history of the target(s) for the three-year lookback period (and, if the target was an applicable corporation, it ceases to be one). The target AFS Group's past AFSI does not change, meaning that the target's allocated AFSI is included in both the acquirer AFS Group's and the target AFS Group's AFSI for the three-year lookback period and therefore is taken into account for purposes of determining the applicable corporation status of both groups.

Distribution of the stock of a controlled company. If an AFS Group distributes a controlled corporation to shareholders of the distributing AFS Group's parent corporation, the controlled corporation is allocated a portion of the distributing AFS Group's AFSI for the three-year lookback period based on any reasonable allocation method. As with the treatment of target AFS Group AFSI in carve-out transactions, the Distributing AFS Group's past AFSI is not reduced as a result of the allocation of a portion of this AFSI to the controlled corporation. In light of this treatment of the Distributing AFS Group, there may be certain advantages in deciding whether to distribute the "minnow" or the "whale" in certain spinoff transactions.

This guidance provides much-needed clarity in some cases, but a number of uncertainties remain:

- First, the definition of Covered Transactions includes any transfers of property (which includes asset and stock acquisitions), but certain aspects of the rules above are unclear as applied to asset acquisitions. For example, it is not clear when and how to allocate AFSI to a "target" (or how much to allocate to an acquirer) where the target disposes of some but not all of its assets.
- Second, the rules provide that until further guidance is issued, the AFSI history of a group may be allocated under any reasonable method, but what constitutes a reasonable method may not always be clear in these circumstances (including, for example, how to combine the AFSI history of two groups in the event they use different accounting standards or accounting periods). Treasury requested comments as to how the allocation should be calculated and noted that the forthcoming proposed regulations will provide a required allocation method.
- Third, the Notice does not provide rules as to how transaction expenses and other extraordinary items should be allocated as between the parties to a transaction or how they impact the calculation of AFSI. Further guidance from Treasury would be welcome on this point. Until then, special attention should be given to the allocation of expenses among transaction parties.

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Determining applicable corporation status of a corporate partner in a consolidated partnership

The statute provides that, for purposes of calculating AFSI for liability purposes, a taxpayer that is a partner in a partnership takes into account only the taxpayer's distributive share of the partnership's AFSI (the "Distributive Share Rule"). The statute also provides that the Distributive Share Rule is disregarded when calculating AFSI for scope purposes. However, the statute is ambiguous as to whether the Distributive Share Rule is disregarded only in circumstances in which the taxpayer and the partnership are aggregated under Section 52(b), or in all cases. Section 7 of the Notice provides that the Distributive Share Rule is disregarded whether or not the taxpayer and the partnership are aggregated under Section 52(b). However, the Notice does not provide any further guidance on how the taxpayer determines its share of partnership AFSI for liability purposes or for scope purposes.

Treatment of tax consolidated groups for purposes of the CAMT

Section 3.05 of the Notice provides that a tax consolidated group is treated as a single entity for purposes of calculating AFSI. This rule applies whether AFSI is calculated for scope purposes or liability purposes.

Certain specific rules for calculating AFSI

In addition to the scoping issues noted above, the Notice contains certain specific rules for purposes of calculating AFSI more generally. These rules are applicable both in determining AFSI for liability purposes and for scope purposes (except in cases where the simplified safe harbor method described above applies). The relevant rules are described below.

Covered nonrecognition transactions

The Notice provides some limited guidance on the treatment of tax-deferred (a.k.a. nonrecognition) transactions under the CAMT, including important relief aligning the treatment of tax-free spinoff and splitoff transactions. Specifically, section 3.03 of the Notice exempts from AFSI financial statement gain or loss directly resulting from certain specified nonrecognition transactions (referred to as "Covered Nonrecognition Transactions" in the Notice).

These provisions apply to nonrecognition transactions involving liquidations of subsidiary corporations into parent corporations (Sections 332 and 337), transfers of property to controlled corporations and corporate formation transactions (Section 351), corporate reorganization transactions including stock-for-stock exchanges, asset acquisitions and mergers that are eligible for nonrecognition treatment under Sections 354, 357, 361 and 368, corporate separations by means of spinoff and splitoff transactions (Section 355), issuances of corporate stock (Section 1032), and contributions to and distributions from partnerships (Sections 721 and 731, respectively).

The Notice further provides that for any Covered Nonrecognition Transaction eligible for the exemption described above, increases and decreases to the financial accounting basis of property that would otherwise have been taken into account for financial reporting purposes are not taken into account for AFSI purposes by the party receiving the transferred property. In other words, the rules would override the normal financial reporting rules to preserve the pre-transaction financial accounting basis solely for purposes of calculating future AFSI. The Notice includes an example of an acquirer that transfers, in a taxable disposition, an asset it previously acquired in a Covered Nonrecognition Transaction. In the example, the acquirer's AFSI resulting from that later taxable disposition is measured based on the original financial accounting basis of the property prior to the Covered Nonrecognition Transaction (subject to any subsequent adjustments), even though for ordinary financial reporting purposes the asset's basis would have been adjusted to fair value at the time of the nonrecognition transaction. As a result, in this subsequent sale, the acquirer's AFSI includes appreciation that occurred during a prior owner's ownership period.

Some noteworthy aspects of the nonrecognition provisions are described below:

– **Both spinoff and splitoff transactions are eligible for tax deferral**. The Notice addresses a concern that had been raised by taxpayers regarding the different treatment, for financial reporting purposes, of splitoff transactions (which could result in financial statement gain) and spinoff transactions (which typically would not). Under the Notice, both forms of transaction are eligible for an exemption from AFSI so long as they qualify for nonrecognition treatment under regular tax principles.

– **Not available for partial nonrecognition transactions**. The proposed rules under the Notice apply only to transactions that qualify for nonrecognition in full, and therefore do not apply at all to any component of a

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nonrecognition transaction that results in partial taxation for regular tax purposes. For example, the treatment of a corporate parent in a carve-out reorganization of a corporate subsidiary would not be covered if a portion of the consideration in the reorganization is taxable boot. Treasury has requested comments from taxpayers on the treatment of partial nonrecognition transactions, and on whether future guidance should address the AFSI consequences of receiving boot in acquisitive reorganizations. Further guidance would be necessary from Treasury to extend the application of these rules to such transactions.

– **Direct consequences only**. The proposed rules apply only to those tax consequences of the transaction that are themselves eligible for nonrecognition treatment under regular tax principles. So, for example, if a transfer of an asset into a corporate subsidiary is a nonrecognition transaction for general tax purposes, then AFSI would exclude financial gain on the built-in gain in the transferred asset under the rule proposed in the Notice. But if there is other financial statement gain that would be included on the taxpayer's AFS (for example, if book gain is triggered on the subsidiary's stock in a book deconsolidation event), the Notice does not appear to address such other gain and it would appear to remain includible in AFSI.

– **Each component of a larger transaction is analyzed separately**. Separate components of an overall nonrecognition transaction must be analyzed separately to determine whether the specific component is eligible for nonrecognition treatment under the Notice. A typical tax-free asset acquisition can involve numerous components for tax purposes including: (i) the transfer of assets from a target to an acquirer, (ii) the assumption by the acquirer of liabilities of the target, (iii) the issuance of acquirer stock to the target and (iv) the distribution of the acquirer stock and any remaining target assets to stockholders (and, potentially, creditors) of the target in exchange for their target stock. Similarly, spinoff and splitoff transactions often involve contributions of property (and distributions of property) to (and from) a controlled corporation, and the distribution of equity of a controlled corporation to a distributing corporation's shareholders, and they can also involve liability assumptions and exchanges. Under the Notice, each separate component must be analyzed to determine whether it specifically is a nonrecognition transaction for regular tax purposes, in order for the gain or loss from that component to be excluded from AFSI. It is possible that certain components are eligible for nonrecognition treatment while others are not.

  - Certain forms of nonrecognition transactions include fictional or deemed transactions for income tax purposes, and the Notice does not clarify how those are addressed for financial statement purposes (assuming that the taxpayer's financial statement method does not itself deem those same fictional transactions to occur). For example, a merger transaction may be viewed, for tax purposes, as involving components that are similar to the asset reorganization described above, even though the actual steps are very different. In the absence of additional guidance, we would expect that only transactions that actually would be relevant for financial statement reporting purposes are subject to this rule, but clarification would be welcome.

– **Step transaction principles apply**. Notwithstanding the fact that each component of a transaction must be analyzed separately, the analysis of each component must also take into account the overall income tax analysis of every other step, to determine whether it would qualify for nonrecognition principles under regular income tax principles. For example, although a contribution of assets from a partner to a partnership followed by a distribution of cash from the partnership to that partner might, independently, each qualify for nonrecognition treatment under regular tax principles, when taken together they could be treated as a disguised sale of property, which is a taxable transaction. If they are treated as such for regular income tax principles, then neither the contribution nor the distribution would be eligible for exemption from AFSI.

– **Only certain "parties" eligible for the exemption**. With respect to nonrecognition transactions involving corporations (including, specifically, the tax-free reorganization rules and tax-free spinoffs and splitoffs), as drafted the proposed rules in the Notice would appear to apply only to the calculation of AFSI for the principal corporations that are parties to the transaction. Other than target companies that are carved out of larger corporate groups in a nonrecognition transaction, or parent corporations receiving property in a complete liquidation of a subsidiary, the Notice does not generally address the treatment of nonconsolidated corporate shareholders of the corporate parties. Therefore, the Notice does not appear to provide an exemption from AFSI to, for instance, corporate shareholders of a corporate target (other than members of the target AFS Group), or corporate shareholders receiving stock in a separation transaction or liquidation, even if those shareholders are themselves "applicable corporations" for CAMT purposes. It is unclear whether this omission is an oversight or intentional, given other references in the rules to Sections of the Code that are relevant primarily to shareholders (including, specifically, references to Section 354). Further guidance from Treasury would be welcome to address this point.

– **Treatment of historic transactions**. The rules for basis adjustments for Covered Nonrecognition Transactions set forth in the Notice apply to "any taxable year." This implies that, in determining AFSI (and, other than for corporations using the simplified safe harbor method in 2023, applicable corporation status) for any year in which the CAMT is applicable, the adjustments to property basis set forth in the Notice in respect of Covered Nonrecognition Transactions (including past ones) must be taken into account. There is, however, some ambiguity on this point because, as described in the Covered Transactions section above, the Notice also includes very specific rules to account for Covered Transactions more generally in the three-year lookback period. Further clarification from Treasury specifically

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addressing this issue would be welcome.

- **Many open areas**. As noted above, the guidance on nonrecognition transactions is welcome but limited. Treasury has requested comments from taxpayers generally, and also on numerous specific issues, including how to treat financial deconsolidation events, whether other transactions should be included in the covered nonrecognition rules, the treatment of intragroup transactions, and on nonrecognition transactions involving partnerships.

Debt workout and bankruptcy provisions

The Notice provides some relief from the impact of the CAMT for financially distressed companies (including those in bankruptcy proceedings). Section 3.06 of the Notice addresses the impact of debt-workout and debt relief transactions that could give rise to cancellation of indebtedness income (CODI), and section 3.07 of the Notice addresses the taxation of companies emerging from bankruptcy protection.

CODI transactions

Under Section 61(a)(11), a company whose debt is discharged or satisfied at a discount (including in a debt-for-debt exchange or a repayment or repurchase below face value) is required to include gross income in respect of the cancellation of indebtedness (CODI). Section 108(a), however, excludes such income from taxation if, among other things, the discharge occurs in a title 11 case, or when the taxpayer is insolvent (to the extent of the amount of insolvency), and in certain other circumstances. But there is a quid pro quo: to the extent income is excluded under Section 108(a), the debtor must reduce its tax attributes, including NOLs, credits and depreciable tax basis, by the amount of excluded income, effectively preserving some of the excluded income for taxation in a later period. There are specific principles under Sections 108(b) and 1017 detailing the category and order in which the debtor's different tax attributes are to be reduced. If the amount of excluded CODI exceeds the attributes eligible for reduction, then the remainder (referred to as "black hole CODI") can still be excluded from income but without attribute reduction.

The CODI exclusion described above does not necessarily apply for financial statement purposes. Therefore, absent a specific adjustment, an applicable corporation that would otherwise be eligible for an exemption from regular income tax under Section 108(a) with respect to CODI could nevertheless have AFSI (and potentially be subject to the CAMT) with respect to that same excluded income. In some cases, the CODI itself could be sufficiently large to cause a corporation to become an applicable corporation.

Section 3.06 of the Notice addresses some of this disparity. In particular, it provides that an amount of financial statement gain attributable to debt discharge transactions that is equal to the amount of the exclusion for CODI available under Section 108 is not taken into account in AFSI in the taxable year of the discharge. It further provides that principles similar to the attribute reduction principles of Sections 108(b) and 1017 described above shall be used to reduce financial statement attributes to the extent of the amount of such reduction under regular tax principles (that is, up to the full amount of excluded CODI, but minus any black hole CODI).

This guidance is welcome, but several aspects of these provisions warrant particular attention:

- First, with respect to excluded CODI, the Notice limits the amount of gain excluded from AFSI to the amount of income that is excluded from regular income tax calculations. As such, taxpayers with higher financial statement gain than excluded taxable income attributable to CODI transactions may not receive full CAMT relief, because they would still be required to include financial statement gain from CODI transactions in AFSI to the extent it exceeds the amount that was excluded under Section 108(a). This could be the case, for example, even where all of the taxpayer's CODI is excluded under Section 108(a). Treasury has requested comments from taxpayers about whether the CAMT relief should instead be extended to all financial statement gain.
- Second, to the extent financial statement gain from CODI transactions arises in a taxable year other than the year of the discharge, it would not be exempt under the proposed regulation.
- Third, with respect to attribute reduction, the Notice requests comments from taxpayers as to how, precisely, to adapt the regular tax attribute reduction principles to a taxpayer's financial statements, including commentary as to which CAMT attributes should be reduced and in what order, and what, if any, transition rules may be necessary. Further clarification from Treasury would be welcome on these points, as both the types and amounts of financial statement attributes could differ significantly from the corresponding items under regular income tax principles. With respect to transition rules, taxpayers with significant CODI transactions from prior periods do not yet have specific rules to determine how to reduce their AFS attributes in the current and subsequent periods to determine how to calculate their AFSI currently.

Emergence from bankruptcy

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Section 3.07 of the Notice provides that financial accounting gain or loss resulting from the emergence from bankruptcy of an AFS Group is not taken into account for purposes of calculating AFSI. It further proposes that, in such a case, adjustments that would otherwise be made to the financial accounting basis of property of a taxpayer resulting from that taxpayer's bankruptcy emergence be ignored (that is, the original financial accounting basis pre-emergence would be preserved for CAMT purposes going forward, regardless of whether it would have been stepped up or stepped down under financial accounting rules). Treasury also requested comments from taxpayers regarding whether there are other financial statement consequences resulting from bankruptcy reorganizations that should be addressed.

Several aspects of this rule are noteworthy:

- First, by its terms, section 3.07 of the Notice appears to provide this exception from CAMT calculations for emergence transactions regardless of whether or not the transactions are taxable under regular tax principles. For example, in some cases taxpayers intentionally structure bankruptcy emergence transactions using taxable "Brunos" structures, where the taxable gain resulting from such transactions is acceptably low or the taxpayer's attributes are sufficiently large to shelter taxable income resulting from the emergence. Financial statement gain or loss from such Brunos structures would, under the Notice, be excluded from AFSI. Moreover, and subject to the point immediately below, any tax basis step-up or step-down achieved under regular tax principles would not be replicated on such taxpayer's financial statements and therefore would not be available for future years' AFSI calculations, potentially resulting in future tax and book mismatches. Treasury has requested comments on whether the CAMT exception should apply to transactions that are taxable for regular income tax purposes. In the absence of further clarification, the Notice provides that it would be.
- Second, with regard to the rules preserving the financial accounting basis, it is not clear from the Notice whether such basis carries over to the acquirer of property in a taxable emergence structure, if the legal entity that was in bankruptcy transfers its assets to another person as part of the emergence transaction.
- Third, the rule excluding gain or loss on emergence applies to an emergence of an AFS Group. It is not entirely clear from the drafting whether the exclusion would apply to the emergence from bankruptcy of a member of an AFS Group if the entire group is not in bankruptcy.
- Finally, the full scope of transactions to which section 3.07 of the Notice might apply is not entirely clear and, absent further guidance from Treasury, taxpayers should be careful to consider whether any of the tax and financial statement gain or loss resulting from bankruptcy emergence transactions could be considered attributable to related but separable transactions that might not be covered by the rule in the Notice.

Treatment of depreciable property

Section 56A(c)(13) provides that in computing AFSI, tax depreciation deductions, rather than financial statement depreciation expense, are taken into account for certain depreciable tangible property. We refer to this rule as the "depreciation rule." Section 4 of the Notice clarifies and expands upon this rule in various ways.

Scope of Section 168 Property

The Notice clarifies that the depreciation rule applies only to tangible depreciable property that is actually depreciated under Section 168 ("Section 168 Property"). If property is eligible to be depreciated under Section 168 but the taxpayer elects not to do so, then the property is not Section 168 Property and not subject to the depreciation rule. Likewise, if an expenditure is capitalized (say, as an improvement) for financial statement purposes, but deducted (say, as a repair) for tax purposes, then the depreciation rule does not apply.

Depreciation deductions capitalized to inventory

The statute clearly applies the depreciation rule to depreciation deductions attributable to Section 168 Property that reduce taxable income in the current year, but it does not address depreciation deductions attributable to Section 168 Property that are capitalized to inventory under Section 263A. The Notice provides that these amounts are taken into account in AFSI as and when recovered as part of the cost of goods sold. Relatedly, any depreciation expense, impairment loss or impairment loss reversal that is taken into account as cost of goods sold for financial statement purposes is eliminated from AFSI.

Corresponding basis adjustments

As noted above, AFSI is computed using financial statement income as the starting point. As a result, when an asset is sold, the financial statement gain or loss—calculated taking into account financial statement basis—will generally be

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included in AFSI. But when the asset is Section 168 Property, its financial statement basis will reflect financial statement expense that has not been reflected in AFSI, and will not reflect tax depreciation deductions that have been reflected in AFSI. To account for this, the Notice provides that, for purposes of calculating AFSI gain or loss on Section 168 Property, the basis of that property will be adjusted to disregard financial statement depreciation expense and instead take into account tax depreciation deductions.

Taxpayers will therefore need to track their AFSI basis in Section 168 Property separately. In many cases, this basis will be the taxpayer's cost basis, less tax depreciation deductions. Section 3.03 of the Notice, however, provides that assets acquired in Covered Nonrecognition Transactions have a "carryover" opening basis for AFSI purposes that equals the transferor group's financial statement basis immediately before the Covered Nonrecognition Transaction. Presumably, therefore, a taxpayer's AFSI basis in any Section 168 Property acquired in a Covered Nonrecognition Transaction will be the transferor's financial statement basis immediately before the Covered Nonrecognition Transaction, adjusted for the taxpayer's tax depreciation deductions.

Section 168 Property placed in service in pre-CAMT years

The statute is silent on whether the depreciation rule applies to Section 168 Property placed in service in pre-CAMT years—that is, before 2023—but the Notice provides that it does. In most cases, this property will have been either fully depreciated or significantly depreciated for tax purposes before the first year in which AFSI is ever calculated. As a result, the taxpayer will get no or little AFSI benefit from its cost basis in the property.

Presumably if a taxpayer places in service Section 168 Property in a year in which it is not an applicable corporation, and that taxpayer later becomes an applicable corporation (either as a result of organic growth or a combination transaction or both), then the depreciation rule will also apply to that Section 168 Property. CAMT could therefore be a relevant consideration in deciding on a method of tax depreciation even for taxpayers that are not currently applicable corporations.

Tax credit monetization payments

The Notice includes important CAMT guidance relating to the new refundable and transferrable tax credit rules for certain clean energy and advanced manufacturing projects. Section 6.02 of the Notice addresses AFSI consequences of (i) amounts electively treated as payments of tax under Sections 48D(d) or 6417, (ii) amounts treated as tax-exempt income (if received by a partnership or S-corporation) under Sections 48D or 6417, and (iii) amounts received by a party that elects to transfer eligible credits for cash payments under Section 6418.

Overview of new refundable and transferable credit provisions. Under Sections 48D(d) (advanced manufacturing investment credit for semiconductor manufacturing facilities enacted under the CHIPS and Science Act of 2022) and 6417 (relating to certain clean energy and energy storage credits enacted under the Inflation Reduction Act), eligible parties may elect to be treated as making a payment of tax equal to the amount of an applicable credit. These "refundable credit" provisions are intended to permit certain parties that otherwise would not benefit from tax credit incentives, such as governmental or tax-exempt investors, to participate in clean energy and infrastructure tax incentives.

Alternatively, under Section 6418, eligible parties are entitled to elect to transfer their entitlement to certain tax credits to other parties for cash. These "transferable credit" provisions permit certain parties to monetize their credits via sales to third parties. Section 6418(b)(2) provides that amounts received as consideration for the transfer are not included in gross income of the recipient taxpayer.

In each case, if a partnership or S corporation owns the project, the relevant election is to be made by, and payments are to be made to, the partnership or S corporation. Payments in respect of refundable or transferable credits received by partnerships or S corporations are treated as tax-exempt income under Sections 705 and 1366.[5]

Potential CAMT issues. These new credit monetization provisions raise regular tax issues that Treasury and the IRS intend to address in future guidance, but they also can raise CAMT issues to the extent that they may give rise to financial statement income without giving rise to corresponding items of taxable income. Section 56A(c)(9) provides that AFSI is to be appropriately adjusted to disregard any amount treated as a payment against tax pursuant to elections under Sections 48D(d) or 6417 (to the extent not otherwise taken into account under the general provision adjusting for taxes in Section 56A(c)(5)), but it does not expressly address adjustments for receipts by partnerships and S corporations treated as tax-exempt income. Similarly, it does not expressly address adjustments to AFSI in respect of credits transferred under Section 6418, either in the case of the transferee which receives payment for the credits, or the transferor which may purchase credits at a discount.

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Guidance under the Notice and remaining issues. The Notice includes guidance as to several of these issues. It provides that AFSI is "appropriately adjusted" to disregard, provided that those amounts are not otherwise disregarded under Section 56A(c)(5), (i) any amount treated as a payment against tax pursuant to elections under Sections 48D(d) or 6417; (ii) any amount received from transfer of an eligible credit under Section 6418 that is not includible in the gross income of the transferor under Section 6418(b); and (iii) any amount treated as tax-exempt income under Sections 48D, 6417 or 6418 pursuant to refundable credit or transfer elections. The Notice does not, however, address AFSI consequences relevant to a purchaser of tax credits under Section 6418 and it does not expound as to the meaning of "appropriate" adjustments. Future guidance from Treasury on these topics would be welcomed.

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If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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1 S corporations, RICs and REITs cannot be applicable corporations.

2 Unless otherwise specified, references to the "Code" are to the Internal Revenue Code of 1986, as amended, and all "Section" references are to sections of the Code.

3 A domestic corporation is a member of a foreign-parented multinational group if it is included on an AFS (defined below) of a group that has a foreign parent.

4 If a corporation's financial results are reported on the AFS of a group of entities, the group is referred to as an "AFS Group," and the AFS Group's AFS is considered to be the corporation's AFS. Items on that AFS are allocated to the corporation under rules similar to Section 451(b)(5).

5 *See* Sections 48D(d)(A)(III), 6417(c)(1)(C), and 6418(c)(1)(A).

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