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The Corporate AMT: Are the Issues Insurmountable?

by Jerred G. Blanchard Jr., Jeff Maydew, Daniel Newton, and Meaghan A. Wolfe

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SPECIAL REPORT

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The Corporate AMT: Are the Issues Insurmountable?

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In this report, the first of two parts, the authors examine the provisions of the new book minimum tax and compare them with those of its short-lived sole predecessor, the book income adjustment enacted in 1986. Part 2 will explore the challenges facing Treasury and the IRS in providing much-needed guidance on the new tax.

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I. Introduction

The Inflation Reduction Act of 2022 (IRA, P.L. 117-169)[1] dusted off and revised a revenue raiser first enacted as part of the Tax Reform Act of 1986[2] that had a brief three-year life.[3] The new corporate alternative minimum tax based on book income, also known as the book minimum tax (BMT), is significantly broader than its predecessor book

[1]IRA section 10101.

[2]TRA 1986 sections 701-702.

[3]The book income adjustment was effective for tax years beginning in 1987 and before 1990. It was repealed by section 11801(a)(3) of the Revenue Reconciliation Act of 1990.

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income adjustment, which was simply one of many adjustments to regular taxable income required to determine the corporate taxpayer's tentative minimum tax (TMT).[4] At the same time, the IRA BMT is narrower in scope than its 1986 ancestor, generally applying only to a corporation (or group of corporations and other entities) having average annual adjusted financial statement income (AFSI) of more than $1 billion for three consecutive tax years ending on the last day of any tax year ending after December 31, 2021.[5]

The IRA BMT is based entirely on book income, subject to adjustments. Thus, a skeptic might conclude that the IRA BMT has far more potential than the 1986 book income adjustment to be difficult, if not impossible, to administer equitably.

This report selectively explores the 1986 predecessor to the IRA BMT, including a few of the problems we believe justified Congress's termination of the book income adjustment in 1989. It then summarizes key provisions of the IRA BMT. In forthcoming part 2 of this report,[6] we will cautiously wade into the issues our initial reading of the IRA BMT indicates will present substantial difficulties for the IRS in providing much-needed guidance in the administration of the minimum tax.

II. Brief History of the BMT

Justice Oliver Wendell Holmes Jr. once remarked that in construing a tax provision, "a page of history is worth a volume of logic."[7] Although it is unclear whether Congress and the Biden administration agree with Holmes's observation, in light of the enactment of the IRA BMT, we do agree. Hence we begin with a short summary of the brief history of the only other BMT enacted by Congress.

A. The 1986 Corporate AMT

An AMT on corporations was first enacted as part of TRA 1986 to replace an add-on minimum tax enacted in 1969.[8] The primary purpose of the 1986 AMT was to ensure that no taxpayer with substantial economic income could avoid significant tax liability by using exclusions, deductions, and credits. Regular tax incentives, while generally desirable, were thought to be counterproductive if virtually all of a taxpayer's tax liability could be eliminated. The law broadened the corporate tax base by creating several tax preferences and adjustments that eliminated many of the exclusions, deductions, and credits used in determining regular tax.[9]

One of the most significant changes under the 1986 AMT system was the introduction of financial accounting principles. When enacted, the book income adjustment (also known as the business untaxed reported profits (BURP) adjustment) was intended to be temporary because of a concern that book income is defined outside the IRC and that corporations would act to reduce book income in response to the book income adjustment.[10] For tax years beginning in 1987 through 1989, the BURP adjustment, equal to 50 percent of the excess of AFSI (generally, book income as reported on the corporate taxpayer's applicable financial statement (AFS) for the tax year, subject to adjustments set forth in former

[4] The term "tentative minimum tax" has the meaning set forth in section 55(b)(1), as in effect for the period under consideration.

[5] See the discussion in Section III.B.1, *infra*. The Joint Committee on Taxation estimates that about 150 taxpayers would be subject to the corporate minimum tax annually — approximately 30 percent of existing *Fortune* 500 companies. Thomas Barthold memorandum, "Proposed Book Minimum Tax Analysis by Industry," JCT (July 28, 2022). This means the IRA BMT has an extremely narrow base, making 150 companies responsible for raising $313 billion of the anticipated $450 billion required to cover the decarbonization expenditures in the IRA.

[6] Jerred G. Blanchard Jr. et al., "The Corporate AMT: Are the Issues Insurmountable? Part 2," *Tax Notes Federal*, Jan. 23, 2023.

[7] *New York Trust Co. v. Eisner*, 256 U.S. 345 (1921).

[8] TRA 1986 sections 701-702. Significant amendments were enacted in 1989 to simplify the corporate AMT provisions, and, as noted, the book income adjustment was repealed in 1990.

[9] S. Rep. No. 99-313, at 518 (1986). As used in this report, the term "regular tax" means the regular tax liability, as defined in section 55(c)(1), imposed on a corporation for the period under consideration.

[10] *See* JCT, "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 434-435 (May 4, 1987). Empirical research has found that taxpayers did in fact manage their earnings, adjusting book income to reduce taxes owed. *See* Mindy Herzfeld, "Taxing Book Profits: New Proposals and 40 Years of Critiques," 73 *Nat'l Tax J.* 1025 (Dec. 2020); Dhammika Dharmapala, "The Tax Elasticity of Financial Statement Income: Implications for Current Reform Proposals," 73 *Nat'l Tax J.* 1047 (Dec. 2020); Dan Dhaliwal and Shiing-wu Wang, "The Effect of Book Income Adjustment in the 1986 Alternative Minimum Tax on Corporate Financial Reporting," 15 *J. Acct. & Econ.* 7 (1992); and Jordan Richmond, "Firm Responses to Book Income Alternative Minimum Taxes" (Feb. 12, 2021).

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section 56(f)) over alternative minimum taxable income, was included in the tax base.[11] For years beginning after 1989, an adjustment (the adjusted current earnings (ACE) adjustment) that relied on income tax principles replaced the book income adjustment.[12]

The committee reports accompanying the 1986 AMT explained the intended role of the BURP adjustment as follows:

> The 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 reporting requirements, or through voluntary disclosure for substantial nontax reasons), that company will pay some tax (unless it has sufficient net operating losses to offset its income for the year).
>
> Thus, the committee believes that it is important to provide that the alternative minimum taxable income of a corporation will be increased when book income for the year exceeds alternative minimum taxable income. Such a provision will *increase both the real and the perceived fairness of the tax system, eliminate the highly publicized instances in which corporations with substantial book income have paid no tax, and further broaden the minimum tax base to approach economic income more closely*.[13] [Emphasis added.]

Thus, Congress intended for the BURP adjustment required during the three-year transition period (1987-1989) to play an important role, including increasing the real and perceived fairness of the tax system. Quite a burden for a transition rule!

B. Why the BURP Adjustment Didn't Last

The reason the BURP adjustment was replaced by the ACE adjustment after only three years may well have been a concern that because book income is not defined in the IRC, corporate taxpayers may reduce their book income and hence their net AMT liability. And because of the absence of general tax principles and the clear reflection of income and antiabuse provisions of the IRC (such as sections 269 and 482), the IRS and the courts lack the tools required to prevent this loss of revenue through the audit of financial statements.[14] Further, there appear to be at least two other sound arguments for not extending the book income adjustment beyond 1989. The first argument was advanced by authors of a well-known corporate tax treatise, albeit perhaps unintentionally:

> The real-and-perceived-fairness issue that troubled the committee arises because book income often reflects items that are included neither in the corporation's taxable income nor in its AMTI, even after AMTI is increased for the tax preferences and other adjustments summarized earlier. The committee did not supply a list of the offending items, and an exhaustive list would be difficult to compile; but it was concerned presumably about items such as tax-exempt interest, unrecognized gains on exchanges, and accrued income earned by cash-basis taxpayers, that swell a corporation's reported book income without generating any current regular tax liability.
>
> Despite the committee's reference to both real and perceived fairness, it is hard to escape the conclusion that the book

[11] For tax years 1987 through 1989, taxable income was increased by half of the excess of adjusted net book income over AMTI before the adjustment and before deduction of any alternative tax NOL. Former section 56(f). Adjusted book income was generally the net income or loss on the corporation's AFS. Former section 56(f)(3).

[12] For tax years beginning after 1989, in lieu of the book income adjustment, AMTI was generally increased by 75 percent of the excess of ACE over "pre-adjustment alternative minimum taxable income." Former section 56(g); former reg. section 1.56(g)-1(a)(2)(ii).

[13] S. Rep. No. 99-313, at 520 (1986) (footnote omitted).

[14] As one commentator sadly notes:

> The most recent in-depth commentary on the subject was written by a former Hill staffer along with some well-regarded practitioners and academics. They reported that studies of the 1986 BURP proved that affected corporations did, in fact, manage down their book income while the tax was in effect, although the authors thought that less likely for the largest public corporations. Some observers that normally would oppose a minimum tax as bad tax policy have supported the new corporate AMT as the best political compromise available under current conditions. Evidently, that will be the fate of 'tax reform' for the foreseeable future.

Jasper L. Cummings, Jr., "The 2022 Corporate AMT," *Tax Notes Federal*, Sept. 26, 2022, p. 2005, at 2009 (footnotes omitted).

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income remedy (which was repealed in 1989) was concerned solely with perceptions, since the adjustment depends on what the corporation reports, not on the underlying naked facts. For example, assume that (1) the 1988 financial history and operations of corporations A and B were identical in every respect; (2) both A and B had taxable income and AMTI (before the book income adjustment) of zero; (3) both A and B received $500,000 of tax-exempt interest and were advised of a potential tort claim of $1 million; (4) A reported zero book income because it created a contingency reserve of $500,000 for the tort liability that offset its $500,000 of tax-exempt interest; and (5) B reported book income of $500,000 because it chose not to set up a reserve for the contingent tort liability. On these facts, A incurred no AMT liability, while B did, solely because of the difference in their reported book income. Of course, B's financial report may have created a public perception of unfairness — no tax liability despite financial prosperity — that was not created by A's financial report. If the book income adjustment was a response to this perception rather than to reality, then, and only then, could the 1987 to 1989 difference in tax treatment between A and B be defended.[15]

An additional point may be added to the commentators' conclusion: B's payment of a meaningful amount of AMT and A's payment of no AMT do not produce an equitable result given that, disregarding the reserve created on A's AFS,[16] A and B are in the same tax and economic positions.[17]

The example given by the commentators is oversimplified to make a point, but clearly there are many items of income or deduction that depend, to a lesser or greater degree, on the taxpayer's reasonable judgment, for which some range of discretion is allowed under generally accepted accounting principles as well as under GAAP's international counterpart, international financial reporting standards.[18] In addition to booking a reserve for contingent tort or breach of contract liabilities,[19] other examples include allowances for doubtful accounts, impairment of goodwill, valuation allowances, and estimates of salvage or residual value.[20] Absent the book income adjustment of the 1986 AMT, the extent to which a corporate taxpayer records one or more of these items on its AFS for a given tax year takes into account concerns other than tax liability, such as the effect of the item on its earnings per share, the business impact of the item (for example, whether a charge for a contingent tort liability hinders the corporation's settlement of the liability for which the reserve was created or encourages future tort claims against the taxpayer), and the effect of the item on its credit rating. Assuming Congress intended tax neutrality in enacting the book income adjustment under the 1986 AMT, no apparent tax policy is served by imposing a higher tax on B than on A merely because B's weighing of these nontax factors differs from A's.

Moreover, the AMT impact of booking a contingent liability reserve undoubtedly has motivational value and, as the drafters of the 1986

[15] Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 5.08[4] (2015, with updates through Nov. 2020).

[16] The definition of AFS, which is practically the same for purposes of the IRA BMT as for purposes of the 1986 AMT, is discussed in Section III.B.2.a.i, *infra*.

[17] While A's $500,000 reserve reduces its net worth, its lenders likely would inquire into the underlying contingent liability in evaluating the credit risk associated with the claim asserted against A. The same likely would be true regarding B. Thus, the reserve likely would not result in any greater diminution in A's creditworthiness than would occur if A had not created the contingent liability reserve.

[18] In addition to GAAP, which is under the governance of the Financial Accounting Standards Board and is used by most U.S. corporations, IFRS are standards established by the International Accounting Standards Board or the International Sustainability Standards Board through the auspices of the IFRS Foundation. The IASB was founded April 1, 2001, in the EU and has become a widely accepted system used by 167 jurisdictions, excluding China and the United States, in lieu of GAAP. For a short summary of the history of the IASB and its interactions with the FASB (particularly in converging standards), see FASB, "Comparability in International Accounting Standards — A Brief History."

[19] FASB Accounting Standards Codification (ASC) 450-20-20 defines a contingency as "an existing condition, situation, or set of circumstances involving uncertainty as to possible gain (gain contingency) or loss (loss contingency) to an entity that will ultimately be resolved when one or more future events occur or fail to occur." A loss contingency must be accrued if it is both probable and reasonably estimable. *See* PwC, *Financial Statement Presentation* (FSP) 23.4.1.1.

[20] FASB ASC 310-10-35 and 450-20-25-2 (doubtful accounts); ASC 350-20-35 and Accounting Standards Update 2017-04 (goodwill impairment); ASC 360-10-35-22 (useful lives and residual or salvage value).

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AMT uneasily anticipated, might even be the principal reason A's management booked the charge. Generally speaking, Congress does not enact a tax provision for the purpose of having a distortive influence on taxpayer behavior.[21] This doctrine of tax neutrality should apply in the context of determining the book income of a corporate taxpayer under GAAP, particularly in cases in which the corporate taxpayer's shares are registered and traded on an established securities market at prices based largely on a multiple of the taxpayer's earnings per share derived from its AFSs.

A third reason for ending the book income adjustment in 1989 might be the matching issue illustrated by the Fourth Circuit's decision in *CSX*.[22] The case involved a restructuring plan, initiated in 1985, requiring CSX Corp., a calendar-year taxpayer, to take a one-time charge of $954 million against its 1985 financial earnings (a tax year ending before the enactment and effective date of the 1986 AMT) to cover the projected costs of the restructuring. CSX could not deduct the special charge on its 1985 consolidated federal income tax return because sections 162, 165, and 461 allow the costs to be deducted only as legal liability becomes fixed, the amounts are determined with reasonable accuracy, and economic performance occurs. In 1987 CSX accrued and paid around $109.9 million in restructuring costs and properly deducted that amount from its taxable income in that year. CSX could not, however, deduct the $109.9 million from its book income in 1987 because it had already deducted that amount for accounting purposes in 1985 as part of the $954 million restructuring charge against book income. Thus, CSX's 1987 book income was around $109 million greater than its taxable income. As a result, CSX incurred approximately $3,903,000[23] of net AMT attributable solely to the timing difference between the book income charge and regular tax deduction attributable to the restructuring loss.

CSX paid the 1987 AMT and sought a refund. The IRS denied the refund based on former reg. section 1.56-1(d) (effective for tax years beginning after 1986 and before 1990), which prohibited adjustments to book income based on timing differences (that is, book items taken into account in different tax years from the years in which the related regular tax items are taken into account).[24] The district court held, on motion for summary judgment, that CSX was entitled to the refund because the regulation was invalid as contrary to the plain language of former section 56(f)(2)(I) (requiring the Treasury secretary to adjust book income "to prevent the omission or duplication of any item").[25]

In reversing, the Fourth Circuit held former reg. section 1.56-1(d) valid. It denied CSX's refund claim, agreeing with the IRS that an "omission" of a book item can exist under former section 56(f)(2)(I) only if the item is erroneously not reported as a charge against, or increase in, book income. The Fourth Circuit relied primarily on the following analysis:

> The Secretary asserts that the words "omission" or "duplication" in [former] section 56(f)(2)(I) do not in any way require inclusion of timing differences but rather are directed only to the elimination of *miscalculations* of book income, for

[21] *See, e.g.*, Portland Golf Club v. Commissioner, 497 U.S. 154 (1990) (holding that the income tax scheme devised by Congress for taxing the income of social clubs under section 512 was designed to achieve tax neutrality); *Estate of Willette v. Commissioner*, 365 F.2d 760 (5th Cir. 1966) (invalidating former reg. section 1.1361-5(b) because "the tax upon incorporation of an enterprise that has made a section 1361 election . . . destroys the Congressional remedial objective of minimizing the distorting influence of tax considerations in a small businessman's choice of business organization"); Jason Furman, testimony before the Senate Finance Committee hearing on "Tax: Fundamentals in Advance of Reform" (Apr. 15, 2008) ("The basic concept [of tax neutrality] is simple: generally the tax system should strive to be neutral so that decisions are made on their economic merits and not for tax reasons.").

[22] *CSX Corp. v. United States*, 124 F.3d 643 (4th Cir. 1997), *rev'g* 929 F. Supp. 223 (E.D. Va. 1996).

[23] Other less significant timing differences brought CSX's net AMT for 1987 up from roughly $3,903,000 to a total of $4,783,029.

[24] The rationale for this prohibition is described in the preamble to T.D. 8307 (the 1990 final regulations addressing the book income adjustment):

> The final regulations provide no adjustment for timing differences. The specific grant of authority to the Secretary under [former section 56(f)(2)(I)] to make adjustments to prevent the omission or duplication of any item was intended to prevent the omission of any item from adjusted net book income and the duplication of any item in adjusted net book income. Because income resulting from a timing difference is reported in adjusted net book income only once, there is no duplication of adjusted net book income to be adjusted under [former section 56(f)(2)(I)].
>
> Further, any imposition of [AMT] resulting from timing differences is mitigated by the minimum tax credit of section 53.

[25] *CSX*, 929 F. Supp. at 225-226. The district court believed that timing differences were "items" within the plain meaning of the statute that were in fact "omitted" in determining the taxpayer's adjusted net book income for 1987.

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> example, to prevent a corporation from excluding or double counting an item in a way contrary to general accounting principles.
>
> . . . Notwithstanding CSX's claims, the plain language of the statute supports this conclusion. [Former] [s]ection 56(f)(2)(I) directs establishment of regulations "to prevent the omission . . . of any item." The dictionary defines "omission" as "apathy toward or neglect of duty: lack of action." Webster's Third New Int'l Dictionary 1574 (1993); *see also* Black's Law Dictionary 1086 (6th ed. 1990) ("The neglect to perform what the law requires."). The statute thus directs that regulations ensure that corporations do not "neglect" items in calculating book income. It does not, as CSX argues, require that the regulations provide for the addition or subtraction of various tax deductions from "adjusted net book income," or change the definition of how to calculate "adjusted net book income."
>
> . . . The legislative history of section 56(f)(2)(I) also supports the Secretary's interpretation. The Senate Report states that regulations under section 56(f)(2)(I) will be used "to prevent the recording of items directly to the financial statement asset, liability, or equity accounts that are properly included as items of financial statement income or expense." S. Rep. No. 99-313, at 534. Congress thus voiced its concern that corporations would hide book income in "asset, liability, or equity accounts," and designed section 56(f)(2)(I) to ensure that these items not be omitted from book income. Congress similarly foresaw that regulations promulgated under section 56(f)(2)(I) would "require adjustments be made to book income where the principles of this provision . . . would be avoided through the disclosure of financial information through the footnotes and other supplementary statements." H.R. Conf. Rep. No. 99-841, at II-274 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4362. Again, through section 56(f)(2)(I) Congress sought to prevent corporations from "omitting" income by use of footnotes in their financial statements.[26]

The Fourth Circuit's opinion in *CSX* does not discuss two additional, relevant points. First, it does not address the AMT credit allowed by former section 53, under which CSX presumably could have used its 1987 AMT payment as a credit against regular tax for any subsequent tax year to the extent that its regular tax for the year (reduced by all other applicable credits) exceeded its TMT for the year.[27] Second, the opinion does not discuss the fact that the book charge against earnings for the restructuring loss, although required to be recorded in a tax year before the enactment and effective date of the 1986 AMT, did in fact reduce CSX's book earnings. Thus, the effect of the prohibition in former reg. section 1.56-1(d) against adjusting book income for timing differences was to effectively treat a timing difference as a permanent difference for purposes determining the impact of the $109.9 million loss allowed as a regular tax deduction in 1987 on the book income adjustment.

Clearly CSX's 1987 net AMT liability was not the result of any erroneous booking of the restructuring charge constituting an omission within the scope of former section 56(f)(2)(I), as construed by the Fourth Circuit. Instead, the liability was incurred because former section 56(f) did not contain a provision allowing the unused book income charge to be carried forward from a tax year for which there was no AMT requiring a book income adjustment to a tax year for which there was an AMT requiring a book income adjustment.[28] In substance, the timing difference was treated as a permanent difference as far as the 1986 AMT was concerned. That transformation of the timing difference into a permanent difference arguably distorted CSX's book income adjustment for a tax year beginning after 1986 and before 1990, in which CSX was entitled to a regular tax

[26] *CSX*, 124 F.3d at 647-649.

[27] *See* section 53(c) ("The credit allowable under subsection (a) for any taxable year shall not exceed the excess (if any) of — (1) the regular tax liability of the taxpayer for such taxable year reduced by the sum of the credits allowable under subparts A, B, D, E, and F of this part, over (2) the tentative minimum tax for the taxable year."). Section 53(d)(2) defines tentative minimum tax as the tax imposed by section 55(b).

[28] As will be seen, the IRA BMT also lacks such a provision.

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deduction for the restructuring loss, given that CSX's book earnings had in fact been reduced by the restructuring loss.

On the other hand, the same AMT consequences may have occurred if the book charge for the restructuring had been required for a tax year of CSX for which the 1986 AMT applied (for example, 1987) but ending before the tax year for which the related regular tax deduction was allowed (for example, 1988), and this is precisely the kind of timing difference at which former reg. section 1.56-1(d) apparently was aimed. A difference between this hypothetical AMT consequence and the facts of *CSX* is that in the hypothetical case, the corporate taxpayer at least had the opportunity to use the book charge in determining its AMT liability for the tax year in which the book charge was recorded, whereas under the facts of *CSX*, the corporate taxpayer was not afforded that opportunity because of the absence of a book charge carryover. Accordingly, while the Fourth Circuit properly decided *CSX*, a more equitable result would have been achieved if former section 56(f) or its regulations had allowed CSX's 1985 restructuring charge to carry forward to 1987, its first tax year subject to the 1986 AMT.

It could be countered that the corporate taxpayer in *CSX* still might benefit from the lack of a book income reduction attributable to the $109.9 million loss by way of the AMT credit carryforward allowed under former section 53 for its 1987 net AMT payment. The AMT credit under the 1986 AMT, like the credit allowed by the IRA BMT, was not limited in application to permanent differences but could also apply to timing differences. That credit would be available to the taxpayer if the book charge to earnings had occurred during a tax year, other than 1987, for which the 1986 AMT was in effect. For example, if GAAP had deferred the $954 million charge to 1988, the same amount of AMT credit attributable to the 1987 loss ($3,903,000) would have been available under section 53 to offset excess regular tax for 1988, *and*, as a result of the $954 million reduction in book income for 1988, the odds that CSX would have been able to use the credit in 1988 (that is, the odds that its regular tax would have exceeded its TMT) would have materially improved. Thus, the denial of the charge in 1987 cannot be justified by reference to the AMT credit.

To summarize, in addition to the concern that corporate taxpayers would understate their book income to avoid AMT, there appear to be two compelling reasons, and one less compelling reason, for not extending the book income adjustment of former section 56(f) beyond 1989. First, because GAAP allows some items to be booked on an AFS based in part on the exercise of discretionary judgment by a corporate taxpayer's management, using book income to measure a corporate taxpayer's tax liability embodies a significant risk of inequitable administration in which similarly situated taxpayers are not afforded similar tax treatment — the playing field is not level.

Second, basing a corporation's federal tax liability on its book income can, in light of the discretion allowed under GAAP in the determination of items of book expense (such as contingent liability reserves), have a distorting influence on taxpayer behavior that violates principles of tax neutrality and may undermine the financial accounting goal of properly reflecting the economic performance of the corporation to shareholders, creditors, and other outside stakeholders.[29] This issue is particularly problematic in the context of publicly traded corporations.

Third, because a charge to book income related to a regular tax deduction allowed in an AMT tax year but recorded in a tax year for which there is no AMT cannot be carried forward to later tax years subject to the AMT, the taxpayer's subsequent book income adjustment will be overstated given that its book earnings are in fact reduced by the deduction.

C. Repeal of the 1986 AMT in 2017

The Tax Cuts and Jobs Act of 2017, effective for tax years beginning after December 31, 2017, both lowered the regular corporate income tax rate from graduated rates to a single rate of 21 percent and repealed the AMT on corporations, in

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[29] *See* Michelle Hanlon, "The Possible Weakening of Financial Accounting From Tax Reforms," 96 *Acct. Rev.* 389 (Sept. 2021) (detailing concerns about the impact of book tax conformity on the quality of financial accounting reporting).

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addition to other significant changes.[30] At the time of the TCJA's enactment, the repeal of the corporate AMT was estimated to reduce federal tax revenues by $40.3 billion from 2018 through 2027.[31]

The principal reason for the repeal of the corporate AMT was simplification. It had become far too complex, requiring the maintenance of multiple sets of books to track ACE adjustments and regular tax adjustments, and the computation of net income and loss under two sets of rules. It had also become less effective in raising corporate taxes because AMT depreciation — originally a significant factor in the increase in the AMT tax base compared with the regular tax base — was conformed more closely to regular tax depreciation. In short, the revenue raised by the corporate AMT was not worth the time and expense incurred by taxpayers and the IRS in administering such a complex system.[32]

III. The Rebirth of the BMT in 2022

The IRA was signed into law by President Biden on August 16, 2022, replete with numerous environmental and green energy credits, and with the 15 percent IRA BMT and a 1 percent excise tax on stock repurchases to help pay for the new credits. The IRA BMT applies to tax years of applicable corporations (discussed in Section III.B.1, *infra*) beginning after December 31, 2022.[33] Thus, corporate America's AMT reprieve lasted only five years (2018-2022).

The concern expressed by Congress in limiting the 1986 book income adjustment to a three-year transition period, as discussed in Section II.B, apparently was assuaged over the 36 years between the enactment of the 1986 AMT and the enactment of the IRA BMT. The following discussion indicates that Congress would have been well advised to have retained a healthy skepticism regarding the implementation of a BMT.

A. Financial Reporting vs. Regular Tax

1. Timing differences and permanent differences.

a. The different purposes (and biases) of the two systems.

While both the federal income tax system (as far as most large corporations are concerned) and the financial reporting system, principally overseen by the Financial Accounting Standards Board and the International Accounting Standards Board, require the use of the accrual method rather than the cash receipts and disbursements method of accounting, there are substantial differences between the two methods springing from their materially different purposes. Generally, the purpose of financial reporting standards, such as GAAP and IFRS, is to communicate the financial performance of a company to outside stakeholders in a manner that is accurate, transparent, and consistent from one organization to another — all of which is essential to the efficient operation of capital markets.[34] For example, FASB Concepts Statement No. 1, Objectives of Financial Reporting by Business Enterprises, states that financial reporting should provide information that helps in assessing the amounts, timing, and uncertainty of prospective net cash inflows to an entity. By comparison, to state the obvious, the general purpose of the federal income tax system is the collection of tax revenue from taxpayers, ideally in direct

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[30] TCJA sections 12001(a) (repealing the corporate AMT) and 13001(a) (reducing the corporate tax rate to a flat 21 percent), effective for tax years beginning after 2017. As a result of the TCJA, a corporation's income tax liability generally was determined by applying a 21 percent rate to its taxable income. Before 2018, the corporate income tax included a four-step graduated tax rate schedule, with a top rate of 35 percent on taxable income exceeding $10 million, as well as an AMT that was payable (in addition to all other tax liabilities) to the extent that it exceeded the corporation's regular income tax liability. As part of the AMT repeal, a corporation was allowed to offset its entire regular tax liability for a tax year with its AMT credits carried forward from prior tax years. Further, the corporate AMT credit was refundable for tax years beginning after 2017 and before 2022.

[31] JCT, "General Explanation of P.L. 115-97," JCS-1-18, at 436 (Dec. 20, 2018).

[32] *See* Eric Zwick, "The Costs of Corporate Tax Complexity," 13 *Am. Econ. J.: Econ. Pol'y* 467 (May 2021); Curtis P. Carlson, "The Corporate Alternative Minimum Tax: Aggregate Historical Trends," Treasury Office of Tax Analysis, OTA Paper 93 (June 2005).

[33] IRA section 10101(f).

[34] *See, e.g.*, *In re WorldCom Inc. Securities Litigation*, 352 F. Supp. 2d 472, 478 (S.D.N.Y. 2005) (quoting *In re Global Crossing Ltd. Securities Litigation*, 322 F. Supp. 2d 319, 339 (S.D.N.Y. 2004) (describing the purpose of GAAP as "to increase investor confidence by ensuring transparency and accuracy in financial reporting")).

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proportion to their financial capacity to pay tax.[35] Further, there are numerous federal income tax provisions designed to encourage or discourage behavior, such as (1) manufacturing semiconductors or investing in specific kinds of property[36] and (2) refraining from other behavior, such as overspending on meals or entertainment, or paying bribes or kickbacks.[37]

While, similar to GAAP and IFRS, the "proper"[38] reflection of income is a significant purpose of many federal income tax provisions, financial statement measurements of income often diverge from taxable income measures.[39] A significant reason for this lies in the different purposes served by the two systems and the natural biases fostered by those purposes. To the extent financial statement standards are biased, also known as the conservatism constraint, the bias points toward minimizing the risk of *overstating* net income.[40] By contrast, to the extent federal income tax provisions are biased, the obvious bias points toward minimizing the risk of *understating* net income in an effort to prevent tax avoidance. If, unlike the BURP adjustment of the 1986 AMT, the IRA BMT remains in the IRC for a meaningful length of time, there is a risk that the tax purpose and bias will predominate as the two systems evolve in tandem, a risk that does not bode well for the capital markets.[41]

These biases and differences in policies lead to two types of differences between the treatment of specific items for federal income tax purposes and under GAAP and IFRS: (1) timing or temporary differences that reverse over time, and (2) permanent differences that do not reverse over time.[42] The next section, III.A.1.b, and sections III.C.3 and III.C.4 of part 2 of this report, discuss the differences and the issues they create under the IRA BMT.

b. Timing differences.

A timing difference occurs when an item of income, gain, loss, or deduction for regular tax purposes is required to be reported in a different tax year from the year in which its book counterpart is required to be recorded or otherwise taken into account in an AFS. As discussed in Section III.B.2, *infra*, unless the timing of a book item is altered to match the timing of the item for regular tax purposes by section 56A(c), the timing difference can result in the double taxation of the item — once when taken into account for IRA BMT purposes and a second time when taken into account for regular tax purposes. Prominent timing differences include the following.

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[35] An accounting expert has described the difference in purpose between financial accounting and taxable income calculations as follows:

> Financial accounting income and taxable income are computed for different purposes. *Financial accounting is intended to reflect economic performance to outside stakeholders. It is how managers inside the firm convey their private information about firm performance to shareholders*. . . . *In contrast, taxable income is designed to raise revenue for governments to use for public finance. The tax rules are often also used by governments to incentivize certain behavior (e.g., investment) and to disincentivize certain behavior (e.g., "excess" executive compensation)*. [Emphasis added.]

Hanlon, *supra* note 29, at 391.

[36] Examples include bonus depreciation under section 168(k), the credit for low-income housing under section 42, and credits for semiconductor advanced manufacturing facilities under section 48D.

[37] Examples include a prohibition on deductions for fines and penalties under section 162(f), for bribes and kickbacks under section 162(c), for specified lobbying expenditures under section 162(e), for share buyback costs under section 162(k), for executive compensation exceeding $1 million, and for specified travel, meals, and entertainment expenses under section 274.

[38] As further discussed in this Section III.A.1, each system has a built-in bias in terms of when income is properly reflected. The financial reporting bias is against *overstating* income taken into account for an accounting period (*e.g.*, advance payments for future performance of services or delivery of goods generally are taken into account under GAAP and IFRS only as and when earned by the corporation), whereas the obvious federal income tax bias is against *understating* income taken into account for a tax year (*e.g.*, those advance payments generally are taken into account by the corporation when received).

[39] *See, e.g.*, *Rockwell International Corp. v. Commissioner*, 77 T.C. 780 (1981) (discussing "the accountant's pervasive fear of misleading the users of the company's financial statements as to its true financial condition" and noting that "the Supreme Court has [in *Thor Power*] made it explicitly clear that a method of accounting that is in accord with GAAP does not necessarily clearly reflect income" for federal income tax purposes). Perhaps the most glaring example of the divergence of financial reporting standards from income tax reporting rules is the different treatment of advance payments of income received by accrual-method taxpayers, discussed in this Section III.A.1.

[40] *See, e.g.*, Donald E. Kieso and J.J. Weygandt, *Intermediate Accounting* 49 (1992) ("Conservatism means: *when in doubt choose the solution that will be least likely to overstate assets and income*. . . . Examples of conservatism in accounting are the use of the lower of cost or market approach in valuing inventories and the rule that accrued net losses should be recognized on firm purchase commitments for goods for inventory. If the issue is in doubt, it is better to understate than overstate.") (emphasis added).

[41] *See* the discussion in part 2 of this report, at Section III.C.1.

[42] Tim Krumwiede and Larry Witner, "The Feasibility of a GAAP-Based Income Tax System," 87 *Taxes* 37, 38 (Jan. 29, 2009) (describing different categories of temporary differences that "result when items are reported in one period for financial accounting and in another period for tax" in contrast to permanent differences, like municipal bond interest, which never reverse).

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i. Expenses.

Expenses are generally accrued under GAAP and IFRS to match coinciding revenues if, for a contingent liability, (1) it is probable that an outflow of resources (typically a payment) will be required to fulfill the obligation, and (2) the amount of the outflow can reasonably be estimated.[43] If a GAAP or IFRS estimate of an accrued expense ultimately proves incorrect, the company generally adjusts its books when the correct amount is determined. For example, corporations often accrue a contingency reserve for ongoing legal disputes, with the accrual adjusted later, as needed, to reflect the actual amount of the settlement or judgment payment. In contrast, expenses generally are not deductible for regular tax purposes until the all-events test is met — that is, all events have occurred that determine the fact of liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[44] These general principles often result in the recognition of an accrued expense in an earlier year for financial statement purposes and in a later year for tax purposes; however, eventually the same amount of expense is reported under both systems. Nonetheless, as discussed below, timing differences can trigger the incurrence of significantly greater tax liability in a BMT system.[45]

ii. Capital costs.

Accelerated depreciation and expensing of specified depreciable assets generally result in deductions for capital costs being reflected in taxable income much earlier than when those amounts are reflected in financial statement income.

- The straight-line method of depreciation is often used for financial accounting purposes, although other methods are permitted. Under GAAP, recovery periods generally are intended to reflect an asset's useful life, and therefore often differ from the recovery periods used for regular tax purposes. Taxpayers may wish to align the recovery period with the tax rules for administrative convenience. However, if the number of years specified for tax purposes for recovery deductions for an asset does not fall within a reasonable range of the asset's useful life, the recovery deductions generally may not be used as depreciation expense for financial reporting purposes.[46]
- Notably, section 56A(c)(13) requires an adjustment to net book income in determining AFSI that eliminates all depreciation used in the AFS in recovering the cost of property described in section 168 and substitutes depreciation used for regular tax purposes for that property. For all other depreciable, depletable, and amortizable property,[47] the capital recovery method, if any, used in the AFS applies in determining AFSI.

iii. Bad debts.

An estimate of bad debts must be accrued for financial statement purposes although no regular tax deduction generally is taken until an account is actually written off.[48] In general, section 166(a) allows a tax deduction for wholly worthless debts in the year they become wholly worthless. For corporate taxpayers, it allows a deduction for partially worthless debts in the year in which they become partially worthless, but only to the extent that the partially worthless debts have been charged off before the end of that tax year.[49]

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[43] *See* FASB ASC 450-20, Accounting for Contingencies, formerly known as FASB Statement No. 5.

[44] Section 461(h).

[45] Other examples of temporary book tax differences arise from capitalization of indirect and direct costs to property produced by the taxpayer under the section 263A uniform capitalization provisions, some acquisition costs under section 263(a), and reserves for future expenses that are not currently deductible under section 461.

[46] *See* FASB ASC 360-10-35, Property, Plant, and Equipment: Overall: Subsequent Measurement. For further discussion, see JCT, "Background and Present Law Relating to Cost Recovery and Domestic Production Activities," JCX-19-12, at 13-18 (Mar. 6, 2012).

[47] A limited exception applies to amortization deductions claimed for qualified wireless spectrum under section 56A(c)(14), as discussed in Section III.B.2.a.vii, *infra*.

[48] FASB ASC 310-10-35-7 through -10 provide rules for estimating the allowance for doubtful accounts. Under ASC 310-10-35-9, losses from uncollectible receivables are accrued when both of the following conditions are met: (1) information available before the financial statements are issued or are available to be issued indicates that an asset probably has been impaired as of the date of the financial statements, and (2) the amount of the loss can reasonably be estimated.

[49] See also section 582 for special rules for worthless securities held by banks.

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iv. Deferred compensation.

Nonqualified deferred compensation expenses are accrued as the employee or other service provider earns the income for financial statement purposes, but they generally are not deductible for regular tax purposes until included in the gross income of the employee or other service provider (that is, when paid by the employer or service recipient, meaning when irrevocably made available to the employee).[50]

v. Advance payments.

Regular tax accounting principles generally require the immediate recognition of advance payments as income by an accrual-method taxpayer,[51] while financial accounting principles may require the income to be recognized in a later period.[52] In this case, taxable income includes an item in an earlier tax period, and the taxpayer pays regular tax on the item in that period. If the item is recognized in a later period for financial accounting purposes (assuming no other adjustments), the taxpayer may include the item in AFSI and may again pay tax on the item, albeit at the lower AMT rate of 15 percent. The same double taxation potential existed for the book income adjustment in the 1986 AMT without the IRS providing any relief, and, as further discussed in Section III.C.3.b of part 2 of this report, the IRS will likely take the same position in the context of the IRA BMT.[53]

vi. Section 481 adjustments.

The rules applicable to changes in accounting methods generally are located in sections 446(e) and 481. The regulations under section 446(e) set forth the procedures for carrying out the section's prohibition on changing a method of accounting without the approval of the commissioner,[54] and section 481 sets forth (1) the adjustments required to give effect to an accounting method change, (2) the manner in which the adjustments are taken into account in determining income, and (3) the method of determining the tax resulting from the adjustments. The section 481 adjustments are designed to avoid the omission or duplication of items of income and expense that otherwise may result from the change in accounting method.[55] The significant IRA BMT issues raised by section 481 adjustments are summarized in Section III.C.8 of part 2 of this report.

vii. Nonrecognition transactions.

Like-kind exchanges described in section 1031, complete liquidations of subsidiaries under sections 332 and 337, acquisitive and divisive transactions described in section 368(a)(1) or section 355, and transfers entitled to nonrecognition treatment under section 351 are examples of transactions that may be afforded partial or complete deferral of income for regular tax purposes while giving rise to financial statement income or loss for book purposes. As

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[50] *See* FASB ASC 710-10-30 (requiring accrual of an employer's obligation under an individual deferred compensation contract in accordance with the terms of the contract, such that the present value of the obligation is fully accrued as of the date the employee attains full eligibility for the benefits); section 404(a)(5); reg. section 1.404(b)-1T (amounts paid within 2½ months of the year in which the amounts were earned by the employee generally are deductible when accrued for financial statement purposes).

[51] *See* section 451(c)(1)(A) (an advance payment generally must be included in income by an accrual-method taxpayer no later than the tax year of receipt), and subparagraph (B) (allowing an election to defer an advance payment to the tax year after the tax year of receipt to the extent the payment is not taken into account in the taxpayer's AFS for the year of receipt); reg. section 1.451-8(b) (generally, an accrual-method taxpayer must include an advance payment . . . in income no later than the tax year of receipt), paragraph (c) (election to defer to the next tax year the portion of advance payment not reported in AFS for the tax year of receipt; election is available only for a taxpayer with an AFS to the extent the taxpayer can determine amount taken into account as AFS revenue for tax year of receipt).

[52] *See* FASB ASC 606.

[53] Section 56A(c)(15)(A) authorizes regulations intended to "carry out the purposes of this section, including adjustments" that "prevent the omission or duplication of any item." A similar issue existed for the 1986 AMT, and the IRS decided not to make an adjustment in the computation of net book income to prevent the duplication of the item, stating in the preamble to T.D. 8307: "The final regulations provide no adjustment for timing differences. . . . Because income resulting from a timing difference is reported in adjusted net book income only once, there is no duplication of adjusted net book income to be adjusted under [former] section 56(f)(2)(J)."

[54] *See* reg. section 1.446-1(e)(2)(i) ("Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.").

[55] *See Huffman v. Commissioner*, 518 F.3d 357 (6th Cir. 2008).

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discussed in Section III.B.2.a.xiv of part 2, section 56A(c)(15)(B) authorizes regulations that eliminate some, but not all, of these timing differences.

viii. Other timing differences.

Other potential timing differences include (1) sales and finance leases in which the transaction may be viewed as a sale or financing for book purposes and a true lease for regular tax purposes (or vice versa), and (2) transfer pricing adjustments under section 482, including buy-in payments under cost-sharing arrangements[56] and advance pricing agreements,[57] all of which may give rise to temporary and, in some cases, permanent differences.

Example 1: *True lease for regular tax purposes and sale for financial reporting purposes*. X, an applicable corporation for 2023 that uses the calendar year as its tax year, owns a new manufacturing facility, completed in December 2022, with a regular tax basis of $700 and a book value of $700. Effective January 1, 2023, X leases the facility to Y, an unrelated applicable corporation for 2023 using the calendar year as its tax year, under a lease qualifying as a true lease for regular tax purposes and a sale-financing for financial reporting purposes. The term of the lease is 19 years, the rental due under the lease is $100 per annum, and the useful life of the facility is 20 years. Y has the option to purchase the facility any time after the 15th year of the lease term and before the end of the lease term at an exercise price of $400 minus rent, to the extent paid, accrued from the first day of the 16th year of the lease term to the date of exercise. At the time the lease is entered into, the market interest rate of a loan by X to Y would be 6 percent per annum.

For financial reporting purposes, X is treated as selling the facility to Y, and Y is treated as purchasing the facility from X, in exchange for an obligation of Y with a fair value of around $1,127 (the present value at a discount rate of 6 percent per annum of the right to receive $100 per annum for 19 years and a facility worth $35 [$700/20 years] at the end of year 19). Assuming the owner of the facility is entitled to depreciation on a straight-line basis over 10 years for regular tax purposes, which is also the depreciation method under section 56A(c)(13) for IRA BMT purposes, the tax consequences to X and Y for 2023 are as shown in Table 1.

Thus, for 2023, X is not a happy camper because its AFSI from the transaction of $432.64 is $402.64 greater than its $30 of net income for regular tax purposes, making it likely that X will incur IRA BMT for 2023. In contrast, Y's $100 net loss for regular tax purposes, consisting solely of rent, is $18.34 less than its $118.34 net loss for IRA BMT purposes, consisting of a $112.70 depreciation deduction and $5.64 interest expense deduction. Thus, Y's loss for IRA BMT purposes, being slightly more than its regular tax loss, virtually assures Y that the transaction will not result in its incurring IRA BMT for 2023.

By assuming the lease remains intact for 19 years, with no default or exercise of the option by Y, it can be established that the timing differences incurred by X and Y even out over time, with X taking into account $1,200 of aggregate AFSI and regular taxable income over the lease term, and Y taking into account $1,900 of aggregate AFS net loss and NOL for regular tax purposes over the lease term.

Nevertheless, it will take more than 17 years for X's regular tax net income to eliminate the $402.64 head start of AFSI in 2023 resulting from the financial reporting treatment of the lease as a sale-financing.[58] In effect, the $427 gain for IRA

[56] *See* reg. section 1.482-7 (a complicated regulatory regime designed to place profits from a cost-shared intangible on a much closer par with normal transfer pricing principles); *Xilinx Inc. v. Commissioner*, 598 F.3d 1191 (9th Cir. 2010) (holding that the general arm's-length rules of reg. section 1.482-2 trump the special rules of reg. section 1.482-7); and *Altera Corp. v. Commissioner*, 145 T.C. 91 (2015), *rev'd*, 926 F.3d 1061 (9th Cir. 2019) (following *Xilinx*). *See also Veritas Software Corp. v. Commissioner*, 133 T.C. 297 (2009), *nonacq.*, AOD 2010-05 (Nov. 10, 2010) (Tax Court used comparable uncontrolled transaction approach in determining buy-in amounts under cost-sharing arrangement (CSA) when existing technology had little value because of advances and the principal value lay in marketing expertise; the IRS disagreed with the Tax Court's disregard of research and development rights and other elements made available under the CSA).

[57] Under Rev. Proc. 91-22, 1991-1 C.B. 526, taxpayers and the IRS can obtain an APA covering the prospective determination and application of transfer pricing methods and cost-sharing practices for specific international transactions between foreign or domestic taxpayers and their related affiliates.

[58] As a result of X's regular tax depreciation deductions totaling $700 for the first 10 years, X's regular tax net income over that period is a total of $300, compared with around $727 of total AFSI for the first 10 years, including the $427 gain and $300 of interest income accrued over that period. By the end of 2040 (the 17th year of the lease term), X's aggregate regular tax net income is $1,000 ($1,700 of rent minus $700 of depreciation deductions), and its total AFSI for the first 17 years is around $1,113.

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Table 1. Results for 2023

Taxpayer	AFSI Impact				Regular Tax Impact		
	Gain	Interest	Depreciation	Net Income	Rent	Depreciation	Net Income
X	$427[a]	$5.64[b]	$0	$432.64	$100	($70)[c]	$30
Y	$0	($5.64)	($112.70)[d]	($118.34)	($100)	$0	($100)

[a]Amount realized of $1,127 minus book value of $700.

[b]The present value at 6 percent per annum of the receipt of $100 at the end of 2023 is $94.34. Thus, $5.66 of the $100 payment is interest income for IRA BMT purposes, and $94.34 reduces the principal amount of the Y note from $1,127 to $1,032.66. For 2024, the principal portion of the $100 payment is $89 and the interest is $11. By the end of 2042 (the 19th and final year of the lease term), the principal portion is $33 and the interest $67.

[c]Straight-line depreciation of the $700 regular tax basis of the facility in the hands of X over 10 years.

[d]Straight-line depreciation of the $1,127 book basis of the facility in the hands of Y over 10 years.

Table 2. Results Over the Total Lease Term

Taxpayer	AFSI Impact				Regular Tax Impact		
	Gain	Interest	Depreciation	Net Income	Rent	Depreciation	Net Income
X	$427	$773	$0	$1,200	$1,900	($700)	$1,200
Y	$0	($773)	($1,127)	($1,900)	($1,900)	$0	($1,900)

BMT purposes is an acceleration of an equivalent amount of rental income taken into account by X in later years of the lease term for regular tax purposes. Unfortunately for X, subjecting the same (or a related) item of income to BMT tax in an early year and regular tax in a later year is allowed, as discussed in Section II.B, *supra*, and Section III.C.3 of part 2 of this report, when that results from a timing difference. The question of whether X has any defense against that double taxation likely will reduce to whether the different characterizations of the lease for financial reporting and regular tax purposes cause a permissible timing difference, and the answer to that question seems to be yes.[59]

c. Permanent differences.

A permanent difference generally is any item, the inclusion or deduction of which for financial accounting purposes has no corresponding inclusion or deduction for regular tax purposes, or vice versa. A permanent difference may also include an expense resulting in a tax credit that reduces regular tax but only in a deduction in determining net book income or loss.[60]

Permanent differences include adjustments to taxable or financial statement income that have no counterpart under the other regime, such as the inclusion under GAAP or IFRS of interest income on tax-exempt bonds, which is excluded for regular tax purposes. Permanent differences also include adjustments to expenses, including, for example: (1) the deduction under GAAP of dividends paid on sponsor stock held by an employee stock option plan that are not

[59]When one thinks of a timing difference, what typically comes to mind is (1) an expense that is fully deductible for financial accounting or regular tax purposes but capitalized and depreciated for purposes of the other regime, or (2) an advance payment of income taken into account upon receipt for regular tax purposes but deferred for financial reporting purposes. Nonetheless, because different characterizations of a lease for financial reporting and regular tax purposes have the same effect on regular taxable income and AFSI as typical timing differences, presumably this effect will also be permitted as a mere timing difference in cases such as that illustrated by Example 1.

[60]FASB ASC 740-10-05-09 and 740-10-25-30.

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deductible for regular tax purposes;[61] (2) the disallowance for regular tax purposes of deductions for a portion of meals and entertainment expenses; (3) fines and penalties for which no deduction is allowed for regular tax purposes;[62] (4) nondeductible interest expense;[63] (5) nondeductible U.S. federal income taxes and creditable foreign taxes claimed as a federal income tax credit;[64] and (6) employee compensation over deductible limits.

Permanent differences may also include special tax deductions, such as the deduction allowed under section 250 for foreign-derived intangible income and global intangible low-taxed income, which are not reflected in AFSI;[65] and special expenditures, such as those for research activities, which reduce book income but are allowed as a credit against the taxpayer's regular tax liability.[66]

2. Accounting for acquisitions.

Before 2001 there were two general approaches in accounting for acquisitions allowed under GAAP — (1) the pooling of interests method, under which the financial statements of the acquiring and acquired corporations were combined, the income of the acquired corporation was reflected on its final financial statement, and the financial statement of the acquiring company reflected both the pre- and post-acquisition income of the acquired company for the year of the combination; and (2) the purchase method. Most acquisitions were accounted for under purchase accounting because of the difficulty in qualifying for pooling.

There were several objections to the use of two completely different methods for accounting for acquisitions. For example, analysts and other users of financial statements indicated that it was difficult to compare the financial results of different entities because different methods of accounting for business combinations were used, and others indicated a need for better information about intangible assets because those assets are an increasingly important economic resource for many entities and are an increasing proportion of the assets acquired in many business combinations. On January 23, 2001, in a move opposed by the business community,[67] FASB revoked APB Opinion No. 16, Business Combinations, and FASB Statement No. 38, Accounting for Preacquisition Contingencies of Purchased Enterprises, and issued Statement 141 to the effect that the purchase method would henceforth be the only accounting method used in an acquisition of a controlling interest in a business.[68]

Under purchase accounting, generally the identifiable assets of the acquired company are stepped up to their current market values, and any excess purchase price over the fair market value of the identifiable assets is recorded as nonamortizable goodwill. In lieu of amortization, goodwill generally is required to be measured annually for impairment, and if there is impairment of goodwill as a result of an annual measurement, the amount of the impairment is

[61] Under section 404(k)(2)(A), a corporate sponsor of an ESOP is allowed a regular tax deduction for a dividend paid on stock of the corporation held by the ESOP only if the dividend is (1) paid directly to plan participants or their beneficiaries; (2) paid to the ESOP and distributed to participants or beneficiaries not later than 90 days after the close of the plan year in which paid; or (3) used by the ESOP to make payments on a loan obtained to acquire the stock on which the dividends are paid.

[62] *See* reg. section 1.162-21.

[63] For example, section 265(a)(2) (interest incurred to acquire tax-exempt assets) and the Treasury regulations under section 385 (interest on debt characterized as equity for regular tax purposes). Disallowed business interest expense under section 163(f), however, should be a timing difference in view of the indefinite carryforward of the disallowed expense under section 163(f)(2).

[64] Section 275(a)(1) (categories of nondeductible U.S. federal taxes); section 275(a)(4) (no deduction for foreign taxes if a credit is claimed); and section 901(j)(3) (no foreign tax credit, or deduction, allowed for taxes paid to designated countries, currently Iran, North Korea, Sudan, and Syria).

[65] Section 250.

[66] Sections 41 (credit for specified R&D expenses) and 48D (credit for advanced manufacturing facilities).

[67] One objection was that excess purchase price paid for the target over the appraised value of its assets was carried on the financial statements as goodwill required to be amortized over a minimum of 20 years. Thus, purchase accounting frequently discouraged acquisitions that risked substantial amortization charges against book income that would reduce earnings per share for a meaningful length of time, which in turn could reduce the flow of capital into some industries and thereby slow the development of new technology. Nonetheless, the FASB ended pooling based on the conclusion that this was required to ensure the neutrality and fairness of acquisition accounting standards. *See* FASB Statement 141.

[68] Effective for accounting periods beginning on or after December 15, 2008, FASB Statement 141 was revised to apply to "all transactions or other events in which an entity (the acquirer) obtains control of one or more businesses (the acquiree)" excluding (1) joint venture formations, (2) an acquisition of assets not comprising a business, (3) a combination of entities under common control, and (4) a combination of not-for-profit organizations or an acquisition of a for-profit entity by a not-for-profit organization.

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treated as a charge in determining net book income for the tax year of the impairment. Effective for accounting periods beginning after December 15, 2001, FASB Statement 142 was issued to change the treatment of goodwill of an acquired entity from a wasting asset to an asset of indefinite duration and to require more detailed information regarding the acquired entity's intangible assets, including goodwill. In lieu of amortization, Statement 142:

> provides specific guidance for testing goodwill for impairment. Goodwill will be tested for impairment at least annually using a two-step process that begins with an estimation of the fair value of a reporting unit. The first step is a screen for potential impairment, and the second step measures the amount of impairment, if any. However, if certain criteria are met, the requirement to test goodwill for impairment annually can be satisfied without a remeasurement of the fair value of a reporting unit.

Thus, if goodwill is required to be booked under the residual method of FASB Statement 141, straight-line amortization of the goodwill over at least 20 years and not more than 40 years is no longer required. Instead, annual valuation of goodwill is required, and if there is impairment of goodwill as a result of an annual measurement, the amount of the impairment is treated as a charge in determining net book income for the tax year of the impairment.

Further, the accounting period of the acquired company terminates on the acquisition date, and its items of income and loss are reflected in new financial statements for accounting periods beginning on or after the day after the acquisition date. As part of accounting for the acquisition, a valuation adjustment creating a net deferred tax asset (DTA) or net deferred tax liability (DTL) generally is required whenever the book value under purchase accounting of assets differs from the assets' regular tax bases.[69] Rather than reflecting the tax effects of those basis differences in the book value of the asset responsible for the DTL or DTA, FASB Accounting Standard Codification (ASC) 805-740-25-3 requires, with some exceptions, that a net DTL or DTA be recorded for an acquired entity's taxable or deductible temporary differences, as well as any operating loss or tax credit carryforwards, in determining the amount (if any) of goodwill deemed acquired under a residual allocation approach similar to that used in reg. section 1.338-6(b). This approach is illustrated by the following example.

Example 2: *Purchase accounting including a valuation adjustment reflecting a DTL.* P purchases all the stock of T from T's shareholders for $650 in cash when T has a single liability (a mortgage debt) of $400, owns a single asset (raw land) with a tax basis of $300 and appraised value of $1,000, and is subject to federal income tax at the rate of 21 percent. No election is made under sections 336(e), 338(g), or 338(h)(10). Under the purchase acquisition method of FASB ASC 805-740-25-3, the $700 difference between the $1,000 book value of the land and its $300 tax basis is a temporary difference for which a $147 DTL (21 percent * $700) must be provided. Further, goodwill is calculated as the excess purchase price and DTL over the fair value of T's ascertained tangible and intangible assets. Thus, P's acquisition journal entries are as shown below:

Parent:		
Dr. Investment in subsidiary	$650	
Cr. Cash		$650
Subsidiary:		
Dr. Net assets	$1,000	
Dr. Goodwill	$197	
Cr. Debt assumption		$400
Cr. Net DTL		$147
Cr. Net equity		$650

Sections III.A.3 and III.B.2.a.v, *infra*, and Section III.C.5 in part 2 of this report, discuss the potential treatment of DTLs and DTAs under the IRA BMT.

[69] *See* FASB APB Opinion No. 16, para. 89; and FASB ASC 805-740-25-3.

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3. Relevance of FIN 48.

Former FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (June 2006), required businesses to analyze and disclose income tax risks. It was effective in 2007 for publicly traded entities and is now effective for all entities adhering to GAAP in the form of ASC Subtopic 740-10 (cited as FIN 48). The principal thrust of the standard is that a business may recognize an income tax benefit only if it is more likely than not that all or a portion of the benefit will be sustained. The amount of benefit recognized is based on relative probable outcomes.[70]

Specifically, FASB ASC Subtopic 740-10, which incorporates most of former FIN 48, requires that each tax position of a corporation adhering to GAAP meet a more-likely-than-not test and that the tax benefits be correspondingly reduced if the result is not certain.[71] The process generally requires the following steps:

- First, all tax positions[72] for all open years, including the current year, and for all relevant jurisdictions, must be inventoried.[73] The only exceptions are that a tax position involving an immaterial amount and a day-to-day business transaction — the tax treatment of which would clearly be sustained on audit — may be disregarded.
- Next, all tax positions must be classified as uncertain or as meeting the more-likely-than-not standard.[74] This frequently is a difficult process, requiring the exercise of substantial technical income tax expertise that often motivates the taxpayer to seek a private letter ruling or tax opinion, depending on the materiality of the item and complexity of the issue.
- Finally, a determination must be made as to whether the tax benefits from uncertain tax positions (and how much of those benefits) should be reported in the financial statements.[75]

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[70]FIN 48, originally issued in June 2006, is now codified in FASB ASC Subtopic 740-10 (2010) and applies to all businesses determining book income and loss under GAAP. Under Subtopic 740-10, businesses must analyze all tax positions that are less than certain. Only those positions that are more likely than not to produce benefit can be recognized in accruing tax.

[71]Michael C. Swenson, "Understanding the Mechanics of FASB ASC Subtopic 740-10," *The Tax Adviser*, Jan. 1, 2020 ("In essence, the reporting requirements provide a glimpse into how much tax risk a company is prepared to take.").

[72]*Id.*:

> A tax position is any determination of tax treatment in a filed return or a return to be filed that is reflected in the measurement of deferred tax assets or liabilities in any financial statement, including interim financial statements. This is a broad definition that includes permanent tax reductions and positions that merely defer tax liabilities, as well as a change in the anticipated recognition of tax obligations. A tax position also encompasses a decision to file or not to file a return, interjurisdiction income allocations (between states, or the United States and foreign countries), and determinations of whether income is taxable or tax-exempt.

[73]*Id.*:

> This means conducting a thorough review of the tax returns for each open year to identify material tax positions. It also means that any decision not to file or how to allocate income must be reviewed. The initial requirement to inventory really means that the taxpayer must assess each material tax position taken on any income tax return for any open year. Thereafter, each tax position taken in the current year must be inventoried, and prior open issues must be reassessed. . . . However, FASB did not intend for Subtopic 740-10 to have a significant effect on routine, day-to-day business tax transactions that would clearly meet the [more likely than not] requirement and be fully allowed on audit. Thus, for example, the normal operating costs of a business would fall outside Subtopic 740-10's scope.

[74]*Id.*

[75]*Id. Cf.* reg. section 1.6012-2(a)(4), effective for tax years beginning on or after January 1, 2010 ("a corporation required to make a return under this section shall attach Schedule UTP, Uncertain Tax Position Statement, or any successor form, to such return, in accordance with forms, instructions, or other appropriate guidance provided by the IRS"). Thus, in addition to stakeholders and others using financial statements, the IRS is keenly interested in understanding any UTPs taken by a corporation subject to FIN 48. *See* Chandra Wallace, "Requiring More Detail on UTPs May Mean Fewer Companies Disclose," *Tax Notes Federal*, Nov. 14, 2022, p. 1012 (discussing new, more expansive disclosure requirements proposed by the IRS in an updated draft Schedule UTP for 2022).

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There is no doubt that FIN 48 will remain a key, brain-numbing part of GAAP after the effective date of the IRA BMT. Nonetheless, problematic circularity would seem to arise if a system designed to measure and impose income tax liability, such as the IRA BMT, required deferred tax assets based on the application of the IRA BMT in future tax years to be included as items of income in determining an applicable corporation's tax liability for the current tax year. Thus, guidance issued by the IRS under section 56A(c)(5), summarized and discussed in Section III.B.2.a.v, *infra*, should disregard DTAs established as a result of an applicable corporation's FIN 48 analysis, at least to the extent those DTAs are attributable to IRA BMT positions.

B. Summary of IRA BMT Provisions

The IRA BMT may be broken down into two sets of rules, although the first set relies heavily on the second. The first set of rules limits the scope of the BMT to very large corporate taxpayers (so-called applicable corporations) with average annual net book income exceeding $1 billion over a three-year period. The second set of rules determines the amount of BMT owed by an applicable corporation.

1. Scope of the IRA BMT.

The IRA BMT applies only to an applicable corporation — generally defined in section 59(k)(1)(A) and (B) as a corporation, other than an S corporation, real estate investment trust, or regulated investment company, but including foreign corporations as well as domestic corporations — having average annual AFSI, as determined under section 56A, of more than $1 billion over the three-consecutive-tax-year period ending on the last day of any tax year ending after December 31, 2021, other than the tax year for which the test is applied. AFSI is determined for this purpose by making adjustments required in section 56A(c),[76] but without regard to (1) any financial statement NOL carryforward allowed under section 56A(d); (2) any partnership income under the adjustment in section 56A(c)(2)(D);[77] or (3) adjustments under section 56A(c)(11) for defined benefit pension plans.[78] Regarding the second income adjustment, the exclusion of book income or loss items on financial statements of controlled partnerships is effectively negated by sections 52(b) and 59(k)(1)(D), which treat the AFSI of a corporation that is a part of a group of entities (including partnerships) constituting a single employer under section 52(b) as including the book income or loss of the partnerships, subject to the adjustments specified in section 56A(c) (other than, presumably, section 56A(c)(11)).

Example 3: *Qualification as an applicable corporation*. X, a calendar-year domestic corporation, has average annual AFSI of $1.1 billion over the three-tax-year period beginning January 1, 2020, and ending December 31, 2022. Therefore, X will first become subject to the IRA BMT for its tax year beginning January 1, 2023. If X's average annual AFSI over the three-year period beginning January 1, 2020, is less than or equal to $1 billion, X will not be an applicable corporation subject to the IRA AMT for its tax year beginning January 1, 2023. If, however, X satisfies the test for the next three-year period beginning January 1, 2021, and ending December 31, 2023, it will be an applicable corporation subject to the IRA BMT for its tax year beginning January 1, 2024.

In view of the complexity of determinations of AFSI, errors and disagreements between the IRS and taxpayers are bound to occur. For taxpayers that are close to the $1 billion threshold and are tackling issues for which there are no clear answers in the statute or subsequent guidance, the IRS should consider a revenue procedure allowing those taxpayers to seek a private letter ruling or letter of determination resolving the

[76] The adjustments under section 56A(c) are discussed beginning at Section III.B.2.a.ii, *infra*.

[77] Section 59(k)(1)(D) ("Solely for purposes of determining whether a corporation is an applicable corporation under this paragraph, all adjusted financial statement income of persons treated as a single employer with such corporation under subsection (a) or (b) of section 52 shall be treated as adjusted financial statement income of such corporation, and adjusted financial statement income of such corporation shall be determined without regard to paragraphs (2)(D)(i) [partnership adjustments] and (11) [qualified deferred compensation plans] of section 56A(c).").

[78] *Id.*

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issues. Otherwise, the IRS may find itself in limbo on important issues on which taxpayers have taken reasonable (and sustainable) positions not to the agency's liking.[79]

Under section 56A(c)(4), the AFSI of a foreign corporation is adjusted to include only items of net income or loss that are effectively connected to the conduct of a trade or business in the United States, applying the principles of section 882. The insertion of section 882 into the IRA BMT means that for large foreign corporations, including large foreign-owned multinational groups, there is even more pressure now to properly report income from permanent establishments or other taxable presences in the United States (that is, effectively connected income) on a timely Form 1120F filed for each tax year included in the three-year average annual AFSI test of section 59(k)(1).[80]

Once a corporate taxpayer satisfies the three-year AFSI test and becomes subject to the IRA BMT for a tax year, it generally remains subject to the IRA BMT for each succeeding tax year regardless of whether it continues to satisfy the test. Two exceptions are created to this general rule, neither of which can apply absent regulatory guidance under section 59(k)(3): (1) the corporation undergoes a change in ownership[81] and "the Secretary determines that it would not be appropriate to continue to treat such corporation as an applicable corporation,"[82] or (2) the corporation fails to satisfy the three-year AFSI test for several consecutive tax years, including the tax year under consideration, as specified by the secretary, taking into account the facts and circumstances of the taxpayer, and, again, the secretary determines that it would not be appropriate to continue to treat the corporation as an applicable corporation.[83] Neither exception, however, will continue to apply for a tax year after the first tax year to which the exception applies, if the corporation again satisfies the three-year AFSI test for the subsequent tax year.[84] Thus, a corporation excepted by the IRS from applicable corporation status is guaranteed at least four tax years of freedom from the IRA BMT.

Special rules are applied to foreign-parented multinational groups, defined as two or more entities that (1) include at least one domestic and one foreign corporation, (2) are included in the same AFS[85] for the relevant year, and (3) whose common parent is a foreign corporation or is deemed to be a foreign corporation under rules adopted by the secretary.[86] For this purpose, if a foreign corporation is engaged in a trade or business conducted in the United States, the trade or business is treated as conducted by a domestic

[79]For authorities sustaining taxpayer positions taken in the absence of guidance, see *Gottesman & Co. Inc. v. Commissioner*, 77 T.C. 1149 (1981); *Corn Belt Hatcheries of Arkansas Inc. v. Commissioner*, 52 T.C. 636 (1969); and *Henry C. Beck Builders v. Commissioner*, 41 T.C. 616 (1964).

[80]Section 56A(c)(4) provides that in determining AFSI of a foreign corporation, "the principles of section 882 shall apply." One principle of section 882 may be the so-called death penalty rule in section 882(c)(2), which states that "deductions and credits are allowed to" a foreign taxpayer "in this subtitle only by filing" a true and accurate return. Thus, clearly the IRA BMT will motivate a foreign corporation, including the foreign parent of a foreign-owned multinational group, to file a timely tax return on Form 1120F for each tax year, including tax years taken into account under the three-year average annual AFSI test under section 59(k)(1), to take advantage of all allowable regular tax deductions and book income charges in determining whether the foreign corporation is an applicable corporation and, if so, the extent to which the foreign corporation's ECI is subject to the IRA BMT.

[81]As a commentator notes: "The potential exception for change of ownership implies that applicable corporation status is a taint that depends on a continuing relationship and doesn't adhere to the corporation as such. It suggests that a change of ownership should cause a change in status when the change moves the corporation out of the group that was aggregated to establish its applicable corporation status." Cummings, *supra* note 14, at 2015. There is, however, no statutory definition of change in ownership or legislative history providing guidance on when a change in ownership of a corporation occurs. Thus, the definition is left to the discretion of the IRS by section 59(k)(3) ("The Secretary shall provide regulations or other guidance for the purposes of carrying out this subsection, including regulations or other guidance . . . addressing the application of this subsection to a corporation that experiences a change in ownership.").

[82]Section 59(k)(1)(C)(i)(I) and (ii). There is, unfortunately, no legislative history indicating the factors to be considered in Treasury's determination that continued treatment of a corporation as an applicable corporation is not appropriate under section 59(k)(1)(C)(ii), which is a requirement that must be satisfied for either exception to apply for a tax year. Section 59(k)(3) is a broad grant of authority to issue regulations carrying out the purposes of section 59(k), including the establishment of safe harbors for purposes of each of the two exceptions in section 59(k)(1)(C), the procedure for satisfying section 59(k)(1)(C)(ii) if a safe harbor doesn't apply (*e.g.*, whether a private letter ruling must be obtained, as, for example, is required by reg. section 1.1502-13(c)(6)(ii)(D) in redetermining an item of income attributable to an intercompany transaction to be excluded from income), and the general factors relevant to the determination of whether the requirement of section 59(k)(1)(C)(ii) is satisfied.

[83]Section 59(k)(1)(C)(i)(II) and (C)(ii).

[84]*Id.*

[85]AFS is defined in sections 56A(b) and 451(b)(3), discussed in Section III.B.2.a.i, *infra*.

[86]Section 59(k)(2)(B) and (D). There is no guidance on when a foreign corporation should be deemed to be the common parent of a multinational group. Thus, this is another rule taxpayers cannot apply until the IRS issues regulations under the grant of authority in section 59(k)(3).

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Table 3. AFS Items for Example 4

	Foreign-Source	Foreign-Source	Effectively Connected	
Tax Year	Book Income of FC1	Book Income of FC2	Book Income of FC1	Total Book Income
2020	$800 million	$400 million	($100 million)	$1,100 million
2021	$650 million	$150 million	$120 million	$920 million
2022	$500 million	$310 million	$180 million	$990 million
Totals	$1,950 million	$860 million	$200 million[a]	$3,010 million

[a]For purposes of section 59(k)(1)(B)(ii)(II), which prevents the $100 million 2020 effectively connected AFS loss from carrying forward under section 56A(d), the total is $300 million.

corporation wholly owned by the foreign corporation.[87] Suppose the foreign common parent of a multinational group is not publicly traded, does not borrow money, and, hence maintains no consolidated or separate financial statements. How do the members of the group determine the extent to which they are applicable corporations absent AFSs covering all members for the three-year period? This is another mystery that presumably will be solved by guidance under section 59(k)(3).

For a foreign or domestic corporation that is a member of a foreign-parented multinational group to be treated as an applicable corporation, the following two requirements must be satisfied:

- treating the AFSI of the corporation as including the AFSI of all members of the group (determined (1) without applying the principles of section 882 to exclude book income that is not ECI and (2) by eliminating adjustments for controlled foreign corporations, partnerships, and defined benefit pension plans) for each year in the three-year period, the average annual AFSI of the corporation exceeds $1 billion;[88] and
- taking into account only the AFSI of the corporation (determined without regard to financial loss carryforwards under section 56A(d) or the provisions of section 59(k)(2)), the average annual AFSI of that corporation for the three-year period is $100 million or more.[89]

These rules are illustrated by Example 4.

Example 4: *Treatment of foreign corporation with effectively connected book income (ECBI) as an applicable corporation.* FC1 is a calendar-year foreign corporation, all the stock of which is widely held and publicly traded on an established securities market. FC1 actively conducts business through PEs located in the United States and other countries. FC1 owns all the stock of FC2, a calendar-year foreign corporation generating only foreign-source income attributable to business conducted outside the United States. For each of the following tax years, (1) a single consolidated AFS is prepared for FC1 and FC2 using IFRS, (2) the only adjustment applicable to

[87]Section 59(k)(2)(C). This treatment of effectively connected book income (ECBI) of a foreign corporation as earned by a domestic corporation wholly owned by the foreign corporation should apply solely for purposes of section 59(k)(2). If the treatment applied for all IRA BMT purposes, two major problems would exist. First, section 56A(c)(4) (applying the principles of section 882 to AFSI of a foreign corporation) would adjust the foreign corporation's net book income to zero because the corporation's ECBI would be treated by section 59(k)(2)(C) as book income of a domestic corporation. Second, if the treatment of ECBI of a foreign corporation as earned by a domestic corporation wholly owned by the foreign corporation also applied for all purposes of section 59(k)(1), the foreign corporation could not be an applicable corporation under section 59(k)(1)(B)(ii)(II).

[88]Section 59(k)(1)(B)(ii)(I) and (k)(2)(A). Section 59(k)(2)(A) provides that if a corporation is a member of a foreign-parented multinational group for any tax year, then, solely in determining whether that corporation meets the average annual AFSI test under section 59(1)(B)(ii)(I) for that tax year, the AFSI of the corporation for that tax year will include the AFSI of all members of that group. Solely for purposes of section 59(k)(2)(A), AFSI is to be determined without regard to section 56A(c)(2)(D)(i) (adjustment to take into account only the partner's distributive share of partnership AFSI), section 56A(c)(3) (adjustment for CFC AFSI), section 56A(c)(4) (applying the principles of section 882 — the rules applicable in determining ECI — to a foreign corporation's AFSI), and section 56A(c)(11) (adjustments for defined benefit pension plans).

[89]Section 59(k)(1)(B)(ii)(II).

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the book income or loss shown in each AFS for determining AFSI is under section 56A(c)(4) (application of the principles of section 882), and (3) each AFS includes the items shown in Table 3.

Under these facts, FC1, but not FC2, is subject to the IRA BMT for its tax year beginning January 1, 2023, for the following reasons:

- Under section 59(k)(2)(C), the ECBI of FC1 is treated as earned by a domestic corporation wholly owned by FC1. Therefore, under section 59(k)(2)(B), FC1 is a member of a foreign-parented multinational group consisting of FC1 as the common parent, FC2, and the hypothetical domestic corporation.[90]
- Each of FC1 and FC2 satisfies the requirement of section 59(k)(1)(B)(ii)(I), as enhanced by section 59(k)(2)(A), because the total average annual AFSI of the multinational group, determined without regard to the ECI adjustment of section 56A(c)(4), is $1.0033 billion ($3.01 billion divided by 3).
- Because FC2 has no ECBI, it cannot satisfy the second and final requirement for applicable corporation treatment found in section 59(k)(1)(B)(ii)(II) (to the effect that the foreign corporation's average annual AFSI, for the three-year period, applying all the adjustments of section 56A(c), must equal or exceed $100 million). In other words, because section 56A(c)(4) adjusts FC2's annual book income for the three-year period to zero, FC2 cannot satisfy section 59(k)(1)(B)(ii)(II).
- On the other hand, FC1's average annual AFSI over the three-year period, as adjusted by section 56A(c)(4) and without allowing the ($100 million) effectively connected AFS loss for 2020 to carry forward to 2021 under section 56A(d),[91] is exactly $100 million ($300 million [$120 million for 2021 plus $180 million for 2022] divided by 3). Accordingly, FC1 satisfies the requirement of section 59(k)(1)(B)(ii)(II) as well as the requirement of section 59(k)(1)(B)(ii)(I) and hence is an applicable corporation for its tax year beginning January 1, 2023.

Example 4 indicates why section 59(k)(2)(C) was enacted. If FC1's ECBI is not treated as earned by a wholly owned domestic subsidiary, neither FC1 nor FC2 would be treated as a member of a foreign-parented multinational group because the group would not include at least one domestic corporation. Consequently, neither would be an applicable corporation for 2023 because, under the general rule of section 59(k)(1)(B)(i), neither foreign corporation's average annual AFSI over the three-year period would exceed $1 billion — FC1's average annual AFSI over the three-year period would be only $100 million after the adjustment required by section 56A(c)(4), and FC2's average annual AFSI over the three-year period would be zero after the adjustment required by section 56A(c)(4). What is not clear, however, is why the definition of foreign-parented multinational group has to include a domestic corporation as a member when one or more foreign corporations have ECI.

Several operating rules apply in determining whether a corporation satisfies the requirements for treatment as an applicable corporation:

1. The aggregate AFSI (subject to some adjustments) of a group of persons treated as a single employer with the corporation under section 52(a)[92] or section 52(b)[93] is

[90] As required by section 59(k)(2)(B), (1) the group includes at least one foreign corporation (FC1 and FC2) and one domestic corporation (the hypothetical domestic subsidiary of FC1); (2) all the entities are included in a single AFS; and (3) the group has a foreign common parent, FC1.

[91] Section 59(k)(1)(B)(ii)(II) states: "the average annual adjusted financial statement income of such corporation (determined without regard to the application of paragraph (2) and *without regard to section 56A(d)*) for the 3-taxable-year-period ending with such taxable year is $100,000,000 or more" (emphasis added). Thus, while the carryforward rule of section 56A(d) is not required to allow the $100 million 2020 effectively connected AFS loss to be netted against the $1.2 billion of foreign-source book income for 2020, section 56A(d) is required to allow the loss to reduce the effectively connected AFSI for 2021 and 2022, and this is prohibited by section 59(k)(1)(B)(ii)(II).

[92] Section 52(a) provides that members of a controlled group within the meaning of section 1563(a) (substituting "more than 50 percent" for "at least 80 percent" and with other adjustments) are treated as a single employer.

[93] Section 52(b) treats trades or businesses, incorporated or not, under common control, as determined under the principles of section 52(a), as a single employer.

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treated as AFSI of each corporation belonging to the group.[94] Because all the AFSI of a controlled partnership is treated as AFSI of each corporation that is part of the same single-employer group as the controlled partnership under sections 52(b) and 59(k)(1)(D), somehow an AFS for the controlled partnership must be located, which may be difficult if the partnership does not borrow money and is not part of a qualifying consolidated AFS.

2. Reference to a corporation includes a reference to its predecessor.[95] Guidance is needed regarding the kinds of transactions in which a corporation is treated as a predecessor of another corporation (the successor) within the meaning of section 59(k)(1)(E)(iii). Presumably, the base case will be a transfer by one corporation of assets to another corporation described in section 381(a) (section 332 liquidations and acquisitive asset reorganizations), in each of which the predecessor's existence terminates. Other transactions that may or may not result in a successor include (1) section 351 exchanges in which the transferor corporation remains, or does not remain, in existence; (2) divisive section 368(a)(1)(D) reorganizations in which the transferor corporation remains in existence; (3) complete liquidations not qualifying under section 332; and (4) if a consolidated group is treated as a single corporation for IRA BMT purposes, an acquisition of the common parent of a consolidated group by another consolidated group through a transaction described above (with the predecessor being the terminated consolidated group, and the successor being the consolidated group that continues under reg. section 1.1502-75(d)).[96]
3. AFSI of a tax year shorter than 12 months is annualized by multiplying the AFSI by 12 and dividing it by the number of months in the short tax year.[97] Presumably, the annualization rule of section 59(k)(1)(E)(ii) is designed to prevent a corporation from avoiding "applicable corporation" status by engaging in a transaction that splits a 12-month tax year into two or more short tax years, thus creating short periods with lesser AFSI and potentially dropping from the three-year testing period an earlier tax year with significant AFSI.[98]
4. If a corporation (including its predecessor) exists for less than the full three-year period, the test is applied based on the period the corporation is in existence.[99]

2. Determining the amount of BMT owed by an applicable corporation.

If, on completion of the somewhat complicated process of applying section 59(k), the corporation determines that it is an applicable corporation for a tax year beginning after December 31, 2022, the complex calculation of whether BMT is owed for the tax year, and any amount owed, begins. The following is a summary of the first 11 steps (part 2 of this report picks up at step 12).

a. Calculation of AFSI.

Section 56A provides the rules for determining an applicable corporation's AFSI for a tax year. Section 56A(a) defines AFSI as the "net

[94] Section 59(k)(1)(D) (providing that all AFSI of persons treated as a single employer with the corporation under section 52(a) or (b) will be treated as AFSI of that corporation, and AFSI of that corporation will be determined without regard to section 56A(c)(2)(D)(i) (limiting AFSI attributable to a partnership) and section 56A(c)(11) (adjustments for defined benefit pension plans)).

[95] Section 59(k)(1)(E)(iii). The IRA BMT does not define predecessor, and there is no guidance in the form of legislative history.

[96] In the context of the base erosion and antiabuse tax, reg. section 1.59A-2(d)(6)(i) limits the definition of predecessor to "the distributor or transferor corporation in a transaction described in section 381(a) in which the taxpayer is the acquiring corporation." It is not apparent why the definition of predecessor in the context of section 59(k) should be broader than in the context of section 59A.

[97] Section 59(k)(1)(E)(ii).

[98] The IRS should therefore clarify that in determining the "applicable corporation" status of a corporation that is a member of a controlled group of entities, the annualization rule does not apply to AFSI of a joint venture entity (whether classified for tax purposes as a partnership or corporation) that is a component of the taxpayer's controlled group under section 52(a) or (b) and that has a short tax year falling within the three-year period.

[99] Section 59(k)(1)(E)(i).

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income or loss of the taxpayer set forth on the taxpayer's applicable financial statement for such taxable year, adjusted as provided in this section." Thus, the first step is ascertaining the AFS for the year, a step that is also required in determining whether the corporation is an applicable corporation.

i. Definition of AFS.

Section 56A(b) defines AFS by reference to section 451(b)(3), which defines AFS as a financial statement, certified as having been prepared in accordance with GAAP, that must be (1) an annual report on Form 10-K or other statement filed with the SEC reporting annual results to shareholders; (2) an audited[100] financial statement used for credit, reporting to equity owners, or for some other substantial nontax purpose; or (3) a financial statement filed with a federal agency other than the IRS.[101]

For registered corporations, the stock of which is traded on an established securities market, only the annual report on Form 10-K will suffice. For other applicable corporations with multiple financial statements of equal priority, ascertaining the AFS may be more difficult, and there likely will be a regulatory bias for using the financial statement resulting in the greatest amount of AFSI.[102] Finally, it would not be surprising to see an antiabuse rule similar to former reg. section 1.56-1T(c)(5)(i)(D) (for example, to the effect that if a taxpayer's corporate structure or financial reporting is modified for a principal purpose of reducing AFSI, the IRS may determine the taxpayer's AFS based on all the facts and circumstances).

In addition to the statutory AFS priority rules of section 451(b)(3), reg. section 1.451-3(a)(5)(iv) provides: "If a taxpayer restates AFS revenue for a taxable year *prior to the date that the taxpayer files its Federal income tax return for such taxable year*, the restated AFS must be used instead of the original AFS." (Emphasis added.) According to the financial reporting literature,[103] restatements of an AFS for a tax year made after the close of the year (prior-period adjustments) were a contentious area under the BURP adjustment required by the 1986 AMT, and one might expect the same to be the case for the IRA BMT. Under the BURP adjustment, prior-period adjustments, including error corrections, were intended to be reflected as a cumulative adjustment to retained earnings or some other equity account to determine the BURP adjustment for the year in which the prior-period adjustment is made known to the taxpayer, not to determine the BURP adjustment for the prior

[100] According to the preamble to T.D. 8138 (Apr. 28, 1987), former reg. section 1.56-1T(c)(1)(ii), in addressing the BURP adjustment under the 1986 AMT, provided that a financial statement will be a certified audited statement if it is certified by an independent CPA to be fairly presented. A statement subject to a qualified opinion was also considered a certified audited statement. However, a statement subject to an adverse opinion was considered certified only if the accountant disclosed the amount of the disagreement with the statement.

[101] Section 451(b)(3)(A). Absent a financial statement described in section 451(b)(3)(A), section 451(b)(3)(B) allows a financial statement that is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC and has reporting standards not less stringent than those of the SEC, "but only if there is no statement of the taxpayer described in subparagraph (A)." If there are no financial statements described in section 451(b)(3)(A) or (B), section 451(b)(3)(C) allows "a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary."

[102] Regarding a taxpayer with multiple financial statements, T.D. 8138 clarified:

> If a taxpayer has more than one statement and the statements are of equal priority, section 1.56-1T(c)(3)(iii)(A) provides that the applicable financial statement is the statement that results in the greatest amount of adjusted net book income. However, under section 1.56-1T(c)(3)(iii)(B)(1) if a taxpayer has more than one statement that is required to be filed with the [SEC], a statement that is a certified audited financial statement takes priority over a statement that is unaudited. In addition, under section 1.56-1T(c)(3)(iii)(B)(2) an unaudited statement that is accompanied by an accountant's review report has priority over other audited [sic] statements.

One might expect that similar rules will be adopted for IRA BMT purposes.

[103] *See, e.g.*, Richard M. Leder, "Giving Rise to BURPs (and Other Preferences) Under the New Corporate Minimum Tax: Selected Aspects," 40 *Tax Law.* 557, 585-586 (1987); Gerald Padwe, "Current Problems With the Corporate AMT," 38 *Tul. Tax Inst.* 1 (1988).

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year.[104] In other words, the timing of the prior-period adjustment was intended to be the tax year in which the adjustment was made, but the treatment of the adjustment (for example, as an increase or decrease in net book income versus an increase or decrease in the balance of a capital account) was based on the treatment that would have applied if the adjustment were taken into account in the tax year for which the adjustment was made.

By contrast, under reg. section 1.451-3(a)(5)(iv), a restated AFS covering a tax year that is received by the applicable corporation after the close of the tax year but before the original tax return for the year is filed, is given effect for the tax year for which the adjustment is made (that is, the timing of the adjustment is the prior period *for* which it is made, not the period *in* which it is made). If this rule is adopted for purposes of the IRA BMT, what happens if the restatement is received after the return is filed for the adjusted period?

If reg. section 1.451-3(a)(5)(iv) is interpreted as allowing a restated AFS to govern the determination of net AMT for the adjustment year only if the restated AFS is received before the date the return is filed for the tax year to which the restated AFS relates, there is no obligation to file an amended return to recompute AFSI for the adjustment year. Indeed, actually filing an amended return to recalculate the net AMT based on the restated AFS would not be given effect under this interpretation of reg. section 1.451-3(a)(5)(iv). Thus, taxpayers facing restatements would have an incentive to defer filing their federal income tax returns if the restatement is expected to be favorable, or to hurry up with filing their returns if the restatement is expected to be unfavorable.

On the other hand, if reg. section 1.451-3(a)(5)(iv) is viewed as merely a procedural directive about the preparation of the original return, this would suggest that the restated AFS, regardless of when received by the taxpayer, is the basis for determining the net AMT for the tax year to which the restated AFS relates.[105] While taxpayers are encouraged to file a corrective amended return if, after the original return is filed, an error in that return is discovered (for example, an overstatement or understatement of income or deductions) before the expiration of the statute of limitations on the assessment of tax for the year in question,[106] a restatement of an AFS can occur for reasons other than an erroneous inclusion or omission of an item of book income or deduction (for example, the accountants may determine, after the return is filed, that a valuation allowance for a DTA was too high or insufficient and require the AFS for the year to be restated to show a more appropriate valuation allowance). In any event, there is no obligation to file an amended return after an error in the original return is discovered.[107] Nonetheless, under this interpretation of reg. section 1.451-3(a)(5)(iv), disregarding the restated AFS if it is received after the original return is filed but before the expiration of the statute of limitations on assessment, risks the IRS's discovering the restated AFS on audit of the tax year to which the restatement relates and including one or more accuracy-related penalty assessments in its notice

[104] *See* S. Rep. No. 99-313, at 534 (Oct. 22, 1986), stating:

> For example, taxpayers may restate prior year financial statements rather than making adjustments to the financial statement for the current period (a prior period adjustment). To prevent the manipulation of book income for the purposes of this provision, it is intended that book income for the current year be adjusted by the cumulative effect of the prior period adjustment on retained earnings or other equity account.

The treatment of prior-period adjustments suggested by the committee report is similar to the relation-back analysis applied by the Supreme Court in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), in which the character, but not the timing, of a shareholder's settlement of a deductible contingent liability incurred by a corporation completely liquidated in a prior tax year was determined to be capital based on the fact that such would be the character of the settlement if it had occurred in the tax year of the corporation's complete liquidation.

[105] If a restated AFS received after the close of the tax year covered by that restated AFS does not supersede the replaced AFS in determining a corporation's AFSI for that year, the corporation would not be directed by reg. section 1.451-3(a)(5)(iv) to prepare its original return based on the restated AFS.

[106] *See* reg. sections 1.451-1(a) and 1.461-1(a)(3).

[107] *Badaracco v. Commissioner*, 464 U.S. 386, 393 (1984) (amended return "is a creature of administrative origin and grace").

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of deficiency for that tax year.[108] The safe approach, then, is to file an amended return based on the restated AFS if the restated AFS is received after the original return is filed. If an amended return is filed after the original return is filed but on or before the due date (with extensions) of the original return, the amended return generally supersedes the original return.[109] If filed after the due date (with extensions), the IRS usually will accept the amended return.[110]

Requiring a taxpayer to file an amended return to avoid an accuracy-related penalty as a result of a restatement of an AFS for an adjustment year for which the return has been filed imposes an unreasonable administrative burden on the taxpayer — especially large corporate taxpayers that file complex, voluminous tax returns — when the taxpayer is unaware of the adjustment before the return is filed. If reg. section 1.451-3(a)(5)(iv) is applied for purposes of the IRA BMT, it should be supplemented by a rule to the effect that if the taxpayer is not aware of an adjustment to the AFS for a prior period, and could not have known about it through the exercise of due diligence, until after the taxpayer has filed its return for the prior period, the treatment of the adjustment (for example, as an increase or decrease in net book income) is dictated by the restated AFS, but, as with the relation-back doctrine of *Arrowsmith*,[111] the timing of the adjustment is governed by the date it is made known to the taxpayer.

After the AFS for a tax year is identified, the next step is to calculate the positive and negative adjustments to the net income or net loss set forth in the AFS that are required in arriving at AFSI for the tax year. The following is a summary of the statutory adjustments, including a few problem areas.

ii. Clarifying adjustments.

Section 56A(c) contains five adjustments designed to clarify how items displayed on an AFS are taken into account in determining AFSI in some circumstances.

Consolidated AFS. If the taxpayer's results are reported on a consolidated AFS for a group of entities and those results are not also reported on a separate AFS having greater or equal priority, then (1) the taxpayer's AFS is the consolidated AFS, and (2) either (A) the taxpayer must include in net income or loss the items separately listed in the consolidated AFS, or (B) if items are not separately listed, presumably, the taxpayer must include in net income or loss the items shown in the source documents it provided for the generation of the consolidated AFS, including amounts eliminated in the consolidated AFS.[112]

Different financial accounting period. If the taxpayer's AFS is prepared on the basis of a financial accounting year that differs from its tax year, appropriate adjustments must be made.[113] Presumably, the taxpayer will be provided a menu of appropriate adjustments similar to those

[108] For purposes of section 6664, the underpayment on which an accuracy-related penalty is based is reduced by the amount shown as tax on a qualified amended return, the definition of which includes a return filed after the due date (including extensions) of the return for the tax year and before the earliest of the date the taxpayer is first contacted by the IRS concerning an examination of the return and certain other dates. Reg. section 1.6664-2(c)(3). Thus, if reg. section 1.451-3(a)(5)(iv) doesn't limit the effect of a restated AFS on AFSI for the tax year covered by the restatement to a restated AFS received before the original return for the tax year of restatement is filed, an underpayment for purposes of section 6664 can arise as a result of a restated AFS received after the original return is filed.

[109] *See Haggar Co. v. Helvering*, 308 U.S. 389 (1940) (a timely amended return is the "first return" under prior statutory provision); Rev. Rul. 56-67, 1956-1 C.B. 437 (a timely amended return is treated as a substitute for the original return); and T.D. 3215, declared obsolete by Rev. Rul. 67-406, 1967-2 C.B. 420 (a timely amended return is viewed as a supplement to the original return rather than as a substitute).

[110] *See Amling-De Vor Nurseries Inc. v. United States*, 139 F. Supp. 303 (N.D. Cal. 1956) (amended return was valid when the purpose was to write off production costs erroneously deferred on the original return). *Compare Evans Cooperage Co. v. United States*, 712 F.2d 199 (5th Cir. 1983) ("tax shown on return" within meaning of sections 6655(b)(1) and 6655(d)(1), concerning underpayment of estimated tax by corporations, means tax shown on the original return, not tax shown on an amended return filed after return due date); Rev. Rul. 86-58, 1986-1 C.B. 365 (same); Rev. Rul. 83-36, 1983-1 C.B. 358 ("tax shown on the return" for purposes of section 6654(b), concerning the penalty for underpayment of estimated tax, means tax shown on an amended return filed before due date for filing but tax shown on the original return if the amended return was filed after the due date).

[111] *Arrowsmith*, 344 U.S. 6.

[112] Sections 56A(c)(2)(A) and 451(b)(5). *See also* reg. section 1.451-3(h)(1)(i) (if the taxpayer's financial results are reported on both a separate AFS and a consolidated AFS, and the separate AFS is of equal or higher priority to the consolidated AFS . . ., then the taxpayer's AFS is the separate AFS); reg. section 1.451-3(h)(2) ("If a consolidated AFS is treated as the taxpayer's AFS, the taxpayer must include the amount of any items listed separately in the consolidated AFS, including any notes or other supplementary data that is considered part of the consolidated AFS."); and reg. section 1.451-3(h)(3) ("*If a consolidated AFS does not separately list items for the taxpayer, the portion of the AFS revenue allocable to the taxpayer is determined by relying on the taxpayer's separate source documents that were used to create the consolidated AFS and includes amounts subsequently eliminated in the consolidated AFS*.") (emphasis added).

[113] Section 56A(c)(1).

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allowed in reg. section 1.451-3(h)(4)(A) through (C).[114]

Members of a consolidated group.[115] The only consolidated return guidance under the IRA BMT is section 56A(c)(2)(B), which provides that the AFSI of a consolidated group "shall take into account items on the group's applicable financial statement which are properly allocable to members of such group."

Because pre-adjustment AMTI under the 1986 AMT was taxable income with adjustments, and because — to paraphrase a statement made by the Supreme Court in *United Dominion*[116] — there is only one definition of taxable income for a consolidated group and that is consolidated taxable income, it was reasonable for pre-adjustment AMTI under the 1986 AMT to be determined on a single-entity basis by applying the principles of reg. section 1.1502-11.[117]

In contrast, because taxable income is not the starting point for determining AFSI under the IRA BMT, applying the single-entity principles of reg. section 1.1502-11 is not required or implied by the statute. Thus, section 56A(c)(2)(B) could be read to mean net book income or loss is properly allocated to the members, after which the adjustments required by sections 56A and 59 are made as if the group were a single corporation for purposes of determining consolidated AFSI. On the other hand, it also could be read as requiring a separate-entity determination of the AFSI of each member of the consolidated group, with the adjustments required by sections 56A and 59 being applied on a separate-entity basis to each member having net book income or loss. The better approach, particularly when a single consolidated AFS covers all members of a consolidated group and does not separately state each member's items of net book income or loss, would seem to be to apply single-entity principles in determining the adjustments under section 56A(c) and (d) and section 59(g) to the net book income or loss of members of the group in computing its AFSI.[118] For further discussion, see Section III.C.10 of part 2 of this report.

Ownership of nonmember stock. If the taxpayer owns stock in a corporation (whether foreign or domestic) that is not a member of the same consolidated group as the taxpayer,[119] the taxpayer's AFSI includes only dividends received from the corporation (reduced to the extent provided in regulations or other guidance) and other amounts that are includable in gross income or deductible as a loss under regular tax principles, other than subpart F inclusions under section 951, tested income or loss under 951A, and "such other amounts as provided by the Secretary."[120]

One reduction that clearly should be allowed for dividends received from a foreign corporation is for a distribution of previously taxed earnings and profits of a CFC that is excluded from the distributee U.S. shareholder's income under section 959. As Treasury noted in regulations issued under the former 1986 AMT, a distribution of previously taxed E&P would be recorded as net

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[114] The generally permissible methods under reg. section 1.451-3(h)(4) are:

> (A) The taxpayer computes AFS revenue as if its financial reporting period is the same as its taxable year by conducting an interim closing of its books using the accounting principles it uses to prepare its AFS.
>
> (B) The taxpayer computes AFS revenue by including a pro rata portion of AFS revenue for each financial accounting year that includes any part of the taxpayer's taxable year.
>
> (C) If a taxpayer's financial accounting year ends five or more months after the end of its taxable year, the taxpayer computes AFS revenue for the taxable year based on the AFS revenue reported on the AFS prepared for the financial accounting year ending within the taxpayer's taxable year.

[115] The term "consolidated group" has the meaning given by reg. section 1.1502-1(h) (*i.e.*, an affiliated group, as defined in section 1504, filing or required to file a consolidated federal income tax return for the tax year under consideration).

[116] *United Dominion Industries Inc. v. Commissioner*, 532 U.S. 822, 835 (2001): "As United Dominion correctly points out, the Code and regulations governing affiliated groups of corporations filing consolidated returns provide only one definition of NOL: 'consolidated' NOL, *see* Treas. Reg. section 1.1502-21(f). There is no definition of separate NOL for a member of an affiliated group."

[117] *See* prop. reg. section 1.1502-55(b)(2). Each member determined its separate pre-adjustment AMTI under the principles of reg. section 1.1502-12, taking into account the preferences and other items listed in former sections 56 (other than the ACE adjustment), 57, and 58, after which consolidated pre-adjustment AMTI was determined under the principles of reg. section 1.1502-11 but without regard to the AMT NOL deduction.

[118] Recent examples of the application of single-entity principles in determining the impact of a corporate tax provision in the consolidated return context include determining a consolidated group's base erosion and antiabuse tax (see reg. section 1.1502-59A) and business interest expense limitation (see reg. sections 1.163(j)-4(d), -5(b)(3), -10(a)(4), and 1.1502-59A(c)).

[119] While this adjustment and the partnership adjustment are under section 56A(c)(2), which is titled "Special Rules for Related Entities," nothing in the text of either adjustment indicates that the corporation or partnership must be related to the taxpayer in any form or fashion.

[120] Section 56A(c)(2)(C).

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book income in the AFS covering the tax year of the distribution, unless the AFS is a consolidated statement that includes both the distributee U.S. shareholder and the distributing CFC.[121] Absent an adjustment under section 56A(c)(2)(C) that eliminates the amount of the distribution qualifying under section 959, the same income will be subject to the IRA BMT twice — once under section 56A(c)(3) and a second time under section 56A(c)(2)(C).

An example of a loss might be a taxpayer's sale of property at a book loss to a corporation, 51 percent in value or voting power of the stock of which is owned by the taxpayer. In a later tax year, the related corporation sells the asset to an unrelated buyer. Presumably, the book loss recognized by the taxpayer would be deferred under the principles of section 267(f) until the later tax year in which the asset is resold to the unrelated buyer, at which time the book loss is taken into account under that provision. Similarly, both book gains and losses on intercompany transactions between members of the same consolidated group should be subject to the timing and attribute redetermination rules of reg. section 1.1502-13 to the extent equivalent rules are not applicable under the relevant financial reporting standards.

Partnerships. Generally, if the taxpayer is a partner in a partnership, its AFSI for the partnership is adjusted to take into account only the taxpayer's distributive share of the AFSI of the partnership.[122] The AFSI of a partnership is the partnership's net income or loss set forth on the partnership's AFS (if, indeed, the partnership has an AFS), adjusted under section 56A.[123]

iii. Adjustments for a CFC's items of foreign income.

If an applicable corporation is a U.S. shareholder, as defined in section 951(b), of one or more CFCs, as defined in section 957, then:

- *General rule*. The taxpayer takes into account its pro rata share (determined under rules similar to those under section 951(a)(2)) of items taken into account in computing the net income or loss set forth on the AFS (as adjusted under rules similar to those that apply in determining AFSI) of each CFC for which that taxpayer is a U.S. shareholder, subject to a limitation on negative adjustments.[124]
- *Negative adjustment*. In any case in which the adjustment determined under the preceding rule would result in a negative adjustment for that tax year, (1) no adjustment is made for the tax year in which the negative adjustment is incurred, and (2) the amount of the adjustment for the next tax year (determined without regard to this limitation on negative adjustments) is reduced by an amount equal to the negative adjustment for that tax year.[125]

The better interpretation of the foregoing two rules is that the adjustment is computed by summing up the positive and negative amounts attributable to all interests in CFCs held by the applicable corporation (that is, allowing netting across all CFCs). The limitation in section 56A(c)(3)(B) on making any negative adjustments (and the indefinite carryforward of the negative adjustment) then applies to the aggregate net negative amount (not on a CFC-by-CFC basis). This scheme, which generally seems to be a reasonable approach similar to that applied by section 951A in the GILTI context, raises the question of what happens to a net negative

[121] Preamble to T.D. 8307.

[122] Section 56A(c)(2)(D)(i).

[123] Section 56A(c)(2)(D)(ii). For example, a joint venture among unrelated corporations may not maintain its own AFS, a gap that should be filled by IRS guidance.

[124] Section 56A(c)(3)(A). In the preamble to T.D. 8307, the IRS made the following observation regarding the net book income of a CFC in determining the BURP adjustment under the 1986 AMT:

> Section 1.56-1T(b)(2)(iv) of the proposed regulations includes the earnings of another corporation in the net book income of the taxpayer when (1) the two corporations are not members of a consolidated group, and (2) the taxpayer must include dividends or other amounts with respect to the earnings of the other corporation in its gross income. This rule applies to amounts included in gross income under section 951. . . . Absent an appropriate adjustment, the same income will be included twice in the adjusted net book income of the taxpayer: First, as subpart F income under section 1.56-1T(b)(2)(iv) of the proposed regulations; and again, as an actual dividend reported on the applicable financial statement. The final regulations provide an adjustment to prevent this duplication to the extent section 959 applies.

IRS guidance should similarly avoid the double taxation of a GILTI-like or subpart F-like inclusion under section 56A(c)(3)(A). *See also* Andrew Velarde, "Treasury Strongly Hints at Corporate AMT CFC Double-Counting Relief," *Tax Notes Federal*, Oct. 24, 2022, p. 591.

[125] Section 56A(c)(3)(B).

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adjustment if one or more of the CFCs responsible for the aggregate net book loss is sold before the negative adjustment is fully absorbed.

Example 5: *Departure of loss CFC after section 56A(c)(3)(A) is applied and results in an aggregate adjusted net book loss across all CFCs*. P, an applicable corporation, owns all the stock of FC1, FC2, and FC3, and is not a U.S. shareholder of any other CFC. For year 1, (1) FC1 has an adjusted (under the principles of section 56A(c)) net book loss of $1,000 as of the close of year 1 that reduces the FMV of the FC1 stock by $900 from $4,000 to $3,100; (2) FC2 has adjusted net book income of $500; and (3) FC3 has adjusted net book income of $200. Thus, absent the limitation in section 56A(c)(3)(B), there would be a negative adjustment to the AFSI of P under section 56A(c)(3)(A) of $300 (the $700 of net book income of FC2 and FC3 minus the $1,000 net book loss of FC1) for year 1. Instead, under section 56A(c)(3)(B), the $300 loss is suspended and applied in making the calculation required by section 56A(c)(3)(A) for year 2.

Shortly after the beginning of year 2, all the stock of FC1 is sold by P to an unrelated buyer, X, for $3,100. Does the elimination of P's ownership of all the FC1 stock for year 2 have any impact on P's use of the $300 net book loss carryforward from year 1 in completing the section 56A(c)(3)(A) calculation for year 2?

There appear to be several potential answers to this question, the first of which would seem to be the most appropriate:

- *Alternative 1*: The elimination of P's ownership of FC1 stock after the close of year 1 has no impact on the use of the full $300 aggregate adjusted net book loss from year 1 in making the calculation required by section 56A(c)(3)(A) for year 2. There is no language in section 56A(c)(3) requiring an adjustment to a loss carryover under section 56A(c)(3)(B) as a result of a disposition of loss CFC stock, nor is there any language in section 56A(c)(3)(B) requiring continued ownership of loss CFC stock for a tax year to which an aggregate adjusted net book loss of CFCs is carried. Also, it is P, not X, that suffered the economic loss — a $900 decline in the value of the FC1 stock caused by FC1's $1,000 adjusted net book loss. Thus, P should be allowed the full use of the $300 aggregate adjusted net book loss from year 1 in making the computation required in year 2 for FC2 and FC3 (as well as any other CFC for which P becomes a U.S. shareholder in year 2).
- *Alternative 2*: The elimination of P's ownership of FC1 stock after the close of year 1 requires the $300 aggregate adjusted net book loss to be reduced, but not below $0, by any adjusted net book loss originated by FC1 for year 1. This would eliminate the negative $300 carryforward by treating FC1 as if its adjusted net book loss for year 1 was only $700. The alternative raises the question whether FC1's stock should carry with it the $300 adjusted net book loss incurred by FC1 in year 1 that is not used by P, which would certainly seem fair under this approach. The alternative also raises the question whether the reduction in the carryover caused by the disposition of FC1 stock should be scaled back based on either or both the percentage of FC1 stock sold in year 2 and the period of time P owns FC1 stock during year 2. This alternative seems to involve more complexity than is required in view of the fact that P, not X (the buyer of the FC1 stock), suffers the economic impact of the FC1 loss.
- *Alternative 3*: The elimination of P's ownership of FC1 stock after the close of year 1 requires a redetermination of the year 1 calculation under section 56A(c)(3)(A) by disregarding the adjusted net book income or loss of FC1 for year 1. This results in a positive $700 of aggregate adjusted net book income that will be taken into account in the calculation required by section 56A(c)(3)(A) for year 2, not year 1, under the relation-back theory discussed in Section III.B.1. There is, however, no support for such a redetermination in the statute, for the reasons expressed in the discussion of Alternative 1. Also, P is the FC1 shareholder that bears the economic consequences of any adjusted net book income or loss generated by FC1 in year 1 in the form of an increase or decrease in the value of the FC1 stock.

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Thus, it would seem that Alternative 1 (no continuity of FC1 stock ownership is required for purposes of the loss carryforward rule of section 56A(c)(3)(B)) is the best approach.

iv. Adjustments for ECI.

For a foreign applicable corporation, only items of net income or loss effectively connected to the conduct of a trade or business within the United States, applying the principles of section 882, are taken into account in determining the taxpayer's AFSI.[126] Is one principle of section 882 the so-called death penalty rule in section 882(c)(2), which provides that deductions and credits are allowed to a foreign taxpayer "in this subtitle only by filing" a true and accurate return? Assuming the answer is yes, the IRA BMT will place more pressure on foreign-owned multinational groups and stand-alone foreign corporations to accurately and timely determine AFSI and regular taxable income.

v. Adjustments for income taxes.

Section 56A(c)(5)[127] provides the following deceptively simple rules regarding adjustments for federal and foreign income taxes:

- *General rule*. Adjustments must be made to disregard U.S. federal income tax and foreign income tax taken as a credit against federal income tax under section 901. The apparent reason for this rule is to avoid the unreasonable circularity that would result if AFSI were adjusted by an expense or benefit based on the amount of AFSI. No similar rule applies for state and local income tax purposes, presumably because those taxes are not allowed as credits against federal income tax.
- *Foreign income tax deducted*. If a creditable foreign income tax expense is deducted for regular tax purposes rather than taken as a credit under section 901, it is not disregarded in determining AFSI.
- *Deferred tax*. The last sentence of section 56A(c)(5) states that "the Secretary shall prescribe such regulations or other guidance as may be necessary and appropriate to provide for the proper treatment of current and deferred taxes for purposes of this paragraph, including the time at which such taxes are properly taken into account." Administrative headaches and footfalls likely will arise in providing guidance under this broad grant of regulatory power.

A simple example of how a similar BURP adjustment operated is found in Section III.C.5 of part 2 of this report. More complex applications of section 56A(c)(5) are unclear. For example, will AFSI be adjusted to account for balance sheet amounts determined under financial reporting standards (for example, FIN 48), including DTAs, DTLs, and valuation allowances against DTAs, and if so, how? These questions would seem to require a detailed inquiry into difficult issues, such as the extent, if any, to which a DTA (together with an appropriate valuation allowance) reflecting a future reduction in IRA BMT liabilities incurred by an applicable corporation should or should not be reflected as an item of net book income in determining the applicable corporation's AFSI for the tax year in which the DTA (and any valuation allowance to the DTA) is taken into account under applicable financial reporting standards such as FIN 48.

It would seem that a DTA reflecting a future IRA BMT benefit (for example, an AFS NOL carryforward of T allowed under section 56A(d) to which P succeeds as a result of a merger of T into P under section 368(a)(1)(A)) should not be taken into account in determining AFSI for the tax year in which it arises or is acquired because doing so has the circular effect of reducing the value of the DTA by 15 percent. If a valuation

[126] Section 56A(c)(4). Section 882(a)(1) was amended by the IRA to include section 55 as one of the tax imposition provisions covered by section 882.

As discussed in Section III.B.1, *supra*, addressing the scope of the new corporate AMT, if a foreign corporation has ECBI, that book income is treated as income of a wholly owned domestic subsidiary of the foreign corporation under section 59(k)(2)(C) in determining whether a foreign corporation is a member of a foreign-owned multinational group. That treatment should not apply for purposes other than section 59(k)(2)(C) since doing so would mean a foreign corporation with ECI is not subject to BMT.

[127] Further, section 56A(c)(9) provides that AFSI "shall be appropriately adjusted" to disregard any amount treated as a payment against the tax imposed by subtitle A under a section 48D(d) election (election to receive direct payment of the 25 percent investment tax credit for investment in a semiconductor manufacturing facility) or section 6417 (direct payment of specified green tax credits), to the extent that amount was not otherwise taken into account under section 56A(c)(5). Thus, if a cash refund of the semiconductor credit is received under section 48D(d) and treated as income for financial reporting purposes, the refund is deducted under section 56A(c)(5) in determining AFSI. For additional discussion, see sections III.A.2 and III.A.3, *supra*, and Section III.C.5 of part 2 of this report.

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allowance reduces the DTA by 15 percent, that does not fully solve the problem because the net DTA is further reduced by 15 percent of the reduced DTA (12.75 percent [15 percent * 85 percent] of the gross DTA), etc.

Thus, the IRS should anticipate that FASB will be prompted to make changes to the DTA and/or valuation allowance rules to reflect the impact of DTAs on IRA BMT liabilities, at least to the extent DTAs for deductions don't morph into usable AMT credits. This in turn could result in further changes to the IRA BMT rules, etc. Accordingly, to avoid such circularity and potential conflicts with the FASB, if a net DTA is required under applicable financial reporting standards to be included in an applicable corporation's net book income for a post-2022 tax year, that income item should be subtracted (that is, disregarded) under the authority of section 56A(c)(5) in determining the taxpayer's AFSI.

On the other hand, arguably similar "disregard" treatment should not be provided for a DTL booked as a valuation adjustment associated with an asset acquisition and taken into account as book income if, when, and to the extent that the DTL is eliminated by depreciation, amortization, or asset dispositions. Unlike a DTA reflecting a future BMT benefit that is included in book income on acquisition of the attribute generating the DTA, allowing the accrual into book income of a reduction in a DTL caused by a valuation adjustment to increase ASFI should not have a circular effect on the amount of future federal income tax liability for which the DTL is created. This is because the DTL is based on the regular tax rate applicable to corporations under section 11 and hence is unaffected by any increase in the corporation's net BMT liability.

vi. Adjustments for depreciation of property to which section 168 applies.

Under section 56A(c)(13), for property to which section 168 applies, any depreciation applied in the AFS in determining net income or loss is disregarded by adding back the depreciation. In lieu of the book depreciation, the depreciation allowed under section 167 for that property is then deducted in determining AFSI. This provision will be helpful to many large corporations after they have logged a few years of IRA BMT experience. Many manufacturers will have taken advantage of the expensing and accelerated depreciation provisions emanating from the TCJA for tax years beginning before January 1, 2023, leaving a much smaller depreciable basis once they become subject to the IRA BMT and resulting in larger amounts of book income until the assets are replaced. For some, TCJA expensing and accelerated depreciation may postpone their becoming applicable corporations under section 59(k), but for those not small enough to escape early application of the BMT, this may be more harmful in the short run.

Further, as illustrated by Example 2 in Section III.A.2, *supra*, replacing book depreciation with regular tax depreciation may result in a significant increase in AFSI for cases in which book depreciation of a target corporation is based on the price paid for stock of the target and that price reflects a significant premium over the inside basis of the target's depreciable assets for regular tax purposes. In that case, the adjustment required by section 56A(c)(13) will produce a net increase in AFSI equal to the excess book over regular tax depreciation. On the other hand, if the regular tax basis of the target's depreciable assets exceeds the book value of those assets based on the purchase price of the target's stock, the adjustment required by section 56A(c)(13) normally will result in a net decrease in AFSI equal to the excess regular tax over book depreciation.

vii. Adjustments allowing section 197 amortization for qualified wireless spectrum.

Regarding the qualified wireless spectrum, defined as a wireless spectrum that (1) is used in the trade or business of a wireless telecommunications carrier and (2) was acquired by the taxpayer after December 31, 2007,[128] and before August 16, 2022 (the enactment date for the IRA BMT):

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[128]See section 56A(c)(14)(B) for the definition of qualified wireless spectrum. Presumably, the adjustment required by section 56A(c)(14) was inserted into the IRA BMT in light of the telecommunications companies acquiring rights from the FCC to operate spectrum in the 700 MHz radio frequency band in the United States under the so-called Auction 73. Bidding for the rights commenced January 28, 2008, and when completed some 38 days later, had raised around $19.6 billion. *See* FCC, "Auction 73:700 MHz Band" (Oct. 7, 2016); and *RCR Wireless News*, "700 MHz Auction Ends: Wireless Heavyweights Biggest Players, Others Surprise," Mar. 21, 2008.

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- *Allowed amortization*. AFSI is reduced by the amortization deduction allowed for the tax year for the qualified wireless spectrum under section 197 in determining the taxpayer's regular tax.[129]
- *Disregard of book charge*. AFSI is "appropriately adjusted" (1) to disregard any amount of amortization expense that is taken into account on the taxpayer's AFS for that qualified wireless spectrum, and (2) to take into account any other item specified by Treasury to provide that the qualified wireless spectrum is accounted for the same way it is accounted for in determining the taxpayer's regular tax liability.[130]

viii. Adjustments for disregarded entities.

AFSI is adjusted to take into account any AFSI of a disregarded entity owned by the taxpayer.[131]

ix. Adjustments for defined benefit pension plans.

For any defined benefit plan establishing an employees' trust under section 401(a) that is exempt from tax under section 501(a) (other than a multiemployer plan described in section 414(f)), a qualified foreign plan described in section 404A(e), or another defined benefit plan providing post-employment benefits other than pension benefits (each a covered benefit plan),[132] the following adjustments are required:

- *Disregard of AFS items*. AFSI is adjusted to disregard any amount of income, cost, or expense that would otherwise be included on the AFS in connection with any covered benefit plan.[133]
- *Regular tax deductions and inclusions*. AFSI is increased by any amount of income in connection with any such covered benefit plan that is included in the corporation's gross income for regular tax purposes, and reduced by deductions allowed for regular tax purposes for any such covered benefit plan.[134]

x. Miscellaneous adjustments.

Additional adjustments to AFSI are required for (1) tax-exempt entities to take into account only items of book income or loss that are (A) attributable to an unrelated trade or business within the meaning of section 513, or (B) derived from debt-financed property, as defined in section 514, to the extent income from the property is treated as unrelated trade or business income;[135] (2) cooperatives, as defined in section 1381, to reduce the cooperative's AFSI for a tax year by amounts described in section 1382(b) (patronage dividends and per-unit "retain" allocations) paid during the tax year, to the extent those payments are not otherwise taken into account in determining AFSI;[136] (3) Alaska Native corporations to allow reductions for specified cost recovery and other deductions required or permitted under the Alaska Native Claims Settlement Act (43 U.S.C. sections 1606(i), 1606(j), and 1620(c));[137] and (4) consistent treatment of mortgage servicing income to (A) prevent AFSI from reflecting that income in a tax year preceding the tax year in which its regular tax counterpart is taken into account for regular tax purposes,[138] and (B) "prevent the avoidance of taxes imposed by this chapter with respect to amounts not representing reasonable

[129] Section 56A(c)(14)(A)(i).

[130] Section 56A(c)(14)(A)(ii).

[131] Section 56A(c)(6).

[132] Section 56A(c)(11)(B) (defining covered benefit plan).

[133] Section 56A(c)(11)(A)(i).

[134] Section 56A(c)(11)(A)(ii) and (iii).

[135] Section 56A(c)(12). It would be interesting to know how many tax-exempt organizations are large enough to generate average, annual, unrelated business AFSI exceeding $1 billion over three consecutive tax years. Likely only a handful of entities will be subject to the IRA BMT. For example, the IRS indicates that of the 63,171 UBTI returns filed for 2015, only 347 showed UBTI of $1 million or more, and those returns reported an aggregate of only $2.96 billion of gross UBTI (an average of $8.53 million of gross UBTI per return). IRS Statistics of Income Division, "SOI Tax Stats — Exempt Organizations' Unrelated Business Income (UBI) Tax Statistics" (Apr. 28, 2022).

[136] Section 56A(c)(7).

[137] Section 56A(c)(8).

[138] Section 56A(c)(10)(A). The tax policy underlying this special timing rule for mortgage servicing income is not readily apparent. What is it about mortgage servicing book income that requires its being matched with its counterpart item of regular taxable income that other items of book income lack?

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compensation (as determined by the Secretary) with respect to a mortgage servicing contract."[139]

xi. Regulatory authority for additional adjustments.

Section 56A(c)(15) authorizes regulations or other guidance creating additional adjustments to AFSI "as the Secretary determines necessary to carry out the purposes of this section, including adjustments — (A) to prevent the omission or duplication of any item,[140] and (B) to carry out the principles of part II of subchapter C of this chapter (relating to corporate liquidations), part III of subchapter C of this chapter (relating to corporate organizations and reorganizations), and part II of subchapter K of this chapter (relating to partnership contributions and distributions)."[141]

Preview of Part 2

The second and final installment of this report completes the summary of adjustments to net book income or loss in determining AFSI:

- Section III.B.2.a.xii discusses section 56A(d) (AFS NOL carryforwards), including transferability under section 381, potential limitations under sections 382 and 384, and consolidated return separate limitation year rules.
- Section III.B.2.a.xiii discusses section 59(g) (adjustments when no regular tax benefit is derived from different treatment).

Part 2 then addresses the following topics:

- Sections III.B.2.b.i and ii discuss the determination of TMT and net AMT.
- Sections III.B.3.a, b, and c discuss the minimum tax credit allowed by section 53, its transferability under section 381, and existing and potential limitations under sections 53(c) and 382 and the separate return limitation year rules.
- Section III.C focuses on a panoply of difficult issues, including (1) well-founded concerns regarding the harmful impact of book-tax conformity on securities disclosure policies; (2) fashioning of workable antiavoidance rules; (3) distortions and unfairness caused by timing differences, such as when the book version of an item of loss is taken into account in a tax year to which the IRA BMT does not apply or when the discretion allowed in booking deductible items, such as charges for doubtful accounts and reserves for contingent liabilities, favors one group of taxpayers over another; (4) effective tax rate concerns in the context of permanent differences; (5) the treatment of goodwill, including the effects of DTAs, in acquisitive transactions; (6) adjustments of book income when its regular tax counterpart is subject to a nonrecognition rule; (7) potential distortions caused by differences in the amount, not merely the timing, of stock-based compensation for regular tax and IRA BMT purposes; (8) the IRA BMT treatment of section 481 adjustments; (9) issues in applying sections 382, 383, and 384 to AFS NOL carryforwards and minimum tax credits; and (10) the approach to be taken in writing consolidated return rules implementing the IRA BMT.
- Finally, Section IV summarizes the significant problems raised by the IRA BMT, such as whether it constitutes an unreasonable delegation of the power to promulgate tax rules to a nongovernmental entity, and the steps potential applicable corporations should take before the effective date of the IRA BMT. ■

[139] Section 56A(c)(10)(B). Is the sole purpose of this provision to prevent the special timing rule of section 56A(c)(10)(A) from applying to amounts received under a mortgage servicing contract in excess of reasonable compensation for the services rendered under the contract, or does the provision have a broader scope?

[140] The grant of authority in section 56A(c)(15)(A) to issue guidance adjusting AFSI to prevent the omission or duplication of any item is virtually identical to the language used in former section 56(f)(2)(I) (requiring Treasury to adjust book income "to prevent the omission or duplication of any item"). As discussed in Section II.B, *supra*, former reg. section 1.56-1(d) prohibited adjustments to book income based on timing differences (*i.e.*, book items taken into account in different tax years from the years in which the related regular tax items are taken into account) and was held valid by the Fourth Circuit in *CSX*, 124 F.3d 643. It is likely that this interpretation will be applied to section 56A(c)(15)(A) — AFSI will be adjusted only if an item of book income or loss is erroneously included in the determination of AFSI more than once, or is erroneously omitted from the determination of AFSI.

[141] As discussed in Section III.C.6 of part 2 of the report, the grant of authority in section 56A(c)(15)(B) is of critical importance, should be exercised expeditiously, and should expand the adjustment to include non-enumerated nonrecognition provisions serving a similar legislative purpose as those enumerated.

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