GIBSON DUNN

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# IRS AND TREASURY ISSUE INTERIM GUIDANCE ADDRESSING THE CORPORATE ALTERNATIVE MINIMUM TAX

To Our Clients and Friends:

On December 27, 2022, the Internal Revenue Service (the "IRS") and the Department of the Treasury ("Treasury") issued Notice 2023-7 (the "Notice") to provide important interim guidance on the new corporate alternative minimum tax (the "CAMT") enacted under the Inflation Reduction Act of 2022.[1] The Notice describes forthcoming regulations that are expected to be consistent with the interim guidance provided in the Notice and retroactive to January 1, 2023 (the date that the CAMT became effective). Taxpayers may rely on the interim guidance until the proposed regulations are issued. Accordingly, we expect this guidance to inform Q1 2023 estimated tax payments and financial reporting for affected taxpayers.

The Notice provides necessary and welcome guidance in many respects, but there remain significant open issues.

**The Statute**

For taxable years beginning after December 31, 2022, the CAMT requires certain corporations (each, an "Applicable Corporation") to pay U.S. federal income tax on their adjusted financial statement income ("AFSI") at a rate of at least 15 percent.[2] A corporation is an Applicable Corporation if it — together with the other members of its controlled group — averages more than $1 billion of AFSI over a three-year testing period. For a U.S. subsidiary of a foreign-parented multinational group to be an Applicable Corporation, the subsidiary also must have AFSI of $100 million or more over the same three-year testing period (taking into account the AFSI only of the domestic members of the group and the "effectively connected" AFSI of each foreign member), with certain adjustments.[3]

**Key Provisions of the Notice**

The Notice provides a safe harbor for determining whether a corporation will constitute an Applicable Corporation for the corporation's first taxable year beginning after December 31, 2022. In addition, the Notice includes interim guidance regarding (i) a safe harbor for determining Applicable Corporation status and certain rules relating to controlled groups, (ii) how certain acquisitive and divisive transactions are taken into account, (iii) the calculation of AFSI for certain distressed corporations, and (iv) the treatment of depreciable property and certain tax credits for purposes of calculating AFSI. Below is a high-level summary of the key provisions of the Notice.

1. Applicable Corporation Determination – Safe Harbor and Certain Group Rule

*a. Safe Harbor*

For purposes of calculating AFSI to determine Applicable Corporation status, the statute requires a number of complex adjustments to the income or loss reported on a corporation's financial statements. To simplify this determination, the Notice includes a safe harbor that allows a corporation, for its first taxable year beginning after December 31, 2022, to disregard the numerous adjustments required by the statute. Under the safe harbor, the corporation can simply use the income or loss reported on the corporation's consolidated financial statements, with limited adjustments, but must apply a reduced AFSI threshold of $500 million (or $50 million in the case of a U.S. corporate subsidiary of a foreign-parented multinational group).

For corporations that are under the $500 million AFSI threshold of the safe harbor, the safe harbor simplifies what otherwise could be a burdensome (and time-sensitive, given upcoming estimated tax payments) determination. Note that if a corporation does not satisfy the safe harbor, it can still avoid being an Applicable Corporation under the statutory computational and threshold rules.

*b. Consolidated Groups, Corporate Partners, and Foreign-Parented Multinational Groups*

The application of the CAMT to consolidated groups, partnerships, and multinational corporations is of critical importance. The Notice clarifies some aspects of these rules but leaves open several questions.

- *Single-entity treatment for consolidated groups*. The Notice provides that a consolidated group is treated as a single entity for purposes of computing AFSI—both for determining Applicable Corporation status as well as for calculating CAMT liability.[4]

- *Corporate partners – manner of taking into account partnership AFSI to determine Applicable Corporation status*. Section 56(c)(2)(D)(i) contains a "distributive share" rule that provides that, for purposes of calculating AFSI to determine an Applicable Corporation's CAMT liability, an Applicable Corporation that is a partner in a partnership takes into account only its distributive share of the partnership's AFSI.[5] The Notice clarifies that the distributive share rule is disregarded for purposes of determining whether a corporation is an Applicable Corporation regardless of whether the partnership is part of the corporate partner's controlled group.[6] The Notice does not provide any guidance regarding how a taxpayer should determine its distributive share. The IRS and Treasury have requested comments on the application of this distributive share rule.

- *Foreign-parented multinational groups*. The Notice addresses how the safe harbor applies to entities in a foreign-parented multinational group and also seeks comments in this area.

Although the determination of Applicable Corporation status in the context of investment fund structures involving partnerships and portfolio companies similarly raises significant issues, the Notice does not address any of these issues.[7]

2. <u>Certain M&A and Restructuring Transactions – Combinations and Divisions</u>

The Notice addresses how M&A and restructuring transactions affect the determination of Applicable Corporation status and the computation of CAMT liability.

*a. Entirely Tax-free transactions disregarded*

The Notice provides that any financial accounting gain or loss resulting from specified tax-free transactions is disregarded for purposes of calculating AFSI — both to determine Applicable Corporation Status and to calculate CAMT liability for the taxable years in which the applicable financial statements take into account the relevant nonrecognition transaction.[8] This guidance is particularly welcome in clarifying that *both* spin-offs and split-offs do not affect AFSI if they are otherwise tax-free even though split-offs can result in financial statement gain or loss. It is important to note that this rule applies *only* to transactions that are wholly tax-free (*i.e.*, that do not have any "boot").[9] The IRS and Treasury have requested comments regarding how to treat transactions that are partially taxable.

In addition, the Notice requires that each component transaction of a larger transaction be examined separately for qualification as a tax-free transaction that is covered by the Notice. The Notice nonetheless also provides that general step transaction doctrine principles apply.

Taxpayers will need to consider these rules when structuring acquisitions and divestitures.

*b. Impact on Applicable Corporation Determination*

The Notice provides three sets of rules regarding the determination of AFSI for a party to an applicable M&A transaction for purposes of determining Applicable Corporation status.

- *Acquisition of Standalone Target or Entire Target Group*. If a corporation acquires a standalone target or entire target group to form a new group, the acquirer group takes into account the AFSI of the acquired target (or target group) for the three-year taxable period ending with the taxable year in which the acquisition takes place (the "Three-Year Period"). The Applicable Corporation status (if it existed immediately prior to the transaction) of the target or target group terminates.

- *Carve-Out*. If a corporation acquires only a portion of a target group, the acquiring corporation takes into account only the portion of the AFSI of the target group allocated to the target (based on any reasonable method until proposed regulations are issued that specify a required allocation method) for the Three-Year Period, and the AFSI of the remaining target group is not adjusted. In other words, the AFSI allocated to the target is included in the AFSI for both the target's group and the acquiror's group for the Three-Year Period. If Applicable Corporation status existed for the target immediately prior to the transaction, it terminates.

- *Spin-off or Split-off*. If a corporation distributes a controlled corporation to its shareholders, the controlled corporation is allocated a portion of the AFSI of the distributing corporation (or the applicable group of which the distributing corporation is the parent) for the Three-Year Period (based on any reasonable allocation method until proposed regulations are issued that specify a required allocation method).[10] The AFSI of the distributing corporation (or the applicable group of which the distributing corporation is the parent) is not adjusted. Rather, as in the carve-out situation, the AFSI allocated to the controlled corporation is included in the AFSI for both the distributing and the controlled groups. If Applicable Corporation status existed for the controlled entity immediately prior to the transaction, it terminates.

Although the application of the CAMT rules to M&A and restructuring transactions is rife with complexity and ambiguity, the interim guidance provides taxpayers with much needed clarity regarding the application of the CAMT to these transactions and is a very helpful starting point for future regulations. It is not surprising that this is a key area in which the IRS and Treasury have requested comments.

3. <u>Distressed Situations</u>

The Notice provides relief for certain distressed corporations. Specifically, the Notice excludes from the calculation of AFSI—for purposes of both determining Applicable Corporation status and calculating CAMT liability—financial accounting gain that is excluded from income for U.S. federal income tax purposes under section 108(a)(1). The Notice also requires a reduction to the taxpayer's CAMT tax attributes to the extent of the amount of the excluded cancellation of indebtedness income that results in a reduction of tax attributes under section 108(b) or Treas. Reg. § 1.1508-28.

The IRS and Treasury have requested comments regarding what CAMT attributes should be adjusted and what methodology should be used to adjust the CAMT attributes (and in what order).

4. <u>Depreciable property and new refundable and transferable tax credit rules</u>

The statute provides that tax depreciation deductions, rather than financial statement depreciation expense, are taken into account in computing AFSI for purposes of both determining Applicable Corporation status and calculating CAMT liability. The Notice includes various rules clarifying the application of this rule to certain tangible property. For example, the Notice provides that this rule applies only to depreciation deductions allowed under section 167 with respect to property that is in fact depreciated under section 168.[11] The Notice also makes clear that AFSI is reduced by tax depreciation that is capitalized to inventory under section 263A and recovered as part of cost of goods sold in computing gross income under section 61.

In addition, the Notice includes guidance regarding the new refundable and transferable tax credit rules for clean energy and advanced manufacturing projects. Specifically, the Notice provides that AFSI (again, for purposes of both determining Applicable Corporation status and calculating CAMT liability) is determined by taking into account appropriate adjustments to disregard amounts (i) that the taxpayer elects to treat as a payment of tax under section 48D(d) or 6417, (ii) treated as tax-exempt income under sections 48D(d) or 6417), and (iii) received from the transfer of an eligible credit that is not includible in the gross income of the transferring taxpayer under section 6418(b) or is treated as tax-exempt income under section 6418(c). Although the Notice does not provide color on the meaning of "appropriate adjustments," the guidance is helpful in clarifying that the imposition of the CAMT is not intended to undermine the new energy incentives enacted last year.

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[1] As was the case with Tax Cuts and Jobs Act, the Senate's reconciliation rules prevented changing the Act's name. Therefore, the Inflation Reduction Act is actually "An Act to provide for reconciliation pursuant to title II of S. Con. Res. 14." Pub. L. No. 117–169, tit. I, § 10201(d), 136 Stat. 1831 (Aug. 16, 2022).

The IRS issued a second notice on December 27, 2022, that provides important initial guidance on the new stock buyback excise tax. See our January 3, 2022, client alert "IRS and Treasury Issue Interim Guidance on New Stock Buyback Excise Tax," *available at https://www.gibsondunn.com/irs-and-treasury-issue-interim-guidance-on-new-stock-buyback-excise-tax/*.

[2] The CAMT increases a taxpayer's tax only to the extent that the 15 percent minimum tax (computed after taking into account applicable foreign tax credits) exceeds the taxpayer's regular tax plus the base erosion and anti-abuse tax.

[3] A U.S. corporation is a member of a foreign-parented multinational group if it is included in the applicable financial statements of a group that has a foreign parent.

[4] Importantly, not all AFSI computational rules apply for both purposes.

[5] Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. §" references are to the Treasury regulations promulgated thereunder.

[6] This guidance was necessary because the statute alone does not make clear whether the distributive share rule applies only in circumstances in which the corporate partner and the partnership are aggregated for purposes of calculating AFSI or in all cases.

[7] What is clear is that the typical private equity partnership is not required to take into account the book income of its portfolio companies. This position was proposed by Senate Democrats before the Act was passed in August of 2022, but Finance Committee member John Thune's amendment removed that language from the bill.

[8] The list of specified transactions has notable exclusions. For example, it does not include tax-free capital contributions under section 118, like-kind exchanges under section 1031, involuntary conversions under section 1033, stock-for-stock exchanges under section 1036, or conversions of convertible debt under Revenue Ruling 72-265.

[9] The Notice requires the transaction not "result" in any amount of gain or loss for U.S. federal income tax purposes. The proposed regulations should clarify that "result" in this context means recognition (and not realization) of gain or loss.

[10] The IRS and Treasury have requested comments on how to allocate AFSI of the distributing group to the controlled corporation.

[11] The precise meaning of the depreciation rule is not entirely clear.

*This alert was prepared by Anne Devereaux, Pamela Lawrence Endreny, Adam Gregory, Kathryn A. Kelly, Jennifer Sabin, and Eric Sloan.*

*Gibson Dunn lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work, the authors, or any of the following leaders and members of the firm's Tax and Global Tax Controversy and Litigation practice groups:*


***Tax Group:***
*Dora Arash – Los Angeles (+1 213-229-7134, darash@gibsondunn.com)*
*Sandy Bhogal – Co-Chair, London (+44 (0) 20 7071 4266, sbhogal@gibsondunn.com)*
*Michael Q. Cannon – Dallas (+1 214-698-3232, mcannon@gibsondunn.com)*
*Jérôme Delaurière – Paris (+33 (0) 1 56 43 13 00, jdelauriere@gibsondunn.com)*
*Michael J. Desmond – Los Angeles/Washington, D.C. (+1 213-229-7531, mdesmond@gibsondunn.com)*
*Anne Devereaux* – Los Angeles (+1 213-229-7616, adevereaux@gibsondunn.com)*
*Matt Donnelly – Washington, D.C. (+1 202-887-3567, mjdonnelly@gibsondunn.com)*
*Pamela Lawrence Endreny – New York (+1 212-351-2474, pendreny@gibsondunn.com)*
*Benjamin Fryer – London (+44 (0) 20 7071 4232, bfryer@gibsondunn.com)*
*Brian R. Hamano – Los Angeles (+1 310-551-8805, bhamano@gibsondunn.com)*
*Kathryn A. Kelly – New York (+1 212-351-3876, kkelly@gibsondunn.com)*
*Brian W. Kniesly – New York (+1 212-351-2379, bkniesly@gibsondunn.com)*
*Loren Lembo – New York (+1 212-351-3986, llembo@gibsondunn.com)*
*Jennifer Sabin – New York (+1 212-351-5208, jsabin@gibsondunn.com)*
*Hans Martin Schmid – Munich (+49 89 189 33 110, mschmid@gibsondunn.com)*
*Eric B. Sloan – Co-Chair, New York/Washington, D.C. (+1 212-351-2340, esloan@gibsondunn.com)*
*Jeffrey M. Trinklein – London/New York (+44 (0) 20 7071 4224 /+1 212-351-2344), jtrinklein@gibsondunn.com)*
*John-Paul Vojtisek – New York (+1 212-351-2320, jvojtisek@gibsondunn.com)*
*Edward S. Wei – New York (+1 212-351-3925, ewei@gibsondunn.com)*
*Lorna Wilson – Los Angeles (+1 213-229-7547, lwilson@gibsondunn.com)*
*Daniel A. Zygielbaum – Washington, D.C. (+1 202-887-3768, dzygielbaum@gibsondunn.com)*

***Global Tax Controversy and Litigation Group:***
*Michael J. Desmond – Co-Chair, Los Angeles/Washington, D.C. (+1 213-229-7531, mdesmond@gibsondunn.com)*
*Saul Mezei – Washington, D.C. (+1 202-955-8693, smezei@gibsondunn.com)*

GIBSON DUNN

*Sanford W. Stark – Co-Chair, Washington, D.C. (+1 202-887-3650, sstark@gibsondunn.com)*
*C. Terrell Ussing – Washington, D.C. (+1 202-887-3612, tussing@gibsondunn.com)*

**Anne Devereaux is an of counsel working in the firm's Los Angeles office who is admitted only in Washington, D.C.*