

Proposed CAMT regulations offer some clarification, but AFSI adjustments are significantly complicated

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Introduction

The recently proposed corporate alternative minimum tax (CAMT) regulations, issued on September 12, 2024, offer guidance for determining whether a corporation is an “applicable corporation” subject to the CAMT and computing an entity’s adjusted financial statement income (AFSI). The AFSI computations, however, are significantly complicated. The proposed regulations also contain guidance on determining the CAMT foreign tax credit (CAMT FTC).

The proposed regulations come more than two years after the CAMT was enacted as part of the Inflation Reduction Act (See Tax Alert 2022-1237), and after the issuance of multiple Treasury Department and IRS notices providing interim CAMT guidance (See Tax Alerts 2023-2105, 2023-0091, 2023-0384 and 2023-1570).

Some of the proposed rules would apply to tax years ending after September 13, 2024, while the remainder of the proposed rules would generally apply to tax years ending after the date the final regulations are published. Taxpayers may choose to early-rely on the proposed regulations, including for 2023 tax years; however, early reliance comes with a number of stipulations.

The Treasury Department and the IRS have requested comments on all aspects of the proposed regulations. The official comment period ends December 12, 2024. Additionally, a public hearing on the proposed regulations is scheduled for 10 a.m. ET on January 16, 2025. Requests to speak at the hearing and outlines of discussion topics are due December 12, 2024. If no outlines are received by December 12, 2024, the public hearing will be cancelled.

On the same date that the proposed regulations were issued, the Treasury Department and the IRS issued Notice 2024-66 to waive the penalty under IRC Section 6655 for corporations that fail to pay estimated taxes with respect to CAMT liabilities for tax years beginning after December 31, 2023, and before January 1, 2025. For more information, see Tax Alert 2024-1688.

Background

I. General

The Inflation Reduction Act (IRA) amended IRC Section 55 to impose a 15% CAMT on the AFSI of “applicable corporations” for tax years beginning after December 31, 2022.

II. AFSI

Generally, AFSI is defined as a taxpayer’s net income or loss set forth in the taxpayer’s applicable financial statement (AFS) for the tax year (financial statement income or FSI), as adjusted under IRC Section 56A. IRC Section 56A(c) and (d) outline the adjustments taxpayers may make to FSI to compute AFSI, including adjustments with respect to:

- ▶ FSI that is determined on the basis of an AFS year that differs from the taxpayer’s tax year
- ▶ A taxpayer with an AFS that is a consolidated financial statement
- ▶ A taxpayer that is a member of a consolidated group for US federal income tax purposes
- ▶ A taxpayer’s investment in stock in another corporation, including a controlled foreign corporation (CFC)
- ▶ A taxpayer’s investment in a partnership
- ▶ Income that is not effectively connected to the conduct of a US trade or business (non-ECI)
- ▶ Federal and foreign income taxes
- ▶ Cooperatives and Alaska Native Corporations
- ▶ Certain US federal income tax credits described in IRC Sections 48D and 6417
- ▶ Income in connection with a mortgage servicing contract
- ▶ Certain post-employment benefit plans
- ▶ Tax-exempt entities
- ▶ Property depreciable under IRC Section 168 and certain wireless spectrum depreciable under IRC Section 197
- ▶ Financial statement net operating losses (FSNOLs) generated in tax years ending after December 31, 2019

IRS Section 56A(c)(15) authorizes the Treasury Department and the IRS to provide AFSI adjustments to carry out the purposes of IRC Section 56A, including to prevent duplications and omissions and to carry out certain IRC subchapter C (corporate) and IRC subchapter K (partnership) principles.

III. Applicable corporation tests

The CAMT applies to corporations that meet the definition of an “applicable corporation” under IRC Section 59(k)(1). In general, a corporation (other than an S corporation, regulated investment company, or real estate investment trust) is an applicable corporation for a tax year if the corporation's average annual AFSI exceeds \$1 billion for any three consecutive tax years that end after December 31, 2021, but before such tax year (Average Annual AFSI Test). For this purpose, a corporation's AFSI includes the AFSI of other entities in the corporation's IRC Section 52 controlled group and is determined without regard to certain AFSI adjustments (specifically, FSNOL adjustments, adjustments for partnership investments and adjustments for post-employment benefit plans).

A corporation that is a member of an international financial reporting group with a foreign parent (i.e., a foreign-parented multinational group or FPMG, as defined in IRC Section 59(k)(2)(B)) (FPMG corporation), however, is an applicable corporation if it satisfies both a \$1 billion Average Annual AFSI Test and a separate \$100 million Average Annual AFSI test. For purposes of the \$1 billion Average Annual AFSI test, the FPMG corporation's AFSI includes the AFSI of all members of the corporation's FPMG and IRC Section 52 controlled group. The FPMG corporation's AFSI is determined without regard to a number of AFSI adjustments under IRC Section 56A (specifically, FSNOL adjustments, adjustments for income that is non-ECI, adjustments for CFC investments, adjustments for partnership investments and adjustments for post-employment benefit plans).

For purposes of the \$100 million Average Annual AFSI test, the FPMG corporation's AFSI includes the AFSI of all entities in the corporation's IRC Section 52 controlled group. The FPMG corporation's AFSI is determined without regard to certain AFSI adjustments (specifically, FSNOL adjustments, adjustments with respect to partnership investments, and adjustments with respect to post-employment benefit plans). The primary difference between AFSI computed for the \$1 billion Average Annual AFSI test and AFSI computed for the \$100 million Average Annual AFSI test is that the former includes AFSI of foreign entities that is non-ECI, while the latter does not.

IRC Section 59(k) authorizes the Treasury Department to (1) permit an applicable corporation to shed its status as an applicable corporation in certain situations, (2) determine the parent of a FPMG and the composition of a FPMG, and (3) establish a simplified method for determining whether a corporation is an applicable corporation.

IV. CAMT liability and CAMT credit

An applicable corporation's CAMT liability is calculated by first determining the corporation's tentative minimum tax (TMT), which is computed by multiplying the corporation's AFSI by 15% and reducing that amount by the corporation's CAMT FTC. The corporation's TMT is compared to the corporation's regular tax liability, plus its liability for the base erosion and anti-abuse tax (BEAT liability). The corporation's regular tax liability is its tax liability before consideration of tax credits other than the foreign tax credit (FTC).

If the TMT exceeds the regular tax liability plus the BEAT liability, the applicable corporation has a CAMT liability. Under modified IRC Section 53, the CAMT liability is carried forward as a credit (CAMT credit) that is used against the taxpayer's regular tax liability, including any BEAT liability. The CAMT credit, however, generally can only be utilized to the extent the taxpayer's regular tax and BEAT liability for a tax year (reduced by certain tax income credits) exceeds the taxpayer's TMT for the tax year.

V. CAMT notices

Treasury and the IRS released four substantive notices (CAMT Notices) that provided interim guidance on certain CAMT issues, including, but not limited to:

- ▶ A simplified method for determining whether a corporation is an applicable corporation
- ▶ General guidance for determining FSI, AFSI and a taxpayer's AFS
- ▶ AFSI adjustments for certain corporate and partnership transactions
- ▶ AFSI adjustments for depreciable property
- ▶ AFSI adjustments for certain tax credits
- ▶ AFSI adjustments for duplications and omissions

For more information on the interim guidance in these Notices, see Tax Alerts 2023-2105, 2023-0091, 2023-0384 and 2023-1570.

Proposed regulations

I. General

The proposed regulations would largely incorporate the interim guidance issued in the prior notices. The proposed regulations, however, would make some key modifications to certain aspects of the interim guidance. Further, the proposed regulations would establish new rules, definitions, clarifications and examples on issues that were not addressed by the interim guidance, including the treatment of partnership investments, the application of AFSI adjustments stemming from pre-effective date transactions, and certain mark-to-market adjustments.

II. Applicable corporation test and determinations (Prop. Reg. Sections 1.59-2 and -3)

Prop. Reg. Section 1.59-2 and -3 generally would incorporate the applicable corporation tests, and AFSI aggregation and adjustment rules in IRC Section 59(k). The proposed regulations, however, would establish additional rules and clarify several notable applicable corporation issues, including:

- ▶ Whether an entity is considered a member of a FPMG
- ▶ The application of the IRC Section 52 controlled group rules
- ▶ The application of the statutory AFSI aggregation rules, including when entities join or leave a corporation's FPMG or IRC Section 52 controlled group during the three-year testing window
- ▶ AFSI adjustments that are disregarded for testing purposes
- ▶ Situations in which an applicable corporation can shed its status as an applicable corporation
- ▶ A safe harbor for determining whether a corporation is an applicable corporation

A. Definition of a FPMG

Prop. Reg. Section 1.59-3 would clarify that the term FPMG means, with respect to any tax year of a corporation, two or more entities (one of which is the corporation) if:

- ▶ At least one of the entities is a domestic corporation and at least one of the entities is a foreign corporation
- ▶ The entities are included in the same applicable financial statement for the tax year
- ▶ One of the entities is an FPMG common parent

This section of the proposed regulations includes numerous defined terms that are relevant to evaluating which entities are included within the FPMG. In particular, the proposed regulations would define a "member of an FPMG" as each entity included in the same applicable financial statement for that tax

year as the FPMG common parent (including the FPMG common parent). For purposes of determining the entities that are included in the same applicable financial statement, the proposed regulations would introduce a deeming rule whereby the FPMG common parent and all entities in which the FPMG common parent has a controlling interest at any time during the tax year would be treated as included in the same applicable financial statement for that tax year. Notably, for this purpose, whether a consolidated financial statement of the FPMG common parent is prepared would be irrelevant. Additionally, whether a particular entity were reflected in the consolidated financial statement of the FPMG common parent or would be reflected if a consolidated financial statement of the FPMG common parent were prepared would be irrelevant.

The proposed regulations would define the “FPMG common parent” as the ultimate parent that is a foreign corporation. An ultimate parent would be an entity with a controlling interest in one or more entities, and in which no entity has a controlling interest. The proposed regulations, however, would include special rules that would apply where the ultimate parent is not a corporation. As a result, if an ultimate parent were not a corporation (e.g., a partnership), the proposed regulations would treat the ultimate parent as a foreign corporation (deemed foreign corporation) if the entity directly or indirectly were to own, other than through a domestic corporation (excluding a deemed domestic corporation):

- ▶ A foreign trade or business as defined in Treas. Reg. Section 1.989(a)-1(c)
- ▶ An equity interest in a foreign corporation in which the ultimate parent has a controlling interest

The Preamble explains that, without this rule, the FPMG rules could effectively be elective.

The proposed regulations also would establish that a deemed domestic corporation would arise if a foreign corporation were, or were treated as, engaged in a trade or business within the United States for purposes of IRC Section 882. Such trade or business would be treated as a deemed domestic corporation wholly owned by the foreign corporation (the deemed domestic corporation rule).

Prop. Reg. Section 1.59-3(f) would define controlling interest to include a general rule, a special rule for the treatment of certain entities and a tiered controlling interest rule. Under the general rule, an entity (upper-tier entity) would have a controlling interest in another entity (lower-tier entity) if, under the applicable financial accounting standard (as described in Prop. Reg. Section 1.59-3(g)), a consolidated financial statement of the upper-tier entity were to reflect the assets, liabilities, equity, income and expenses of the lower-tier entity (regardless of whether a consolidated financial statement is, or is required to be, prepared or is prepared correctly). Thus, whether the upper-tier entity would have a controlling interest under the general rule would be based on the rules of the applicable financial accounting standard and, therefore, would not depend on what is reflected in the entities’ financial statements. Thus, an upper-tier entity could nonetheless have a controlling interest in a lower-tier entity under the applicable financial accounting standard even if the lower-tier entity were not included in the upper-tier entity’s consolidated financial statement.

In addition, the proposed regulations would include special rules on the treatment of certain entities in three circumstances. Under those rules, an upper-tier entity would have a controlling interest in another entity even if there were no controlling interest under the applicable financial accounting standard:

- ▶ First, the upper-tier entity would be deemed to have a controlling interest in any deemed domestic corporation that the upper-tier entity, or any foreign corporation in which the upper-tier entity has a controlling interest, is treated as owning under the deemed domestic corporation rule described previously. For example, if the upper-tier entity were engaged in a trade or business in the United States and, therefore, deemed to own a deemed domestic corporation, the upper-tier entity would be treated as having a controlling interest in that deemed domestic corporation, even if, for accounting purposes, there would be only one entity and, therefore, no consolidated financial statement.
- ▶ Second, if an entity were owned, directly or indirectly, by a member of an FPMG without regard to this controlling interest rule and both entities were in the same IRC Section 52 group, then the member of the FPMG (and therefore the FPMG common parent) would be deemed to have a controlling interest in the entity. An IRC Section 52 group is described in Prop. Reg. Section 1.59-2.
- ▶ Finally, the upper-tier entity would be deemed to have a controlling interest in any entity in which it would have a controlling interest but for the fact that the entity is (or would be) excluded from the upper-tier entity's consolidated financial statement: (1) based on size or materiality; (2) because the entity is held for sale; (3) because the entity or business is being wound down, liquidating, or otherwise ceasing operations or being terminated or disposed of; or (4) because the entity is permitted but not required to be excluded under the applicable financial accounting standard from a consolidated financial statement of the upper-tier entity.

The proposed regulations also would clarify the applicable financial accounting standard used to determine whether a controlling interest exists. Under the proposed regulations, the applicable financial accounting standard would be generally accepted accounting principles (GAAP), unless one of the following exceptions apply (which exceptions apply in descending order of priority):

- ▶ IFRS: If a corporation's assets, liabilities, equity, income, and expenses were reported in an ultimate parent's consolidated financial statement prepared under IFRS and filed with the SEC or a foreign equivalent, IFRS would be the applicable financial accounting standard.
- ▶ Other accounting standard - single accounting standard: If those items were reported in a single consolidated financial statement under a generally accepted accounting standard other than GAAP and IFRS, that standard would apply.
- ▶ Other accounting standard - multiple accounting standards:
 - ▶ When these items are included in multiple consolidated financial statements with the same ultimate parent, the applicable financial accounting standard from the previous year would carry over.
 - ▶ If no standard were used previously, the proposed regulations would require the corporation to choose one from the options available and either attach a statement to Form 4626 (Alternative Minimum Tax - Corporations) or follow instructions provided. If the corporation did not choose, selected a non-permissible standard, or failed to disclose on Form 4626, the Commissioner would have the discretion to either treat the applicable financial accounting standard as GAAP or treat the applicable financial accounting standard as one of the accounting standards used to prepare one of those consolidated financial statements.

Observations: The proposed regulations' expanded definitions, including for a deemed foreign corporation, deemed domestic corporation, and controlling interest, could significantly widen the scope of entities included within an FPMG group relative to the statute and prior guidance.

B. IRC Section 52 controlled group

In general, for purposes of determining whether a corporation is an applicable corporation, IRC Section 59(k)(1)(D) requires all AFSI of persons treated as a single employer with the corporation under IRC Section 52(a) or (b) to be treated as AFSI of that corporation. IRC Section 52(a) provides rules for aggregating groups of corporations. As prescribed by the Secretary in regulations, IRC Section 52(b) aggregates groups of trades or businesses under similar principles regardless of whether the entities are incorporated.

For the relevant substantive rules, IRC Section 52(a) cross-references the controlled group rules under IRC Section 1563(a), with certain modifications—most notably reducing the ownership threshold in IRC Section 1563(a)(1) from “at least 80 percent” to “more than 50 percent.” Therefore, entities generally are treated as a single employer, and thus must be aggregated for purposes of determining applicable corporation status, if there is a parent-subsidiary controlled group, a brother-sister controlled group, or a combined group under IRC Section 1563(a) applying the “more than 50%” threshold.

Consistent with Notice 2023-64, Prop. Reg. Section 1.59-2(e) would clarify that, because IRC Section 52(a) cross-references IRC Section 1563(a), it is irrelevant whether a corporation is a “component member” of a controlled group of corporations as described in IRC Section 1563(b). Thus, for example, a foreign corporation may need to be aggregated, regardless of its “component member” status.

Consistent with both Notice 2023-64 and proposed regulations published on December 6, 2023 (88 FR 84770), Prop. Reg. Section 1.59-2(e) would clarify that the constructive ownership rules apply to attribute ownership of a partnership’s subsidiary to any greater-than-5% corporate partner to the extent of its share in the partnership.

Prop. Reg. Section 1.59-2(e) would include a helpful example that was not included in Notice 2023-64. In the example, a parent corporation (X) owns 80% of a partnership (PRS), which owns 80% of another corporation (Y). Because X constructively owns more than 50% of Y (80% of 80% is 64%), X and Y must be aggregated under IRC Section 52(a). In addition, if PRS is engaged in a trade or business, Y, PRS and X must be aggregated under IRC Section 52(b). (In contrast, X and Y are aggregated regardless of whether PRS is engaged in a trade or business.)

Observations: Some practitioners may be comforted by the proposed regulations’ confirmation that the partnership in the example is only required to be aggregated with the corporations if it is engaged in a trade or business.

The December 6, 2023, proposed regulations are articulated as corrections to proposed regulations published on August 7, 2023 (88 FR 52057), which generally would implement “housekeeping” changes to clarify, modernize and reflect statutory changes to the consolidated return regulations. The consolidated return rule changes would apply to income tax returns due (disregarding extensions) after publication of the final rules (see Tax Alert 2023-1375). No applicability date, however, is specified for the IRC Section 1563 portion of those proposed regulations or the conforming changes to the IRC Section 52 or 414 regulations made by the December 6 correction. The CAMT proposed rules would incorporate by reference Treas. Reg. Section 1.52-1 as proposed to be modified by the December 6 correction. Once applicable, the effects of these rules would extend to the dozens of US federal tax provisions that cross-reference IRC Section 52 and could result in larger aggregated groups not only for purposes of determining applicable corporation status but also for many purposes unrelated to the CAMT.

IRC Section 1563 was amended in 1988 by the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, to extend the statutory attribution rules for partnerships, estates, and trusts to parent-subsidiary groups (these rules were previously limited to brother-sister groups). IRC Section 52(a) applies these rules to aggregate groups of corporations, and IRC Section 52(b) applies similar principles to groups of trades or businesses as prescribed by the Secretary. Since this statutory change, the regulations under IRC Section 52 have not been amended in this respect.

C. Special rules for aggregating AFSI

Prop. Reg. Section 1.59-2 would establish special rules for aggregating the AFSI of related entities under IRC Section 59(k)(1)(D) and 59(k)(2)(A) (AFSI Aggregation Rules) for purposes of applying the Average Annual AFSI Tests. Prop. Reg. Section 1.59-2(f) would address the application of the AFSI Aggregation Rules when an entity joins or leaves a corporation's "test group" (i.e., the corporation's FPMG or IRC Section 52 controlled group, as applicable) and would require the corporation to aggregate its AFSI with the AFSI of the test group entity, but only for the portion of the corporation's tax year in which the corporation and the entity satisfy the relevant test group relationship criteria (i.e., AFSI is only aggregated while entities are related).

Prop. Reg. Section 1.59-2(f), however, would include an exception to the aggregation rule when a corporation experiences a change in ownership, which occurs when the corporation undergoes a transaction that results in the corporation no longer being related to the ultimate parent of the corporation's test group. Under this change in ownership exception, the corporation would exclude (i.e., not aggregate), for all periods preceding the change in ownership, the AFSI of entities that leave the corporation's test group as a result of the change in ownership. As illustrated in the examples in Prop. Reg. Section 1.59-2(f), other corporations that severed their test group relationship with a corporation experiencing a change in ownership, however, could still be required to aggregate the corporation's AFSI with their own AFSI for periods before the ownership change. In other words, the change in ownership exception would apply only to the corporation experiencing the change in ownership. The change in ownership exception would go hand-in-hand with Prop. Reg. Section 1.59-2(h), which, as discussed later, permits the corporation experiencing a change in ownership to shed its applicable corporation status.

Prop. Reg. Section 1.59-2(c) would establish rules for aggregating AFSI when the corporation and a relevant test group entity have different tax years. In that situation, the proposed regulations would require the corporation's AFSI to include the AFSI of the relevant test group entity for the tax year of the test group entity that ends with or within the corporation's tax year, which means the AFSI of the relevant test group entity would not have to be adjusted to conform with the corporation's tax year.

Observations: The special AFSI aggregation rules in Prop. Reg. Section 1.59-2(f) deviate, in part, from the interim guidance in Section 3.04 of Notice 2023-7, which would have required a corporation to aggregate the historical AFSI of an entity that joins the corporation's test group (including for periods before the entity joined) and resulted in the duplication of that AFSI in the CAMT system. Both special aggregation rules noted previously are consistent with the gross receipts aggregation rules under Treas. Reg. Section 1.59A-3(c) of the BEAT regulations.

D. Determining AFSI of foreign entities

Some AFSI adjustments hinge on an entity's treatment of an item for regular tax purposes. Foreign entities that are outside the scope of US tax generally do not have a regular tax treatment for an item but are nonetheless required to determine their AFSI under the \$1 billion Average Annual AFSI Test (as income that is non-ECI must be included under that test). Prop. Reg. Section 1.59-2(c) would clarify that foreign entities are not permitted or required to make any AFSI adjustment described in IRC Section 56A that depends on the treatment of an item for regular tax purposes, if the foreign entity does not take that item into account for regular tax purposes. In other words, if the foreign person did not take into account an item for regular tax purposes, the proposed regulations would not require the foreign entity to adjust the amount included in FSI for that item even if IRC Section 56A requires the amount reflected in FSI be replaced with the regular tax amount.

Observations: This rule would appear to decrease the burden of trying to make an AFSI adjustment when there is in fact no regular tax treatment already determined. However, in certain situations, this rule could produce disadvantageous results (for example, where AFSI would be reduced if a "hypothetical" regular tax treatment were determined).

E. Shedding applicable corporation status

The proposed regulations would include two paths for a corporation to shed its status as an applicable corporation. Prop. Reg. Section 1.59-2(h) would no longer treat a corporation as an applicable corporation on the first day of the first tax year following the tax year in which the corporation (1) experiences a change in ownership (see prior discussion), or (2) satisfies the termination test. A corporation would satisfy the termination test for a tax year if it did not meet the relevant Average Annual AFSI Test for five consecutive tax years ending with that tax year.

The proposed regulations, however, would require the corporation to continue to annually test in the year its applicable corporation status terminates and each subsequent tax year (i.e., a corporation could shed its applicable corporation status due to a change in ownership and regain it in the same tax year). If, following a change in ownership, the corporation were to join a new tax consolidated group that is already treated as an applicable corporation, the proposed regulations would automatically treat the corporation as an applicable corporation upon joining the group.

Observations: The proposed rules on the termination of applicable corporation status are welcome, though they may not be as generous as many were hoping. For example, a corporation may ordinarily generate AFSI that is well below the relevant testing thresholds but may meet the Average Annual AFSI Test due to an extraordinary event (e.g., sale of a business). In that case, a corporation would need to wait at least five years to shed its status as an applicable corporation, notwithstanding that it would not have been an applicable corporation had the extraordinary event never occurred (or occurred before 2020). It remains to be seen whether the Treasury Department and the IRS will provide additional exit paths in future guidance.

F. Safe harbor for determining applicable corporation status

Prop. Reg. Section 1.59-2(g) would permanently extend the safe harbor or “simplified method” in Section 5 of Notice 2023-7 for determining whether a corporation is an applicable corporation. The simplified method generally would apply by cutting the statutory testing thresholds in half (\$1 billion to \$500 million and \$100 million to \$50 million) and simplifying the AFSI determinations by disregarding most AFSI adjustments (generally resulting in the use of pre-tax FSI).

III. Determining the AFS (Prop. Reg. Section 1.56A-2)

A. General

IRC Section 56A(b) defines AFS by cross reference to IRC Section 451(b) and authorizes Treasury to treat other financial statements as the taxpayer's AFS for CAMT purposes. Section 4 of Notice 2023-64, as modified and clarified by Notice 2024-10, (AFS interim guidance) proposed additional financial statement categories (beyond those set forth in IRC Section 451(b) and its regulations) and prioritized certain financial statements differently from IRC Section 451(b) and its regulations. For example, under the AFS interim guidance, consolidated financial statements issued by the FPMG parent would be prioritized over all other financial statements issued by any FPMG member. The proposed regulations generally would follow the AFS definition and priority guidance provided in the AFS interim guidance. Prop. Reg. Section 1.56A-2, however, would add a financial statement category to the AFS priority list and clarify certain provisions relevant to AFS prioritization.

B. AFS categories

Under Prop. Reg. Section 1.56A-2, audited US GAAP and audited IFRS financial statements would retain first and second priority, respectively, consistent with the statute (which cross references IRC Section 451(b) for determining an AFS) and the AFS interim guidance. The proposed regulations, however, would add a third priority category: audited financial statements prepared with generally accepted accounting standards other than GAAP and IFRS. Financial statements filed with a government or governmental regulatory agency would be fourth on the priority list, followed by unaudited (or audited but not certified) financial statements used for an external non-tax purpose, which would be fifth. The federal tax return would be last on the priority list. Regarding the last category (federal tax return), the proposed regulations would clarify that the Form 5471 is the federal tax return of a CFC.

The following table shows the difference between the priority list in the proposed regulations and AFS interim guidance:

Priority	Proposed regulations	AFS interim guidance
1	Audited GAAP statements	Certified GAAP statements
2	Audited IFRS statements	Certified IFRS statements
3	Audited financial statements (other than GAAP or IFRS)	Other government or regulatory statements
4	Other government or regulatory statements	Unaudited external statements
5	Unaudited external statements	Federal income tax return
6	Federal income tax return	----

Observations: Due to changes in the AFS definition and priority list, taxpayers should consider whether their AFS would change under the proposed regulations. This is particularly important as Prop. Reg. Section 1.56A-17 would treat the change from one AFS to another as a change in accounting principle that triggers an AFSI adjustment to prevent omissions or duplications.

C. Special priority rules

Consistent with the AFS interim guidance, Prop. Reg. Section 1.56A-2 would prioritize certain consolidated financial statements over those that are otherwise listed in a higher priority category. More specifically, for a member of a tax consolidated group, the proposed regulations would generally prioritize the consolidated financial statement (other than a federal tax return) that includes all (or the most) members of the tax consolidated group over another financial statement listed in a higher priority category that contains fewer members of the group. When not all members of a tax consolidated group appear on a single consolidated financial statement, the proposed regulations would require the aggregation of the members' AFSs to form a single AFS for the tax consolidated group. If an entity were a member of a FPMG in which the parent prepares a consolidated statement, the proposed regulations would require the entity to use that consolidated financial statement as its AFS, even if the entity's financial results are also reported on a separate financial statement that is listed in a higher priority category.

IV. Determining AFSI (Prop. Reg. Sections 1.56A-1 through -27)

A. Foundational rules for determining FSI and AFSI (Prop. Reg. Sections 1.56A-1, -3, and -17)

Prop. Reg. Section 1.56A-1 would include definitions and general rules for determining the FSI and AFSI of an entity that is relevant for CAMT purposes. Prop. Reg. Section 1.56A-3 would provide rules for determining FSI and AFSI when a CAMT entity uses an AFS year that differs from its tax year. Finally Prop. Reg. Section 1.56A-17 would provide rules for adjusting AFSI to prevent the omission or duplication of any item.

1. FSI

Consistent with Notice 2023-64, the proposed regulations would generally include in FSI all items of income, expense, gain and loss, including nonrecurring items and net income or loss from discontinued operations. FSI would not include items reflected elsewhere in the CAMT entity's AFS, including equity accounts such as retained earnings and other comprehensive income (OCI). Additionally, amounts reported on a CAMT entity's AFS would generally be included in FSI regardless of whether the amount is realized or recognized for regular tax purposes. For example, gain reported on an AFS would be included in FSI even though the gain would qualify for nonrecognition treatment as a like-kind exchange under IRC Section 1031.

Observations: The proposed regulations would deviate from the term “taxpayer” used in the interim guidance by using the term “CAMT entity,” even though both are based on the list of entities identified in IRC Section 7701 and the regulations, except for disregarded entities. The proposed regulations would apply to corporations and other CAMT entities that are relevant for determining a corporation's applicable corporation status or CAMT liability.

The proposed regulations would include special rules that may apply if a CAMT entity's FSI is based on a consolidated AFS. The proposed regulations would require the consolidated FSI that is the CAMT entity's FSI to be supported by the CAMT entity's separate books and records that were used to create the consolidated AFS and determined without regard to the financial results of other members in the financial statement group. The rule would limit the ability for one member's loss in a financial statement group to offset the income of another member in determining the CAMT entity's FSI. Further, elimination entries (for transactions and investments in subsidiary entities) would generally be disregarded when computing a CAMT entity's FSI, with special adjustments potentially required for “investment in subsidiary entity” accounts. The proposed regulations also would include rules for consolidation entries other than elimination entries. Notably, if an AFS consolidation entry were to relate to one or more CAMT entities that are members of the same financial statement group but were not reflected in the separate books and records of the CAMT entities, the proposed regulations would require amounts to be allocated or pushed down to each CAMT entity to which the entries relate for those amounts to be reflected in each applicable CAMT entity's FSI.

2. AFSI

Prop. Reg. Section 1.56A-1(d) would provide foundational rules for determining AFSI that permeate the rest of the proposed regulations. Subject to some exceptions, Prop. Reg. Section 1.56A-1(d)(1) would provide that AFSI includes all items of income, expense, gain, and loss reflected in a CAMT entity's FSI regardless of whether those items are realized, recognized, or otherwise taken into account for regular tax purposes. Additionally, Prop. Reg. Section 1.56A-1(d)(2) would limit adjustments to AFSI to only those provided in the proposed regulations.

Prop. Reg. Section 1.56A-1(b)(7) and (d)(4) would introduce the concept of "CAMT basis" and require an AFSI adjustment to redetermine an item's gain or loss if the CAMT basis of the item were to differ from the AFS basis of the item. Depending on the item, CAMT basis could equal the item's AFS basis, regular tax basis or something in-between.

Observations: The proposed regulations would effectively require CAMT entities to maintain a third set of books to track CAMT basis in addition to AFS basis and regular tax basis.

Finally, Prop. Reg. Section 1.56A-1(d)(3)(i) would require a CAMT entity to begin making AFSI adjustments for tax years ending after December 31, 2019. However, subject to some exceptions, Prop. Reg. Section 1.56A-1(d)(3)(ii) would not permit or require CAMT entities to make an AFSI adjustment (including an AFSI adjustment that affects CAMT basis) for those tax years to extent the adjustment arose from a transaction or event that occurred in a tax year that ends on or before December 31, 2019.

Observations: The proposed regulations do not provide a definition for "transaction" or "event," nor do they provide any examples illustrating this rule. While the scope of this rule is unclear, it may have far-reaching effects, and could significantly limit AFSI adjustments that CAMT entities otherwise expected to make in current and future years.

3. Mismatched book and tax years

To the extent that a CAMT entity's AFS financial accounting period differs from the CAMT entity's tax year, the proposed regulations would require the CAMT entity to compute its FSI and AFSI by conducting an interim closing of the books using the accounting standards the CAMT entity uses to prepare its AFS.

Observations: Before the proposed regulations, there was no guidance on how to compute FSI and AFSI when there was a mismatch in year ends. As a result, taxpayers may have taken reasonable approaches that do not align to the proposed regulations. Therefore, taxpayers should carefully consider the effective dates of this provision and whether they should reevaluate their prior position and how they determine their AFSI for mismatched accounting periods.

The proposed regulations also would clarify what is a "certified" financial statement and establish rules in Prop. Reg. Section 1.56A-2(c) to assist taxpayers with determining the priority of their differing financial statements. The Preamble to the proposed regulations states that the definition used in the proposed regulations generally follows the Public Company Oversight Board's rules governing an audit opinion of

an independent financial statement auditor and the definition of a “certified audited” financial statement in the former Corporate Alternative Minimum Tax Book Income Adjustment. See T.D. 8307 (Aug. 17, 1990).

4. Omissions and duplications

Like the interim guidance, the proposed regulations would provide that AFSI should be adjusted to prevent omissions and duplications. The proposed regulations, however, would clarify that taxpayers could not self-identify duplications and omissions. Prop. Reg. Section 1.56A-17 would require taxpayers to adjust AFSI for changes in accounting principles, which would include both changes in accounting standards and the use of a different AFS. Additionally, like the interim guidance, Prop. Reg. Section 1.56A-17(c) would include adjustment periods for taking the accounting principle change amount into account for AFSI. The adjustment period for an accounting principle change amount that prevents a duplication would generally be four years, although shorter or longer periods (not to exceed 15 years) could be permitted. The adjustment period for an accounting principle change amount that prevents an omission would generally be four years, if positive and one year, if negative. However, unlike the interim guidance, the proposed regulation would limit accounting principle change amounts to amounts attributable to tax years ending December 31, 2019. Finally, like the interim guidance, Prop. Reg. Section 1.56A-17(f) would clarify that temporary book-to-tax differences, including those straddling the CAMT effective date, would not give rise to an omission or duplication.

B. AFSI with respect to partnership investments (Prop. Reg. Sections 1.56A-5 and -20)

1. Determining a partner’s “Distributive Share Amount”

Under IRC Section 56A(c)(2)(D), a partner’s AFSI must be adjusted to include its distributive share of partnership AFSI (Distributive Share Amount). The proposed regulations generally approach determining a partner’s Distributive Share Amount based on financial accounting principles, rather than partnership tax principles. Before the issuance of the proposed regulations, there was no guidance on how to determine a partner’s Distributive Share Amount.

The proposed regulations would adopt a “bottom-up” approach, under which a partnership would determine its AFSI and allocate each partner its Distributive Share Amount. To determine the Distributive Share Amount of an applicable corporation of an upper-tier partnership, the process would start with the lowest-tier partnership, which would determine its AFSI and would allocate each partner its respective Distributive Share Amount. That process would be repeated at each succeeding tier until the highest-tier partnership allocates to the partner that is an applicable corporation its Distributive Share Amount. The proposed regulations would reject a “top-down” approach, under which a partner would determine its Distributive Share Amount based on the method it uses to account for its investment in the partnership for AFS purposes.

The proposed regulations would provide a six-step process for determining a partner’s Distributive Share Amount. First, the partner would disregard any amount that is reflected in its FSI with respect to its partnership investment (e.g., changes in the fair value of its investment under the fair value method of accounting). If the partner and the partnership were consolidated for financial accounting purposes, then the partner would determine its FSI as though it prepared a separate financial statement in which the investment in the partnership is accounted for under the relevant accounting standards for investments

in other entities. However, certain items would have to remain within the partner's FSI, such as amounts attributable to transactions between partners or a transaction between the partner and the partnership.

Second, the partner would determine its distributive share percentage, which would be a fraction that is prescribed based on the method of financial accounting the partner uses to account for its partnership investment for AFS purposes. If a taxpayer's financial accounting method were not listed in Prop. Reg. Section 1.56A-5(e), the taxpayer would have to determine its distributive share percentage using a method that is reasonable under the facts and circumstances, and reflective of the proportionate amount of the partnership's FSI that the partner is reporting for AFS purposes. Notably, a partner's distributive share percentage could exceed 100% (such as where a partner's loss from its investment in a partnership under the hypothetical liquidation at book value method exceeds the partnership's FSI for the year; see Prop. Reg. Section 1.56A-5(k)(3)(ii)(B) (Ex. 3 - Step 2)).

Third, the partnership would determine its AFSI, as modified by certain adjustments in the proposed regulations. Fourth, the partner would multiply the partnership's modified FSI by its distributive share percentage. Fifth, the partner would adjust its share of modified FSI by certain separately stated adjustments, such as IRC Section 743(b) adjustments to IRC Section 168 property, or deferred distribution gain or loss (described below). The end result would be the partner's Distributive Share Amount, which the partner would include in its FSI in the final step.

Example - Assume that X, a corporation, owns a 50% partnership interest in PRS. For GAAP purposes, X accounts for its interest in PRS under the equity method. For 2024, PRS has \$100 of FSI and X has FSI of \$250, which includes \$50 from its investment in PRS. Under the equity method of accounting, X includes 50% of PRS's FSI for 2024 on its AFS.

Step 1: X disregards the \$50 of FSI included on its AFS with respect to its investment in PRS.

Step 2: Since X accounts for its investment in PRS under the equity method, under Prop. Reg. Section 1.56A-5(e)(2)(i), the denominator of X's distributive share percentage is 100% of PRS's FSI for 2024. Accordingly, X's distributive share percentage is 50%, or \$50 (the amount disregarded under Step 1), over \$100 (100% of PRS's FSI for 2024).

Step 3: PRS's FSI of \$100 includes \$20 of income from a covered benefit plan and \$10 of covered book depreciation expense. To determine PRS's modified FSI, PRS must reduce its FSI by the \$20 of covered benefit plan income. In addition, PRS must back out the \$10 of book depreciation expense and replace it with \$10 of deductible tax depreciation. Accordingly, PRS's modified FSI is \$80 (\$100 - \$20 + \$10 - \$10).

Step 4: X multiplies its modified FSI (\$80) by its distributive share percentage (50%), resulting in \$40 of modified FSI for X.

Step 5: X has no separately stated adjustments that must be accounted for, so there is no adjustment to X's share of modified FSI as a result of this step.

Step 6: As discussed, after Step 1, X's FSI is \$200 (\$250 - \$50). As a result of Step 6, X increases its FSI by \$40, for a total of \$240.

2. Reporting and filing requirements for partnerships

If a partner were unable to determine its Distributive Share Amount without receiving information from the partnership, the partner generally would be required to request information from the partnership by the 30th day after the end of the partnership's tax year. If the partnership were not to provide the requested information, the partner would be required to determine its Distributive Share Amount by making a "required good faith estimate." In general, this means the partner would be obligated to determine its Distributive Share Amount based "on whatever information it [could] reasonably obtain" if received before the statute of limitations period expires (generally, three years after its return was filed); the partner would be required to continue using "best efforts" to obtain the required information from the partnership. A partnership that fails to provide requested information could be subject to penalties and adjustments. These compliance requirements are expected to require significant additional resources.

Observations: Because the proposed regulations rely heavily on financial accounting principles to determine a partner's Distributive Share Amount, taxpayers are expected to need significant expertise in financial accounting to comply. In addition, significant tax compliance resources will likely be required to track and allocate separately stated CAMT items, comply with information requests from partners, and account for FSI from transactions between partners or between a partner and the partnership.

Regarding the last point, transactions that have historically had little relevance from a federal income tax perspective would now need to be scrutinized. Take, for example, a contribution of cash to a partnership that dilutes another partner that accounts for its partnership investment using the equity method of accounting. While that transaction would generally not cause any of the diluted partners to recognize gain for US federal income tax purposes, it would now need to be determined whether a partner would need to take into account dilution gains (or losses) as part of that partner's FSI.

3. Partnership contributions and partnership distributions

While Notice 2023-7 disregarded "covered nonrecognition transactions" (i.e., transactions in which no gain or loss is recognized for US federal income tax purposes) between partners and partnerships for AFSI purposes, Prop. Reg. Section 1.56A-20 would adopt a "deferred sale" approach. Under this approach, a contribution of property to a partnership or a distribution by a partnership could cause a partner to recognize AFSI gain or loss over time even if the entire contribution or distribution qualified for nonrecognition under IRC Section 721(a) or IRC Section 731(b), respectively. If a contribution of property to a partnership were to qualify for nonrecognition under IRC Section 721(a) but resulted in FSI gain or loss to the contributor, the contributor would have to include this gain or loss in its AFSI over the transferred property's applicable recovery period. If a distribution of property by a partnership were to qualify for nonrecognition under IRC 731(b) but resulted in FSI gain or loss to the partnership, the gain or loss would be excluded from the partnership's modified FSI (as determined under Prop. Reg. Section 1.56A-5) but would be included in the partners' distributive shares over the applicable recovery period. Special rules in Prop. Reg. Section 1.56A-4(b) would apply to contributions and distributions of stock of a foreign corporation.

The applicable recovery period would be the period over which the property would be depreciated for tax or AFS purposes, depending on the nature of the property, or 15 years for non-depreciable property.

Certain events (e.g., a partnership disposing of deferred sale property) would accelerate inclusion of the deferred sale gain or loss into AFSI.

The proposed regulations would provide that a partnership's CAMT basis in contributed property is the partnership's basis for AFS purposes. The contributor's initial CAMT basis in its partnership investment would equal its AFS basis, decreased by any deferred sale gain and increased by any deferred sale loss. The contributor's CAMT basis in its partnership investment would then be adjusted over time, as the contributor recognizes deferred sale gain or loss.

The IRC Section 752 liability rules would be disregarded in applying the deferred sale approach. As a result, a contribution of property encumbered by a qualified liability that could be a nonrecognition transaction for regular tax purposes may not be an IRC Section 721(a) transaction under the proposed regulations. In that case, the contributor would be required to recognize any FSI gain or loss at the time of contribution (subject to the rule for partial nonrecognition transactions, described below), rather than over the applicable recovery period.

For partial nonrecognition transactions (for regular tax purposes or as a result of disregarding IRC Section 752), FSI gain or loss would be recognized in the year of the transaction in the same proportion as taxable gain would be recognized if one disregarded IRC Section 752. Any FSI gain or loss not recognized in the year of the transaction would have to be recognized over the applicable recovery period.

Observations: The deferred sale approach departs from Section 3 of Notice 2023-7, which provides that FSI from contributions of property to, and distributions of property from, a partnership is excluded from a partner's and the partnership's AFSI if the contribution or distribution is a "covered nonrecognition transaction" (i.e., a transaction that qualifies in its entirety for nonrecognition treatment under IRC Section 721 or IRC Section 731, respectively). The Preamble notes that taxpayers can generally rely on Section 3 of Notice 2023-7 for tax years ending on or before September 13, 2024. In addition, the Preamble provides that a taxpayer cannot rely on the distributive share rules in Prop. Reg. Section 1.56A-5 unless it (and each member of its test group) relies on both Prop. Reg. Section 1.56A-5 and Prop. Reg. Section 1.56A-20 in their entirety. Thus, it appears that a taxpayer wishing to rely upon the covered nonrecognition transaction rule in Section 3 of Notice 2023-7 for a tax year ending on or before September 13, 2024, should not rely upon Prop. Reg. Section 1.56A-5 or Prop. Reg. Section 1.56A-20 for such period.

Taxpayers that do not rely on Prop. Reg. Section 1.56A-5 (regarding the determination of a partner's Distributive Share Amount) can rely on section 3 of Notice 2023-7 instead of Prop. Reg. Section 1.56A-20 for tax years ending on or before September 13, 2024.

C. AFSI adjustments with respect to foreign corporations (Prop. Reg. Section 1.56A-4)

The proposed regulations would provide new rules for AFSI adjustments resulting solely from a CAMT entity's ownership of a foreign corporation's stock and certain asset transactions involving the stock of a foreign corporation. These rules would apply to all foreign corporations, whether or not they are CFCs. The proposed regulations would also create new CAMT basis rules for certain transactions involving the transfer of such stock.

1. Adjustments with respect to ownership of stock in a foreign corporation

For a CAMT entity directly owning stock of a foreign corporation, the proposed regulations would adjust the CAMT entity's AFSI with respect to its ownership of the foreign corporation stock to:

- ▶ Disregard “any items of income, expense, gain and loss resulting from the ownership of the stock of the foreign corporation, including any items that result from acquiring or transferring the stock, reflected in the CAMT entity's FSI”

and

- ▶ Include any items of income, deduction, gain and loss for regular tax purposes resulting from the ownership of the stock of the foreign corporation, including any items that result from acquiring or transferring the stock (for example, transaction costs), other than any items of income, deduction, gain, and loss resulting from the application of IRC Sections 78, 250, 951, or 951A

Observations: The proposed regulations would expand the general principle of Notice 2024-10 beyond covered CFC distributions. Regular tax rules would determine the CAMT consequences from any items arising from ownership of foreign corporation stock, except for subpart F or GILTI inclusions and the associated IRC Section 250 deduction and IRC Section 78 gross-up. This approach is generally favorable to taxpayers because it eliminates duplication of items for CAMT purposes and avoids the complexity from determining the CAMT consequences if a foreign corporation comes in and out of the CFC status.

The proposed regulations would also provide that CAMT basis in foreign stock would equal its basis for regular tax purposes and CAMT retained earnings are not relevant with respect to ownership of foreign corporation stock.

2. Adjustments with respect to covered asset transactions

If a CAMT entity were to transfer an asset (other than the stock of a foreign corporation) in a covered asset transaction, the proposed regulations would require the CAMT entity's AFSI to be adjusted to:

- ▶ Disregard “any items of income, expense, gain, and loss with respect to the transferred asset resulting from the covered asset transaction reflected in the CAMT entity's FSI”

and

- ▶ Include any items of income, deduction, gain, and loss for regular tax purposes with respect to the transferred asset resulting from the covered asset transaction but compute each item using the CAMT entity's CAMT basis in the transferred asset instead of the CAMT entity's basis in the transferred asset for regular tax purposes

A covered asset transaction generally refers to a component transaction involving (1) the transfer of one or more assets by or to a foreign corporation to which IRC Sections 311, 332, 337, 351, 354, 355, 356, or 361 apply, or (2) the transfer of one or more assets, at least one of which is stock of a foreign corporation, to or by a domestic corporation, to which the same sections apply. Prop. Reg. Section 1.56A-4(b)(1) would specifically define a “covered asset transaction.”

For covered asset transactions, the proposed regulations would generally determine a transferee’s CAMT basis in the transferred asset (that is not foreign corporation stock) by applying the regular tax principles (for example, the rules of IRC Sections 301(d), 334(b), 362, 358, as applicable) to the CAMT basis (rather than the regular tax basis). If the asset transferred were stock or securities of a domestic corporation under IRC Section 355 and the asset were transferred by a foreign corporation in a covered asset transaction, however, the transferee’s CAMT basis in the transferred stock or securities of the domestic corporation would equal the transferee’s basis in the stock or securities for regular tax purposes.

Observations: The proposed regulations would adopt a somewhat hybrid approach by creating a new concept of CAMT basis while leveraging the regular tax rules to determine the adjustments to the CAMT basis required by nonrecognition transactions for regular tax purposes. It seems that the CAMT basis would equal the regular tax basis only in rare cases (e.g., in the case of foreign corporation stock). In transactions involving both foreign and domestic corporations’ stock and assets, a careful review of these rules to ensure proper tracking of the CAMT basis adjustments is warranted.

3. Adjustments with respect to IRC Section 338(g) transactions

For transactions in which the stock of a foreign corporation is acquired in an IRC Section 338(g) transaction, the proposed regulations would adjust the foreign corporation’s AFSI to include any net gain or loss that results from treating the foreign corporation’s assets as sold for regular tax purposes by reason of the IRC Section 338(g) transaction. However, for this purpose, the gain or loss would be computed using the foreign corporation’s CAMT basis in the asset, instead of its basis in the asset for regular tax purposes.

Immediately after the IRC Section 338(g) transaction, the foreign corporation’s CAMT basis in the assets that it is deemed to have purchased by reason of the IRC Section 338(g) transaction would equal its basis in those assets for regular tax purposes.

4. Adjustments with respect to purchase accounting and pushdown accounting

If a CAMT entity were to acquire the stock of a foreign corporation, the proposed regulations would disregard any purchase accounting and pushdown accounting adjustments (as applicable) resulting from the acquisition of the foreign corporation’s stock for purposes of determining the CAMT entity’s AFSI and the CAMT basis in the foreign corporation’s assets.

D. Adjustments with respect to controlled foreign corporations (Prop. Reg. Section 1.56A-6)

The proposed regulations would provide various rules under IRC Section 56A(c)(3), including rules for AFSI adjustments for U.S. shareholders of a CFCs, rules for computing a CFC's adjusted net income or loss, and CAMT excluded dividends.

Consistent with Notice 2023-64, the proposed regulations would clarify that a CAMT entity that is a US shareholder of one or more CFCs makes a single IRC Section 56A(c)(3) AFSI adjustment for any tax year; the adjustment would equal the aggregate of the CAMT entity's pro rata share of each CFC's adjusted net income or loss, reduced by:

- ▶ The aggregate pro rata share of eligible current-year taxes as determined under Treas. Reg. Section 1.59-4(d)(3) if the applicable corporation does not elect to claim foreign tax credits (but not reduced for taxes deemed paid by the applicable corporation on PTEP under IRC Section 960(b)) (Tax Reduction)

and

- ▶ The aggregate amount of CFC adjustment carryovers to the tax year (CFC Adjustment Carryover)

A CFC Adjustment Carryover would typically arise when a US shareholder's aggregate IRC Section 56A(c)(3) adjustment for a tax year (including a tax year in which the corporation is not an applicable corporation) is negative after accounting for the Tax Reduction but before considering any existing CFC Adjustment Carryover. This negative adjustment would then become a CFC Adjustment Carryover for that year. In future years, when the adjustment would otherwise be positive after any Tax Reduction, the carryover would apply to reduce the positive adjustment, but not below zero. CFC Adjustment Carryovers would be utilized in the order of the tax years in which they were generated.

For the first tax year that a corporation qualified as an applicable corporation (and for any subsequent years), a CFC Adjustment Carryover would be used to reduce the CFC Adjustment Carryover in tax years beginning after the year in which the CFC Adjustment Carryover was generated and before the first year the corporation becomes an applicable corporation.

The proposed regulations would align the CFC Adjustment Carryover with the definition of financial statement net operating loss by limiting the negative adjustment to be "with respect to a [US] shareholder for any [tax] year ending after December 19, 2019."

A CFC's adjusted net income or loss would generally equal its FSI, adjusted for all AFSI adjustments under the IRC Section 56A regulations, except for the following:

- ▶ Adjustments relating to the ownership of foreign corporation stock. Under the proposed regulations, the AFSI adjustments in Prop. Treas. Reg. Section 1.56A-4(c)(1) (regarding ownership a foreign corporation's stock) would not apply. Instead, the following adjustments would apply, and a CFC's adjusted net income or loss would:

- ▶ Exclude “any items of income, expense, gain, and loss resulting from ownership of stock of a foreign corporation, including acquiring or disposing of such stock, reflected in the CFC’s FSI”
- and
- ▶ Include any items of income, deduction, gain, and loss resulting from the CFC’s ownership of a foreign corporation’s stock, including acquiring or transferring that stock, for regular tax purposes (taking into account IRC Section 961(c)) (except for any dividend received from another foreign corporation to the extent the dividend is a CAMT excluded dividend)
- A CAMT excluded dividend is a dividend received by a CFC to the extent it is excluded from (1) the recipient CFC’s gross income under IRC Section 959(b), or (2) both the recipient CFC’s foreign personal holding company income under IRC Section 954(c)(3) or (c)(6), and gross tested income under Treas. Reg. Section 1.951A-2(c)(1)(iv).
- ▶ Other adjustments. The Proposed Regulations provide other AFSI adjustments to income or loss from the conduct of a US trade or business, foreign income tax expense and FSNOL carryovers.

The proposed regulations would clarify that a CAMT entity’s pro rata share of a CFC’s adjusted net income or loss would be determined for the CFC’s tax year that ends with or within the CAMT entity’s tax year. The pro rata share(s) would be determined under the principles of IRC Section 951(a)(2) (including the aggregation rules in Treas. Reg. Section 1.958-1(d)).

As the Preamble notes, a domestic partnership would not have a pro rata share of a CFC’s adjusted net income or loss with respect to CFC in which it owns stock, thus requiring no adjustment to the partnership’s FSI. A partner that is a US shareholder with respect to the CFC, however, would determine its own pro rata share of the CFC’s adjusted net income or loss and would be required to adjust its AFSI appropriately.

E. Adjustments to effectively connected income (ECI) (Prop. Reg. Section 1.56A-7)

Consistent with Notice 2023-64, the proposed regulations would require a foreign corporation to determine its AFSI by applying the principles of IRC Section 882, taking into account only amounts and items of FSI that would be included in ECI from the conduct of a US trade or business or allowable deductions under IRC Section 882(c) for regular tax purposes.

Observations: The Preamble explained that, unlike the approach in Notice 2023-64 (which specified that the principles of income tax treaty provisions would apply to a foreign corporation qualifying for the treaty benefit), Treasury and the IRS believe there is no need to make the same clarification in the proposed regulations, because normal operation of US income tax treaties (specifically the interplay between US domestic law and income tax treaties) should apply in this context.

F. Adjustments to federal and foreign income taxes (Prop. Reg. Section 1.56A-8)

The proposed regulations would provide AFSI adjustments to disregard any “applicable income taxes” that would be taken into account in a CAMT entity’s AFS. Applicable income taxes would mean federal income taxes and foreign income taxes (as defined in Treas. Reg. Section 1.901-2) taken into account as current or deferred tax expenses (or benefits), through increases or decreases to other AFS accounts of the CAMT entity (for example, AFS accounts used to account for FSI from investments in other CAMT entities, AFS accounts used to account for Section 168 property, or AFI accounts used to account for other items of income and expense).

An applicable corporation that does not choose to claim a foreign tax credit for the tax year would reduce its AFSI by the foreign income taxes that would be deducted for regular tax purposes under IRC Section 164 for the tax year. This would include the foreign income taxes of a disregarded entity that the applicable corporation owns for regular tax purposes and any creditable foreign tax expenditures (within the meaning of Treas. Reg. Section 1.704-1(b)(4)(viii)) allocated to the applicable corporation as a partner in a partnership. This adjustment would be disregarded in applying the average annual AFSI tests to determine whether a corporation is an applicable corporation.

According to the Preamble, all taxpayers should determine AFSI on a pre-tax basis when determining whether a corporation is an applicable corporation, regardless of whether the taxpayer chooses to claim foreign tax credits for the tax year. This approach ensures that all taxpayers determine whether a corporation is an applicable corporation using the same metric (pre-tax AFSI) so that the choice of whether to claim foreign tax credits does not affect the applicable corporation status. In contrast, for purposes of determining an applicable corporation’s CAMT liability, Treasury and the IRS believe they are authorized to allow a reduction to AFSI for foreign income taxes if an applicable corporation does not choose to claim foreign tax credits for the tax year and thus could not claim a CAMT FTC.

In providing the requirements for an applicable income tax to be taken into account in an AFS, consistent with Notice 2023-64, the proposed regulations would consider applicable income taxes “taken into account” in a CAMT entity’s AFS “if any journal entry has been recorded in the books and records used to determine an amount in the [CAMT entity’s AFS] for any year to reflect the taxes.” Applicable income taxes would be considered “taken into account” in a CAMT entity’s AFS even if the taxes did not increase or decrease the CAMT entity’s FSI at the time of the journal entry.

The proposed regulations would also consider applicable income taxes to be taken into account in any AFS of the partnership’s partners if they were taken into account in the partnership’s AFS.

G. AFSI adjustments resulting from corporate transactions (Prop. Reg. Sections 1.56A-18 and -19)

1. Adjustments for corporations and shareholders: IRC Sections 56A(c)(2)(C) and (c)(15)(B)

The proposed regulations would combine and coordinate IRC Section 56A(c)(2)(C) and IRC Section 56A(c)(15)(B)—two AFSI-adjusting provisions—through Prop. Reg. Sections 1.56A-18 and 1.56A-19, which would apply to tax years ending after the date the final regulations are published.¹

¹ See Prop. Reg. Sections 1.56A-18(i) and 1.56A-19(h).

Under IRC Section 56A(c)(2)(C), if a corporation is not included on a tax consolidated return with the taxpayer, the AFSI of the taxpayer with respect to that corporation is determined by taking into account (1) dividends received from that corporation (reduced to the extent provided by the Secretary in regulations or other guidance) and (2) other amounts includible in gross income or deductible as a loss (unless those amounts must be included under IRC Sections 951 and 951A or as provided by the Secretary).

Separately, IRC Section 56A(c)(15)(B) authorizes, in making adjustments to arrive at AFSI, regulations that carry out the principles of Part II of Subchapter C (relating to corporate liquidations, such as transactions under IRC Sections 331, 332, 336 or 337) and Part III of Subchapter C (relating to corporate organizations and reorganizations, such as transactions under IRC Sections 351 and 368, respectively).

2. Overview of principles

Because the financial accounting treatment of stock being held by a party and stock transactions differs significantly from the tax treatment thereof, the dominating issue Prop. Reg. Sections 1.56A-18 and 1.56A-19 strive to resolve is how to transform a corporation's FSI into the results mandated by the Code in each situation. To accomplish this, the proposed regulations would implement overarching concepts particular to IRC Sections 56A(c)(2)(C) and 56A(c)(15)(B).

Stock held by a party. Prop. Reg. Section 1.56A-18, which focuses primarily on IRC Section 56A(c)(2)(C), would limit the applicability of IRC Section 56A(c)(2)(C) to situations in which the tax event pertains to the party's role as a "holder" of the stock (as contrasted with the party engaging in a transaction with respect to the stock of a corporation). This would include, among other things, transactions under IRC Sections 301, 302, 303 and 305. In these transactions, the basic principle adopted by the proposed regulations is that the regular tax rules would dictate the parties' treatment for CAMT purposes, albeit with CAMT inputs such as CAMT basis and CAMT earnings.² Where, however, the corporation is a party to a transaction involving the stock of the corporation (such as a liquidation, stock disposition or IRC Section 351 exchange), Prop. Reg. Section 1.56A-18 would not apply IRC Section 56A(c)(2)(C) principles and instead either provide particular stock transaction rules (e.g., for liquidating transactions) or direct taxpayers to Prop. Reg. Section 1.56A-19 (e.g., for IRC Section 351 exchanges), as appropriate.

Stock transactions. Prop. Reg. Section 1.56A-19, which focuses primarily on IRC Section 56A(c)(15)(B), would provide rules dedicated to the effects of "covered nonrecognition transactions" and "covered recognition transactions," including for transactions under IRC Sections 351 and 368. In these two types of transactions, the basic principle adopted by the proposed regulations concerning covered nonrecognition transactions is that FSI (if any) would be disregarded and no AFSI would be recognized as a result of the transaction, with basis and earnings following the Code (albeit with CAMT inputs). For covered recognition transactions, on the other hand, the basic principle is that AFSI would be computed using FSI (albeit with CAMT inputs, such as basis and earnings).³

² For definitions of these terms, see Prop. Reg. Sections 1.56A-1(b)(7) and (b)(4). Note that the nature of the regular tax rules taken into account will depend on whether the transaction is a covered recognition transaction or a covered nonrecognition transaction.

³ This treatment differs from that in IRC Section 56A(c)(2)(C), even though both transactions may be taxable, because, under IRC Section 56A(c)(2)(C), the statute mandates what is effectively a tax-for-book swap of items.

The term “covered nonrecognition transaction” generally would mean a transaction that, with regard to the specific party:

- ▶ Qualifies for nonrecognition treatment for regular tax purposes under IRC Sections 305, 311(a), 332, 337, 351, 354, 355, 357, 361 or 1032(a)
- ▶ Is not treated as resulting in the recognition of any amount of gain or loss for regular tax purposes solely with regard to that party
- ▶ Is not treated as a covered recognition transaction under Prop. Reg. Sections 1.56A-18 or 1.56A-19⁴

The effects of a covered nonrecognition transaction generally would be:

- ▶ Any gain or loss reflected in FSI resulting from the transaction is disregarded
- ▶ AFSI resulting from the transaction is determined by applying the relevant Code section (that is, no AFSI is recognized)
- ▶ The basis consequences of the transaction are determined by applying the relevant Code section (using CAMT basis)
- ▶ CAMT earnings are adjusted by applying IRC Section 312 (and, if applicable, IRC Section 381(c)(2))

In other words, the effects of a covered nonrecognition transaction generally would reflect a replacement of the AFS results with regular tax results (albeit with CAMT inputs, such as CAMT basis). Importantly, because a transaction that results in any amount of gain or loss for regular tax purposes precludes covered nonrecognition transaction status, there is a so-called cliff effect that results in application of the covered recognition rules instead (which, as noted later, would apply the relevant financial accounting principles (and not the applicable section of the Code) to the covered recognition transaction).

The term “covered recognition transaction” would generally mean a transfer, sale, contribution, distribution or other disposition of property that, with regard to a particular party, does not qualify as a covered nonrecognition transaction solely with regard to the party (and therefore could result in the recognition of gain or loss for regular tax purposes to the party).⁵ The effects of a covered recognition transaction (outside of IRC Section 56A(c)(2)(C)), on the other hand, would generally be as follows:

- ▶ AFSI is determined by recomputing any gain or loss reflected in its FSI using the CAMT basis of any property transferred in the transaction
- ▶ The CAMT basis in any property received in the transaction is determined to be its AFS basis
- ▶ CAMT earnings are adjusted by the amount of AFSI resulting from the transaction

⁴ See Prop. Reg. Section 1.56A-18(b)(9).

⁵ See Prop. Reg. Section 1.56A-18(b)(10).

In other words, the effects of a covered recognition transaction would generally reflect the AFS results (albeit with CAMT inputs, such as CAMT basis).

In both covered nonrecognition transactions and covered recognition transactions, each component would be separately analyzed (e.g., for a target corporation in an acquisitive reorganization under IRC Section 368(a)(1)(A), its IRC Section 361(a) transfer would be analyzed separately from its IRC Section 361(c) distribution).⁶

Prop. Reg. Sections 1.56A-18 and 1.56A-19 would not apply to any transaction that is (1) between members of the same tax consolidated group during any period that they are shareholders of other members of the same tax consolidated group; or (2) a covered asset transaction (as defined in Prop. Reg. Section 1.56A-4(b)(1)), an IRC Section 338(g) transaction, or an acquisition or transfer of stock of a foreign corporation subject to Prop. Reg. Section 1.56A-4(c)(1).

3. CAMT treatment of certain corporate transactions (Prop. Reg. Section 1.56A-18)

The approach of Prop. Reg. Section 1.56A-18 is to provide rules on a transaction-type-by-transaction-type basis to determine CAMT treatment of certain transactions, with special operating rules augmenting the transaction rules. For those transactions for which Prop. Reg. Section 1.56A-18 would apply IRC Section 56A(c)(2)(C) principles (as opposed to IRC Section 56A(c)(15)(B) principles), the CAMT treatment would generally follow the regular tax rules but with CAMT inputs. For those transactions for which Prop. Reg. Section 1.56A-18 would apply IRC Section 56A(c)(15)(B) principles, the CAMT treatment would generally reflect a replacement of the AFS results with regular tax results (albeit with CAMT inputs, such as CAMT basis).

Treatment of nonliquidating distributions. Prop. Reg. Section 1.56A-18(d) addresses transactions under provisions including IRC Sections 301, 302, 305 and 311, which may be covered nonrecognition transactions or covered recognition transactions. As discussed previously, the general treatment would be to replace the AFS result with the regular tax result (but with CAMT inputs). The particular regular tax results may depend on whether the transaction is a covered nonrecognition transaction (such as under IRC Sections 305(a) or 311(a)) or a covered recognition transaction (such as under IRC Sections 301 or 311(b)).

Example - IRC Section 305(a) and 311(a) stock distribution (covered nonrecognition transaction).

X owns 25 shares of Y's stock, which has a FMV of \$125x and a CAMT basis of \$60x. X does not qualify for a dividends-received deduction for any distribution from Y. Y distributes solely newly-issued stock to X (a distribution recipient) in a transaction that qualifies X for nonrecognition treatment under IRC Section 305(a) and that qualifies Y (the distributing corporation) for nonrecognition treatment under IRC Section 311(a). Y has CAMT earnings of \$100x.

⁶ See Prop. Reg. Section 1.56A-18(c)(5). Note that, in some instances, one party's component may affect another's (e.g., where one of multiple transferors in a purported IRC Section 351 transaction disposes of its transferee shares in such a manner as to "bust" the IRC Section 351 transaction (and its covered nonrecognition transaction status) for all parties.

Y's distribution of the additional shares of Y stock is a covered nonrecognition transaction. As a result, in determining Y's AFSI resulting from the distribution, Y disregards any FSI reflected on Y's AFS resulting from the distribution, and Y applies IRC Section 311(a) to the distribution. Accordingly, Y has \$0x of AFSI resulting from the distribution. Y adjusts Y's CAMT earnings under IRC Section 312 by Y's AFSI resulting from the distribution, or \$0x.

X's receipt of the additional Y stock is a covered nonrecognition transaction with regard to X. In determining the amount of AFSI resulting from the distribution, X first disregards any FSI reflected in X's AFS, and then applies IRC Section 305(a) to the distribution. Accordingly, X has \$0x of AFSI resulting from the distribution. X determines X's CAMT basis in the additional Y stock by applying IRC Section 307(a) and Treas. Reg. Section 1.307-1(a), thereby allocating CAMT basis in proportion to fair market value. As a result, X allocates \$10x of X's existing CAMT basis in X's Y stock to the new Y stock ($(\$25x / (\$125x + \$25x)) \times \$60x = \$10x$). X adjusts X's CAMT earnings under IRC Section 312 by X's AFSI resulting from the distribution, or \$0x.⁷

Treatment of liquidating distributions. Prop. Reg. Section 1.56A-18(f) addresses liquidating distributions under IRC Sections 331, 332, 336 and 337, which may be covered nonrecognition transactions or covered recognition transactions. Unlike nonliquidating transactions, liquidating transactions fall outside the IRC Section 56A(c)(2)(C) treatment as interpreted by Prop. Reg. Section 1.56A-18; instead, the principles of IRC Section 56A(c)(15)(B) apply.

Example - Liquidation under IRC Sections 331, 332, 336 and 337 (dual covered nonrecognition transaction and covered recognition transaction). X owns 85% of the stock of Y with a fair market value of \$85x, an AFS basis of \$60x and a CAMT basis of \$40x. Unrelated Z owns the remaining 15% of the stock of Y with a fair market value of \$15x, an AFS basis of \$20x and a CAMT basis of \$10x. X and Y do not file a consolidated financial statement. Y's assets include \$10x cash, Asset 1 and Asset 2. Asset 1 has a fair market value of \$13x, an AFS basis of \$19x and a CAMT basis of \$10x. Asset 2 has a fair market value of \$77x, an AFS basis of \$50x and a CAMT basis of \$40x. Y's CAMT retained earnings are \$50x. X and Z determine to dissolve Y. Y distributes Asset 1 and \$2x cash to Z, and Y distributes Asset 2 and \$8x cash to X, in exchange for each shareholder's Y stock.

The dissolution of Y is a covered nonrecognition transaction to Y with respect to the liquidating distribution to X, and a covered recognition transaction to Y with respect to the liquidating distribution to Z. Y determines Y's AFSI and CAMT retained earnings by treating the component transactions separately.

⁷ See Prop. Reg. Section 1.56A-18(d)(5)(i), Ex. 1. Consistent with the principles stated previously, the FSI would be disregarded, no AFSI would be recognized, basis would be determined by applying the relevant Code section (using CAMT basis), and CAMT earnings would be adjusted by applying IRC Section 312. For an example in which X avails itself of the IRC Section 243 dividends-received deduction, see Prop. Reg. Section 1.56A-18(d)(5)(iv), Ex. 4.

The liquidating distribution to X is a covered nonrecognition transaction. In determining Y's AFSI resulting from the distribution to X, Y disregards any FSI reflected in Y's AFS resulting from the distribution to X, and Y applies IRC Section 337(a) to the distribution. Accordingly, Y has \$0x of AFSI resulting from the distribution to X. Y adjusts Y's CAMT retained earnings by applying IRC Section 312 based on the amount of AFSI, or \$0x.

In determining the amount of X's AFSI resulting from the dissolution of Y, X disregards any FSI reflected in X's AFS resulting from the liquidating distribution from Y, and X applies IRC Section 332 to the liquidating distribution. Accordingly, X has \$0x of AFSI resulting from the dissolution. X determines X's CAMT basis in Asset 2 by applying IRC Section 334(b), using the CAMT basis in the hands of Y, or \$40x. X succeeds to Y's CAMT earnings. See IRC Sections 381(c)(2) and 312.

The liquidating distribution to Z is a covered recognition transaction. In determining Y's AFSI resulting from the distribution to Z, Y redetermines any resulting gain or loss reflected in Y's FSI using Y's CAMT basis in Asset 1. Accordingly, Y has \$3x of AFSI resulting from the liquidating distribution to Z. Under Prop. Reg. Section 1.56A-18(f)(2)(ii), Y would adjust Y's CAMT earnings based on Y's AFSI resulting from the liquidating distribution to Z, or \$3x and reduce them by the CAMT basis of the property, or \$10x, and \$2x cash distributed to Z.⁸

Treatment of stock sales and asset sales. As noted previously, Prop. Reg. Section 1.56A-18 would not extend IRC Section 56A(c)(2)(C) principles to dispositions of stock. Instead for a taxable stock sale to an acquiror corporation, Prop. Reg. Section 1.56A-18(g)(1) would generally require a target corporation shareholder to follow the covered recognition transaction treatment model.⁹ Analogous rules are provided for the acquiror corporation under Prop. Reg. Section 1.56A-18(g)(3). The target corporation, not surprisingly, would experience no effects from the stock sale.¹⁰

Prop. Reg. Section 1.56A-18(h) would generally follow the AFS treatment of taxable asset sales to the selling corporation and the purchasing corporation,¹¹ albeit with CAMT inputs, such as CAMT basis.

Operating rules under Prop. Reg. Section 1.56A-18. In addition to the transaction-specific rules described previously, Prop. Reg. Section 1.56A-18(c) would create important operating rules with the following framework for the transaction-specific rules:

- ▶ Stock ownership would be respected as such rather than treated as a conduit to the underlying assets (such as may occur for financial accounting purposes)

⁸ Prop. Reg. Section 1.56A-18(f)(6)(ii), Ex. 2.

⁹ See Prop. Reg. Section 1.56A-18(g)(1)(ii) for a modification of this rule for an election under IRC Sections 336(e) or 338(h)(10).

¹⁰ Note that IRC Section 304 does not apply for purposes of Prop. Reg. Section 1.56A-18.

¹¹ Such treatment makes sense given that the principles of IRC Section 56A(c)(2)(C) (pertaining to stock ownership) and IRC Section 56A(c)(15)(B) (pertaining to subchapter C rules that do not address taxable asset transactions) do not apply to taxable asset sales.

- ▶ Shareholder-level FSI from equity method or fair value method accounting would be disregarded, although amounts resulting from remeasurement would be respected if resulting from covered recognition transactions
- ▶ Purchase accounting and pushdown accounting resulting from the stock purchase by an acquiror corporation would generally be disregarded, whereas, for asset purchases, these items would only be disregarded for a covered nonrecognition transaction
- ▶ The CAMT basis of stock in a corporation held by an entity would equal the adjusted basis of the stock for regular tax purposes as of the beginning of the entity's first tax year beginning after December 31, 2019, taking into account all subsequent adjustments required under Prop. Reg. Section 1.56A-18 and §1.56A-19

4. CAMT treatment of certain corporate reorganizations and organizations (Prop. Reg. Section 1.56A-19)

Prop. Reg. Section 1.56A-19 would provide rules on a transaction-specific basis (like Prop. Reg. Section 1.56A-18) but would focus primarily on incorporating subchapter C principles into the CAMT system under IRC Section 56A(c)(15)(B) and not focus on the FSI adjustment rules of IRC Section 56A(c)(2)(C). As previously described, covered nonrecognition transactions generally implement a replacement of the AFS results with regular tax results (albeit with CAMT inputs such as CAMT basis), and covered recognition transactions generally follow the AFS results (albeit with CAMT inputs such as CAMT basis). Following these approaches are the transactions specifically identified in Prop. Reg. Section 1.56A-19, which include IRC Section 368(a)(1)(B) reorganizations, acquisitive reorganizations other than under IRC Section 368(a)(1)(B), IRC Section 355 distributions, IRC Sections 368(a)(1)(E) and (F) single-party reorganizations,¹² and IRC Section 351 exchanges.

B reorganizations. Prop. Reg. Section 1.56A-19(b) would create rules for reorganizations under IRC Section 368(a)(1)(B) (a “B reorganization”) that are consistent in their treatment of the parties to covered nonrecognition treatment transactions previously described, as well as special rules for triangular B reorganizations and “busted” B reorganizations.¹³

Acquisitive reorganizations. Prop. Reg. Section 1.56A-19(c) addresses the parties involved in an acquisitive reorganization under IRC Sections 368(a)(1)(A), (C) and (D). Keeping with the treatment of nonrecognition B reorganizations discussed previously, these rules would be consistent in their treatment of the parties to covered nonrecognition treatment transactions. In addition, the proposed regulations would create special rules for triangular acquisitive reorganizations and “busted” acquisitive reorganizations. Further, as an acknowledgement of the “cliff effect,” a target corporation recognizing gain on the distribution of non-qualified property under IRC Section 361(c)(2) would lose the covered nonrecognition transaction status it otherwise would enjoy on the qualified property distributed under IRC Section 361(c)(1).¹⁴

¹² Rules for IRC Sections 368(a)(1)(E) and (F) reorganizations are in Prop. Reg. Sections 1.56A-19(e) and (f), respectively.

¹³ See, e.g., Prop. Reg. Sections 1.56A-19(b)(2) and (b)(4).

¹⁴ See Prop. Reg. Section 1.56A-19(c)(2).

Example - IRC Section 368(a)(1)(A) reorganization (covered nonrecognition transaction). During the tax year, Target, whose stock is wholly owned by X, merges with and into Acquiror in a transaction that qualifies as an IRC Section 368(a)(1)(A) reorganization. In the merger, X receives solely Acquiror stock with a fair market value of \$100x. At the time of Target's merger into Acquiror, Target's assets have a CAMT basis of \$15x and a value of \$30x, Target has \$10x CAMT retained earnings, and X has \$40x of CAMT basis in its Target stock.

Acquiror's acquisition of Target's assets would be a covered nonrecognition transaction. In computing AFSI resulting from the transaction, Target would disregard any FSI reflected in its AFS resulting from the exchange of its assets for the Acquiror stock.

Acquiror would disregard any FSI reflected in its AFS resulting from the exchange of its stock for Target's assets, and instead apply IRC Section 1032(a). Acquiror would take the Target assets with a CAMT basis of \$15x. Acquiror would adjust its CAMT retained earnings to reflect Target's \$10x CAMT retained earnings.

X would disregard any FSI resulting from the exchange of its Target stock for Acquiror stock. X would take the Acquiror stock with a \$40x CAMT basis.¹⁵

Divisive transactions under IRC Section 355. The proposed regulations would confirm that a spin-off or split-off that qualifies as entirely tax-free to the distributing corporation (Distributing) under the regular tax rules (i.e., IRC Sections 355, 357, 361 and 368(a)(1)(D)) would not give rise to AFSI to Distributing or the controlled corporation (SpinCo). In such a covered nonrecognition transaction, regular tax rules (i.e., IRC Sections 358 and 362) would apply to determine the CAMT basis that Distributing and SpinCo have in any property received from the other party, except those amounts would be determined using Distributing's CAMT basis in the property transferred to SpinCo. Similarly, regular tax rules (i.e., IRC section 312) would apply to adjust Distributing and SpinCo's CAMT earnings.

By contrast, if Distributing were to recognize any amount either on a transfer of property to SpinCo or on a distribution (i.e., a covered recognition transaction), Distributing would have to take into account any FSI gain or loss resulting from such transfer. Further, if SpinCo were to transfer any money or property other than SpinCo stock to Distributing, unless Distributing distributes or transfers all of the money or other property in a transaction that qualifies as fully tax-free to Distributing, SpinCo would have to take into account any FSI resulting from the transaction (i.e., this exchange would also be a covered recognition transaction to SpinCo). The amount of FSI gain or loss taken into account under these rules would be redetermined using CAMT basis rather than AFS basis. In addition, Distributing and SpinCo would determine their CAMT basis in any property received from the other party based on such corporation's AFS basis in that property, and would determine their CAMT earnings based on such corporation's AFSI taken into account under these rules.

¹⁵ See Prop. Reg. Section 1.56A-19(c)(8)(i), Ex. 1. For an illustration of the impact of *boot* on the transaction, see Prop. Reg. Section 1.56A-19(c)(8)(ii), Ex. 2.

The proposed regulations include an example illustrating that, if Distributing distributes only 90% of the SpinCo stock, under rules applicable to ownership of domestic stock investments, Distributing would disregard any FSI reflected in its AFS resulting from any mark-to-market of the fair value of the retained SpinCo stock.¹⁶

If a CAMT entity were to receive SpinCo stock or securities (or money or other property treated as “boot” in the transaction) as a Distributing shareholder or security holder, regular tax rules generally would apply to determine its AFSI and basis consequences, except that such amounts would be determined using the distribution amount reflected in AFS (other than with respect to Distributing stock), CAMT basis and CAMT earnings.¹⁷ The consequences to such Distributing shareholder or security holder would not depend on whether the transaction is a covered nonrecognition transaction or a covered recognition transaction.

Additional rules would apply, and could change the consequences described previously for (1) certain cross-border spin-off and split-off transactions, and (2) distributions for which an IRC Section 336(e) election is made. Finally, the definitions of a “distributing corporation” and a “controlled corporation” in the proposed regulations differ depending on whether the transaction is a covered nonrecognition transaction (in which case the regular-tax-rule meanings would apply) or a covered recognition transaction (in which case, the definitions would depend on which party is treated as distributing the stock of the other party on its AFS).¹⁸

Corporate organizations under IRC Section 351. Prop. Reg. Section 1.56A-19(g) contemplates IRC Section 351 transactions, including those involving a dual classification when there is both a covered nonrecognition transaction and a covered recognition transaction. The proposed regulations are consistent in their treatment of the parties to covered nonrecognition treatment transactions (IRC Section 351(a)) and covered recognition transactions (IRC Section 351(b)) as discussed previously.

Example - IRC Section 351(b) (covered recognition transaction). Acquiror transfers assets with a CAMT basis of \$40x and a fair market value of \$90x to newly formed Target in an IRC Section 351 exchange (the Exchange). Acquiror receives \$10x of cash in addition to \$80x of Target stock in the Exchange. On its AFS, Acquiror recognizes \$50x of FSI on the Exchange (\$90x - \$40x).

The Exchange is a covered recognition transaction to Acquiror and Target.¹⁹ Acquiror would disregard any FSI resulting from the Exchange reflected in its AFS and instead redetermine its AFSI by computing any gain or loss using its CAMT basis in the assets transferred to Target, or \$50x (\$90x - \$40x). Acquiror's CAMT basis in the Target stock received would be its AFS basis, or \$80x. Acquiror would adjust its CAMT retained earnings by the amount of AFSI resulting from the Exchange, or \$50x.

¹⁶ Prop. Reg. Section 1.56A-19(d)(6), Ex. 3.

¹⁷ Prop. Reg. Section 1.56A-19(d)(3).

¹⁸ Prop. Reg. Section 1.56A-18(b)(7), (12).

Target would disregard any FSI resulting from the Exchange and instead determine AFSI using CAMT basis, or \$90x. Target would determine its CAMT basis using its AFS basis in the property, or \$90x. Target would adjust its CAMT retained earnings by the amount of AFSI recognized on the Exchange, or \$90x, reduced by the \$10x cash distributed.²⁰

Observations: Overall, Prop. Reg. Sections 1.56A-18 and 1.56A-19 provide much needed clarity to the initial rules introduced in Notice 2023-7. The consistent underlying theory with respect to IRC Sections 56A(c)(2)(C) and 56A(c)(15)(B) enhances taxpayers' ability to predict the correct treatment under the rules. Moreover, certain glitches that made applying the rules of Notice 2023-7 difficult in even some ordinary situations appear to have been addressed in the proposed regulations. However, they continue the unfavorable "cliff-effect" approach of Notice 2023-7 in that partial recognition transactions would be fully precluded from being treated as a covered nonrecognition transaction.

The further refinements of Notice 2023-7 will be a mixed bag for some taxpayers. For instance, eliminating the purchase accounting and pushdown accounting consequences in stock acquisitions will be unwelcome in many quarters. The transition rule under which regular stock basis in place after December 31, 2019, is used as a starting point for CAMT, however, will undoubtedly be a welcome relief from the possibility of having to determine a CAMT stock basis all the way back to the time of its original acquisition.

¹⁹ This result helps illustrate the "cliff effect" referenced previously. In the overall scheme of the transaction, the \$10x consideration is not particularly large, but it is enough to prevent a covered nonrecognition transaction.

²⁰ See Prop. Reg. Section 1.56A-19(g)(6)(ii), Ex. 2.

H. Adjustments for financial statement NOLs (Prop. Reg. Sections 1.56A-22 and -23)

Under IRC Section 56A(d)(1), AFSI is reduced by the lesser of:

- ▶ The aggregate amount of financial statement net operating loss (FSNOL) carryovers to the tax year²¹ or
- ▶ 80% of AFSI computed without regard to the FSNOL deduction allowable under IRC Section 56A(d)

Prop. Reg. Section 1.56A-23 would replicate this general rule and provide detailed requirements on the utilization (and limitations on the utilization) of the FSNOL.²² Importantly, these rules would apply even before a corporation becomes an applicable corporation, meaning that the computation and limitation rules would apply to determine the amount and usage of an FSNOL before the FSNOL becoming relevant.²³ This is necessary so the FSNOL that is ultimately carried into a tax year in which the corporation is an applicable corporation is appropriately sized.

1. General utilization of FSNOLs

Taxpayers reduce AFSI in a tax year by the FSNOL carryovers to that year, and these rules generally draw from the principles pertaining to net operating losses under IRC Section 172.

The term “FSNOL” means, for a corporation with a tax year ending after December 31, 2019, the amount of the corporation's negative AFSI for the tax year (determined after applying the IRC Section 56A regulations and without regard to the FSNOL rules of Prop. Reg. Section 1.56A-23).²⁴ FSNOL carryovers used to reduce a corporation's AFSI under Prop. Reg. Section 1.56A-23(c) would be used in the order of the tax years in which the FSNOLs arose and reduced to the extent previously absorbed.²⁵

²¹ An FSNOL for any tax year (including a tax year in which the corporation is not an applicable corporation) is carried forward to each tax year following the tax year of the loss. See Prop. Reg. Section 1.56A-23(d)(1).

²² Prop. Reg. Section 1.56A-23 would apply to tax years ending after the date the final regulations are published. See Prop. Reg. Section 1.56A-23(g).

²³ See Prop. Reg. Section 1.56A-23(d).

²⁴ See Prop. Reg. Section 1.56A-23(b). As discussed later, in certain instances, a built-in loss of the corporation may be treated as an FSNOL.

²⁵ See Prop. Reg. Section 1.56A-23(d)(1).

2. Limitation: Acquired FSNOLs

Under Prop. Reg. Section 1.56A-23(e), if a corporation or a tax consolidated group (“successor,” “successor corporation”²⁶ or “successor group,” respectively) succeeds to the FSNOL carryovers (acquired FSNOLs) of another corporation (predecessor corporation) in a successor transaction,²⁷ the use of the acquired FSNOLs by the successor would be subject to the limitation described in Prop. Reg. Section 1.56A-23(e)(3).

The limitation would allow using acquired FSNOLs to reduce the AFSI of a successor only if the business that generated the acquired FSNOLs (predecessor business) is separately tracked in the successor's books and records (separately tracked business), and only to the extent of the positive AFSI generated by the separately tracked business after the successor transaction (separately tracked income), subject to the 80% limitation in IRC Section 56A(d).²⁸ The process for this separate tracking, which may be challenging in some cases, is laid out in Prop. Reg. Section 1.56A-23(e)(3)(ii). Except to the extent provided with respect to the treatment of built-in losses under Prop. Reg. Section 1.56A-23(f), the rules of IRC Section 382 do not apply to acquired FSNOLs for CAMT purposes.

Because of the importance of tracking the post-acquisition performance of the specific underlying business, special rules address tracking in the event of certain business-affecting transactions that occur subsequent to the successor transaction.²⁹

²⁶ For a stock acquisition, the acquired corporation itself would be treated as the successor. See Prop. Reg. Section 1.56A-23(e)(1)(i).

²⁷ The term “successor transaction” generally means a transaction under IRC Section 381(a), a transaction that constitutes an ownership change within the meaning of Prop. Reg. Section 1.59-2(f) or a transaction in which the predecessor corporation joins a tax consolidated group. See Prop. Reg. Section 1.56A-23(e)(2).

²⁸ See Prop. Reg. Section 1.56A-23(e)(3)(i). This limitation is modeled after the SRLY rules of the consolidated return regulations, including a register concept. See, e.g., Treas. Reg. Section 1.1502-21(c).

²⁹ See Prop. Reg. Section 1.56A-23(e)(3)(ii)(A) (business separated from the FSNOL, such as dropping the business in an IRC Section 351 transfer); Prop. Reg. Section 1.56A-23(e)(3)(iii)(B) (transfers within a tax consolidated group); Prop. Reg. Section 1.56A-23(e)(3)(iv) (combination of business with other businesses); Prop. Reg. Section 1.56A-23(e)(3)(v) (multiple predecessor businesses).

Example - Acquired FSNOL utilization and carryforward. Acquiror purchases all of Target's stock for cash (Acquisition) on December 31, 2023. At the time of the Acquisition, Target operates Business X, and Target has a \$200x FSNOL. Target has no other separately tracked businesses. Following the Acquisition, Acquiror contributes assets to Target to expand Business X (Expansion). Following the Expansion, Business X (including the contributed assets) is separately tracked in Target's books and records. In 2024, Business X has separately tracked income of \$25x.

The Acquisition would be a successor transaction. Target is treated as the successor after the Acquisition. Because Business X is a separately tracked business, the tracked register at the end of 2024 is \$25x. Accordingly, \$25x of the \$200x FSNOL can be applied against the \$25x of tracked income for the year, subject to the 80% limitation. As a result, Target may deduct \$20x (80% of \$25x) of the acquired FSNOL in 2024, and the tracked register is reduced to \$0x. The remaining \$180x of acquired FSNOL (\$200x - \$20x) is carried forward to 2025.³⁰

3. Limitation: Built-In losses treated as FSNOLs

Under Prop. Reg. Section 1.56A-23(e), if a corporation or a tax consolidated group ("successor," Under Prop. Reg. Section 1.56A-23(f), the loss limitation under Prop. Reg. Section 1.56A-23(e) would apply to using built-in losses recognized for AFSI purposes following the successor transaction,³¹ provided that the predecessor corporation has a CAMT net unrealized built-in loss immediately before the successor transaction.³²

The term "built-in losses" includes all losses of a separately tracked business that are recognized for AFSI purposes during the five-year period beginning on the date of the successor transaction, except to the extent the successor establishes that the asset at issue was not held by the predecessor corporation immediately before the successor transaction or that the loss exceeds the loss in the asset as of the date of the successor transaction.³³

Because of the importance of separate tracking under Prop. Reg. Section 1.56A-23(e) (to which the built-in losses under Prop. Reg. Section 1.56A-23(f) are subject), Prop. Reg. Section 1.56A-23(f)(2)(iii) would treat every built-in loss as allocable to the separately tracked acquired business with which it was associated immediately before the successor transaction.

³⁰ See Prop. Reg. Section 1.56A-23(e)(4)(i), Ex. 1.

³¹ For this purpose, the built-in loss is treated as an acquired FSNOL, with the usable amount of built-in loss being absorbed prior to any acquired FSNOL. See Prop. Reg. Section 1.56A-23(f)(2). Any unabsorbed built-in loss is treated as a separate FSNOL carryforward from the period preceding the successor transaction.

³² For rules describing the determination of a built-in loss (which depends in part on whether the successor transaction results in an ownership change under IRC Section 382 for regular tax purposes), see Prop. Reg. Section 1.56A-23(f)(4).

³³ See Prop. Reg. Section 1.56A-23(f)(3)(i). Note that a loss that is recognized but **disallowed** or **deferred** for AFSI purposes is not treated as a built-in loss unless and until the loss would be allowed to be taken into AFSI without regard to the application of Prop. Reg. Section 1.56A-23(f).

Example – *Application of Prop. Reg. Section 1.56A-23(e) to built-in loss.* Target and Acquiror are unrelated domestic corporations, each of which uses the calendar year as its tax year. Target merges with and into Acquiror in a successor transaction (the Merger). At the time of the Merger, Target holds two assets that are used in the same business. Asset 1 has an unrealized loss for AFSI purposes of \$55x (CAMT basis \$75x, value \$20x (i.e., a -\$55x built-in loss)), and Asset 2 has an unrealized gain for AFSI purposes of \$20x (CAMT basis \$30x, value \$50x (i.e., a \$20x built-in gain)). Target has no other income or expense items that would be treated as built-in items.

Computed using CAMT basis, Target has a \$35x net unrealized built-in loss at the time of the Merger ($-\$55x + \$20x = -\$35x$).

The entire \$55x of unrealized loss (and not just the \$35x net unrealized loss) would be treated under Prop. Reg. Section 1.56A-23(f)(2) and (3) as a built-in loss to the extent it is recognized within five years of the Merger. Under Prop. Reg. Section 1.56A-23(e)(1), this \$55x built-in loss would be subject to limitation under Prop. Reg. Section 1.56A-23(e)(3).³⁴

Observations: The decision generally not to impose the IRC Section 382 loss limitation rules on FSNOLs is a significant victory for administrability for both taxpayers and the government. Nevertheless, the limitation rules of Prop. Reg. Section 1.56A-23(e) and (f) are likely to be challenging for many taxpayers. For example, tracking the performance of a very specific business that may be integrated could represent a significant undertaking. Further, tracking the amount of built-in loss on specific assets could present challenges (e.g., if the taxpayer's books and records are not that granular in their presentation).

I. AFSI adjustments for related party and avoidance transactions (Prop. Reg. Section 1.56A-26)

Prop. Reg. Section 1.56A-26 would introduce three new concepts to the CAMT system through rules that address related party transactions, purposeful avoidance arrangements and IRC Section 482 principles.³⁵ These proposed regulations serve as a backstop to the rest of the CAMT rules, so CAMT liability is not improperly reduced.

First, concerning related party transactions, if AFSI (as determined after applying all other sections of the IRC Section 56A regulations) reflects a loss resulting from a sale, exchange or any other disposition of property (including stock) between an entity and one or more entities that are part of that entity's CAMT-related group, that loss would be deferred for AFSI purposes until no member of that entity's CAMT-related group holds that property (in whole or in part).³⁶ The term "CAMT-related group" means any two or more entities that are treated as a single employer under IRC Section 52(a) and (b). This proposed rule

³⁴ Prop. Reg. Section 1.56A-23(f)(5), Example.

³⁵ Prop. Reg. Section 1.56A-26 applies to tax years ending after September 13, 2024. Prop. Reg. Section 1.56A-26(e).

³⁶ See Prop. Reg. Section 1.56A-26(b)(2).

seems to borrow its basic concept from IRC Section 267(f), which similarly defers losses from related party transactions until the asset ceases to be held or the parties cease to be related.

Second, concerning affirmative planning around the CAMT rules, arrangements entered into with a principal purpose of avoiding the application of the CAMT rules under IRC Sections 55 through 59, the IRC Section 56A regulations, or Prop. Reg. Sections 1.59-2 through 1.59-4, including avoiding treatment as an applicable corporation or reducing or otherwise avoiding a liability under IRC Section 55(a), may be disregarded or recharacterized by the Commissioner to the extent necessary to carry out the purposes of the CAMT, the IRC Section 56A regulations, and Prop. Reg. Sections 1.59-2 through 1.59-4.³⁷

Third, for purposes of determining AFSI, if any item of income, expense, gain or loss reflected in the FSI with respect to a controlled transaction or controlled transfer (as defined in Treas. Reg. Section 1.482-1(i)(8)) between two or more entities does not reflect the principles of IRC Section 482 and its regulations, then the entity must make appropriate adjustments to CAMT basis to reflect these principles (regardless of whether IRC Section 482 is otherwise considered to apply).³⁸

Example - Application of IRC Section 482 principles. X is a domestic corporation that owns all the stock of FC, a CFC. FC's functional currency is the US dollar. X's and FC's financial results are consolidated in the financial statement included with X's Form 10-K, filed with the SEC and prepared using GAAP, and which serves as both X's and FC's AFS. On July 1, FC sells to X self-created intangible property with a zero AFS basis in the financial accounts of FC, a zero CAMT basis and a zero basis for regular tax purposes on the date of transfer. GAAP measures the transferred intangible property at the carrying value of the intangible property in the accounts of FC on the date of the transfer. No gain is reflected in the AFS for the transfer of the intangible property. Under the arm's length standard in the IRC Section 482 regulations, the arm's length sale price of the intangible property at the time of transfer is \$10x.

The sale of the self-created intangible property by FC to X is a controlled transaction or controlled transfer under Treas. Reg. Section 1.482-1(i)(8). Under Prop. Reg. Section 1.56A-26(d)(1), X's AFSI with respect to the sale would be adjusted to reflect the arm's length price at the time of the sale, or \$10x, rather than the \$0 properly shown for financial accounting purposes. Accordingly, FC would recognize a gain of \$10x, and X's AFSI would be increased by its pro rata share, or 100%, of the additional FC income. Going forward, under Prop. Reg. Section 1.56-26(d)(2), X's CAMT basis in the intangible property would be appropriately adjusted to reflect the \$10x that X is treated as paying for the intangible property.³⁹

³⁷ See Prop. Reg. Section 1.56A-26(c).

³⁸ See Prop. Reg. Section 1.56A-26(d)(1). Note that the reference to "CAMT basis" reflects what appears to be a typographical error and should instead refer to a broader mechanism (e.g., AFSI) for arriving at the IRC Section 482-mandated result.

³⁹ See Prop. Reg. Section 1.56A-26(d)(3).

Observations: Although very brief and not prominently presented within the Proposed Regulations, Prop. Reg. Section 1.56A-26 may end up having an outsized impact. In particular, Prop. Reg. Section 1.56A-26(c) could end up being applied with some frequency given its very low testing threshold of “a” principal purpose standard (as opposed to, e.g., “the” principal purpose standard, such as in IRC Section 269(a)), coupled with the apparent lack of restraining rules on the government’s power and discretion to “disregard” or “recharacterize” a transaction. Further, the IRC Section 482-inspired rule in Prop. Treas. Reg. Section 1.56A-26(d) may have broad application given the frequency with which items in a taxpayer’s FSI may deviate from fair value (e.g., certain situations in which the financial accounting rules record no income, gain, loss, or deduction with respect to transactions within the AFS group).

J. AFSI adjustments for troubled companies (Prop. Reg. Section 1.56A-21)

Prop. Reg. Section 1.56A-21 would contain rules for determining AFSI for a financially distressed CAMT entity. The financial accounting rules generally require the recognition of financial statement gain upon debt discharge. The proposed regulations would modify the financial accounting rules by incorporating rules similar to those for discharge of debt set forth in IRC Sections 108 and 1017.

1. Financial accounting rules for troubled companies

The following is a general overview of some of the salient financial accounting rules for troubled companies.

As under IRC Section 61(a)(11), financial accounting principles generally require debtors to recognize gain on debt discharges. If debts are extinguished, GAAP requires gain to be recognized on the difference between the price at which the debt is satisfied and the carrying value of the debt. See ASC 470-50-40-2. Outside of bankruptcy, troubled companies recognize gain for financial accounting purposes upon the satisfaction of debt to the extent that the carrying value of the debt exceeds the fair value of the assets transferred to the creditor in satisfaction of the debt. See ASC 470-60-35-1. If a company enters bankruptcy, the carrying value of pre-petition debt is adjusted to the probable amount of the allowed claims for the debt, and gain is recognized in cases in which the former is higher than the latter. See ASC 852-10-45-6 and 852-10-45-9. (There is no corresponding income inclusion under [IRC S]ection 61 to be excluded under [IRC S]ection 108 because no realization event has occurred.) When liabilities subsequently are settled in accordance with the plan of reorganization approved by the bankruptcy court, the difference between the fair value of the consideration a creditor receives and the allowed claim of the debt is recognized in the income statement. See ASC 405-20-40-1.⁴⁰

⁴⁰ Preamble to Reg-112129-23, pages 151-152

GAAP requires companies that are emerging from bankruptcy to use "fresh-start accounting," which effectively treats the company as if it were a new entity acquiring the bankrupt company's assets.⁴¹ Assets are adjusted to their fair value, with any resulting gain or loss reflected in the financial statements. If liabilities are settled for amounts different from those recorded in the company's books, they result in a gain or loss. Additionally, any retained earnings in a bankrupt company's books are removed upon emergence.

2. Determining the AFSI of a bankrupt or insolvent CAMT entity (Prop. Reg. Section 1.56A-21)

If AFSI is not adjusted for income from debt discharges and fresh-start accounting, financially troubled companies may incur extra tax liabilities under the CAMT, which could obstruct their path to solvency or hinder their emergence from bankruptcy. Prop. Reg. Section 1.56A-21 would modify the rules for determining the AFSI of a bankrupt or insolvent CAMT entity. In addition, the proposed regulations would include rules for determining AFSI on the receipt of federal financial assistance (within the meaning of IRC Section 597(c) and Treas. Reg. Section 1.597-1(b)).

Bankrupt and insolvent CAMT entities. Similar to the bankruptcy exclusion set forth in IRC Section 108(a), Prop. Reg. Section 1.56A-21(c)(1) would exclude from AFSI any income resulting from the discharge of debt of CAMT entities involved in a Title 11 bankruptcy case, whether arising from the cancellation or modification of a debt instrument. Similarly, under Prop. Reg. Section 1.56A-21(c)(2), any income resulting from the discharge of debt of an insolvent⁴² CAMT entity outside of bankruptcy would be excluded from AFSI in an amount equal to the lesser of the discharge of debt and the amount by which the CAMT entity is insolvent. The extent to which a CAMT entity is insolvent would be determined based on the CAMT entity's assets and liabilities (for regular tax purposes) immediately before the discharge.⁴³ If the existence of the CAMT entity is disregarded for US federal income tax purposes, these rules would apply only to the extent the CAMT entity's owner is in bankruptcy or is insolvent.⁴⁴

Attribute reduction. Prop. Reg. Section 1.56A-21(c)(4) and (5) would require a bankrupt or insolvent CAMT entity that excludes income from the discharge of debt to reduce certain attributes. In general, the proposed regulations would require a bankrupt or insolvent CAMT entity to reduce the following CAMT attributes (but not below zero) in the following order: (1) the CAMT basis of covered property,⁴⁵ but only to the extent the basis of the covered property is reduced by the CAMT entity under IRC Section 108 for regular tax purposes; (2) FSNOLs; (3) CFC adjustment carryovers; (4) the CAMT basis of property (other than covered property) that is depreciated or amortized for AFS purposes; (5) the CAMT basis of property (other than covered property) that is not depreciated or amortized for AFS purposes; (6) CAMT

⁴¹ See ASC 852-10-45-21

⁴² "Insolvent" would have the same meaning as that set forth in IRC Section 108(d) (insolvent means the excess of liabilities over the fair market value of assets). Prop. Reg. Section 1.56A-21(b)(6)(i).

⁴³ See Prop. Reg. Section 1.56A-21(b)(6)(ii).

⁴⁴ See Prop. Reg. Section 1.56A-21(c)(3)(i)-(ii). See also Treas. Reg. Section 1.108-9.

⁴⁵ The term "covered property" means "IRC Section 168 property," qualified wireless spectrum, and property whose regular tax basis is determined under Section 21(c) of the ANCSA. Prop. Reg. Section 1.56A-21(b)(2).

foreign tax credits; and (7) any remaining CAMT basis of covered property.

The basis reduction in CAMT property would be allocated among the individual items of property in accordance with the ordering rules in Treas. Reg. Section 1.1017-1(c).⁴⁶ Basis reductions would be made in the property the CAMT entity holds on the first day of the tax year following the year of discharge.⁴⁷

The bankrupt or insolvent CAMT entity would reduce the CAMT attributes after the determination of the tentative minimum tax under IRC Section 55(b)(2)(A) of the CAMT entity's tax year of discharge. In general, the CAMT attributes would be reduced by one dollar for each dollar of excluded discharge of debt income under Prop. Reg. Section 1.56A-21(c)(1)(i) and (c)(2)(i), subject to certain limitations for basis reductions.⁴⁸ CAMT FTCs, however, would be reduced under a conversion formula that takes into account the differing economic values of deductions and credits.⁴⁹

The rule limiting CAMT basis reduction in basis in covered property to the extent of basis reduction under IRC Section 108(b) (i.e., the "proposed prioritization rule") addresses concerns expressed by commentators regarding a double detriment. The double detriment would arise because AFSI is calculated using regular tax depreciation on IRC Section 168 Property, as specified in IRC Section 56A(c)(13) and Prop. Reg. Section 1.56A-15. Decreasing the depreciable basis for regular tax purposes not only increases future regular taxable income but also raises future AFSI since the basis eligible for depreciation is no longer available. Consequently, if CAMT entities are required to reduce CAMT attributes other than the depreciable basis after already reducing the regular tax depreciable basis, their future AFSI would increase by \$2 for every \$1 of excluded income of discharge of debt.

Prop. Reg. Section 1.56A-21(c)(4)(ii)(B) would limit the CAMT attribute reduction to the amount of CAMT attributes subject to reduction. This represents a change from the rule set forth Section 3.06(2) of Notice 2023-7, which limited the amount of reduction in CAMT attributes to the amount of tax attributes reduced under IRC Section 108(b). Commentators recommended this change because CAMT attributes are separate and are determined differently from the regular tax attributes subject to reduction under IRC Section 108(b).

Exclusion of income from fresh-start accounting. Under Prop. Reg. Section 1.56A-21(d), any gain or loss included in financial statement income as a result of a CAMT entity's emergence from bankruptcy would be excluded. In addition, corresponding adjustments to CAMT basis and earnings would be made to remove the financial accounting effects of this gain or loss. Prop. Reg. Section 1.56A-21(d)(2)(ii) would further provide that a CAMT entity should use the rules in Prop. Reg. Section 1.56A-21(c) to determine the treatment of a debt discharge. For an emergence from bankruptcy that involves a covered transaction, Prop. Reg. Section 1.56A-21(d)(2)(iii) and (d)(3) would require the rules in Prop. Reg. Sections 1.56A-18 and 1.56A-19 to apply.

Investments in partnerships. Consistent with IRC Section 108(d)(6) and Treas. Reg. Section 1.108-9(b), the proposed regulations would require the AFSI exclusions for discharge of debt income in the case of bankruptcy or insolvency to be made at the partner level.⁵⁰ Similarly, the reduction of CAMT attributes

⁴⁶ See Prop. Reg. Section 1.56A-21(c)(4)(iv)(C).

⁴⁷ See Prop. Reg. Section 1.56A-21(c)(4)(iv)(B).

⁴⁸ See Prop. Reg. Section 1.56A-21(c)(5)(i), (ii).

⁴⁹ See Prop. Reg. Section 1.56A-21(c)(5)(iv).

⁵⁰ See Prop. Reg. Section 1.56A-21(e)(2)(ii).

would be made at the partner level.⁵¹ The proposed regulations would include special rules for treating investments in partnerships as covered property for purposes of the attribute reduction rules.⁵²

Federal financial assistance. Federal financial assistance (within the meaning of IRC Section 597(c) and Treas. Reg. Section 1.597-1(b)) may arise in the context of an acquisition of a troubled financial institution. Prop. Reg. Section 1.56A-21(f) would include adjustments to AFSI, so that any financial accounting gain attributable to federal financial assistance would not be included in income any earlier than when the gain is included in gross income for purposes of IRC Section 597 and the regulations thereunder.

Observations: Prop. Reg. Section 1.56A-21 provides helpful guidance regarding the treatment of discharge of debt realized by a CAMT entity. Because the proposed regulations rely heavily on the treatment of discharge of debt under IRC Section 108 and 1017, it will be important for a CAMT entity to determine the tax consequences of its regular tax discharge of debt income.

K. Insurance & specified industries (Prop. Reg. Section 1.56A-22)

Prop. Reg. Section 1.56A-22 would address rules under IRC Section 56A regarding insurance companies and other specified industries. The proposed regulations would leave largely intact the interim guidance on AFSI adjustments for covered variable contracts, AFSI adjustments for covered reinsurance agreements, and AFSI determinations regarding congressional “fresh start” provisions in Notice 2023-20, released on February 17, 2023.

The proposed regulations would include a slight mechanical change to the treatment of AFSI adjustments for covered variable contracts. Under that change, the IRC Section 56A(c)(2)(C) & (D) exclusions would not apply to gains or losses on assets supporting those contracts to the extent that (1) the gains and losses would change the obligations to the contract holders; and (2) the change would be included in the insurance company’s FSI. This compares to Notice 2023-20, which provides for a separate exclusion for the change in liability to the extent it relates to unrealized gain/loss on underlying assets that are also excluded from AFSI, in addition to the IRC Section 56A(c)(2)(C) & (D) exclusion. The revised solution in Prop. Reg. Section 1.56A-22(c)(1) would be more administrable and less prone to error. Additionally, the definition of covered variable contracts has been broadened within Prop. Reg. Section 1.56A-22(b)(5).

The proposed regulations are consistent with Notice 2023-20’s provisions on covered reinsurance agreements and congressional “fresh start” provisions, which provide for conformity in AFSI for certain adjustments that economically offset but are recorded separately in AFS (e.g., account for through OCI or net income) and a step-up in asset basis used in calculating AFSI, similar to the step-up received at the congressionally authorized “fresh start” date.

Observations: Given Prop. Reg. Section 1.56A-22 largely aligns with Notice 2023-20, these regulations should continue to be a welcome development for companies in the insurance industry to help ameliorate some unintended adverse consequences facing many insurers in the application of CAMT.

⁵¹ See *id.*

⁵² See Prop. Reg. Section 1.56A-21(e)(2)(ii)(B).

L. Depreciation issues and AFSI adjustments for IRC Section 168 property and wireless spectrum property (Prop. Reg. Sections 1.56A-15 and -16)

1. IRC Section 168 property

IRC Section 56A(c)(13) requires taxpayers to adjust AFSI to take into account regular tax depreciation deductions for IRC Section 168 property and disregard book depreciation and other items (as specified by the Treasury Department) for that property. Prop. Reg. Section 1.56A-15 generally would follow the interim guidance in Notice 2023-7 and Notice 2023-64 regarding AFSI adjustments for IRC Section 168 property but would add more adjustments and clarify certain aspects of the interim guidance. At a high-level, the proposed regulations seemingly attempt to mirror the regular tax treatment of IRC Section 168 property, except in certain disposition transactions in which gain is not recognized or deferred.

Observations: The proposed regulations do not provide any relief for entities that are required to account for IRC Section 168 property on a mark-to-market basis in their AFS. Although the proposed regulations do not explicitly address this issue, they appear to require those entities to disregard any mark-to-market losses but regard (that is, not adjust) any mark-to-market gains (with the gains giving rise to additional CAMT basis in the IRC Section 168 property that can be used to reduce future realized gains). Those entities, however, would be entitled to reduce AFSI by any regular tax depreciation deductions related to that property.

The Preamble to the proposed regulations explains that the proposed regulations' stated goal is for IRC Section 56A(c)(13) not to provide taxpayers with a better result for AFSI than for regular tax purposes. Accordingly, the proposed regulations would require AFSI adjustments for all IRC Section 168 property, regardless of when placed in service, and exclude as an AFSI adjustment tax deductible expenditures with respect to IRC Section 168 property (e.g., tax deductible repairs that are capitalized and depreciated on an AFS) because those amounts are not depreciable under IRC Section 168.

Observations: The Preamble to the proposed regulations stated that the Treasury Department and IRS are continuing to study this issue in light of comments received. Specifically, commentators stated that including tax deductions that are depreciated on an AFS simplifies the AFSI computation and reduces the compliance burden on taxpayers. Commentators also stated that certain industries (e.g., regulated utilities) are subject to industry-specific GAAP or IFRS rules that increase the disparity between the amount of repair expenditures expensed for AFS purposes compared to the deductible repair expenditures for regular tax purposes and, therefore, those industries have increased AFSI amounts. Given that Treasury and the IRS are continuing to look at this issue, taxpayers may want to consider submitting comments to assist the Treasury Department and the IRS with considering these issues.

The proposed regulations would expand the interpretation of “property depreciable under Section 168” to include property depreciable under IRC Section 168 even if the property is not ultimately depreciated under IRC Section 168, but only to the extent of the depreciation allowed under IRC Section 167. This would include IRC Section 168 property that has not yet been placed in service but would be property “depreciable” under IRC Section 168 once placed in service. Under the proposed regulations, the IRC Section 56A(c)(13) adjustment would include property eligible for bonus depreciation, even if the taxpayer elects out of bonus depreciation under IRC Section 168(k). The proposed regulations also would clarify that the adjustments under IRC Section 56A(c)(13) apply only to the portion of the cost of property depreciable under IRC Sections 167 and 168, and not the portion deductible under IRC Section 181 or recovered under any other section of the Code.

With respect to the treatment of dispositions, the proposed regulations generally would follow the adjustments described in the interim guidance but would add to the list of adjustments modifications for federal tax credits that reduce the basis of IRC Section 168 property. Specifically, the proposed regulations would include an adjustment to decrease the CAMT basis of IRC Section 168 property upon disposition by any amount allowed as a federal tax credit to the extent an amount reduces the basis of IRC Section 168 property for regular tax purposes. Additionally, the proposed regulations would allow for negative basis of IRC Section 168 property (e.g., where AFSI basis is lower than regular tax basis). The negative amounts would be recognized as AFSI gain when the IRC Section 168 property is disposed of for regular tax purposes.

Although the proposed regulations generally would implement the concepts included in the interim guidance, there are notable additions to AFSI depreciation adjustments (including the definitions) under IRC Section 56A(c)(13) for certain taxpayers to consider. Two of these include IRC Section 481(a) adjustments and simplified methods for identifying IRC Section 168 depreciation amounts included in inventory and cost of goods sold.

While Notice 2023-64 generally only provided for an adjustment to AFSI for IRC Section 481(a) adjustments related to changes in methods for depreciation of IRC Section 168 property, the proposed regulations would provide additional AFSI adjustments for other regular tax accounting method changes involving IRC Section 168 property, including a change from deducting depreciation to capitalizing depreciation under IRC Section 263A, and a change from deducting to capitalizing and depreciating costs as IRC Section 168 property (or vice versa).

Additionally, the proposed regulations would permit taxpayers to use a simplified method for identifying the amount of IRC Section 168 property depreciation that is included in ending inventory at year end. The proposed regulations would establish simplified methods for first in, first out (FIFO) and last in, first out (LIFO) taxpayers. The simplified method calculations for LIFO taxpayers would depend on whether the taxpayer has a LIFO increment or a decrement in its LIFO layers. See Prop. Reg. Section 1.56A-15(d)(3)(ii).

The proposed regulations also would include special rules for applying the depreciation adjustments to IRC Section 168 property held by partnerships. In part, the proposed regulations would clarify that the AFSI adjustment under IRC Section 56A(c)(13) includes amounts resulting from certain basis adjustments under IRC Section 734(b), IRC Section 743(b) and Treas. Reg. Section 1.1017-1(g)(2) that are attributable to IRC Section 168 property held by a partnership.

2. Wireless spectrum property

Prop. Reg. Section 1.56A-16 would use the statutory definition of wireless spectrum property in IRC Section 56A(c)(14). The proposed regulations, however, would expressly clarify that qualified wireless spectrum property excludes wireless spectrum depreciated under a provision other than IRC Section 197 for regular tax purposes. For example, if a foreign corporation—other than a CFC—is not subject to US tax, then any wireless spectrum owned by the foreign corporation is not treated as qualified wireless spectrum. To the extent applicable, the proposed regulations generally would apply the principles and rules for IRC Section 168 property to wireless spectrum property and mirror the regular tax treatment of all qualified wireless spectrum as to the timing and amount of regular tax basis recovery with respect to the qualified wireless spectrum property. This would include provisions for AFSI adjustments for amortization and dispositions.

M. AFSI adjustments for certain tax credits (Prop. Reg. Section 1.56A-12)

IRC Section 56A(c)(9) allows an adjustment to AFSI for amounts related to certain tax credits under IRC Sections 48D and 6417. The proposed regulations are generally consistent with the interim guidance in Notice 2023-7, including permitting the exclusion of certain amounts received from the transfer of certain credits under IRC Section 6418. Prop. Reg. Section 1.56A-12, however, would expand the application of IRC Section 56A(c)(9) to provide rules for the treatment of purchasers of eligible credits for AFSI treatment. These new rules would mirror the regular tax treatment of the eligible credits in the regulations under IRC Section 6418 (i.e., no income included in AFSI).

To the extent FSI reflects a decrease for credit recapture under provisions in IRC Sections 48D(d)(5), 50(a)(3), 6417(g), or 6418(g)(3), the proposed regulations would require AFSI to be adjusted to disregard the decrease to FSI if not otherwise disregarded under the IRC Section 56A(c)(5) AFSI adjustment for certain taxes, so that the CAMT treatment is not more advantageous than regular tax treatment.

Observations: The inclusion of purchased eligible credits in the proposed regulations is a helpful addition to ensure CAMT treatment mirrors the potentially favorable regular tax treatment. Because these rules and eligible credits implicate taxes, taxpayers should carefully consider the interaction of the rules in Prop. Reg. Section 1.56A-12 with the adjustment for certain taxes in Prop. Reg. Section 1.56A-8.

N. AFSI adjustments for covered benefit plans (Prop. Reg. Section 1.56A-13)

IRC Section 59A(c)(11) includes an adjustment to AFSI for any “covered benefit plan,” defined as a single employer qualified defined benefit retirement plan under IRC Section 401(a) (commonly referred to as a “pension”), a qualified foreign plan under IRC Section 404A(e), or any other defined benefit plan providing post-employment benefits other than pension benefits. The effect of this adjustment is to give these items their normal US federal income tax treatment.

The proposed regulations would interpret the third type of plan to mean a plan that, under the accounting standards that apply to the AFS, is treated as a defined benefit plan providing post-employment benefits other than pension benefits (commonly referred to as “OPEB” or “retiree medical benefits”).

Observations: The adjustment for covered benefit plans presumably reflects Congress's judgment that the policy preferences underlying the US federal income tax treatment of these plans should be preserved for CAMT purposes rather than giving way to their accounting treatment. In general, this means that the timing of the employer's deductions aligns rather closely with its cash outlays and the employer only recognizes income in the unlikely event that plan assets actually revert to the employer. In contrast, the accounting treatment of these items is determined by actuarial calculations that may not correspond to any actual payments or receipts by the employer in a particular year.

O. AFSI adjustments for hedging transactions and hedged items (Prop. Reg. Section 1.56A-24)

1. Treatment of fair value measurement adjustments for certain AFSI hedges or hedged items (Prop. Reg. Section 1.56A-24(c) and (e)(1) and (2))

As noted in the Preamble, CAMT entities that enter into hedging transactions may have AFS mismatches and distortions due to financial accounting differences between the hedging transaction and the corresponding hedged item. For example, in certain situations, a hedging transaction may be required to be periodically measured at fair value, but the underlying hedged item might not under financial accounting standards. To address the potential mismatches and distortions, Prop. Reg. Section 1.56A-24(c)(2), would require a CAMT entity to disregard a “fair value measurement adjustment”⁵³ for an “AFSI hedge”⁵⁴ or a “hedged item”⁵⁵ for a tax year for purposes of determining the CAMT entity's AFSI, if such fair value measurement adjustment applies to the AFSI hedge but not the hedged item or vice versa. However, the fair value measurement adjustment would not be disregarded if either the AFSI

⁵³ Prop. Reg. Section 1.56A-24(b)(3) would define a “fair value measurement adjustment” as a change in the value of an asset or a liability due to required periodic determinations at least annually of the increases or decreases in the fair value of that asset or liability included in a CAMT entity's FSI, regardless of whether the determinations are required due to the type of asset or liability or due to an election by the CAMT entity. A fair value measurement adjustment would not include an impairment loss or impairment loss reversal as defined in Prop. Reg. Section 1.56A-1(b)(29) and (30), respectively.

⁵⁴ Prop. Reg. Section 1.56A-24(b)(1) would define an “AFSI hedge” generally as an asset or liability of a CAMT entity (1) for which there are fair value measurement adjustments, and (2) that is entered into as a hedging transaction for regular tax purposes or is subject to hedge accounting for financial accounting purposes and reported on a CAMT entity's AFS. Hedging transactions for regular tax purposes would include transactions specified in Treas. Reg. Section 1.1221-2(b), IRC Section 1256(e), IRC Section 475(c)(2)(F), and certain integrated transactions under Treas. Reg. Sections 1.1275-6 and 1.988-5 or otherwise under IRC Section 988(d). However, certain insurance hedges entered into by an insurance company to hedge obligations to holders of life insurance or annuity contracts that take into account the value of one or more specified assets or indices would not constitute an AFSI hedge.

⁵⁵ Prop. Reg. Section 1.56A-24(b)(4) would define “hedged item” as an asset or a liability that is reported on a CAMT entity's AFS and for which there are one or more AFSI hedges managing a risk of interest rate or price changes, a risk of currency fluctuations, or another risk that is eligible to be managed by an AFSI hedge.

hedge or the hedged item is marked to market for regular tax purposes. As noted in the Preamble, by disregarding the fair value measurement adjustment, unrealized gain or loss attributable to fair value measurement adjustments is delayed until the earlier of when the gain or loss on the corresponding hedged item or AFSI hedge (as applicable) is recognized for FSI purposes or an “AFSI subsequent adjustment date”⁵⁶ otherwise occurs. The adjustments to AFSI are required to be made for all tax years prior to the tax year in which the AFSI hedge or hedged item matures or is sold, disposed of, or otherwise terminated, including tax years that end on or before December 31, 2019.

Additionally, Prop. Reg. Section 1.56A-24(e)(1) and (2) would provide operative rules for the inclusion of certain taxable amounts in AFSI for fair value measurement adjustments disregarded under Prop. Reg. Section 1.56A-24(c)(2), for subsequent adjustments to AFSI in the tax year of an AFSI subsequent adjustment date, and for certain adjustments to CAMT basis.

2. Net investment hedge adjustments – Prop. Reg. Section 1.56A-24(d) and (e)(3)

CAMT entities that enter into net investment hedges also may have AFSI mismatches or distortions due to changes in the fair value of such hedges being included in equity accounts for financial accounting purposes, while such hedges might be marked to market for regular tax purposes. To address the potential mismatch and distortion in AFSI, Prop. Reg. Section 1.56A-24(d) would provide that in situations in which a CAMT entity marks to market a “net investment hedge”⁵⁷ for regular tax purposes for a tax year, the CAMT entity would include in AFSI the amount of mark to market gain or loss for regular tax purposes. As noted in the Preamble, this adjustment is intended to result in greater conformity between the timing of the net investment hedge for financial accounting purposes and for regular tax purposes by including the unrealized gain or loss for the net investment hedge in AFSI.

Additionally, Prop. Reg. Section 1.56A-24(e)(3) would provide for subsequent adjustments to AFSI in the tax year in which the net investment hedge matures or is sold, disposed of, or otherwise terminated, or in which the asset or liability that was a net investment hedge ceases to constitute a net investment hedge.

⁵⁶ Prop. Reg. Section 1.56A-24(b)(2) would define an “AFSI subsequent adjustment date” generally as the earliest day on which an AFSI hedge or a hedged item matures or is sold, disposed of, or otherwise terminated or an asset or liability ceases to constitute an AFSI hedge or hedged item subject to Prop. Reg. Section 1.56A-24(c)(2). Additional rules apply for certain corporate and partnership transactions.

⁵⁷ Prop. Reg. Section 1.56A-24(b)(5) would define a “net investment hedge” as an asset or liability entered into by a CAMT entity to manage the foreign currency exposure of a net investment in a foreign operation for which there are changes in the value of the asset or liability due to required periodic determinations (at least annually) of the increases or decreases in the fair value of that asset or liability that are included in the CAMT entity’s equity accounts on the CAMT entity’s AFS, such as retained earnings or other comprehensive income.

Observations: To make the AFSI adjustments in Prop. Reg. Section 1.56A-24, CAMT entities will need to understand when income, deduction, gains, and losses from their hedging transactions and hedged items are included in income for both regular tax purposes and for financial accounting purposes. While the proposed regulations do not specifically define when a taxpayer marks to market an AFSI hedge, the hedged item, or a net investment hedge for regular tax purposes, various provisions of the Code and regulations provide for mandatory or elective mark to market treatment for certain taxpayers and certain transactions (for example, IRC Sections 475 and 1256, Treas. Reg. Sections 1.446-4(e)(2) and 1.988-2(b)(15), and Prop. Reg. Section 1.988-7). With respect to net investment hedges, ASC 815 allows the hedging of the foreign currency risk of a net investment in a foreign operation with either a foreign currency derivative instrument or a foreign-currency-denominated nonderivative financial instrument (e.g., foreign-currency-denominated debt). Therefore, CAMT entities with net investment hedges should confirm what type of instrument (derivative or nonderivative financial) is functioning as the hedging transaction and whether that instrument is subject to mandatory or elective mark to market treatment for regular tax purposes.

P. AFSI adjustments for income of foreign governments (Prop. Reg. Section 1.56A-27)

The Proposed Regulations would exclude from AFSI any FSI that would be excluded from gross income and exempt from taxation under IRC Section 892, if it were properly treated as gross income for regular tax purposes.

V. Corporate/consolidated group issues and considerations (Prop. Reg. Sections 1.1502-56A and 1.1502-53)

A. Application of CAMT to consolidated groups

If a taxpayer is part of an affiliated group of corporations filing a consolidated return for any tax year, IRC Section 56A(c)(2)(B) generally requires the group's AFSI for the tax year to take into account on the group's AFS items that are properly allocable to its members. Section 3.05 of Notice 2023-7 clarified IRC Section 56A(c)(2)(B) by treating a tax consolidated group as a single entity for purposes of (1) calculating AFSI when determining applicable corporation status, and (2) calculating AFSI for CAMT liability. Under the proposed regulations, Prop. Reg. Section 1.1502-56A would add significantly more detail to the statute and notice.⁵⁸

1. Tax consolidated group as a single entity

Members of a tax consolidated group would generally be treated as a single CAMT entity, only while they belong to that tax consolidated group, for purposes of determining (1) the tax consolidated group's AFSI, (2) the tentative minimum tax under IRC Section 55(b)(2)(A), and (3) status as an applicable corporation under IRC Section 59(k).⁵⁹ These three purposes are discussed next.

For purposes of Prop. Reg. Section 1.1502-56A, the term "tax consolidated group" has the same meaning as "consolidated group" in Treas. Reg. Section 1.1502-1(h); the term "CAMT entity" generally means any entity other than a disregarded entity.⁶⁰

Despite the "single CAMT entity" treatment, this concept is not so powerful as to cause the collapse of a partnership wholly owned by members of the same tax consolidated group.⁶¹

2. AFSI determination for tax consolidated group

The rules under Prop. Reg. Section 1.1502-56A would provide special rules on a tax consolidated group's AFSI computation, including rules for the FSI computation, the treatment of intercompany transactions, the treatment of member stock dispositions, and the treatment of FSNOLs.

⁵⁸ Prop. Reg. Section 1.1502-56A would apply to consolidated return years for which the due date of the income tax return (without extensions) is after the publication of the final regulations. Prop. Reg. Section 1.1502-56A(l).

⁵⁹ See Prop. Reg. Section 1.1502-56A(a)(2).

⁶⁰ See Prop. Reg. Section 1.1502-56A(b); Prop. Reg. Section 1.56A-1(b)(8).

⁶¹ See Prop. Reg. Section 1.1502-56A(c)(4).

FSI computation for a tax consolidated group. A tax consolidated group would determine its FSI for a tax year based on the group's AFS.⁶² If the financial statement group were composed solely of tax consolidated group members, the FSI of the tax consolidated group would equal the consolidated FSI reflected on that AFS; if other, non-member CAMT entities were in the financial statement group, the tax consolidated group members would be treated as a single CAMT entity and certain adjustments would be made.⁶³ Specifically, the AFS consolidation entries between members of the tax consolidated group would be respected,⁶⁴ while the AFS consolidation entries between members and non-members of the tax consolidated group would be disregarded.⁶⁵ In certain instances, the respect accorded the consolidation entries between tax consolidated group members would cease (e.g., when one of the parties, or the underlying asset, leaves the tax consolidated group); the CAMT consequences would then be determined under the IRC Section 56A regulations.⁶⁶

Example - Consolidation entries respected until consolidated group member deconsolidates. P is the common parent of a tax consolidated group that uses the calendar year as its tax year. S1, S2, and S3 are members of P's tax consolidated group (the P group). S2 owns all of S3's stock.

On February 1, 2023, S3 merges into S1 in a transaction that qualifies as a reorganization under IRC Section 368(a)(1)(A) (the Merger). In the Merger, S2 receives both S1 voting stock and cash. On December 31, 2024, P sells S1 to X, a corporation unrelated to P or any member of the P group.

The Merger is a covered nonrecognition transaction. At the end of the P group's 2023 tax year, S1 remains a member of the group, and no property transferred in the Merger has left the P group. As a result, under Prop. Reg. Section 1.1502-56A(c)(3)(i), any AFS consolidating entries related to the Merger continue to be given effect, and the IRC Section 56A regulations do not apply to the Merger.

At the end of the P group's 2024 tax year, S1 is no longer a member of the P group. As a result, all AFS consolidating entries relating to the Merger cease to be taken into account immediately before S1 ceases to be a member of the P group, and the CAMT consequences of the Merger are determined under the IRC Section 56A regulations.⁶⁷

⁶² See Prop. Reg. Section 1.1502-56A(c). A "tax consolidated group AFS" would be the AFS of a tax consolidated group and all its members (as well as CAMT entities that are **not** members), as determined under Prop. Reg. Sections 1.56A-1(c)(2)(i) and 1.56A-2(g).

⁶³ *Id.*

⁶⁴ The term "AFS consolidation entries" would mean the financial accounting journal entries that are made in preparing a consolidated financial statement for a financial statement group in order to present the financial results of that financial statement group as though all members of the financial statement group were a single economic entity. Prop. Reg. Section 1.56A-1(b)(4). For the AFS consolidated entries to be respected, the parties to the underlying transaction would have to continue to exist as tax consolidated group members and the property involved in the transaction would have to continue to be held within the tax consolidated group. See Prop. Reg. Section 1.1502-56A(c)(3)(i).

⁶⁵ See Prop. Reg. Section 1.1502-56A(c)(2).

⁶⁶ Reg. Prop. Reg. Section 1.1502-56A(c)(3).

⁶⁷ See Prop. Reg. Section 1.1502-56A(c)(3)(iii), Example.

Treatment of intercompany transactions. Various provisions in IRC Section 56A(c), such as the treatment of depreciation under IRC Section 56A(c)(13), replace AFS items with regular tax items. According to the Preamble, the government is concerned that the interaction of these tax-for-AFS replacement rules with transactions between members of the same tax consolidated group could yield inappropriate results. For instance, if one tax consolidated group member sold depreciable property to another tax consolidated group member at a gain, such that the buyer's stepped-up basis gave rise to greater depreciation for AFSI purposes, that outcome would run counter to the treatment of a tax consolidated group as a single CAMT entity (i.e., no basis step-up would result from such a sale).

To prevent those inappropriate results, Prop. Reg. Section 1.1502-56A(e) would disregard any increase or decrease in a regular tax item resulting from an intercompany transaction for purposes of including the item in AFSI.

Example - Basis step-up and IRC Section 168(i)(7) recovery from intercompany sale disregarded. On January 1, 2024, S buys IRC Section 168 property (as defined in Prop. Reg. Section 1.56A-15(b)(6)) for \$100x (Asset A) and depreciates it using the straight-line method and a 10-year recovery period for regular tax purposes. For AFS purposes, S depreciates Asset A over 20 years using the straight-line method.

On January 1, 2026, S sells Asset A to B for \$130x, and S recognizes a \$40x net gain for AFS purposes (\$130x consideration - \$90x AFS basis (\$100x cost - \$10x accumulated book depreciation)). However, the P Group's AFS includes AFS consolidating entries that eliminate the effect of the sale of Asset A to B. For regular tax purposes, under IRC Section 168(i)(7), B is treated as S to the extent B's \$130x basis does not exceed S's adjusted basis at the time of the sale. Accordingly, B takes a \$80x carryover basis (S's \$100x cost - S's \$20x accumulated tax depreciation) in Asset A and continues to depreciate the \$80x basis using S's depreciation methods. B has additional basis of \$50x in Asset A (\$130x consideration - \$80x IRC Section 168(i)(7) basis), which B treats as new 10-year recovery IRC Section 168 property and depreciates using the straight-line method. (To simplify the example, the half-year convention is disregarded by both S and B for AFS and regular tax purposes, and any depreciation on Asset A is not subject to capitalization under any other Code provision.)

Under Prop. Reg. Section 1.56A-15(d)(1)(iii), the covered book depreciation expense (as defined in Prop. Reg. Section 1.56A-15(b)(3)) that is taken into account in FSI by S or B with respect to Asset A is disregarded in computing AFSI and replaced with deductible tax depreciation (as defined in Prop. Reg. Section 1.56A-15(b)(5)). In 2024 and 2025, the P Group's AFSI therefore reflects S's \$10x of deductible tax depreciation from Asset A (\$100x cost / 10 years).

In 2026, for regular tax purposes, B takes into account \$15x of deductible tax depreciation from Asset A (\$10x under IRC Section 168(i)(7) + \$5x ((\$130x - \$80x) / 10 years) relating to B's additional depreciable basis in Asset A). However, under Prop. Reg. Section 1.1502-56A(e)(2), the P Group's AFSI disregards the \$5x increase resulting from the intercompany transaction between S and B. Thus, the P Group's AFSI in 2026 reflects only \$10x of deductible tax depreciation from Asset A. Under Prop. Reg. Section 1.1502-56A(c), the P Group's AFSI for 2026 takes into account the AFS consolidation entries that eliminate the effect of the sale of Asset A to B; under Prop. Reg.

Section 1.56A-15(e)(7), the P Group does not adjust AFSI for 2026 for S's AFSI adjustment determined under Prop. Reg. Section 1.56A-15(e)(1) of \$10x (S's re determined gain or loss from the sale of Asset A on January 1, 2026 of \$50x (\$130x consideration - \$80x CAMT basis (\$90x AFS basis + \$10x covered book depreciation expense - \$20x deductible tax depreciation) minus the \$40x net gain included in S's FSI before elimination). Accordingly, the P Group's AFSI in 2026 does not reflect any gain from the intercompany sale.⁶⁸

However, if AFS consolidation entries for an item described in Prop. Reg. Section 1.1502-56A(e) become disregarded under Prop. Reg. Section 1.1502-56A(c) (pertaining to AFS consolidation entries, discussed previously), then, immediately before the AFS consolidation entries become disregarded, AFSI of the tax consolidated group is increased or decreased by the regular tax items that previously were disregarded under Prop. Reg. Section 1.1502-56A(e).⁶⁹

Treatment of member stock dispositions. Despite treatment of the tax consolidated group as a single CAMT entity, Prop. Reg. Section 1.1502-56A(d) would include in the AFSI of a tax consolidated group for a tax year gain or loss from one member's sale or exchange of stock of another member (i.e., the disposition of stock is not, under the single-CAMT-entity approach, treated as a disposition of assets). In computing the AFSI gain or loss on the stock, the tax consolidated group would use (1) the rules that otherwise may apply under the IRC Section 56A regulations, and (2) the CAMT basis in the stock.⁷⁰

Included in these stock-basis adjustments would be adjustments to the AFS basis of the member stock for the period during which the member was a member of a tax consolidated group (including adjustments to reflect all other adjustments to FSI in determining AFSI under the IRC Section 56A regulations); the CAMT basis of stock, however, would include negative adjustments for expenses or losses of a member only to the extent that those items were absorbed by a member of the tax consolidated group under the IRC Section 56A regulations.⁷¹

Treatment of FSNOLs. As with other applicable corporations, a tax consolidated group that is an applicable corporation may use FSNOLs to reduce its AFSI under IRC Section 56A(d). The rules in Prop. Reg. Section 1.1502-56A(f) would address the general utilization of FSNOLs generated by a tax consolidated group, the utilization of FSNOLs imported into the tax consolidated group, and the allocation of the tax consolidated group's FSNOLs to departing members.

First, subject to the limitations under Prop. Reg. Section 1.56A-23 (discussed previously) and Prop. Reg. Section 1.1502-56A(f) (discussed later), the tax consolidated group's FSNOL carryovers that could be used to reduce its AFSI for any consolidated return year would generally be the aggregate of the group's consolidated FSNOL carryovers to that year.

⁶⁸ See Prop. Reg. Section 1.1502-56A(e)(4)(i), Ex. 1.

⁶⁹ See Prop. Reg. Section 1.1502-56A(e)(3).

⁷⁰ The CAMT basis in a share of stock could reflect the **regular tax basis** of the subsidiary member stock in the hands of the shareholder member on the first day of the shareholder member's first tax year beginning after December 31, 2019. See Prop. Reg. Section 1.1502-56A(d)(3)(i).

⁷¹ Prop. Reg. Section 1.1502-56A(d)(3)(iii).

The “consolidated FSNOL carryovers” would consist of (1) any consolidated FSNOL of the tax consolidated group; and (2) any FSNOLs of the group’s members arising in their respective separate return years (as defined in Treas. Reg. Section 1.1502-1(e)) (to the extent otherwise available for use under Prop. Reg. Sections 1.56A-23 and 1.1502-56A).⁷² A “consolidated FSNOL” would be the portion of an FSNOL that is attributable to a tax consolidated group, as determined under Prop. Reg. Section 1.1502-56A(f).⁷³ The term “FSNOL” would have the same meaning as “financial statement net operating loss” (FSNOL) in Prop. Reg. Section 1.56A-23(b).⁷⁴

FSNOLs would generally be absorbed against the group’s AFSI in the order of the tax years in which they arose⁷⁵; when absorbed, the absorbed amount would be apportioned among members based on the percentage of the FSNOL that is eligible for carryover, attributable to each member and available for absorption.⁷⁶

Second, concerning limitations on the use of FSNOLs, the amount of FSNOL that a tax consolidated group could use to reduce the group’s AFSI for a consolidated return year would equal the lesser of (1) the aggregate of FSNOLs carried to that consolidated return year; or (2) the amount determined by multiplying 80% by the consolidated AFSI for the group for that year, computed without regard to the FSNOL deduction allowable under IRC Section 56A(d).⁷⁷ That is, the standard 80% limitation on the use of FSNOLs would apply to a tax consolidated group, too. Further, the standard separate-return-limitation-year (SRLY) type of limitation on FSNOLs imposed under Prop. Reg. Section 1.56A-23 would also apply to a tax consolidated group.⁷⁸

Third, concerning apportionment of FSNOLs to a departing member of a tax consolidated group, Prop. Reg. Section 1.1502-56A(f)(5) would apportion to the member any consolidated FSNOL attributable to that member and have the FSNOL carried to the member’s separate return year if it is otherwise permitted.⁷⁹ The portion of the group’s consolidated FSNOL that is attributable to a member would equal the product obtained by multiplying the consolidated FSNOL and the percentage of the FSNOL attributable to the member, the latter of which would generally equal the member’s separate FSNOL for the consolidated return year divided by the sum of the separate FSNOLs for that year of all members having FSNOLs for that year.⁸⁰

⁷² See Prop. Reg. Section 1.1502-56A(f)(2).

⁷³ See Prop. Reg. Section 1.1502-56A(b)(6).

⁷⁴ See Prop. Reg. Section 1.1502-56A(b)(8).

⁷⁵ See Prop. Reg. Section 1.1502-56A(f)(4)(i).

⁷⁶ See Prop. Reg. Section 1.1502-56A(f)(4)(iii).

⁷⁷ See Prop. Reg. Section 1.1502-56A(f)(3)(i).

⁷⁸ Prop. Reg. Section 1.1502-56A(g).

⁷⁹ The amount apportioned to the departing member could nevertheless be absorbed by the tax consolidated group in the year of departure. See Prop. Reg. Section 1.1502-56A(f)(5)(ii)(A).

⁸⁰ A member’s separate FSNOL would be determined by computing the FSNOL by reference only to the member’s income, expense, gain, and loss, including the member’s losses and expenses actually absorbed by the group in the consolidated return year. In certain instances (e.g., a non-pro rata reduction of a member’s portion of a consolidated FSNOL), each member’s portion would be recomputed. See Prop. Reg. Section 1.1502-56A(f)(5)(iv).

Example - Apportionment of consolidated FSNOL to deconsolidating member. P, M1, M2 and M3 are members of the P Group, which uses the calendar year as its tax year. P, M1, M2 and M3 report their financial results on a tax consolidated group AFS.

In 2026, the P Group generates an FSNOL of \$55x, computed by the P Group as a single CAMT entity. See Prop. Reg. Section 1.1502-56A(a)(2). In that year, P has a separate FSNOL of \$40x, M1 has separate AFSI of \$10x, M2 has a separate FSNOL of \$20x, and M3 has a separate FSNOL of \$5x. On December 31, 2026, M2 ceases to be a member of the P group, but M2's FSI continues to be reported on P's consolidated AFS.

A portion of the P Group's \$55x FSNOL is apportioned to M2 because M2 ceases to be a member of the P Group. Specifically, $\$16.9x$ of FSNOL is apportioned to M2 ($(\$20x / (\$20x + \$40x + \$5x)) \times \$55x = \$16.9x$). The remaining $\$38.1x$ of FSNOL remains with the P Group.⁸¹

3. Tentative minimum tax determination for tax consolidated group

Federal income tax liabilities are taken into account in determining the earnings and profits and the stock basis of each consolidated group member under Treas. Reg. Sections 1.1502-33 and 1.1502-32, respectively. The tentative minimum tax, like other income taxes, must therefore be taken into account.

Under Prop. Reg. Section 1.1502-56A(j), liability for the tentative minimum tax under IRC Section 55(b)(2)(A) for a consolidated return year would be apportioned among members of the tax consolidated group based on the percentage of AFSI that is attributable to each member for the year.

The percentage of AFSI attributable to a member for the consolidated return year would equal (1) the member's separate positive AFSI for the consolidated return year, divided by (2) the sum of the AFSI for that year of all members having separate positive AFSI for that year. A member's separate AFSI would be determined by referencing only its items of income, expense, gain and loss.⁸²

Example - Allocation of CAMT liability. P, S, and T are members of the P Group, which uses the calendar year as its tax year. P, S, and T report their financial results on a tax consolidated group AFS. For 2024, if AFSI were computed by reference to only each member's items of income, expense, gain, and loss, P would have separate AFSI of \$1,000x, S would have a separate FSNOL of \$100x, and T would have separate AFSI of \$200x. The P Group has no regular tax liability, no liability for tax on base erosion payments under IRC Section 59A, and no CAMT FTC for 2024. Thus, the P Group's AFSI for 2024 is \$1,100x, and the P Group's liability for the tentative minimum tax under IRC Section 55(b)(2)(A) is \$165x ($\$1,100x \times 15\% = \$165x$).

Of the P Group's 2024 liability for the tentative minimum tax under IRC Section 55(b)(2)(A), \$137.5x is apportioned to P ($(\$1,000x / (\$1,000x + \$200x)) \times \$165x = \$137.5x$), and \$27.5x is apportioned to T ($(\$200x / (\$200x + \$1,000x)) \times \$165x = \$27.5x$).⁸³

⁸¹ See Prop. Reg. Section 1.1502-56A(f)(6), Example.

⁸² See Prop. Reg. Section 1.1502-56A(j)(2).

⁸³ See Prop. Reg. Section 1.1502-56A(j)(3), Example.

4. Applicable corporation status determination for tax consolidated group

If a member departs from a tax consolidated group, consideration must be given to the current and/or future applicable corporation status of both the tax consolidated group and the departing member.

When a member leaves a tax consolidated group (the departing member), the group would allocate to the departing member the member's AFSI (for purposes of applying the average annual AFSI test under Prop. Reg. Section 1.59-2(c)) for each tax year (or portion thereof) in which the departing member was a member of the tax consolidated group (for tax years relevant under Prop. Reg. Section 1.59-2(c)(1)(i) and (c)(2)(i)).⁸⁴ The AFSI allocated to the departing member would be determined as if the member were a separate CAMT entity during the period in which it was a member of the tax consolidated group.

The AFSI allocated to the departing member would not be subtracted from the AFSI of the tax consolidated group of which the departing member ceased to be a member. See Prop. Reg. Section 1.59-2(f).

B. Application of the minimum tax credit to tax consolidated group

Under IRC Section 53, taxpayers may generally claim a minimum tax credit (MTC) equal to the CAMT liability previously paid (and not previously recovered as a credit). For a tax consolidated group, Prop. Reg. Section 1.1502-53 would introduce rules on determining the MTC allowed, limitations on the MTC's use, and the MTC's apportionment to a member departing from the tax consolidated group.⁸⁵

First, subject to IRC Section 53 and Prop. Reg. Section 1.1502-53(b), a group could claim its consolidated MTC under Prop. Reg. Section 1.152-53 against its consolidated tax liability for consolidated return years after the group's first consolidated return year beginning after 2022.⁸⁶ Generally, the credit allowed to the tax consolidated group for a tax year would equal the sum of (1) the group's consolidated MTCs, and (2) the separate-year MTCs of group members for earlier tax years to the extent they have not been absorbed in earlier years.⁸⁷

Second, two limitations would apply to the tax consolidated group's use of the MTC. The more general of the two limitations would be an extension to tax consolidated groups of the standard separate return MTC limitation under IRC Section 53(c), which limits the MTC allowed for any consolidated return year to the excess (if any) of (1) the group's consolidated regular tax liability for the consolidated return year, reduced by the sum of the credits allowable under subparts B, D, E, and F of part IV of subchapter A of chapter 1 of the Code, increased by the tax imposed under IRC Section 59A (i.e., BEAT) for the consolidated return year; over (2) the group's consolidated tentative minimum tax for the consolidated return year.⁸⁸

⁸⁴ See Prop. Reg. Section 1.1502-56A(k).

⁸⁵ Prop. Reg. Section 1.1502-53 would apply to consolidated return years for which the due date of the income tax return (without extensions) is after publication of the final regulations. See Prop. Reg. Section 1.1502-53(e).

⁸⁶ See Prop. Reg. Section 1.1502-53(a). The term "consolidated MTC" would mean the MTC that is attributable to a tax consolidated group's CAMT liability under IRC Section 55; the term "MTC" would mean the minimum tax credit, within the meaning of IRC Section 53(b) (as modified by IRC Section 53(e)). See Prop. Reg. Section 1.1502-53(b)(1).

⁸⁷ See Prop. Reg. Section 1.1502-53(b)(3). The absorption order would follow the chronology of the credit. Prop. Reg. Section 1.1502-56A(b)(4).

⁸⁸ See Prop. Reg. Section 1.1502-53(b)(5).

The more specific limitation, which pertains solely to tax consolidated groups, appears in Prop. Reg. Section 1.1502-53(c)(1). Under that provision, the aggregate of a member's MTCs from SRLYs that are included in the consolidated MTCs allowed for all of the group's consolidated return years may not exceed (1) the aggregate for all consolidated return years of the member's contributions to the consolidated IRC Section 53(c) limitation for each consolidated return year;⁸⁹ reduced by (2) the aggregate of consolidated MTCs that are attributable to the member (determined in the manner provided in Prop. Reg. Section 1.1502-56A(j)) and absorbed in all consolidated return years.⁹⁰ For a year in which consolidated regular tax liability were to exceed the consolidated tentative minimum tax, a member's "contribution to the consolidated [IRC Section] 53(c) limitation" for a consolidated return year would equal (1) the member's share of the consolidated regular tax liability,⁹¹ minus (2) its share of consolidated tentative minimum tax.⁹²

Prop. Reg. Section 1.1502-53(c), like SRLY limitations on other attributes arising in separate return years (e.g., under Treas. Reg. Sections 1.1502-21(c) and 1.1502-22(c)), contains predecessor and successor principles, SRLY subgroup principles, and, importantly, an overlap exception with respect to IRC Section 383.⁹³

Third, concerning the apportionment of MTC to a member departing from a tax consolidated group, Prop. Reg. Section 1.1502-53(d)(1) would apportion to a member any consolidated MTC attributable to that member and have the MTC carried to the member's separate return year, if otherwise permitted, using mechanics similar to those in Treas. Reg. Section 1.1502-21(b). The amount attributable to the member would be determined in the manner provided in Prop. Reg. Section 1.1502-56A(j) (with regard to allocation of CAMT liability).⁹⁴

Example - MTC apportioned to departing member. P, S, and T are members of the P Group, which uses the calendar year as its tax year. P, S, and T report their financial results on a tax consolidated group AFS. For 2024, if AFSI were computed by reference only to each member's income, expense, gain, and loss, P would have separate AFSI of \$1,000x, S would have a separate FSNOL of \$100x, and T would have separate AFSI of \$200x.

⁸⁹ For a consolidated return year for which consolidated tentative minimum tax is **greater** than consolidated regular tax liability, the group would reduce the member's aggregate contribution to the consolidated IRC Section 53(c) limitation by the member's share of the consolidated CAMT for the year as determined under Prop. Reg. Section 1.1502-56A(j). See Prop. Reg. Section 1.1502-53(c)(2)(ii).

⁹⁰ See Prop. Reg. Section 1.1502-53(c)(1).

⁹¹ The member's share of consolidated regular tax liability would be computed by applying to the respective consolidated amounts the principles of IRC Section 1552 and the percentage method under Treas. Reg. Section 1.1502-33(d)(3), assuming a 100% allocation of any decreased tax liability. See Prop. Reg. Section 1.1502-53(c)(2).

⁹² See Prop. Reg. Section 1.1502-53(c)(2). The member's share of consolidated tentative minimum tax would be computed by multiplying (1) the consolidated tentative minimum tax by (2) a fraction, the denominator of which is the group's AFSI, and the numerator of which is the member's positive separate AFSI as defined in Prop. Reg. Section 1.1502-56A(j)(2). *Id.*

⁹³ *Id.*

⁹⁴ Regarding FSNOLs, a member's attributable amount could be recomputed in certain instances. See Prop. Reg. Section 1.1502-53(d)(2).

The P Group has no regular tax liability, no liability for tax on base erosion payments under IRC Section 59A, and no CAMT FTC for 2024. Thus, the P Group's AFSI for 2024 is \$1,100x, and the P Group's liability for the tentative minimum tax under IRC Section 55(b)(2)(A) is \$165x ($\$1,100x \times 15\% = \$165x$). On December 31, 2024, T is acquired by an unrelated party and ceases to be a member of the P Group.

Of the P Group's tax consolidated MTC of \$165x, as determined under IRC Section 53(b), \$27.5x is apportioned to T ($(\$200x / (\$200x + \$1,000x)) \times \$165x = \$27.5x$), and \$137.5x remains to offset the P Group's regular income tax liability.⁹⁵

Observations: The addition of numerous, robust tax consolidated group rules will be of great use to taxpayers; the very limited language existing in IRC Section 56A(d) and Notice 2023-7 on tax consolidated groups left many questions unanswered, not least of which was how potent their "single entity" concept would be. With the Proposed CAMT Regulations, taxpayers now have a clearer view on, for instance, certain CAMT consequences for members joining or leaving a tax consolidated group, as well as the treatment of CAMT attributes by a tax consolidated group. To be sure, this clarity does not in all cases equate to equitable results, such as the fact that a departing member takes its AFSI, but the remaining tax consolidated group also continues to take that same AFSI into account, thereby duplicating that AFSI as it exists in the CAMT system.

⁹⁵ See Prop. Reg. Section 1.1502-53(d)(4), Example.

VI. CAMT foreign tax credit

The proposed regulations would provide rules for determining the CAMT FTC. The CAMT FTC for an applicable corporation for the tax year would generally equal the sum of:

- ▶ The lesser of:
 - ▶ The aggregate of the applicable corporation's pro rata share of CFC taxes
 - or
 - ▶ The product of the adjustment under Prop. Reg. Section 1.56A-6(b)(1) and the percentage specified in IRC Section 55(b)(2)(A)(i) (currently, 15%)
- and
- ▶ The eligible taxes paid by the applicable corporation during the tax year, to the extent the taxes have been taken into account under Prop. Reg. Section 1.56A-8(d), on the applicable corporation's AFS

A CAMT FTC would only be available for an "eligible tax," which would be defined as a foreign income tax (as defined in Treas. Reg. Section 1.901-2), excluding any tax for which a credit would be disallowed or suspended for regular tax purposes under IRC Sections 245A(d) and (e)(3), 901(e) and (f), 901(i) through (m), 907, 908, 909, 965(g), 999, or 6038(c) (various disallowances for dividends-received deductions, international boycotts, covered asset acquisitions, and foreign oil and mineral income).

Observations: Excluding taxes that are disallowed or suspended for regular tax purposes from the CAMT FTC might catch taxpayers by surprise as the statute does not appear to include these limitations. As the Preamble to the proposed regulations explains, the Treasury and the IRS would exclude foreign income taxes subject to regular tax disallowances and suspensions from the CAMT FTC to maintain policy consistency and ease compliance and administrative burdens.

The proposed regulations would also define the "applicable corporation's pro rata share of taxes of a CFC" as the sum of (1) the aggregate pro rata share of taxes under IRC Section 960(b), and (2) the aggregate pro rata share of the eligible current tax year taxes; this sum would then be reduced by suspensions and disallowances for non-eligible taxes described previously and applicable at the US shareholder level.

The aggregate pro rata share of taxes under IRC Section 960(b) would generally include foreign income taxes deemed paid by the applicable corporation under Treas. Reg. Section 1.960-3(b) (e.g., taxes imposed on PTEP distributions), to the extent those taxes were taken into account on the AFS of the applicable corporation or any CFC for which the applicable corporation is a US shareholder.

The aggregate pro rata share of the eligible current-year taxes would generally include the sum of:

- ▶ The eligible current-year taxes (defined in Treas. Reg. Section 1.960-1(b)(5)) deemed paid by the applicable corporation under Treas. Reg. Section 1.960-2(b) (relating to foreign income taxes properly attributable to subpart F income), to the extent those taxes have been taken into account on the AFS of the CFC or the applicable corporation
- ▶ The aggregate of the applicable corporation's proportionate share of the CFC's eligible current-year taxes (as defined in Treas. Reg. Section 1.960-1(b)(5)) for the tested income group, as determined under Treas. Reg. Section 1.960-2(c)(5) for the applicable corporation's tax year, to the extent the taxes have been taken into account on the AFS of the CFC or applicable corporation
- ▶ The aggregate eligible current-year taxes of the CFC for each such subpart F income group and tested income group multiplied by the pro rata share percentage (as defined in Prop. Reg. Section 1.59-4(b)(3)), for the CFC's tax year that ends with or within the tax year of the applicable corporation (this would apply solely for any subpart F income group and tested income group for which the denominator of the applicable corporation's proportionate share fraction (as described in Treas. Reg. Section 1.960-2(b)(3)(i) and (c)(5), respectively) is zero or less than zero (which could occur because the CFC has a loss in the income group or, for a subpart F income group, because the denominator of the fraction is reduced due to a current-year E&P limitation or a chain deficit, respectively))
and
- ▶ The aggregate of the CFC's eligible current-year taxes for each residual income group of the CFC multiplied by the pro rata share percentage (as defined in Prop. Reg. Section 1.59-4(b)(3)), for the tax year of the CFC that ends with or within the tax year of the applicable corporation

Observations: It is interesting to see the definition of an “applicable corporation's pro rata share of taxes of a CFC” refined to include taxes attributable to tested loss or residual income group while excluding taxes suspended or disallowed under other regular US tax rules. The Preamble explains that a CAMT CFC would include taxes imposed on a CFC's residual earnings because those residual earnings are included in AFSI of the CFC's US shareholder through the application of IRC Section 56A(c)(3). The Treasury and IRS request comments on additional rules that may be appropriate where the applicable corporation takes into account a CFC's qualified deficit under IRC Section 951(c)(1)(B).

In addition, the proposed regulations would allow for the carryover of unused CFC taxes. Unused CFC taxes would equal the difference (if any) between (1) the aggregate of the applicable corporation's pro rata shares of CFCs taxes and (2) the product of the IRC Section 56A(c)(3) aggregate adjustment (determined under Prop. Reg. Section 1.56A-6(b)(1)) and the percentage specified in IRC Section 55(b)(2)(A)(i) (currently, 15%). Unused CFC taxes could be carried forward to the next five years and would be absorbed in chronological order, regardless of the taxpayer's election for a foreign tax credit in the carryover year, with an ordering rule prioritizing the absorption of the oldest taxes first.

Consistent with Notice 2023-64, the proposed regulations would permit foreign income taxes paid or accrued as a result of a foreign tax redetermination to be claimed as a CAMT FTC only if the domestic corporation were an applicable corporation in the tax year to which the foreign tax redetermination

relates (the relation-back year), even if the taxes were reflected in a journal entry of an AFS within a tax year that is later than the relation-back year.

For foreign income taxes incurred by a partnership, the proposed regulations would provide that the eligible taxes paid by an applicable corporation that is a partner in a partnership would include the partnership's creditable foreign tax expenditures (within the meaning of Treas. Reg. Section 1.704-1(b)(4)(viii)) allocated to the partner for regular tax purposes, reduced by the suspensions and disallowances of taxes that apply at the partner level.

Observations: This special rule answered the open question of how to determine a partner's share of the partnership's foreign income taxes for CAMT FTC purposes. Applying the regular tax rules for creditable foreign tax expenditures for CAMT FTC purposes provides certainty and simplicity.

Applicability dates and final regulation transition rules

I. Applicability dates

The proposed regulations provide various applicability dates for the different regulations. Generally, most regulations, including those identified as a “specified regulation” are proposed to be applicable for tax years ending after September 13, 2024. While the remaining regulations are generally proposed to be applicable for tax years ending after the date final regulations are published in the Federal Register.

Taxpayers may generally rely on the proposed regulations for tax years ending (or transactions occurring) on or before the date of publication in the Federal Register. However, all members of a CAMT testing group (i.e., IRC Section 52 control group or FPMG, as applicable) would be required to follow the proposed regulations consistently. To early-rely on a specific provision in the proposed regulations, a taxpayer must rely on certain other provisions in the proposed regulations. The provisions the taxpayer is required to rely on in that situation depend on whether the taxpayer is choosing to early-rely on a provision in a “specified regulation.”

The following are identified as specified regulations:

- ▶ Prop. Reg. Sections 1.56A-1 through 1.56A-4
- ▶ Prop. Reg. Section 1.56A-5(l)(2)(ii) and 1.56A-5(l)(2)(iii)
- ▶ Prop. Reg. Sections 1.56A-6 through 1.56A-11
- ▶ Prop. Reg. Sections 1.56A-13, 1.56A-14
- ▶ Prop. Reg. Section 1.56A-17
- ▶ Prop. Reg. Section 1.56A-26
- ▶ Prop. Reg. Section 1.56A-27
- ▶ Prop. Reg. Sections 1.59-2 through 1.59-4

Observations: Taxpayers, particularly those included as a testing group under the FPMG rules or single employer under IRC Section 52(a-b), may find it hard to coordinate to confirm all CAMT entities are consistently applying the required proposed regulation provisions.

For ease of reference, the following chart lists the applicability dates and early-reliance requirements for all sections within the proposed regulations:

Prop. Reg. Section	Applicability date	Availability to early-rely on proposed regulations	“Specified Regulation”
1.56A-1	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-2	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-3	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-4	Tax years ending after September 13, 2024	Transactions occurring on or before September 13, 2024, provided each member of test group consistently follows 1.56A-4 and 1.56A-6 for all such transfers. If transfers occur in a tax year ending on or before September 13, 2024, they must rely on specified regulations for such tax years.	Yes
1.56A-5 (except -5(l)(2)(ii) and (iii))	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows 1.56A-5 (except -5(l)(2)(ii) and (iii)) and 1.56A-20 in their entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-5(l)(2)(ii) and (iii)	Tax years ending after September 13, 2024, and before final regulations	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-6	Tax years ending after September 13, 2024	Transactions occurring on or before September 13, 2024, provided each member of test group consistently follows 1.56A-4 and 1.56A-6 for all such transfers. If transfers occur in a tax year ending on or before September 13, 2024, they must rely on specified regulations for such tax years.	Yes

1.56A-7	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-8	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-9	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-10	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-11	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-12	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-13	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-14	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-15	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-16	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No

1.56A-17	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows all specified regulations.	Yes
1.56A-18	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows 1.56A-18, -19, and -21 in their entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-19	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows 1.56A-18, -19, and -21 in their entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-20	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows 1.56A-5 (except -5(l)(2)(ii) & (iii)) and 1.56A-20 in their entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-21	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows 1.56A-18, -19, and -21 in their entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-22	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-23	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-24	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No

1.56A-25	Tax years ending after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.56A-26	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows for all specified regulations.	Yes
1.56A-27	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows for all specified regulations.	Yes
1.59-2	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows for all specified regulations.	Yes
1.59-3	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows for all specified regulations.	Yes
1.59-4	Tax years ending after September 13, 2024	Tax years ending on or before September 13, 2024, provided each member of test group consistently follows for all specified regulations.	Yes
1.1502-2	Consolidated return years for which the due date of income tax return (without extensions) is after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.1502-53	Consolidated return years for which the due date of income tax return (without extensions) is after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No
1.1502-56A	Consolidated return years for which the due date of income tax return (without extensions) is after publication of final regulations	Tax years ending on or before publication of final regulations, if each member of test group consistently follows in its entirety and follows all specified regulations in their entirety in that tax year and each subsequent tax year.	No

II. Final regulation transition rules

The Preamble to the proposed regulations requests comments on three different approaches for transitioning to the final CAMT regulations when a taxpayer has computed AFSI in a manner inconsistent with the final CAMT regulations in prior tax years.

Under the “transition year adjustment approach,” a taxpayer would be required to compute an AFSI adjustment for the first tax year for which the final CAMT regulations are applicable (transition year) and CAMT attributes would be adjusted accordingly. The AFSI adjustment for the transition year would generally equal the difference between (1) cumulative AFSI for tax years ending after December 31, 2019, and before the transition year, and (2) cumulative AFSI that would have been computed for those years had the final CAMT regulations been applied instead. The Preamble to the proposed regulations indicates that Treasury and the IRS may permit taxpayers to spread the AFSI transition year adjustment.

Under the “cut-off basis transition approach,” there would be no AFSI transition year adjustment and CAMT attributes would not be redetermined.

Under the “fresh start transition approach,” there would be no AFSI transition year adjustment; however, CAMT attributes would be redetermined (as if the final CAMT regulations had always applied) as of the first day of the transition year.

The Preamble to the proposed regulations indicates that Treasury and the IRS are considering applying different approaches to different provisions in the proposed regulations.

Observations: When determining whether to take positions that are inconsistent with the proposed regulations, taxpayers should consider the possibility that one or more of these transition rules may apply. Taxpayers should model the potential impact that each of these transition rules (particularly the “transition year adjustment approach”) could have on positions that are inconsistent with the proposed regulation.

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