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Treasury and IRS Issue Proposed Regulations on Corporate Alternative Minimum Tax

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On September 13, 2024, the U.S. Department of Treasury and the Internal Revenue Service published Proposed Regulations (the "Proposed Regulations") regarding the corporate alternative minimum tax ("CAMT") under Section 55 and related provisions.[1] The CAMT was created as part of the Inflation Reduction Act of 2022 and generally imposes, for tax years beginning after December 31, 2022, a 15% minimum tax on the adjusted financial statement income ("AFSI") of certain corporations (or groups of corporations) with three-year average annual AFSI exceeding $1 billion ("Applicable Corporations").[2]

The Proposed Regulations — which are massively complex and comprise more than 600 pages — largely incorporate and expand on interim guidance that Treasury and the IRS laid out in multiple notices issued since January 2023. The Proposed Regulations are likely to remain in proposed form for many months and the final regulations may be substantially different, especially if there is a Republican administration in January.

Following are some preliminary, high-level thoughts on the scope of the CAMT under the Proposed Regulations; certain implications for M&A transactions, corporations invested in entities treated as partnerships for federal income tax purposes, and financially distressed corporations; certain limitations on CAMT loss carryforwards; and audit and enforcement considerations.

Determining Whether a Taxpayer Is an Applicable Corporation Subject to the CAMT

- To determine whether a corporation's annual AFSI exceeds the $1 billion threshold for the three-year testing period, the relevant AFSI includes not just that of the corporation but also any other entities (including partnerships) that are treated as a single employer with the corporation under Section 52(a) or (b).
  - The Proposed Regulations provide some relief from this aggregation rule when the relationship between the two entities changes during the three-year period. In such event, a corporation would only have to include the AFSI amount of the other entity during the period the two entities met the single employer test.
  - Less favorable is the Proposed Regulations' treatment of a member leaving a tax consolidated group. There, the AFSI allocable to the departing member during the period it was in the group would both be treated as the departing member's separate AFSI and continue to be included in the group's AFSI — meaning it would effectively be double counted.

- Subject to the "cliff effect" described below, the Proposed Regulations retain the adjustments that remove financial statement income ("FSI") from AFSI for a broad set of non-taxable transactions (e.g., reorganizations, contributions to capital, distributions, liquidations, and spin-offs) when determining whether a corporation's annual AFSI exceeds the $1 billion threshold.
- For the funds industry, a critical issue with CAMT is whether portfolio companies managed by the same PE fund are treated as a single employer — which turns on whether the PE fund would be treated as engaged in a trade or business for this purpose. The Proposed Regulations provide no clarification on this issue so the conclusions previously reached by funds and their advisors should be unaffected.
- When a corporation and a partnership are treated as a single employer, the Proposed Regulations retain the government-friendly approach of requiring the corporation to include the partnership's entire AFSI when determining whether it exceeds the $1 billion threshold to be an Applicable Corporation, rather than limiting the inclusion to a corporation's distributive share of AFSI. This increases the likelihood that public companies utilizing Up-C structures or, in certain circumstances, "blocker" corporations utilized by private equity investors may be subject to CAMT.

Certain Implications for M&A Transactions

- In the case of taxable acquisitions of stock, purchase accounting — which generally results in an FMV basis in target assets for financial accounting purposes — is disregarded.

- Transactions that are entirely tax-free for regular income tax purposes generally are not subject to CAMT (i.e., the relevant FSI is not included in AFSI). However, the Proposed Regulations provide for a "cliff effect" pursuant to which an *entire* transaction can be subject to CAMT where *any* gain or loss is recognized by a transferor corporation — including in connection with an otherwise tax-free spin-off and in connection with a contribution to a corporation or partnership.
  - An exception to the "cliff effect" applies to the extent the transferor corporation distributes the taxable "boot" to its shareholders in connection with a reorganization (including a tax-free spin-off), but this exception would not apply in connection with a contribution to a corporation or partnership.
  - The "cliff effect" can be extremely punitive in situations where only a small amount of gain is recognized in an otherwise tax-free transaction; Applicable Corporations should carefully consider the impact of this rule when engaging in tax-free transactions involving the recognition of any gain by a transferor corporation.

- For M&A transactions resulting in a step-up of target assets, the Proposed Regulations align CAMT treatment with regular income tax treatment for most depreciable assets (rather than following financial accounting conventions). This approach also applies with respect to acquisitions of partnership interests involving a Section 743 election and to stock acquisitions that are treated as asset acquisitions for regular income tax purposes (e.g., due to a Section 336(e) or Section 338 election).

Certain Implications for Corporations Invested in Tax Partnerships

- For purposes of determining the CAMT base of an Applicable Corporation with a direct or indirect interest in a partnership, the Proposed Regulations adopt a complex, multi-step calculation for determining the corporation's distributive share of the partnership's AFSI (referred to in the Proposed Regulations as the "bottoms-up" method). Under the "bottoms-up" method, the Proposed Regulations initially require the Applicable Corporation to disregard the actual FSI associated with partnership operations and instead include a distributive share of the partnership's AFSI.
  - The Proposed Regulations would impose various information reporting and filing requirements on partnerships (including tiered partnerships) owned by Applicable Corporations. An Applicable Corporation that is a direct or indirect partner in a partnership can request information from the partnership that is necessary for the

    corporation to calculate its distributive share of the partnership's AFSI. The applicable partnership is then required to provide this information on an annual basis no later than the due date of the partnership's tax return for the year.

- The Proposed Regulations adopt special rules for tax-deferred contributions to and distributions from partnerships. At a high level, the Proposed Regulations adopt a "deferred sale" method that requires contributors and distributees to include the amount of built-in gain or loss (as measured utilizing a specific "CAMT basis" for such property) over an applicable recovery period, adapting a framework loosely analogous to the "remedial method" for contributions of built-in gain property to partnerships.
- The Proposed Regulations also adopt special rules to ensure tax-credit derivative partnership items that are intended to be exempt from tax retain that character. Specifically, the Proposed Regulations exclude from CAMT gross income amounts received pursuant to Section 6417 (direct payments in lieu of tax credits), Section 6418 (income from the sale of tax credits), and Section 48D (advanced manufacturing direct payments). Presumably, the foregoing items flowing into Applicable Corporations from partnerships would retain their character consistent with the intended CAMT treatment.

Certain Implications for Financially Distressed Corporations

- The Proposed Regulations substantially ameliorate concerns raised by earlier guidance that financially distressed companies could end up with a CAMT liability as a result of cancellation of debt income ("CODI") and the income statement items generated by "fresh start" accounting on emergence from bankruptcy.
- For CODI, the Proposed Regulations largely track the regular income tax rules, generally excluding from AFSI any CODI that is recognized for book purposes ("CAMT CODI") either (a) during a bankruptcy case and as a result of a confirmed bankruptcy plan or bankruptcy court order or (b) while the taxpayer is insolvent (to the extent of the taxpayer's insolvency).
    - To the extent CAMT CODI is excluded under these rules, it reduces CAMT tax attributes in a manner largely similar to the regular income tax rules. There is an exception that reduces basis in assets depreciable under Section 168 as a priority if such basis is reduced for regular income tax purposes. These rules, together with the uncertainty regarding how they apply in the consolidated context (as discussed below), could lead to considerable distortions, including by reducing

CAMT tax attributes with a shorter turnaround time than tax attributes for regular income tax purposes.

- The Proposed Regulations are unclear whether the bankruptcy exclusion, rather than the insolvency exclusion, applies to certain bankruptcy-adjacent book liability write-downs (e.g., the rules applicable to liabilities subject to compromise). This is because these bankruptcy-adjacent events are not directly attributable to the actual extinguishment or modification of debt pursuant to a bankruptcy court order or confirmed plan, and the bankruptcy exclusion itself appears to be limited to book CODI that is attributable to those items. Excluding these items from the CAMT CODI exclusion would be a very unfortunate limitation to the scope of the bankruptcy exclusion, essentially subjecting every company to valuation uncertainty around the time of its filing.
- Unlike in the regular income tax context, the Proposed Regulations do not provide any special rules for applying the CAMT attribute reduction rules to consolidated tax groups. Where each relevant entity is a member of a CAMT group and a tax consolidated group, the CAMT attribute reduction rules are relatively straightforward and it appears they would apply on a single-entity basis. However, if there are entities that are members of a tax consolidated group but not a financial statement group (e.g., in a situation where only some financial statement members file for bankruptcy, the book rules may deconsolidate an entity), the application of the rules is unclear.
- As is the case under the regular income tax rules, for insolvent or bankrupt partnerships or "disregarded entities," solvency or bankruptcy is tested at the partner, or regarded owner, level. As a result, it generally would not be possible for owners of these kinds of entities to rely on the bankruptcy exclusion, and the insolvency exclusion typically would not be available to owners that own assets other than the investment in the underlying troubled company.
- There are some omissions from the CAMT CODI provisions in the Proposed Regulations that are addressed for regular income tax purposes. Most notably, the Proposed Regulations do not appear to incorporate certain rules that can eliminate CODI on items that do not constitute "indebtedness" for general tax purposes (e.g., items that would give rise to future deductions when paid or where indebtedness is contributed to capital). These omissions could pose significant problems for companies in certain industries that use the bankruptcy process to modify or renegotiate non-"indebtedness" liabilities (e.g., long-term leases).
- The Proposed Regulations exclude from the calculation of AFSI book income that is solely attributable to fresh start accounting. In a departure from prior guidance, a bankruptcy transaction that is taxable for regular income tax purposes would remain taxable for CAMT purposes.

- So-called “G reorganizations” — a special type of tax-free reorganization that can only be accomplished by companies in bankruptcy — would be covered by the nonrecognition transaction rules discussed above.
- The Proposed Regulations unfortunately do not adopt any special rules that either exempt troubled companies from the CAMT or terminate their Applicable Corporation status. In determining whether a troubled company is an Applicable Corporation, the AFSI adjustments described above generally are taken into account. However, those adjustments are not taken into account under the Proposed Regulation’s simplified safe harbor for non-Applicable Corporation status, with the unfortunate result that many troubled companies would be unable to take advantage of that safe harbor.

Certain Limits on CAMT Loss Carryforwards

- In general, financial statement net operating loss (“FSNOL”) carryforwards may be used against AFSI in a manner similar to the way NOL carryforwards may be applied for regular income tax purposes. As was previewed in prior guidance, an Applicable Corporation’s FSNOL would take into account results for years prior to becoming an Applicable Corporation, with the result that all persons, whether or not current Applicable Corporations, would need to track their FSNOL.
- The Proposed Regulations would impose unfortunately onerous rules in connection with M&A transactions and changes of control with respect to troubled companies. In particular:
  - The Proposed Regulations adopt rules similar to, but in many ways even more onerous than, the “separate return limitation year” (or “SRLY”) rules that apply in the absence of the application of Section 382. Under the CAMT SRLY rules, an acquirer generally may use acquired FSNOL carryforwards only against AFSI generated by the acquired entity.
  - The Proposed Regulations would impose onerous tracking and tracing requirements, on an “acquired business line” basis, necessitating significant compliance efforts in order to benefit from acquired FSNOLs and potentially impeding integration efforts. Most notably, the rules essentially would require the continued tracking of losses following an integration, thereby defeating some of the significant non-tax benefits associated with integration (e.g., potential elimination of the need for separate accounting).
  - With respect to “net unrealized built in loss” companies, potentially onerous rules could apply to limit an acquirer group’s ability to benefit from such companies’ built in losses.

- Mercifully, the Proposed Regulations do not incorporate the very complicated change of control rules and limitations of Section 382.

Audit and Enforcement Considerations

- As with any detailed and complex regulations, taxpayers should maintain contemporaneous substantiation documenting positions under these Proposed Regulations to be audit ready. Similarly, because the Proposed Regulations leave many technical questions unaddressed, it is important that taxpayers retain records documenting how positions on such issues were determined.
- Treasury and the IRS included a detailed preamble to the Proposed Regulations, presumably to avoid challenges under the Administrative Procedure Act ("APA") by addressing comments submitted in response to earlier guidance. Treasury and the IRS have asked the public to submit comments on the Proposed Regulations by December 12, 2024. How they respond to such comments will affect whether any APA challenge could be successfully mounted against the final regulations; accordingly, taxpayers are urged to submit comments either directly or by working with appropriate trade associations on comment projects.
- Although Congress provided express delegations of authority to Treasury to fill in certain gaps and expand certain parts of the CAMT statute, the Proposed Regulations' breadth and scope arguably exceeds even that broad grant of authority, potentially subjecting the final regulations to challenges under the Supreme Court's recent decision in *Loper Bright* (overturning "*Chevron* deference").
- While more guidance from the Supreme Court likely is coming soon on the scope of the "major questions" doctrine to challenge agency guidance, portions of the Proposed Regulations may run afoul of that doctrine, e.g., because Treasury and the IRS are making policy decisions on questions of vast economic significance without sufficient guidance from Congress.
- The Proposed Regulations contain an anti-abuse rule that is broadly drafted to invalidate arrangements "with a principal purpose of avoiding the application" of the CAMT, including by avoiding being an Applicable Corporation and by reducing/avoiding a CAMT liability. Another rule would apply clear reflection of income principles between related parties, effectively imposing a Section 482 approach regardless of whether Section 482 otherwise applies. We anticipate that the IRS will rely on these rules to challenge what it perceives as abusive CAMT planning. To the extent they are retained in the final regulations, these rules may be vulnerable to challenge under *Loper Bright* and/or the "major questions" doctrine.

For questions regarding the application of the Proposed Regulations, please reach out to any member of the Kirkland tax team, including the authors below.

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1. Section references are to the Internal Revenue Code of 1986, as amended. ↩

2. Certain provisions of the Proposed Regulations would apply only to tax years ending after the regulations are finalized. Other provisions are effective for tax years ending after September 13, 2024, although taxpayers may with certain conditions rely on those provisions for prior tax years. ↩

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