Tax News and Developments

North America

Client Alert

November 2021

By the Book — Bringing Back a Corporate AMT

On Tuesday, October 26, 2021, Senators Elizabeth Warren (D-MA), Angus King (I-ME), and Ron Wyden (D-OR) introduced the Corporate Profits Minimum Tax Act (the "Corporate AMT Act") and, on October 28, the Corporate AMT Act was incorporated into the House Rules Committee's updated legislative text of the tax provisions in the reconciliation bill. With the exception of a change relating to the NOL provisions (noted below), the text in the Rules Committee draft matches the text in the Corporate AMT Act. The Corporate AMT Act was a revised version of the previously-introduced Real Corporate Profits Tax Act, which would have imposed a surtax on book income greater than $100 million and which had not garnered much support. On November 3, 2021, the House Rules Committee released a manager's amendment to its updated legislative text. Unless otherwise noted, this article describes the November 3, 2021 manager's amendment.

Background

Until recently, a minimum tax on book income was considered a long shot for inclusion in the tax bill, and the smart money was on an increase in the corporate income tax rate (likely to be 25%, despite the higher rates in the Ways & Means draft bill and the Biden administration's first Green Book). Expectations changed, however, when Senator Sinema made it clear that her objection to an increase in tax rates was unwavering. Now, the expectation is that the Corporate AMT Act will be passed as part of a larger reconciliation bill. While the timing of the final bill is still undetermined, we expect that the social spending bill (which includes the tax provisions) will be enacted by the end of 2021, if not before.

When the Tax Cuts and Jobs Act (the "TCJA") was enacted in 2017, it eliminated the existing corporate alternative minimum tax (the "AMT"). The Corporate AMT Act would effectively reinstate the corporate AMT, although it changes the thresholds at which the AMT would apply and changes the calculation. Under the Corporate AMT Act, corporations that report more than $1 billion in profits on their financial statements would be subject to a 15% tax rate on those book profits. We understand that Congress looked to Former Code Section 56(f) and Former Treas. Reg. § 1.56-1, Adjustment for the Book Income of Corporations, in designing the Corporate AMT Act. Affected taxpayers would be wise to familiarize themselves with these now-defunct rules should the Corporate AMT Act be passed into law. The bill's sponsors expect that it will apply to about 200 corporations, and the Joint Committee on Taxation has estimated that the provision will raise $318.9 billion over a ten-year period.

The Corporate AMT

As noted above, the TCJA effectively repealed the then-existing AMT to exclude all corporations from its scope. The Build Back Better Act (the "BBBA") would enact a vastly different and more impactful AMT for applicable corporations for taxable years beginning after 31 December 2022. The BBBA amends section 55(b)(2) to impose on applicable corporations a tentative minimum tax equal to 15% of its adjusted financial statement income (as determined under proposed section 56A) (the "AFSI") for each taxable year reduced by the corporate AMT foreign tax credit (as determined under proposed section 59(l)) for such year. Any corporate AMT paid is allowed as a credit against regular corporate tax liability in a subsequent year to the extent the regular corporate tax liability exceeds the corporate AMT liability (tentative minimum tax).

> **Observation**: For most, if not almost all, corporations, the corporate AMT will have no impact on the corporation's effective tax rate. Allowing a credit for corporate AMT paid creates a deferred tax asset for a corporation. Only if the corporation sets up a valuation allowance against the deferred tax asset will the corporate AMT impact a corporation's effective tax rate.

The applicable corporation must pay the excess of its tentative minimum tax over the sum of its regular tax liability and the tax imposed by the base erosion and anti-abuse tax (the "BEAT") of section 59A. Thus, application of the BEAT to a corporate taxpayer might generate sufficient minimum tax (when combined with the taxpayer's regular tax liability) that the taxpayer owes no tax under section 55. Of note, the tax base upon which the proposed corporate AMT is imposed is not a derivative of taxable income, as was the case under the prior corporate AMT. Rather the proposed corporate AMT is imposed on the applicable corporation's book income reported to its shareholders, creditors and other interested parties on its audited financial statements.

> **Observation**: The proposed corporate AMT creates, quite intentionally, a tension between an applicable corporation's desire to maximize its financial statement income (and earnings per share for publicly-traded corporations) reported to shareholders and its desire to minimize its taxable income subject to U.S. federal income tax. In relying primarily on book income, Congress will cede, to some degree, its control over the base upon which such tax is imposed to financial statement auditors, something it had been reluctant to do. These and other concerns about utilizing financial statement income as the taxable base have been raised with Congress. See, e.g., *Letter to Congressional Leadership dated November 4, 2021 from over 260 Academics*, reproduced in Tax Notes on November 4, 2021.

Applicable Corporation

Under proposed section 59(k), an "applicable corporation" is, with respect to any taxable year, any corporation, other than an S corporation, a real estate investment trust or a regulated investment company, which meets an average annual adjusted financial statement income ("average AFSI") test for one or more taxable years which are prior to such taxable year and end after 31 December 2021. Under this test, a corporation is an applicable corporation if its average annual AFSI for the three-taxable-year period ending with such taxable year is greater than $1 billion. From the current legislative text, it appears that the determination as to whether a corporation is an applicable corporation (and thus subject to the proposed corporate AMT) is made on an annual basis.

Solely for purposes of determining whether a corporation is an applicable corporation, proposed section 59(k)(1)(D)(i) provides that all persons treated as a single employer under section 52(a) or (b) are treated as one person. Section 52(a), in turn, provides that a controlled group of corporations, as defined in section 1563(a) (with certain modifications), is treated as a single employer. Of note, a foreign corporation that is subject to tax only under section 881 cannot be a component member of a controlled group of corporations under section 1563.

Instead, in determining whether a foreign corporation is an applicable corporation by virtue of exceeding the $1 billion threshold (alone), certain limitations under proposed section 59(k)(1)(D)(ii) apply. First, in the case of a foreign corporation that is a controlled foreign corporation, only its income that would constitute an adjustment to the AFSI of a U.S. shareholder of such CFC is taken into account. Second, the principles of section 882 (income effectively connected to a U.S. trade or business) apply in determining the AFSI of such corporation.

> **Observation**: Taxpayers should note that the $1 billion threshold for determining an applicable corporation is not indexed for inflation and taxpayers that are within striking distance of this amount may soon be subject to the proposal. Of course, organic growth and growth through acquisitions may also push taxpayers over the edge and into the scope of the proposed AMT

For a corporation that is a member of an international financial reporting group the common parent of which is a foreign corporation (i.e., a foreign-parented corporation), the corporation includes in its average annual AFSI the average annual AFSI (determined without regard to the limitations of proposed section 59(k)(1)(D)(ii)) of all foreign members for purposes of determining whether the $1 billion threshold is met. However, if the $1 billion threshold is satisfied, then to be considered an applicable corporation, the foreign-parented corporation must also have an average annual AFSI of at least $100 million for the three-taxable-year-period ending with such taxable year but without taking into account the entire international financial reporting group. Proposed section

59(k)(2)(B) defines an "international financial reporting group", by reference to section 163(n)(3), to mean (for any reporting year) two or more entities that are included in the same applicable financial statement (for such year) if any of them are foreign corporations engaged in a U.S. trade or business or if one is a foreign corporation and one is a domestic corporation.

For purposes of determining whether a corporation is an applicable corporation, if a corporation is in existence for less than three taxable years, then the actual period during which it is in existence is used. If any taxable year is less than 12 months, the corporation's AFSI is annualized.

A corporation that would otherwise be treated as an applicable corporation for purposes of the proposed corporate AMT may be excused by the Secretary from that classification (and the scope of the AMT) if the Secretary determines it would not be appropriate to continue to treat it as an applicable corporation and: 1) that corporation has a change of ownership (presumably within the meaning of section 382); or 2) has a specified number (as determined by the Secretary taking into the facts and circumstances) of consecutive taxable years, including the most recent taxable year, in which its annual average AFSI is below the thresholds discussed above. However, if after the Secretary makes this determination for a taxable year, the corporation meets the average annual AFSI test for any taxable year after the first taxable year to which the determination applies, then this exception from the proposed corporate AMT will cease to apply. The proposed legislative text is arguably unclear as to whether such cessation will be prospective only or will be retroactive to the year that the Secretary's original determination applied.

> **Observation**: While the legislative text provides some very general guidance as to the circumstances under which the Secretary can determine that a corporation is no longer an applicable corporation subject to the corporate AMT, it vests even more discretion in the Secretary as to if, when, and how it will make its determination. Guidance from the Secretary on these points will be critical for taxpayers intending to seek such a determination.

> **Observation**: For purposes of determining if a corporation is an applicable corporation, any reference to a corporation includes a reference to any predecessor of such corporation. Although the proposed legislative text is not clear on what constitutes a predecessor corporation, in an M&A context, taxpayers should pay particular attention in business combination transactions where separate financial results of the corporations would not meet the average AFSI thresholds but where combined, the two companies would meet the requirements based on the historic performance of the companies.

Proposed section 59(k) also grants the Secretary the authority to issue regulations and other guidance to carry out its purposes including regulations or other guidance that provide a simplified mechanism to determine whether a corporation is an applicable corporation and that address the application of these rules to a corporation that undergoes a change in ownership.

Adjusted Financial Statement Income

Proposed section 55(b)(2) also imposes a 15% tax on a taxpayer's AFSI reduced by the corporate AMT foreign tax credit.

Under proposed section 56A, a corporation's AFSI is the net income or loss for a tax year as set forth in that corporation's "applicable financial statement" as defined in section 451(b)(3)(e.g., a financial statement prepared in accordance with GAAP and filed with the SEC or which is audited and used for credit, reporting or nontax purposes, or a financial statement prepared on the basis of international financial reporting standards and filed with a foreign government agency equivalent to the SEC).

If a taxpayer's financial results are only reported on its own applicable financial statement, then the taxpayer's AFSI will be the income reported on that financial statement. However, if the taxpayer's financial results are reported on the applicable financial statement for a group of entities, then the AFSI calculation is more complicated and based on the group's applicable financial statement.

The proposed legislation requires four main adjustments to the taxpayer's net income or loss. First, a US consolidated tax group determines its AFSI by taking into account the items from the group's applicable financial statement that are "properly allocable" to members of the US consolidated group included on such return. The BBBA does not give any guidance on how to properly allocate financial statement items to a US consolidated tax group. However, as we understand that Former Treas. Reg.§ 1.56-1 was used as a guide for drafting the new minimum tax provisions, the principles in Former Treas. Reg.§ 1.56-1 may provide insight into the regulations that treasury could issue to interpret this broad phrase.

Second, if a company is a part of the taxpayer's financial reporting group, but not the taxpayer's US consolidated tax group, then the taxpayer must take into account "earnings" from that other company to the extent those earnings are included in the gross income of the taxpayer for tax purposes (e.g., by way of a dividend, but not inclusions under sections 951 and 951A).

> **Observation:** Under this rule, it would appear that a taxpayer cannot reduce its AFSI by an accounting loss generated by its corporate subsidiary that is a member of the taxpayer's financial

reporting group but that is not a member of the taxpayer's US consolidated tax group.

Observation: Under regular tax principles, a taxpayer could claim a dividends received deduction ("DRD") under sections 243, 245, or 245A for dividends paid by a lower-tier company that is not part of the taxpayer's US consolidated tax group. However, for purposes of section 55, the taxpayer could not claim a DRD for the earnings of the lower-tier company, even though the earnings of the lower-tier company would have already been subject to US federal income tax on its earnings. Thus, a material double tax situation could result for any dividends paid by the lower-tier company. Nevertheless, the November 3, 2021 manager's amendment allows Treasury to issue regulations that would reduce the dividend inclusion amount for unconsolidated entities, but the House has given no guidance on how Treasury should exercise this authority.

Third, if the taxpayer is a US shareholder of a CFC, then the taxpayer must take into account the taxpayer's pro-rata share, as determined under rules similar to those of section 951(a)(2) of the CFC's items of income or loss that is recorded on the CFC's applicable financial statement. Importantly, a taxpayer cannot reduce its AFSI by the CFC's losses, but such negative adjustment can offset the succeeding taxable year's adjustment.

Observation: While a taxpayer cannot reduce its AFSI by its pro-rata share of its CFC's losses, the section-by-section summary that was released with the legislative text clarifies that a taxpayer can use its CFC's losses to offset income from its other CFCs.

Observation: Under Treas. Reg. § 1.451-3(a)(5), a CFC's US GAAP financial statement would take primacy over a CFC's IFRS or other local GAAP financial statement. However, a CFC's foreign taxable income is often based in part on local accounting accrual and mark-to-market principles. Thus, it would make sense for Treasury to allow taxpayers to recognize the income reported on a CFC's IFRS or other local GAAP financial statement, so that the taxpayer's pro-rata share of the CFC's taxable income matches the CFC's associated foreign taxes.

Observation: The proposal does not contain a coordinating rule between the second and third rules described above when a CFC pays a dividend to its US shareholder. One would hope that Treasury would use its authority to prevent duplication of income and issue rules that would disregard any dividends that the taxpayer receives from a CFC, to the extent the taxpayer has already included the CFC's earnings in the taxpayer's AFSI. Under Former Treas. Reg.§ 1.56-1, AFSI excluded any distribution of Subpart F income that was not taxable under Section 959.

Fourth, AFSI is adjusted to disregard any Federal taxes or income, war profits, or excess profits taxes imposed by a foreign country or possession of the US, which are directly or indirectly taken into account on the taxpayer's applicable financial statements. This adjustment, as it relates to foreign taxes, is only required to the extent the taxpayer chooses to claim a foreign tax credit for those taxes.

In addition, the proposal in the November 3, 2021 manager's amendment would provide specific rules for foreign corporations to determine their effectively connected AFSI. Under this proposal, if the taxpayer is a foreign company, then the taxpayer should apply the principles in section 882 to determine what portion of the taxpayer's income is effectively connected AFSI. Former Treas. Reg. § 1.56-1 had incorporated similar rules to determine the book income that was effectively connected with a US trade or business.

A taxpayer is required to make certain other adjustments to AFSI, some of which include adjustments to take into account income and losses from disregarded entities that are a member of the taxpayer's financial reporting group, regardless of whether the disregarded entity paid dividends to the taxpayer and adjustments that must be made if the applicable financial statement covers a period other than the taxable year. In addition, the November 3, 2021 manager's amendment would require taxpayers to take into account the earnings of the partnership in the same proportion as the taxpayer's distributive share of items from the partnership.

The proposed legislation also grants the Secretary the authority to issue regulations and other guidance for adjustments to financial statement income to carry out the purposes of the rules, including adjustments to prevent omission or duplication of any item and to coordinate the rules with the rules that govern corporate liquidations, organizations and reorganizations.

> **Observation:** The proposal provides specific rules for determining which income of a foreign-parented multinational group is taken into account for purposes of determining whether the US subsidiary is an "applicable corporation." However, the proposal does not provide specific rules on how a foreign-parented multinational should determine the AFSI of its US corporate subsidiary. Nevertheless, Former Treas. Reg.§ 1.56-1 indicated that the US subsidiary would rely on its separately prepared financial statement for purposes of determining its AFSI (rather than the consolidated financial statements of the foreign parent).

Net Operating Losses and CFC Losses

Proposed section 59A(d) creates new "financial statement operating loss" ("FSOL") rules to provide some relief for taxpayers that have carryforward tax NOLs. An FSOL means a loss recognized on the taxpayer's applicable financial statement for taxable years ending after December 31, 2019. Because an FSOL is based on a taxpayer's US GAAP loss, the amount of a taxpayer's FSOL will differ from a taxpayer's section 172 NOL carryforward. An FSOL that arises after Dec. 31, 2019 can be carried forward to future years to reduce the taxpayer's AFSI in those later years. However, the amount of the carried forward FSOL that can be used in a given year is limited to 80% of the taxpayer's AFSI for that year.

Unfortunately, the proposal would not allow taxpayers to reduce their AFSI by any accounting losses incurred prior to 2020. We understand that 2020 was chosen as a cut-off date so as not to harm taxpayers with large COVID related losses.

> **Observation**: As a result of this temporal limitation for pre-2020 accounting losses, the utility and value of a taxpayer's existing section 172 NOL's may substantially decrease. It will be interesting to see whether financial auditors could require some taxpayers in a perpetual AMT position to book valuation allowances for NOLs already recorded on a taxpayer's balance sheet.

> **Observation**: It will be interesting to see whether Treasury will limit when taxpayers can recognize large GAAP losses from goodwill or other impairments that cannot be recognized for tax purposes. These financial accounting losses could be beneficial to taxpayers that are permanently subject to the AMT. However, taxpayers that recognize large goodwill impairments in years before the associated tax loss is recognized (which can take the form of a later worthless stock deduction) may be adversely affected.

A taxpayer's FSOL often will not equal the taxpayer's loss reported on its 10-K or consolidated financial statements. The previously described AFSI rules provide that a taxpayer that is part of a US consolidated tax group can only have a FSOL to the extent that the consolidated GAAP loss is "properly attributable" to members of the US consolidated tax group. Thus, it may be possible for the US consolidated tax group to have an FSOL, even though the taxpayer's 10-K or consolidated financial statement shows a profit.

R&D and Other Business Credits

Helpfully, the proposal allows taxpayers to reduce their AMT tax by R&D credits and other business credits. Under the proposal, a corporation's

R&D and other business credits would generally be limited to the sum of (1) 75% of the corporation's regular income tax liability (reduced by foreign tax credits) plus (2) corporation's AMT tax liability.

Thus, the proposed R&D credit provisions are more taxpayer friendly than the previous version of the corporate AMT that was repealed in 2017.

Foreign Tax Credits

The proposal allows taxpayers to partially benefit from their foreign tax credits. Under the proposal, a taxpayer can reduce its AMT tax by the taxpayer's "AMT foreign tax credits" (AMT FTC). However, this FTC allowance does not mean that taxpayers can take the benefit of all the foreign taxes that the taxpayer claimed for regular tax purposes. The proposal provides specific rules that can limit the section 901 and section 960 credits that are taken into account.

For "direct" section 901 foreign taxes, a taxpayer can claim an AMT FTC to the extent such foreign taxes are taken into account on the taxpayer's applicable financial statement and are paid and accrued for Federal income tax purposes.

> **Observation**: The proposal is not clear as to whether the foreign taxes must be reflected on the taxpayer's financial statement in the same year that the foreign taxes are treated as being paid or accrued for US tax purposes. For example, if a disregarded entity's foreign tax year does not align with the taxpayer's US tax year, then the disregarded entity's foreign taxes could be treated as accruing for Federal tax purposes in a different year than when the same taxes accrued for financial statement purposes. Taxpayers should request clarity from Congress to prevent this illogical result for both section 901 and section 960 AMT FTCs.

For "indirect" section 960 foreign taxes, a taxpayer can claim an AMT FTC equal to the lesser of:

(1) The taxpayer's AFSI from its CFCs multiplied by the 15% AMT corporate tax rate, or

(2) The sum of the taxpayer's pro-rata share of the section 960 foreign taxes that are taken into account on the taxpayer's applicable financial statement and that are paid or accrued by the CFC for Federal income tax purposes.

Thus, generally, if the taxpayer's CFC's pay foreign taxes at a rate higher than 15%, then the taxpayer will only be able to benefit a portion of these foreign tax credits for AMT purposes. However, the taxpayer is allowed to carry forward any foreign tax credits in excess of this 15% limitation for the five subsequent tax years.

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Observation: The proposal does not include a country-by-country or other foreign tax credit limitation for AMT FTC's. However, it is possible that Treasury could use its broad grant of regulatory authority to impose such limitations on AMT FTC's. Nevertheless, given that the purpose of the AMT is to ensure that a minimum amount of tax has been paid, we would question whether it would be a good policy choice for Treasury to impose any foreign tax credit limitation—other than the 15% taxable income limitation—on AMT FTCs because the minimum amount of foreign tax has already been paid on this income.

Conclusion

Based on recent Congressional developments, it appears likely that the Corporate AMT Act will be included in a tax reconciliation bill in lieu of prior proposals to increase the corporate income tax rate. Changes have been made in each version of the proposal that has been publicly released – from the bill introduced by Senator Warren and others, to the proposal included in the House Rules Committee legislative draft, to the manager's amendment released by the House Rules Committee on November 3, 2021 – indicating that staff and members are responsive to stakeholder comments about the proposal. Despite this, it appears that many of the most complicated questions that stakeholders have raised are unlikely to be addressed in legislative text and will, instead, be left to Treasury to address through regulations or other guidance.

Taxpayers who are potentially subject to this proposal should not view legislative enactment as the end of the process. Rather, should the reconciliation bill be enacted, potentially-impacted taxpayers should shift their focus to engaging with Treasury and IRS to identify areas where guidance and further clarification is required.

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