December 6, 2022

The Honorable Lily Batchelder
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**Re: Additional Recommendations for Guidance on the Corporate Alternative Minimum Tax**

Dear Assistant Secretary Batchelder, Acting Commissioner O'Donnell, and Principal Deputy Chief Counsel Paul,

In follow-up to our letter dated September 28, 2022 (the "September 28th Comment"), please find enclosed additional initial recommendations for guidance concerning the corporate alternative minimum tax enacted in P.L. 117-169 (known as the Inflation Reduction Act). The Tax Law Center at NYU Law is a public interest initiative that seeks to improve the integrity of the tax system. Our staff includes tax law experts with experience in tax administration, private practice, and the tax legislative process.

We would be pleased to discuss these recommendations with you or your staff.

Sincerely,

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Executive Director, Tax Law Center at NYU Law

Enclosure

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## 1 Introduction[1]

The corporate alternative minimum tax enacted in P.L. 117-169 (known as the Inflation Reduction Act or "IRA" and such tax the "CAMT") requires the computation of a corporation's adjusted financial statement income ("AFSI") for two significant purposes. First, AFSI helps determine the tax base of the new regime. Second, AFSI helps determine whether a corporation is an applicable corporation (an "AC") potentially subject to tax.[2]

The computation of a corporation's AFSI raises numerous technical issues and policy considerations. In this comment, we primarily focus on several rules that impact the computation of AFSI in the context of related entities.[3] In particular, we address some of the provisions involving corporate subsidiaries, partnerships, and foreign corporations.

Our principal recommendations are:

1. Guidance should clarify that the Dividends Rule (as defined below) does not nullify the Pro Rata Share Rule (as defined below).
2. Guidance should include rules to prevent duplicative inclusions of net income in the AFSI of an AC under the Dividends Rule and Pro Rata Share Rule.
3. Treasury and the IRS should consider rules to ensure the application of the Dividends Rule and ECAFSI Rule (as defined below) does not result in duplicative inclusions of net income in the AFSI of a foreign corporation and a distributee shareholder.
4. Guidance should clarify the meaning of the term "dividends" as used in the Dividends Rule.
5. Guidance should clarify that the Distributive Share Rule (as defined below) requires a partner to include in AFSI its distributive share of partnership AFSI, whether or not any amounts with respect to the partnership are reflected on the partner's AFS.
6. Guidance should provide that a partnership uses a standalone financial statement for its AFS.
7. Guidance should provide rules for determining a partner's distributive share of partnership AFSI.
8. Guidance should clarify whether a partnership is treated as an entity or an aggregate of its partners for various purposes under the CAMT.
9. Guidance should provide rules for the determination of the pro rata share of a United States shareholder (a "USSH") under the Pro Rata Share Rule.
10. Guidance should clarify that, for purposes of the Pro Rata Share Rule, a controlled foreign corporation (a "CFC") adjusts the net income or loss set forth on the AFS without regard to the ECAFSI Rule.

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[1] The principal authors of this comment are Rose Jenkins and Peter Richman.

[2] While all corporations are subject to the CAMT, if a corporation is not an AC, its CAMT liability is zero. *See* section 55(a) and (b)(2)(B).

[3] *See* the September 28th Comment for additional recommendations regarding the computation of AFSI.

11. Guidance should clarify whether the Pro Rata Share Rule applies on a CFC-by-CFC basis or to determine an aggregate amount with respect to all of a USSH's CFCs.
12. Treasury and the IRS should consider rules to ensure that, to the extent guidance permits an adjustment to AFSI for a transaction that is afforded nonrecognition treatment for US federal income tax purposes, the acquiror does not inappropriately benefit from a step-up in financial accounting basis.
13. Guidance should provide that a corporate partner disregards the Distributive Share Rule with respect to a partnership for purposes of the General Aggregation Rule (as defined below) only when it is aggregated with the partnership.
14. Guidance should include rules to prevent duplicative inclusions of net income in AFSI under the General Aggregation Rule for purposes of the AAAFSI Test (as defined below).
15. Treasury and the IRS should consider rules to prevent duplicative inclusions of ECAFSI (as defined below) in AFSI under the ECAFSI Rule and Pro Rata Share Rule for purposes of the AAAFSI Test.
16. Guidance should provide that a member of a FPMNG (as defined below) disregards the Distributive Share Rule for purposes of the FPMNG Aggregation Rule (as defined below) only when the partnership is treated as part of the FPMNG.

## 2 Overview of Relevant Statutory Provisions

The issues involved in the computation of a corporation's AFSI may be sorted into two categories that align with the dual purposes of that computation described in Part 1. The first category, which relates to the computation of the CAMT's base, includes issues that arise primarily due to the interaction of the various rules in section 56A. The second category, which relates to the determination of the CAMT's scope, includes some, but not all, of the issues in the first category. The partial overlap exists because section 59(k) defines an AC, in part, by reference to AFSI. However, as explained further in Part 2.2, section 59(k) modifies the application of section 56A in several ways for purposes of determining whether a corporation is an AC. In some instances, these modifications ensure that issues included in the first category are not replicated in the second category; in other instances, these modifications create new technical issues that only affect the determination of whether a corporation is an AC.

### 2.1 Section 56A

Regarding section 56A, our recommendations primarily relate to the following provisions:

- Section 56A(c)(2)(C) (the "Dividends Rule"): The Dividends Rule provides that, if a corporation ("Subsidiary") is not included on the consolidated return of the taxpayer ("Parent"), Parent's AFSI with respect to Subsidiary is generally determined by only taking into account the dividends received from Subsidiary and other amounts which are includible in gross income (other than pursuant to sections 951 and 951A) or deductible

as a loss by Parent with respect to Subsidiary.[4] The Dividends Rule includes specific grants of authority to the Secretary to (i) issue regulations or other guidance reducing the amount of dividends Parent must include in AFSI, and (ii) provide other amounts which should not be taken into account in the determination of Parent's AFSI.[5]

- Section 56A(c)(2)(D): Section 56A(c)(2)(D) provides two rules relevant to partners in a partnership. First, except as otherwise provided in guidance, the AFSI of a partner with respect a partnership is adjusted to only take into account the partner's distributive share of the partnership's AFSI (the "Distributive Share Rule").[6] Second, the partnership's AFSI is defined as the partnership's net income or loss set forth on its applicable financial statement ("AFS"), adjusted under rules similar to those of section 56A (the "Partnership AFSI Rule").[7]
- Section 56A(c)(3) (the "Pro Rata Share Rule"): The Pro Rata Share Rule generally provides that the AFSI of a USSH with respect to a CFC is adjusted to account for the USSH's pro rata share of items taken into account in computing the net income or loss set forth on the AFS of the CFC.[8] The USSH's pro rata share is to be determined under rules similar to the rules under section 951(a)(2).[9] The net income or loss set forth on the CFC's AFS is to be adjusted under rules similar to those that apply in determining AFSI.[10] No negative adjustment to a USSH's AFSI may be made pursuant to the Pro Rata Share Rule;[11] instead, any such adjustment carries forward to the succeeding taxable year and reduces the adjustment that would otherwise apply under the Pro Rata Share Rule in such year.[12]
- Section 56A(c)(4) (the "ECAFSI Rule"): The ECAFSI Rule provides that to determine the AFSI of a foreign corporation, the principles of section 882 apply.[13] Net income of a foreign corporation that is effectively connected with the conduct of a trade or business in the US and thus, applying the principles of section 882, would be treated as AFSI of the corporation under the ECAFSI Rule is referred to herein as effectively connected AFSI ("ECAFSI").
- Section 56A(d) (the "FSNOL Rule"): The FSNOL Rule generally provides that, after AFSI is determined pursuant to section 56A(c), it is reduced by the lesser of (i) the

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[4] Section 56(c)(2)(C).

[5] *Id*.

[6] Section 56(c)(2)(D)(i).

[7] Section 56(c)(2)(D)(ii).

[8] Section 56(c)(3)(A).

[9] *Id*.

[10] *Id*.

[11] Section 56A(c)(3)(B)(i).

[12] Section 56A(c)(3)(B)(ii).

[13] Section 56A(c)(4).

aggregate amount of financial statement net operating loss carryovers ("FSNOLs") to the taxable year, or (ii) 80 percent of AFSI computed without regard to the FSNOL Rule.[14]

- Section 56A(c)(15): The grant of authority in section 56A(c)(15) authorizes the Secretary to issue regulations or other guidance to provide adjustments to AFSI as the Secretary determines necessary to carry out the purposes of section 56A, including adjustments (i) to prevent the omission or duplication of any item,[15] and (ii) to carry out the principles of parts II and III of subchapter C and part II of subchapter K.[16]

### 2.2 Section 59(k)

Regarding section 59(k), our recommendations primarily relate to the following provisions:

- Section 59(k)(1)(B) (the "AAAFSI Test"): The AAAFSI Test is used to determine whether a corporation is an AC.[17] The AAAFSI Test consists of two different tests:
    - Section 59(k)(1)(B)(i) (the "One-Prong Test"): A corporation satisfies the One-Prong Test for a taxable year if its average annual AFSI ("AAAFSI"), determined without regard to the FSNOL Rule, for the 3-taxable-year period ending with the year exceeds $1,000,000,000.[18]
    - Section 59(k)(1)(B)(ii) (the "Two-Prong Test"): A corporation that is a member of a FPMNG (defined below) is subject to the Two-Prong Test instead of the One-Prong Test.[19] A corporation satisfies the Two-Prong Test if (i) it satisfies the One-Prong Test for the taxable year (determined after applying the FPMNG Rule (defined below)),[20] and (ii) its AAAFSI, determined without regard to the FPMNG Rule or the FSNOL Rule, for the 3-taxable-year period ending with the taxable year is $100,000,000 or more.[21]
- Section 59(k)(1)(D) (the "General Aggregation Rule"): The General Aggregation Rule generally provides that, for purposes of determining whether a corporation is an AC under the One-Prong Test, all AFSI of persons treated as a single employer with the corporation under subsection (a) or (b) of section 52 is treated as the AFSI of such corporation, and the AFSI of such corporation is determined without regard to the Distributive Share Rule and section 56A(c)(11).[22]

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[14] Section 56A(d).

[15] Section 56A(c)(15)(A).

[16] Section 56A(c)(15)(B).

[17] Any corporation other than an S corporation, a regulated investment company, or a real estate investment trust may be an AC. Section 59(k)(1)(A).

[18] Section 59(k)(1)(B)(i).

[19] Section 59(k)(1)(B)(ii).

[20] Section 59(k)(1)(B)(ii)(I).

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

[22] Section 59(k)(1)(D).

- Section 59(k)(2) (the "FPMNG Rule"): The FPMNG Rule provides special rules that apply in the case of a foreign-parented multinational group (a "FPMNG"). In general, for purposes of determining whether a corporation that is a member of a FPMNG satisfies the first prong of the Two-Prong Test, the corporation's AFSI includes the AFSI of all members of the FPMNG (the "FPMNG Aggregation Rule").[23] However, for purposes of the FPMNG Aggregation Rule, AFSI is determined without regard to the Distributive Share Rule, the Pro Rata Share Rule, the ECAFSI Rule, and section 56A(c)(11).[24]

# 3 Determination of AFSI

## 3.1 The Dividends Rule

### 3.1.1 Application of the Dividends Rule and the Pro Rata Share Rule

There may be an argument that the use of the word "only" in the Dividends Rule effectively nullifies the Pro Rata Share Rule. As described in Part 2.1, the Dividends Rule provides that the AFSI of a taxpayer with respect to a corporation not included on its consolidated return is determined "by ***only*** taking into account" dividends and certain other amounts. (Emphasis added.) Thus, any other item with respect to a non-consolidated subsidiary is arguably precluded from being taken into account in the AFSI of the taxpayer, including those items that would otherwise be accounted for under the Pro Rata Share Rule. Under this interpretation, the Dividends Rule would effectively override the Pro Rata Share Rule.

However, the language of the Pro Rata Share Rule—as well as fundamental principles of statutory construction—make clear that it is to be applied alongside the Dividends Rule. During the development of the IRA, the Pro Rata Share Rule was modified in a manner that confirms it is not nullified by the Dividends Rule. In an earlier version of the IRA, the Pro Rata Share Rule provided that, for a USSH of a CFC, AFSI "shall be adjusted to take into account such taxpayer's pro rata share . . . of items taken into account in computing the net income or loss" set forth on the CFC's AFS.[25] By contrast, the Pro Rata Share Rule, as enacted, provides that, for a USSH of a CFC, AFSI "***with respect to such CFC (as determined under paragraph (2)(C))*** shall be adjusted to ***also*** take into account such taxpayer's pro rata share . . . of items taken into account in computing the net income or loss set forth" on the CFC's AFS." (Emphasis added.) The first modification appears to suggest that the USSH first applies the Dividends Rule, and then applies the Pro Rata Share Rule, to compute its AFSI with respect to a CFC. As discussed in Part 3.1.2, Treasury and the IRS may wish to consider a formulation of the Dividends Rule that would likely require reversing this order of application. However, regardless of the proper sequencing, the second modification (that is, the use of the word "also") confirms that the USSH must apply both the Dividends Rule and the Pro Rata Share Rule. Accordingly, we recommend that guidance make clear that the Dividends Rule does not nullify the Pro Rata Share Rule.

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[23] *See s*ection 59(k)(2)(A).

[24] *Id*.

[25] *See* An Amendment in the Nature of a Substitute to H.R. 5376, The "Inflation Reduction Act of 2022" (July 27, 2022).

### 3.1.2 Exclusion of Some Dividends from the Application of the Dividends Rule

The interaction of the Dividends Rule and the Pro Rata Share Rule presents the possibility that some items of net income might be included in AFSI more than once. In particular, when amounts of net income that have been included in the AFSI of a USSH under the Pro Rata Share Rule are later distributed, they may be "double-counted" in AFSI if they are again included in the AFSI or net income (as relevant)[26] of the distributee under the Dividends Rule.[27]

Since enactment of the IRA, Treasury and the IRS have publicly indicated that guidance would address the potential for duplications of items in AFSI.[28] Government officials have communicated an intent to harmonize the Dividends Rule with the Pro Rata Share Rule, pointing to the grant of authority in the Dividends Rule to reduce the amount of dividends taken into account in AFSI as well as the grant of authority in section 56A(c)(15) to prevent the omission or duplication of any item.[29] However, the precise mechanic that will be adopted to prevent double-counting remains uncertain.[30]

We recommend that Treasury and the IRS address the potential for duplication of items in AFSI by limiting the application of the Dividends Rule and offer three specific alternative approaches for doing so. Dividends might be excluded from inclusion in AFSI by reason of the Dividends Rule: (i) if they are drawn from amounts previously included in AFSI ("PIAFSI"); (ii) if the distributing corporation is a CFC; or (iii) based on the characterization of the dividend for US federal income tax purposes. Each of these three options involves some tradeoff between precision and administrability.

#### 3.1.2.1 Option 1: Exclude Distributions of PIAFSI

The most precise mechanism for preventing double-counting would be a system that tracks previously included AFSI (i.e., PIAFSI) from its original inclusion in the AFSI of a USSH under the Pro Rata Share Rule through its distribution to a domestic corporation ("Option 1"). This system, which would be conceptually similar to the system for tracking previously taxed earnings and profits ("PTEP") under sections 959 and 961, would entail three main components: (i) designating certain amounts included in AFSI under the Pro Rata Share Rule as PIAFSI; (ii) tracking PIAFSI and a corresponding basis-like attribute ("PIAFSI basis"); and (iii) excluding from the net income of a distributee dividends that are made out of PIAFSI or gain that is offset

[26] If the distribution is made to a United States person, the dividend may constitute net income of the distributee that is characterized as AFSI. If the distribution is made to a CFC, the dividend may constitute an item of net income of the distributee included in the AFSI of a USSH under the Pro Rata Share Rule.

[27] The concern regarding double-counting may also arise in the case of net income that has been included in the AFSI of a foreign corporation under the ECAFSI Rule. The potential for double-counting ECAFSI in AFSI is further discussed in Part 3.1.2.4.

[28] *See, e.g.,* Andrew Velarde, *IRS Notes Concerns About CFC Double Counting Under Corporate AMT*, Tax Notes Today International (October 17, 2022) (quoting a government official as stating that "duplications are definitely not intended").

[29] *See id*.

[30] *See* Andrew Velarde, *Treasury Strongly Hints at Corporate AMT CFC Double-Counting Relief*, Tax Notes Today International, (October 21, 2022) (quoting a government official as stating that Treasury is seeking to prevent the omission or duplication of any item, but "[t]he question is the mechanism. That is something where we are still gathering comments and input.").

by PIAFSI basis. Each of these components presents important issues to be considered in the evaluation of Option 1.

#### 3.1.2.1.1 Designation of PIAFSI

The designation of some amounts included in AFSI as PIAFSI raises the threshold issue of defining which amounts are considered to have been previously included. Stated differently, what item might, in the absence of guidance, be inappropriately double-counted when distributed as a dividend? In theory, PIAFSI could be defined as (i) amounts that were previously included in the CAMT liability of an AC, (ii) amounts that were previously included in the AFSI of any corporation, or (iii) amounts that were previously included in the AFSI of an AC. For the reasons discussed below, we recommend that, if Option 1 is adopted, PIAFSI be defined as amounts previously included in the AFSI of an AC.

##### 3.1.2.1.1.1 Amounts Previously Included in the CAMT Liability of an AC

There may be an argument that the definition of PIAFSI should be limited to amounts previously taxed under the CAMT. Under this approach, an AC that is a USSH would need to allocate all or a portion of its CAMT liability to its CFCs, presumably in proportion to the amounts included by the USSH in its AFSI by reason of the Pro Rata Share Rule with respect to each of the CFCs. However, this approach would present significant mechanical complexity while failing to appropriately address the concern for double-counting.

As an initial matter, it is unclear how this approach would be implemented accurately. An AC's AFSI is adjusted under many rules in section 56A(c) other than the Pro Rata Share Rule and reduced for FSNOLs under the FSNOL Rule. Once AFSI is determined, an AC's potential CAMT liability may be affected by the AC's CAMT foreign tax credit, section 59A liability, and regular tax liability. Thus, the AC's AFSI accounted for under the Pro Rata Share Rule is a single component in one of a series of formulas that ultimately produce the AC's CAMT liability. Disaggregating this CAMT liability into amounts that can be traced to each of the AC's CFCs and appropriately designated as PIAFSI would be inordinately complex.

In addition, this approach would not result in the appropriate computation of a corporation's AFSI. Consider a USSH that is an AC that accounts for significant AFSI under the Pro Rata Share Rule with respect to its CFCs in year 1 but does not have any CAMT liability because its AFSI is fully offset by an FSNOL. If the net income of the CFCs is not designated PIAFSI due to the lack of a CAMT liability, when distributed in year 2, it would be included in the AFSI of the USSH under the Dividends Rule. While the underlying net income may not result in the duplication of a CAMT liability, the failure to exclude the year 2 distribution from application of the Dividends Rule would effectively eliminate the value of the FSNOL. Thus, defining PIAFSI as amounts previously taxed under the CAMT could effectively nullify section 56A(d). Accordingly, for both administrative and policy reasons, if Option 1 is adopted, PIAFSI should not be defined as amounts previously included in the CAMT liability of an AC.

##### 3.1.2.1.1.2 Amounts Previously Included in the AFSI of any Corporation

The CAMT ostensibly requires that *all* corporations track their AFSI for purposes of determining whether they satisfy the AAAFSI Test. Thus, there may be an argument that any AFSI accounted for under the AAAFSI Test, regardless of whether the test is ultimately satisfied, has been "included" once and therefore should not be included again in AFSI for any purpose. In practical

terms, this approach would designate all net income accounted for under the Pro Rata Share Rule for any purpose as PIAFSI.

However, this approach would unjustifiably extend the concern over double-counting from one regarding the imposition of tax to one regarding scope. Amounts included in AFSI under the Pro Rata Share Rule by a corporation that is not an AC do not factor into the computation of that corporation's potential CAMT liability. Thus, the amounts have not been included for any purpose for which relief from a subsequent inclusion is warranted. Moreover, if distributions are subsequently made out of the underlying net income to a USSH that is an AC (e.g., because the USSH becomes an AC after the net income is earned but prior to the distribution), their exclusion from the AFSI or net income (as relevant) of the distributee would eliminate that amount from the CAMT base altogether. Thus, as a policy matter, defining amounts previously included in the AFSI of any corporation as PIAFSI would be an inappropriately broad response to the concern over double-counting.

In addition, this approach would present significant compliance and enforcement difficulties. In theory, the PIAFSI generated by any CFC—regardless of its size or whether it or any of its USSHs is an AC—would become a meaningful tax attribute, as future distributions by the CFC might be subject to the Dividends Rule. For example, a USSH that is not an AC might become an AC, or the stock of a CFC not previously owned by an AC might be acquired by an AC. Unless the PIAFSI was tracked from its original inclusion in the AAAFSI Test, these situations would require extensive retroactive record-keeping. The difficulty involved in recreating the relevant tax and financial accounting histories would present significant difficulties for both taxpayers and the IRS. Thus, for both policy and administrative reasons, if Option 1 is adopted, PIAFSI should not be defined as amounts previously included in the AFSI of any corporation.

#### 3.1.2.1.1.3 Amounts Previously Included in the AFSI of an AC

Under Option 1, concerns regarding double-counting would be most appropriately addressed by defining PIAFSI as amounts previously included in the AFSI of an AC. Under this approach, only those amounts that were previously accounted for in the computation of a potential CAMT liability would be excluded from the AFSI or net income (as relevant) of a distributee when distributed as a dividend. As a result, the Dividends Rule would not result in the double-counting of items for purposes of the imposition of tax. Accordingly, if a PIAFSI system is adopted, it should be based on amounts previously included in AFSI by an AC, regardless of whether and to what extent those amounts were ultimately subject to taxation under section 55.

#### 3.1.2.1.2 Designation of PIAFSI Basis

Option 1 likely requires the adoption of a system for tracking PIAFSI basis in order to prevent the duplication of PIAFSI in stock gain. For example, if a CFC earns net income that is included under the Pro Rata Share Rule in the AFSI of a USSH that is an AC, a sale by the USSH of the CFC stock prior to a distribution of the PIAFSI could result in net income to the USSH that reflects the undistributed PIAFSI. To prevent this duplication, the inclusion of a CFC's net income in the AFSI of a USSH should give rise to PIAFSI basis in the stock of the CFC to the extent the USSH's basis in the CFC stock was not otherwise adjusted for financial accounting purposes. In the case of tiers of CFCs, the PIAFSI basis should be replicated at each tier above the CFC that earned the net income. When PIAFSI is distributed, the corresponding PIAFSI basis in the stock of the distributing corporation should be reduced. If PIAFSI basis is recovered

before the PIAFSI is distributed, PIAFSI basis in the stock of any upper-tier CFCs should be preserved.

#### 3.1.2.1.3 Exclusion of Distributed PIAFSI Under the Dividends Rule

Under Option 1, a dividend should be excluded from the AFSI or net income (as relevant) of the distributee under the Dividends Rule only if it is made from PIAFSI. This system precludes the need to consider the characterization of the dividend for US federal income tax purposes, other than potentially the initial determination of whether the distribution qualifies as a dividend (depending on if and how guidance defines the term "dividends" as used in the Dividends Rule).[31] Rather, all that is required is the tracking of the PIAFSI accounts and PIAFSI basis. As under the PTEP system, all dividends should be considered as first made from PIAFSI to the extent of the amounts in the PIAFSI accounts. In addition, dividends distributed to a USSH during a year should access the PIAFSI that results from the USSH's inclusion of the corresponding net income in its AFSI during the year.

#### 3.1.2.1.4 Summary of Option 1

Option 1 would be the most precise mechanism for preventing double-counting. By tracking PIAFSI, Option 1 ensures that amounts included in AFSI under the Pro Rata Share Rule are not again included in AFSI by reason of the Dividends Rule. Similarly, by only excluding from the distributee's AFSI or net income (as relevant) dividends from PIAFSI, Option 1 also limits the potential for omissions of amounts from AFSI. However, this precision requires a significant amount of complexity.[32] PIAFSI accounts must be created and maintained. PIAFSI basis must be tracked to prevent the duplication of PIAFSI in stock gain. And other issues similar to those arising under sections 959 and 961, such as the mechanics for tracking PIAFSI and the treatment of successors, would need to be considered.

#### 3.1.2.2 Option 2: Exclude Distributions Made by CFCs to USSHs

As an alternative to Option 1, double-counting could be addressed by providing that dividends made by a CFC to a USSH are excluded from the application of the Dividends Rule ("Option 2"). This approach would be based on the simple premise that, because a CFC's net income is accounted for by USSHs under the Pro Rata Share Rule, no dividends made by a CFC to a USSH should be again included in AFSI by reason of the Dividends Rule.

However, Option 2 does not fully eliminate the potential for duplications and also creates the potential for omissions. In particular, if the organizational structure or classification of entities does not remain static, the failure to track net income previously included under the Pro Rata Share Rule could result in certain items being included in AFSI twice and others not included at all. For example, if a foreign corporation is a CFC when it earns net income but not a CFC when the net income is distributed as a dividend, the net income will be included in AFSI twice under Option 2. Similarly, if the foreign corporation is not a CFC when it earns the net income but is a CFC when the net income is distributed, the net income will not be included in AFSI at all. Inappropriate duplications or omissions could also result in other circumstances, including

[31] See Part 3.1.3 for further discussion.

[32] Note, however, that due to differences in the scope of affected taxpayers, categories of income tracked, and breadth of governing statutory rules, a PIAFSI system could likely be less complex than the existing PTEP system.

changes in USSH status as well as changes in the status of a USSH as an AC. Thus, the relative simplicity of Option 2 must be evaluated against its imprecision.

#### 3.1.2.3 Option 3: Exclude Distributions Based on Their Characterization

Some of the duplications and omissions presented under Option 2 may be addressed by a more refined approach that focuses on the characterization of the distribution for US federal income tax purposes ("Option 3"). In particular, guidance may provide that a distributee does not include in AFSI or net income (as relevant) (i) amounts excluded from gross income under section 959(a)[33] or (b),[34] or (ii) dividends from non-PTEP earnings and profits ("E&P") made by a CFC to a USSH.[35] In general, Option 3 would mitigate much of the leakage expected under Option 2, but still would not achieve the same level of precision as Option 1.

Option 3 operates with different levels of accuracy with respect to different categories of a CFC's net income. Because section 959 applies regardless of whether the distributing foreign corporation is a CFC at the time of the distribution, amounts that are taxed with respect to a USSH under section 951 or 951A would not be double-counted in AFSI, regardless of changes in CFC status. In addition, if the foreign corporation was not a CFC at the time the net income was earned, such that the Pro Rata Share Rule did not apply, there will have been no inclusion under section 951 or 951A. Thus, a subsequent distribution would not be excluded from gross income under section 959 and therefore would be subject to the Dividends Rule. In this regard, Option 3 ensures that, going forward, amounts treated as PTEP are counted in AFSI once and only once.[36]

However, distributions made from non-PTEP E&P present the same challenges as under Option 2. For example, if the CFC was not a CFC at the time the net income was earned, the amounts later distributed would not have been accounted for under the Pro Rata Share Rule. Thus, their exclusion under the Dividends Rule would result in an inappropriate omission from AFSI. Similarly, if the foreign corporation was a CFC at the time the net income was earned, but is no longer a CFC (or the USSH is no longer a USSH) at the time of the distribution, the inclusion of the distributed amounts under the Dividends Rule would result in an inappropriate duplication of items in AFSI.

One implementation challenge under Option 3 involves determining the proper treatment of existing PTEP and non-PTEP E&P of CFCs. Because taxpayers are currently expected to track PTEP in annual accounts, it may be reasonable to provide that a distributee does not include in AFSI or net income (as relevant) amounts excluded from gross income under section 959(a) or

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[33] *See* Part 3.1.3.

[34] While a dividend received by a CFC that is excluded from gross income under section 959(b) would not be ECAFSI and therefore not AFSI of the CFC, it would constitute net income that may be included in the AFSI of a USSH under the Pro Rata Share Rule.

[35] The exclusion under the Dividends Rule for dividends from non-PTEP E&P should not be limited to dividends that are eligible for a section 245A deduction, as dividends of some items of a CFC's net income that were accounted for under the Pro Rata Share Rule may not satisfy the requirements of sections 245A and 246.

[36] *See also* former Treas. Reg. § 1.56-1(d)(4)(v) (generally providing that, under the so-called business undertaxed reported profits adjustments (the "BURP adjustment") to the former corporate alternative minimum tax, net book income does not include a distribution excluded from income under section 959 if it the distributed amounts were previously included in the adjusted net book income under an old rule that operated similarly to the Pro Rata Share Rule).

(b) only if they are made from PTEP that relate to the first inclusion year in which the CAMT could apply or any subsequent year.[37] However, administrability concerns may suggest that Option 3 not seek to separately address dividends out of pre-existing non-PTEP E&P.

In sum, Option 3 does not fully eliminate the potential for some omissions and duplications. However, it is simpler than Option 1 and more precise than Option 2. Moreover, under Option 3, consideration may be given to relieving the potential for duplication through a private letter ruling ("PLR") or closing agreement ("CLAG") program that provides taxpayers an opportunity to demonstrate that a dividend is out of amounts that were previously accounted for in AFSI and therefore should be excluded from AFSI or net income under the Dividends Rule. While such a program would still require the tracking of AFSI previously included under the Pro Rata Share Rule (perhaps retroactively), the compliance burden would be significantly less than that required under Option 1.

#### 3.1.2.4 Consideration of ECAFSI

The interaction of the Dividends Rule and ECAFSI Rule may also create the potential for double-counting. However, in contrast to the interaction between the Dividends Rule and the Pro Rata Share Rule—which could involve the same entity double-counting the same item of net income in AFSI—the interaction between the Dividends Rule and the ECAFSI Rule could involve different entities both counting the same item of net income in AFSI. That is, a foreign AC would include the ECAFSI in its AFSI when earned under the ECAFSI Rule, and the distributee AC would include the ECAFSI in its AFSI when distributed under the Dividends Rule. If this double-counting is to be addressed, it could be done consistently with Options 1 through 3 as described in Parts 3.1.2.1 through 3.1.2.3. In connection with Option 1, ECAFSI of an AC might be designated PIAFSI and accompanied by PIAFSI basis. If Option 2 or 3 were adopted, guidance could adopt a standalone rule that excludes from application of the Dividends Rule distributions by foreign corporations out of income effectively connected (or treated as effectively connected) with the conduct of a US trade or business.

### 3.1.3 Definition of "Dividends"

It is unclear whether the term "dividends" as used in the Dividends Rule refers to dividends as defined for US federal income tax purposes or dividends as defined for financial accounting purposes. If the former, guidance should address rules that exclude amounts from dividend treatment, such as sections 959(d) and 1293(c).[38] In such cases, guidance could provide that AFSI generally includes distributed amounts that are excluded from gross income, even though the distributions are not treated as dividends, unless such inclusion would result in double-counting.[39]

## 3.2 The Distributive Share Rule

### 3.2.1 Scope of Application

As described in Part 2.1, the Distributive Share Rule provides that the AFSI of a taxpayer "with respect to" a partnership is "adjusted" to only take into account the partner's distributive share of

[37] *See also* former Treas. Reg. § 1.56-1(d)(4)(v) (providing a similar rule under the BURP adjustment).

[38] *See* Part 3.1.2.3.

[39] *See* Part 3.1.2.

the partnership's AFSI. This rule could be understood to suggest that a partner's AFSI only includes amounts with respect to a partnership if some amounts with respect to the partnership are included in the partner's net income under the financial accounting rules governing the partner's AFS. However, this understanding would not be consistent with the framework established in section 56A that relies on US federal income tax principles to determine which amounts of AFSI are attributable to a taxpayer. For example, the references to section 951(a)(2) in the Pro Rata Share Rule and "amounts includible in gross income or deductible as a loss under this chapter" in the Dividends Rule each apply US federal income tax principles to determine what AFSI is attributable to a taxpayer. Furthermore, the formulation of the Distributive Share Rule is broadly consistent with the formulation of the Pro Rata Share Rule, which clearly requires inclusions in AFSI based on US federal income tax principles. Based on this understanding, the Distributive Share Rule should similarly be understood as requiring inclusions by a taxpayer with respect to all partnerships in which it is a partner. Accordingly, regulations should clarify that the Distributive Share Rule requires a partner to include its distributive share of partnership AFSI, whether or not any amounts with respect to the partnership are reflected on the partner's AFS.

To further clarify the scope of the Distributive Share Rule, regulations should also address the interaction of the Partnership AFSI Rule with section 56A(c)(2)(A). Because neither provision highlights the other as a limitation on, or exception to, its application, an AFS for a group of entities that includes a partnership could, without further guidance, be considered the AFS of the partnership. However, this understanding would seem to render the Partnership AFSI Rule superfluous for partnerships included in a consolidated financial statement. Accordingly, if Treasury and the IRS do not adopt the recommendation in our September 28th Comment to generally provide for the use of a standalone financial statement as an AFS,[40] regulations under section 56A(b) should clarify that a partnership should use for its AFS a standalone financial statement, notwithstanding section 56A(c)(2)(A).

### 3.2.2 Determination of Distributive Share of Partnership AFSI

The Distributive Share Rule provides no guidance regarding how to determine a partner's distributive share.[41] Moreover, as highlighted in other contexts,[42] the broad parameters of section 704 are uninformative in situations that require the determination of a distributive share of items unrelated to taxable income or not specifically allocated in partnership agreements, particularly when the agreements provide for varying allocations. Accordingly, guidance should provide rules for determining a partner's distributive share of partnership AFSI.[43]

[40] *See* September 28th Comment, p. 10-11.

[41] In this regard, the Distributive Share Rule may be contrasted with the Pro Rata Share Rule, which provides a cross-reference to section 951(a)(2) as the starting point for the determination of a pro rata share of the items taken into account in computing the net income or loss of a CFC.

[42] *See* Tax Law Center at NYU Law, *Recommendations for the 2022-2023 Priority Guidance Plan* 23 (June 2, 2022) (discussing the need for analogous guidance under section 958 and highlighting pre-existing commentary surveying the range of possibilities for rules); *see also* Rob Holo, Drew Purcell, and Pierce Pandolph, *The Partnership Active Trade or Business in Corporate Divisions*, Tax Notes (June 4, 2018), Part III (discussing similar issues arising under section 355).

[43] Consideration could be given to developing rules that would also apply in other contexts that require similar determinations. *See supra* footnote 42.

### 3.2.3 Partnership Treatment and Interaction with Other Rules

The treatment of a partnership as an entity or an aggregate of its partners under section 56A(c) has significance for the interaction of the Distributive Share Rule with the Dividends Rule and the Pro Rata Share Rule. The requirement in the Partnership AFSI Rule that a partnership compute its own AFSI, with adjustments under rules similar to those in section 56A, may suggest that the partnership be viewed as an entity. Under this approach, if a partnership owns stock in a corporation, the Dividends Rule and the Pro Rata Share Rule would apply first to determine the partnership's AFSI with respect to the corporation, and then the Distributive Share Rule would require the partners (whether corporations or other partnerships) to determine their distributive shares of the partnership's AFSI.

However, a partnership may also be treated as an aggregate of its partners, at least for purposes of the Pro Rata Share Rule. By referencing section 951(a)(2), the Pro Rata Share Rule could require the application of Treas. Reg. § 1.958-1(d),[44] which treats stock owned by a domestic partnership as owned, in the aggregate, by the partners of the partnership, as well as Treas. Reg. § 1.958-1(b), which applies similarly for foreign partnerships. Thus, when a partnership owns stock in a CFC, the partnership would be effectively disregarded, and AFSI inclusions would accrue to the direct or indirect partners (i.e., the same persons who would have subpart F and GILTI inclusions with respect to the CFC). Accordingly, if aggregate treatment applies, Treasury and the IRS should confirm that, notwithstanding the Partnership AFSI Rule's requirement that the partnership adjusts it AFSI under rules similar to the rules in section 56A, the partnership itself does not include a pro rata share of the net income or loss of a CFC in its own AFSI under the Pro Rata Share Rule.

Whether the partnership is treated as an entity or an aggregate of its partners also has consequences for the application of the Dividends Rule. If a partnership is viewed as an entity, a corporate partner could be required to include in AFSI its distributive share of dividends received by the partnership from a CFC, even if the underlying net income was previously included by the corporate partner in its AFSI under the Pro Rata Share Rule. This double-counting should be prevented by ensuring that—regardless of which, if any, of the recommendations in Part 3.1.2 are adopted—the Dividends Rule accounts for the application of the Distributive Share Rule. Specifically, if the net income of a CFC owned by a partnership is included in the AFSI of a partner under the Pro Rata Share Rule, it should not again be included in the AFSI of the partner by reason of the Distributive Share Rule when the CFC distributes the underlying net income to the partnership. This double-counting could also be prevented by applying aggregate treatment to the partnership for purposes of the Dividends Rule, mitigating the need to further coordinate the Dividends Rule with the Distributive Share Rule. Ultimately, whether the partnership is viewed as an entity or, consistent with Treas. Reg. § 1.958-1, an aggregate of its partners, guidance should provide for consistent treatment of partnerships for purposes of section 56A. Treasury and the IRS should also consider coordinating such treatment with the treatment of partnerships under the corresponding general income tax provisions.

[44] Treas. Reg. § 1.958-1(d) provides that it applies for purposes of any rule that "specifically applies by reference to" section 951. If the Pro Share Rule's instruction to apply rules "similar to the rules under section 951(a)(2)" were not considered a specific reference to section 951, entity treatment would apparently apply by default for purposes of applying the Pro Rata Share Rule to domestic partnerships.

### 3.3 The Pro Rata Share Rule

### 3.3.1 Determination of Pro Rata Shares

As noted in Part 2.1, the Pro Rata Share Rule provides that a taxpayer's pro rata share of CFC items is determined under rules "similar to the rules under section 951(a)(2)." Presumably, consistent with regulations under other statutory provisions that invoke those rules,[45] Treasury and the IRS will cross-reference the rules in Treas. Reg. § 1.951-1(b) and (e) in guidance for determining what constitutes a pro rata share.[46] Furthermore, guidance could include rules similar to those in Treas. Reg. § 1.960-2 for determining a corporation's pro rata share of taxes, as required for purposes of section 59(l)(1)(A)(i).

Guidance should also clarify what items with respect to a CFC are to be taken into account in determining the AFSI of its USSHs. As described in Part 2.1, the Pro Rata Share Rule refers to "items taken into account in computing the net income or loss" set forth on a CFC's AFS. The specific reference to "items taken into account" may be intended to ensure that if items had been adjusted or eliminated in the process of preparing an AFS for a group of entities (a "consolidated AFS") that includes the CFC, the full unadjusted amounts would be included in the USSH's AFSI. This understanding is supported by contrasting the Pro Rata Share Rule with the Distributive Share Rule, which, as discussed in Part 3.2.1, more straightforwardly requires the inclusion of a distributive share of a partnership's net income or loss, but unlike the Pro Rata Share Rule, seems to anticipate the use of a standalone AFS for a partnership.[47]

Regardless of whether standalone financial statements are used to determine an entity's net income or loss,[48] or whether rules will effectively provide for a reconstruction of entity-by-entity net income or loss from a consolidated AFS, a USSH should account for its pro rata share of a CFC's net income or loss in its AFSI. Providing for this approach in guidance would clarify the application of the Pro Rata Share Rule generally while also potentially addressing the interaction of the Pro Rata Share rule with the rule in section 56A(c)(5) requiring adjustments to disregard certain taxes in determining AFSI.

### 3.3.2 Interaction with Other Rules

Guidance should also clarify the interaction of the Pro Rata Share Rule with the ECAFSI Rule. The Pro Rata Share Rule provides that the items taken into account in determining a CFC's net

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[45] *See, e.g.,* Treas. Reg. § 1.965-1(f)(30) (applying language similar to the Pro Rata Share Rule in section 965(f)(1)) and Treas. Reg. § 1.951A-1(d) (applying the rule in section 951A(e)(1) that pro rata shares "are to be determined under the rules of section 951(a)(2)").

[46] Consideration should be given to addressing some of the issues that have been raised under those rules, including concerns regarding the determination of a pro rata share of a loss. *Compare, e.g.,* New York State Bar Association, Report No. 1406—Report on Proposed GILTI Regulations (November 26, 2018), at III.A.2(d) and B.2(c), and Guidance Related to Section 951A (Global Intangible Low-Taxed Income) and Certain Guidance Related to Foreign Tax Credits, TD 9866, 84 Fed. Reg. 29288, 29292-29293 (June 21, 2019).

[47] The fact that the statute does not itself address the use of a standalone AFS for a CFC, however, does not preclude Treasury and the IRS from requiring it, given the clear authority and administrability rationales for doing so discussed in our September 28th Comment. *See* September 28th Comment, p. 10-11.

[48] *See supra* footnote 40 and accompanying text.

income or loss are to be "adjusted under rules similar to those that apply in determining [AFSI]." Under the ECAFSI Rule—that is, one of the rules that apply in determining AFSI—a foreign corporation's AFSI consists only of its ECAFSI. Accordingly, the Pro Rata Share rule could be interpreted as only requiring a USSH to include its pro rata share of the ECAFSI of its CFCs. However, that reading would omit non-ECAFSI of CFCs from AFSI altogether (at least until amounts attributable to the ECAFSI are distributed as a dividend), while potentially duplicating the same ECAFSI in the AFSI of the USSH and the CFC. If the CFC is itself an AC, the same underlying ECAFSI could give rise to two CAMT liabilities.[49]

Instead, the Pro Rata Share Rule should generally be interpreted as requiring the CFC to adjust its net income or loss without regard to the ECAFSI Rule. Accordingly, the non-ECAFSI of a CFC would be properly accounted for in the AFSI of a USSH. This approach could be reconciled with the ECAFSI Rule by interpreting the prescription in the Pro Rata Share Rule that a CFC adjust its net income or loss under rules similar to those that apply in determining AFSI to be limited to rules of general applicability. Such an interpretation would be consistent with the fact that the Pro Rata Share Rule does not require the determination of the AFSI of a CFC (and thus does not require the determination of the AFSI of a foreign corporation), but merely uses the adjusted net income or loss of a CFC as an adjustment to the AFSI of its USSH. This interpretation would prevent the ECAFSI Rule from limiting the items of a CFC that may be taken into account under the Pro Rata Share Rule in a way that would produce an absurd result that is under-inclusive.

It is less clear how to address the potential for duplications of ECAFSI in AFSI. As an initial matter, the Pro Rata Share Rule does not incorporate the limitations that prevent the income of a CFC which is effectively connected with a US trade or business and thus taxed under section 882 from being again subject to tax in the hands of the USSH.[50] If, however, guidance adopts a PIAFSI system as described in Part 3.1.2.1, consideration could be given to excluding from application of the Pro Rata Share Rule PIAFSI attributable to ECAFSI. Guidance may also provide that ECAFSI is excluded from the net income or loss of a CFC for purposes of the Pro Rata Share Rule. Either approach could be supported by the broad authority in section 56A(c)(15)(A) to prevent duplications.

### 3.3.3 Application to CFC Net Losses

Guidance should also clarify whether the Pro Rata Share Rule applies on a CFC-by-CFC basis or to determine an aggregate amount with respect to all of a USSH's CFCs. The references in section 56A(c)(3)(B) and section 59(l)(A)(ii) to "the adjustment" might suggest that a single adjustment is made under section 56A(c)(3), which necessarily would be an aggregate amount with respect to all of a USSH's CFCs. Such a reading would seemingly be supported by the House Rules Committee's description of the Pro Rata Share Rule in the draft of the Build Back Better Act released November 3, 2021[51] ("November 3rd Draft"), which stated: "The AFSI of CFCs are aggregated globally, and losses in one CFC may offset income of another CFC.

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[49] Although a CFC in which only minority interests are owned by domestic ACs may be less likely to itself be an AC, a CFC more than 50 percent owned by an AC may be more likely to also be an AC due to the application of the section 52 aggregation rules under section 59(k)(1)(D).

[50] *See* sections 952(b) and 951A(c)(2)(A)(i)(I).

[51] Rules Committee Print 117-18, Text of H.R. 5376, Build Back Better Act (November 3, 2021).

Overall losses of CFCs may not reduce AFSI of a U.S. corporation, but they may be carried forward and used to offset CFC income in future years."[52]

However, the description of the November 3rd Draft—which is not official legislative history—does not reflect the text of the enacted statute, which specifies that section 56A(c)(3)(A) applies to determine the AFSI of a taxpayer "with respect to such controlled foreign corporation."[53] As described in Part 3.1.1, this language was added during the development of the IRA, along with the immediately following parenthetical explaining that the adjustment under the Pro Rata Share Rule is made to AFSI as determined under the Dividends Rule. This broader context could suggest that the change was solely intended to address the interaction of the Dividends Rule and the Pro Rata Share Rule. Nevertheless, the reference to "such controlled foreign corporation" could also support an understanding that section 56A(c)(3)(A) requires separate adjustments with respect to each of a USSH's CFCs. This CFC-by-CFC determination would then be imported into section 56A(c)(3)(B), which applies by reference to "the adjustment determined under" section 56A(c)(3)(A). As a result, any negative adjustment with respect to a CFC would not offset positive adjustments with respect to other CFCs, but simply be carried forward as an attribute to offset future positive adjustments with respect to the CFC. If a CFC-by-CFC approach is adopted, guidance would also need to provide that section 59(l)(1)(A)(ii) refers to the aggregate of the adjustments under the Pro Rata Share Rule.

### 3.4 Adjustments to AFSI for Certain Nonrecognition Transactions

As noted in the September 28th Comment,[54] the interaction of the CAMT with certain transactions that are afforded nonrecognition treatment for US federal income tax purposes raises a number of important issues that may be addressed in guidance. In particular, certain transactions that do not result in the recognition of gain or loss for US federal income tax purposes may be recognition events for financial accounting purposes, and thus affect a taxpayer's AFSI. As described in Part 2.1, section 56A(c)(15) authorizes the Secretary to issue regulations or other guidance necessary to carry out the purposes of section 56A, including adjustments to carry out certain nonrecognition principles in subchapters C and K. Accordingly, Treasury and the IRS may issue guidance providing that the financial accounting gain recognized on certain transactions described in subchapters C and K is adjusted out of AFSI. However, guidance of this sort requires careful consideration of the broader transaction, as the acquiror may receive a stepped-up basis in the assets for financial accounting purposes. Going forward, the depreciation, amortization, or disposition of those assets could reduce the acquiror's net income and result in a lower AFSI.

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[52] Build Back Better Act – Rules Committee Print 117-18, Section-by-Section, at 159.

[53] By contrast, the November 3rd Draft provided: "If, for any taxable year, a taxpayer is a United States shareholder of one or more controlled foreign corporations, the adjusted financial statement income of such taxpayer shall be adjusted to take into account such taxpayer's pro rata share (determined under rules similar to the rules under section 951(a)(2)) of items taken into account in computing the net income or loss set forth on the applicable financial statement of each such controlled foreign corporation with respect to which such taxpayer is a United States shareholder."

[54] *See* September 28th Comment, p. 4-6.

Guidance could address this issue in at least two different ways.[55] Treasury and the IRS could require that taxpayers maintain a separate basis-like attribute ("CAMT basis") as necessary to ensure that an adjustment to financial accounting gain is reflected in financial accounting basis. Indeed, CAMT basis may be required for the implementation of other provisions of section 56A(c), such as the adjustment for depreciation deductions allowed under section 167 for property to which section 168 applies.[56] Alternatively, guidance could provide that adjustments to AFSI for the nonrecognition transactions described in section 56A(c)(15)(B) require a ratable inclusion in AFSI over a specified number of years in an amount equal to the aggregate step-up in the financial accounting basis of the assets. This approach would not be as precise as the CAMT basis approach. For example, the ratable inclusion could have a smoothing effect on AFSI that might otherwise be concentrated in a limited number of years. On the other hand, the ratable inclusion over a specified number of years might cause a taxpayer to include an aggregate amount of AFSI sooner than it otherwise would have. Nevertheless, this approach could mitigate some of the compliance and administrative burden that tracking CAMT basis would entail, while addressing the potential concern that the allowance of an adjustment to AFSI under section 56A(c)(15)(B) might inappropriately result in a double benefit.

# 4 Identification of an AC

## 4.1 The General Aggregation Rule

As described in Part 2.1, the General Aggregation Rule aggregates the AFSI of all persons treated as a single employer under section 52(a) or (b) for purposes of the One-Prong Test, but provides that the Distributive Share Rule does not apply for this purpose.[57] This rule raises a number of technical questions regarding the computation of a corporation's AAAFSI.

### 4.1.1 Consequences of Disregarding the Distributive Share Rule

The phrasing of the General Aggregation Rule is unclear as to when, exactly, the Distributive Share Rule is disregarded. Specifically, it could be interpreted as providing that the Distributive Share Rule is disregarded *only* when the partnership is aggregated with the corporate partner. Alternatively, the statute may be read as providing that the Distributive Share Rule is disregarded for all purposes of applying the General Aggregation Rule, regardless of whether the corporate partner and partnership are aggregated.

Treasury and the IRS should resolve this ambiguity by providing that a corporate partner disregards the Distributive Share Rule with respect to a partnership only when it is aggregated with the partnership.[58] Accordingly, if a corporate partner is not aggregated with the partnership, the partner should continue to account for the AFSI of the partnership in its own AFSI under the Distributive Share Rule, consistent with the pass-through nature of the partnership. Under the alternative interpretation, none of the AFSI of the partnership would be taken into account for

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[55] It is unclear whether this issue should be addressed if either the transferor or the acquiror in the transaction is not an AC. Regarding the former, any adjustment prescribed under section 56A(c)(15)(B) would not factor into the computation of any CAMT liability. Regarding the latter, the stepped-up financial accounting basis would not factor into the computation of any CAMT liability until the acquiror becomes an AC.

[56] *See* section 56A(c)(13).

[57] The General Aggregation Rule also disengages section 56A(c)(11).

[58] *See* Part 4.2 for a similar recommendation under the FPMNG Rule.

purposes of the scope of the CAMT, as the partnership's AFSI would not be included in the AFSI of its partners and the partnership itself would be ineligible to be treated as an AC. Disregarding the pass-through nature of the partnership would thus represent a significant departure from the US federal income tax principles that govern several rules in section 56A, including the Distributive Share Rule, as discussed further in Part 3.2.1.

#### 4.1.2 Interaction of the General Aggregation Rule with the Dividends Rule

The interaction of the General Aggregation Rule and the Dividends Rule raises the potential for double-counting for purposes of the AAAFSI Test. As an initial matter, because the Dividends Rule is not explicitly disregarded under the General Aggregation Rule, it presumably continues to apply. Thus, under the statute, a shareholder that is aggregated with a subsidiary corporation should generally include dividends received from the subsidiary in AFSI for purposes of the AAAFSI Test.

However, the application of the Dividends Rule to a dividend received by a shareholder from a subsidiary corporation with which it is aggregated under the General Aggregation Rule presents the potential for double-counting the same net income for purposes of determining whether a corporation is an AC. When the subsidiary earns the net income, it will be included in the AFSI of both entities. When that net income is distributed as a dividend, it will again be included in the AFSI of both entities. This double-counting may result in a corporation that would not otherwise be classified as an AC becoming an AC. Depending on the implementation of 59(k)(1)(C), it may also prevent an AC that would otherwise be eligible to shed its status as an AC from doing so.

The potential for double-counting in this regard depends, in part, on the relationship between the distributing subsidiary corporation and the shareholder with which it is aggregated under the General Aggregation Rule. If the distributing subsidiary is foreign, the only net income of the foreign corporation that may qualify as its AFSI is ECAFSI. (The role of ECAFSI in the AAAFSI Test is addressed in further detail in Part 4.1.3.) Thus, as long as the foreign corporation's net income is not ECAFSI, it will not be accounted for in the AFSI of the shareholder under the General Aggregation Rule, and therefore not double counted under the Dividends Rule when distributed. In addition, if the distributing subsidiary joins in the filing of a consolidated return with the distributee shareholder, the Dividends Rule is inapplicable by its own terms.

Nevertheless, Treasury and the IRS should issue guidance to ensure that the same economic income is not inappropriately double-counted under the General Aggregation Rule. This guidance may be issued under the grant of authority in section 59(k)(3)(A) to provide a "simplified method" for determining whether a corporation satisfies section 59(k)(1), the first parenthetical grant of authority in the Dividends Rule, and arguably the grant of authority in section 56A(c)(15)(A) to prevent omissions or duplications in the computation of AFSI.[59]

As with the double-counting considerations addressed in Part 3.1.2, double-counting under the General Aggregation Rule would be most precisely addressed by tracking AFSI previously included under the AAAFSI Test ("PIAAAFSI"). Under this approach, a shareholder aggregated with a subsidiary corporation under the General Aggregation Rule would exclude a dividend

[59] Consideration would need to be given to whether a rule aimed at the proper functioning of section 59(k) is authorized by a grant of authority based on the purposes of section 56A.

from the subsidiary from the application of the Dividends Rule for purposes of the AAAFSI Test only if it previously included the underlying AFSI in the AAAFSI Test—that is, if the underlying AFSI is PIAAAFSI. However, unlike under the PIAFSI system described in Part 3.1.2.1, the exclusion should not depend on whether the shareholder or subsidiary were ACs at the time the PIAAAFSI was originally accounted for. In addition, the modifications to the determination of AFSI for purposes of the AAAFSI Test result in a substantively different computation under section 59(k) than under section 56A. Thus, it does not appear that a potential AFSI system and potential PIAAAFSI system could be integrated.

Whether the additional compliance and administrative burden introduced by a PIAAAFSI system is justified may depend, in part, on other aspects of section 59(k) policy. For example, if entities depart or join a group that is aggregated under the General Aggregation Rule, there would be a question as to how, if at all, PIAAAFSI is tracked. The resolution of this issue, in turn, would likely depend, at least in part, on other rules addressing the treatment of the members of a group whose composition is dynamic.

As an alternative to a PIAAAFSI system, guidance could provide default operating rules. For example, if a shareholder receives a dividend from a corporation with which it has been aggregated under the General Aggregation Rule for three years or more, the dividend might be presumptively excluded from the application of the Dividends Rule for purposes of the AAAFSI Test. If the corporation has been aggregated with the shareholder under the General Aggregation Rule for less than three years, the dividend might presumptively be included in the AAAFSI of the shareholder unless the parties demonstrate to the satisfaction of the Secretary that the distribution is out of PIAAAFSI.

### 4.1.3 Potential for Triple-Counting

The application of the ECAFSI Rule, in combination with the application of the Dividends Rule, the Pro Rata Share Rule, and the General Aggregation Rule, appears to present the potential for triple-counting some AFSI for purposes of the AAAFSI Test. If a shareholder is aggregated with a foreign corporation, and the foreign corporation has ECAFSI, the ECAFSI is included in the AFSI of both the shareholder and foreign corporation under the General Aggregation Rule. If the foreign corporation is a CFC, the ECAFSI may again be included in the AFSI of the shareholder under the Pro Rata Share Rule. Finally, the ECAFSI may be included in the AFSI of the shareholder a third time under the Dividends Rule. However, guidance under the Pro Rata Share Rule[60] and the Dividends Rule[61] could address those potential sources of duplication.

## 4.2 The FPMNG Rule

Guidance under the FPMNG Rule should also clarify the scope and consequences of disregarding certain provisions of section 56A(c) for purposes of the FPMNG Aggregation Rule. Specifically, Treasury and the IRS should provide that a member of a FPMNG disregards the Distributive Share Rule for purposes of the FPMNG Aggregation Rule only when the partnership is treated as part of the FPMNG, such that its net income or loss is otherwise included in the

[60] *See* Part 3.3.2.

[61] *See* Part 3.1.2.4. As indicated in Part 3.1.2 and this part, a PIAFSI system and PIAAAFSI would track different attributes and thus likely could not be integrated.

corporate members' AFSI. This interpretation would be consistent with the interpretation recommended in Part 4.1.1.