March 14, 2023

Via Electronic Submission

The Honorable Lily Batchelder
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Mr. William Paul
Principal Deputy Chief Counsel
Internal Revenue Service
111 Constitution Ave., NW
Washington, DC 20224

Re: Request for Comments Relating to Unrealized Gains and Losses in Notice 2023-7

Dear Ms. Batchelder and Mr. Paul:

We appreciate the opportunity to submit this letter in response to the request from Treasury and the IRS for comments in Notice 2023-7 (2023-3 I.R.B. 390) on future guidance implementing the new corporate alternative minimum tax ("CAMT"). According to the Notice, such guidance would be intended in part to avoid "substantial unintended adverse consequences" that could arise under the CAMT from the mark-to-market of items for financial statement purposes but not for tax purposes.

Questions 16 – 19 of Section 9.02 of Notice 2023-7 request comment on the treatment of unrealized gains (or losses), including items included in other comprehensive income ("OCI") on financial statements. For the reasons set forth below, we respectfully request that guidance be issued that excludes from applicable financial statement income ("AFSI") unrealized gains and losses on investments that are marked to fair market value for book purposes but not for tax purposes. Timely guidance is needed to avoid chilling and distorting common and essential corporate investment decisions.

A. Excluding Book-Tax Differences Arising from Fair Value Accounting is Consistent with the Purpose of the Corporate Alternative Minimum Tax

Congress enacted the CAMT in the Inflation Reduction Act of 2022 to address the perceived excessive use of tax allowances and aggressive tax planning in order to reduce the taxable income of a corporation significantly below its book income. The CAMT has its origins in a proposal included in the President's Fiscal Year 2022 Budget Proposal. According to the Treasury Greenbook, the CAMT was intended as "a targeted approach to ensure that the most aggressive corporate tax avoiders bear meaningful federal income tax liabilities."[1]

Under fair value accounting, companies are required (or in some instances may elect) to mark certain of their assets to market, thereby increasing (or decreasing) their book income by the unrealized gain (or loss) in the value of such assets. By contrast, under the realization principle, unrealized gains are not

[1] General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals, Department of Treasury (May 2021), p. 21.

taxed until an asset is sold or is otherwise disposed. Consequently, the use of fair value accounting can result in a company's book income being higher (or lower) than its taxable income solely as a result of market fluctuations in the value of its assets that are reported for book purposes but are not included in taxable income.

Book-tax differences arising from the use of fair value accounting have nothing to do with the intended purpose of the CAMT. Taxpayers whose book income exceeds their taxable income because of fair value accounting are not taking advantage of excessive "tax allowances" or engaging in the kind of "aggressive" tax avoidance targeted by the provision. Indeed, a taxpayer using fair value accounting may not be claiming any tax allowances, deductions, or credits or engaging in any tax planning: in such a case, its CAMT liability would be attributable solely to unrealized gains reported on its books under fair value accounting while those unrealized gains have not been included in its taxable income under the realization principle.[2]

B. Congress Has Consistently Rejected Proposals to Tax Unrealized Gains

Congress has consistently rejected proposals to tax unrealized gains for good policy reasons. In addition to being inconsistent with the realization principle, Congress has expressed concern that taxpayers would have liquidity problems if they did not have sufficient cash to pay the tax on their unrealized gains. These considerations should inform Treasury's and the IRS's interpretation of the scope of the CAMT. If unrealized gains were included in AFSI and therefore subject to tax under the CAMT, taxpayers would be forced to sell assets and/or increase their borrowings (assuming they could) to pay the book minimum tax on their unrealized gains.

In addition, subjecting unrealized gains to tax would also result in many valuation disputes between taxpayers and the IRS, forcing taxpayers to spend time and money on external controversies and diverting valuable resources from the IRS.

C. Taxing Certain Unrealized Gains Will Cause Horizontal Inequities, Distort Investment Decisions and Encourage Tax Planning

As described in the attached Appendix, many categories of unrealized gains and losses are already excluded from AFSI and therefore will not give rise to CAMT liability. Further, as described in the Appendix, at a minimum, Treasury and the IRS seemingly will need to issue guidance excluding various other categories of unrealized gains and losses from AFSI in order to avoid disparate and inequitable results.[3] Assuming this assumption is right, the end-result would be a patchwork of ad hoc rules excluding most but not all categories of unrealized gains and losses from AFSI. The principal categories of unrealized gains and losses that would remain included in AFSI are unrealized gains and losses on real estate, foreign currencies, precious metals and non-equity derivatives that are not part of a hedging

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[2] For example, assume a corporation that is subject to the book minimum tax acquired a real estate asset (e.g., raw land) for $60x. The corporation receives no rental income from the asset and does not realize any losses from depreciation of the asset. But, by the end of the year, the value of the real estate increased to $100x. The corporation would have no taxable income or loss in that year. However, under the fair value accounting rules, the corporation would report $40x of book income from the unrealized gain. As a result, the corporation would be subject to a 15% tax on the $40x of mark-to-market gain without having generated any cash to pay the tax.

[3] Treasury and the IRS have already issued Notice 2023-20 "to avoid substantial unintended adverse consequences" of various mismatches in treatment for book and tax purposes in the life insurance industry.

transaction. There is no sound tax policy reason to distinguish unrealized gains and losses on these categories of assets from those that are excluded from AFSI. Taxing unrealized gains on certain types of investments and not on others will inevitably distort investment decisions by providing a tax incentive to invest in assets in excluded asset categories or in assets that do not require recurring mark-to-market adjustments under the fair value accounting rules. Under these circumstances, we respectfully submit that, as a matter of horizontal equity and economic efficiency, Treasury and the IRS should extend the exclusion of unrealized gains and losses from AFSI to all assets that are marked-to-market under the fair value accounting rules, to the extent not marked-to-market under the tax rules.

D. Failure to Exclude All Unrealized Gains and Losses Would Disincentivize Companies from Electing Fair Value Accounting

In addition to distorting investment decisions, absent a comprehensive exclusion for all book unrealized gains or losses (as described above), companies will have a tax incentive not to elect fair value accounting (where possible) to avoid subjecting their unrealized gains to the CAMT. In that event, the benefit of fair value accounting in providing relevant information to investors, creditors, regulators and the general public to assess the financial health of companies will be lost.

E. Excluding All Unrealized Gains and Losses is Consistent with the Broad Regulatory Authority Granted by Congress

Congress granted broad regulatory authority to Treasury and the IRS in sections 56A(c)(15) and 56A(e), to exclude items from AFSI to prevent unintended consequences that might result from the many novel and unanticipated issues that would be presented by the CAMT. In Notice 2023-7, Treasury and the IRS appropriately exercised that regulatory authority to provide exclusions from AFSI for corporate spin-offs and other nonrecognition transactions, and by excluding cancellation of indebtedness income from AFSI pursuant to section 56A(e) notwithstanding the absence of specific statutory provisions excluding such income from AFSI. The Notice anticipates that Treasury and the IRS will issue additional guidance needed to avoid "substantial unintended adverse consequences" relating, at a minimum, to certain types of additional mark-to-market book gains and losses. We are grateful that Treasury and the IRS subsequently issued Notice 2023-20 to address certain mismatches that gave rise to some of those consequences with respect to the life insurance industry.

F. Conclusion

To summarize, providing a comprehensive exclusion for unrealized gains and losses that are marked-to-market for book purposes would be consistent with the purpose of the CAMT and Congress's rejection of prior proposals to tax unrealized gains. Moreover, it would avoid a patchwork of unprincipled and ad hoc rules that would inexplicably leave a few categories of unrealized gains and losses in AFSI and thereby distort investment decisions, create a disincentive for taxpayers to elect fair value accounting, and force taxpayers to sell assets or borrow money to pay their taxes.[4]

For all of the foregoing reasons, we respectfully request that guidance be issued that excludes unrealized gains and losses from AFSI on all investments that are marked to fair market value for book purposes but

[4] We would note that, to avoid volatility and liquidity concerns, the OECD Model Rules with respect to Pillar Two would allow companies to elect to treat assets subject to fair value accounting on a realization basis for purposes of applying GloBE minimum tax. See Article 3.2.5.

not for tax purposes. In connection with any exclusions of book unrealized gains from AFSI, it would be appropriate for Treasury and the IRS to provide that these exclusions should not apply to the extent the unrealized gains and losses are included in taxable income on a mark-to-market basis.

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Thank you in advance for your consideration of our comments.

Sincerely,

American Exploration and & Production Council
American Investment Council
American Petroleum Institute
Electric Power Supply Association
Energy Infrastructure Council
Interstate Natural Gas Association of America
The Real Estate Roundtable
Reinsurance Association of America
U.S. Chamber of Commerce

cc: Tom West, Deputy Assistant Secretary for Domestic Business Tax, Office of Tax Policy, Department of the Treasury
Krishna Vallabhaneni, Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury
Brett York, Deputy Tax Legislative Counsel, Office of Tax Policy, Department of the Treasury
Lindsay Kitzinger, International Tax Counsel, Office of Tax Policy, Department of the Treasury
Timothy Powell, Tax Policy Advisor, Office of Tax Policy, Department of the Treasury
Isaac Wood, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
Colin Campbell, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
Brenda Zent, Special Advisor on International Taxation, Office of Tax Policy, Department of the Treasury

APPENDIX

Various categories of unrealized gains and losses are expressly excluded from AFSI under the statute. These include:

1. **Unrealized gains and losses on certain holdings of corporate stock** are excluded from AFSI under section 56A(c)(2)(C), which provides that, when a corporation is not included in a consolidated return with the taxpayer, the AFSI of the taxpayer "with respect to such other corporation shall be determined by *only taking into account* the dividends received from such other corporation . . . and other amounts which are includible in gross income or deductible as a loss under this chapter (other than amounts required to be included under sections 951 and 951A or such other amounts as provided by the Secretary) with respect to such other corporation." (emphasis added). Notice 2023-20, section 3.02, confirms this result.

2. **Unrealized gains and losses on partnership interests** are excluded from AFSI under section 56A(c)(2)(D)(i), which provides that, in general, "if the taxpayer is a partner in a partnership, [AFSI] of the taxpayer with respect to such partnership shall be adjusted to *only take into account* the taxpayer's distributive share of the [AFSI] of such partnership." (emphasis added). Notice 2023-20, section 3.02, confirms this result.

3. **Unrealized gains and losses on assets or liabilities of a partnership that does not apply fair value accounting with respect to those gains and losses** are excluded from the AFSI of a corporate partner in the partnership (as well as from the AFSI of each intermediate partnership through which the corporate partner owns the partnership interest) as section 56A(c)(2)(D) applies the aggregate theory of partnerships to determine a corporate-partner's distributive share of the partnership's AFSI.

4. **Unrealized gains and losses reported for book purposes as other comprehensive income ("OCI")** are excluded from AFSI. Under section 56A(a), AFSI is defined as "*the net income or loss* of the taxpayer set forth on the taxpayer's applicable financial statement." (emphasis added). OCI generally is defined as amounts of revenues, expenses, gains, and losses that are included in comprehensive income under GAAP *"but excluded from net income."*[5] Thus, OCI is not included in AFSI because OCI is not included in "net income or loss". A colloquy between Senator Ben Cardin and Senate Finance Committee Chairman Wyden confirms this reading of the statute that amounts included in OCI were not intended to be included in AFSI.[6] The discussion of covered reinsurance agreements in Notice 2023-20 is consistent with this result.

5. **Unrealized gains and losses on mortgage servicing rights** are excluded from AFSI under section 56A(c)(10).

6. **Unrealized gains and losses on assets held by defined benefit pension plans, etc.** are excluded from AFSI under section 56A(c)(11).

[5] ASC 220-10-20 (emphasis added)

[6] Colloquy between Sen. Ben Cardin (D-MD) and Finance Committee Chairman Ron Wyden (D-OR) on corporate book minimum tax under IRA Congressional Record Page S4166 (August 6, 2022). https://www.congress.gov/congressional-record/volume-168/issue-133/senatesection/article/S4165-3

As referenced in the text of our letter, in Notice 2023-20, Treasury and the IRS recently addressed a few issues affecting insurance companies to avoid adverse consequences where a mismatch existed with respect to unrealized gains and losses not included in AFSI and offsetting changes in a corresponding liability which was included in AFSI.

1. **Funds Withheld Reinsurance ("FWH") and Modified Coinsurance ("Modco").** While FWH and Modco are similar in practical effect to a coinsurance transaction, the retention of assets by the ceding company in a FWH or Modco transaction creates a potential mismatch in the accounting treatment because the unrealized gains and losses on the assets are treated as OCI, whereas any offsetting changes in the corresponding liability payable to the reinsurer are reported on the income statement. Notice 2023-20 addresses this issue by allowing the corresponding change in the offsetting liability to be disregarded in determining AFSI. We commend Treasury and the IRS for making this change to ensure that FWH and Modco transactions are not treated less favorably than standard coinsurance, merely because of differences in financial accounting treatment.

2. **Covered Variable Contracts.** In general, for variable insurance contracts, unrealized gains and losses are marked-to-market in GAAP with a corresponding and equally offsetting change in reserves, netting to zero impact in GAAP net income. For regular tax purposes, there is also zero net taxable income due to asset valuation and related reserve changes. However, because of the application of sections 56A(c)(2)(C) and 56A(c)(2)(D)(i), unrealized gains and losses attributable to a stock or partnership interest held in a variable separate account would be excluded from AFSI, while the corresponding adjustment for the offsetting effect on reserves would still be reported on the income statement.. Notice 2023-20 addresses this potential mismatch by allowing a corresponding change in related liabilities to be disregarded in determining AFSI, to the extent the unrealized gains or losses on stock or partnership interests are excluded under sections 56A(c)(2)(C) and 56A(c)(2)(D)(i).

For similar reasons, we anticipate Treasury and the IRS will likely need to issue guidance that at a minimum excludes the following categories of unrealized gains and losses from AFSI, to avoid anomalous, inefficient and inequitable results:

1. **Unrealized gains and losses on equity derivatives and other similar instruments with respect to portfolio stock and partnership interests**, such as warrants, options or equity derivatives in respect of portfolio stock or partnership interests, should also be excluded from AFSI**.** Arguably this exclusion results under application of sections 56A(c)(2)(C) and 56A(c)(2)(D)(i). In any event, regulatory guidance explicitly providing for this result will avoid disparate treatment with respect to economically identical instruments. Also, this treatment will help avoid the split hedge issue described in #3 below where the derivatives are hedges of other equity positions.

2. **Debt instruments**. Regulatory guidance should clarify that unrealized gains and losses from investments in debt instruments, whether or not available for sale, are not included in AFSI. A taxpayer that owns a debt instrument that is available for sale would not include any unrealized gain or loss under fair value accounting in AFSI, because it would be reported as OCI. By contrast, absent favorable guidance, unrealized gain or loss on similar debt instruments classified as trading securities for accounting purposes would be included in AFSI. Not only might this difference create an opportunity for tax planning, it is unclear as a policy matter why the treatment of unrealized gains or losses on investments in debt instruments should differ for CAMT purposes

merely because of where those unrealized gains or losses are reported on financial statements. Inconsistent treatment of debt (or between debt and equity) could cause inefficiencies in the financial markets, potentially leading to the type of “significant unintended adverse consequences” Treasury and the IRS have said they want to prevent in Notice 2023-7.

3. **Hedging Transactions and Other Risk Management Positions.** A regulatory exception should be provided for unrealized gains and losses with respect to derivative instruments involving a hedging transaction or otherwise managing a risk with respect to offsetting assets or liabilities, where the other side of the hedge (or other risk-management position) is an asset or liability for which unrealized gains and losses are not included in AFSI. A number of special tax rules[7] applicable to identified hedges generally match both the timing and character of items of income, gain and loss on the hedging instrument with the item hedged. Similar principles should apply for CAMT purposes. This guidance should apply to a broad scope of “hedging transactions”, and thus, for example, should cover risk management positions that may not satisfy the technical requirements for a hedging transaction under the tax law, including some of the cases described below.

   Similar to the items addressed already in Notice 2023-20, failure to provide regulatory guidance would create a mismatch between the treatment of the hedged item and the hedging instrument for CAMT purposes that is likely to cause unintended adverse results, significantly increase volatility, and consequently discourage taxpayers from engaging in hedges. Also, absent a regulatory exclusion, where derivatives are used as hedges of other positions and one position has appreciated while the offsetting position has depreciated in value, either the taxpayer or the fisc would suffer adverse consequences (the so-called “split hedge” issue, where the different legs of a hedged position are subject to different tax rules).

   Specific examples of risk management positions that present a compelling case for such an exception include:

   a. **Commodity producer’s risk management activities.** The producer typically manages risk inherent to its business related to the fluctuations of commodity prices, production activities, foreign exchange movements and changes in interest rates. Such risk management activities include entering into derivatives and other contracts that are marked-to-market for financial accounting purposes.

   b. **Hedging Related to Life Insurance Contracts.** Life insurance companies frequently use derivative contracts to manage their obligations to policyholders. For example, life insurers manage interest rate risk, liability duration risk, and other risks using hedging use strategies that are reviewed and approved by regulators. Regulatory guidance should ensure that unrealized gains or losses on such derivative contracts, which are volatile items that may be spread over the duration of insurance liabilities for regular tax purposes, should likewise be excluded for purposes of calculating the taxpayer’s AFSI except to the extent that such amounts are included in taxable income or loss for the year under other provisions of the Code.

[7] See, e.g., Section 1221(a)(7) and Treas. Reg. sec. 1.446-4.

c. **Hedging Related to Wholesale Sales and Purchases for Electric Power Generation Load Obligations**. Power companies hedge both wholesale sales and purchases to support retail electric power generation load obligations to provide the lowest cost power and energy to customers. This provides stability in both returns and pricing regardless of underlying volatility in the commodity market. Derivatives and Hedging, or ASC 815, requires the company to record all derivatives on the balance sheet at fair value with changes in the fair value resulting from fluctuations in the underlying commodity prices immediately recognized in earnings, unless the derivative qualifies for cash flow hedge accounting treatment or a scope exception. As a result, the company reports substantial unrealized hedging gains and losses caused by fluctuations in energy market prices. These fluctuations, are not real economic gains or losses because they do not reflect the underlying cost associated with required power and fuel purchases to support retail load obligations.