Tax provisions in the "Inflation Reduction Act of 2022" relevant to the banking industry; potential implications

September 23, 2022

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Introduction

President Biden on August 16, 2022, signed into law H.R. 5376 (commonly called the "Inflation Reduction Act of 2022" or "IRA"). The IRA includes significant law changes related to tax, climate change, energy, and healthcare.

This report provides high-level, preliminary observations regarding certain tax provisions in the IRA that could be relevant to the banking industry and discusses how such provisions could affect financial institutions.

- For a more detailed discussion of tax provisions in the IRA, read a KPMG report **Analysis and observations: Tax law changes in the "Inflation Reduction Act of 2022"** [PDF 1.5 MB] (73 pages). This report is referred to in this document as the "KPMG Report on the IRA."

- For a more detailed discussion of how tax provisions in the IRA should be accounted for on financial statements, read a KPMG report **U.S. tax legislation: IRA and CHIPS** [PDF 695 KB] (19 pages). This report is referred to in this document as the "KPMG Report on Accounting for the IRA."

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Minimum tax on book income

The IRA introduces a 15% corporate alternative minimum tax ("Corporate AMT") on the "adjusted financial statement income" (AFSI) of certain large corporations (very generally, corporations reporting at least $1 billion average adjusted pre-tax net income on their consolidated financial statements).

The Corporate AMT applies to "applicable corporations" (corporations other than S corporations, regulated investment companies (RICs), or real estate investment trusts (REITs)) that meet the "average annual adjusted financial statement income test" ("Income Test") in one or more tax years ending after December 31, 2021, but prior to the tax year at issue (e.g., if a corporation first met the Income Test in its 2022 tax year, it would be an applicable corporation beginning in its 2023 tax year). The Income Test is generally met for a tax year if the average annual AFSI of a corporation in the three tax years ending with the tax year at issue exceeds $1 billion (subject to certain adjustments). For purposes of the Income Test, taxpayers must apply the aggregation rules under section 52(a) and (b). Generally, these aggregation rules apply (with some exceptions) to count all the adjusted financial statement profits of domestic and foreign entities connected through greater than 50% ownership towards the $1 billion AFSI threshold test. If the corporation is a member of a foreign-parented multinational group (MNG), the $1 billion AFSI threshold is modified to also include non-effectively connected income (ECI) financial statement profits of foreign corporations (which is not AFSI by its terms) and is

supplemented by a special three-year average $100 million AFSI test that only takes into account the group's actual AFSI (i.e., U.S. ECI-related adjusted financial statement profits of foreign corporations and AFSI of domestic corporations, including CFC income). Thus, while the "applicable corporation" definition does not, by its terms, limit the scope of such term only to companies that owe U.S. tax (i.e., foreign corporations with U.S. ECI and domestic corporations), a foreign corporation without U.S. ECI does not appear to be subject to the Corporate AMT because it does not have AFSI.

Once a corporation satisfies the Income Test in any tax year ending after December 31, 2021, the corporation generally continues to stay an applicable corporation even if its income subsequently declines. The IRA provides that a corporation that previously satisfied the Income Test would no longer be considered an applicable corporation if (1) either (a) there is a change in ownership with respect to such corporation or (b) there is a consistent reduction in AFSI below the relevant threshold; and (2) the Secretary determines it would not be appropriate to continue to treat the corporation as an applicable corporation. Thus, the exception to applicable corporation status for a taxpayer that has previously met the Income Test appears to require some form of affirmative guidance from Treasury.

AFSI generally starts with net income or loss reported on an "applicable financial statement" (AFS) (defined by reference to section 451(b)(3)). Financial statement income could then be adjusted by an array of adjustments. Such adjustments include, but are not limited to, an add-back for federal income and foreign taxes; special rules for related entities (such as consolidated and non-consolidated corporations, CFCs, and partnerships); determining ECI related AFSI for foreign corporations using principles of section 882; and tax conformity for depreciation, mortgage servicing contracts, and defined benefit pensions. With respect to mortgage servicing contracts, the IRA indicates that the Secretary shall provide regulations to prevent the avoidance of tax imposed with respect to amounts not representing reasonable compensation (as determined by the Secretary).

An applicable corporation is liable for the Corporate AMT to the extent its "tentative minimum tax" exceeds its regular U.S. federal income tax liability (including the "BEAT" under section 59A), prior to taking into account general business credits under section 38. The tentative minimum tax equals 15% of the applicable corporation's AFSI over the applicable corporation's eligible Corporate AMT foreign tax credits (an amount equal to the sum of (1) the lesser of (a) the corporation's pro-rata share of section 901 creditable foreign taxes paid or accrued by its CFCs that are taken into account on the AFS of the CFCs and (b) 15% of the corporation's pro-rata share of aggregate CFC-level AFSI for the year, and (2) the total amount of section 901 creditable foreign taxes paid or accrued by the taxpayer that are taken into account on its AFS). Further, the IRA allows AFSI to be reduced by financial statement net operating losses (FS NOLs) but not below 20% of AFSI for a given year. FS NOLs begin to arise from AFSI net losses for tax years ending after December 31, 2019, and can be carried forward indefinitely. Notably, FS NOLs can only be applied against AFSI for purposes of computing the Corporate AMT and cannot be taken into account for purposes of the Income Test (including the $100 million test of the foreign-parented MNG rule) when determining whether a corporation is an applicable corporation. The IRA also allows applicable corporations to apply general business credits towards its Corporate AMT.

Applicable corporations subject to the Corporate AMT are allowed to claim a credit for Corporate AMT paid against regular tax in future years, but the credit cannot reduce that future year's tax liability below the computed Corporate AMT for that year.

For a more detailed discussion of the minimum tax on book income, read the KPMG Report on the IRA.

KPMG observation

- The special rules for mortgage servicing contracts are favorable for the banking industry, but also

raise some issues and questions. For example, could income from a position that hedges mortgage servicing contracts be considered "any item of income in connection with a mortgage servicing contract" and thus subject to this special rule? Further, it is unclear how mortgage servicing contracts with an excess servicing component will be treated under the Corporate AMT regime as the statute defers to the Secretary to provide guidance to prevent the avoidance of tax in such a scenario.

- Captive REITs are sometimes included in a financial institution's organizational structure. REITs are not subject to the Corporate AMT because a REIT cannot be an applicable corporation. However, certain income from a REIT is includable in a shareholder's AFSI. More specifically, if a taxpayer corporation holds an interest in another non-consolidated corporation (e.g., a REIT), such taxpayer corporation must include dividend income (and other amounts includible in gross income or deductible as a loss) in its AFSI. It is not entirely clear whether the rule for "dividends" refers to financial statement dividends or tax dividends. The section's reference to "other" amounts includible in taxable income when determining AFSI with respect to a non-consolidated corporation appears to support the position that the reference is to tax dividends (i.e., an amount includible in taxable income). Clarification on this point, however, would be helpful.

- The adjustments for depreciation are taxpayer favorable in years that tax depreciation exceeds financial statement depreciation (e.g., as a result of bonus depreciation). This could have a considerable impact to banks that have significant leasing portfolios in which they claim tax depreciation. It is not entirely clear, however, how assets should be treated that are depreciable for tax purposes but non-depreciable for financial statement purposes (e.g., leases characterized as "true leases" for tax but characterized as "financing leases" for financial accounting purposes). More specifically, the IRA indicates that AFSI is reduced by tax depreciation and appropriately adjusted to disregard any amount of depreciation taken into account on the taxpayer's AFS with respect to such property. Using the above example of an asset subject to a true lease for tax purposes but a financing lease for financial accounting purposes, the AFS would presumably have interest income from the lease (and no depreciation expense). For tax purposes, there would be both rental income and depreciation expense. The IRA directs Treasury to draft rules that require items with respect to the property to be accounted for under tax principles.

- Banks often invest in partnership structures to obtain tax credits (e.g., low-income housing tax credits (LIHTCs), renewable energy credits). The Corporate AMT generally requires partners in partnerships to take into account in its AFSI its distributive share of AFSI of the partnership (the partnership's net income or loss on such partnership's applicable financial statements). This raises a number of issues. First, tax credit partnerships may not have applicable financial statements (within the meaning of section 451(b)(3)).

  Second, tax credit partnerships may be accounted for on a taxpayer's AFS under various financial accounting methodologies. For example, an investor that accounts for its investment in a LIHTC partnership under the proportional amortization method must reflect the amortization of the investment's cost as a component of income tax expense. As discussed above, a corporation's AFSI is adjusted to disregard any Federal income taxes. While the amortization of the investment's cost is reflected as a component of income tax expense in the financial statements, it would seem inappropriate for an investor to increase its AFSI by the amortization. More specifically, the 'book' amortization is not a part of the investor's Federal income taxes.

  The accounting for other credit investments can raise similar issues. For example, investments in partnerships that generate investment tax credits may be accounted for under the deferral method. Under the deferral method, the benefit from the credit may be reflected in the financial

statements in a year other than the year the credit is claimed on the tax return. In addition, the credit's benefit may be netted with other items of income and expense associated with the investment.

These fact patterns raise a number of technical and operational complexities with respect to how credit investments are accounted for when computing AFSI and the Corporate AMT.

- Certain tax-exempt investments (e.g., municipal bonds, BOLI) could lose their tax benefits to the extent a taxpayer is subject to a minimum tax on book income.

- The Corporate AMT credit carryforward mechanism is generally intended to ameliorate the impact of timing differences between AFSI and taxable income over time. However, there could be a number of scenarios that could convert timing differences into permanent differences. For example, deferred tax assets that exist on transition for expenses that have been recognized prior to the effective date for book purposes but are not yet deductible for tax purposes, could potentially convert to permanent differences for Corporate AMT purposes. Additionally, pre-2020 FS NOLs, as well as carryforwards of other attributes from pre-2023 tax years, could pose a similar problem (among other scenarios).

- The minimum book tax could potentially create odd results for financial institutions during a financial crisis. For example, assume there is a credit event in Year 1, and a bank must significantly increase its allowance for loan loss. However, such loans are not charged-off for book purposes until Year 2 (i.e., the year the bank frequently recognizes bad debt deductions for tax). This could result in the bank paying regular corporate tax in Year 1 and paying minimum book tax in Year 2. Similarly, if conditions improve in Year 2 and the bank releases a portion of its allowance for loan loss, the release could result in book income exceeding taxable income in Year 2.

- Deferred tax assets arising from minimum book tax carryforwards need to be factored into regulatory capital calculations. These carryforwards may be subject to threshold limitations in a manner similar to other carryforwards.

- Foreign banks will need to apply section 882 principles to determine AFSI that relates to its US business. Banks have not needed to apply these principles to financial statement income in the past and doing so could pose a number of operational and technical challenges for banks to consider.

- Like the legacy AMT regime, we believe companies should account for the incremental tax owed under the Corporate AMT as it is incurred and continue to measure their deferred taxes at regular tax rates—at enactment and going forward. Companies may also need to take into account expectations of its Corporate AMT status when evaluating whether a valuation allowance is required on certain deferred tax assets. For more detail on this, please see KPMG Report on Accounting for the IRA.

Excise tax on stock repurchases

The IRA introduces a 1% excise tax on repurchases of stock by certain publicly traded companies (i.e., domestic corporations with stock traded on an established securities market). The provisions of the excise tax are similar to those that were introduced under the Build Back Better Act (BBBA) except that the IRA applies to transactions occurring after December 31, 2022 (instead of 2021 under the BBBA).

"Repurchase" is defined as a redemption within the meaning of section 317(b), which generally includes any acquisition by a corporation of its stock from a shareholder in exchange for property, except for its stock or rights to acquire its stock. Thus, the excise tax extends to typical stock buy-back programs implemented through traditional open market transactions and through privately negotiated purchases. A repurchase by a "Specified Affiliate" of the public corporation is also subject to the excise tax. A Specified Affiliate is a corporation or partnership more than 50% owned (directly or indirectly) by the public corporation whose stock is being repurchased. The IRA also authorizes the IRS to treat economically similar transactions as repurchases.

The excise tax is imposed on the value of the stock repurchased. The amount subject to tax is reduced by the value of any stock issued during the tax year (including stock issued to employees).

There are a number of exceptions to the excise tax including: (1) to the extent a repurchase is part of a reorganization under section 368(a) and no gain or loss is recognized by the shareholder; (2) if the stock repurchased or an amount of stock equal to the value of such stock is contributed to an employer-sponsored retirement plan, an employee stock ownership plan, or similar plan; (3) if the total value of the stock repurchased during the tax year does not exceed $1 million; (4) under regulations prescribed by Treasury, repurchases by dealers of securities in the ordinary course of business; (5) repurchases by RICs or REITs; and (6) repurchases treated as dividends.

The excise tax is non-deductible for tax purposes.

For a more detailed discussion of the excise tax on stock repurchases, see the KPMG Report on the IRA.

KPMG observation

- Until regulations are issued, there could be uncertainty with respect to the scope of the exception to the excise tax for repurchases by dealers of securities.
- Two basic ways for corporations to distribute profits to shareholders are to (1) issue dividends or (2) buy back a certain number of their own shares, which raises the value of remaining stocks held by shareholders. While these two options are economically similar, they are taxed differently. Banks may need to consider the impact of the stock buyback excise tax when evaluating how to provide value to shareholders.
- Banks considering M&A or restructuring transactions will need to consider whether the stock buyback excise tax could impact the transaction.
- Many financial institutions have issued preferred stock that they periodically redeem. In connection with evaluating a redemption of its preferred stock, a financial institution will now need to consider the cost associated with the excise tax.
- The excise tax is determined on a non-income-based measure and is therefore not accounted for as an income tax. As a result, we believe that companies will generally account for the excise tax as a direct cost of repurchase. A company follows the balance sheet classification of the stock being repurchased to determine the geography of the tax imposed. For more detail on this, read KPMG Report on Accounting for the IRA.

Green energy incentives

The green energy provisions in the IRA make many of the same, or substantially similar, changes to the green energy tax incentives as were proposed in the version of the BBBA that passed the House in November of 2021, with certain modifications as described below.

Similar to proposals in the BBBA, the IRA extends the expiration and phase-down dates for the investment tax credit for solar (ITC) and production tax credit for wind (PTC). The amended ITC and PTC provisions apply to any projects placed in service after 2021 and on which construction begins prior to 2025. A new technology neutral clean energy production credit is available for projects placed in service after 2024.

The IRA imposes a multi-tiered credit system approach for energy tax credits that allow for higher credits when certain apprenticeship and wage requirements are satisfied, which would be further increased if new domestic content or energy community requirements are satisfied.

The IRA includes a "direct pay" mechanism for energy credits through which taxpayers could make certain energy credits refundable, but in a scaled-back manner from proposals in the BBBA. More specifically, direct pay is generally only available to certain tax-exempt and government entities (other taxpayers, however, could take advantage of direct pay for sections 45Q, 45V, and 45X credits). As an apparent trade-off, the IRA allows taxpayers ineligible for direct pay to sell their tax credits to third parties. Taxpayers are permitted to transfer all or a portion of certain tax credits to unrelated parties in exchange for cash consideration that would be excluded from the selling taxpayer's income.

The IRA also revises section 39 to allow eligible energy credits to be carried back three years (rather than the one-year carryback for traditional general business credits).

For a more detailed discussion of the green energy incentives, see the KPMG Report on the IRA.

KPMG observation

- For flow-through entities (partnerships, S-corps), the election to transfer credits is made at the partnership level. For banks that continue to provide traditional tax equity through a partnership structure, the banks will presumably want contractual protection addressing whether the partnership can transfer the credit.

- Fiscal year financial institutions that purchase credits should consider the possible one-year delay in the year the institution can claim the purchased credit (as compared to traditional tax equity investments). The purchased credit cannot be taken into account until the first year ending with, or after, the tax year of the transferor corporation to which the credit was determined. For example, if the transferor's tax yearend is December 31 and the transferee's yearend is November 30, and the credit becomes available October 31, the transferee cannot claim the credit until its yearend November 30, Year 2. However, if the transferee invested directly in the credit property, it could claim the credit for the yearend November 30, Year 1.

- The proposed three-year carryback period presumably provides additional flexibility for equity investors that face a down tax year. Further, in a down economy, certain taxpayers may become more active in purchasing credits to the extent they have tax capacity in the current year or prior three years.

- These provisions could increase demand for credit investment as tax-exempt entities may now participate through the direct pay mechanism and taxable entities, including developers, can transfer credits. This could potentially impact the necessity for tax-equity financing as well as credit pricing. It is important to note, however, that transferability applies only to credits, and not to other tax attributes associated with certain credit structures. Depreciation deductions, for example, are not transferable. As a result, certain credit deals may still require equity investment for purposes of the non-transferable tax attributes associated with a credit structure.

- Financial institutions should consider how the proposed energy provisions could not only provide tax benefits, but also help achieve economic, social, and governance (ESG) initiatives, and/or impact CRA requirements.

- Consideration for a purchased credit must be paid in cash. Banks (and other lending institutions) may have a business opportunity to provide financing to transferee taxpayers to purchase the credit.

- Transferee taxpayers will need to consider ways to protect themselves against the risk of a project failing to be eligible to claim the credit (e.g., IRS examines the property, and the IRS reduces or disallows the credit). This could include contractual protection or taking risk into account when determining the purchase price of a credit.

- For a discussion on financial accounting with respect to these new green energy incentives, please refer to the KPMG Report on Accounting for the IRA.

- The "CHIPS and Science Act of 2022" introduced a similar direct pay mechanism for investment tax credits for certain investments in semiconductor manufacturing. Similar to the discussion above, the introduction of direct pay and transferability mechanisms may impact demand for traditional tax-equity provided by banks. For more detail on these provisions, read ***President signs CHIPS legislation that includes advanced investment tax credit for semiconductor manufacturing***.

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