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PTEP: Recent Guidance on Inbound Transactions and Looking Ahead

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Notice 2024-16 is welcome guidance for U.S. corporations considering an inbound liquidation or asset reorganization of a first-tier CFC, while many PTEP questions remain that may be answered by the forthcoming proposed rules, says Amanda Pedvin Varma of Steptoe & Johnson.

The previously taxed earnings and profits (PTEP) regime is generally intended to prevent double taxation, so that a U.S. shareholder is not taxed twice on controlled foreign corporation (CFC) income—once when earned under the subpart F or global intangible low-taxed income (GILTI) and again when distributed to the U.S. shareholder. While this policy intent is clear, there are numerous fact patterns where the result under the statute and existing regulations is not, a major issue in the post-TCJA world where most CFC income is PTEP. The government helpfully addressed two of these fact patterns in 2023, and Treasury and the IRS are working on proposed regulations that are expected to provide a general regulatory framework for the post-TCJA PTEP regime.

Most recently, on December 28, 2023, Treasury and the IRS issued Notice 2024-16, which is the focus of this article. The notice announces that Treasury and the IRS plan to issue proposed regulations addressing the treatment of basis adjustments under §961(c) following an inbound liquidation or asset reorganization of a first-tier CFC. The notice is welcome guidance for U.S. corporations considering restructuring first-tier CFCs in light of global tax developments, for example, to eliminate or change the jurisdiction of holding companies.

Earlier in 2023, the IRS Office of Chief Counsel (International) issued a legal advice memorandum (AM 2023-002) concluding that current-year CFC income inclusions are taken into account when determining basis for purposes of determining whether a mid-year distribution of PTEP generates gain (Amanda Pedvin Varma, *IRS Advice Memorandum Addresses Mid-Year PTEP Distributions* , 52 Tax Mgmt. Int'l J. No. 4 (Apr. 7, 2023)). This advice memorandum provided helpful perspective for taxpayers concerned that a PTEP distribution made before the end of the year could generate gain where the amount of the distribution exceeds basis at the beginning of the year (but does not exceed such basis year plus current-year income inclusions).

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What's at Stake

Sections 959 and 961 work together to prevent double taxation of PTEP. Under §959(a)(1), distributions of PTEP are excluded from a U.S. shareholder's gross income.
Section 961 addresses basis adjustments related to PTEP.

Under §961(a), a U.S. shareholder increases its basis in the stock of a directly-held CFC by the amount of PTEP generated, including amounts attributable to lower-tier CFCs indirectly owned. Under §961(b)(1), a U.S shareholder that receives PTEP excluded from gross income generally decreases its basis in the CFC stock by such amount. To the extent that the amount of the distribution excluded from gross income exceeds the adjusted basis of the relevant CFC stock, the amount is treated as gain from the sale or exchange of property. Section 961(c) provides that, under regulations, if a U.S. shareholder is treated as owning stock in a lower-tier CFC, adjustments similar to those provided by §961(a) and (b) are made with respect to the basis of the stock in such lower-tier CFC, but only for the limited purpose of determining the amount included in the gross income of such U.S. shareholder under §951.

Prior to the issuance of Notice 2024-16, there was uncertainty regarding the basis consequences where a first-tier CFC that owned a lower-tier CFC or CFCs undertook an inbound nonrecognition transaction, such as an inbound liquidation or asset reorganization. For example, if USP wholly owns CFC1, which wholly owns CFC2, and CFC1 liquidates, does USP's §961(a) basis in CFC1 disappear? What happens to the §961(c) basis with respect to CFC2? Does the §961(c) basis (which is for the limited purpose of determining the amount included in the gross income of such U.S. shareholder under §951) "morph" into §961(a) basis? Or, is a §961(a) basis adjustment made when CFC2 becomes a first-tier CFC?

Given that many U.S. multinationals have significant amounts of PTEP post-TCJA (due to the §965 transition tax and GILTI regime), and thus significant §961(a) basis in first-tier CFCs and §961(c) basis in second-tier CFCs, it generally was not advisable to undertake an inbound nonrecognition transaction of a first-tier CFC given uncertainty about the answers to these questions. For example, in a basic fact pattern involving the inbound liquidation of CFC1, USP could recognize gain on a subsequent distribution of PTEP from CFC2 (now a first-tier CFC following the liquidation) under §961(b)(2) or recognize gain attributable to PTEP on a disposition of the CFC2 stock if USP's adjusted basis in CFC2 was considered to not reflect the §961(c) basis in CFC2 before the liquidation. Notice 2024-16 recognizes that concerns about this result (which would be inconsistent with the statutory framework intended to prevent double taxation of CFC earnings) could prevent taxpayers from engaging in inbound nonrecognition transactions.

Basis Answers for Covered Inbound Transactions

Notice 2024-16 states that Treasury and the IRS intend to issue proposed regulations providing that, in the case of a "covered inbound transaction," a U.S. acquiring corporation's adjusted basis of the stock of an acquired CFC is determined as if the transferor CFC's §961(c) basis were adjusted basis. The transferor CFC's §961(c) basis is taken into account only to the extent

the §961(c) basis resulted from prior CFC income inclusions of the U.S. corporation under the subpart F income or GILTI rules or was inherited by the U.S. corporation in an acquisition by the U.S. corporation of stock of the transferor CFC from another person.

Thus, where USP wholly owns CFC1, which wholly owns CFC2, and there is a "covered inbound transaction" of CFC1, USP will take an adjusted basis in CFC2 that reflects the amount of the §961(c) basis in CFC2. Importantly, taxpayers may rely on the notice for transactions completed on or before the date proposed regulations are published, as long as the taxpayer and its related parties follow the rules in their entirety and in a consistent manner.

The notice defines a "covered inbound transaction" as two categories of transactions. The first category consists of a liquidation described in §332 and nontriangular asset reorganizations described in §368(a)(1)(A) or §368(a)(1)(C), in which all of the stock of the transferor CFC is owned directly by the domestic acquiring corporation immediately before the transaction. The second category consists of a nontriangular reorganization under §368(a)(1)(A), a nontriangular reorganization under §368(a)(1)(C), a non-divisive reorganization under §368(a)(1)(D), and a reorganization described in §368(a)(1)(F), in which all of the stock of the transferor CFC is owned directly by a single domestic corporation (or by members of the same consolidated group) immediately before the transaction, and that same domestic corporation (or members of the same consolidated group) directly owns all of the stock of the domestic acquiring corporation immediately after the transaction and any related transactions.

The requirements above are subject to a de minimis exception, under which a transaction does not fail to be a covered inbound transaction solely because, immediately before the transaction, one or more persons other than the U.S. corporation (or members of a consolidated group, as applicable) own (in the aggregate) one percent or less of the total fair market value of the stock of the transferor CFC, provided that a continued stock ownership requirement is met. In addition, while a reorganization would not be a covered inbound transaction if money or other property ("boot") is received, the notice provides an exception where the amount of the boot received represents no more than one percent of the total fair market value of the stock of the transferor CFC.

Several other exceptions also apply. A transaction is not treated as a covered inbound transaction if there is a built-in loss in the acquired CFC stock. In addition, a transaction is not treated as a covered inbound transaction if stock of the acquired CFC is transferred pursuant to §368(a)(2)(C) or Treas. Reg. §1.368-2(k)(1), unless the transfer is within a consolidated group. In addition, a transaction does not qualify as a covered inbound transaction if, pursuant to a plan (or series of related transactions), stock of the acquired CFC is transferred to a partnership or foreign corporation in connection with a covered inbound transaction. A plan is presumed to exist if stock of the acquired CFC is transferred within two years of the covered inbound transaction. Finally, a transaction is not a covered inbound transaction if the U.S. acquiring corporation is a regulated investment company, a real estate investment trust, or an S corporation.

The notice also requires that a taxpayer that has maintained §961(c) basis in a currency that is not the U.S. dollar must translate §961(c) basis into U.S. dollars, under a reasonable method consistently applied to all acquired CFCs in any covered inbound transaction. A reasonable method must use an exchange rate that reflects the original U.S. dollar inclusion amounts of the U.S. shareholder that gave rise to the §961(c) basis, reduced as appropriate, including to take into account distributions of PTEP on such stock.

Looking Forward to More PTEP Guidance

Notice 2024-16 is important guidance, addressing a critical issue for taxpayers considering inbound nonrecognition transactions. Although the notice addresses only a narrow category of transactions and many uncertainties continue to exist in the world of PTEP, it is helpful that the government has addressed two major issues (inbound nonrecognition transactions and, as mentioned above, mid-year distributions) as it continues to work on comprehensive proposed regulations. It will be interesting to see whether and how the proposed regulations address a number of other interesting questions. For example, is §961(c) basis taken into account in computing tested income for purposes of determining a U.S. shareholder's GILTI inclusion? Should §961(c) basis be viewed as a U.S. shareholder attribute or a CFC attribute? How do the §959 and §961 rules operate in the context of a consolidated group? How do the rules apply where a taxpayer (or group) owns different blocks of stock? How do the rules apply where a CFC is held by U.S. shareholders through a partnership? Perhaps taxpayers and practitioners will see proposed regulations addressing some of these issues in 2024.

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