Code Sec. 961 Basis in Inbound Nonrecognition Transactions

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When a United States shareholder ("U.S. shareholder")[1] that directly owns stock of a controlled foreign corporation ("CFC")[2] has an inclusion in gross income under the Subpart F or Global Intangible Low-Taxed Income ("GILTI") regimes, it must increase the basis of its stock in the CFC under Code Sec. 961(a) by the amount of the inclusion. Where the inclusion is with respect to a second-tier CFC, the basis of the stock in the first-tier CFC ("CFC1") is increased under Code Sec. 961(a) and the basis of the stock in the lower-tier CFC ("CFC2") is increased under Code Sec. 961(c), but only for limited purposes.

Unlike the "Code Sec. 961(a) basis" with respect to the CFC1 stock, the "Code Sec. 961(c) basis" with respect to the CFC2 stock is only taken into for purposes of determining subpart F income (and possibly GILTI, but this has yet to be confirmed in regulations). Thus, there has been a concern that when CFC2 becomes a first-tier CFC because CFC1 liquidates under Code Sec. 332 or otherwise transfers CFC2 to the U.S. shareholder in a nonrecognition transaction, the U.S. shareholder would not have any basis under Code Sec. 961 with respect to CFC2. This could result in double taxation if the U.S. shareholder exchanges stock in CFC2 in a subsequent recognition transaction.

In December 2023, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS") took note of the potential for double taxation in this fact pattern and offered some relief in Notice 2024-16. Why now, with proposed Code Sec. 961 regulations promised for the first half of 2024? A possible reason is that after many years of Treasury and IRS officials making sympathetic noises on conference panels, taxpayers had requested private rulings confirming a reasonable result, which the Treasury and the IRS instead determined to do by way of more generally applicable guidance. The issue may have become pressing for taxpayers, many of whom have been seeking to eliminate unnecessary foreign holding companies in their structures in order to manage Pillar 2 and increasingly aggressive assertions by foreign tax authorities of withholding tax obligations on dividends paid to such holding companies. At the same time, confidence in the arrival of Code Sec. 961 proposed regulations has been on the wane, following four years in which proposed regulations were promised but not delivered.

The Double Taxation Issue

Suppose CFC1 capitalized CFC2 with $50 at its formation and that CFC2 subsequently earned $100 of subpart F income that was included in the U.S. shareholder's gross income. If CFC1 liquidates and the U.S. shareholder takes CFC2 stock with only $50 of basis, then the U.S. shareholder would be taxed on $100 of gain if it sold AT Lux Holding Sub stock for $150 (an amount representing the $50 initial capital and $100 of subsequent earnings). Similarly, double taxation could result if CFC2 distributed $150 to the U.S. shareholder, since Code Sec. 961(b)(2) generally requires gain recognition on a distribution of previously taxed earnings and profits ("PTEP") described in Code Sec. 959 to the extent the PTEP portion of the distribution (here, $100) exceeds the shareholder's basis in the distributing CFC (here, $50).

Taxpayers no doubt look forward to more comprehensive guidance providing a similar result in fact patterns other than "covered inbound transactions" as described in Notice 2024-16, including nonrecognition transactions in which gain may be partially recognized (including as a result of boot).

The gain subject to tax in this scenario would be uneconomic and contrary to the legislative intent of avoiding double taxation attributable to PTEP. The 1997 legislative history in particular refers to the purpose of Code Sec. 961(a) and (b) basis adjustments being to "avoid double taxation on a later disposition of the stock" of a company that has earned subpart F income. Additionally, as noted by Notice 2024-16, the 1962 legislative history of Code Sec. 961 referred to the basis adjustments under Code Sec. 961 as having a purpose "to prevent doubling up of tax where stock in a controlled foreign corporation is sold at a gain which reflects the retained earnings already taxed to United States persons."

Relief Under Notice 2024-16

In general, under Notice 2024-16, in the case of a "covered inbound transaction," a domestic acquiring corporation's "adjusted basis of the stock of an acquired CFC determined under Code Sec. 334(b) or 362(b) is determined as if the transferor CFC's Code Sec. 961(c) basis were adjusted basis." That is, the Code Sec. 961(c) basis that under the terms of Code Sec. 961(c) only applies for purposes of preventing an inclusion in subpart F income of CFC1 effectively morphs into general purpose basis like Code Sec. 961(a) basis. Although Notice 2024-16 does not explicitly say so, presumably "Code Sec. 961(c) basis" for this purpose means basis increases under Code Sec. 961(c) less basis reductions required under Code Sec. 961(b) as a result of PTEP distributions.

Code Sec. 961(c) basis in a lower-tier CFC only morphs into Code Sec. 961(a) basis, or all purpose basis, if the lower-tier CFC becomes a first-tier CFC in a covered inbound transaction. The notice generally defines a covered inbound transaction, with respect to an "acquired CFC" (*i.e.*, a lower-tier CFC that becomes a first-tier CFC), to mean certain specified transactions in which a domestic acquiring corporation acquires all of the stock of the acquired CFC from a transferor CFC that, immediately before the transaction and any related transactions, owns (directly or indirectly) all of the stock of the acquired CFC.[3]

One category of such specified transactions includes a Code Sec. 332 liquidation (*e.g.*, a check-the-box election to disregard CFC1), a non-triangular "A" reorganization (*e.g.*, an upstream merger of CFC1 into the U.S. shareholder), or a non-triangular upstream "C" reorganization (*e.g.*, a liquidation of CFC1 into the U.S. shareholder followed by a reincorporation of more than 30% of CFC1's assets). For this category of transactions, all of the stock of the transferor CFC must be owned directly by the domestic acquiring corporation immediately before the transactions.

The second category of specified transactions includes a non-triangular "A" reorganization, a non-triangular "C" reorganization, a non-divisive "D" reorganization, and an "F" reorganization.[4] For this category of transactions, all of the stock of the transferor CFC must be directly owned by a single domestic corporation (or members of the same consolidated group) immediately before the transaction, and that same domestic corporation (or members of the same consolidated group) must directly own all of the stock of the domestic acquiring corporation (*i.e.*, the recipient of CFC2) immediately after the transaction and any related transactions. Thus, it would include an inbound "F" reorganization and various inbound "sideways" reorganizations.

Notice 2024-16 imposes certain limitations on the scope of covered inbound transactions. For instance, reorganizations involving non-*de minimis* boot (*i.e.*, more than 1 percent of the fair market value of the stock of the transferor CFC) would be outside of the scope of covered inbound transactions.[5] Additionally, a transaction where the transferor CFC has a loss in the stock of the acquired CFC immediately before the transaction.[6] Moreover, a transaction would not be a covered inbound transaction if the domestic acquiring corporation is a regulated investment company ("RIC"), real estate investment trust ("REIT"), or an S corporation.[7]

As a general matter, a transaction that would otherwise qualify as a covered inbound transaction will be disqualified in the event of a subsequent transfer of the stock of the acquired CFC to a partnership or a foreign corporation, or potentially to an unrelated domestic corporation, in or a series of related transactions.[8] An exception is for a "drop" of stock to a member of the same consolidated group that includes the domestic acquiring corporation (and that is wholly owned by other consolidated members), following an "A", "B," or "C" reorganization, pursuant to Code Sec. 368(a)(2)(C) or Reg. §1.368-2(k)(1).

Only Upside?

As a general matter, Notice 2024-16 appears to have only upside for taxpayers, who may rely on the notice for all transactions completed on or before the date proposed regulations on the same topic are published. In order to rely, taxpayers and their related parties are generally required to follow the rules in the notice entirely and in a consistent manner. While this consistency language may raise questions regarding the need to amend prior returns to ensure consistent treatment, IRS officials have clarified in public remarks that they did not intend to require taxpayers to amend prior returns and rather only contemplated prospective consistency.[9]

There is no apparent reason why a taxpayer would not want to take advantage of the additional basis contemplated by Notice 2024-16. Some may wonder whether the additional basis would have any implication for allocation expenses under the asset method for purposes of applying the Code Sec. 904 foreign tax credit limitation. In general, assuming the additional basis is considered an amount included in basis under Code Sec. 961, then it should be disregarded under Reg. §1.861-12(c)(2)(B) for purposes of allocating expenses under the tax book value method. (Earnings and profits, including PTEP, are added to the non-Code Sec. 961 basis under Reg. §1.861-12(c)(2)(A)(1) for purposes of applying the expense allocation rules.) While Notice 2024-16 does not explicitly state that the basis adjustments it allows are amounts included in basis under Code Sec. 961, it suggests as much in indicating that the regulations announced by the notice will be issued pursuant to the grant of regulatory authority under Code Sec. 961.

Taxpayers no doubt look forward to more comprehensive guidance providing a similar result in fact patterns other than "covered inbound transactions" as described in Notice 2024-16, including nonrecognition transactions in which gain may be partially recognized (including as a result of boot). For now, however, the relief provided in Notice 2024-16 should indeed be a relief to taxpayers that undertook inbound nonrecognition transactions amid uncertainty (or without consideration of the basis consequences).

ENDNOTES

1 Code Sec. 951(b).
2 Code Sec. 957.
3 Notice 2024-16, section 3.02(1), IRB 2024-5, 622.
4 *Id.* at section 3.02(2).
5 *Id.* at section 3.04(1).
6 *Id.* at section 3.04(2).
7 *Id.* at section 3.04(5).
8 *Id.* at section 3.04(3).
9 Andrew Velarde, *PTEP Notice Reliance Language Meant to Apply Only Prospectively*, TAX NOTES TODAY INT'L (February 13, 2024).