Watch Your Step on Inbounding Transactions

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Beginning with the Tax Cuts and Jobs Act of 2017[1] (TCJA), the U.S. government has enacted legislation and issued administrative guidance with the objective of encouraging U.S. multinationals to repatriate assets and operations to the United States. First, Congress enacted Code Sec.[2] 965, with the policy objective of encouraging the repatriation of untaxed foreign earnings. More recently, the U.S. Treasury Department (Treasury) and Internal Revenue Service (IRS) have provided helpful guidance under Code Sec. 961 to facilitate the repatriation of previously taxed earnings.[3] In addition, Treasury and the IRS have proposed regulations that would terminate the application of Code Sec. 367(d) upon certain repatriations of intangible property (IP), thereby removing disincentives from repatriating such property.[4] These repatriation incentives, along with the reduction of the U.S. corporate income tax rate,[5] have encouraged some U.S. companies to bring inbound some of their foreign operations *via* the liquidation, deemed liquidation (by means of a "check-the-box" election), or reorganization of one or more of their foreign subsidiaries.

Historically, the inbounding of a foreign subsidiary, whether through a Code Sec. 332 liquidation or a Code Sec. 368(a)(1) asset reorganization, has resulted in taxation of the foreign subsidiary's non-previously taxed earnings and profits (E&P) as a deemed dividend to the U.S. shareholder.[6] Such deemed dividend is referred to as the "all E&P amount."[7] Since the enactment of the TCJA, however, the all E&P amount may be eligible for the 100% dividend-received deduction (by the U.S. corporate parent) under Code Sec. 245A(a) (the "Code Sec. 245A DRD"). Consequently, taxpayers may generally view the inbounding of a foreign subsidiary (whether in a Code Sec. 332 liquidation or in a Code Sec. 368(a)(1) asset reorganization) as a benign transaction in which there is no gain recognition at either the shareholder level or the target corporation level, and in which the deemed dividend resulting from the all E&P amount (if any) is fully offset by a Code Sec. 245A DRD.[8]

Notwithstanding the above, there are numerous U.S. tax issues (and non-U.S. tax issues[9]) to consider when inbounding a foreign subsidiary. Many of these issues arise from various Code sections enacted as part of the TCJA and related regulatory guidance or from more recent legislation and guidance. Other issues were present even before the TCJA. This article focuses on issues arising from recently issued guidance, including Code Sec. 961 guidance in Notice 2024-16, guidance on the Corporate Alternative Minimum Tax (CAMT), Code Sec. 367(d) guidance, and guidance on dual consolidated losses (DCLs). The article, however, does not purport to consider all issues that may arise, so each inbounding transaction should be considered in light of its own facts.

I. All E&P Amount in General

As mentioned, the inbounding of a foreign subsidiary, whether through a Code Sec. 332 liquidation or a Code Sec. 368(a)(1) asset reorganization, may give rise to a deemed dividend of the all E&P amount. The all E&P amount is the net positive E&P (if any) attributable to the stock of the foreign-acquired corporation, determined under the principles of Code Sec. 1248 (with certain modifications).[10] Code Sec. 1248(d) provides several exclusions from E&P for these purposes, including for E&P attributable to any amount previously included in the gross income of the U.S. shareholder under Code Sec. 951 or 951A (*i.e.*, previously taxed E&P (PTEP)).[11] Accordingly, the PTEP of the foreign target in a Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization is excluded from the all E&P amount.[12]

While inbounding transactions qualifying as a Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization are typically thought to be benign transactions post-TCJA due to the general availability of the Code Sec. 245A DRD, recent legislation and administrative guidance have complicated the landscape and added to the breadth of issues that must be considered when bringing operations inbound.

In view of the above, the all E&P amount consists solely of Code Sec. 959(c)(3) E&P (*i.e.*, "non-PTEP" or "untaxed E&P") and is treated as a dividend for purposes of the Code.[13] Accordingly, the all E&P amount would generally be treated as a dividend eligible for the Code Sec. 245A DRD,[14] subject to the regular requirements for that DRD.[15]

II. Lower-Tier PTEP and Loss of Code Sec. 961(a) Basis

Even if the all E&P amount fully qualifies for the Code Sec. 245A DRD, other consequences may need to be considered in determining whether the inbounding transaction is desirable from a U.S. tax perspective. For example, as explained below, the inbounding transaction could result in a loss of basis that may be needed to avoid gain recognition on the repatriation of PTEP from lower-tier controlled foreign corporations (CFCs) owned (directly or indirectly) by the foreign target corporation.

Under Code Sec. 961(a), a U.S. shareholder's adjusted basis in the stock of a CFC (and in any property by reason of which the shareholder is considered under Code Sec. 958(a)(2) to own the CFC stock) is increased by the amount included by the U.S. shareholder as a Subpart F inclusion or a global intangible low-taxed income (GILTI) inclusion.[16] Conversely, under Code Sec. 961(b)(1), the U.S. shareholder's adjusted basis in the CFC's stock (or other property) is decreased by the amount of PTEP that is distributed by the CFC to the U.S. shareholder and excluded from the U.S. shareholder's income under Code Sec. 959(a).[17] To the extent the amount distributed to the U.S. shareholder and excluded under Code Sec. 959(a) exceeds the adjusted basis of the CFC stock with respect to which it is received, the excess amount is treated under Code Sec. 961(b)(2) as gain from the sale or exchange of property.

Importantly, the basis adjustments under Code Secs. 961(a) and (b) generally apply only to the adjusted basis in the stock of a first-tier CFC. Code Sec. 961(c), however, requires, "[u]nder regulations prescribed by the Secretary," basis adjustments to be made to an upper-tier CFC's basis in a lower-tier CFC, similar to the adjustments in Code Secs. 961(a) and 961(b).[18] Such basis adjustments under Code Sec. 961(c) are made, however, "only for the purposes of determining the amount included under [Code Sec.] 951" by the CFC's U.S. shareholder. Thus, Code Sec. 961(c) basis is respected as basis only for limited purposes.

In view of the above, where a first-tier CFC (CFC1) owns a lower-tier CFC (CFC2), the inbounding of CFC1 in a Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization may result in the U.S. parent (USP) having a lower basis in the CFC2 stock than the basis it had in the CFC1 stock. In particular, the "regular" basis in CFC2 that carries over to USP[19] may be less than USP's basis in CFC1 stock since basis increases under Code Sec. 961(a) apply only to first-tier CFC stock. Consequently, once CFC2 becomes the top-tier CFC, there may not be sufficient basis in CFC2 to offset the PTEP in CFC2 and lower-tier subsidiaries, in which case a subsequent distribution of PTEP from CFC2 and lower-tier subsidiaries up to USP may result in gain recognition under Code Sec. 961(b)(2). Moreover, a subsequent sale of the CFC2 stock by USP might also result in the PTEP in CFC2 (and lower-tier subsidiaries) being effectively subject to another round of U.S. taxation since the adjusted basis in the stock of CFC2 used to calculate the gain on the sale would appear not to reflect the Code Sec. 961(c) basis that CFC1 had in CFC2 before the transaction.

These results are inconsistent with one of the primary purposes of Code Sec. 961, namely, to prevent the double taxation of the same CFC earnings.[20] Recognizing this, Treasury and the IRS recently issued Notice 2024-16. Under that notice, in the case of a "covered inbound transaction" (including certain liquidations under Code Sec. 332 and certain Code Sec. 368(a)(1) asset reorganizations), the Code Sec. 961(c) basis in the stock of the second-tier CFC would carry over to the domestic acquiring corporation as if the Code Sec. 961(c) basis were adjusted basis (*i.e.*, regular basis).[21] Thus, in the above example, CFC1's Code Sec. 961(c) basis in CFC2 stock would be included in USP's carryover basis in CFC2 stock after the liquidation or reorganization (provided it is a "covered inbound transaction").

Importantly, there are various limitations on the scope of "covered inbound transactions." For example, (i) the domestic acquiring corporation must acquire *all the stock* of the acquired (second-tier) CFC from the transferor (first-tier) CFC[22] and (ii) the transferor (first-tier) CFC must own directly or indirectly (under Code Sec. 958(a)(2)) *all the stock* of the acquired (second-tier) CFC immediately before the transaction and any related transactions.[23] In addition, for Code Sec. 332 liquidations and non-triangular upstream asset reorganizations under Code Secs. 368(a)(1)(A) and 368(a)(1)(C), *all the stock* of the transferor CFC (CFC1) must be owned *directly* by the domestic acquiring corporation immediately before the transaction.[24] A similar requirement also applies to non-upstream asset reorganizations (including Code Sec. 368(a)(1)(D) and (F) reorganizations) such that (i) all the stock of the transferor (first-tier) CFC must be owned directly by a single domestic corporation (*or* by members of the same U.S. consolidated group) immediately before the transaction; and (ii) the same domestic corporation (*or* members of the same U.S. consolidated group) must own all the stock of the domestic acquiring corporation immediately after the transaction.[25]

In view of the above, depending on the type of inbounding transaction, different treatments might follow, potentially leading to surprising outcomes. For example, if CFC1 is owned 95% by USP and 5% by another domestic corporation (US1), a Code Sec. 332 liquidation of CFC1 would not be considered a "covered inbound transaction" because less than 'all the stock' of the transferor CFC (CFC1) is directly owned by USP immediately before the transaction. However, if the inbounding of CFC1 is instead implemented as a Code Sec. 368(a)(1)(D) or (F) reorganization, it could still qualify as a "covered inbound transaction," assuming both USP and US1 are members of the same consolidated group.

In addition, a reorganization in which "boot" is received cannot be a covered inbound transaction unless the boot does not exceed 1% of the total fair market value of the stock of the transferor CFC.[26] Further, a transaction cannot be a covered inbound transaction if the transferor CFC (CFC1) has a built-in loss in the acquired CFC (CFC2) stock (taking into account Code Sec. 961(c) basis) immediately before the transaction.[27] Such a built-in loss in the CFC2 stock would apparently have a cliff effect, such that none of the Code Sec. 961(c) basis would be available as regular basis to the domestic acquiring corporation even if that would leave the domestic acquiring corporation with a built-in gain in the CFC2 stock. While it may seem appropriate for the domestic acquiring corporation to receive basis in the CFC2 stock at least equal to the stock's fair market value, the notice does not provide this result.

Lastly, a covered inbound transaction does not include a transaction where the acquired CFC's stock is transferred to a partnership or foreign corporation pursuant to a plan (or series of related transactions).[28] This limitation is deemed to apply if the transfer to the partnership or foreign corporation is completed within two years of the inbound transaction.[29]

In view of these limitations and others, Notice 2024-16 is not a cure-all for the potential problem of insufficient basis following an inbounding transaction where the lower-tier CFCs have material undistributed PTEP. Therefore, in the presence of lower-tier PTEP, the inability to carry over Code Sec. 961(c) basis as "regular" adjusted basis (or to transfer Code Sec. 961(a) basis from the transferor CFC to the acquired CFC (which becomes the new first-tier CFC)) may be a significant downside to inbounding a foreign subsidiary in a Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization, even if the inbounding transaction does not have other immediate adverse U.S. tax consequences. Proposed regulations, however, are expected at some point to implement the rules in Notice 2024-16 and may expand the relief provided in the notice to a broader set of circumstances. For transactions completed before those proposed regulations are published, taxpayers may rely on the rules in Notice 2024-16, provided they and their related parties follow the rules in their entirety and in a consistent manner.[30]

III. Corporate Alternative Minimum Tax

The inbounding of a foreign subsidiary may also give rise to considerations under the CAMT. The CAMT was enacted as part of the Inflation Reduction Act of 2022.[31] In general terms, the CAMT is a tax imposed on the excess of 15% of the Adjusted Financial Statement Income (AFSI) of an "applicable corporation" over such corporation's regular tax liability.[32] AFSI is generally calculated by making various adjustments to the net income or loss that is set forth on the relevant corporation's Applicable Financial Statement (AFS).[33]

One matter to consider is whether the all E&P amount is included in the AFSI of the U.S. shareholder under Code Sec. 56A(c)(2)(C). Under that provision, a taxpayer must take into account in AFSI (i) dividends received from another corporation (*e.g.*, a CFC) that is not included in the taxpayer's U.S. consolidated return (but such dividends are reduced to the extent provided in regulations or other guidance), and (ii) "other amounts which are includible in gross income or deductible as a loss" (other than amounts included under Code Sec. 951 or 951A, or other amounts as provided by the IRS) with respect to such other corporation. Thus, if the all E&P amount constitutes a dividend or "other [includible] amount" that is not otherwise reduced or excluded from AFSI under IRS guidance, it could potentially be included in the U.S. shareholder's AFSI.

New proposed regulations[34] on the CAMT (the "Proposed CAMT Regulations") would adjust the AFSI of a "CAMT entity"[35] (*e.g.*, the U.S. parent) that directly owns a foreign corporation by (i) disregarding any "income, expense, gain and loss resulting from ownership of stock of the foreign corporation …, reflected in the CAMT entity's [financial statement income] FSI" (*i.e.*, reversing out such financial accounting item), and (ii) including in AFSI any regular tax items of income, deduction, gain and loss (other than certain specified items[36]) resulting from the ownership of such stock.[37] An example in the Proposed CAMT Regulations makes it clear that, under this rule, in an inbounding transaction, an all E&P amount would be included in the CAMT entity's AFSI, but the AFSI would *also* be adjusted to include the corresponding Code Sec. 245A DRD (provided the deemed dividend qualifies for the Code Sec. 245A DRD for regular tax purposes).[38]

The Proposed CAMT Regulations also address the AFSI consequences to the foreign corporation itself in an inbounding nonrecognition transaction. Generally, for regular tax purposes, where a wholly owned foreign corporation is inbounded in a Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization, the foreign corporation does not realize any gain or loss under Code Sec. 337 or 361 (as applicable). For CAMT purposes, the Proposed CAMT Regulations view these "component transactions"[39] (for the foreign corporation) as "covered asset transactions."[40] Consequently, the AFSI of an inbounding foreign corporation transferring assets (other than stock of a foreign corporation) under Code Sec. 337 or 361 (i) would *not* include any items of income, expense, gain, or loss that result from the covered asset transaction and are reflected in the inbounding foreign corporation's FSI (effectively reversing out any financial accounting gain or loss resulting from the transaction), and (ii) would include any regular tax items of income, deduction, gain, and loss resulting from the transfer of the assets in the covered asset transaction.[41] As noted, transfers under Code Secs. 337 and 361 generally do not result in any gain or loss for regular tax purposes. Accordingly, no items of gain or loss resulting from the transfer of assets (other than stock of a foreign corporation) should generally be included in the inbounding foreign corporation's AFSI.

IV. Code Sec. 367(d) Implications

When considering the inbounding of a CFC, it is important to consider whether the CFC owns IP for which the CFC's U.S. parent (*i.e.*, the domestic acquiring corporation) or a related domestic corporation has been including deemed payments from the CFC under Code Sec. 367(d).[42] The "repatriation" of the IP to the U.S. (to the domestic acquiring corporation) upon the inbounding of the CFC raises the question of whether the deemed inclusions under Code Sec. 367(d) would be continued or discontinued, as well as corollary issues, such as the basis that the domestic acquiring corporation would receive in the repatriated IP.[43]

If the transferee foreign corporation (TFC) in a transfer governed by Code Sec. 367(d) subsequently transfers the previously expatriated IP to a *related person* (whether a U.S. or non-U.S. person), the temporary regulations under Code Sec. 367(d) have historically provided that the operation of Code Sec. 367(d) is uninterrupted, except that the related person that now owns the IP is treated as the TFC.[44] Recognizing that this result would be inappropriate for IP transferred to a *U.S.* related person (since the future income from the IP would be taxed in the United States directly), Treasury and the IRS broadly addressed the application of Code Sec. 367(d) to repatriation transactions in proposed regulations issued in May 2023.[45] The proposed regulations address the application of Code Sec. 367(d) specifically where the U.S. transferee in the IP repatriation transaction is a qualified domestic person (QDP).[46] In an inbound Code Sec. 332 liquidation or inbound Code Sec. 368(a)(1) asset reorganization, the domestic acquiring corporation would be a QDP if, for example, it were either the U.S. transferor (the UST) that initially transferred the IP or related (within the meaning of Temporary Reg. §1.367(d)-1T(h)) to the UST.

The proposed regulations—as applied to an inbound Code Sec. 332 liquidation or inbound Code Sec. 368(a)(1) asset reorganization in which the domestic acquiring corporation is a QDP—would generally terminate the deemed inclusions by the UST under Code Sec. 367(d), provided certain reporting requirements are met.[47] (This would be the case, however, only if the repatriated IP is not subsequently transferred (as part of a series of related transactions that includes the repatriation transfer) to another person that is not a QDP.[48]) Furthermore, so long as the TFC from the Code Sec. 367(d) transfer (here, the inbounded CFC) would recognize no gain on the IP repatriation transfer if its tax basis in the IP were equal to the UST's former adjusted basis in the IP, the UST would not recognize any gain on the repatriation transfer.[49] (This is the case specifically where the repatriated IP is "transferred basis property"[50] in the hands of the QDP, which would be the case in an inbound "Code Sec. 381(a) transaction," which generally includes a Code Sec. 332 liquidation and a Code Sec. 368(a)(1) asset reorganization.) In an inbound Code Sec. 381(a) transaction, the TFC would generally not recognize any gain in connection with the IP repatriation transfer under Code Sec. 337 or 361 (as applicable). Therefore, the UST would generally not recognize any gain on the IP repatriation transfer in an inbound Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization.

Where the repatriated IP is transferred basis property in the hands of the QDP (which, as mentioned, would be the case in an inbound Code Sec. 381(a) transaction), the QDP's tax basis in the IP equals **(A)** the lesser of (a) the UST's former tax basis in the IP at the time of the original Code Sec. 367(d) transfer, or (b) the TFC's adjusted basis in the IP immediately before the repatriation, *increased by* **(B)** the greater of (1) the gain recognized by the UST in connection with the repatriation transfer, or (2) the gain recognized by the TFC due to the repatriation.[51] This rule is especially intriguing as there has been a longstanding question as to whether the UST's basis in the IP carries over to the TFC at the time of the initial outbound transaction (and whether that basis is amortized in the hands of the TFC). More specifically, the interaction between Code Secs. 367(d) and 362 (the latter of which provides that the transferee receives a transferred basis in Code Sec. 351 and 361 exchanges) has long been a matter of debate.[52] Therefore, in the context of an inbound Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization, even if the QDP's tax basis in the repatriated IP could be the TFC's basis immediately before the repatriation transfer (assuming it is less than the UST's former tax basis and there is no gain recognition), the starting point for the TFC's basis at the time of the initial outbound transaction still remains a matter of debate.

The rules under the proposed regulations would be effective only for IP repatriations occurring on or after the date on which the final regulations are published.[53] Treasury and IRS officials have indicated unofficially that the final regulations for Code Sec. 367(d) are in an advanced stage and should be published soon.[54] They have also indicated that the final regulations may include some clarifications, but will not differ substantively from the proposed regulations.[55] Until the final regulations are issued, taxpayers undertaking inbound transactions involving the repatriation of IP should consider the Code Sec. 367(d) implications, as relevant.

V. Dual Consolidated Losses and Related Considerations

Inbounding a CFC may result in the foreign entity's post-transaction expenses becoming subject to certain deductibility limitations that typically apply only to domestic corporations. For example, as discussed below in more detail, once the CFC becomes a disregarded entity (following a check-the-box election) or a foreign branch of a domestic corporation, the domestic-use limitation under the DCL rules may apply to its post-transaction expenses.[56] The ability to utilize certain tax attributes may also be affected once the foreign operations are treated as conducted by a foreign branch of the U.S. parent.[57] Moreover, basis in the inbounded CFC's assets may be lost where the liquidation or reorganization is a loss importation transaction.[58] This section will focus on the potential DCL implications, along with possible implications under the newly proposed disregarded-payment-loss rules.

The inbounding of a CFC that is engaged directly (or *via* an entity treated as disregarded for U.S. federal tax purposes) in business operations in a country outside the United States may result in those foreign operations becoming a "separate unit" of the U.S. parent under the DCL rules.[59] As a result, a net loss attributable to those foreign operations in a post-inbounding tax year would be a DCL, and therefore would generally *not* be available to offset (directly or indirectly) the U.S. taxable income of the U.S. parent (or the U.S. consolidated group, if applicable). The DCL regulations refer to this rule as the "domestic use limitation."[60] While the U.S. parent can typically make a "domestic use election" to override the domestic use limitation, a domestic use election cannot be filed if there has been a "foreign use" of the DCL.[61] For example, it is possible that a portion of a DCL incurred after the inbounding transaction may have already been made available to offset or reduce the pre-inbounding foreign law income of a foreign corporation (the inbounded CFC) such that no "domestic use election" can be made for that DCL (as there would have been a "foreign use" of the DCL).[62] Thus, the possible inability to deduct a post-inbounding DCL on account of a pre-inbounding "foreign use" should be considered when evaluating the costs and benefits of the inbounding transaction.

In addition, under recently proposed regulations, a "foreign use" of a DCL may include the use of the separate unit's loss in the top-up tax calculation under the Pillar 2 regime (for purposes of calculating a charge under an Income Inclusion Rule (IIR) or a Qualifying Domestic Minimum Top-up Tax (QDMTT)).[63] Such a foreign use would generally occur where the multinational enterprise (MNE) group contains a constituent entity in the same tax jurisdiction as the separate unit, and that entity is treated as a foreign corporation for U.S. federal tax purposes. In such case, the separate unit's DCL would generally be treated as being put to a "foreign use" on account of it being included in the calculation of the blended Net GloBE Income for all the constituent entities in the separate unit's tax jurisdiction.[64]

The same package of recently proposed regulations also introduced the new disregarded payment loss (DPL) rules. Under these rules, broadly speaking, the foreign use of disregarded interest and royalty payments that are made by a foreign disregarded entity owned by a domestic corporation may trigger a deemed income inclusion by the domestic corporation in the amount of the corresponding net disregarded income.[65] The existence of a DPL is determined by netting the disregarded interest and royalty payments (and certain other disregarded items) of the foreign "disregarded payment entity" against the disregarded interest and royalty *income* received by such disregarded payment entity.[66] Foreign use under the DPL rules is substantially the same as under the DCL rules, with limited modifications (and, therefore, may include a foreign use due to the inclusion of the disregarded payments in the Pillar 2 minimum tax calculations where another constituent entity in the group is treated as a foreign corporation for U.S. federal tax purposes).[67]

In view of the DCL and DPL rules, inbounding a CFC could result in the taxpayer having to deal with new DCL and DPL issues depending on the various income and expense items of the resulting foreign disregarded entity or foreign branch (including items that become disregarded as a result of the inbounding transaction), along with the income and expense items of other foreign disregarded entities and foreign branches that are organized or located in that same foreign tax jurisdiction and owned by members of the same U.S. consolidated group. Further, given the broad application of the "foreign use" definition (including its extension to losses included in a Pillar 2 minimum tax calculation), taxpayers may need to take into account the potential inability to make a domestic use election for certain DCLs that are incurred after an inbounding transaction that results in a foreign entity becoming a separate unit.

VI. Conclusion

The issues discussed in this article represent a sampling of the issues that need to be considered when inbounding a foreign subsidiary. Of course, each fact pattern needs to be considered independently as any number of issues may arise in the context of a particular inbounding transaction. While inbounding transactions qualifying as a Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization are typically thought to be benign transactions post-TCJA due to the general availability of the Code Sec. 245A DRD, recent legislation and administrative guidance have complicated the landscape and added to the breadth of issues that must be considered when bringing operations inbound. Forthcoming proposed and final regulations will hopefully clarify some of these issues. Until then, the considerations raised here will continue to be relevant in the inbounding context and should not be overlooked.

ENDNOTES

* The views expressed herein are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or other members of the global EY organization. This article is intended solely for the purpose of enhancing knowledge on tax matters; it does not provide accounting, tax, or other professional advice.

1 P.L. 115-97.

2 All section references are to the Internal Revenue Code, as amended (the "Code"), or related Treasury regulations, unless otherwise indicated.

3 *See* Notice 2024-16, IRB 2024-5, 622, discussed in detail below.

4 *See* REG-124064-19 (published May 3, 2023), discussed in detail below.

5 Under the TCJA, the Federal corporate income tax rate was reduced to 21%. Furthermore, domestic income from goods and services destined for offshore use may qualify for a reduced rate of tax of 13.125% (16.406% in any tax year beginning after December 31, 2025) under the foreign-derived intangible income (FDII) regime.

6 Reg. §1.367(b)-3(b)(3).

7 *Id.*

8 This article generally addresses the inbounding of foreign operations. Where an inbounding CFC owns a U.S. real property interest (USRPI) with built-in gain, however, the normal nonrecognition rules under Code Sec. 332 and the reorganization provisions do not apply unless certain conditions (including the payment of a "FIRPTA toll charge") are satisfied. Instead, the inbounding CFC may recognize gain (but not loss) on the disposition of the USRPI as if the gain were effectively connected with a U.S. trade or business. *See* Code Sec. 897. The FIRPTA toll charge is equal to the taxes (along with interest) that would have been imposed under Code Sec. 897 on all foreign persons that disposed of an interest in the inbounded foreign corporation during a look-back period (generally, ten years), as if the foreign corporation were a domestic corporation. *See* Notice 89-85, 1989-2 CB 403, as modified by Notice 2006-46, 2006-1 CB 1044, Sec. 2.

9 For example, under the OECD's Pillar 2 global minimum taxation regime, it would need to be evaluated if the inbounding transaction (*i.e.*, a liquidation or an asset reorganization) can qualify as a GloBE Reorganisation under Article 10.1.1 of the Model Rules (MR) such that the disposing constituent entity (*e.g.*, the inbounded CFC) would exclude any gain or loss on the disposition from the computation of GloBE Income or Loss. *See* MR Article 6.3.2. If the transaction does not meet the conditions for a GloBE Reorganisation, then the gain or loss on the transaction is included in the computation of the disposing constituent entity's GloBE Income or Loss. *See* MR Article 6.3.1. In the latter case, however, the GloBE Income or Loss on the disposition is determined in accordance with MR Article 3.2.3, so the financial accounting gain or loss on the disposition may need to be adjusted to conform with the arm's length principle (*i.e.*, based on the disposition occurring at fair value). *See* OECD (2024), *Tax Challenges Arising from the Digitalisation of the Economy—Consolidated Commentary to the Global Anti-Base Erosion Model Rules (2023): Inclusive Framework on BEPS*, OECD Publishing, Paris, Art. 6.3.1, ¶73.1.

10 *See* Reg. §§1.367(b)-2(d)(1) and 1.367(b)-2(d)(3)(i)(A)(*1*).

11 *See* Reg. §1.367(b)-2(d)(2)(ii).

12 PTEP in the inbounding foreign target corporation could nonetheless give rise to adverse consequences due to the recognition of Code Sec. 986(c) foreign currency gain (although net foreign currency losses have been more prevalent in recent years due to the relative appreciation of the U.S. dollar). Code Sec. 986(c) gain or loss generally equals the difference between (i) the amount of PTEP translated into U.S. dollars on the date when the PTEP is distributed and (ii) the U.S. dollar basis of that PTEP determined on the date of the Subpart F or GILTI inclusion that gave rise to the PTEP. If a U.S. person is required to include an all E&P amount in an inbound transaction, then the U.S. person is treated as receiving, immediately before the transaction and *solely for purposes of computing Code Sec. 986(c) gain or loss*, a distribution of the amount of the foreign target's PTEP that is attributable to the foreign target stock treated as exchanged by the U.S. person in the transaction. Reg. §1.367(b)-2(j)(2)(i). Therefore, where a foreign subsidiary with PTEP is inbounded in a Code Sec. 332 liquidation or a Code Sec. 368(a)(1) asset reorganization, that PTEP may give rise to Code Sec. 986(c) gain or loss.

In addition, where the foreign target corporation owns one or more Code Sec. 987 qualified business units (QBUs), Code Sec. 987 gain or loss may be recognized as the result of the termination of those Code Sec. 987 QBUs upon the inbound Code Sec. 332 liquidation or reorganization of the foreign target corporation. Reg. §§1.987-8(e), 1.987-8(c)(1)(ii), and 1.987-8(c)(2)(ii).

13 Under Reg. §1.367(b)-2(e)(2), the Reg. §1.367(b)-3 inclusion is treated as a dividend for purposes of the Code.

14 In the Conference Report to the TCJA, Congress stated that "the term 'dividend received' is intended to be interpreted broadly" for purposes of Code Sec. 245A. H.R. Rep. No. 115-466, at 595 (Dec. 15, 2017) (Conf. Rep.). Furthermore, the IRS has privately ruled that an all E&P amount is a "dividend" for the purposes of the Code Sec. 245A DRD. *See* LTR 202107011, Ruling #7 (Nov. 24, 2020).

15 The Code Sec. 245A DRD qualification requirements include, *inter alia*, the following: (i) only the foreign-source portion of the dividend may qualify; (ii) a dividend from a controlled foreign corporation (CFC) to the extent of the U.S. shareholder's "hybrid deduction account" would not qualify (Code Sec. 245A(e)(1); Reg. §1.245A(e)-1(b)(2)); and (iii) a continuous 366-day holding period must be met during which time the foreign distributing corporation has the status of a "specified 10-percent owned foreign corporation" at all times and the dividend-recipient must be a "U.S. shareholder" at all times (Code Sec. 246(c)(1) as modified by Code Sec. 246(c)(5)(A)). In determining whether the all E&P amount qualifies for the Code Sec. 245A DRD, one must also consider whether any additional all E&P amount may arise due to the presence of "excess asset basis" in the foreign acquired corporation under the rules of Reg. §1.367(b)-3(g). In such case, the all E&P amount may include E&P of

lower-tier foreign subsidiaries (not just the E&P of the foreign acquired corporation). One must also determine whether a portion of the all E&P amount is an "extraordinary disposition amount" (*i.e.*, from certain E&P generated during the so-called GILTI gap period in a fiscal year ended in 2018, reflected in an "extraordinary disposition account"). *See* Reg. §1.245A-5(c). 50% of an "extraordinary disposition amount" is ineligible for the Code Sec. 245A DRD. Reg. §1.245A-5(b)(2)(i).

16 Code Sec. 961(a); Reg. §1.961-1; Code Sec. 951A(f)(1). The Code Sec. 961(a) basis increase may apply to stock of a CFC that is directly owned by a U.S shareholder as well as to property directly owned by a U.S. shareholder through which a CFC generating Subpart F or GILTI inclusion is owned indirectly, *e.g.*, (i) an interest in a foreign partnership owned by the U.S. shareholder through which stock in a CFC is owned, or (ii) the stock in a first-tier CFC through which a lower-tier CFC (that generates a Subpart F or GILTI inclusion) is owned.

17 Reg. §1.961-2.

18 The Gulf Opportunity Zone Act of 2005 amended Code Sec. 961(c) to clarify that basis adjustments should be made throughout the chain of ownership (applying Code Sec. 958(a)(2)) with respect to which stock in a lower-tier CFC is held. *See* Gulf Opportunity Zone Act of 2005, Sec. 409(b), P.L. 109-135 (H.R. 4440, 109th Cong.).

19 *See* Code Secs. 334(b) and 362(b).

20 *See* Notice 2024-16, IRB 2024-5, 622, Sec. 2.

21 *See* Notice 2024-16, IRB 2024-5, 622, Sec. 3.01.

22 The "transferor CFC" is the target corporation in the Code Sec. 332 liquidation or Code Sec. 368(a)(1) asset reorganization. The "acquired CFC" is the CFC owned by the transferor CFC.

23 *See* Notice 2024-16, IRB 2024-5, 622, Sec. 3.02. There is also a limited *de minimis* exception such that a transaction would not fail to be a "covered inbound transaction" on account of minority interests in the transferor CFC or acquired CFC which total to one percent or less of the total fair market value of the stock of the transferor CFC or acquired CFC (as applicable). Each minority owner of the acquired CFC, however, must continue to own its stock in the acquired CFC after the transaction if such owner is not related to the relevant domestic corporation. *See* Notice 2024-16, IRB 2024-5, 622, Sec. 3.03.

24 *See* Notice 2024-16, IRB 2024-5, 622, Sec. 3.02(1).

25 *See* Notice 2024-16, IRB 2024-5, 622, Sec. 3.02(2).

26 *See* Notice 2024-16, IRB 2024-5, 622, Sec. 3.04(1).

27 *See* Notice 2024-16, IRB 2024-5, 622, Sec. 3.04(2). There are other general exclusions from the definition of "covered inbound transactions" including where the inbound transaction is followed by certain transfers of the stock of the acquired CFC outside the U.S. consolidated group of which the domestic acquiring corporation is a member. *See* Notice 2024-16, IRB 2024-5, 622, Secs. 3.04(3), and 3.04(5).

28 Notice 2024-16, IRB 2024-5, 622, Sec. 3.04(4).

29 *Id.*

30 Notice 2024-16, IRB 2024-5, 622, Sec. 4.

31 P.L. 117-169 (Aug. 16, 2022).

32 *See* Code Secs. 55(a) and 55(b)(2)(A). An "applicable corporation" for a tax year is a corporation (other than an S corporation, a regulated investment company, or a real estate investment trust) that meets the Average Annual Adjusted Financial Statement Income ("Average Annual AFSI") test for at least one tax year (preceding the tax year in question) that ends after December 31, 2021. *See* Code Sec. 59(k)(1)(A). Generally, a corporation meets the Average Annual AFSI test for a given tax year if its Average Annual AFSI for the three-tax-year period ending with that tax year exceeds USD 1 billion (subject to certain other adjustments for newly formed corporations, short tax years, and predecessor corporations). *See* Code Secs. 59(k)(1)(B) and 59(k)(1)(E). Solely for purposes of the Average Annual AFSI test, all AFSI of persons treated as a single employer under Code Sec. 52(a) or 52(b) (*i.e.*, component members of certain specially defined ''controlled groups'') are aggregated. *See* Code Sec. 59(k)(1)(D).

33 Code Sec. 56A(a). The term "applicable financial statement" is defined in Code Sec. 451(b)(3) to be (where available) a financial statement that is certified as being prepared in accordance with generally accepted accounting principles (GAAP) and which is a 10-K (or successor form). Where a 10-K does not exist, certain other financial statements may qualify as an AFS.

34 REG-112129-23 (published September 13, 2024).

35 The term "CAMT entity" means any entity identified in Code Sec. 7701 and its regulations other than a disregarded entity. Proposed Reg. §1.56A-1(b)(8).

36 The excluded specified items include any items of income, deduction, gain and loss resulting from the application of Code Sec. 78, 250, 951, or 951A. *See* Proposed Reg. §1.56A-4(c)(1)(ii).

37 *See* Proposed Reg. §1.56A-4(c)(1). The items of income, deduction, gain, and loss resulting from the CAMT entity's ownership of foreign corporation stock include, among others, any items that result from acquiring or transferring that stock.

38 *See* Proposed Reg. §1.56A-4(h)(8). Before the proposed regulations were issued, Treasury and the IRS in Notice 2024-10, had provided that, for "Covered CFC Distributions," the AFSI of a U.S. shareholder is determined by (i) disregarding items that are reported on the U.S. shareholder's AFS and result from the receipt of the Covered CFC Distribution and (ii) including in AFSI the U.S. shareholder's items of income and deduction for U.S. federal income tax purposes resulting from the receipt of the Covered CFC Distribution (with certain exceptions). *See* Notice 2024-10, IRB 2024-3, 406, Sec. 3.03. Further, a "Covered CFC Distribution" was defined as a distribution that is made by the CFC and is a dividend *within the meaning of Code Sec. 316* (determined without regard to Code Sec. 959(d)). Notice 2024-10, IRB 2024-3, 406, Sec. 3.02. Thus, there was some doubt as to whether an all E&P amount would be included in AFSI as it was unclear whether the deemed dividend of an all E&P amount was a *Code Sec. 316* dividend. With the issuance of the proposed regulations, the issue of whether the all E&P amount is included in AFSI now seems to be settled.

39 The term "component transaction" means, with regard to a party to a transaction (as described in Proposed Reg. §1.56A-18 or 1.56A-19), an element of the transaction for which the regular tax consequences are determined solely with regard to that party. Proposed Reg. §1.56A-18(b)(6).

40 *See* Proposed Reg. §§1.56A-4(b)(1)(i)(B) and (D).

41 Proposed Reg. §1.56A-4(c)(2).

42 Where IP is used by the U.S. parent in manufacturing, apart from Code Sec. 367(d) considerations, the repatriation of the IP to the U.S. could be beneficial on account of (i) business efficiencies to be gained from having IP owned in the U.S., (ii) the ability to take advantage of the FDII regime on outbound sales or licenses using the IP, and (ii) the avoidance of adverse U.S. tax consequences resulting from royalties paid by the U.S. parent (the manufacturer in this case) to the CFC for the use of the IP. Those outbound royalty payments would be Subpart F income to the CFC and could be subject to the BEAT under Code Sec. 59A. The royalty payments also may be subject to gross basis taxation in the U.S. (*via* withholding) under Code Sec. 881 (imposed at a 30% rate), subject to reduction or elimination under an applicable double tax treaty.

43 By way of background, where a U.S. person transfers intangible property (as defined in Code Sec. 367(d)(4)) to a foreign corporation in a Code Sec. 351 or 361 non-recognition transfer, the U.S. person is, in general, treated as (i) having sold the intangible property to the transferee foreign corporation in exchange for payments which are contingent upon the productivity, use or disposition of such property, and (ii) receiving annual deemed payments (which it must include in income) over the useful life of the property that are "commensurate with the income" attributable to the transferred intangible property.

44 *See generally* Reg. §1.367(d)-1T(f)(3).

45 REG-124064-19 (published May 3, 2023).

46 The proposed regulations define a QDP to be (i) the U.S. transferor that initially transferred the IP; (ii) a U.S. person treated as a successor U.S. transferor under Temporary Reg. §1.367(d)-1T(e)(1) (with certain exceptions); (iii) a U.S. person that is an individual related (within the meaning of Temporary Reg. §1.367(d)-1T(h)) to the persons described in (i) and (ii); and (iv) a U.S. corporation that

is related (within the meaning of Temporary Reg. §1.367(d)-1T(h)) to the persons described in (i) and (ii) (with certain exceptions). *See* Proposed Reg. §1.367(d)-1(f)(4)(iii).

[47] Proposed Reg. §1.367(d)-1(f)(4)(i)(B).

[48] Proposed Reg. §1.367(d)-1(f)(4)(v).

[49] *See* Proposed Reg. §1.367(d)-1(f)(4)(ii).

[50] "Transferred basis property" is defined in Code Sec. 7701(a)(43).

[51] *See* Proposed Reg. §1.367(d)-1(f)(4)(iv)(A).

[52] Code Sec. 367(d) and the corresponding regulations do not explicitly turn-off Code Sec. 362 for an outbound transfer of IP. The preamble to the proposed regulations (REG-124064-19) notes that Treasury and the IRS are aware of the uncertainty regarding the treatment of the adjusted basis of the IP in the hands of the TFC while Code Sec. 367(d) still applies, and that they will address general basis rules under Code Sec. 367(d) in future rulemaking.

[53] Proposed Reg. §1.367(d)-1(j)(2).

[54] *See* Andrew Velarde, *IP Repatriation Regs in Final Clearance Stage*, 184 TAX NOTES FEDERAL 2572 (2024).

[55] See Andrew Velarde, *IRS Considering Move to Entity Approach in Foreign Currency Regs*, 183 TAX NOTES FEDERAL 1275 (2024).

[56] Another deductibility limitation may effectively arise in connection with the base erosion anti-abuse tax (BEAT). *See* Code Sec. 59A. Once the CFC's foreign operations are treated as being conducted through a branch of the U.S. parent, certain payments made by the foreign entity to "foreign related parties" may henceforth be treated as outbound "base erosion payments." Such base erosion payments could increase the U.S. parent's BEAT liability, and may cause the U.S. parent, in some cases, to fall over the "base erosion percentage" cliff (thereby resulting in the U.S. parent becoming an "applicable taxpayer" for purposes of applying the BEAT).

[57] For example, foreign taxes that would have been allocated to the general category or the Code Sec. 951A category if generated at the CFC level may end up in the foreign branch category, which could affect the usability of the foreign tax credits. In addition, where a foreign corporation is inbounded by means of a mid-year check-the-box election (becoming a pass-through entity for U.S. tax purposes), the foreign income tax paid or accrued by the foreign entity during the foreign tax year (other than a withholding tax described in Code Sec. 901(k)(1)(B)) would need to be allocated for U.S. foreign tax credit purposes between (i) the foreign corporation (for its final short U.S. tax year ending with the inbounding transaction), and (ii) the owner(s) of the resulting foreign pass-through entity (for the foreign pass-through entity's first short-year following the inbounding transaction). Reg. §§1.901-2(f)(5)(i) and (ii).

[58] If an inbounding liquidation or asset reorganization involves the importation of a net built-in-loss (taking into account the unrealized gains and losses from all of the inbounded assets), then the basis of each property acquired by the U.S. shareholder in the transaction equals its fair market value immediately after the transaction. *See* Code Secs. 362(e)(1) and 362(b); Reg. §1.362-3(b)(1); Code Sec. 334(b)(1)(B); Reg. §1.334-1(b)(3). Thus, where the transferred property has an overall net built-in loss, the taxpayer would lose any potential tax benefit from the built-in loss in the acquired property.

[59] Under the current final DCL regulations, the term "separate unit," in general, means either of the following: (i) a foreign business operation that is carried on or owned, directly or indirectly, by a domestic corporation and would constitute a "foreign branch" as defined in Temporary Reg. §1.367(a)-6T(g)(1), if carried on by a U.S. person; or (ii) an interest in a hybrid entity (as defined in Reg. §1.1503(d)-1(b)(3)) that is owned directly or indirectly by a domestic corporation. *See* Reg. §1.1503(d)-1(b)(4)(i). The first type of separate unit is called a "foreign branch separate unit" and the second type is called a "hybrid entity separate unit." These definitions have been expanded in the recently proposed DCL regulations to accommodate the context of a separate unit's loss being put to a "foreign use" under the Pillar 2 regime. *See* Proposed Reg. §1.1503(d)-1(b)(4)(i).

[60] Reg. §1.1503(d)-4(b). The domestic use limitation prevents the U.S. group from using the DCL to offset its taxable income other than the taxable income attributable to the separate unit that generated the DCL.

[61] To file a "domestic use election," the domestic owner (or common parent of the U.S. consolidated group) must certify that there has not been and will not be a "foreign use" as described in Reg. §1.1503(d)-3. Under those regulations, a foreign use of a DCL shall, *inter alia*, "be deemed to occur when any portion of a deduction or loss taken into account in computing the dual consolidated loss is made available under the income tax laws of a foreign country to offset or reduce, directly or indirectly, any item that is recognized as income or gain under such laws and that is, or would be, considered under U.S. tax principles to be an item of a foreign corporation." Reg. §1.1503(d)-3(a)(1)(i).

[62] *See, e.g.*, AM 2009-011 (Oct. 2, 2009) (the "2009 GLAM"), in which a mid-year check-the-box election was made to classify a pre-existing CFC (wholly owned by a domestic corporation) as a disregarded entity for U.S. federal tax purposes. The 2009 GLAM concludes that a DCL incurred by the resulting separate unit during the remainder of the tax year was made available under the income tax laws of the foreign country to offset the pre-inbounding foreign law income of the entity earned when it was a foreign corporation for U.S. federal tax purposes. The 2009 GLAM also points out that a foreign use of a post-inbounding DCL could result from differences in tax treatment or timing of items under foreign country and U.S. tax laws. Similarly, a foreign use of a DCL in these circumstances can occur if the foreign country requires some portion of the loss to be carried back to a year in which the separate unit was treated as a foreign corporation for U.S. tax purposes.

[63] *See* REG-105128-23, published on August 7, 2024 (corrected on September 3, 2024). The proposed regulations provide that an income tax may include a minimum tax that is computed based on financial accounting net income or loss, such as a QDMTT or an IIR. Proposed Reg. §§1.1503(d)-1(b)(6)(ii) and 1.1503(d)-1(b)(21). They do not provide any guidance on the UTPR (also referred to as the undertaxed profits rule), however, as Treasury continues to analyze issues related to the UTPR. The proposed regulations, however, would not deem a foreign use to occur in connection with Pillar 2 taxes for DCLs incurred in tax years beginning before August 6, 2024. Proposed Reg. §1.1503(d)-8(b)(12).

[64] Such a foreign use could also occur where the DCL is included in determining that the Transitional CbCR Safe Harbour is satisfied for the separate unit's tax jurisdiction.

[65] The DPL computation also includes structured payments (defined in Reg. §1.267A-5(b)(ii)), a deduction for equity and a deduction for an imputed interest payment on a debt instrument. *See* Proposed Reg. §1.1503(d)-1(d)(6).

[66] In this connection, note that both the DCL rules and the proposed DPL rules have a combination rule that treats foreign disregarded entities and foreign branches subject to the same foreign tax law as a single "combined separate unit" or "combined disregarded payment entity" (as relevant) where those foreign disregarded entities and foreign branches have the same domestic owner (or where their domestic owners are members of the same U.S. consolidated group).

[67] *See* Proposed Reg. §1.1503(d)-1(d)(3)(i).