Report No. 1402

New York State Bar Association Tax Section

Report on Previously Taxed Earnings under Section 959

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Table of Contents

Page

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I. Introduction

This Report[1] comments on the rules governing previously taxed earnings and profits under Section 959[2] ("**PTI**") and the related basis adjustments under Section 961, primarily focusing on the changes to the Code made by An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018 (the "**Act**").[3] In addition to issues that have arisen specifically with respect to the Act, this Report also addresses certain previously existing issues, some of which have heightened importance (and others with perhaps lesser importance) after the Act.

One key provision of the Act is Section 965, which raises a variety of PTI issues. New York State Bar Association Tax Section Report No. 1401[4] comments on recently proposed Regulations under Section 965 (the "**Proposed 965 Regulations**")[5] including certain PTI issues related to Section 965. The Section 965 PTI issues are also discussed in this Report as a necessary building block for the analytical framework for analyzing PTI issues more broadly. With "traditional" Subpart F income, the retention of Section 956, and the addition of Section 951A ("**GILTI**") by the Act, PTI issues extend well beyond income included under Section 965.

This Report discusses the issues under the PTI regime that we have identified and consider most significant. There are many issues that are beyond the scope of the Report. Part II of this Report is a summary of our principal recommendations. Part III of this Report provides an overview of the relevant statutory provisions of Sections 959 and 961, and describes a variety of reasons why PTI is still relevant after the Act. Part IV of this Report lays out several analytical frameworks through which PTI issues should be considered. In particular, the analytical frameworks tie the treatment of PTI to alternative possibilities of Congressional intent; namely, whether Congress intended certain types of income to be exempt from tax, taxed at a reduced rate,

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[1] The principal drafter of this Report is Andrew Herman, with substantial assistance from James Coss. Helpful comments were received from Kim Blanchard, Andy Braiterman, Tymon Daniels, Jose Murillo, Joshua Ruland, Michael Schler, Karen Gilbreath Sowell, Nathan Tasso, Joe Toce, Gordon Warnke, and Chengcheng Zhang. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Except as otherwise noted, all "**Section**" references in this Report are to sections of the Internal Revenue Code of 1986, as amended (the "**Code**"), references to "**Regulations**" or "**Reg. §**" are to the Treasury Regulations promulgated thereunder, and references to "**Prop. Reg. §**" are to proposed Regulations. Department of the Treasury and the Internal Revenue Service are referred to collectively as "**Treasury**".

[3] P.L. 115-97.

[4] NYSBA Tax Section Report No. 1401, *Report on Proposed Section 965 Regulations* (October 5, 2018) (the "**965 Proposed Regulations Report**").

[5] REG-104226-18; Prop. Reg. §§1.965-1 through -9; 1.962-1, -2; 1.986(c)-1 (2018).

or fully taxed at the highest marginal rate (i.e., Exempt Income, Reduced Rate Income, or Fully Taxed Income, in each case as defined below). Also, the analytical frameworks compare results of multiple controlled foreign corporations conducting foreign activities to the results if the foreign activities were conducted by a single controlled foreign corporation (i.e., the Single CFC Approach, defined below), and articulate the principle of avoiding double taxation or unintended non-taxation of the same earnings, whenever possible. Part V through Part VII discuss relevant issues in the current PTI regime raised by the Act, including stock basis adjustments under Section 961, the determination of amounts and types of PTI earned and distributed, and the credits allowed for foreign income taxes paid or accrued with respect to PTI.

II. Summary of Principal Recommendations

Our observations and recommendations regarding guidance under Sections 959, 951A, 961, 965, and other related provisions are set forth below:[6]

1. The issue of whether and how PTI attributes can be shared within a consolidated group as provided by the 2006 Proposed Regulations is a different calculus after the Act, and requires consideration of the ability to take FTCs and the complexities of Section 1059.

2. The limited gain reduction rule in Notice 2018-7 and the Proposed 965 Regulations might be read as a way for Treasury to leave open the possibility that Section 961 basis reductions (and gain) occur prior to basis increases. Instead of leaving the issue open and providing a helpful (but limited) gain reduction rule that only applies to distributions of 965(a) PTI and 965(b) PTI during the transition year, Treasury should resolve the issue by modifying Reg. §§1.961-1(a)(1) and 1.961-2(a)(1) to clarify that for purposes of determining Section 961(b)(2) gain, basis decreases in CFC stock under Section 961(b) (and negative basis adjustments pursuant to an election under Prop. Reg. §1.965-2(g) (2018)), and gain under Section 961(b)(2), do not occur prior to giving effect to basis increases under Section 961(a).

3. If Treasury does not clarify that basis decreases in CFC stock under Section 961(b) do not occur prior to giving effect to basis increases under Section 961(a) (as recommended above), then Treasury should allow distributions during the transition year to be treated as being made first out of 965(a) PTI and 965(b) PTI (before other types of PTI), so that such distributions, if necessary, would be eligible for the gain reduction rule in Notices 2018-7 and 2018-13 and the Proposed 965 Regulations.

4. Given the large amounts of PTI in lower-tier CFCs that are present after the application of Section 965, and the apparent policy of the PTI regime to allow U.S. Shareholders to recover PTI at the earliest possible time, Treasury should consider issuing Regulations

[6] Terms used in this summary of principal recommendations and not yet defined are defined below.

providing that there should be no gain recognition (or basis reduction) by reason of PTI distributions in excess of basis in cases where the upper-tier CFC did not previously increase its basis in lower-tier CFC stock under Section 961(a) and (c); to the extent that the PTI did cause a basis increase in lower-tier CFC stock, it seems appropriate for a distribution of PTI to reduce basis and then cause gain. Notwithstanding the foregoing, 965(b) PTI might present different policy issues and should be handled in a manner consistent with Congressional intent underlying 965(b) PTI.

5. Treasury should issue Regulations providing that Section 961(c) basis adjustments in lower-tier CFC stock apply not only for purposes of calculating the Subpart F income of upper-tier CFCs, but also for purposes of calculating GILTI tested income of upper-tier CFCs.

6. Treasury should confirm that Section 1248 recharacterization is available for Section 961(b)(2) gain.

7. Treasury should clarify whether Section 1248(d)(1) excludes 965(b) PTI from availability to recharacterize gain as a dividend.

8. Treasury should consider issuing Regulations providing that a Section 959(c)(3) deficit is not netted with the amount of PTI; rather, both amounts can coexist as disaggregated components of a CFC's E&P.

9. Treasury should consider issuing Regulations providing that a distribution under Section 301(c)(2) does not reduce PTI; rather, that PTI should only be reduced by the amount of a distribution that otherwise would have been included in gross income by a U.S. Shareholder (i.e, a distribution is only a PTI distribution to the extent it could have been treated as a dividend under Section 316). However, there are several potential approaches, depending on which statutory requirements are interpreted flexibly.

10. Treasury should consider the cases where there is an inappropriate coupling of loss on CFC stock with a gain on CFC stock recharacterized as a Section 1248 dividend eligible for Section 245A, taking into account whether a deficit CFC's single economic loss is utilized twice (i.e., once to offset GILTI tested income of another CFC and again as loss of the U.S. Shareholder upon disposition of the deficit CFC stock). However, consistent with the Proposed GILTI Regulations which attempt to deal with this issue under the GILTI regime, we think the PTI regime is not the appropriate vehicle to deal with this issue.

11. Treasury should consider if policies, including policies to prioritize the distribution of 965(a) PTI and 965(b) PTI, dictate a priority between different types of Section 959(c)(2) PTI. In the absence of competing policies, distributing PTI within Section 959(c)(2) categories on a LIFO basis seems to be consistent with the general ordering of Section

316(a)(2) and the reference to Section 316 in Section 959(c), and thus would be a reasonable approach.

12. There are numerous uncertainties concerning FTCs associated with PTI. The subject of FTCs is beyond the scope of this Report. Select issues are presented here in summary form for consideration by Treasury.

III. Background

A. Overview of the relevant statutory provisions

Sections 951-965 ("**Subpart F**") establish an anti-deferral regime that requires certain U.S. 10% shareholders ("**U.S. Shareholders**")[7] to include currently in gross income certain earnings and profits ("**E&P**") of a controlled foreign corporation ("**CFC**")[8] regardless of whether the CFC distributes such E&P. Sections 959 and 961 provide that such earnings are not again taxed when distributed to a U.S. Shareholder that included the earnings under Subpart F (or successors in interest).[9] Section 959 excludes from a U.S. Shareholder's gross income distributions of E&P that were previously included in the U.S. Shareholder's income under Section 951(a) (i.e., PTI).[10] Section 961 provides for adjustments to the basis of stock in the CFC and certain other property upon a U.S. Shareholder including income pursuant to Subpart F and upon distributions of PTI, in

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[7] A U.S. Shareholder is a U.S. person directly, indirectly, or constructively owning 10% or more of the voting power or value of stock of a CFC. Prior to the Act, status as a U.S. Shareholder was determined solely with reference to voting power. *See* the Act §14214 (adding the value prong of the test, effective for taxable years beginning after December 31, 2017).

[8] A CFC is any foreign corporation in which U.S. Shareholders own more than 50% of the stock by vote or value. Sections 951(b) and 957(a).

[9] For detailed description of the legislative history of Sections 959 and 961, *see* the 2015 NYSBA Report No. 1321, *Report on 2006 Proposed Regulations Regarding the Exclusion from Income of Previously Taxed Earnings under Section 959 and Related Basis Adjustments under Section 961* (Mar. 20, 2015) (the "**2015 Report**") which responds to the 2006 proposed PTI Regulations under Sections 959, 961, and 1502 (the "**2006 Proposed Regulations**"). The 2006 Proposed Regulations provide for maintenance of PTI accounts at the shareholder level and the corporate level. *See* REG-121509-00; Prop. Reg. §1.959-3(b)(1) and (2) (2006). The merits of the proposed PTI account maintenance system, or other features of the 2006 Proposed Regulations, are beyond the scope of this Report, except where otherwise stated. The scope of this Report generally is limited to issues raised by the Act that we believe require timely guidance.

[10] Distributions of amounts previously included under Section 951A generally should similarly be excluded from gross income. *See* Section 951A(f)(1)(A) (treating Section 951A inclusions as Section 951(a) inclusions for certain purposes, including Sections 959 and 961). As discussed in Part V, the interaction between Sections 951A and 959 is further complicated by the fact that Section 951A inclusions are not limited by E&P in the way that Section 951(a) inclusions are so limited under Section 952(c)(1)(A).

each case in order to properly tax a subsequent disposition of CFC stock, or distribution by the CFC.

1. Section 959 and the types of PTI

Section 959(a)(1) provides an exclusion from the gross income of a U.S. Shareholder for actual distributions of PTI. Section 959(a)(2) provides an exclusion from the gross income of a U.S. Shareholder for investments in U.S. property under Section 956 that otherwise would cause the PTI earnings to be included by the U.S. Shareholder under Section 951(a)(1)(B). Section 959(b) excludes PTI from the gross income of an upper-tier CFC when the PTI is distributed through a chain of ownership described in Section 958(a), for purposes of applying Section 951(a) to such upper-tier CFC with respect to the U.S. Shareholder that included the earnings that were distributed (i.e., it prevents a second Subpart F inclusion when a CFC makes a PTI distribution to another CFC). Section 959(c) provides E&P ordering rules that supersede the general ordering rules of Section 316(a) governing distributions.[11]

Section 959 divides PTI into three categories and provides that PTI will be treated as distributed: (i) first, under Section 959(c)(1), out of PTI attributable to amounts previously included in gross income under Section 951(a)(1)(B) ("**Section 956 PTI**"),[12] (ii) second, under Section 959(c)(2), out of PTI attributable to amounts included under Section 951(a)(1)(A) ("**Section 959(c)(2) PTI**") (which, as discussed below, now has several subcategories after giving effect to the Act, and such subcategories might or might not be treated differently from one another when applying the ordering rule of Section 959(c)), and (iii) finally, under Section 959(c)(3), out of other E&P ("**Non-PTI E&P**").

Before the Act, Section 959(c)(2) PTI generally was attributable to "traditional" Subpart F income included under Section 951 (such PTI, including post-Act PTI attributable to Subpart F income other than Section 965 Subpart F income, "**Subpart F PTI**").[13] Following the Act, Section 959(c)(2) PTI also includes PTI attributable to income included by reason of Section 965[14]

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[11] Under Section 316(a), a distribution of a dividend is made out of the corporation's current year E&P, then out of the E&P accumulated after February 28, 1913.

[12] PTI attributable to the former Section 956A excess passive asset rules is also included in the first category. Distributions are allocated proportionately to PTI included by reason of Section 956 and PTI included by reason of former Section 956A. Section 956A was repealed for taxable years beginning after 1996 and this type of PTI is not relevant for the majority of taxpayers. Accordingly, it is not discussed further in this Report.

[13] Section 959(e) treats amounts included as a dividend under Section 1248 as an amount included under Section 951, for purposes of applying Section 959 (and Section 960).

[14] Section 965 requires a U.S. Shareholder of a specified foreign corporation ("**SFC**") (i.e., a CFC or a foreign corporation in which a domestic corporation is a U.S. Shareholder) to include in income its pro rata share of the accumulated post-1986 deferred foreign income ("**ADFI**") of such SFC. The amount determined under Section 965 is treated as Subpart F income and is included in gross income of the U.S. Shareholder under Section 951(a). Thus,

("**965(a) PTI**"), 965(b) PTI (as defined below), and PTI attributable to E&P included by reason of Section 951A ("**GILTI PTI**").[15]

Section 965(b)(1) provides that if a taxpayer is a U.S. Shareholder with respect to both a deferred foreign income corporation (i.e., a foreign corporation with ADFI) (a "**DFIC**") and an E&P deficit foreign corporation, then the U.S. Shareholder's inclusion of its pro rata share of the ADFI is reduced by its pro rata share of the E&P deficit (i.e., the deficit effectively offsets ADFI that would otherwise be taken into account under Section 951(a)(1)).[16] Section 965(b)(4)(A) provides that the offset "shall be treated as an amount which was included…under [S]ection 951(a)", but only "[f]or purposes of applying [S]ection 959" ("**965(b) PTI**"). Thus, the amount of the offset is treated as PTI even though the corresponding E&P was not included in the gross income of the U.S. Shareholder.[17] The Proposed 965 Regulations provide for basis consequences of a Section 965(a) inclusion and 965(b) PTI, including an election to reallocate basis from a deficit CFC to a DFIC in an amount equal to the 965(b) PTI.[18]

Example 1: CFC with different types of PTI

This Example 1 introduces the notion that various types of PTI can arise as a result of a CFC's activities and notes that, while the basis consequences under Section 961 generally do not change as a result of the type of PTI distributed, certain other tax consequences may vary significantly depending on what type of PTI is distributed.

965(a) PTI might be treated as if it were Subpart F PTI for purposes of Section 959(c). For a detailed description of Section 965, *see* NYSBA Tax Section Report No.1388, *Report on Section 965* (Feb. 6, 2018) (the "**965 Statute Report**"), and the 965 Proposed Regulations Report.

[15] For a detailed description of the GILTI provisions, *see* NYSBA Tax Section Report No.1394, *Report on the GILTI Provisions of the Code* (May 4, 2018) (the "**GILTI Report**").

[16] *See* the 965 Statute Report for a detailed discussion of the operative mechanics.

[17] Because Section 965(b)(4)(A) limits the treatment of such earnings as PTI to the application of Section 959, it does not appear that 965(b) PTI gives rise to a basis increase under Section 961. Moreover, treating amounts that were not previously included in gross income as PTI raises the question of whether Congress intended such amounts to be completely exempt from tax or deferred but taxed at a later time. These issue are discussed in greater detail below.

[18] *See* 965 Proposed Regulations Report.

	2016	2017	2018	2019
956 PTI	10			
965(a) PTI		10		
965(b) PTI		10		
Subpart F PTI			10	
GILTI PTI			10	
Distribution				25

USP owns 100% of the stock of CFC. CFC has $10 of PTI from a Section 956 investment in 2016, $10 of 965(a) PTI and $10 of 965(b) PTI in 2017, and $10 of Subpart F PTI and $10 of GILTI PTI in 2018. CFC makes a distribution of $25 to USP in 2019. Which PTI is distributed in the 2019 distribution? In this case, the basis consequences under Section 961 do not appear to change based on which PTI is distributed, but the foreign tax credit ("**FTC**") consequences and the foreign currency consequences (including the corresponding "haircuts" with respect to 965(a) PTI, as discussed below) can vary significantly based on which PTI is distributed. This issue is presented here to set the stage for discussion further below.

2. Section 961 basis adjustments

Section 961 adjusts basis in the stock of a CFC for PTI attributable to such stock (upwards upon earning PTI and downwards upon distributing PTI), and thus prevents the U.S. Shareholder from being taxed twice on the same economic income of the CFC (i.e., if the U.S. Shareholder sells its stock in the CFC before the CFC distributes the PTI, then without a positive basis adjustment for the PTI, the U.S. Shareholder would recognize gain attributable to the earnings that were already subject to tax). Section 961(a) generally provides for an increase in a U.S. Shareholder's basis in its CFC stock (or in the property by reason of which it is considered to own such stock) by the amount required to be included in its gross income under Section 951(a) with respect to such stock. Correspondingly, under Section 961(b), when a U.S. Shareholder receives an amount which is excluded from gross income under Section 959(a), its basis in its CFC stock (or the property by reason of which it is considered to own such stock) is reduced by the amount of the exclusion, and any excess reduction over the amount of basis in its CFC stock (or other property) is treated as gain from the sale or exchange of property.

Section 961(c) was added to the Code in 1997 to prevent duplicative inclusions that could otherwise arise if an upper-tier CFC sells the stock of a lower-tier CFC, where the lower-tier CFC has PTI.[19] Section 961(c) authorizes Treasury to promulgate Regulations pursuant to which "adjustments" (as discussed below, "adjustments" might not include "gain" under Section 961(b)(2)) similar to those required by Sections 961(a) and (b) are made to the basis of stock in a lower-tier CFC held by an upper-tier CFC, but only for the purpose of determining the amount included under Section 951 in the gross income of a U.S. Shareholder (as discussed below, the reference to Section 951 might also include a reference to Section 951A). It is possible that Section 961(c) is not self-executing, and to date there are no Regulations implementing the lower-tier basis adjustments contemplated by Section 961(c), but because the statute uses the phrase "under Regulations" and provides that adjustments "shall" be made, such adjustments likely are self-executing. Further, under the Proposed 965 Regulations (the relevant portions of which are described in more detail below), there is no explicit basis adjustment in lower-tier stock for amounts included under Section 965(a) with respect to the indirect ownership of such stock. It is not clear whether Treasury merely deferred answering this question in the Proposed 965 Regulations or was affirmatively suggesting that there is no lower-tier adjustment. The lack of references to lower-tier adjustments is noteworthy. For example, the Proposed 965 Regulations include a gain reduction rule for PTI distributions by a top-tier CFC, as articulated by Notice 2018-7,[20] but did not provide the corresponding gain reduction rule for PTI distributions by a lower-tier CFC, as articulated by Notice 2018-13.[21] In certain of the numerical examples in this Report, we assume a lower-tier basis adjustment under Section 961(c) for ease of discussion and to illustrate the issues, on the assumption that Section 961(c) is self-executing.

B. Relevance of PTI Post-Act

Given the Section 245A 100% dividends received deduction (the "**Section 245A DRD**"),[22] it may at first seem that the PTI regime has diminished importance following the Act. However, as discussed below, basis adjustments, foreign tax credits, and foreign currency gain or loss, among other consequences, highlight the continued importance of the PTI regime.

1. Basis adjustments under Section 961

Basis adjustments under Section 961 are one primary difference between a distribution of PTI and a distribution of a dividend that is eligible for the Section 245A DRD.[23] In particular,

[19] *See* the 2015 Report.

[20] 2018-4 I.R.B. 317.

[21] 2018-6 I.R.B. 341.

[22] Under Section 245A, for distributions made after December 31, 2017, if certain requirements are satisfied, a 100% dividends-received deduction is provided for the foreign-source portion of distributions received by a domestic corporation from a "specified 10%-owned foreign corporation".

[23] However, Section 1059 could operate to reduce basis (or cause gain) if the dividend is extraordinary and there is no

earnings that are available for the Section 245A DRD generally do not cause a basis increase in the stock of the CFC, and a distribution of the dividend generally does not reduce basis in CFC stock, other than in certain circumstances pursuant to Sections 961(d) or 1059.[24] In contrast, generation of PTI generally (though not always, as discussed further below) gives rise to a positive basis adjustment in the stock of the CFC under Section 961(a), and a distribution of PTI causes a reduction in stock basis under Section 961(b) and, to the extent this reduction exceeds basis, capital gain under Section 961(b)(2). Notwithstanding that foreign earnings, other than the limited categories of income constituting Subpart F income, are generally either subject to a reduced 10.5% effective rate of tax under the GILTI regime or are excluded from income pursuant to Section 245A, gain from the sale, exchange, or other disposition of CFC stock is still subject to corporate income tax at the highest marginal rate (individuals are eligible to benefit from a reduced capital gains rate). Stock gain is Fully Taxed Income (for corporations) even though the underlying income is often Reduced Rate Income or Exempt Income (in each case defined below). Thus, it is necessary to determine the basis in CFC stock, for the treatment of both dispositions of such stock and PTI distributions by such CFC.

As discussed below, there is uncertainty about the timing of the basis increases and decreases pursuant to Section 961, and this raises questions as to whether a distribution of PTI during the year it is earned (including, but not limited to, a distribution of 965(a) PTI during the transition year) could result in gain under Section 961(b)(2). Similarly, it is unclear whether a distribution of 965(b) PTI causes recognition of gain in certain circumstances. These issues are explored in greater detail below.

Example 2: Gain/Earnings Duplication on disposition of CFC stock

This Example 2 demonstrates how the PTI regime operates to avoid double taxation on the same economic income when a U.S. Shareholder disposes of CFC stock, and a portion of the value of that CFC reflects undistributed PTI (that has already been included in income by the U.S. Shareholder).

2-year holding period (or if the distribution is a per se extraordinary dividend under Section 1059(e)).

[24] In the case of a Section 245A DRD, Section 961(d) reduces basis (and thus disallows some or all of a loss) for purposes of determining loss on the disposition of stock of the foreign corporation that made the distribution, to the extent of the Section 245A DRD (except to the extent such distribution caused a basis reduction under Section 1059). Similar to the "unified loss rule" of Reg. §1.1502-36, Section 961(d) does not apply to dispositions of stock at a gain. Thus, Section 245A (through an actual dividend or through the application of Section 1248) can reduce gain (but not create loss) on the disposition of CFC stock.

	Year 1	Year 2
Starting basis	100	
Subpart F income	80	
Sales proceeds		180
Gain		0

USP forms CFC with $100 in exchange for 100% of the stock of CFC. In Year 1, CFC earns $80 of Subpart F income and this amount is included in USP's gross income under Section 951(a). In Year 2, USP sells CFC to an unrelated person for $180.

As a result of CFC's Year 1 Subpart F income, CFC has $80 of PTI and USP's basis in its CFC stock is increased from $100 to $180 under Section 961(a). Thus, USP does not realize any gain on the Year 2 disposition for $180.

As noted above, notwithstanding certain "territorial"-like features of the Act (i.e., the Section 245A DRD), U.S. taxpayers are still taxed on gain recognized from a disposition of foreign corporation stock. Thus, absent a Section 961(a) adjustment, USP would have realized $80 of gain on the disposition of CFC stock ($180 amount realized less the unadjusted $100 basis), potentially causing USP to be taxed a second time on the $80 of CFC earnings. This would represent double-taxation at the U.S. Shareholder level on the same economic earnings of a CFC; once on the earnings of CFC under Section 951(a) and once on the disposition of CFC stock ("**Gain/Earnings Duplication**").[25] Thus, but for the PTI regime, Gain/Earnings Duplication could arise in the case of a disposition of CFC stock.[26]

[25] There are ways the tax system could avoid taxing USP twice on CFC's earnings (i.e., Gain/Earnings Duplication) other than through the PTI regime of Sections 959 and 961. For example, in the absence of the PTI regime, under the facts of this Example 1, the gain could be recharacterized as a dividend under Section 1248 and be eligible for the Section 245A DRD, thus effectively eliminating the second level of tax on the stock disposition. However, Section 245A has various requirements that must be satisfied (e.g., holding period under Section 246(c)(5), lack of hybridity under Section 245A(e)), and thus certain fact patterns will not allow for a Section 245A deduction. Furthermore, when a Section 245A deduction is taken, Section 1059 is implicated, and might apply to reduce basis (or cause gain recognition) on the disposition, thus increasing complexity and potentially failing to mitigate Gain/Earnings Duplication. Moreover, the Code in fact provides for the PTI regime, and thus alternative methods of dealing with Gain/Earnings Duplication are not discussed further herein.

[26] Another type of problematic duplication that the PTI regime attempts to mitigate is Dividend/Earnings Duplication (defined below) which can arise in the case of a distribution by a CFC to its U.S. Shareholder of income previously included in income by such U.S. Shareholder.

The above example involves a CFC earning "traditional" Subpart F income resulting in a Section 951(a) inclusion, but the same results and analysis generally apply in the case of amounts treated as Subpart F income under Section 965, amounts included by a U.S. Shareholder pursuant to the GILTI regime of Section 951A, and E&P taxed by reason of investments in U.S. property under Sections 956 and 951(a)(1)(B) (such earnings collectively, "**Taxed Income**"). Neither Taxed Income nor Non-PTI E&P includes 965(b) PTI, which, although treated as PTI for purposes of applying Section 959, was never included in income by a U.S. Shareholder.

Example 3: Basis reduction for distributions of PTI

This Example 3 demonstrates how the PTI regime operates to reduce basis in the stock of a CFC upon a distribution of PTI, thereby preventing a noneconomic loss (or noneconomic reduction of gain) upon a subsequent disposition of that CFC. Without this mechanism, CFC income that originally was Taxed Income could be offset by loss on disposition of the CFC stock, and thus essentially convert Taxed Income into Exempt Income (defined below). There is no apparent policy justification for treating the earnings giving rise to PTI (i.e., Taxed Income) as Exempt Income (potentially other than 965(b) PTI, as discussed below).

	Year 1	Year 2	Year 3
Starting basis	100		
Taxed Income	80		
Distribution		60	
Sales proceeds			120
Gain (loss)			0

USP forms CFC with $100 in exchange for 100% of the stock of CFC. In Year 1, CFC earns $80 of Taxed Income and this amount is included in USP's gross income. In Year 2, CFC distributes $60 to USP. In Year 3, USP sells CFC to an unrelated party for $120.

After giving effect to the $80 basis increase in Year 1 under Section 961(a), USP has a $180 basis in CFC stock, which we assume has a value of $180 (it was formed with $100 and then earned $80). Thus, upon a $60 distribution of PTI, the value of CFC would be reduced to $120, and without a basis reduction under Section 961(b), there would be a noneconomic loss in the CFC stock by reason of the positive Section 961(a) adjustment.

Example 4: Gain recharacterization under Section 1248

This Example 4 discusses the basic operation of Section 1248 upon the disposition of CFC stock and demonstrates that generally only Non-PTI E&P is available to support recharacterization of gain as dividend income. Section 1248 converts what would otherwise be stock gain that is Fully Taxed Income (defined below) into a dividend that potentially qualifies under Section 245A and would be Exempt Income (defined below). As discussed further below, it is not clear whether 965(b) PTI can cause a Section 1248 recharacterization, in part because it is fundamentally unclear whether Congress intended 965(b) PTI to be treated as Exempt Income, Fully Taxed Income, or some combination thereof.

	Year 1	Year 2
Starting basis	100	
Taxed Income	40	
Non-PTI E&P	30	
Sales proceeds		180
1248/245A dividend		30
Remaining Gain		10

USP forms CFC with $100 in exchange for 100% of the stock of CFC. In Year 1, CFC earns $40 of Taxed Income and this amount is included in USP's gross income, and CFC also earns $30 of Non-PTI E&P. In Year 2, USP sells CFC to an unrelated person for $180.

As a result of CFC's Year 1 Subpart F income, CFC has $40 of PTI and USP's basis in its CFC stock is increased from $100 to $140 under Section 961(a). Thus, USP realizes $40 of gain on the Year 2 disposition for $180. Only the $30 of Non-PTI E&P (and not the $40 of Taxed Income) is available to support the Section 1248 recharacterization as dividend income.[27] The $30 recharacterized as a dividend is eligible for the Section 245A DRD, provided that USP has held the CFC stock for one year or more, and the requirements of Section 245A are met.[28] Thus, USP pays tax only on the remaining $10 of gain.

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[27] *See* Sections 1248(d)(1) and 951A(f)(1)(A).

[28] *See* Section 1248(j). Whether Section 1059 can apply to gain that is included in the gross income of a U.S.

2. Claiming foreign tax credits

The PTI regime also continues to be important for claiming FTCs. Generally, Section 960 deems a U.S. corporation to have paid foreign income taxes that are properly attributable to GILTI and Subpart F income.[29] However, in many cases, additional taxes arise upon the distribution of this income (e.g., withholding taxes, intermediate income taxes).[30] In such case, Section 960(b)(1) provides that a domestic corporation U.S. Shareholder receiving a distribution of PTI from a CFC will be deemed to have paid so much of the CFC's foreign taxes as are (i) properly attributable to the distribution of PTI and (ii) have not previously been deemed paid.[31] Section 960(b)(2) provides a similar rule for distributions of PTI from one CFC to another.

As described below, Fully Taxed Income potentially causes a U.S. Shareholder to be treated as paying its entire share of the foreign taxes properly attributable to such income, whereas Reduced Rate Income generally treats the U.S. Shareholder as paying only a portion of its share of such foreign taxes. By contrast, Exempt Income is treated differently, because under Section 245A(d), no FTCs are allowed with respect to a dividend eligible for the Section 245A DRD. Similarly, under Section 245A(e)(3), no FTCs are allowed with respect to a hybrid dividend, notwithstanding that such dividends are not eligible for the Section 245A DRD. As a consequence, withholding taxes (and income taxes on intermediate entities) attributable to these dividends will not be creditable.

Example 5: Withholding tax on distribution of PTI

This Example 5 demonstrates how new Section 960(b)(1) (or old Section 960(a)(3)) permits a corporate U.S. Shareholder receiving a distribution of PTI to be treated as paying foreign taxes that arise upon the distribution of that PTI (and that are properly attributable to such PTI), in contrast to the payment of a dividend of Non-PTI E&P (which would be Exempt Income), which would not allow foreign tax to be treated as paid, under Section 245A(d). The potential allowance

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Shareholder "as a dividend" under Section 1248 (i.e., as opposed to a "dividend" as such term is used in Section 1059) is beyond the scope of this Report.

[29] *See* Sections 960(a) and (d).

[30] Regarding intermediate income taxes (i.e., other than withholding taxes), the Proposed 965 Regulations are explicit that such taxes are treated as paid under Section 960(a)(3). *See* Prop. Reg. §1.965-5(c)(1)(ii) (2018). Outside of the Section 965 context, CCA 200223022 (Mar. 2002) suggests similar treatment, as does Notice 2005-64, 2005-2 C.B. 47 (dealing with *former* Section 965). There is also a question presented below as to whether, in addition to withholding taxes and income taxes on intermediate entities imposed with respect to distributions of PTI, FTCs attributable to 965(b) PTI (i.e., foreign income taxes on the earnings that were offset by deficits under Section 965(b)) can be taken under Section 960(b) (or former Section 960(a)(3) for tax years beginning before January 1, 2018) upon distribution of the 965(b) PTI.

[31] New Section 960(b) is applicable to taxable years of a CFC subsequent to its transition year. *See* the Act §14301(d). It replaced former Section 960(a)(3), which served the same general purpose and is effective for a CFC's transition year and prior years.

of FTCs is a feature of Fully Taxed Income or Reduced Rate Income that is not available for Exempt Income.

	Year 1	Year 2	Year 3
CFC2 Taxed Income	100		
Foreign tax	15		
CFC2 distribution		100	
Withholding tax		3	
CFC1 distribution			97
Section 960(b) FTC			3

USP owns 100% of the stock of CFC1 and CFC1 owns 100% of the stock of CFC2. In Year 1, CFC2 earns $100 of Taxed Income included by USP, net of foreign taxes of $15 associated with that income (i.e., CFC1 earned $115 of pre-foreign tax income, paid foreign income tax of $15 on such income, resulting in $100 of post-foreign tax income). In Year 2, CFC2 distributes $100 to CFC1 and a $3 withholding tax is imposed on the distribution. In Year 3, CFC1 distributes $97 to USP. USP elects to claim FTCs in all relevant years.

As a result of CFC2's Year 1 Taxed Income, USP includes $100 of income, includes a Section 78 dividend of $15, and is treated as paying some or all (depending on whether the Taxed Income is Fully Taxed Income such as "traditional" Subpart F income or Reduced Rate Income such as GILTI or Section 965) of the $15 of Year 1 foreign taxes. In the case that the Taxed Income is GILTI, USP would be treated as paying 80% of the $15 of foreign tax, under Section 960(d); in the case that the Taxed Income is a Section 965(a) inclusion, the Section 965(g) haircut would apply; in the case that the Taxed Income is "traditional" Subpart F income, USP would be treated as paying the full $15 of foreign taxes.[32] CFC2 has $100 of PTI from Year 1. Upon the Year 2 distribution of the $100 PTI from CFC2 to CFC1, CFC1 incurs the $3 withholding tax. Upon the Year 3 distribution of $97 from CFC1 to USP, USP is deemed to have paid an additional $3 of foreign taxes (assuming the Taxed Income was Fully Taxed Income), under Section

[32] Issues regarding the determination of the actual credit allowed with respect to the deemed paid foreign taxes (e.g., determining the Section 904(a) FTC limitation) are beyond the scope of this Report.

960(b)(1).[33] Thus, without the PTI regime, the $3 withholding tax could not be credited, as Section 245A(d) disallows FTCs for taxes with respect to which a Section 245A DRD is allowed.[34]

3. Foreign currency gain or loss under Section 986(c)

Where amounts that constitute PTI are denominated in a foreign currency, fluctuations in exchange rates between the time of the inclusion that gives rise to PTI and the actual distribution of PTI can give rise to foreign currency gain or loss.[35] Under Section 986(c), such foreign currency gain or loss between the times of the inclusion of Taxed Income and the distribution of PTI is treated as ordinary income or loss from the same source as the associated inclusion. Under Section 989(b), amounts included under Section 951(a)(1)(A) are translated using the average exchange rate for the year of the CFC, and the amount of a distribution is translated at the spot rate on the date of the distribution.

Example 6: FX Fluctuation between inclusion and distribution

This Example 6 demonstrates how fluctuations in exchange rates can give rise to foreign currency gain or loss upon distribution of PTI.

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[33] It appears that the additional $3 of deemed paid foreign taxes results in an additional $3 Section 78 gross-up, as Section 78 provides dividend treatment for "an amount equal to the taxes deemed to be paid by such corporation under subsections (a), (b), and (d) of section 960". This seems inconsistent with the taxation of CFC2's $115 pre-foreign tax income, as it would result in $118 of taxable income to USP ($100 of Taxed Income, and then $15 and $3, respectively, of Section 78 dividends). However, the application of Section 78 is beyond the scope of this Report.

[34] See Example 19 below for an illustration of the issue of whether FTCs attributable to 965(b) PTI should be taken under Section 960(b) (or former Section 960(a)(3) for tax years beginning before January 1, 2018), upon a distribution of 965(b) PTI.

[35] Under the Proposed 965 Regulations, Section 986(c) does not apply to distributions of 965(b) PTI. *See* Prop. Reg. §1.986(c)-1(c) (2018). This is one of several reasons, as discussed below, why the type of PTI that is treated as distributed (when a CFC has multiple types of PTI) is relevant to the U.S. Shareholder.

	Year 1	Year 2
CFC Taxed Income	100u	
Distribution		100u
Exchange rate	1u = $1	1u = $0.70
FX gain (loss)		(30)

USP owns 100% of the stock of CFC. CFC earns 100u of Taxed Income in Year 1. The average exchange rate for the taxable year of CFC in Year 1 is 1u = $1. In Year 2, CFC distributes 100u to USP. The spot exchange rate on the date of the distribution is 1u = $0.70.

As a result of CFC's Year 1 Taxed Income, USP includes $100 in income and CFC has 100u of PTI.[36] Subsequently, upon the distribution of the 100u PTI from CFC to USP, USP recognizes an ordinary loss of $30 under Section 986(c) due to the movement between the applicable exchange rate for the Year 1 inclusion and the applicable exchange rate for the Year 2 distribution. Thus, the determination of which PTI is distributed to U.S. Shareholders, particularly when there are multiple pools of PTI, may be important in calculating foreign exchange gain or loss. Similar issues arise in the translation of foreign taxes paid for which an FTC is taken by the U.S. Shareholder.

4. Ineligibility for/inapplicability of Section 245A

The PTI regime is particularly important in situations where a distributee is either ineligible for the Section 245A DRD or the Section 245A DRD is otherwise inapplicable. Section 245A is simply inapplicable unless the dividend is received by a "C" corporation[37] that is not a real estate investment trust or regulated investment company (i.e., individuals and certain special tax regime entities cannot take the Section 245A DRD, whereas they could exclude a distribution of PTI from gross income).[38] The shareholder must own at least 10% of the stock (by vote or value) of the

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[36] Pursuant to the 2006 Proposed Regulations, both the shareholder-level and corporate-level PTI accounts are maintained in the functional currency of the CFC. *See* Prop. Reg. §1.959-3(b)(1) and (2) (2006).

[37] *S*ee H.R. Rep. No. 115-466 at 470 (2017) (Conf. Rep.) (the "**Conference Committee Report**"); Section 1363(b) (providing that, with enumerated exceptions, the taxable income of an S corporation shall be computed in the same manner as in the case of an individual). Whether foreign corporations can take a Section 245A DRD is beyond the scope of this Report

[38] The Conference Committee Report provides that a domestic corporation that holds stock through a foreign partnership should be eligible for the Section 245A DRD. *See* Conference Committee Report at 466 ("For example, if a domestic corporation indirectly owns stock of a foreign corporation through a foreign partnership and the domestic

foreign corporation, and the foreign corporation cannot be a passive foreign investment company within the meaning of Section 1297. Certain partnership arrangements cause uncertainty as to whether a corporate partner satisfies, through its partnership interest, the requirements of Section 245A (e.g., whether the 10% ownership threshold is met where the partner holds only a profits interest).

Section 245A also does not apply to income inclusions under Section 951(a)(1)(B). Section 956 was retained by the Act, and thus Section 956 investments in U.S. property are includible by U.S. Shareholders as ordinary income, generally to the extent of Non-PTI E&P of the CFC.[39] Whereas such inclusions are not eligible for the Section 245A DRD, the PTI regime allows a CFC to hold U.S. property without causing a Section 951(a)(1)(B) inclusion to the extent of PTI. Specifically, Section 959(a)(2) provides that PTI previously included under Section 951(a)(1)(A) (i.e., by reason of Subpart F, GILTI (by cross-reference[40]) or Section 965) will not be included a second time under Section 951(a)(1)(B).

Where Section 245A might otherwise apply, there are still several requirements that must be satisfied. The stock with respect to which the dividend is paid must have been owned by the shareholder corporation for at least 366 days during the 731-day period beginning 365 days before the ex-dividend date.[41] For purposes of determining such holding period, the shareholder corporation is only treated as owning the stock of the foreign corporation during the period that the shareholder was a U.S. Shareholder (i.e., direct or constructive owner of 10% vote or value) with respect to the foreign corporation.[42] Further, the Section 245A DRD is not allowed for a "hybrid dividend" from a CFC, which is an amount for which the Section 245A DRD would otherwise be allowed and for which the CFC received a deduction (or other tax benefit) with

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corporation would qualify for the participation DRD with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly, the domestic corporation would be allowed a participation DRD with respect to its distributive share of the partnership's dividend from the foreign corporation.")

[39] Section 956(a) provides that the amount of the inclusion is the lesser of (i) the U.S. shareholder's share of the CFC's average adjusted U.S tax basis in U.S. property, reduced by the amount of the CFC's Section 956 PTI or (ii) the U.S. shareholder's pro rata share of the CFC's applicable earnings. Under Section 956(b), applicable earnings are the CFC's current and accumulated E&P, reduced by the amount of Section 956 PTI and distributions made during the current year.

[40] *See* Section 951A(f)(1)(A).

[41] Section 246(c)(5). The determination of who is entitled to receipt of a dividend depends on the "record date" and the "ex-dividend date". The record date is the date on which a shareholder must be included in the company's records as a shareholder to receive a dividend. The ex-dividend date is determined by stock exchange rules, but is generally set one business day before the record date. Stock must be purchased prior to the ex-dividend date in order for the purchaser to be entitled to the dividend.

[42] *See id*.

respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States.[43]

Finally, even for taxpayers that qualify for the Section 245A DRD and do not incur creditable taxes on the distribution of foreign income, the PTI regime would be relevant to the extent that Congress ever reduced the Section 245A DRD below 100%.

Example 7: Dividend/Earnings Duplication on distribution by CFC in later year

This Example 7 shows that, where Section 245A does not apply to the distribution by a CFC to its U.S. Shareholder of earnings that were already included by the U.S. Shareholder, the PTI regime is necessary to prevent such earnings from being taxed a second time.

	Year 1	Year 2
CFC Taxed Income	80	
Hybrid dividend/956		80
245A DRD		0
959 exclusion		80

USP owns 100% of the stock of CFC. In Year 1, CFC earns $80 of Taxed Income and this amount is included in USP's gross income. In Year 2, CFC distributes $80 to USP in a distribution that does not qualify under Section 245A (e.g., a hybrid dividend),[44] or CFC makes a Section 956 investment in U.S. property of $80.

As a result of CFC's Year 1 Taxed Income, CFC has $80 of PTI. Thus, the $80 Year 2 distribution is characterized as a distribution of PTI under Section 959(c) and is excluded from USP's gross income.

Absent the exclusion of the $80 of PTI from USP's gross income when such amount was distributed in Year 2, USP would have included the same $80 of CFC's Taxed Income twice; once in Year 1 (under Section 951 or 951A), and then, by reason of a distribution that fails to qualify for Section 245A or a Section 956 inclusion, which does not qualify for Section 245A, a second

[43] Section 245A(e)(5).

[44] Although not relevant on the facts of this example, as noted above, no FTC are allowed with respect to a hybrid dividend.

time on the Year 2 distribution under Section 301(c)(1) (i.e., Dividend/Earnings Duplication). Thus, the PTI regime mitigates Dividend/Earnings Duplication.

5. Analog to QEF inclusions under Section 1293(c)

Under Section 1297(a), a foreign corporation will be a "PFIC" if certain requirements regarding passive assets or passive income are satisfied. Under Section 1295, a U.S. Shareholder can elect to treat a PFIC as a "QEF", and if the QEF election is made, the shareholder's pro rata share of the ordinary earnings and capital gain of the QEF is included in income currently[45] and the shareholder is not subject to tax on the subsequent receipt of earnings previously included in the shareholder's income.[46] Under Section 1293(c), distributions out of previously included earnings are treated as a distribution that is not a dividend. This mechanism is analogous to the PTI regime, and while this Report does not discuss PFIC issues, certain issues discussed herein could be relevant to PFICs and the PFIC regime should be considered.

6. PTI in a consolidated group

Example 8: Sharing of PTI attributes within a consolidated group

This Example 8 illustrates sharing of PTI attributes among members of a consolidated group, and explores how the Act changed the calculus of how the benefits of such sharing PTI attributes compares to the complexity associated with the system providing such sharing.

	Year 1	Year 2	Year 3
Taxed Income	100		
USS2 contribution		$X	
Distribution to USS2			30

USP is the parent of a consolidated group, and owns 100% of the stock of each of USS1 and USS2. As of the beginning of Year 1, USS1 owns 100% of the stock of CFC. In Year 1, CFC earns $100 of Taxed Income and this amount is included in USS1's gross income. In Year 2, USS2 contributes zero-basis property to CFC in exchange for a new class of CFC stock. In Year 3, CFC distributes $30 to USS2. One issue is whether USS2 can share USS1's PTI attributes.

The 2015 Report generally supported sharing of PTI attributes among members of a consolidated group. If PTI attributes can be shared between members of a consolidated group,

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[45] Section 1293(a).

[46] Section 1293(c).

then $30 of USS1's $100 PTI account with respect to CFC is reallocated to USS2 and the distribution is characterized as a distribution of PTI under Section 959(a). Presumably, $30 of USS1's Section 961(a) basis in CFC would shift to USS2's stock of CFC (increasing it to $30) and then USS2's basis in CFC stock would be reduced by the $30 PTI distribution (reducing it back to zero).[47] Further, $30 of USP's basis in USS1 stock would shift to USS2 stock.[48]

Alternatively, if PTI attributes cannot be shared between members of a consolidated group, the distribution to USS2 in Year 3 would not be a distribution of PTI because USS2 has no PTI account with respect to CFC (i.e., the distribution would not cause CFC's earnings to be included again by the same U.S. Shareholder, USS1, or a successor in interest). Thus, USS2 would have taxable dividend income of $30, but the dividend would be eligible for the Section 245A DRD if its requirements are met.[49] Section 1059 could operate to reduce basis (or in this case, cause gain) if the dividend is extraordinary and there is no 2-year holding period (or if the distribution is a non pro rata redemption under Section 1059(e)).

The issue of whether and how PTI attributes can be shared within a consolidated group as provided by the 2006 Proposed Regulations[50] is a different calculus after the Act, and requires consideration of the ability to take FTCs and the complexities of Section 1059. The 2006 Proposed Regulations provided that if one member of a consolidated group receives distributions from a CFC that would exceed such member's PTI with respect to the CFC (i.e., would exceed such member's "PTI account"), then the PTI of all members of the consolidated group with respect to such CFC are adjusted.[51] Pursuant to such adjustments, the PTI of other group members is decreased, in the aggregate, by the amount of the excess distribution amount to the member that received the distribution (i.e., the excess of the distribution over such member's PTI) (but not below zero). The PTI account of such member that received the distribution is correspondingly increased by the same amount, and then adjusted to zero by reason of the distribution. The proposed Regulations make a cross-reference to Reg. §1.1502-32, and Prop. Reg. §1.1502-32(b)(3)(ii)(D) and (iii)(B) (2006) provide corresponding upward (by treating as tax-exempt income) and downward (by treating as a noncapital nondeductible expense) basis adjustments,

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[47] *See* Prop. Reg. §§1.961-1(b)(1); 1.961-2(a)(2); 1.959-3(e)(2) (2006).

[48] *See* Prop. Reg. §§1.959-3(g)(3); 1.1502-32(b)(3)(ii)(D) and (iii)(B) (2006). Consideration might be given to the case where this basis shift creates a loss in USS2 stock.

[49] Under this approach, presumably USS1 would retain its $100 PTI account, notwithstanding that CFC's E&P is reduced to $70 by reason of the $30 distribution to USS2; thus, $30 of USS1's PTI account would be latent, awaiting future E&P generated by CFC. However, such mechanics are not clear.

[50] *See* Prop. Reg. §1.959-3(g) (2006).

[51] *See* Prop. Reg. §1.959-3(g)(1)(i) (2006).

respectively, to the stock of the member that received the distribution (and "took" the excess PTI) and the stock of the member that shared the PTI with such member.

The complexities of PTI sharing that arise with respect to basis adjustments under Section 961 and Reg. §1.1502-32 might represent a larger burden relative to the policies underpinning the PTI regime, given the lower stakes post-Act. In particular, Section 245A is likely to operate to prevent Dividend/Earnings Duplication, at least where Section 1059 does not apply. Thus, sharing PTI will be unnecessary to prevent Dividend/Earnings Duplication in many (but not all) cases (and to reiterate, PTI may be necessary to reach the correct result for other consequences, such as FTCs). Potential complexities with PTI sharing include ensuring the lack of inappropriate basis shifts from the stock of one member of a consolidated group to the stock of another member.[52] These issues would be ongoing, and could involve opportunities for inappropriate tax planning, which is unlike the one-time imposition of the Section 965 transition tax and the potential basis sharing in connection with 965(b) PTI, discussed below in Examples 13-15. However, the ability to take an FTC for withholding taxes (and intermediate income taxes) on distributions up the chain to USP would be disallowed under Section 245A(d) if the distributions are not treated as made out of PTI, and further, Section 1059 could apply to reduce basis (or cause gain) in certain circumstances. Such consequences might be unduly unfavorable to a taxpayer, and inconsistent with the apparent policy of allowing U.S. Shareholders to recover PTI at the earliest possible time.[53] Furthermore, it is not clear that basis results under Section 245A would reach a more correct result.

[52] Similar basis shifts can take place when a single U.S. Shareholder that previously included Taxed Income with respect to a CFC buys a second block of stock of the CFC, with respect to which there is no PTI, and the CFC makes a distribution on that second block of stock. The 2015 Report indicated support for sharing PTI among all shares owned by a single U.S. Shareholder, as well as among shares owned among a single consolidated group.

[53] The statutory construct of Section 959(c), which overrides the general dividend ordering rules of Section 316 to cause dividends to be sourced first from PTI under Section 959(c)(1) and (2) before sourcing them from Untaxed Income under Section 959(c)(3), seems to suggest the policy of allowing the recovery at the earliest possible time (i.e., as opposed to tracing E&P to PTI and Untaxed Income, or to sourcing dividends pro rata from PTI and Untaxed Income). The only articulation of what appears to be this legislative policy that we are aware of is in the Preamble to the 2006 Proposed Regulations. *See* REG-121509-00 (2006) ("Section 959 was enacted so that PTI is excluded from gross income and, thus, not taxed again when distributed by the foreign corporation. Moreover, section 959 effects the relevant gross income exclusion at the earliest possible point. Thus, the 'allocation of distribution' rules of section 959(c) ensure that distributions from the foreign corporation are to be paid first out of earnings and profits attributable to amounts that have been previously included in income by the United States shareholders. Accordingly, as a result of its section 951(a)(1) inclusion, a United States shareholder is made whole by receiving, without further U.S. tax, PTI attributable to its stock in a foreign corporation before it receives any taxable distributions from the foreign corporation. Section 961, which adjusts basis in the stock in a foreign corporation for PTI attributable to such stock, also ensures that PTI is not taxed twice if the stock in the foreign corporation is sold before the PTI is distributed."). This apparent "PTI first" policy, as articulated by the Preamble, also extends to avoiding Gain/Earnings Duplication in the context of a stock sale prior to the PTI being distributed.

IV. Analytical Frameworks

The post-Act landscape has changed the relevant considerations for developing appropriate rules for PTI. The following considerations will be relevant in assessing the merits of the potential rules.

A. Types of Income

The Act introduced several new international tax provisions and significantly modified several existing international tax regimes; in many cases, it is difficult to ascertain with clarity the underlying policies such changes are intended to implement. Through such changes, the Act created an international tax system in which income of foreign subsidiaries is taxed in (at least) three different ways – Exempt Income, Reduced Rate Income and Fully Taxed Income, each as defined below. Whether Congress intended to tax a particular class of income, or item of income, in one of the three ways as opposed to another should inform the nature of the guidance issued by Treasury. In particular, Regulations governing the PTI regime should take into account how Congress intended to treat the underlying type of income. The Act does not always make explicit which items of income should be Exempt Income, Reduced Rate Income, or Fully Taxed Income, but for many items of income we can intuit the category they reasonably might belong to, while acknowledging that there are still many ambiguities.

Exempt Income

First, certain income derived by foreign subsidiaries is effectively exempt from U.S. federal income tax (including tax, or reduced tax benefit, on a future distribution from the foreign subsidiary or a disposition of its stock or other property) and precludes the U.S. Shareholder from being treated as having paid foreign taxes with respect to such income ("**Exempt Income**"). Exempt Income is generally the type of income that will give rise to a Section 245A DRD when distributed to a corporate U.S. Shareholder,[54] and thus no foreign tax credit will be allowed with respect to such income, under Section 245A(d). The primary component of Exempt Income appears to be GILTI net tested income that is reduced by the 10% net deemed tangible income

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[54] A U.S. Shareholder that is an individual is treated differently under several provisions of the Act, as well as under pre-existing law. For example, generally, an individual cannot take a dividends-received deduction, is not treated as paying its share of foreign income taxes paid by a CFC under former Section 902 or current or former Section 960, does not benefit from the Section 250 deduction that reduces the effective rate on GILTI, and does not benefit to the same extent as corporations from the Section 965(c) deduction that reduces the effective rate on the Section 965(a) inclusion. An election under Section 962 is available to treat an individual as a domestic corporation for certain purposes. Notwithstanding the foregoing differences in the way individuals are taxed, many aspects of the PTI regime apply similarly to individuals, and thus many of the same issues are presented. This Report generally describes the issues that relate to corporations, and thus the application of the PTI regime to individuals (to the extent they receive different treatment) is generally beyond the scope of this Report.

return ("**NTDIR**") on qualified business asset investment ("**QBAI**") in determining the U.S. Shareholder's GILTI inclusion under Section 951A. We are not aware of a policy of the Act suggesting that such income should be subject to U.S. tax, either currently as earned or upon distribution to the U.S. Shareholder.

GILTI positive tested income of one CFC that is offset by tested loss of another CFC owned by the same U.S. Shareholder is another likely candidate for Exempt Income.[55] Under current law, before taking into account recently proposed GILTI Regulations (the "**Proposed GILTI Regulations**"),[56] there are potential anomalies when stock of such CFCs is disposed of, in that it appears that stock gain on the tested income CFC would be recharacterized as a dividend under Section 1248(a) and thus be eligible for the Section 245A DRD (and thus be Exempt Income), whereas stock loss on the tested loss CFC would be fully available to offset capital gains of the U.S. Shareholder. Notwithstanding such potential anomalies, such "offset" tested income is Exempt Income under the statute. However, the Proposed GILTI Regulations (which are generally beyond the scope of this Report) provide for basis adjustments that mitigate this effect. In particular, basis in the stock of CFCs with "used tested loss" (i.e., CFCs that have shared tested loss to offset tested income of other CFCs, regardless of the amount of QBAI of such tested income CFCs) is, upon a disposition of such stock, reduced by the amount of such net used tested loss (i.e., the aggregate used tested loss from all years, reduced by offset tested income of the CFC).[57] There are no basis adjustments to CFC stock for its net offset tested income. The effect of these adjustments is generally to reduce taxable loss (or increase taxable gain) on a future disposition of CFC stock, where the CFC's losses have already benefitted the U.S. Shareholder through offsetting the tested income of another CFC owned by the U.S. Shareholder. Thus, although tested income that is offset by tested loss is not taxed currently through a GILTI inclusion, it does operate to reduce loss (or increase gain) on the stock of another CFC. Accordingly, such income (after giving effect to the Proposed GILTI Regulations if finalized in current form) has some features of Exempt Income and some features of Fully Taxed Income.

Similar to GILTI offset tested income, 965(b) PTI has some features of Exempt Income and some features of Fully Taxed Income. As discussed below, 965(b) PTI, despite its statutory designation as PTI, might (or might not) be Exempt Income under current law, as distributions of 965(b) PTI, or dispositions of the stock of CFCs with 965(b) PTI, might cause gain attributable to such earnings under Section 961(b)(2) or Section 1001, respectively. Similarly, if basis in the stock of the CFC that shared its Section 965 E&P deficit is reduced pursuant to a basis reallocation election described below, then such basis reduction might result in current or future gain with

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[55] Certain categories of income excluded from GILTI tested income also appear to be Exempt Income. For example, income excluded from Subpart F income by reason of the "high tax kickout" of Section 954(b)(4) is excluded from GILTI tested income, and thus appears to be Exempt Income. *See* Section 951A(c)(2)(A)(i)(III).

[56] *See* REG-104390-18; Prop. Reg. §§1.951A-1 through -7 (2018), and related rules.

[57] *See* Prop. Reg. §1.951A-6(e) (2018).

respect to the stock of such deficit CFC. On the other hand, as discussed below, gain on the stock of a CFC that has 965(b) PTI might be recharacterized as a dividend under Section 1248 that is eligible for the Section 245A DRD, and thus constitute Exempt Income. Congressional intent as to the proper treatment of 965(b) PTI is unclear in several ways, including the fundamental question of whether 965(b) PTI is intended to be Exempt Income or Fully Taxed Income.

We note that Exempt Income of a CFC can be converted into Fully Taxed Income by way of a Section 956 investment in U.S. property giving rise to a Section 951(a)(1)(B) inclusion by the U.S. Shareholder. Under Section 960, the U.S. Shareholder would be treated as paying its share of the foreign taxes paid or accrued by the CFC that are properly attributable to the income. Thus, there is a degree of transactional electivity between Exempt Income and Fully Taxed Income.

Reduced Rate Income

The second type of income derived by foreign subsidiaries is subject to current tax in the hands of the U.S. Shareholder, but at a reduced effective tax rate, and causes the U.S. shareholder to be treated as paying a limited portion (i.e., subject to a haircut) of the foreign taxes properly attributable to such income ("**Reduced Rate Income**"). GILTI tested income (that is not offset by tested loss) is Reduced Rate Income, as the GILTI regime generally subjects net tested income to a 10.5% effective rate of tax (by reason of a 50% deduction for corporate U.S. Shareholders under Section 250) and treats the U.S. Shareholder as paying 80% of the foreign taxes properly attributable to such income under Section 960(d). Similarly, Section 965 ADFI (to the extent not offset by deficits under Section 965(b)) is Reduced Rate Income, as it is subject to tax in the hands of the corporate U.S. Shareholder at an effective rate of tax between 8% and 15.5% (by reason of a deduction under Section 965(c)), and treats the U.S. Shareholder as paying a proportionate amount of the foreign taxes properly attributable to such income (generally, the ratio of the effective tax rate to 35%, the top marginal rate during the transition year). As noted below, there is a degree of transactional electivity between Reduced Rate Income and Fully Taxed Income.

Fully Taxed Income

Finally, certain income derived by foreign subsidiaries is subject to current tax in the hands of the U.S. Shareholder at the ordinary statutory rate, and potentially causes the U.S. shareholder to be treated as paying all of the foreign taxes (i.e., potentially without a haircut) properly attributable to such income (after giving effect to the regular FTC rules, such as the Section 904 limitation, including expense apportionment) ("**Fully Taxed Income**"). Fully Taxed Income includes Subpart F income (other than Subpart F income attributable to Section 965, which is Reduced Rate Income as described above), with respect to which the U.S. Shareholder is treated as paying properly attributable foreign taxes under Section 960(a)(1), and also includes gain from the sale of CFC stock, which does not cause deemed-paid foreign taxes, to the extent it is not recharacterized under Section 1248 as a dividend eligible for the Section 245A DRD.[58] Unrealized appreciation in the assets of a CFC would be reflected in stock gain but not E&P and thus would produce Fully Taxed Income upon a sale of CFC stock, because there is no E&P to support a Section 1248 recharacterization resulting in a Section 245A DRD. Fully Taxed Income also includes a dividend out of Non-PTI E&P to the extent that the dividend is not eligible for a dividends-received deduction (e.g., a hybrid dividend under Section 245A(e) or a dividend paid to a U.S. shareholder that has held the CFC stock for one year or less and thus fails to satisfy the holding period requirements of Section 246(c)(5)), and, as noted above, earnings giving rise to a Section 951(a)(1)(B) inclusion by reason of a CFC's Section 956 investment in U.S. property. Because of the enactment of Section 245A and the retention of Section 956, there is a degree of transactional electivity between treating income as Fully Taxed Income or Exempt Income, because Exempt Income can be converted into Fully Taxed Income by way of a Section 956 investment in U.S. property. For example, if a CFC earns GILTI tested income that does not result in a GILTI inclusion by reason of sufficient NTDIR, such earnings would be Exempt Income, but if in addition, the CFC made a Section 956 investment in U.S. property, the earnings would be converted in to Fully Taxed Income by reason of a Section 951(a)(1)(B) inclusion by the U.S. Shareholder. Similarly, there is also a degree of transactional electivity between Fully Taxed Income and Reduced Rate Income. As noted above, economic income or value appreciation of a CFC that has not yet been realized for U.S. federal income tax purposes (e.g., unrealized gain in the CFC's assets) would give rise to Fully Taxed Income upon the sale of the CFC stock under Section 1001, but if instead of the U.S. Shareholder selling the CFC stock, the CFC sold its assets and thus realized the value appreciation in its assets, the asset gain in many circumstances would be GILTI (except, for example, the extent to which such gain was Subpart F income, which would be Fully Taxed Income), which is Reduced Rate Income (as opposed to Fully Taxed Income). Thus, an asset disposition (including a stock sale with respect to which a Section 338(g) election is made) would likely give rise to Reduced Rate Income, even though a stock disposition (without a Section 338(g) election) that reflected the same economic appreciation would give rise to Fully Taxed Income.

B. The Single CFC Approach

In addition to the three types of income described above, the Act introduced an expansive system of sharing items and attributes among different CFCs owned by the same U.S. Shareholder (and in some circumstances provided by the Code or by current or future Regulations, owned by different members of the same consolidated group). For example, a U.S. Shareholder's Section 965(a) inclusion and its Section 951A inclusion are calculated with reference to an aggregate net

[58] Undistributed Untaxed Income of a foreign subsidiary generally will be eligible for such Section 1248 recharacterization, and thus would become Exempt Income as opposed to Fully Taxed Income, provided that the holding period and other requirements of Sections 1248 and 245A are satisfied.

amount of earnings or income across all of the U.S. Shareholder's CFCs,[59] with deficits or losses offsetting the earnings or income. The corresponding basis, E&P, and PTI adjustments that should (or should not) take place were not dealt with thoroughly (or in some cases, at all) in the Act and guidance should consider how to make sense of this. One principle that might serve as a general touchpoint is whether different results should obtain where attributes or items are housed in two CFCs as opposed to one. In some cases, such differing treatment is explicitly provided in the Code (and thus there is little room for interpretation),[60] but where it is not so explicitly provided, guidance causing such differing treatment may lead to anomalous results, and guidance reaching the same results whether the foreign activities are housed in one CFC or two might have merit. Thus, it is worthwhile comparing the results where two CFCs have items or attributes to the results attained by assuming that all of the items and attributes are in a single CFC (the "**Single CFC Approach**").

C. Avoidance of Double Taxation and Unintended Non-taxation

Finally, where certain treatment results in double taxation of the same economic income, or unintentional non-taxation of certain income (i.e., non-taxation other than by reason of the Act affirmatively treating certain types of income as Exempt Income, as described above), then such results should be scrutinized as being potentially inconsistent with Congressional intent. In particular, the PTI regime is necessary to avoid double-taxation at the U.S. Shareholder level on the same economic earnings of a CFC; once on the earnings of the CFC under Section 951(a) or Section 951A (as Fully Taxed Income or Reduced Rate Income, respectively) and once on the disposition of CFC stock (as Fully Taxed Income, except to the extent of recharacterization under Section 1248 resulting in a Section 245A DRD) (i.e., Gain/Earnings Duplication). Similarly, the PTI regime is necessary to avoid a U.S. Shareholder including again upon receipt of a distribution (by reason of a distribution that fails to qualify for Section 245A or a Section 956 inclusion, which does not qualify for Section 245A, each of which would be Fully Taxed Income) the same earnings that it had already included under Section 951(a) or Section 951A (as Fully Taxed Income or Reduced Income, respectively) ("**Dividend/Earnings Duplication**").

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[59] The Proposed 965 Regulations and the Proposed GILTI Regulations aggregate the CFCs owned by members of a consolidated group for purposes of sharing deficits. *See* Prop. Reg. §§1.965-8(e)(1) (2018); 1.1502-51(b), (e)(12) (2018).

[60] For example, traditional Subpart F income of one CFC is generally not netted with a deficit from a different CFC, even though such netting would occur naturally if the CFCs were a single entity. In the GILTI context, QBAI of a tested loss CFC is not available to determine the NTDIR of the U.S. Shareholder, even though if such tested loss CFC combined with a tested income CFC and the combined entity was a tested income CFC, the QBAI would be available. This result is confirmed by the Proposed GILTI Regulations. In the Section 965 context, PTI of one CFC has the effect of "soaking" up the non-PTI deficit of such CFC and making the deficit unavailable to offset ADFI of other CFCs, even though if the CFC were combined with another CFC that had ADFI, the deficits of the first CFC would be available to offset such ADFI of the second CFC without diminution by reason of the first CFC's PTI.

V. Stock Basis Adjustments for PTI

A. Timing of Section 961(a) basis increase

The timing of the positive and negative basis adjustments to CFC stock under Section 961 is uncertain, and under existing law possibly causes inappropriate recognition of gain. We do not see any persuasive policy rationale for requiring such gain when distributions are made during the year that Taxed Income is earned. With respect to positive adjustments, Reg. §1.961-1(a)(1) provides that basis is increased "as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation." Similarly, with respect to taxpayers who make an election under the Proposed 965 Regulations to reallocate basis from stock of a deficit CFC to stock of a DFIC, the basis adjustments are made as of the close of the last day of the SFC's transition year.[61] Negative adjustments are made "as of the time such person receives such excluded amount."[62] Given that Section 959(c) treats distributions as coming first out of PTI, including PTI generated in the year of the distribution,[63] it is possible that the timing mismatch between the positive and negative basis adjustments under Section 961 could give rise to inappropriate Gain/Earnings Duplication on a distribution of PTI in the same year as the PTI was generated. Such Gain/Earnings Duplication could potentially be eliminated upon a future disposition of the CFC stock at a loss (by reason of the basis that ultimately is provided by Section 961(a)), so this can reasonably be interpreted as a timing problem; however, it is possible that there is no intention to dispose of the CFC, and thus no opportunity to recover the excess basis.

Example 9: Gain/Earnings Duplication on distribution in same year as Taxed Income

This Example 9 demonstrates the potential for Gain/Earnings Duplication where a CFC distributes PTI in the same year as the income inclusion that gave rise to that PTI. In particular, if the basis decrease under Section 961(b) from the distribution of PTI occurs prior to the basis increase under Section 961(a) from the income inclusion, then gain could result under Section 961(b)(2), which would be a second tax on the same economic income. As explained further below,

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[61] *See* Prop. Reg. §1.965-2(h)(1) (2018). Thus, it is also possible that basis adjustments will occur in different tax years of the U.S. Shareholder, by reason of it owning the stock of SFCs that have different tax years (e.g., one SFC with a transition year ending December 31, 2017 and another SFC with a transition year ending June 30, 2018).

[62] *See* Reg. §1.961-(2)(a). It is possible that such phrase should be interpreted as first giving effect to positive adjustments under Section 961 prior to reducing basis (i.e., once all such adjustments are known at the end of the year), but still making the basis reduction effective as of the time of the distribution for other purposes for which basis is relevant at such time (e.g., an intervening sale of CFC stock or a subsequent distribution by the CFC). Nonetheless, Treasury can solve these interpretive questions by clarifying the issue in a Regulation.

[63] In a taxable year, Subpart F inclusions are determined before taking into account distributions (thus the distributions are PTI), whereas distributions are taken into account before determining the amount of earnings included under Sections 956 and 951(a)(1)(B). *See* Section 956(b)(1) (in the case of Section 951(a)(1)(B) inclusions, reducing "applicable earnings" by amount of distributions made during the taxable year); Section 959(f)(2) (actual distributions taken into account before Section 956 investments in U.S. property for purposes of applying Section 959).

we recommend that Treasury clarify that basis decreases under Section 961(b) do not occur prior to basis reflecting increases under Section 961(a).

	Year 1
Starting basis in CFC	10
Taxed Income	80
Distribution	40

USP owns 100% of the stock of CFC and has $10 basis in its CFC stock. In Year 1, CFC earns $80 of Taxed Income and this amount is included in USP's gross income under Section 951(a). Later in Year 1, CFC distributes $40 to USP.

The tax consequences of this transaction depend on the timing of the basis increases and decreases under Section 961(a) and (b). Regardless of the timing, the entire $40 distribution is characterized as a distribution of PTI under Section 959(c). As noted above, one possibility is that USP does not increase its basis in CFC stock under Section 961(a) until the end of the year, whereas USP must decrease its basis in CFC under Section 961(b) at the time of the distribution.[64] Under this interpretation, at the time of the distribution, USP would have $10 basis in its CFC stock and, as a result, USP would recognize $30 of gain under Section 961(b)(2) on the $40 distribution. This results in Gain/Earnings Duplication, which appears to be an inappropriate result.

On the other hand, there are technical and policy reasons for interpreting Section 961 differently. At the time of the $40 distribution, USP would not yet know if it is receiving a distribution of PTI (assuming that CFC had no PTI from prior years; if it had PTI from prior years, presumably USP's basis in CFC stock already reflects such PTI). This suggests that the correct technical reading is that adjustments wait until the end of the year, at which time USP would know its positive and negative basis adjustments with respect to CFC stock, and that the "retroactivity" referred to in the current Section 961 Regulations (i.e., basis reduction at the time of the distribution) is only intended to be relevant to intervening events between the time of distribution and the end of the year (e.g., if USP sold some of CFC stock between the time of the distribution and the end of the year, in determining the amount of gain or loss on such sale, the Section 961(b) basis reduction would be given effect at the time of the distribution, but the basis reduction itself would not cause gain under Section 961(b)(2) if there was a sufficient basis increase under Section 961(a)). Once USP knows at the end of the year how much PTI CFC had (and thus how much PTI was distributed by CFC), USP would make both the positive Section 961(a) adjustments and

[64] *See generally*, Reg. §1.961-1(a)(1) (basis increase "as of the last day in the taxable year"); Reg. §1.961-2(a)(1) (basis decrease "as of the time such person receives such excluded amount").

negative Section 961(b) adjustments. Most importantly, there is no apparent policy rationale for requiring Section 961(b)(2) gain in the case of a PTI distribution during the year the Taxed Income was earned. Such a result would be inconsistent with the apparent policy of allowing U.S. Shareholders to access PTI at the earliest possible time.

In light of the above, Treasury could address this issue by clarifying that basis decreases under Section 961(b) do not occur prior to basis reflecting increases under Section 961(a) (e.g., both increases and decreases occur at the end of the year).[65] Thus, at the end of Year 1, USP would increase its basis in CFC by $30 under Section 961(a) and then decrease its basis in CFC by $30 under Section 961(b)(1), resulting in no gain, and thus no Gain/Earnings Duplication. As noted above, one can interpret the current regulatory language as having this effect, but the language should be clarified. The 2006 Proposed Regulations generally provide for positive and negative basis adjustments to occur at the same time, each corresponding with the U.S. Shareholder's adjustment in its PTI account with respect to the CFC, which generally occurs at the end of the CFC's taxable year.[66]

Another way to mitigate this Gain/Earnings Duplication is to provide a limited gain reduction rule, similar to the mechanism employed in Notice 2018-7[67] (with respect to first-tier CFCs) and Notice 2018-13[68] (with respect to lower-tier CFCs) in the case of 965(a) PTI, whereby any gain otherwise recognized under Section 961(b)(2) with respect to a distribution during the year the PTI was generated would be reduced (but not below zero) by the amount included under Section 951(a) for that year. The Proposed 965 Regulations implement the top-tier CFC gain reduction rule of Notice 2018-7 (but as noted above, not the lower-tier CFC gain reduction rule of Notice 2018-13), with respect to distributions of 965(a) PTI and distributions of 965(b) PTI.[69] Although Notices 2018-7 and 2018-13 were not explicit on this point, the basis in the stock with respect to which gain was reduced should be reduced at the end of the year, after giving effect to

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[65] *See* Section 1368(d) and Reg. §1.731-1(a)(1)(ii) for analogous rules providing, generally, for end of year basis adjustments that take into account both increases and decreases. The 965 Statute Report describes these methodologies, in the context of the transition tax. Another helpful analogous mechanism is the consolidated return basis adjustment system for the stock of subsidiaries. In that case, basis adjustments in subsidiary stock are made as of the close of each consolidated return year, and as of any other time (an interim adjustment) if a determination at that time is necessary to determine a tax liability of any person. *See* Reg. §1.1502-32(b)(1)(i). As applied to Section 961(a) and (b), the principle might suggest that downward adjustments are not made retroactively to the time of the distribution unless an intervening event between the distribution and the end of the year (e.g., a disposition of some or all of CFC stock) caused the downward adjustment to be necessary to determine the tax consequences of such intervening event.

[66] *See* Prop. Reg. §§1.961-1(b)(1) (2006); -2(a)(1) (2006); 1.959-3(e)(2) (2006).

[67] 2018-4 I.R.B. 317.

[68] 2018-6 I.R.B. 341.

[69] *See* Prop. Reg. §1.965-2(g)(1) (2018).

the basis increase under Section 961(a) (i.e., the U.S. Shareholder should not be able to keep the "free" Section 961(a) basis). The Proposed Regulations confirm that such basis reductions are required.[70] The guidance under Section 965, however, does not extend to distributions of other types of Taxed Income or distributions during years other than the transition year.

The limited gain reduction rule might be read as a way for Treasury to leave open the possibility that Section 961 basis reductions (and gain) occur prior to basis increases. Instead of leaving the issue open and providing a helpful (but limited) gain reduction rule that only applies to distributions of 965(a) PTI and 965(b) PTI, Treasury should resolve the issue by modifying Reg. §§1.961-1(a)(1) and 1.961-2(a)(1) to clarify that basis decreases under Section 961(b) (and negative basis adjustments pursuant to an election under Prop. Reg. §1.965-2(g) (2018)), and gain under Section 961(b)(2), do not occur prior to giving effect to basis increases under Section 961(a). There is no apparent policy rationale supporting the basis reduction occurring earlier than the basis increase. Furthermore, providing such a clarification prevents Gain/Earnings Duplication and furthers the apparent policy of allowing U.S. Shareholders to recover PTI at the earliest possible time.

If the above recommendation is not adopted, and there is only a gain reduction rule for distributions of 965(a) PTI and 965(b) PTI, then further complexity results, because in such case it must be determined which PTI is distributed (i.e., 965(a) PTI or 965(b) PTI, each of which is eligible for the gain reduction rule of the Proposed 965 Regulations, or other types of PTI, which are not so eligible). There does not appear to be a clear ordering rule for determining which type of PTI is distributed.

Example 10: Distributions during transition year when CFC has multiple types of PTI

This Example 10 illustrates distributions of PTI during the transition year when a CFC has multiple types of PTI. As discussed below, there is no ordering rule governing the various types of Section 959(c)(2) PTI and, as a result, the tax consequences of a distribution may differ depending on what type of PTI is distributed. In the event our recommendation above is not adopted regarding reducing basis under Section 961(b) only after giving effect to basis increases under Section 961(a), we recommend that Treasury adopt a rule treating such a distribution as being made first out of 965(a) PTI and 965(b) PTI.

[70] *See* Prop. Reg. §1.965-2(g)(2) (2018).

	2017
Starting basis in CFC	10
Traditional Subpart F PTI	50
965(a) PTI	50
Distribution	40

USP owns 100% of the stock of CFC. In 2017, CFC earns $50 of "traditional" Subpart F income and, as of November 2, 2017 and December 31, 2017 has $50 of ADFI, and USP includes $100 in income under Section 951(a). Also in 2017, CFC distributes $40 to USP.

If the recommendation above to clarify that basis decreases under Section 961(b) do not occur prior to the basis reflecting increases under Section 961(a) is adopted, then the basis consequences of the 2017 distribution should not differ whether traditional PTI or 965(a) PTI is deemed distributed first, or whether a pro rata share of each is treated as being distributed. If however, Gain/Earnings Duplication is only mitigated for 965(a) PTI by reason of a gain reduction rule as articulated by Notice 2018-7, then a priority for 965(a) PTI would arrive at the correct result of only taxing the U.S. Shareholder on distributions in excess of the sum of existing basis plus basis arising from Taxed Income in the year of distribution (assuming that the distribution did not exceed the amount of 965(a) PTI). In any case, there could be significantly different FTC and foreign currency consequences.

The Proposed 965 Regulations provide a gain reduction rule similar to the rule announced in Notice 2018-7.[71] Pursuant to the gain reduction rule, if a U.S. Shareholder receives a distribution from a DFIC during the inclusion year of the DFIC that is "attributable to" 965(a) PTI, then the amount of gain that otherwise would be recognized under Section 961(b)(2) by the U.S. Shareholder is reduced (but not below zero) by an amount equal to the 965(a) PTI of the DFIC with respect to the U.S. Shareholder. The gain reduction rule extends to 965(b) PTI.[72]

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[71] *See* Prop. Reg. §1.965-2(g) (2018).

[72] *See* Prop. Reg. §1.965-2(g)(1)(ii) (2018). The gain reduction rule with respect to 965(b) PTI facilitates the election to reallocate basis from a deficit CFC to a DFIC, because such basis adjustment takes place at the close of the transition year. *See* Prop. Reg. §1.965-2(h)(1) (2018). Presumably, other basis increases in DFIC stock during the year (e.g., capital contributions, other Section 961(a) basis) are also available to reduce the gain on the distribution of 965(b) PTI during the transition year.

If Treasury does not clarify that basis decreases under Section 961(b) do not occur prior to giving effect to basis increases under Section 961(a) (as recommended above), then Treasury should allow distributions during the transition year to be treated as being made first out of 965(a) PTI and 965(b) PTI (before other types of PTI), so that such distributions, if necessary, would be eligible for the gain reduction rule in Notices 2018-7 and 2018-13 and the Proposed 965 Regulations.[73] This would further the apparent policy of allowing U.S. Shareholders to recover PTI at the earliest possible time.

Example 11: Do PTI distributions from lower-tier CFC to upper-tier CFC cause gain under Sections 961(b)(2) and (c)?

This Example 11 discusses whether a distribution of PTI by a lower-tier CFC in excess of basis in the stock of such lower-tier CFC (including basis, if any, provided by Section 961(c)) should result in gain recognition under Section 961(b)(2). We recommend that Treasury issue Regulations providing generally that there should be no gain recognition (or basis reduction) by reason of PTI distributions in excess of basis in cases where the upper-tier CFC did not previously increase its basis in lower-tier CFC stock under Section 961(a) and (c); to the extent that the PTI did cause a basis increase in lower-tier CFC stock, it seems appropriate for a distribution of PTI to reduce basis and then cause gain. Notwithstanding the foregoing, 965(b) PTI might present different policy issues and should be handled in a manner consistent with Congressional intent underlying 965(b) PTI.

	Year 1
CFC1 basis in CFC2	0
CFC2 PTI	100
CFC2 distribution	70

USP owns 100% of the stock of CFC1 and CFC1 owns 100% of the stock of CFC2 with $0 basis in its CFC2 stock (including $0 basis for Subpart F purposes under Section 961(c)). CFC2 has $100 of PTI from a prior inclusion by USP.[74] In Year 1, CFC2 distributes $70 to CFC1. The

[73] This is consistent with recommendations in the 965 Statute Report. The Proposed 965 Regulations do not provide a lower-tier gain reduction rule as articulated by Notice 2018-13. It is not clear whether the proposed Regulations affirmatively deny such a rule, or rather if Treasury is simply waiting to issue such guidance once it further considers issues relating to stock of lower-tier CFCs.

[74] This situation where CFC2 has PTI but there is no basis in CFC2 stock could arise, for example, if basis from prior Taxed Income had been reduced by reason of Section 301(c)(2) distributions (because of intervening E&P deficits), or potentially if a CFC with PTI is acquired by CFC2 in an asset reorganization. Similarly (although potentially

issue is whether the distribution of $70 by CFC2 to CFC1 results in CFC1 recognizing gain under Sections 961(b)(2) and (c).

Section 961(c) provides that, under Regulations, adjustments similar to the adjustments provided by Sections 961(a) and (b) shall be made with respect to the basis of certain lower-tier CFCs for purposes of determining the amount to be included in a U.S. Shareholder's gross income under Section 951. On the one hand, if CFC2 were instead a first-tier CFC, the distribution would result in $70 of gain under Section 961(b)(2) (although, generally USP would have the benefit of the $100 stock basis increase in the case that CFC2 were a first-tier CFC). This would suggest that Section 961(c) would operate to cause CFC1 to have analogous gain recognition with respect to CFC2 stock.

However, the term "adjustments" arguably refers only to basis increases and decreases under Section 961(a) and Section 961(b)(1), respectively, and gain is not such an "adjustment"; therefore, Section 961(c) arguably does not provide for a rule similar to Section 961(b)(2) gain recognition in the context of lower-tier CFC distributions of PTI.[75] Consistent with that, the 2006 Proposed Regulations do not appear to require gain recognition on PTI distributions from lower-tier CFCs in excess of basis.[76] Further, because Section 961(c) states that adjustments shall be made pursuant to Regulations, and no such Regulations have been issued, it is not free from doubt that Section 961(c) is self-executing (although we understand that increasing and decreasing basis pursuant to Section 961(c) is widely accepted as the correct result).

Comparing to a Single CFC Approach might be useful here as well. In particular, assume that instead of an upper-tier CFC and a lower-tier CFC, there was just a single top-tier CFC that generated Taxed Income. In such a case, the Section 961(a) and (b) adjustments would be

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implicating different policies), this situation could arise if CFC2 has 965(b) PTI in the case that no basis increase is provided for such earnings (as described below). The election in the Proposed 965 Regulations to reallocate basis from a deficit CFC to a DFIC to the extent of 965(b) PTI does not appear to provide a similar reallocation of basis to an upper-tier CFC's stock in a lower-tier DFIC under Section 961(c), although further Regulations may provide for such a reallocation. The foregoing are examples of fact patterns in which a lower-tier CFC has PTI in excess of the upper-tier CFC's basis in the stock of the lower-tier CFC, but do not affect the recommended limitation on Section 961(b)(2) gain to the extent that basis was increased under Section 961(a) and (c) (e.g., basis reductions under Section 301(c)(2) would not apply to reduce or eliminate such limitation).

[75] Notwithstanding that Section 961(c) arguably does not provide for gain recognition, Notice 2018-13 provides a limited gain reduction rule for distributions of 965(a) PTI from lower-tier CFCs to upper-tier CFCs. The gain reduction rule is silent on whether the upper-tier CFC would indeed otherwise have gain, and instead seems to operate "just in case" there would otherwise be gain. As noted above, the Proposed 965 Regulations did not provide for basis adjustments in lower-tier CFC stock.

[76] *See* Prop. Reg. §1.961-3(a)(1) (2006) ("any downward adjustment to such United States shareholder's (or its successor in interest's) previously taxed earnings and profits account with respect to its stock in a distributor under §1.959-3(e)(3) shall result in a corresponding reduction of the basis of the distributee's stock in the distributor for purposes of determining the amount included in such United States shareholder's gross income under section 951(a)").

relatively clear under current law (other than the case of 965(b) PTI). If there were just a single top-tier CFC, and no gain would have been recognized on a PTI distribution to the U.S. Shareholder under Section 961(b)(2), then it seems reasonable that similarly no gain should be recognized by an upper-tier CFC on a PTI distribution by the lower-tier CFC under Section 961(b)(2) and (c). In fact, in a Single CFC Approach, PTI distributions from one CFC to another would generally not result in gain recognition, because there would be no regarded item within a single CFC, and thus Section 961(b)(2) would only apply on PTI distributions to the U.S. Shareholder. This would be consistent with the statutory interpretation described above, that when Section 961(c) refers to "adjustments", it only refers to basis and not to gain. It is not clear whether the Single CFC Approach should be extended in this manner.

Given the large amounts of PTI in lower-tier CFCs that are present after the application of Section 965, and the apparent policy of the PTI regime to allow U.S. Shareholders to recover PTI at the earliest possible time, Treasury should consider issuing Regulations providing generally that there should be no gain recognition (or basis reduction) by reason of PTI distributions in excess of basis in cases where the upper-tier CFC did not previously increase its basis in lower-tier CFC stock under Section 961(a) and (c); to the extent that the PTI did cause a basis increase in lower-tier CFC stock, it seems appropriate for a distribution of PTI to reduce basis and then cause gain. For example, if CFC2 has PTI, but CFC1 for some reason did not increase its basis in CFC2 stock by reason of such Taxed Income (e.g., CFC2 succeeded under Section 381 to the PTI of another CFC in a Section 332 liquidation or Section 368 asset reorganization, but the Taxed Income of such other CFC had not caused a basis increase in CFC2 stock because such CFC was not owned by CFC2 at the time it generated the Taxed Income), then a PTI distribution by CFC2 to CFC1 should not cause CFC1 to reduce basis or recognize gain under Section 961(b)(2) and (c). Notwithstanding the foregoing, 965(b) PTI might present different policy issues and should be handled in a manner consistent with Congressional intent underlying 965(b) PTI. Thus, if Congress intended 965(b) PTI to be Exempt Income, then such intent would not be furthered by causing gain recognition on the distribution of 965(b) PTI to an upper-tier CFC. But if Congress intended 965(b) PTI to be Fully Taxed Income, then causing gain upon a distribution of 965(b) PTI to an upper-tier CFC (or eventually upon distribution to the U.S. Shareholder) might be appropriate. Issues relating to 965(b) PTI are discussed in Examples 13-15 below.

B. Does Section 961(c) basis increase to stock of lower-tier CFCs apply for purposes of determining GILTI tested income of upper-tier CFCs?

The GILTI regime expressly requires that an enumerated set of other provisions, including Section 961, treats a GILTI inclusion in the same manner as a Subpart F inclusion.[77] Potentially in conflict with this GILTI requirement, Section 961(c) states that its basis adjustments to lower-

[77] *See* Section 951A(f)(1)(A). Section 951A(f)(1)(B) allows for other non-enumerated provisions to treat a GILTI inclusion as a Subpart F inclusion, in any case in which the determination of Subpart F income is required to be made at the level of the CFC.

tier CFC stock apply "only for the purposes of determining the amount included under section 951" (i.e., there is no reference to Section 961(c) applying for purposes of determining GILTI tested income). Thus, depending on the interpretation of these two provisions, it is not clear whether Section 961(c) basis adjustments apply for purposes of determining the amount included under Section 951A. The resolution of this issue can affect whether certain items of income are, in part, inappropriately taxed twice.[78]

Example 12: GILTI tested income from disposition of lower-tier CFC with PTI

This Example 12 illustrates several alternative approaches to the GILTI consequences of a disposition CFC stock, where the CFC has PTI and its stock basis reflects adjustments under Section 961(c). As described further below, we recommend that Treasury issue Regulations providing that Section 961(c) basis adjustments apply for purposes of calculating GILTI tested income, just as they apply for purposes of Subpart F income, upon disposition of the stock of a lower-tier CFC.

	Year 1	Year 2
CFC1 basis in CFC2	100	100? 170?
CFC2 Non-PTI E&P	0	0
CFC2 Taxed Income	70	0
CFC2 sale proceeds		190

USP owns 100% of the stock of CFC1, and CFC1 owns 100% of the stock of CFC2 with a $100 basis. CFC2 has no E&P. In Year 1, CFC2 earns $70 of Taxed Income and this amount is included in USP's gross income. In Year 2, CFC1 sells its CFC2 stock to an unrelated party for $190.

As a result of CFC2's Taxed Income, CFC2 has $70 of PTI and CFC1's basis in its CFC2 stock is increased, for certain purposes (i.e., only Subpart F, or Subpart F and GILTI), from $100 to $170 under Section 961(c). Upon the disposition of CFC2 stock in Year 2, CFC1 will recognize

[78] Unintentional non-taxation should also be avoided, but given that this issue involves a previous GILTI inclusion (i.e., there was already tax imposed on the income), non-taxation does not seem relevant.

$20 of gain for purposes of determining its Subpart F income ($190 minus $170). CFC2 does not have any Non-PTI E&P, and thus such gain on the disposition of CFC2 stock is not recharacterized as a dividend under Section 964(e). Should CFC1's $70 of Section 961(c) basis in CFC2 stock be taken into account for purposes of computing CFC1's GILTI tested income (if any) from the disposition of CFC2 stock? If CFC1 is required to recognize $70 of GILTI tested income, this result would be a form of Gain/Earnings Duplication, because it would result in taxing the same economic income twice, in an inappropriate manner.

Several alternative approaches are possible. First, Section 961(c) basis adjustments could apply both for purposes of Subpart F income and GILTI tested income. Under this view, CFC1 does not have any GILTI tested income upon the disposition of CFC2 because CFC1's basis in CFC2 stock was increased from $100 to $170 for GILTI purposes as well as Subpart F purposes, and the $20 of realized gain on the disposition for $190 is taken into account as Subpart F income, which thus is excluded from GILTI tested income.

Second, perhaps GILTI tested income simply does not include *items* of gross income (as opposed to *amounts* of gross income) taken into account in determining the Subpart F income of the CFC (i.e., items that give rise to Subpart F income, such as gain on the disposition of stock, would be excluded from GILTI tested income even if the amount of gross income would be greater for GILTI purposes by reason of Section 961(c) applying positive basis adjustments for Subpart F purposes but not for GILTI purposes). Section 951A(c)(2)(A) provides that tested income does not include "gross income taken into account" in determining the Subpart F income of a CFC. Under this theory, because the sale of CFC2 stock is taken into account under Subpart F, no items from such stock sale are taken into account in determining GILTI tested income, regardless of whether Section 961(c) applies for purposes of computing GILTI tested income. It follows that CFC1 simply cannot have tested income from the sale of CFC2 stock if some or all of such item constituted an item of Subpart F income. Thus, if for some reason, none of CFC1's gain on CFC2 stock were taken into account in determining Subpart F income, then such gain could be GILTI tested income; this is important, because Congress did not identify stock gain as Exempt Income, and thus it would be inappropriate to let such gain escape tax under both Subpart F and GILTI. A potential counterargument to this approach is that GILTI tested income specifically excludes certain other types of income (i.e., Exempt Income) that are of a type that can give rise to Subpart F income (e.g., income that would be Subpart F income but for the high-tax kickout, and dividends from related corporations),[79] and so if Congress had wanted to exclude gain from the sale of stock, it could have provided a specific rule. Distinctions can be drawn between the high-tax kickout and related party dividends, on the one hand, and incremental gain from the sale of stock by reason of differing stock basis, on the other hand (e.g., the former are completely excluded from Subpart F income whereas the latter is taken into account, at least in part, in determining Subpart F income), and thus the counterargument is not dispositive. Taking the foregoing into account, it is not clear

[79] *See* Section 951A(c)(2)(A)(i).

from the statute whether gains from sale of stock are excluded altogether from the determination of GILTI tested income.

Third, Section 961(c) could apply only for purposes of calculating Subpart F income and be inapplicable for purposes of calculating GILTI tested income, which would include stock gain other than to the extent taken into account under Subpart F. Under this view, CFC1 realizes $90 of gain upon the disposition for purposes of GILTI tested income, and $20 of that gain is recognized as Subpart F income (by reason of the $170 basis for Subpart F purposes) and thus excluded from GILTI tested income, with the remaining $70 of gain taken into account as GILTI tested income.

Treasury should issue Regulations adopting the first approach, that Section 961(c) basis adjustments in lower-tier CFC stock apply not only for purposes of calculating the Subpart F income of upper-tier CFCs, but also for purposes of calculating GILTI tested income of upper-tier CFCs. If GILTI tested income did not exclude stock gain and Section 961(c) did not apply for purposes of GILTI tested income, it would require a parallel GILTI basis regime that is divorced from the Subpart F basis regime. Notwithstanding the acknowledged lack of statutory clarity, absent a specific mandate to do so, creating a separate basis regime that operates in the background for GILTI purposes seems inconsistent with the general concept that Subpart F income is excluded from GILTI tested income. The first approach is a fair interpretation of the statute, as Section 951A(f)(1)(A) refers to treating a GILTI inclusion as if it were a Subpart F inclusion, and this can be read as not only *causing* Section 961 adjustments (i.e., GILTI inclusion as an "entry ticket" into Section 961), but as a direction for *applying* Section 961 (i.e., references to Subpart F income within Section 961 should be interpreted as including a reference to GILTI income). The statute could potentially also be read to support the second approach, although it is unclear, because the statutory definition of tested income does not refer to "items" of income taken into account in determining Subpart F income. Consideration should also be given to how stock losses are treated (i.e., if there is any case in which stock loss can constitute a deduction properly allocable to GILTI tested income, under Section 951A(c)(2)(A)(ii)).

C. Distribution of 965(b) PTI

As discussed above, under Section 965(b)(4)(A), ADFI of a DFIC that is offset by an E&P deficit gives rise to PTI (i.e., 965(b) PTI). Specifically, Section 965(b)(4)(A) states:

> *For purposes of applying section 959*…an amount equal to such shareholder's reduction under [Section 965(b)(1)] which is allocated to such deferred foreign income corporation under this subsection shall be treated as an amount which was included in the gross income of such United States shareholder under section 951(a). [Emphasis added]

Because Section 965(b)(4)(A) expressly limits its operation to purposes of Section 959, it does not appear that 965(b) PTI gives rise to a basis increase under Section 961(a).[80] Conversely, because there are no qualifications or limitations regarding the treatment of 965(b) PTI when it is actually distributed, it appears that the distribution of 965(b) PTI will cause a reduction in basis under Section 961(b). An ongoing theme regarding 965(b) PTI is whether Congress intended it to be Exempt Income, in which case special rules for basis increases or reallocations, and/or gain reduction, are necessary, or Congress intended it to be Fully Taxed Income, in which case the gain with respect to such income should be preserved in the stock of the CFC that earned the income (or stock of another CFC).

Example 13: Distribution of 965(b) PTI

This Example 13 illustrates the basis (and potentially gain) consequences of a distribution of 965(b) PTI when the U.S. Shareholder does not have sufficient basis in the stock of the CFC making the distribution. In particular, because 965(b) PTI does not appear to give rise to a basis increase, but distributions thereof do cause a basis decrease (and gain), there is potential for taxing PTI in an unintended manner. If Congress intended 965(b) PTI to be Exempt Income, then taxing distributions in this manner is inconsistent with such intention, because it leads to 965(b) PTI being treated as Fully Taxed Income (i.e., it precludes the Section 245A DRD and implements a basis reduction and gain mechanism). If, on the other hand, Congress intended 965(b) PTI to be Fully Taxed Income, then such basis reduction and gain is necessary (in some form) to preserve the ability to tax the stock gain. In addition, we recommend that Treasury confirm that Section 1248 recharacterization is available for Section 961(b)(2) gain. As noted above, the 965 Regulations Report will make recommendations to Treasury on issues primarily relating to Section 965, but the issues and potential alternatives are discussed in this Report because the principles relate conceptually to other issues discussed herein.

[80] The Proposed 965 Regulations do not provide a basis increase for 965(b) PTI, unless an election (described below) is made to reallocate basis from a deficit CFC to a DFIC (in each case, or to 961 Applicable Property, defined below).

	2017	2018
Starting basis in CFC1	0	30
Starting basis in CFC2	10	10
CFC1 ADFI (deficit)	100	
CFC2 ADFI (deficit)	(70)	
CFC1 Distribution		40

USP owns 100% of the stock of CFC1 and CFC2. USP has $0 basis in its CFC1 stock and $10 basis in its CFC2 stock. As of November 2, 2017 and December 31, 2017, CFC1 has ADFI of $100 and CFC2 has a deficit in post-1986 E&P of $70. Pursuant to Section 965, USP includes $30 of income under Section 951(a). In 2018, CFC1 distributes $40 to USP.

As a result of CFC1's Taxed Income and CFC2's deficit, CFC1 has $30 of 965(a) PTI and $70 of 965(b) PTI. With respect to the $30 of 965(a) PTI, USP's basis in its CFC1 stock is increased from $0 to $30 under Section 961(a) (and, as discussed below, under Prop. Reg. §1.965-2(e)(1) (2018)). However, it appears that Section 961(a) does not, but for an election to reallocate basis from CFC2 stock to CFC1 stock under the Proposed 965 Regulations, provide USP with additional basis in CFC1 stock for the $70 of 965(b) PTI.

CFC1's 2018 distribution of $40 is a PTI distribution (comprised in part of 965(a) PTI and in part of 965(b) PTI[81]). If USP's basis increase in CFC1 stock is limited to the $30 of the Section 951(a) inclusion (i.e., if basis does not reflect the $70 of 965(b) PTI), then USP's basis in its CFC1 stock will be reduced from $30 to $0 under Section 961(b)(1), and USP will recognize $10 of gain under Section 961(b)(2).[82] On its face, this result appears to be inconsistent with an apparent policy

[81] Whether the 2018 distribution is made out of 965(a) PTI or out of 965(b) PTI could make a difference, for example, because Section 986(c) does not apply to require the recognition of foreign currency gain or loss with respect to distributions of 965(b) PTI. *See* Prop. Reg. §1.986(c)-1(c) (2018). It is not clear whether 965(a) PTI or 965(b) PTI would be treated as being distributed before the other. See the discussion below of issues relating to the ordering of PTI distributions.

[82] If CFC1 (or a lower-tier CFC) had Non-PTI E&P, then presumably such E&P would be available to recharacterize USP's gain, if any, under Section 961(b)(2), as a dividend pursuant to Section 1248, and thus cause such amount to potentially qualify for the Section 245A DRD. Section 961(b)(2) treats PTI distributions in excess of basis as gain from the sale or exchange "of property" (i.e., as opposed to gain from the sale or exchange of the distributing CFC's stock; contrast with gain under Section 1059(a)(2), which provides for "gain from the sale or exchange of such stock").

underlying the PTI regime to allow U.S. Shareholders to recover PTI at the earliest possible time There is sufficient basis and PTI in the system in aggregate for the distribution to be recovered without additional tax, but Section 965 mechanics do not appear to allow for this, because even with the basis reallocation election in the Proposed 965 Regulations, there would be gain on this fact pattern equal to the excess of CFC1's $70 965(b) PTI over USP's existing $10 basis in CFC2 stock. Thus, counterintuitively, by allowing deficit CFCs to offset DFICs (and thus reduce a transition tax at a rate between 8% and 15.5%), Congress created 965(b) PTI that ultimately (upon distribution of the PTI or upon disposition of the CFC stock) appears to be taxed at 21%, thereby subjecting U.S. Shareholders to more tax (upon such distribution or disposition) than if there simply were no deficit offset. This essentially makes 965(b) PTI Fully Taxed Income, which is counterintuitive because one would think that designation as PTI would convert income into Exempt Income. Query what result Congress intended as to the treatment of 965(b) PTI.

Further, a Single CFC Approach to 965(b) PTI would lead to materially different tax consequences arising from the same economic activity. In particular, if a deficit CFC and a DFIC were instead a single CFC, then the deficit would "naturally" offset the income in determining ADFI and the net amount would give rise to a Section 965(a) inclusion (and a Section 961(a) basis increase in stock of the CFC), but there would be no 965(b) PTI created. Thus, distributions out of future earnings in excess of the 965(a) PTI would be eligible for the Section 245A DRD and would not reduce basis (assuming Section 1059 did not apply). This is in stark contrast to the

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Section 301(c)(3) contains similar language to Section 961(b)(2), as it provides for gain from the sale or exchange of "property", and Section 1248 contains an explicit rule to treat gain under Section 301(c)(3) as gain from the sale or exchange of the CFC stock. *See* Reg. §1.1248-1(b). There is no apparent policy distinction between Section 301(c)(3) and Section 961(b)(2) that would support Section 1248 characterization for one but not the other (i.e., there is no apparent policy rationale for treating Section 301(c)(3) gain as Exempt Income and Section 961(b)(2) gain as Fully Taxed Income). Both provisions represent gain on stock by reason of distributions on such stock in excess of basis. Thus, we recommend that Treasury confirm that Section 1248 recharacterization is available for Section 961(b)(2) gain.

For example, assume USP owns 100% of the stock of CFC1, which in turn owns 100% of the stock of CFC2. USP has zero basis in its CFC1 stock, CFC1 has no E&P, and CFC2 has $80 of E&P. CFC1 distributes $100 to USP. USP recognizes $100 of gain under Section 301(c)(3), and $80 of such gain is recharacterized as a dividend under Section 1248 by reason of CFC2's $80 of Non-PTI E&P (because lower-tier earnings are available for Section 1248 recharacterization). *See* Reg. §1.1248-1(b) (discussed above). The foregoing are the results under current law. Changing the facts slightly, assume that CFC1 has $100 of 965(b) PTI, but the other attributes and transactions are the same (e.g., USP still has zero basis in CFC1 stock because, for example, it did not make a basis reallocation election under Prop. Reg. §1.965-2(f)(2)(ii) (2018)). Instead of USP recognizing $100 of Section 301(c)(3) gain, it recognizes $100 of gain under Section 961(b)(2). There is no apparent policy reason why USP's Section 961(b)(2) gain should not similarly be recharacterized under Section 1248 to the extent of CFC2's $80 of Non-PTI E&P. In other words, explicitly providing for Section 301(c)(3) gain to potentially be Exempt Income under Section 245A while requiring that Section 961(b)(2) gain to be Fully Taxed Income seems anomalous.

creation of 965(b) PTI, which together with 965(a) PTI would cause future distributions to reduce stock basis (and potentially cause gain), regardless of future earnings.

The tax on USP's incremental $10 of Section 961(b)(2) gain could be prevented in one of several ways. First, USP could be allowed to increase its basis in CFC1 stock to the extent of its $70 of 965(b) PTI, without any adjustment to USP's basis in CFC2 stock. If Congressional intent was to allow the repatriation of 965(b) PTI without the imposition of tax on the distribution or a corresponding reduction of loss in other property (i.e., to treat 965(b) PTI as Exempt Income), then this approach accomplishes the goal. In this Example 13, under such an approach, USP would have sufficient basis in CFC1 stock to avoid gain under Section 961(b)(2) ($100 basis from the 965(a) PTI and 965(b) PTI, reduced by the $40 distribution). However, if Congress did not intend for 965(b) PTI to be Exempt Income (i.e., if Congress did not intend for 965(b) PTI to avoid tax (and preserve corresponding loss) both currently and also upon a future distribution by the DFIC or disposition of the DFIC stock (or other property)), it seems inappropriate to allow the avoidance of gain with respect to CFC1 stock when USP could still recognize a loss on the disposition of CFC2 stock. Thus, this first option would appear to be a noneconomic increase to basis. Moreover, while Congressional intent is not clear, we find it unlikely that Congress intended to allow 965(b) PTI to be so exempt from tax that a contemporaneous loss on the deficit CFC stock would be allowed. That would effectively represent double non-taxation.

Second, all or a portion of USP's basis in its CFC2 stock could be reallocated to its CFC1 stock, either automatically or by election.[83] Whether such a basis reallocation avoids (or causes) current gain to USP depends on the nature of the reallocation (e.g., whether reallocation is limited to the amount of basis in CFC2 stock or whether gain is required if the reallocation exceeds such basis), as well as the amount of basis that USP has in its CFC2 stock. On these facts, if basis equal to the entire amount of 965(b) PTI ($70) is reallocated from the stock of CFC2 to CFC1 and gain recognition is required to the extent that the reallocation exceeds USP's basis in CFC2 stock (as provided in the Proposed 965 Regulations discussed below), then USP might prefer to not make the election, because the election would cause $60 of gain recognition (i.e., $70 basis reallocation less $10 existing basis in CFC2 stock) whereas the $40 2018 distribution would, with no basis reallocation, only cause $10 of gain under Section 961(b)(2) (i.e., the excess of the $40 PTI distribution over the $30 basis in CFC1 stock). It is also possible to provide an election for U.S. Shareholders to reallocate basis to a limited extent, up to the amount of basis in the deficit CFC stock, and thus to at least partially mitigate gain recognition on distributions by the DFIC while not causing immediate gain with respect to the deficit CFC stock. In this Example 13, that approach would allow USP to reallocate all $10 of its basis in CFC2 stock to CFC1 stock, but

[83] As described below, the Proposed 965 Regulations provide for an election by which basis equal to 965(b) PTI would be reallocated from its CFC2 stock to its CFC1 stock.

would not cause any gain recognition with respect to CFC2 stock or provide additional basis beyond the $10 to CFC1 stock.

Consider the application of this second approach allowing for basis reallocation in a case where the DFIC and the deficit CFC are in the same chain (i.e., one is a direct or indirect subsidiary of the other). Because under Sections 961(a) and (b), stock basis adjustments are made with respect to the top-tier CFC (in addition to basis adjustments to the stock of lower-tier CFCs under Section 961(c), which, as noted above, we have assumed is self-executing), the net effect of a positive stock basis adjustment under Section 961(a) and a negative stock basis adjustment under Section 961(b), in each case to the stock of the top-tier CFC, is neutral with respect to the top-tier CFC in the case that the DFIC and the deficit CFC are in the same chain. For example, in a tiered structure, assume that as of November 2, 2017 and December 31, 2017, second-tier CFC has $100 ADFI and is owned by first-tier CFC, which has a deficit in post-1986 E&P of $70. In such a case, both the upwards adjustment of $100 to the stock of the first-tier CFC (because basis adjustments under Section 961(a), and as discussed below, also under Prop. Reg. §1.965-2(e)(1) and (f)(2) (2018), are made to the top-tier CFC stock) and the downwards adjustment of $70, also to the stock of the first-tier CFC (because it is the deficit CFC that is "sharing" its basis), would be made with respect to the stock of the first-tier CFC, resulting in no net change to the basis in upper-tier CFC stock as a result of the basis reallocation election (i.e., without the election, the U.S. Shareholder would have increased its basis in the first-tier CFC stock by $30 by reason of the net Section 965(a) inclusion of $30, and with the election, basis in first-tier CFC stock would be increased by $100 and reduced by $70, with the same net increase of $30). This result in a tiered CFC structure is counter-intuitive, but may simply be the inevitable result of basis reallocation among the stock owned by the U.S. Shareholder.

Third, Regulations could provide deferral of USP's gain under Section 961(b)(2) until USP disposes of its CFC1 stock, but this solution is likely complex and would require detailed rules describing what transactions trigger the deferred gain.[84] Notwithstanding this complexity, since Section 961 is implemented by Regulations, there is flexibility to develop this approach. Fourth, distributions of 965(b) PTI in excess of basis could (theoretically) be treated as eligible for the Section 245A DRD, but this approach, even if sensible, might be inconsistent with Section 959(d), which provides that any distribution excluded from gross income under Section 959(a) is treated, as a distribution which is not a dividend (and thus presumably not eligible for Section 245A), except that it reduces E&P. Furthermore, treating a PTI distribution as eligible for Section 245A

[84] This type of deferral of items with respect to shares is broadly similar to a mechanic used in the 2002 proposed Section 302 Regulations (subsequently withdrawn in 2006) for the treatment of the basis of redeemed shares following a Section 302(d) redemption. *See* REG-150313-01, 2002-2 C.B. 777; Prior Prop. Reg. §1.302-5(a), (c) (2002); *withdrawn by* Ann. 2006-30, 2006-1 C.B. 879.

would disallow FTCs for CFC1's taxes under Section 245A(d), including withholding taxes, and would implicate the complexities of Section 1059.

The Proposed 965 Regulations essentially adopt the second approach, allowing an election to reallocate basis from the stock of a deficit CFC to the stock of a DFIC. In particular, if a U.S. Shareholder makes an election, the U.S. Shareholder's basis in its stock of a DFIC (or property by reason of which it is considered under Section 958(a)(2) as owning stock of a DFIC ("**961 Applicable Property**")), is increased by an amount equal to the 965(b) PTI of the DFIC.[85] Correspondingly, the U.S. Shareholder's basis in stock of the deficit CFC (or 961 Applicable Property), is reduced by an amount equal to the portion of its pro rata share of the CFC's deficit taken into account under Section 965(b) (i.e., the deficit that created 965(b) PTI). This election is "all or nothing" in that if made, it requires a basis adjustment (and possible gain) equal to the entire amount of 965(b) PTI, as opposed to limiting the basis adjustment to the amount of basis the U.S. Shareholder has in the deficit CFC stock, which would eliminate the necessity of triggering gain immediately, at the cost of limiting the basis increase in the income CFC stock. The basis adjustment occurs as of the close of the last day of the transition year.[86] The excess, if any, of a net reduction in basis with respect to deficit CFC stock (or 961 Applicable Property) over the U.S. Shareholder's basis in such stock (or 961 Applicable Property) (without regard to the Section 961 basis adjustments) is treated as gain from the sale or exchange of property.[87] Except for CFC stock owned indirectly through a foreign partnership (the stock basis of such a CFC is adjusted in the hands of the partnership, as well as the outside basis in partnership interests in the case of tiered foreign partnerships), the basis adjustments are made solely with respect to the CFC stock or 961 Applicable Property owned directly by the U.S. Shareholder.[88] As noted above, it would be possible to provide an election for U.S. Shareholders to instead reallocate basis to such a limited

[85] *See* Prop. Reg. §1.965-2(f)(2)(ii) (2018). The basis increase (and corresponding decrease in the stock of the deficit CFC, as described below) is translated (if necessary) into U.S. dollars using the spot rate on December 31, 2017. Prop. Reg. §1.965-2(h)(1) (2018) provides that the basis adjustment is made as of the close of the last day of the last taxable year of the specified foreign corporation that begins before January 1, 2018.

[86] *See* Prop. Reg. §1.965-2(h)(1) (2018).

[87] *See* Prop. Reg. §1.965-2(h)(3) (2018).

[88] *See* Prop. Reg. §1.965-2(h)(5) (2018). Basis adjustments under Section 961 with respect to CFCs owned indirectly through partnerships, or tiered partnerships, are not discussed in detail herein. This mechanism provided by the Proposed 965 Regulations, which allows Section 961 adjustments to look through foreign partnerships, including tiers of foreign partnerships, as if the U.S. Shareholder held the CFC stock directly and thus adjusting the outside basis in partnership interests for each partnership in the chain as well as the stock of the CFC, appears to be a reasonable approach to handle these issues, including for Taxed Income other than a Section 965(a) inclusion. Treasury should consider extending this approach to Section 961 adjustments with respect to other types of Taxed Income, in addition to Section 965. There is no apparent policy rationale for creating this special rule for Section 961 adjustments for inclusions under Section 965 as opposed to other types of Taxed Income. Moreover, this reflects an aggregate theory of partnerships, which seems appropriate in this context.

extent, but the election provided by the Proposed 965 Regulations uses the “all or nothing” election.

Further consideration of the basis reallocation election provided by the Proposed 965 Regulations, and discussion of whether a more limited basis reallocation rule capped at the amount of basis in the deficit CFC stock would be more appropriate, or whether mandatory basis adjustments are more appropriate than an election, is contained in the 965 Regulations Report.

Example 14: Disposition of CFC with 965(b) PTI

This Example 14 illustrates the disposition of CFC stock where the CFC has 965(b) PTI, and observes that the lack of a basis increase attributable to the 965(b) PTI increases the amount of gain on disposition, with the possibility that Section 1248 might not apply to recharacterize this portion of gain as a dividend potentially eligible for Section 245A. If Congress intended 965(b) PTI to be Exempt Income, then excluding 965(b) PTI from Section 1248 recharacterization (together with not providing stock basis for 965(b) PTI) would be inconsistent with such intention, because it leads to 965(b) PTI giving rise to Fully Taxed Income on the sale of CFC stock (i.e., it precludes Section 1248 recharacterizing the gain as dividend income eligible for the Section 245A DRD, which would be Exempt Income). On the other hand, providing a basis increase for 965(b) PTI without an offsetting basis reduction to stock of the deficit CFC would effectively allow double non-taxation, as it would exempt gain on the DFIC but allow a fully taxable loss on sale of the deficit CFC. As discussed below, Treasury should clarify whether Section 1248(d)(1) excludes 965(b) PTI from availability to recharacterize gain as a dividend. The merits of the basis reallocation election provided by the Proposed 965 Regulations are discussed in the 965 Regulations Report.

	2017	2018
Starting basis in CFC1	0	30
Starting basis in CFC2	10	10
CFC1 ADFI	100	
CFC2 deficit	(70)	
CFC1 sales proceeds		100

Same facts as Example 13, except that in 2018, rather than CFC1 distributing $40 to USP, USP sells its CFC1 stock to an unrelated party for $100.

Similar to gain recognition under Section 961(b)(2) described above, if USP is not allowed a basis increase in CFC1 stock with respect to the $70 of 965(b) PTI, USP would recognize $70 of gain on the disposition of CFC1 for $100. However, as noted above, providing a basis increase for the full $70 of 965(b) PTI without an offsetting basis reduction of $70 (or $10 basis reduction and $60 gain) to stock of the deficit CFC would effectively allow double non-taxation of the $70 amount, as it would exempt the $70 gain on the DFIC but allow a fully taxable loss on sale of the deficit CFC. With respect to the DFIC, Section 1248(a) might not apply to recharacterize any of this gain as a dividend with respect to which USP could claim a Section 245A DRD, because PTI is generally not available for Section 1248 purposes,[89] and CFC1 has no Non-PTI E&P. Thus, the 965(b) PTI would be treated as Fully Taxed Income. However, it is possible that such $70 of 965(b) PTI is available for Section 1248 purposes, and thus potentially could be eligible for the Section 245A DRD and be Exempt Income. Section 1248(d)(1) excludes amounts "previously included in the gross income of such person" under Section 951 (including for this purpose, Section 951A[90]). Although 965(b) PTI is treated as PTI for purposes of applying Section 959 to distributions in the transition year or later years, 965(b) PTI was never in fact "included in the gross income" of the U.S. Shareholder (i.e., it was offset by deficits under Section 965(b)). Thus, it is not clear that Section 1248(d)(1) operates to exclude 965(b) PTI from Section 1248(a) treatment. In fact, this statutory language suggests that 965(b) PTI should not be prohibited from causing a Section 1248 recharacterization. If 965(b) PTI can in fact support a Section 1248 dividend, it is also not clear what the characteristics of a Section 1248 deemed dividend would be if sourced from PTI. For example, would such a deemed dividend reduce basis (or cause gain) in the CFC stock under Section 961(b) by reason of it being a PTI distribution, or when Section 1248

[89] *See* Sections 1248(d)(1); 951A(f)(1)(A).

[90] *See* Section 951A(f)(1)(A).

mandates treatment as a dividend, does that preclude application of the PTI regime because distributions of PTI to a U.S. Shareholder are not treated as dividends pursuant to Section 959(d)? Further, the treatment of 965(b) PTI under Section 1248 may inform how Section 965(b) PTI affects stock basis. For example, presumably, if 965(b) PTI is available to source a Section 1248 dividend, it would not also result in basis to the U.S. Shareholder in its CFC stock; that would both reduce gain on disposition of the CFC stock and then recharacterize some or all of the remaining gain as a dividend potentially eligible for Section 245A. That would be an inappropriate double-counting of the 965(b) PTI. If Congress intended 965(b) PTI to be treated as Exempt Income, the Section 1248 recharacterization provides a mechanism to accomplish such treatment. But if Congress intended 965(b) PTI to be Fully Taxed Income (albeit deferred until a future distribution or disposition), then treating 965(b) PTI as eligible for Section 1248 would require corresponding adjustments (e.g., basis reduction in the stock of the deficit CFC) to ensure that the amount of 965(b) PTI does not permanently escape taxation.

As noted above, the Proposed 965 Regulations have provided an "all or nothing" election for a U.S. Shareholder to reallocate basis in the stock of a deficit CFC to the stock of a DFIC.[91] In this case, if USP makes the election, its basis in CFC1 stock would increase from $30 to $100, its basis in CFC2 stock would decrease from $10 to zero, and it would recognize $60 of gain from the sale or exchange of property.[92] One might question whether this $60 gain is an instance of Gain/Earnings Duplication. It is unlike the more traditional Gain/Earnings Duplication in that the $70 of CFC1 earnings were not in fact included in income by USP, and thus no amount appears to be duplicated. However, if Congressional intent in treating the $70 of earnings as PTI was to eliminate tax on repatriation of that amount (i.e., to treat 965(b) PTI as Exempt Income) (which, counterintuitively, was not the apparent result of the statute as drafted), then the "all or nothing" election generally does not achieve this. Also noted above, Treasury could instead provide an election for U.S. Shareholders to reallocate basis only to the extent of its basis in the deficit CFC stock, and thus at least prevent the election from triggering immediate gain. This partial reallocation of basis would be consistent with the Single CFC Approach, as it would first allow USP to utilize all basis with respect to CFC1 stock and CFC2 stock before triggering gain (just as it generally would be able to access all basis in the stock of a single CFC before triggering gain).

Example 15: Section 965 deficit CFC owned by one consolidated group member offsets income CFC owned by another consolidated group member

This Example 15 illustrates the basis consequences where a deficit CFC owned by one consolidated group member offsets income of a DFIC owned by another consolidated group member. Similar to Example 13, the lack of a basis increase for 965(b) PTI causes 965(b) PTI to be Fully Taxed Income and thus taxed in a potentially unintended manner. The election to

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[91] *See* Prop. Reg. §1.965-2(f)(2)(ii) (2018).

[92] *See* Prop. Reg. §1.965-2(f)(2)(ii), (h)(3) (2018).

reallocate basis under the Proposed 965 Regulations appears to apply where the income CFC and deficit CFC are owned by different consolidated group members, thus providing some relief to U.S. Shareholders anticipating the receipt of a distribution of 965(b) PTI. As noted previously, the 965 Regulations Report will discuss the merits of the basis reallocation election.

	2017	2018
Starting basis in CFC1 (USS1)	0	30
Starting basis in CFC2 (USS2)	10	10
CFC1 ADFI	100	
CFC2 deficit	(70)	
CFC1 Distribution (USS1)		40

USP is the parent of a consolidated group. USP owns 100% of the stock of each of USS1 and USS2. USS1 owns 100% of the stock of CFC1 and has $0 basis in its CFC1 stock. USS2 owns 100% of the stock of CFC2 and has $10 basis in its CFC2 stock. As of November 2, 2017 and December 31, 2017, CFC1 has ADFI of $100 and CFC2 has a deficit in post-1986 E&P of $70. Pursuant to Section 965, USS1 includes $30 of income under Section 951(a).[93] In 2018, CFC1 distributes $40 to USS1.

As a result of CFC1's Taxed Income and CFC2's deficit, CFC1 has $30 of 965(a) PTI and $70 of 965(b) PTI. With respect to the $30 of 965(a) PTI, USS1's basis in its CFC1 stock is increased from $0 to $30 under Section 961(a) (with a conforming $30 positive basis adjustment in USP's USS1 stock under Reg. §1.1502-32). However, it appears that Section 961(a) does not provide USS1 with additional basis in CFC1 stock (nor does Reg. §1.1502-32 provide USP a positive basis adjustment with respect to its USS1 stock) for the $70 of 965(b) PTI.

As above in Example 13, absent some mechanism to increase or adjust USS1's basis in CFC1, upon the 2018 distribution of $40 by CFC1 to USS1, USS1's basis in its CFC stock will be reduced from $30 to $0 under Section 961(b)(1), and USS1 will recognize $10 gain under Section

[93] *See* Section 965(b)(5); Prop. Reg. §1.965-8(b) (2018) (deficits of CFC owned by one group member can offset ADFI of CFC owned by another member); Prop. Reg. §1.965-8(e)(2) (2018) (single entity treatment of a consolidated group does not apply to treat all members as a single U.S. Shareholder for purposes of determining the amount of any member's Section 951 inclusion (including a Section 965(a) inclusion), the foreign income taxes deemed paid with respect to a Section 965(a) inclusion, or any purpose other than those specifically listed in Prop. Reg. §1.965-8(e)(1) (2018) or elsewhere in the Proposed 965 Regulations).

961(b)(2). As discussed above, in the Proposed 965 Regulations, Treasury provided an election to reallocate basis from a deficit CFC owned by a U.S. Shareholder to a DFIC owned by the U.S. Shareholder. It appears that the Proposed 965 Regulations make this election available to reallocate basis from stock of a CFC owned by one member of a consolidated group to stock of a CFC owned by a different member of the consolidated group.[94]

It is worth distinguishing between two different types of PTI and basis sharing among members of a consolidated group. Further above in connection with reexamination of recommendations made by the 2015 Report, Example 8 involved ongoing distributions of PTI to consolidated group members that had no inclusion under Sections 951 or 951A. Shifting basis or PTI in such a case, while it has benefits that might outweigh the complexity, arguably leads to noneconomic basis shifts, in that the member receiving the PTI distribution did not necessarily have any economic income and yet the basis in its stock is increased. In contrast, the basis reallocation election in the 965 Proposed Regulations arguably causes basis to follow economic income and loss (i.e., from a deficit CFC chain to an income CFC chain). Further, the election is a one-time event less likely to result in ongoing manipulation. Thus, it is possible that sharing basis in one context is appropriate but in the other context is inappropriate. Nonetheless, as noted above, precluding the sharing of PTI attributes among consolidated group members in the case of ongoing distributions has its own complexities and might not achieve a better result.

VI. Amount and Type of PTI

Under pre-Act law, the tax treatment of U.S. Shareholders often depended on the amount and type of PTI created or distributed, and the importance of the amount and type of PTI has been enhanced by the Act, both because of the large amount of PTI in the system under the transition tax and, going forward, the GILTI regime, and because of the additional types of PTI in the system. Given that the tax treatment differs based on the type of PTI distributed, the lack of a precise ordering rule between different types of Section 959(c)(2) PTI (i.e., Subpart F PTI, GILTI PTI, 965(a) PTI, 965(b) PTI) creates significant uncertainty. For example, as discussed above, if Gain/Earnings Duplication is prevented by a limited gain reduction rule only applicable to 965(a) PTI and 965(b) PTI (as provided in the Proposed 965 Regulations), then a distribution treated as made out of 965(a) PTI or 965(b) PTI in the transition year may have significant advantages as compared to a distribution of Subpart F PTI. Similarly, whether haircuts apply, and the amount of

[94] In particular, under the election, the amount of basis reduction in the deficit CFC is the amount of its deficit that is shared, and the amount of basis increase in the income CFC is the amount of its Section 965(b) PTI. Those amounts (the shared deficit and the 965(b) PTI) are determined on a consolidated basis under Prop. Reg. §1.965-8(b) and (e)(1) (2018), and thus the basis reallocation appears to also be done on a consolidated basis, notwithstanding the language in Prop. Reg. §1.965-8(e)(2) (2018) that limits the purposes for which a consolidated group is treated as a single entity. Further, because of a consistency requirement among related parties under Prop. Reg. §1.965-2(f)(2)(iii) (2018), if one member of a consolidated group makes the election, then all members are required to make the election; thus we do not have to consider a situation where inconsistent actions are taken within the group (i.e., a scenario where some members elect and others not do not elect).

haircuts, on FTC utilization and foreign currency gain or loss may depend on the type of PTI distributed. Thus, it would be helpful for Treasury to provide clarification on the ordering rules for distributions of Section 959(c)(2) PTI. As explored further below, the specific type of Section 959(c)(2) PTI distributed is also relevant for purposes of computing applicable deemed paid foreign taxes, as the various types of PTI may be associated with different foreign taxes.

Another issue relates to the appropriate treatment of E&P related to GILTI tested income of a CFC that is offset by a loss in a related CFC when calculating the GILTI inclusion. As explored further below, because the GILTI regime does not create "deemed" PTI similar to 965(b) PTI, the deficit offset reduces the U.S. Shareholder's GILTI inclusion, and gives rise to Non-PTI E&P which can effectively reduce or eliminate taxable gain on a subsequent disposition of the income CFC (by reason of Section 1248 and Section 245A), while leaving a built-in loss in the stock of the related deficit CFC (assuming the value of the deficit CFC's stock is below basis, which is not always the case) that can be realized upon a subsequent disposition. In certain cases, this appears to be a potentially inappropriate tax benefit. However, as discussed below, the statutory authority to address this set of facts is quite limited, and PTI in particular is not the appropriate regime to resolve the issue. As noted above, the Proposed GILTI Regulations (which are generally beyond the scope of this Report) provide for basis adjustments that mitigate this potentially inappropriate result, by reducing basis in the stock of CFCs with "used tested loss" upon a disposition of such stock,[95] with no basis adjustments to income CFC stock for its net offset tested income. The effect of these adjustments is generally to reduce taxable loss (or increase taxable gain) on a future disposition of CFC stock, where the CFC's losses have already benefitted the U.S. Shareholder through offsetting the tested income of another CFC owned by the U.S. Shareholder.

Finally, it is not clear how PTI interacts with a deficit in Non-PTI E&P under Section 959(c)(3), and how distributions are treated when a CFC has both attributes. This can arise, for example, through the generation of Taxed Income in one year followed by operating losses in a future year, or through GILTI tested income (a gross income concept, reduced by properly allocable deductions) in excess of the year's E&P. The above issue, as well certain other issues, pertain to historic uncertainties unrelated to the Act. For example, where a CFC has positive PTI and a deficit in Non-PTI E&P, what consequences should arise upon a distribution under Section 301(c)(2)?

Example 16: Effect on PTI of E&P deficits and Section 301(c)(2) distributions

This Example 16 explores whether a loss that gives rise to an E&P deficit, or a distribution under Section 301(c)(2), can reduce PTI. As explained in further detail below, we recommend that Treasury consider issuing Regulations providing that an E&P deficit is not netted with PTI and, similarly, that a distribution under Section 301(c)(2) does not reduce PTI (i.e., to be a PTI

[95] *See* Prop. Reg. §1.951A-6(e).

distribution, the distribution must have otherwise been a Section 301(c)(1) distribution out of E&P). Notwithstanding the foregoing, when amounts attributable to GILTI tested income that was included by a U.S. Shareholder under Section 951A are distributed to such U.S. Shareholder (regardless of whether there is E&P attributable to such amounts), it is possible that such distributions are PTI distributions, despite the lack of E&P.

	Year 1	Year 2	Year 3	Year 4
Taxed Income	100			
Non-PTI E&P (loss)		(130)		10
Distributions			100	10

USP owns 100% of the stock of CFC. CFC has no E&P. In Year 1, CFC earns $100 of Taxed Income and this amount is included in USP's gross income. In Year 2, CFC has $130 of operating losses and no other earnings. In Year 3, CFC distributes $100 to USP. In Year 4, CFC earns $10 of Non-PTI E&P and distributes $10 to USP.

As a result of the Year 1 Taxed Income, CFC has $100 of PTI. As a result of the Year 2 operating loss, CFC has a $130 Section 959(c)(3) E&P deficit. Consequently, at the time of the Year 3 distribution, CFC has an overall accumulated E&P deficit and the Year 3 distribution should reduce USP's basis in CFC stock under Section 301(c)(2).

One issue is whether the Year 2 loss or the Year 3 Section 301(c)(2) distribution also reduces CFC's PTI from $100 to zero. In other words, can PTI be distributed even if a dividend within the meaning of Section 316 cannot be distributed (by reason of lack of E&P)? If it does reduce PTI (because PTI can be distributed), the Year 4 distribution will be made out of Year 4's Section 959(c)(3) current E&P (because CFC exhausted its PTI in Year 3) and USP will include $10 in income as a dividend (potentially resulting in a Section 245A DRD, and resulting in no FTCs for withholding taxes imposed on USP or recognition of foreign currency gain or loss). If the Year 2 loss and the Year 3 Section 301(c)(2) distribution do not reduce PTI, then the Year 4 distribution will be characterized as a distribution of PTI, will be excluded from USP's gross income under Section 959(a)(1), will reduce USP's basis in CFC stock (and cause gain to the extent the reduction exceeds basis) under Section 961(b)(1) and (2) (and will potentially allow USP to take FTCs on withholding taxes under Section 960(b) and cause recognition of foreign currency gain or loss under Section 986(c)).

One area in which the relationship between PTI and E&P deficits is implicated is the resulting attributes of a DFIC subject to Section 965, because as discussed below, there are cases where the amount of E&P included by the U.S. Shareholder with respect to a CFC under Section 965 (i.e., its ADFI, adjusted for various items such as deficits of other CFCs) exceeds the CFC's E&P for general tax purposes. Treasury has taken a position on the treatment of such excess, in a manner generally consistent with our recommendation that an E&P deficit should not reduce PTI. The Proposed 965 Regulations provide for reduction of a DFIC's Section 959(c)(3) E&P,

including the creation or increase of a Section 959(c)(3) deficit, equal to the amount of the Section 965(a) inclusion with respect to the DFIC.[96] In certain cases, the Section 965(a) inclusion amount with respect to the DFIC can exceed the Section 959(c)(3) E&P of the DFIC, for example, if a DFIC incurs a loss after its ADFI measurement date and before the end of its inclusion year (e.g., if a calendar year CFC's ADFI on November 2, 2017 exceeds its ADFI on December 31, 2017), or it makes a Section 312(a)(3) distribution to another SFC in its inclusion year (which reduces "regular" E&P but does not reduce ADFI), or it had pre-1986 E&P losses that are taken into account for regular E&P purposes but are excluded from Section 965 calculations.[97] In such a case, under the Proposed 965 Regulations, a Section 959(c)(3) deficit is created or increased. The implication of this mechanism is that PTI can coexist with a Section 959(c)(3) deficit; if instead PTI were to be netted with a Section 959(c)(3) deficit, it would be anomalous for Treasury to write a Regulation that explicitly creates both. As discussed below, Treasury should make this implication explicit, and provide guidance on the impact of distributions when there is both PTI and a Section 959(c)(3) deficit.

This situation can also arise when applying the GILTI regime. In particular, an inclusion under Section 951A is not limited by the amount of a CFC's E&P.[98] Thus, a CFC's tested income for the year, and the U.S. Shareholder's inclusion under Section 951A, can exceed the CFC's current E&P. Similarly, the amount of the CFC's PTI should be able to exceed E&P, by reason of the fact that the GILTI inclusion can exceed E&P. For example, assume a CFC has $100 of net tested income and $10 of deductions that are not properly allocable to tested income under Section 951A(c)(2)(A)(ii). The U.S. Shareholder would have a $100 inclusion, and thus the CFC would have $100 of PTI yet only $90 of E&P. The analogous issue in the GILTI context is whether the CFC's earnings should be treated as comprised of the disaggregated amounts of $100 of PTI and $10 of Section 959(c)(3) deficit, or whether the amounts should be netted (i.e., a reduction of PTI to take into account the Section 959(c)(3) deficit), such that CFC's earnings are comprised solely of a net $90 of PTI. Further, if PTI remains at $100, the issue is whether a distribution by the CFC of $100 would reduce PTI to zero, or would only $90 of the distribution be treated as out of PTI, because the CFC could only pay $90 of dividend under Section 316 (by reason of its aggregate $90 of E&P), such that the remaining $10 would be a Section 301(c)(2) distribution as opposed to a PTI distribution.

In this case where a GILTI inclusion exceeds E&P, the interaction between Sections 959(a) and 951A(f)(1)(A) creates a lack of clarity as to what earnings or amounts constitute PTI, and when such PTI should be treated as being distributed (and thus reduced). Interpreting such provisions to arrive at a logical conclusion to the issues raised above requires reading at least some of the language in such provisions flexibly. The relevant portions of Section 959(a) refer to E&P

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[96] *See* Prop. Reg. §1.965-2(c) (2018).

[97] *See* REG-104226-18.

[98] In contrast, a CFC's Subpart F income for any year is limited to its E&P for the year. *See* Section 952(c)(1)(A).

(the "**E&P Requirement**") attributable to amounts included under Section 951(a) (the "**Attributable to Requirement**") not being again included in the income of the U.S. Shareholder (the "**Again Included Requirement**"). These Section 959 requirements generally dictate what constitutes a distribution of PTI. The relevant portion of Section 951A(f)(1)(A) provides that a GILTI inclusion is treated in the same manner as a Subpart F inclusion for purposes of applying Section 959 (the "**Same Manner Requirement**").

Assume that in Year 1, there was a $100 GILTI inclusion but only $90 of E&P, and then in Year 2 there was $10 of Non-PTI E&P and a $100 distribution by the CFC to USP. The $100 distribution reflects E&P (because there was a total of $100 E&P, comprised of $90 from Year 1 and $10 from Year 2) that, but for Section 959, would have been again included by USP (because USP included the E&P as income once in Year 1 under Section 951A and then would have included the E&P again in Year 2 as a distribution (the Section 245A DRD should not be relevant to the Again Included Requirement, because Section 245A does not exclude dividends received from income). Thus, both the E&P Requirement and the Again Included Requirement should be satisfied for purposes of determining whether the entire $100 Year 2 distribution is out of PTI. However, it is not clear that the Attributable to Requirement is satisfied, because the entire $100 GILTI inclusion was in Year 1, whereas the $100 of E&P distributed in Year 2 was comprised of $90 in Year 1 and $10 in Year 2. It is not clear that the $10 of E&P generated in Year 2 is "attributable to" the amounts included by USP (i.e., a $10 portion of the Year 1 GILTI inclusion).

One approach would be to consider the Year 2 distribution as entirely out of PTI (as opposed to just $90 out of PTI), which would require a flexible interpretation of the Attributable to Requirement. This approach would view the $10 of Year 2 E&P as attributable to $10 of the Year 1 GILTI inclusion (and thus treat the Year 2 distribution as out of PTI), but it is not clear what the attributive link between the Year 2 E&P and the Year 1 GILTI is. The Same Manner Requirement, which seems to require the full $100 of Year 1 income to be treated as PTI (although see below for an alternative interpretation of the Same Manner Requirement), together with the ordering rules of Section 959(c), which require PTI to be distributed first before Non-PTI E&P, perhaps suggest that the Attributable to Requirement should be interpreted flexibly enough to allow the $10 of Year 2 Non-PTI E&P to be attributable to the Year 1 GILTI inclusion. In other words, the priority apparently given to PTI, together with the GILTI regime mandate that the full amount included by the U.S. Shareholder is treated as PTI, is perhaps enough to overcome the lack of an attributive link between the E&P distributed in Year 2 and the amount included in Year 1. But this result is not wholly satisfying, in part because of the lack of an attributive link (as noted above), and in part because Section 959(c) itself requires E&P to be attributable to amounts previously included (i.e., Section 959(c) has its own version of the Attributable to Requirement, which requires E&P to be attributable to amounts previously included by the U.S. Shareholder before such E&P can be given a priority under Section 959(c)). Thus, relying on Section 959(c) to work around the Attributable to Requirement presents difficult technical questions.

Another approach to the fact pattern described above would be to treat the amount of the GILTI inclusion in excess of E&P ($10) as simply never becoming PTI. This approach would adhere strictly to the Attributable to Requirement, and thus would conclude that because no E&P is attributable to the $10 amount of GILTI inclusion that is in excess of CFC's $90 of E&P, then such $10 excess cannot become PTI (regardless of the fact that the E&P Requirement and the Again Included Requirement are satisfied). Presumably, under this approach Section 961(a) would cause a positive basis adjustment in CFC stock equal to the full $100 inclusion, because the amount of such adjustment is derived from the amount included by the U.S. Shareholder, not by the amount of PTI. It would follow that a distribution of such $10 excess would be a dividend included by the U.S. Shareholder, but giving rise to a Section 245A DRD (if its requirements are satisfied), and it would not reduce basis under Section 961(b) (and would not cause the U.S. Shareholder to be treated as paying any foreign taxes, and would not cause recognition of foreign currency gain or loss). Thus, on these facts, the value of CFC stock would (assuming values moved coextensively with earnings) increase in total by $10 ($100 of tested income plus $10 Non-PTI E&P, less the $100 distribution) and the basis in CFC stock would similarly increase in total by $10 ($100 basis increase under Section 961(a) less $90 basis decrease under Section 961(b)). The basis consequences thus are sensible.

However, this approach requires a flexible interpretation of the Same Manner Requirement. In particular, Section 951A(f)(1)(A) requires GILTI inclusions to be treated in the "same manner" as Subpart F inclusions for purposes of Section 959, and under this approach, GILTI inclusions are explicitly not being treated in the same manner as a Subpart F inclusion. A $100 Subpart F inclusion would create $100 of PTI, whereas under this approach, a $100 GILTI inclusion would create only $90 of PTI; so, concluding that a GILTI inclusion is treated in the same manner as a Subpart F inclusion raises technical questions. The argument supporting this approach would be that there are fundamental differences between the Subpart F regime and the GILTI regime (most relevantly, GILTI being a net income concept, as opposed to Subpart F income, which generally is limited to E&P for the taxable year) that require different Section 959 mechanics. Under this view, it is simply not feasible for the GILTI regime to mechanically follow how Section 959 applies to Subpart F inclusions and achieve a satisfactory result.

A third approach would prioritize the Same Manner Requirement over the E&P Requirement and the Again Included Requirement. Assume CFC earned the $100 of GILTI tested income in Year 1, again with only $90 of E&P, and also in Year 1 CFC distributed the $100 to USP. This approach would conclude that, notwithstanding that the E&P is only $90, the full $100 distribution is a distribution out of PTI. With respect to the $10 excess, the E&P Requirement and the Again Included Requirement do not appear to be satisfied, because such excess is not in fact E&P, nor would the distribution of such amount be again included in income by USP. The Same Manner Requirement appears to be satisfied, though, because the entire inclusion is treated as PTI that will be distributed at the earliest possible time, analogous to the results if the inclusion in Year 1 were instead for traditional Subpart F income.

In Rev. Rul. 82-16,[99] the Service seems to have ignored (or flexibly interpreted) either the Attributable to Requirement or the Again Included Requirement. In the ruling, Section 959(b) did not literally cover a distribution from a lower-tier CFC to an upper-tier CFC. USP owned 70% of CFC1 stock (with non-U.S. shareholders owning the remaining 30% of CFC1 stock), and CFC1 owned 100% of the stock of CFC2. CFC2 earned $100 of Subpart F income, and USP included $70 under Section 951(a). CFC2 distributed $200 to CFC, of which only $70 had been included by USP under Section 951(a). Notwithstanding that only $70 had actually been included, the ruling holds that $100 of the distribution can be excluded from CFC1's gross income for purposes of applying Section 951 to USP. Without allowing the full $100 to be excluded from gross income, USP would be taxed twice on its share of the extra $30. Thus, the Service took a practical approach to get to the correct PTI answer. But that extra $30 had never been included in USP's gross income, so the $30 did not reflect E&P attributable to an amount previously included (thus violating either the Attributable to Requirement or the Again Included Requirement). This ruling demonstrates a willingness to be flexible in interpreting Section 959.

With respect to the netting of PTI with E&P deficits, Treasury should consider issuing Regulations providing that a Section 959(c)(3) deficit is not netted with the amount of PTI;[100] rather, both amounts can coexist as disaggregated components of a CFC's E&P. The 2006 Proposed Regulations sensibly provide that Section 959(c)(3) deficits do not reduce PTI.[101]

Whether what would otherwise be Section 301(c)(2) distributions can be PTI distributions depends on what approach is taken in interpreting the statutory language of Sections 959(a) and 951A(f)(1)(A). As noted in the three alternatives laid out above, the analysis is dependent upon which of the E&P Requirement, the Attributable Requirement, the Again Included Requirement, and the Same Manner Requirement is interpreted strictly and which is interpreted flexibly.

Example 17: Whether GILTI tested income that is offset by tested loss of another CFC creates "offset" PTI

This Example 17 addresses whether an "offset" PTI amount (similar to 965(b) PTI, but in the context of GILTI) should result where the tested loss of one CFC offsets the tested income of another CFC. If the stock of both CFCs are subsequently disposed of, the deficit of the tested loss

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[99] 1982-1 C.B. 106.

[100] This should extend to a Section 965 SFC that is neither a DFIC nor an E&P deficit foreign corporation deficit (e.g., because the SFC has $20 of PTI and a $10 deficit in Non-PTI E&P); such amounts should not offset each other for purposes of analyzing future distributions.

[101] *See* Prop. Reg. §1.959-3(e)(5) (2006). The 2015 Report referred to this proposed Regulation, and in the context of Section 959(c)(3) deficits, discussed the implications of Section 362(e) basis adjustments on the amount of Section 961 basis. The 2015 Report did not explicitly address the merits of this feature of the 2006 Proposed Regulations.

CFC both reduces the GILTI inclusion and creates a loss upon disposition of CFC stock. At the same time, the earnings of the tested income CFC appear to be Exempt Income, by reason of the application of Section 1248 and the Section 245A DRD to the disposition of the tested income CFC. As discussed further below, we do not think that a deficit PTI amount is contemplated by the statute (at least it is not explicitly contemplated). Consistent with this observation, the Proposed GILTI Regulations do not provide a PTI regime; rather, as described above, they reduce basis in the stock of a deficit CFC to the extent of its net used tested loss, effective immediately prior to disposition of such stock. The key policy determination appears to be whether Congress intended to allow one CFC's earnings to give rise to Exempt Income where another CFC's deficit gives rise to a fully taxable loss.

	Year 1	Year 2
CFC1 starting basis	100	120
CFC2 starting basis	100	100
CFC1 tested income (loss)	100	
CFC2 tested income (loss)	(80)	
Total QBAI	0	0
CFC1 sale proceeds		200
CFC2 sale proceeds		20

USP owns 100% of the stock of each of CFC1 and CFC2, and USP has a basis of $100 in the stock of each of CFC1 and CFC2. In Year 1, CFC1 has tested income of $100 and CFC2 has a tested loss of $80. Neither CFC1 nor CFC2 has QBAI and there are no foreign taxes associated with the tested income. In Year 2, USP sells the stock of each of CFC1 and CFC2 to an unrelated party for $200 and $20, respectively.

As a result of the Year 1 Taxed Income, USP has a GILTI inclusion of $20 under Section 951A. CFC1 has $20 of PTI (assuming there is no "offset" PTI) and USP increases its basis in its stock of CFC1 from $100 to $120. Furthermore, CFC1 has $80 of Non-PTI E&P. Accordingly, before taking the Proposed GILTI Regulations into account, upon the Year 2 disposition, USP's $80 gain with respect to CFC1 stock is recharacterized under Section 1248 as a dividend eligible for the Section 245A DRD. USP has an $80 capital loss on its sale of CFC2 stock for $20.[102]

[102] This could be viewed as an inappropriate result, because foreign earnings are effectively not taxed while foreign deficits create a loss, notwithstanding the sale of both the income entity and the loss entity. In theory, a negative basis adjustment to the stock of the tested loss CFC and a positive basis adjustment to the stock of the tested income CFC would be one reasonable approach; however, there does not appear to be any explicit statutory authority to adjust basis in such manner (the Proposed GILTI Regulations cite *Charles Ilfeld Co. v. Hernandez,* 292 U.S. 62 (1934), as general authority for disallowing a double deduction; the validity of such basis adjustments are outside the scope of this Report) unlike certain other areas under Sections 959, 961, and 951A. However, there are different fact patterns where

One issue relevant to the PTI regime is whether CFC1 instead should be treated as having 100 PTI (i.e., 20 actual PTI, and 80 "deemed" PTI, similar to 965(b) PTI). Arguably, this approach would make all of CFC1's E&P unavailable for Section 1248 recharacterization, thus resulting in USP's entire $80 gain to be treated as taxable capital gain (converting Exempt Income into Fully Taxed Income). However, as noted above in the context of 965(b) PTI, Section 1248(d)(1) only excludes from Section 1248 recharacterization amounts actually "previously included in the gross income of such person" under Section 951 (including for this purpose, Section 951A[103]). Although hypothetical GILTI "deemed" PTI might be treated as PTI for purposes of applying Section 959 to distributions, such earnings were never in fact "included in the gross income" of the U.S. Shareholder (i.e., they were offset by deficits). Thus, it is not clear that Section 1248(d)(1) would operate to exclude such earnings from Section 1248(a) treatment, and in fact the statutory language suggests otherwise. Thus, converting GILTI tested income that is offset by tested loss into "deemed" PTI creates a new set of issues. Similar to 965(b) PTI, a new type of deemed PTI also would create results different from a Single CFC Approach.

Furthermore, whereas Congress specifically provided for 965(b) PTI in the case of a deficit CFC offsetting the ADFI of a DFIC for purposes of determining the Section 965 inclusion amount, it did not provide an analogous mechanism for GILTI tested income that is offset by GILTI tested loss. Similarly, the PTI regime does not appear to provide explicit statutory authority to create "offset" PTI on account of tested loss. The regulatory authority under the GILTI regime is narrow, allowing Treasury to issue Regulations to prevent the avoidance of the purposes of the QBAI rules, and, as such, may not support addressing any concerns through the PTI regime. If Treasury did adopt a special PTI rule in this case, complex basis rules would be necessary both for CFC stock

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it may be appropriate to allow a loss on the tested loss CFC even though the gain on the tested income CFC is recharacterized as a Section 1248 dividend eligible for Section 245A. For example, if CFC1's tested income would not have given rise to a GILTI inclusion because CFC1 had sufficient QBAI (resulting in NTDIR in excess of tested income), CFC1 would not be "using" CFC2's loss to reduce the GILTI inclusion. Rather, there, Congress specifically chose to treat such earnings as Exempt Income, and thus to not to tax such earnings. In such a case, there was no need to share CFC2's tested loss with CFC1, because CFC1's income was already Exempt Income. Allowing USP to recognize a loss on the sale of CFC2 does not involve the same "double utilization" of CFC2's single economic loss; rather, it involves using one attribute (QBAI in CFC1) to shield economic income of CFC1 and another attribute (economic loss in CFC2) to cause a tax loss on CFC2 stock. Nonetheless, the Proposed GILTI Regulations require a negative basis adjustment to the stock of a CFC with net used tested loss, irrespective of the corresponding income CFC's QBAI. A future NYSBA report dealing with the Proposed GILTI Regulations is expected to discuss these issues, and whether there are policy concerns supporting this negative basis adjustment.

If it was CFC2 (and not CFC1) that had the QBAI, and CFC2 earned some immaterial amount of tested income (instead of having tested loss), then a similar type of GILTI attribute sharing occurs. In such a case, it is not apparent that basis should shift from CFC2 stock to CFC1 stock, even if there were statutory authority to make such a shift. Thus, whether USP should be allowed tax-free gain on CFC1 stock and taxable loss on CFC2 stock may depend on why the gain on CFC1 stock is tax-free.

[103] *See* Section 951A(f)(1)(A).

under Section 961 and consolidated group member stock under Reg. §1.1502-32, and consideration would need to be given to the proper treatment of FTCs on the distribution of the deemed PTI.

Example 18: Different PTI types carry different tax credits

As discussed above, there is no ordering rule governing the various types of Section 959(c)(2) PTI. As a simple example of the resulting issues from lack of an ordering rule, if CFC earns Subpart F income in Year 1 and GILTI tested income in Year 2, each of which is included by USP, and then in Year 3 CFC makes a distribution to USP, there is a question as to which PTI sourced the distribution. This could make a difference if, for example, foreign currency exchange rates fluctuated between Years 1 and 2 such that a different amount of foreign currency gain or loss would need to be recognized in Year 3 under Section 986(c) depending on whether Year 1 PTI or Year 2 PTI sourced the distribution. As a more involved example, this Example 18 illustrates how a CFC may generate different types of Section 959(c)(2) PTI that are each associated with different amounts of foreign taxes paid or accrued and, as a result, the tax consequences of a PTI distribution may differ depending on what type of PTI is distributed. As explained below, Treasury should consider policies which may dictate a particular priority between the different types of Section 959(c)(2) PTI, but in the absence of contrary policies, using a LIFO approach seems consistent with Sections 316 and 959(c).

	Year 1	Year 2	Year 3
CFC2 Sub F income	100		
CFC2 tested income		60	
CFC2 distribution	100	60	
Withholding tax	10	0	
(net of withholding)	90	60	
CFC1 distribution			50

USP owns 100% of the stock of CFC1, which owns 100% of the stock of CFC2. In Year 1, CFC2 earned \$100 of Subpart F income and distributed \$90 (net of a \$10 withholding tax) to CFC1. In Year 2, CFC2 earned \$60 of GILTI tested income and USP included \$60 of GILTI under Section 951A. Also in Year 2, CFC2 distributed \$60 to CFC1 but there was no withholding tax on the distribution (for example, by reason of becoming eligible for an applicable treaty). In Year 3, CFC1 distributes $50 to USP.

At the time of the Year 3 distribution, CFC1 has $150 of PTI ($90 of Subpart F PTI with $10 of associated taxes from Year 1, and $60 of GILTI PTI with $0 of associated taxes from Year 2). One issue is which PTI is treated as distributed in Year 3. This may be relevant for purposes of USP taking the correct amount of FTCs, including if taxes on distributions of GILTI PTI need to be separately tracked by reason of going into the GILTI FTC basket. It should be noted that Section 956 PTI from prior investments in U.S. property (none in this Example 18) would be treated as distributed first under Section 959(c)(1), prior to the distribution of any Section 959(c)(2) PTI.

One approach would be to treat the $50 distribution as carrying a pro rata portion of CFC1's Section 959(c)(2) PTI, regardless of the year in which such PTI was generated. Under this view, $30 of Subpart F PTI and $20 of GILTI PTI (proportionate to the $90 Subpart F PTI and $60 GILTI PTI) would be deemed distributed. Thus, the $30 of Subpart F PTI would presumably carry $3.33 of FTCs under Section 960(b) from the withholding tax ($30/$90, or one third, of the $10 withholding tax).

A second approach would be to create a priority between the categories of Section 959(c)(2) PTI (i.e., GILTI PTI, traditional Subpart F PTI, 965(a) PTI, or 965(b) PTI). Under this approach, the $50 distribution would come out of the Subpart F PTI or GILTI PTI, depending on such priority, and the FTC results (and foreign currency results, if any) would follow from such priority. For example, perhaps there is a systemic preference for the distribution of PTI attributable to Section 965; but if there is such a preference, it is not clear from existing authorities.

Finally, the PTI could be distributed under a "last-in first-out" method, such that, on the facts of this Example 18, the entire distribution would be deemed to be made out of GILTI PTI, and the distribution would not carry any FTCs under Section 960(b) (on other fact patterns, the LIFO method of course might have favorable FTC consequences). If different categories of Section 959(c)(2) PTI were generated in the same year, then a pro rata rule would apply.

A separate issue arising when multiple types of PTI could be the source of a distribution is specific to Section 965, namely the "haircuts" required for certain items with respect to Section 965. As noted above, Section 965(g) generally disallows a portion of an SFC's FTCs to take into account the lower effective rate on ADFI (i.e., in the case of a corporation, 15.5%, 8%, or a blend thereof). Similarly, the same proportion of foreign currency gain or loss is ignored for purposes of Section 986(c), which otherwise would require gain or loss on the foreign currency to capture currency movements between generating the earnings and distributing them.[104] Further, under the

[104] *See* Prop. Reg. §1.986(c)-1(b) (2018) (any gain or loss recognized under Section 986(c) with respect to distributions

Proposed 965 Regulations, Section 986(c) does not apply to distributions of 965(b) PTI.[105] For these reasons, there may be a preference so give a higher priority to distributions of 965(a) PTI and 965(b) PTI, in part to further the apparent policy of allowing U.S. Shareholders to recover PTI at the earliest possible time, and in part to clear out the complications that come along with Section 965 attributes as soon as possible.

Treasury should consider whether policies, including policies to prioritize the distribution of 965(a) PTI and 965(b) PTI, dictate a priority between different types of Section 959(c)(2) PTI, but in the absence of competing policies, the final approach described above, of distributing PTI within Section 959(c)(2) categories on a LIFO basis, seems to be consistent with the general ordering of Section 316(a)(2) and the reference to Section 316 in Section 959(c), and thus would be a reasonable approach.

VII. Foreign Tax Credits Relating to PTI

There are numerous uncertainties concerning FTCs associated with PTI. The subject of FTCs is beyond the scope of this Report. Select issues are presented here in summary form for consideration by Treasury.

One issue, noted above, is whether FTCs taken by reason of withholding tax imposed on a distribution of PTI from one CFC to another CFC results in an additional Section 78 gross-up equal to the amount of the foreign tax credit. Section 78 provides dividend treatment for "an amount equal to the taxes deemed to be paid by such corporation under subsections (a), (b), and (d) of section 960", and the withholding taxes imposed on distributions of PTI are creditable under Section 960(b). While this result seems incorrect, the application of Section 78 is beyond the scope of this Report.

Another issue, explored further below, is whether FTCs attributable to 965(b) PTI can be taken under Section 960(b) (or former Section 960(a)(3) for tax years beginning before January 1, 2018), upon distribution of 965(b) PTI. The Proposed 965 Regulations address this with respect to former Section 960(a)(3), as described below.

A final issue explored below is whether the haircut under Section 965(g) should apply to FTCs associated with a distribution of 965(a) PTI (e.g., withholding or intermediate income taxes). The Proposed 965 Regulations address this, as described below.

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of 965(a) PTI is reduced in the same proportion as the Section 965(c) deduction bears to the Section 965(a) inclusion amount).

[105] *See* Prop. Reg. §1.986(c)-1(c) (2018).

Example 19: FTCs on distribution of 965(b) PTI

This Example 19 examines whether FTCs attributable to 965(b) PTI should be taken under Section 960(b) (or former Section 960(a)(3) for tax years beginning before January 1, 2018), upon a distribution of 965(b) PTI. The Proposed 965 Regulations do not allow such a credit. We do not make a recommendation concerning this issue, but present the issue for consideration. A future NYSBA report dealing with foreign tax credits may address this issue.

	2017	2018
CFC1 ADFI (deficit)	100	
CFC2 ADFI (deficit)	(100)	
CFC1 foreign taxes on ADFI	10	
CFC1 distribution		100

USP owns 100% of the stock of each of CFC1 and CFC2. As of November 2, 2017 and December 31, 2017, CFC1 has $100 of ADFI (and has paid $10 of foreign tax associated with that ADFI), and CFC2 has a deficit in post-1986 E&P of $100. Consequently, USP has no inclusion under Section 965 and CFC1 has $100 of 965(b) PTI. In 2018, CFC1 distributes the $100 of 965(b) PTI to USP.

Under the statute, it would appear that USP can claim the $10 of FTCs under Section 960(b). Is this result appropriate? The issue is whether the "properly attributable" standard of new Section 960 is interpreted to include such taxes. It may not be appropriate to allow USP to take FTCs on a distribution of 965(b) PTI, given that USP did not have a Section 965 inclusion amount. However, as discussed above, 965(b) PTI has many features of Fully Taxed Income (as opposed to Exempt Income), suggesting that a U.S. Shareholder taxed directly or indirectly on 965(b) PTI should be treated as paying the associated foreign taxes. Whether USP is taxed on the *distribution* of 965(b) PTI may drive the policies here. In other words, if 965(b) PTI is treated as Exempt Income (i.e., it neither causes gain nor reduces a tax benefit with respect to stock of another CFC), then it would seem inappropriate for a distribution of 965(b) PTI to cause the U.S. Shareholder to be treated as having paid the CFC's foreign taxes. If, however, 965(b) PTI is treated as Fully Taxed Income, then allowing FTCs might be appropriate.[106] In particular, if USP does not have sufficient basis in CFC1 stock, and is not provided basis under Section 961(a) (as described above) (or does not make the election under Prop. Reg. §1.965-2(f) (2018)), then USP may be taxed on the 2018 distribution. In such a case, the Section 960(b) FTC might be appropriate, in order to

[106] Even if 965(b) PTI is treated as Fully Taxed Income, the U.S. Shareholder will likely still hold its deficit CFC stock at a loss, and thus could neutralize the excess gain from a distribution by, or disposition of, the DFIC by disposing of the deficit CFC stock. In some fact patterns, however, disposing of the deficit CFC stock is not practical.

mitigate double taxation at the corporate level. Furthermore, if the 2018 distribution results in a basis reduction under Section 961(b) (without an earlier basis increase under Section 961(a)), this reduction could give rise to future gain upon a disposition of CFC1 stock. Comparing to a Single CFC Approach, consideration might be given to whether the effects of a single CFC (presumably less foreign tax by reason of the ability to offset income with deficit) as opposed to multiple CFCs should be taken into account in determining which foreign taxes are treated as paid by the U.S. Shareholder.

The Proposed 965 Regulations disallow any credit under Section 960(a)(3)[107] (or any other Section[108]) for FTCs that would have been deemed paid with respect to 965(b) PTI.[109] The Proposed 965 Regulations reserve on the issue for credits under new Section 960(b) (i.e., with respect to distributions occurring during taxable years after the transition year).

Example 20: Section 965(g) haircut on distribution of 965(a) PTI

This final Example 20 explores whether the haircut under Section 965(g) should apply to foreign taxes associated with a distribution of 965(a) PTI or 965(b) PTI (e.g., withholding or intermediate income taxes). The Proposed 965 Regulations provide for such a haircut on distributions of 965(a) PTI and 965(b) PTI. We do not make a recommendation concerning this issue, but present the issue for consideration. A future NYSBA report dealing with foreign tax credits may address this issue.

[107] Section 960(a)(3) is the precursor to new Section 960(b) and is applicable to the transition year and prior years. Prior to being replaced by Section 960(b), Section 960(a)(3) treated a PTI distribution to a U.S. corporation as a dividend, solely for purposes of taking into account Section 902 FTCs on the earnings with from which the distribution was made (and that were not previously deemed paid by the U.S. corporation).

[108] Presumably the reference to any other Section does not include new Section 960(b), on which the Proposed 965 Regulations specifically reserve. *See* Prop. Reg. §1.965-5(c)(1)(iii) (2018).

[109] *See* Prop. Reg. §1.965-5(c)(1)(ii) (2018). A portion of withholding taxes on transition year distributions of both 965(a) PTI and 965(b) PTI are available under the Proposed 965 Regulations. *See* Prop. Reg. §1.965-5(c)(1)(i) and (ii) (2018).

	2017
CFC2 ADFI	90
CFC2 foreign taxes	10
USP rate on 965 inclusion	15.5%
CFC2 distribution	90
Withholding tax	5
(net of withholding)	85
CFC1 distribution	85

USP owns 100% of the stock of CFC1 which owns 100% of the stock of CFC2. CFC2 has $90 of ADFI and has paid $10 of foreign taxes associated with that income (i.e, CFC2 earned $100 of pre-foreign tax income, on which it paid $10 of foreign tax, resulting in $90 of ADFI). USP is taxed on CFC2's $90 ADFI at a rate of 15.5%. CFC2 distributes $85 to CFC1 and (net of a $5 withholding tax on the distribution). CFC1 distributes $85 to USP.

USP's FTC with respect to CFC2's ADFI is determined under prior Section 960(a)(1) (effective during the transition year and prior years) and is subject to a haircut of $5.57 (i.e., (35% -15.5%) / 35%), or .557,[110] of $10), resulting in $4.43 of foreign taxes deemed paid. Should USP's FTC for the $5 withholding tax on the distribution from CFC2 to CFC1 under prior Section 960(a)(3) (or, if in a later year, new Section 960(b)) be similarly haircut under Section 965(g)? Under the statute, it appears that no haircut should apply, because Section 965(g) refers to deductions under Section 965 and the distribution from CFC2 to CFC1 does not result in a deduction under Section 965. However, the Proposed 965 Regulations provide for a haircut on withholding taxes and intermediate income taxes imposed on distributions of 965(a) PTI and 965(b) PTI.[111]

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[110] *See* Section 965(g)(2)(B).

[111] *See* Prop. Reg. §1.965(c)(1)(i) (2018).