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Report No. 1485
December 21, 2023

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The Honorable Richard Neal
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Re: Report No. 1485 – Report on Proposed Section 1059(g)

Dear Messrs. Wyden, Crapo, Smith and Neal:

I am pleased to submit Report No. 1485 of the Tax Section of the New York State Bar Association on selected issues relating to proposed Section 1059(g), a provision contained in bills for the "Build Back Better Act" previously considered by Congress.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Philip Wagman
Chair

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Report No. 1485

New York State Bar Association Tax Section

Report on Proposed Section 1059(g)

December 21, 2023

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Report No. 1485

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Report on Proposed Section 1059(g)

I. Introduction

The New York State Bar Association Tax Section (the "**Tax Section**") is submitting this report (the "**Report**")[1] on a proposal made in the Build Back Better Act passed by the House of Representatives in November 2021 ("**Proposed Section 1059(g)**").[2] If enacted, Proposed Section 1059(g) would require a basis reduction for distributions of "disqualified CFC dividends" by a controlled foreign corporation ("**CFC**")[3] for which a dividends received deduction ("**DRD**") is allowable.[4] A "disqualified CFC dividend" generally is a distribution from earnings and profits ("**E&P**") earned during any period that the distributing corporation was not a CFC and E&P earned during any period that the distributing corporation was a CFC that is attributable to stock that was not owned by United States shareholders ("**U.S. Shareholders**")[5] (collectively, such E&P "**Section 1059(g) E&P**" and all other E&P "**non-Section 1059(g) E&P**").

[1] The drafters of this Report were Gordon E. Warnke, Karen Gilbreath Sowell, Matthew W. Hemond, Stephen M. Massed, and Joshua Micelotta. Helpful comments were received from William D. Alexander, Robert Cassanos, Marc A. Countryman, Lawrence M. Garrett, Andrew M. Herman, Joshua M. Holmes, Kevin M. Jacobs, Jiyeon Lee-Lim, Richard M. Nugent, Arvind Ravichandran, Joseph B. Ryan, Jason Sacks, Gary R. Scanlon, Michael L. Schler, Peter F.G. Schuur, Stephen E. Shay, Linda Z. Swartz, Joseph Toce, Philip Wagman, and Andrew R. Walker. This report reflects solely the views of the Tax Section and not those of the New York State Bar Association's ("**NYSBA**") Executive Committee or its House of Delegates.

[2] Section 138148(b), H.R. 5376 (Nov. 18, 2021). Unless otherwise indicated, all references to "**Section**" in this Report are to the U.S. Internal Revenue Code of 1986, as amended (the "**Code**"), or the regulations promulgated pursuant to the Code ("**Regulations**"), as the context requires. All references to the "**Service**" are to the Internal Revenue Service and the U.S. Department of the Treasury and the Service are referred to collectively as the "**Treasury**". All terms used in this Report and not otherwise defined herein have the meaning ascribed to them in the appendices to this Report.

[3] A CFC is any foreign corporation in which U.S. Shareholders (defined below) own more than 50 percent of the stock by vote or value, directly, indirectly or through attribution. Sections 951(b), 957(a) and 958.

[4] To the extent the required basis reduction exceeded the basis of the stock in the CFC, current gain recognition would be required.

[5] A U.S. Shareholder is a U.S. person that directly, indirectly, or through attribution owns 10 percent or more of the voting power or value of stock of a CFC. Section 951(b). Prior to The Tax Cuts and Jobs Act of 2017 (formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*", P.L. 115-97 (the "**TCJA**")), status as a U.S. Shareholder was determined solely with reference to voting power. *See* the TCJA, Section 14214 (adding the value prong of the U.S. Shareholder test, effective for taxable years beginning after December 31, 2017). In addition, prior to the TCJA, Section 958(b)(4) prevented the downward attribution of stock ownership by way of a foreign person.

There is no stated explanation of the policy concerns that led to Proposed Section 1059(g) or any indication of the expected universe of taxpayers to which it would apply.[6] At a high level, Proposed Section 1059(g) generally appears to be focused on ensuring that E&P imported from outside the U.S. taxing system (*i.e.*, Section 1059(g) E&P) cannot be distributed to result in a reduction or elimination of gain on a future disposition of CFC shares or with respect to distributions in excess of CFC stock basis. In light of this apparent focus, existing provisions in the Code that already apply to distributions of E&P by foreign corporations (current Section 1059 and Section 961(d)), and elections often made with respect to certain acquisitions of stock of foreign corporations (*i.e.*, elections under Section 338(g)), we believe that Proposed Section 1059(g) will apply only in relatively narrow additional circumstances.[7]

The rules that we believe will be required to allow Proposed Section 1059(g) to operate precisely and be neither over nor under inclusive would require creation of a new E&P tracing regime to delineate Section 1059(g) E&P from non-Section 1059(g) E&P and to determine when it is distributed. Such a tracing regime, while possible to create, would require a departure from the general rules for accounting for E&P that have been part of the Code since 1916, which generally treat E&P as an indivisible corporate-level attribute. While Congress has enacted special E&P regimes that require complex tracing mechanics to address policy issues that affect all multinational corporations (for example, previously taxed E&P under Section 959 ("**PTEP**") and the treatment of certain stock gains as dividends under Section 1248), such regimes have required considerable Treasury resources and complex rules, some of which have been under construction for decades.

We believe that it is important to consider whether the new tracing guidance needed to precisely implement Proposed Section 1059(g)[8] is appropriate relative to the expected small universe of affected taxpayers, or whether there is another approach to addressing the policy considerations underlying Proposed Section 1059(g) that may require less invasive changes to the current architecture of the Code. In this regard, the Report outlines the Pre-Sale Basis Reduction Rule (defined and discussed in Part V) for consideration, which would rely on existing Section 1248 tracing architecture. Because Section 1248 was designed for tracing E&P for different purposes, the Pre-Sale Basis Reduction Rule will not be a perfect substitute for a precise

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[6] Joint Comm. Tax'n, Estimated Budget Effects of the Revenue Provisions of Title XIII – Committee on Ways and Means, of H.R. 5376, the "Build Back Better Act," as Reported by the Committee on the Budget, with Modifications (Rules Committee Print 117-18, at 6 (Nov. 4, 2021)). The estimate of the funds expected to be generated by Proposed Section 1059(g) are subsumed under modifications to foreign tax credit limitations. The concept for Proposed Section 1059(g) has not been included in any of the Treasury proposals made in any "Greenbook" (*i.e.*, General Explanations of the Administration's Revenue Proposals).

[7] *See* Part IV.A.

[8] *See* Appendix B for examples of the tracing decisions and complexity that we believe would need to be addressed if Proposed Section 1059(g) were enacted in its current form and precisely applied so as to be neither underinclusive nor overinclusive as regards what we believe is its intended purpose.

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application of Proposed Section 1059(g). Nevertheless, when compared to the complexity that we believe would be necessary to precisely implement Proposed Section 1059(g), the resulting differences may be viewed as an acceptable tradeoff.[9]

Part II of this Report summarizes our recommendations as regards Proposed Section 1059(g). Part III reviews Proposed Section 1059(g) and current law Section 1248 as background for the discussion of our recommendations. Part IV discusses the scope, policy and administrative considerations related to Proposed Section 1059(g), which are important for formulating the appropriate guidance if enacted. Part V recommends that Congress consider alternatives to creating a new tracing regime, including in particular the Pre-Sale Basis Reduction Rule. Part VI outlines the possibilities for implementing Proposed Section 1059(g), if enacted in its current form. Finally, Part VII offers some reflections on other germane policy considerations.

In addition, we have included Appendices A through C to provide more granularity with respect to various matters discussed in this Report. Appendix A (Other Relevant Background) summarizes the extensive body of law that is required to fully understand Proposed Section 1059(g) and craft the required implementation regime. Appendix B (Allocation Rule) and Appendix C (Ordering Rule) contain our exploration of different models that could be considered for implementing Proposed Section 1059(g). These examples illustrate the result of our study that developing a tracing regime is the only path to implementing the precise policy of Proposed Section 1059(g) and that any simplifying method will not consistently produce the correct result.

II. Summary of Recommendations

A. Consider alternative approaches to Proposed Section 1059(g), including in particular the Pre-Sale Basis Reduction Rule, which are built from existing Code architecture instead of creating a new tracing regime.

B. Regardless of whether Proposed Section 1059(g) or another approach is adopted, provide ordering rules that would order E&P resulting in basis reductions last, thereby further reducing complexity and providing consistency with other rules in the cross-border arena addressing certain distributions and deemed distributions to U.S. Shareholders.

---

[9] In developing our analysis of the rules that would be needed to implement proposed Section 1059(g), as well as the Pre-Sale Basis Reduction Rule as a potential alternative, we have adhered to the fundamental construct that a CFC is a non-transparent entity and E&P is a corporate-level attribute. The effort needed to reconcile that fundamental construct with a proposed tracing regime like Section 1059(g), or more broadly with the GILTI regime, inevitably leads to substantial complexity, which a shift to a paradigm treating a CFC as transparent, with each equity holder having their own account, might mitigate. The considerations related to such a shift are beyond the scope of this Report. *See generally* David H. Schnabel, *Squaring the Circle—The New Rules Applicable When Selling CFCs*, 97 Taxes – The Tax Magazine 120 (Feb. 22, 2019).

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III. Proposed Section 1059(g) and Current Law Section 1248

The Code has a labyrinth of rules relevant to understanding how Proposed Section 1059(g) would fit into the current system. As noted above, Appendix A contains a detailed review of relevant areas of the law to provide perspective for reading the Report and its recommendations. This Part III reviews Proposed Section 1059(g) as well as Section 1248, which would be the measure of non-Section 1059(g) E&P (or E&P that was not imported) for applying the Pre-Sale Basis Reduction Rule discussed in Part V.

A. Proposed Section 1059(g)

1. HW&M Proposal

In September 2021, the House Committee on Ways and Means focused on the application of Section 1059 in the wake of the TCJA, introducing a proposal to expand Section 1059 by adding a new Section 1059(g),[10] which would treat "disqualified CFC dividends" as *per se* extraordinary dividends (the "**HW&M Proposal**").[11]

In the HW&M Proposal, a "disqualified CFC dividend" is a dividend paid by a CFC to a U.S. Shareholder that is attributable to E&P that was either (i) earned by such CFC during a "disqualified period" or (ii) attributable to gain on property which accrued during such disqualified period (the "**Built-in Gain Rule**").[12] The "disqualified period" included any period during which either the foreign corporation was not a CFC (the "**Non-CFC Period**" and such E&P, "**Non-CFC Period E&P**"), or such stock was not owned by a U.S. Shareholder (the "**Non-U.S. Shareholder Period**" and such E&P, "**Non-U.S. Shareholder Period E&P**"). Thus, under the HW&M Proposal, it appeared that both Non-CFC Period E&P and Non-U.S. Shareholder Period E&P constituted Section 1059(g) E&P.[13]

Under the HW&M Proposal, the distribution of Section 1059(g) E&P would be a *per se* extraordinary dividend that would result in a basis reduction in the subsidiary stock to the extent of the non-taxed portion of the dividend and gain recognition to the extent the basis reduction exceeded available basis. The Built-in Gain Rule would require taxpayers to value assets upon the direct or indirect acquisition of a foreign target corporation's stock, determine the assets' bases,

[10] Current Section 1059(g) would have been redesignated as Section 1059(h); the remainder of current Section 1059 would have been unaffected.

[11] H.R. 5376 (Sept. 27, 2021).

[12] Section 1059(g)(2) and (3) of H.R. 5376 (Sept. 27, 2021).

[13] As noted below, the Build Back Better Act as passed by the House of Representatives clarified that Section 1059(g) E&P included Non-U.S. Shareholder Period E&P in its version of Proposed Section 1059(g), which included a more detailed provision with respect to such E&P.

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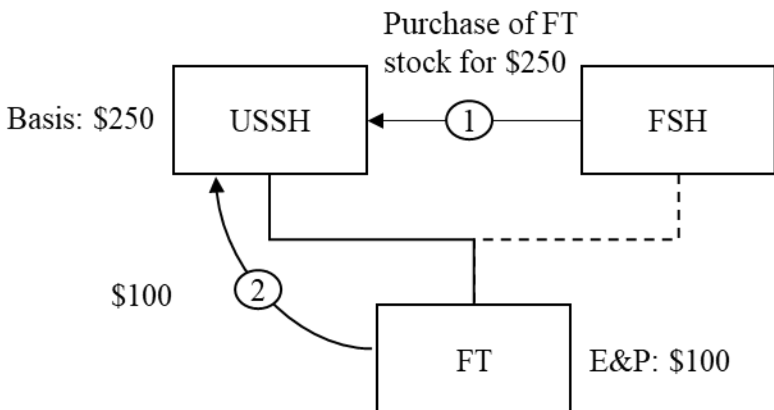
and maintain records regarding the movement of these assets.[14] The two basic concepts are illustrated in the following examples:[15]

Example 1: Non-CFC Period E&P – Basic



- USSH purchases FT from FSH, an unrelated foreign seller, for $250 on 1/1 of Year 1, when FT has $100 of untaxed E&P. Assume that USSH does not make a Section 338(g) election for the purchase.
- In Year 5, FT makes a $100 distribution to USSH that is eligible for a Section 245A DRD.[16]

Under the HW&M Proposal, USSH would be required to reduce the basis of its FT stock by $100 (from $250 to $150) because FT's $100 distribution would be sourced from Non-CFC Period E&P.

---

[14] The Built-in Gain Rule in the HW&M Proposal would have required taxpayers to track unrealized appreciation (but not depreciation) in a target's assets. This rule is discussed further in Part VII.B.

[15] In all examples in this Report and the appendices hereto, unless otherwise noted, each corporation has only one class of shares outstanding, all shares in any corporation held by a shareholder have been owned by that shareholder since the formation of the corporation, the corporation has no E&P or E&P deficits other than that set forth in the example, all E&P of the corporation is untaxed E&P (*i.e.*, it has not previously been included in income by a U.S. Shareholder), each USSH is a domestic corporation and each FSH is a foreign corporation without any U.S. Shareholders, each USSH has uniform basis in the stock it owns (*i.e.*, no USSH has "basis blocks" with respect to a subsidiary), each USSH is eligible for a 100-percent Section 245A DRD with respect to all dividends received, and Section 304 does not apply to any sales among shareholders.

[16] As discussed in footnote 15, in all examples in this Report and the appendices hereto it is assumed that a CFC has no E&P and no E&P deficits, except as otherwise noted in the example. Accordingly, in this Example 1, CFC has no E&P and no E&P deficit in Years 1 through 5.

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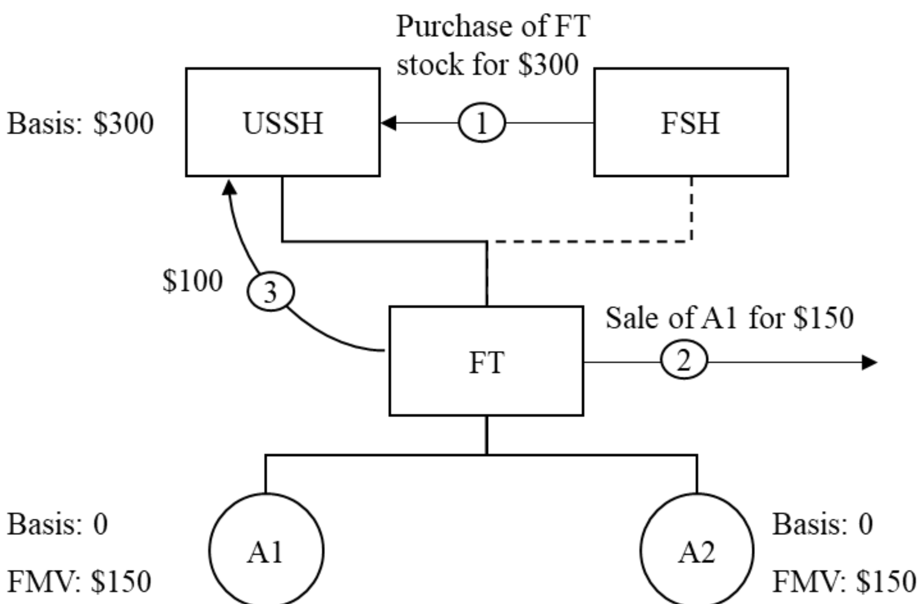
Example 2: Built-in Gain Rule



- USSH purchases FT from FSH, an unrelated foreign seller, for $300 on 1/1 of Year 1, when FT has $0 of E&P and owns Assets 1 and 2. Assume that USSH does not make a Section 338(g) election for the purchase.

- FT has a basis of zero in Assets 1 and 2, and Assets 1 and 2 each has a fair market value of $150.

- On 1/1 of Year 2, FT sells Asset 1 for $150, recognizing $150 of gain that is neither Subpart F income nor results in GILTI.[17]

- In Year 5, FT makes a $100 distribution to USSH that is eligible for a Section 245A DRD.

Under the HW&M Proposal, USSH would be required to reduce its basis in the FT stock by $100 (from $300 to $200) because FT's $100 distribution would be sourced from Built-in Gain Rule E&P.[18]

[17] For example, assume the gain in Asset 1 is subject to a high-tax election. *See* Section 951A(c)(2)(A)(i)(III) (excluding any foreign income for which a high-tax election is made from GILTI).

[18] For a further discussion of issues relating to built-in gains, see Part VII.B.

2. Proposed Section 1059(g)

The core of the HW&M Proposal appeared in the version of the Build Back Better Act passed by the House of Representatives in November 2021 (*i.e.*, Proposed Section 1059(g)), effective for distributions after the date of enactment.[19] Proposed Section 1059(g) differed from the HW&M Proposal in certain important respects.

First, Proposed Section 1059(g) removed the Built-in Gain Rule from the definition of "disqualified CFC dividend," thereby abandoning the notion that inchoate E&P of an acquired foreign entity should be tainted for purposes of Section 1059. As noted above and discussed further in Part VII.B, the Built-in-Gain Rule would have been a relatively unprecedented feature of an E&P-based rule, would have required significant compliance time and expense and would appear to have been of questionable scope. With respect to the inclusion of both Non-CFC Period E&P and Non-U.S. Shareholder Period E&P in Section 1059(g) E&P, Proposed Section 1059(g) did not differ materially from the HW&M Proposal.[20]

Second, Proposed Section 1059(g) expanded the definition of disqualified CFC dividends to include dividends paid by a CFC from E&P that is attributable to disqualified CFC dividends received from other CFCs (the "**CFC-to-CFC Rule**").[21] The CFC-to-CFC Rule would address a fact pattern where, for example, a CFC acquires a foreign target with Non-CFC Period E&P, the foreign target makes a distribution to the CFC, and CFC repatriates the cash to its U.S. Shareholder.[22]

[19] Section 138148(b), H.R. 5376 (Nov. 18, 2021).

[20] Proposed Section 1059(g) removed the definition of "disqualified period" from the HW&M Proposal, and instead applied Section 1059(g) more specifically to corporations not wholly owned by U.S. Shareholders in Proposed Section 1059(g)(2)(C).

[21] Proposed Section 1059(g)(2)(A)(ii) of H.R. 5376 (Nov. 18, 2021).

[22] Under the HW&M Proposal, a distribution from the foreign target to the CFC could effectively purge the Non-CFC Period taint from the foreign target's Non-CFC Period E&P by creating "new" E&P at the level of the CFC, which E&P would not be Non-CFC Period E&P because it was generated by the recipient CFC while it was owned by the U.S. Shareholder.

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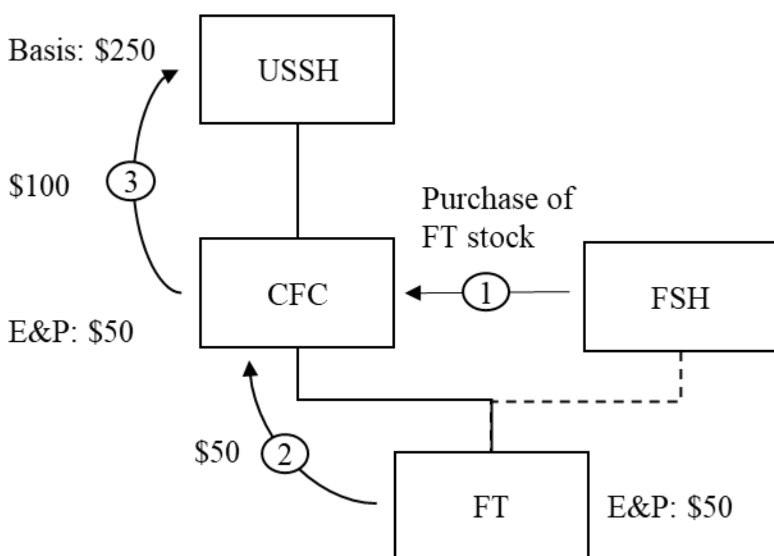
Example 3: CFC-to-CFC Rule – Basic



- USSH has owned CFC since its formation on 1/1 Year 1. CFC has $50 of untaxed E&P and USSH has a basis of $250 in the stock of CFC.

- On 1/1 Year 2, CFC purchases FT from FSH, an unrelated foreign seller, when FT has $50 of untaxed E&P. Assume that CFC does not make a Section 338(g) election for the purchase.

- In Year 5, FT makes a $50 distribution to CFC that is eligible for Section 954(c)(6) look-through treatment.[23]

- Also in Year 5, CFC makes a $100 distribution to USSH that is eligible for a Section 245A DRD.

Under the CFC-to-CFC Rule, the $50 of the $100 dividend from CFC to USSH attributable to the Non-CFC Period E&P of FT would be a disqualified dividend, and thus USSH would be required to reduce its basis in the CFC stock by $50 (from $250 to $200).

Third, Proposed Section 1059(g) provided that (i) the determination of whether a foreign corporation is a CFC is made without regard to Section 958(b)(4) repeal,[24] and (ii) domestic

[23] Eligibility for Section 954(c)(6) look-through treatment in this example assumes that Section 954(c)(6) will be extended past 2025.

[24] Proposed Section 1059(g)(2)(D) of H.R. 5376 (Nov. 18, 2021).

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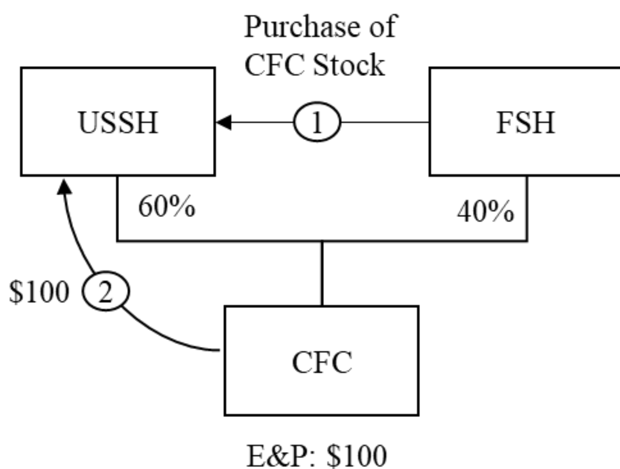
partnerships and certain trusts are not treated as U.S. Shareholders.[25] Determining CFC status by applying pre-repeal Section 958(b)(4) expands the amount of Non-CFC Period E&P by treating many CFCs as foreign corporations that are not CFCs for the years since repeal. This provision apparently has the impact of treating even E&P earned on shares owned by U.S. Shareholders in such foreign corporations as Section 1059(g) E&P for purposes of applying Proposed Section 1059(g).[26]

As noted above, Proposed Section 1059(g) also applies to Non-U.S. Shareholder Period E&P, which is treated as Non-CFC Period E&P for all purposes of Section 1059(g), even though earned by a foreign corporation at a time when it was a CFC.[27] More specifically, under Proposed Section 1059(g), where a CFC has non-U.S. Shareholders during any period, the "portion of [E&P] which is properly attributable to stock [owned by the non-U.S. Shareholders]" is treated as earned during a period when the CFC was not a CFC (*i.e.*, Non-U.S. Shareholder Period E&P).[28]

Example 4: Non-U.S. Shareholder Period E&P – Basic



- USSH has owned 60 percent of the stock in CFC, and unrelated FSH has owned the

[25] Proposed Section 1059(g)(2)(C) of H.R. 5376 (Nov. 18, 2021).

[26] E&P earned on shares in such foreign corporations by non-U.S. Shareholders would be treated as Section 1059(g) E&P without regard to whether the foreign corporation was a CFC. Accordingly, determining CFC status by applying pre-repeal Section 958(b)(4) would not appear to impact the treatment of E&P underlying any such shares as Section 1059(g) E&P versus non-Section 1059(g) E&P. We note that the Build Back Better Act would have reinstated Section 958(b)(4) and limited Section 245A to only foreign corporations that qualify as CFCs. Thus, the impact would have been limited to dividends from 10/50 corporations (owned at least 10 percent but not more than 50 percent by a U.S. corporation) that later become CFCs.

[27] Proposed Section 1059(g)(2)(B) of H.R. 5376 (November 18, 2021).

[28] *See* Proposed Section 1059(g)(2)(B).

remaining 40 percent of the stock in CFC, since its formation on 1/1 of Year 1.

- In Year 1, CFC generates $100 of untaxed E&P.
- On 1/1 of Year 2, FSH sells its 40 percent interest in CFC to USSH.
- In Year 5, CFC makes a $100 distribution to USSH.

Under Proposed Section 1059(g), USSH would reduce its basis in its CFC stock by $40, and recognize gain to the extent the basis reduction was in excess of available basis, because CFC's $100 distribution would be sourced from $40 of Non-U.S. Shareholder Period E&P. [29]

Proposed Section 1059(g), like the HW&M Proposal, would provide the Secretary of the Treasury with broad authority to prescribe regulations (or other guidance) as may be appropriate to carry out the purposes of Section 1059, including by providing for the coordination of Section 1059(g) with Section 1248 and other provisions.[30]

The draft legislative text released on December 11, 2021, by U.S. Senate Finance Committee Chairman Ron Wyden in response to Proposed Section 1059(g) was nearly identical to Proposed Section 1059(g). The Senate draft takes the grant of authority one step further, allowing the Secretary to effectively extend the CFC-to-CFC Rule to cover dividends attributable to E&P of foreign corporations that are not CFCs.[31]

The House bill and the Senate draft also would have restricted the Section 245A DRD to distributions on shares in CFCs held by U.S. Shareholders.[32] The Senate draft, however, would have provided a separate 65 percent DRD for dividends paid to corporate U.S. Shareholders in a specified 10-percent owned foreign corporation (an STFC[33]) that was not a CFC but for which the 100 percent DRD under Section 245A is available under current law.[34]

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[29] The CFC shares in which USSH would reduce its basis would depend on which shares the $40 of E&P attributable to the stock formerly owned by FSH is treated as distributed. For a discussion of this issue, see Appendix B, Examples 7 through 9.

[30] Section 138148(b), H.R. 5376 (Sept 27, 2021, and Nov. 18, 2021).

[31] Section 128147(b), H.R. 5376 (Dec. 11, 2021).

[32] Section 138128(a), H.R. 5376 (Sept 27, 2021).

[33] *See* Appendix A, Section C.2. for further delineation of the requirements for being an STFC.

[34] Section 128128(a) H.R. 5376 (Dec. 11, 2021). In the Senate draft, in the case of dividends received from an STFC that is not a CFC, the deduction would be limited to the applicable percentage under Section 243(a)(1) with respect to a 20-percent owned corporation (as defined in Section 243(c)(2)). As Proposed Section 1059(g) was drafted, evidently dividends formerly eligible for the 100 percent DRD under Section 245A but only eligible for a 65 percent DRD under

B. Section 1248 and Relevance to Proposed Section 1059(g)

Under Section 1248(a), gain recognized on a U.S. Shareholder's disposition of stock in a CFC is treated as dividend income to the extent of relevant accumulated E&P while the stock was held by that U.S. Shareholder. However, a U.S. Shareholder's gain can be reduced by any distributions that are eligible for Section 245A, regardless of whether the E&P was earned while the U.S. Shareholder held the stock. As noted in Appendix A, Section 961(d) was enacted by TCJA to require a reduction of basis in stock (but not below zero) by the amount of the Section 245A DRD for purposes of calculating the amount of any loss resulting from the disposition of the stock of an STFC in a subsequent taxable year. Congress purposefully limited Section 961(d) to loss augmentation to prevent a double tax benefit (loss and a DRD) and believed that reducing gain in this manner was appropriate in light of the policy of Section 1248.[35] It seems that perhaps Proposed Section 1059(g) would have the effect of extending Section 961(d) to gain reduction when the E&P is imported from a non-U.S. Shareholder, but E&P imported from a U.S. Shareholder and distributed before a disposition of shares could continue to have the effect of reducing gain upon disposition.

Section 1248 generally applies if a U.S. person sells or exchanges stock of a foreign corporation, and such person has owned 10 percent or more of the foreign corporation stock by voting power (under Sections 958(a) and (b)) at any time during the five-year period ending on the date of the sale or exchange when the foreign corporation was a CFC.[36] In that case, the U.S. person (a "**Section 1248 shareholder**") must include in income as a dividend any gain recognized on the sale or exchange (determined on a share-by-share basis) to the extent of the E&P of the foreign corporation attributable to the stock sold or exchanged that was generated during the time the stock was held by the Section 1248 shareholder while the foreign corporation was a CFC ("**Section 1248 E&P**").[37] If a corporate Section 1248 shareholder has owned a share of stock in the foreign corporation for at least one year before such stock is sold or exchanged, dividend income recognized by such shareholder under Section 1248 with respect to such share is treated

the Senate draft would not have been subject to Proposed Section 1059(g) because such dividends were not paid by CFCs.

[35] Committee on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, 115th Cong. 1st Sess. at 360 (S. Prt. No. 115-20). The legislative history of Section 961(d) is discussed further in footnote 63 of Appendix A. It does not mention distributions of E&P not subject to the rigors of the U.S. tax system.

[36] Section 1248(a). Section 964(e)(1) applies Section 1248 principles to treat a first-tier corporation's gain on the sale of shares of lower-tier corporation stock as a dividend to the extent of the lower-tier corporation's E&P attributable to the shares of stock sold by the first corporation.

[37] *Id.*; *see also* Section 1248(c)(2) (attributing E&P of lower-tier CFCs to an upper-tier CFC in certain cases).

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as a dividend for purposes of the Section 245A DRD.[38] Section 1248 E&P does not include certain types of E&P, including PTEP.[39]

The rules for determining Section 1248 E&P generally are well established and understood, providing a solid roadmap for developing an alternative approach like the Pre-Sale Basis Reduction Rule discussed in Part V. Certain of the more relevant Section 1248 rules are summarized below.

In determining the amount of Section 1248 E&P attributable to a share in a foreign corporation held by a particular Section 1248 shareholder, only the E&P generated by the foreign corporation during the period that the Section 1248 shareholder held the share and the foreign corporation was a CFC is taken into account. For this purpose, the Section 1248 shareholder's holding period generally includes any tacked holding period during which the Section 1248 shareholder is considered to have held the share under Section 1223, taking into account Regulations Section 1.1248-8 (discussed below).[40] There are two methods for attributing a foreign corporation's E&P to its shares: the simple case method (set forth in Regulations Section 1.1248-2) and the complex case method (set forth in Regulations Section 1.1248-3). Under the simple case method, a foreign corporation's Section 1248 E&P with respect to a Section 1248 shareholder is generally determined using the Code's normal E&P computation rules.[41] For all other cases, the complex case method will apply. The starting point for computing a foreign corporation's Section 1248 E&P with respect to a Section 1248 shareholder for a taxable year under the complex case method is the Code's normal E&P computation rules, but the complex case method also includes special adjustments for operating deficits of and distributions by a foreign corporation.[42] In certain circumstances, E&P of lower-tier subsidiaries is taken into account upon a disposition of CFC stock, by adding such amount to the Section 1248 E&P attributable to the stock of the upper-tier CFC stock being sold.[43] Section 1248 uses an annual layering approach for determining Section 1248 E&P.

To address concerns that the tacking of holding periods could lead to the attribution of an excessive amount of E&P to shares after certain "restructuring transactions" (*i.e.*, nonrecognition exchanges pursuant to acquisitive Section 368 reorganizations, Section 351 exchanges, and

[38] Section 1248(j).

[39] Section 1248(d).

[40] *See* Regulations Section 1.1248-1(a)(1).

[41] A Section 1248 shareholder can use the simple case method only if certain criteria are met (*e.g.,* the foreign corporation has only one class of stock and a constant number of shares outstanding on each day of each post-1962 taxable year which falls within the relevant holding period). Regulations Section 1.1248-2(d)(1).

[42] Regulations Section 1.1248-3(b), (d).

[43] Regulations Section 1.1248-3; Section 1248(c)(2).

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Section 332 liquidations), the Treasury issued Regulations Section 1.1248-8.[44] In general, Regulations Section 1.1248-8 ensures that only an "appropriate" amount of E&P is attributed to shares received by an exchanging shareholder by making adjustments to the tacking period depending on the circumstances and the property contributed.[45] There is also a catch-all provision aimed at avoiding multiple inclusions with respect to the same E&P.[46]

IV. Scope, Policy, and Administrative Considerations

A. Scope

As noted above, the scope of transactions to which Proposed Section 1059(g) may apply that are not already addressed by current law seems limited. In our experience, Section 338(g) elections are frequently made, when available, with respect to acquisitions of foreign corporations,

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[44] REG-135866-02 (June 2, 2006). The preamble to the proposed Section 1248 Regulations provides the following example to illustrate the potential for excessive attribution of E&P:

> For example, in a transaction described in [S]ection 351, a domestic corporation (DC1) contributes property to a foreign acquiring corporation (FA) in exchange for 80 percent of the voting stock in FA. Prior to the transaction, FA was wholly owned by another domestic corporation (DC2). Assume in the transaction that DC1 does not recognize gain under [S]ection 367(a) and the regulations under that [S]ection or include income under [S]ection 367(b) and the regulations under that [S]ection. The basis of the stock in FA received by DC1 in the transaction will be determined pursuant to [S]ection 358, and in determining DC1's holding period in the FA stock, DC1 will include, under [S]ection 1223(1), the period DC1 held the property it contributed to FA. Some taxpayers incorrectly interpret the existing [S]ection 1248 regulations to require that, if DC1 subsequently sells or exchanges the FA stock received in the restructuring transaction, the earnings and profits accumulated by FA before the transaction (*e.g.*, before DC1's period of actual ownership of the FA stock), but within the [S]ection 1223(1) holding period, are attributed to the FA stock received and sold by DC1. This interpretation would result in the inappropriate attribution of such accumulated earnings and profits to the FA stock held by both DC2 and DC1 (if DC2 sells or exchanges its FA stock, the accumulated earnings and profits of FA that were attributed to the FA stock sold by DC1 would correctly be attributed under the existing [S]ection 1248 regulations to the FA stock held by DC2).

[45] Regulations Section 1.1248-8 provides that where an exchanging shareholder receives, in a restructuring transaction, stock in a foreign corporation, the holding period of which is determined under Section 1223(1), and the exchanging shareholder is either a Section 1248 shareholder or a foreign corporate shareholder with respect to that foreign corporation immediately after the restructuring transaction, the E&P attributable to the stock the exchanging shareholder receives is determined on the basis of the type of property exchanged. *See* Regulations Section 1.1248-8(b)(2)-(4). For example, if the property exchanged is not stock of a foreign acquired corporation with respect to which the exchanging shareholder is a Section 1248 shareholder or a foreign corporate shareholder immediately before the transaction, the E&P attributable to the foreign corporation stock received by the exchanging shareholder is determined in accordance with Regulations Sections 1.1248-2 or 1.1248-3 (whichever is applicable) without regard to any portion of the Section 1223(1) holding period in that stock that reflects periods prior to the restructuring transaction. *See* Regulations Section 1.1248-8(b)(2)(i).

[46] *See* Regulations Section 1.1248-8(b)(5).

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thereby eliminating any pre-acquisition E&P of the foreign corporation.[47] Moreover, as discussed in Section D.2 of Appendix A, current Section 1059 already addresses dividends for which a DRD is available that exceed the Threshold Percentage and which are made within two years of the shares' acquisition, and, under Section 1059(e)(1), dividends arising from certain redemptions are subject to Section 1059 regardless of when the redemption occurs. Lastly, Section 961(d) applies to eliminate loss on the disposition of a CFC's stock to the extent of any prior dividends for which a Section 245A DRD was available.

Accordingly, the transactions with which Proposed Section 1059(g) is concerned seem limited to:

- the acquisition of a foreign corporation's shares directly or indirectly by a U.S. Shareholder without a Section 338(g) election or the acquisition of a foreign corporation's assets by a CFC in an E&P carryover transaction,
- followed by one or more distributions of the target corporation's E&P:
    - more than two years after the acquisition, or in an amount less than the Threshold Percentage, or with respect to shares that have already been owned more than two years;
    - to which Section 1059(e)(1) does not apply; and
    - which are in excess of basis or reduce gain upon a subsequent disposition of the acquired shares.

One such potential transaction is illustrated by Example 1. In that case, if not for the application of Proposed Section 1059(g), no reduction in USSH's $250 basis in the FT stock would occur. If the value of that stock (which presumably would decline to $150 immediately after the $100 distribution), were to increase to $250 or above in the future and then USSH were to sell such stock, Section 961(d) would not apply and USSH would maintain its $250 basis in the CFC stock.[48] Thus, the $100 distribution of FT's Non-CFC Period E&P could shelter up to $100 of post-acquisition appreciation (that is not matched by either an increase in PTEP and Section 961(a)

[47] In theory, the availability and potential use of imported E&P could be a factor in a taxpayer's decision whether to make a Section 338 election, although that is not consistent with the authors' experience.

[48] Even if the value of the stock were to increase to less than $250, Section 961(d) would not apply to such appreciation because it only applies to the extent there is otherwise loss.

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basis or untaxed E&P that would be available for Section 1248 purposes) in the FT stock owned by USSH.[49]

While Proposed Section 1059(g) would prevent this result, if applied as written without significant additional changes to the current E&P rules of the Code, it would have untoward results with respect to a number of other transactions that likely were not intended to be within its scope. These other transactions and the potential application of Proposed Section 1059(g) to them is illustrated in the examples in Appendix B.

B. Policy Considerations

As discussed above, Congress provided no explanation for Proposed Section 1059(g). Further, there is no separately stated revenue estimate that may give a window into the intended goals of Proposed Section 1059(g).[50] Consistent with other recently enacted statutory provisions,[51] determining how to interpret and administer a law that is not accompanied by explanation is difficult for the Treasury and taxpayers alike and may lead to incongruous results. Of course, understanding the rationale for new legislation is critical to the development of the implementing guidance required by the Treasury.

We suspect that Congress is focused on ensuring only earnings that have been subject to the rigors of the U.S. tax regime will be awarded the protection of Section 245A upon repatriation by an STFC. If a corporation's E&P is earned prior to becoming a CFC, such earnings would not have been subject to Section 965, GILTI, or Subpart F, but could be repatriated free of tax using Section 245A.[52] Perhaps the TCJA regime was intended to provide that there is only certain

[49] A similar outcome would result if (i) a CFC that had been owned by a U.S. Shareholder for more than two years acquired the stock of a foreign target without a Section 338(g) election or acquired the assets of a foreign target in an acquisitive asset reorganization, (ii) the historical E&P of the foreign target was distributed to the CFC's U.S. Shareholder as a dividend, and then (iii) the U.S. Shareholder disposed of its CFC stock. The dividend paid by the CFC would reduce the value, but not the basis, of the U.S. Shareholder's CFC stock (assuming Section 1059 is otherwise satisfied), thereby reducing the U.S. Shareholder's built-in gain with respect to its CFC stock.

[50] Joint Comm. Tax'n, Estimated Budget Effects of the Revenue Provisions of Title XIII – Committee on Ways and Means, of H.R. 5376, the "Build Back Better Act," as Reported by the Committee on the Budget, with Modifications (Rules Committee Print 117-18, at 6 (Nov. 4, 2021)).

[51] *See, e.g.*, Section 965 (added as part of the TCJA), the new corporate alternative minimum tax under Sections 55, 56A, and 59, and the stock buyback excise tax under Section 4501.

[52] This policy was also articulated as the rationale for Regulations Section 1.245A-5 (the "**Section 1.245A-5 Regulations**"), which limits the Section 245A DRD to the portion of a dividend that exceeds the "**ineligible amount**". In general, the ineligible amount is the sum of (i) 50% of the "**extraordinary disposition amount**", and (ii) 100% of the "**extraordinary reduction amount**". Generally, an extraordinary disposition amount is the portion of a dividend that is received by a Section 245A shareholder that is attributable to the shareholder's extraordinary disposition account with respect to the payor foreign corporation. Generally stated, a shareholder's extraordinary disposition amount reflects E&P generated from non-ordinary course dispositions of property by a CFC to a related party during

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income that is effectively exempt from U.S. federal income tax and for which a Section 245A DRD is allowed when distributed to a corporate U.S. Shareholder. For income earned after 2017, a primary component of this exempt income appears to be GILTI net tested income that is reduced by the 10 percent deemed return on qualified business asset investment in determining the U.S. Shareholder's GILTI inclusion under Section 951A.[53] Income earned before 2018 and after 1987 was required to be included in income by the TCJA under Section 965. Income earned before 1987 was not subject to Section 965.

Said differently, it seems that Proposed Section 1059(g) is focused on insuring that a taxpayer that acquires a foreign target cannot reduce gain on a later sale of the foreign target by repatriating earnings that were not subject to the rigors of the U.S. tax system when earned. The potential for recognizing a loss upon the sale of stock of a CFC that is attributable to a dividend that qualified for the Section 245A DRD was addressed by the addition of Section 961(d) by the TCJA. But Section 961(d) does not apply to reduce gain on a sale of stock.

Observations regarding additional policy issues that would be implicated if Proposed Section 1059(g) were to be enacted are discussed in Part VII.

C. Administrability Considerations

Companies that are not within the U.S. tax jurisdiction often do not keep detailed records of timing or amounts of earnings. While it is possible to forensically gain a sense of the amount and timing of earnings from local reporting requirements and Forms 5471 (for CFCs), such an

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the period from December 31, 2017 (the Section 965 measurement date) and before the TCJA was effective for fiscal year taxpayers. For purposes of determining the amount of a distribution that is attributable to a shareholder's extraordinary disposition account, a payor foreign corporation's non-extraordinary disposition E&P (*i.e.*, E&P not generated in an extraordinary disposition) is prioritized above its extraordinary disposition E&P.

With respect to a dividend received by a controlling Section 245A shareholder from a CFC during a year in which an "**extraordinary reduction**" occurs with respect to such shareholder's ownership in such CFC, the extraordinary reduction amount generally is the lesser of (i) the amount of such dividend, and (ii) such shareholder's pre-reduction, *pro rata* share of the CFC's Subpart F income and tested income. In general, an extraordinary reduction occurs when either (i) a controlling Section 245A shareholder directly or indirectly transfers, in the aggregate, more than 10% (by value) of its stock in a CFC, provided the amount transferred represents at least 5% (by value) of the outstanding stock in such CFC; or (b) there is a greater than 10% dilution in a controlling Section 245A shareholder's direct or indirect ownership in a CFC, provided the dilution is at least 5 percentage points (by value). If an extraordinary reduction occurs with respect to controlling Section 245A shareholder's ownership in a CFC and there would otherwise be an extraordinary reduction amount with respect to such shareholder, an election is permitted to close such CFC's taxable year as of the date of the extraordinary reduction. The result of this election is that the controlling Section 245A shareholder includes its *pro rata* share of such CFC's Subpart F income and tested income (*i.e.*, current year distributions by the CFC do not erode the U.S. taxation of such income).

[53] For more details on this reduction, and the GILTI rules in general, see Section B of Appendix A. For a discussion of other types of exempt income, see Part VII.B., below.

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exercise may not be simple.[54] This is the reason that many U.S. acquirors of foreign targets make Section 338(g) elections which result in the elimination of the earnings history and historic asset basis of the target corporation. The making of a Section 338(g) election gives the acquiror certainty regarding the attributes of the target corporation. However, it is not always possible to make a Section 338(g) election in light of the requirements to qualify for the election.[55]

Where no Section 338(g) election is made, regardless of Proposed Section 1059(g), the information regarding E&P will be necessary for accurate reporting of distributions by the acquired foreign corporation and the determination of the foreign-sourced portion of the distribution for the Section 245A DRD. If enacted, Proposed Section 1059(g) would require an additional level of information related to the history of ownership and changes in such ownership, as well as when income was earned as relates to such ownership (and potentially categories thereof). This information could be difficult to obtain if the foreign corporation was a CFC and ceased to be a CFC. If the foreign corporation was always a CFC, the information would be more readily available.[56]

Perhaps the most significant concern for the tax system is the need for a new tracing regime to make Proposed Section 1059(g) operational if it is to be precisely applied, and the required resources and time commitment for the Treasury to develop guidance. Current Section 1059, unlike Proposed Section 1059(g), generally does not require tracing of E&P to particular sources.[57] The complexity that would be involved in refining Proposed Section 1059(g) so that it addresses what we believe to be the focus of Congress is demonstrated in Part VI and Appendices B and C

[54] In a number of cases, it should be possible to trace the past ownership of a foreign target in order to determine whether the target went from foreign ownership to U.S. ownership for intervening years and whether E&P, if there were earnings, was subject to U.S. tax. However, this may not always be feasible, particularly if U.S. ownership was by attribution through intermediate entities.

[55] To be eligible to make a Section 338(g) election, a purchasing corporation must make a qualified stock purchase ("**QSP**") and make an election no later than the 15th day of the ninth month beginning after the month that includes the acquisition date. Section 338(g)(1). In order to make a QSP, the purchasing corporation must acquire at least 80 percent of the total voting power and at least 80 percent of the total value of the target stock from an unrelated party in a taxable transaction within a 12-month period. *See* Section 338(d)(3).

[56] Moreover, while Proposed Section 1059(g) would be effective for distributions after the date of enactment, the E&P accumulated prior to the date of enactment would still be subject to the rules and consequences of Proposed Section 1059(g). Therefore, Proposed Section 1059(g) has a retroactive effect. This effective date would mean that taxpayers that acquired foreign targets prior to the date of enactment for which a Section 338(g) election was not made would be charged with knowing the intricacies of the timing and source of the target's earnings and the history of the target's ownership, potentially with little ability to obtain such information.

[57] There are certain cases in which current Section 1059 requires tracing of E&P to particular sources. *See, e.g.*, the discussion of Sections 1059(d)(6) and (e)(2) in Appendix A. But those cases are not common and, moreover, the complexity involved in those cases can generally be avoided by deferring a distribution (or keeping it below the Threshold Percentage) and avoiding distributions to which Section 1059(e)(1) applies.

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through discussion of various possible E&P tracing approaches in the context of a variety of factual examples.

V. Alternative Approach to Addressing the Proposed Section 1059(g) Policy Goal

We urge Congress to consider whether there is an alternative approach that could address the policy concerns that motivated Proposed Section 1059(g) without creating a new E&P tracing regime. The Tax Section has explored a number of potential alternatives that may address the underlying congressional concern. For example, the Tax Section discussed a rule that would eliminate all of a foreign target's E&P regardless of whether a Section 338(g) election were made, which rule could be automatic or elective. These alternatives, while at first blush are seemingly simpler, generally raise the same need for a labyrinth of new rules to isolate the offending Section 1059(g) E&P.

One approach that we believe merits further consideration is a targeted rule to address what we perceive may be the primary problematic fact patterns without requiring the creation of a new E&P tracing regime to implement Proposed Section 1059(g). Proposed Section 1059(g) seems to be focused on a U.S. acquiror acquiring a foreign corporation with E&P that was not subject to the U.S. tax regime, distributing the E&P to reduce value and not basis, and selling the foreign corporation. Assuming this is the case, a rule fashioned after Section 1059(a) that polices such planning by focusing on the effect of distributions where there is a disposition of the foreign corporation within a certain timeframe could be used.

A. Outline of Pre-Sale Basis Reduction Rule

As an example, a rule could be developed to address cases in which a U.S. Shareholder acquires a foreign target and the foreign target makes distributions of certain types of E&P within a certain period of time (the "**Look-Back Period**")[58] prior to a taxable disposition (a "**Sale**") of shares in the foreign target (the "**Pre-Sale Basis Reduction Rule**"). Under the Pre-Sale Basis Reduction Rule, if a foreign corporation makes distributions on a share of stock within the Look-Back Period before a Sale of such share, the seller's basis in such share would be reduced immediately before the Sale by an amount equal to the amount of the foreign corporation's dividends made during the Look-Back Period from E&P earned while the shares were owned by another shareholder.

More specifically, instead of tracing to identify distributions of Section 1059(g) E&P as is evidently contemplated by the language of Proposed Section 1059(g) and reducing basis by that amount, the Pre-Sale Basis Reduction Rule would identify distributed Section 1248 E&P using the

[58] For example, the Look-Back Period could be defined to include distributions made in the five years preceding the Sale. Five years has been used, for example, in the built-in gain and loss rules in Section 382(h), the purchased basis rules of Section 355(d), and the five-year look-back period in the built-in gain provisions of Section 1374. Other areas of the Code and the Regulations also would provide support for other lengths of time for the Look-Back Period.

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architecture of the Section 1248 Regulations. While there are details that would need to be considered,[59] at its core, the Pre-Sale Basis Reduction Rule would apply to reduce a shareholder's basis in foreign corporation stock immediately prior to a Sale of such stock by a specified amount (the "**Reduction Amount**").[60] The Reduction Amount would be equal to the amount of the dividends made by the foreign corporation with respect to the foreign corporation's stock during the Look-Back Period that qualified for the Section 245A DRD,[61] *less* the *sum of* the amount of such dividends that were already subject to Section 1059 and the amount of such dividends comprised of Section 1248 E&P ("**Distributed Section 1248 E&P**").[62]

The adjustment for dividends that were already subject to Section 1059 would be necessary to avoid duplicative basis reductions, and the adjustment for Distributed Section 1248 E&P is appropriate because Section 1248 E&P distributed, by definition, was earned by a CFC during the

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[59] For example, for dispositions that are non-recognition transactions (*e.g.,* Section 368 reorganizations and Section 332 liquidations), consideration would need to be given to whether the Reduction Amount is inherited, eliminated, or recaptured. Moreover, whether a distribution taxable under Section 301(c)(3) should be treated as a Sale would need to be considered. In addition, for distributions to a corporation in a group filing consolidated returns followed by a sale of shares in that corporation or a higher tier corporation, rather than by a sale of shares in the distributing CFC, rules may need to be developed to avoid inappropriate results. In this latter regard, compare the provisions of the proposed GILTI Regulations that would adjust CFC stock basis (and stock basis of a consolidated group member that owns stock in the member holding the CFC stock) for "net used tested loss amounts". *See* 83 Fed. Reg. 51072 (2018). These provisions were the subject of a number of comments expressing concern that their operation would not appropriately address a number of issues and were not adopted when Treasury finalized other parts of the proposed GILTI Regulations in 2019. *See*, *e.g.*, the 2018 NYSBA Tax Section Report No. 1406, *Report on Proposed GILTI Regulations* (Nov. 26, 2018).

[60] Alternatively, instead of reducing basis (as with the Pre-Sale Basis Reduction Rule), a targeted rule might be formulated to increase the value of the disposed shares by an amount equal to what would otherwise be the Reduction Amount solely for purposes of determining gain (and not, for example, for purposes of adjusting basis or of Section 312(b)(2)). We expect that this formulation essentially would have the same effect as the Pre-Sale Basis Reduction Rule. The concept is similar to that provided in Regulations Section 1.7874-10 for non-ordinary course distributions ("**NOCDs**"), which increase the "by reason of" stock in the foreign acquiring corporation treated as received by former domestic entity shareholders by the fair market value of NOCDs made during the 36-month look-back period ending on the date of completion of the domestic entity acquisition and all related transactions. Regulations Section 1.7874-10(b), (k)(4).

[61] As in the case of Section 1248, the stock sold would not need to be stock in a CFC at the time of the Sale nor would a shareholder need to be a U.S. Shareholder at such time in order for the Pre-Sale Basis Reduction Rule to apply, so long as there had been a distribution during the relevant Look-Back Period with respect to which there was a Section 245A DRD.

[62] There are various ways in which Distributed Section 1248 E&P might be determined. Conceptually, Distributed Section 1248 E&P can be thought of as the amount that a dividend reduces the Section 1248 amount with respect to foreign corporation stock, determined without regard to the Section 1248(a) gain limitation. As so viewed, one way Distributed Section 1248 E&P might be determined with respect to a current year distribution is to calculate the amount that would be recharacterized as a dividend under Section 1248 (without regard to the gain limitation) if the U.S. Shareholder sold its shares immediately before the distribution and then repeat the computation with reductions for the distribution, with the difference being the Distributed Section 1248 E&P for U.S. Shareholder with respect to the distribution.

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Section 1248 shareholder's ownership period or during the ownership period properly succeeded to by a Section 1248 shareholder[63] and was not otherwise imported from another person.

Once the Reduction Amount is determined, it is possible that the Reduction Amount could exceed the U.S. Shareholder's basis in the sold shares immediately prior to a Sale. In that case, the U.S. Shareholder would have additional gain on the Sale of the stock. In addition, if, after applying the Pre-Sale Basis Reduction Rule, there is a loss in the CFC stock, Section 961(d) would then apply.[64]

We note that, because Section 1248 generally only recharacterizes gain as a dividend to the extent that the E&P underlying the shares sold was earned during the selling shareholder's period of ownership, a special rule would be needed so that the Pre-Sale Basis Reduction Rule would not reduce basis to the extent of non-Section 1059(g) E&P that was imported from another U.S. Shareholder. Proposed Section 1059(g) focuses on E&P imported only from non-U.S. shareholders.[65] In order to align with the Proposed Section 1059(g) focus, it should be possible to draft a rule to allow a U.S. Shareholder to make distributions of its share of E&P imported from other U.S. Shareholders solely for purposes of computing its Distributed Section 1248 E&P in applying the Pre-Sale Basis Reduction Rule so that the scope of the Pre-Sale Basis Reduction Rule would better align with the scope of Proposed Section 1059(g) in terms of the types of E&P subject to its purview.[66]

In addition, we note that adopting a Pre-Sale Basis Reduction Rule could result in less than the E&P earned during a U.S. Shareholder's period of ownership being treated as Distributed Section 1248 E&P. This is unavoidable in any system applying the current E&P determination of the Code, which can cause a shift in E&P underlying shares from existing shares to new shares whenever a new investment is made into a corporation.[67] Nevertheless, we believe this possible

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[63] *See* Regulations Section § 1.1248-8 (providing rules for Section 1248 E&P attribution in certain restructuring transactions).

[64] To prevent duplication of basis adjustments, Section 961(d) would ignore any distributions for which a basis reduction had already been effected under the Pre-Sale Basis Reduction Rule.

[65] Proposed Section 1059(g) would also apply with respect to certain E&P earned while shares were owned by U.S. Shareholders in foreign corporations that would not be CFCs under pre-repeal Section 958(b)(4). Any references to non-U.S. Shareholders in this Report and the appendices hereto also include U.S. Shareholders of such "technical" CFCs.

[66] Of course, this expanded approach may lead to greater complexity and would require further rules coordinating current Section 1248 as it applies to gains upon sales with the E&P treated as leaving the corporation upon a pre-sale distribution to ensure there is no over- or under-accounting for E&P to which Section 1248 should apply.

[67] *See* Section B of Appendix B for a further discussion of the shifting of E&P underlying shares from existing shares to new shares when a new investment is made.

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loss in precision is an acceptable tradeoff to the extreme complexity and alteration to the fundamental rules currently in the Code that would be necessitated by a precise tracing approach.

Lastly, current Section 1248 has the effect of "stacking" E&P earned while a U.S. Shareholder owned stock of a CFC first upon a disposition of that stock at a gain. That is, gain recognized upon a disposition of shares by a U.S. Shareholder is recharacterized as a dividend only to the extent of E&P earned while the share was owned by the disposing U.S. Shareholder and is so recharacterized regardless of the layering of E&P in the CFC. We believe the Pre-Sale Basis Reduction Rule would implicitly retain this stacking of E&P. To the extent that prior distributions are treated as from non-Section 1248 E&P, generally the concomitant basis reduction and increased gain will result in any remaining Section 1248 E&P up to the amount of the prior non-Section 1248 E&P distributions being recharacterized upon a Sale as a distribution of a dividend that is eligible for the Section 245A DRD. That is, the Pre-Sale Basis Reduction Rule, combined with the operation of Section 1248, generally will result in all Section 1248 E&P being accessed before any non-Section 1248 E&P impacts the overall outcome of the distribution and disposition transactions.[68]

B. Comparison of Pre-Sale Basis Reduction Rule to a New Proposed Section 1059 Regime

As noted above, there may be some differences in result between the Pre-Sale Basis Reduction Rule and a newly created Proposed Section 1059(g) regime. In terms of administrability and simplification, however, we believe the adoption of the Pre-Sale Basis Reduction Rule (or some variant thereof), even with the outlined rules needed to adapt current Section 1248 and the other issues that may need to be addressed, likely would be a significant improvement over Proposed Section 1059(g) and the tracing regime it would require.[69]

A key benefit of the Pre-Sale Basis Reduction Rule, when compared to Proposed Section 1059(g), is that it would utilize existing Section 1248 architecture, rather than create a new E&P tracing regime like those explored in Part VI.A. and Appendix B. Moreover, compared to Proposed Section 1059(g), the Pre-Sale Basis Reduction Rule provides greater parity in determining the amounts recharacterized as dividends with respect to gain on a disposition of CFC stock under Section 1248 for which a 100-percent Section 245A DRD may be available, and

[68] This self-correcting feature of the interaction of the basis reduction and dividend recharacterization rules will not hold as regards importation of Section 1248 E&P from other U.S. Shareholders, if such importation of E&P is desired. In those circumstances, absent additional changes, that E&P would only be eligible for dividend treatment to the extent distributed prior to a Sale. Accordingly, particular ordering rules stacking distributions of the imported Section 1248 E&P first might be considered.

[69] Even without any time-based limitation, we believe the Pre-Sale Basis Reduction Rule would be superior to creating a new tracing regime under Proposed Section 1059(g). We do not mean to suggest, however, that there might not be other alternatives to the Pre-Sale Basis Reduction Rule that might achieve Congress's goals while also being more consistent with existing Code architecture.

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amounts that would be treated as non-basis-reducing dividends if there is a distribution to which the Pre-Sale Basis Reduction Rule applied. As such, the Pre-Sale Basis Reduction Rule would aid in the coordination between distributions and current Section 1248 envisioned by the Proposed Section 1059(g) legislation.[70]

Another benefit of the Pre-Sale Basis Reduction Rule over Proposed Section 1059(g) is that the former would only be relevant when there is a Sale, at which point the taxpayer would otherwise be required to determine its Section 1248 E&P if the sale were at a gain. Proposed Section 1059(g), on the other hand, would require analysis and computations each time there is a distribution regardless of whether the corporation is ever sold. Limiting the rule to those situations that implicate the policy of Proposed Section 1059(g) would be a significant improvement as it relates to taxpayer burden.[71]

In addition, the rule would be time-limited, consistent with Section 1059(a), to address those fact patterns that appear to involve planning to take advantage of imported E&P. If the acquiring shareholder retains the foreign corporation or later disposes of the foreign corporation but did not make distributions that had the effect of reducing gain during the Look-Back Period, the Pre-Sale Basis Reduction Rule would not apply. Providing a temporal limitation with respect to application of the Pre-Sale Basis Reduction Rule diverges from Proposed Section 1059(g), which applies in perpetuity. Although we suggest the Look-Back Period could be five years, current Code Section 1059 would still apply for two years post-acquisition, such that Section 1059 would capture up to seven years of distributions (which may not be consecutive years).[72]

VI. Basic Operating Rules Needed if Proposed Section 1059(g) Is Enacted

Before taxpayers and the Service can appropriately apply Proposed Section 1059(g), if enacted, certain fundamental rules would need to be written to differentiate Section 1059(g) E&P from non-Section 1059(g) E&P. As explored in this Report and the appendices hereto, the needed rules would require the development of a new tracing regime for E&P which, as noted, would have a limited role in the tax law. To the extent that Congress does not address these issues if it enacts Proposed Section 1059(g), we believe that it is critical that the Treasury be given clear authority to provide guidance on these issues and that the effective date for the provision be delayed until

[70] *See* footnote 30, *supra*.

[71] It might be argued that delaying the basis reduction (and potential tax) until a Sale is not as consistent with the policies underlying Proposed Section 1059(g) as would a basis reduction contemporaneous with a distribution. If taxpayers are perceived to be regularly taking advantage of this timing benefit, an anti-abuse rule (or interest charge) could be drafted to address the concern.

[72] For example, assume USSH purchases the shares of CFC on Day 1, Year 1, and USSH holds the shares of CFC until Day 1, Year 10, at which time, USSH sells the shares of CFC. Distributions during Years 1 and 2 are covered under current Code Section 1059, and distributions during the Look-Back Period, *i.e.*, Years 5 through 9, would be covered by the Pre-Sale Basis Reduction Rule.

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this basic guidance is provided. If the implementation is directed to the Treasury, we recommend that Congress provide some indications as to the intended outcome and policy of Proposed Section 1059(g). Otherwise, this exercise may prove daunting in light of the known complexities of distinguishing and tracing types of E&P.

In particular, the new tracing regime needed to implement Proposed Section 1059(g) as drafted would need to address:

- To which shares (or to which shareholders) should Section 1059(g) E&P be treated as allocated (the "**Allocation Issue**"); and
- In what order should allocated Section 1059(g) E&P and non-Section 1059(g) E&P be treated as accessed (the "**Ordering Issue**").

A. Allocation Issue

For Proposed Section 1059(g) to operate, there must be clarity as to how Section 1059(g) E&P is allocated among particular shares (or shareholders). One way of doing this allocation that would not impact the regular E&P rules of the Code would be to keep shareholder level accounts tracking amounts that, when distributed to the shareholder, would be treated as Section 1059(g) E&P or non-Section 1059(g) E&P. This is essentially the approach that would be employed by the Pre-Sale Basis Reduction Rule suggested in Part V of this Report (and that is employed by current Section 1248 for purposes of determining the recharacterization of gain as a dividend when shares are sold).[73] While we suggest this approach (or a similar approach) be adopted, as previously noted, it can result in less non-Section 1059(g) E&P being treated as distributed with respect to the shares to which it is properly attributable than actually exists with respect to those shares because it does not account for E&P shifts that can occur when new investments are made in a corporation. (Preventing this result would require adoption of tracing rules similarly complex to the Full or Silo Tracing Approach discussed below and in Appendix B).

As discussed below and in the examples in Appendix B and C, one possible allocation interpretation of the current wording of Proposed Section 1059(g) that would not involve the keeping of shareholder accounts is that one should merely follow the current Section 316 allocation of E&P[74] (a "**Pro Rata Approach**"). There are at least two alternative Pro Rata Approaches that

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[73] As discussed in footnote 52, *supra*, the Section 1.245A-5 Regulations also provide a model for delineating shareholder E&P accounts and prioritizing E&P that qualifies for the Section 245 DRD.

[74] *See* Regulations Section 1.316-2(b). For distributions with respect to multiple classes of stock, see Rev. Rul. 69-440, 1969-2 C.B. 46 (if total distributions for two classes of stock are in excess of E&P, dividends must be regarded as having been distributed to those stockholders having priority under the corporate charter). To avoid adding greater complexity in the examples in this Report and the appendices hereto, all examples address only corporations with a single class of shares outstanding. Of course, in many real-world cases there will be multiple classes outstanding, and

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could be adopted – a "**Pure Pro Rata Approach**" or a "**Pooled Pro Rata Approach**", each of which is discussed further in Appendix B. Under a Pure Pro Rata Approach, all E&P is treated as a corporate-level attribute that is generally undifferentiated among shares or shareholders. As a result, when distributed to shareholders owning the same class of stock, the E&P generally would be allocated proportionally among all shares, without any tracing of E&P to shares with respect to which the E&P was earned or otherwise channeling particular types of E&P to particular shares. Under this approach, significant shifting of non-Section 1059(g) E&P to non-U.S. Shareholders and Section 1059(g) E&P to U.S. Shareholders can occur.

Under a Pooled Pro Rata Approach, two pools of E&P would be created—a non-Section 1059(g) E&P pool and Section 1059(g) E&P pool—with the former being allocated ratably among all U.S. Shareholders and the latter being allocated ratably among all non-U.S. Shareholders. Once one of the pools is exhausted, E&P in the remaining pool, whether non-Section 1059(g) E&P or Section 1059(g) E&P, would be allocated *pro rata* among all shareholders. The Pooled Pro Rata Approach achieves a more equitable result than the Pure Pro Rata Approach, at least with respect to U.S. Shareholders in the aggregate, as they will be allocated all of the non-Section 1059(g) E&P until that pool is exhausted. However, under the Pooled Pro Rata Approach, a U.S. Shareholder that acquired stock from a non-U.S. Shareholder will share the benefit of the non-Section 1059(g) E&P pool to the detriment of a U.S. Shareholder that owned the shares when the E&P was generated.[75]

A second approach (a "**Tracing Approach**") would trace the Section 1059(g) E&P to particular shares outstanding during the period in which the Section 1059(g) E&P was earned and treat distributions of that Section 1059(g) E&P as being on those shares to the greatest extent possible.[76] Tracing would then continue to apply through ownership changes, combination transactions and other events. As with a Pro Rata Approach, there are several alternative means for implementing a Tracing Approach. Appendix B discusses three alternatives—the "**Full Tracing Approach**", the "**Silo Tracing Approach**", and the "**Modified Silo Tracing Approach**".

The Full Tracing Approach, which is the purest version of a Tracing Approach, would create a silo of E&P under each share and characterize the E&P within each layer under that share as either Section 1059(g) E&P or non-Section 1059(g) E&P, depending on who owned the share at the time the E&P was earned. Once the silo of E&P under a particular share was exhausted, subsequent distributions would be treated as non-dividend distributions with respect to that share,

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the already complex choices and analysis set forth in this Report and the appendices hereto will become even more complex. *Cf.* Regulations Section 1.951-1(e)(3).

[75] *See* Appendix B for examples of the shifting of E&P that would result under the Pure Pro Rata Approach and the Pooled Pro Rata Approach.

[76] By extension, any distribution on shares not out of Section 1059(g) E&P would be treated as being out of non-Section 1059(g) E&P to the greatest extent possible.

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even if simultaneous distributions on other shares of the same class are treated as dividends with respect to those shares. At least conceptually, the Full Tracing Approach may best implement the assumed aims of Proposed Section 1059(g), in that none of the shifting described above with respect to either Pro Rata Approach alternative would occur under the Full Tracing approach. This Tracing Approach is, however, highly complex and less practical from an administrative perspective than either Pro Rata Approach alternative. In addition, the Full Tracing Approach would require a significant departure from the current rules governing E&P in that it would permit non-dividend distributions to be made on some shares of a class while remaining E&P still exists in the corporation. Moreover, as currently drafted, Proposed Section 1059(g) focuses only on E&P earned on shares while owned by non-U.S. Shareholders and imposes no restrictions on the sharing of non-Section 1059(g) E&P among U.S. Shareholders. As discussed further in Appendix B, a Full Tracing Approach would not facilitate such sharing.

The Silo Tracing Approach is similar to the Full Tracing Approach, but works within the constraint of applying current Code E&P *pro rata* allocation rules among all shares that have only non-Section 1059(g) E&P. Like the Full Tracing Approach, however, the Silo Tracing Approach may result in some shareholders receiving dividend distributions and others receiving non-dividend distributions, a result not imagined under current Code E&P rules. The Modified Silo Tracing Approach solves for the novel impact of non-dividend distributions on some shares and simultaneous dividend distributions on other shares, although it does so at the cost of additional complexity and inaccuracy, by shifting Section 1059(g) E&P and non-Section 1059(g) E&P between the different share silos when the E&P in one silo is exhausted while E&P remains in other silos. It is otherwise generally indistinguishable from the Silo Tracing Approach.[77]

As illustrated in the various examples in Appendix B, each of the Tracing Approaches would address the cases that we believe were the impetus for Proposed Section 1059(g) but would do so at the cost of introducing extreme new complexity into existing rules, and, in the case of the Modified Silo Tracing Approach, would still achieve arguably incorrect results in certain fact patterns. As also illustrated in the various examples in Appendix B, either Pro Rata Approach would be easier to administer but with the increased simplicity also comes increased incidents of achieving "incorrect" results.

The language of Proposed Section 1059(g) is unclear as to whether a Pro Rata Approach or a Tracing Approach is contemplated. In the case where a CFC has non-U.S. Shareholders during any period, it provides the "portion of [E&P] which is properly attributable to the stock [owned by non-U.S. Shareholders]" is to be treated as earned during a period when the CFC was not a CFC.[78] This has the impact of treating the E&P "properly attributable" to stock owned by non-U.S.

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[77] *But see* Section C of Appendix C for a discussion of particular ordering issues and complexities that may arise under a Modified Silo Tracing Approach that would not arise under a Silo Tracing Approach.

[78] *See* Proposed Section 1059(g)(2)(B).

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Shareholders as Section 1059(g) E&P. That might be read as an indication that the drafters of Proposed Section 1059(g) intended that a Tracing Approach apply so that Section 1059(g) E&P can be traced to the shares owned by the non-U.S. Shareholders not just for purposes of determining the characterization of the E&P as Section 1059(g) E&P or non-Section 1059(g) E&P, but also for purposes of determining on which shares the Section 1059(g) E&P is distributed. On the other hand, there is no specific language in Proposed Section 1059(g) that purports to change the normal treatment under Section 316 of distributions of E&P as being proportional among all shares of the same class in determining "the extent to which [dividends paid by a CFC on particular shares] is attributable to [Section 1059(g) E&P]", so perhaps a Pro Rata Approach was envisioned.[79]

B. Ordering Issue

Regardless of what approach is adopted for allocating E&P to particular shares or shareholders (be it a shareholder account approach, a Pro Rata Approach or a Tracing Approach), an additional question arises as to the ordering of E&P treated as distributed where there is more than one type of relevant E&P underlying a share. The existence of more than one type of E&P underlying a share may arise in certain cases where there is a mid-year transfer of shares or mid-year additional investment in a corporation or where differing types of E&P underlying the shares in question have been earned in separate years (or "layers"). These ordering issues are explored further as regards a Pro Rata Approach and Tracing Approach in Appendix C. As regards a shareholder account approach, such as the Pre-Sale Basis Reduction Rule, we recommend adoption of an ordering rule that would stack non-basis reducing E&P first, for the reasons set forth in Part V.[80]

VII. Other Policy Observations

If Proposed Section 1059(g) were enacted, in addition to issues regarding how to properly trace Section 1059(g) E&P (which is addressed in Part VI and Appendices B and C), there are two other matters that we believe are worth commenting on. The first matter relates to the types of income to which Proposed Section 1059(g) should apply (the "**Categorization Issue**"). The second matter is whether Proposed Section 1059(g) should apply to built-in gain (as was proposed in the HW&M Proposal but dropped in Proposed Section 1059(g)) (the "**Built-In Gain Issue**").

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[79] *See* Proposed Section 1059(g)(2)(A). Because no language indicates a change in the treatment of E&P distributions under the normal rules of Section 316, a change to the statutory language of Proposed Section 1059(g) may be required if an approach other than a Pro Rata Approach is intended.

[80] *See* the ordering rules in the Section 1.245A-4 Regulations, discussed *supra* in footnote 52, for a precedent that provides a favorable stacking rule for E&P to qualify for the Section 245A DRD. *See also* the discussion in the text accompanying footnote 68, *supra*, of the implicit stacking rules that generally would apply under the Pre-Sale Basis Reduction Rule.

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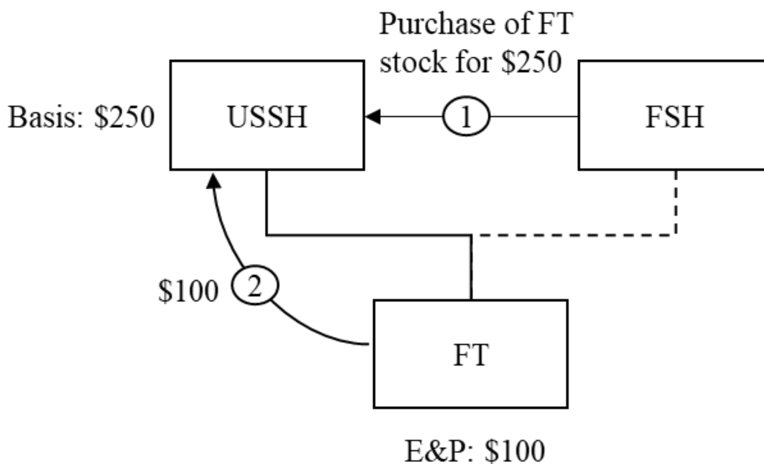
A. The Categorization Issue

There would appear to be at least two different approaches to determining which categories of E&P should give rise to the application of Proposed Section 1059(g). One approach would be to focus on the type of income giving rise to the E&P. Under this approach, for example, E&P might be treated as Section 1059(g) E&P only if the income underlying the E&P would have been currently included in income by the relevant shareholders of the foreign corporation had they been U.S. Shareholders in a CFC at the time the income was earned.

A second approach, and the one largely reflected in Proposed Section 1059(g), would be to look to the nature of the shareholders owning shares in the foreign corporation in question at the time the E&P is earned. Under Proposed Section 1059(g), any earnings (i) earned during the period that the CFC was not a CFC (Non-CFC Period E&P) or (ii) properly attributable to shares held by non-U.S. Shareholders at a time that the CFC was a CFC (Non-U.S. Shareholder Period E&P) are subject to Proposed Section 1059(g). Said another way, Proposed Section 1059(g) would treat as Section 1059(g) E&P all E&P of a foreign corporation attributable to any shareholders that were not U.S. Shareholders in a CFC at the time the E&P was earned. The focus is solely on the shareholder.

The differences between a shareholder focus and an income focus are illustrated in the below example.

<u>Example 5: Pre-1987 E&P</u>



- USSH purchases FT from an unrelated foreign seller (FSH) for $250 on 1/1 of Year 1, when FT has $100 of non-Subpart F, pre-1987 E&P, and no other E&P. Assume that USSH does **<u>not</u>** make a Section 338(g) election for the purchase.

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- FT generates no additional E&P in Years 1-4.
- In Year 4, FT makes a $100 distribution to USSH that is eligible for a Section 245A DRD.

Under Proposed Section 1059(g), USSH would be required to reduce its basis in the FT stock by $100 (from $250 to $150). By contrast, if the shareholders of FT had at all times been U.S. Shareholders in a CFC, none would have included in income any amounts under Sections 951, 951A or 965, and if Section 1059(g) E&P categorization were determined under this approach, USSH would not be required to reduce its basis in the FT stock under Proposed Section 1059(g).

Although either approach could be adopted, even if one believed that an income focus was preferable, the administrative difficulties in implementing such a choice would be formidable. In addition to pre-1987 non-Subpart F income, other categories of E&P that would not have been included in income by shareholders had they been U.S. Shareholders of a CFC include E&P attributable to (i) tested income of a CFC offset by tested losses of other CFCs or by NDTIR, (ii) high-taxed income of a CFC for which a high-tax election was made, and (iii) FOGEI. But determining the amount of tested income of a CFC offset by tested losses of other CFCs or NDTIR would require a choice as to who should be treated as being the relevant hypothetical U.S. Shareholder for each of the relevant periods – USSH or FSH – as the amount of tested losses and NDTIR will vary depending on interests in other foreign corporations held by the relevant hypothetical U.S. Shareholder during these periods and various attributes of those affiliates. In addition, in the case of high-taxed income, a decision would need to be made as to whether the relevant hypothetical U.S. Shareholder should or should not be deemed to have made the high-tax election had such shareholder been a U.S. Shareholder of FT during the relevant periods. Accordingly, even if one believed an income focus was preferable as a conceptual matter, the administrative complexity of implementing such choice would make it decidedly suboptimal.

B. Built-in Gain Issue

As discussed in Part III.A.1, the HW&M Proposal contained the Built-In Gain Rule. Under this rule, a dividend paid by a CFC to a U.S. Shareholder would be subject to Proposed Section 1059(g) if the dividend was attributable to E&P from gain on property which accrued during a period during which either the CFC was not a CFC or the stock with respect to which the dividend is paid was not owned by a U.S. Shareholder.[81] This Built-In Gain Rule, however, was not included in either the House bill or the Senate draft. Although dropped from Proposed Section 1059(g), we discuss the Built-In Gain Rule here briefly.

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[81] Proposed Section 1059(g)(2)(A)(ii) of the HW&M Proposal defined a "disqualified CFC dividend" as a dividend paid by a CFC to a U.S. Shareholder if attributable to E&P which is, *inter alia*, attributable to gain on property which accrued during a "disqualified period". Proposed Section 1059(g)(3) defines a "disqualified period" as any period during which the foreign corporation was not a CFC, or such stock was not owned by a U.S. Shareholder.

As discussed in Section D.2. of Appendix A, current Section 1059 contains two references to gain accrued prior to certain dates (*i.e.*, built-in gain) and provides special rules with respect to that built-in gain. The first reference to built-in gain is in Section 1059(d)(6)(B)(ii)(II). That provision excludes from the application of the Since Formation Exception to extraordinary dividend treatment, any dividend from a corporation whose E&P is attributable to earnings or gain on property which accrued at a time it was held by a different, non-qualifying, corporation. The second reference to built-in gain is in Section 1059(e)(2)(B)(ii). That provision excludes from the definition of a Qualifying Dividend (*e.g.*, dividends qualifying for a 100-percent DRD under Section 243 that are exempted from treatment as extraordinary dividends under Section 1059), any Non-Affiliated Asset Appreciation (*i.e.*, dividends attributable to E&P from gain that accrued at a time the corporations were not affiliated) (these two exceptions, the "**BIG Exceptions**").

The legislative history to the BIG Exceptions is relatively sparse. But what legislative history there is indicates a concern that exceptions to the general "greater than two year" holding period, Threshold Percentage and Section 1059(e)(1) Dividend requirements be limited to E&P that was "not attributable" to other shareholders.[82]

Analysis of these BIG Exceptions is beyond the scope of this Report. We note, however, that the circumstances in which these exceptions are likely to apply are quite narrow, because the circumstances generally can be avoided by holding the stock of the distributing corporation for more than two years, or distributing less than the Threshold Percentage, and making sure the means by which the E&P is distributed is not by virtue of one of the types of redemptions specified in Section 1059(e)(1). Accordingly, as a practical matter, the need to determine whether E&P is attributable to built-in gain under current Section 1059 is unlikely to arise.

By contrast, the Built-In Gain Rule would have applied any time a foreign corporation with built-in gain in its assets became a CFC (or any time shares in an existing CFC were acquired by a U.S. Shareholder from a non-U.S. Shareholder), the built-in gain was subsequently recognized, and E&P attributable to that built-in gain was distributed. Beyond requiring a valuation of all of the foreign corporation's underlying assets (which may or may not have been conducted in connection with the acquisition), the tracing needed to make these determinations would have resulted in extreme complexity and administrative difficulty.[83]

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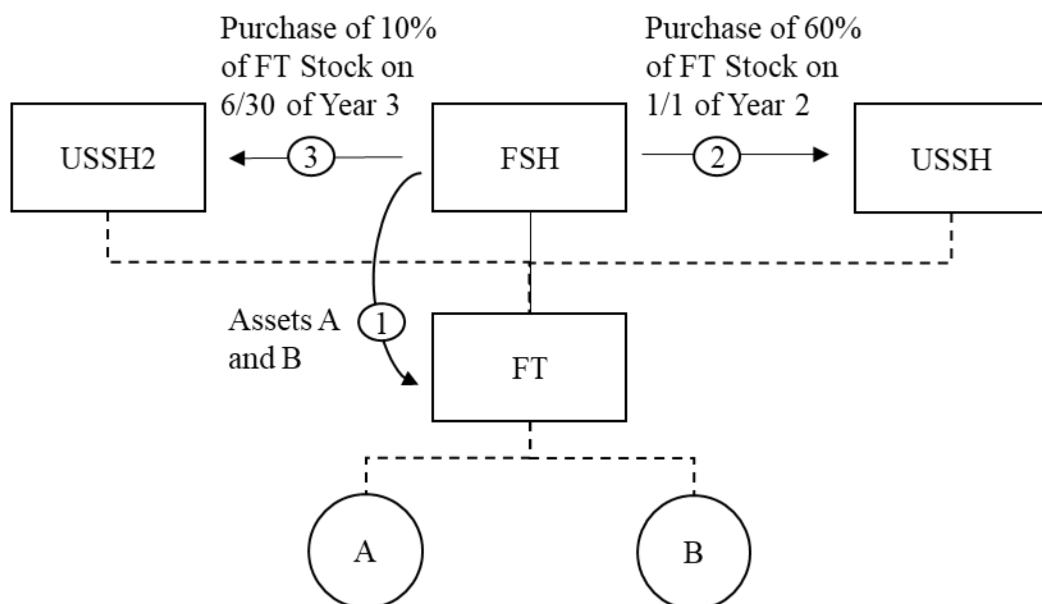
[82] *See* Joint Comm. Tax'n, Description of the Technical Corrections Act of 1988, 41-42 (March 31, 1988). For example, the E&P would be indirectly attributable to a person other than the shareholder receiving the distribution if attributable to transfers from or E&P of any non-qualified corporation. *Id*., at 42. Although earnings that accrued prior to the time of affiliation would not be entitled to a 100-percent DRD in any event, the rule apparently is aimed at tiered-up dividends from subsidiaries during earlier years. *See* Bittker & Eustice: *Federal Income Taxation of Corporations & Shareholders*, ¶ 5.058 n 218, citing S.Rep. No. 445, 100th Cong., 2d Sess. 50 (1988).

[83] For a discussion of the complexity of tracing built-in gain, see the sources cited in footnote 38 of Appendix A. Also, in cases where a CFC was partially owned by non-U.S. Shareholders, tracing built-in gain with respect to assets

Example 6: Built-In Gain Rule Issues



- FSH forms FT on 1/1 of Year 1 and transfers Assets A and B to FT in exchange for all of FT's stock.
- On 1/1 of Year 2, USSH purchases 60 percent of FT from FSH.
- During Years 2 and 3, FT makes capital improvements to Asset A.
- On 6/30 of Year 3, USSH2 purchases 10 percent of FT from FSH.

To apply the Built-In Gain Rule to USSH and USSH2, the fair market value and U.S. tax basis of Assets A and B would have to be determined as of 1/1 of Year 2 and 6/30 of Year 3, which would require asset-level valuations and the application of U.S. tax basis and basis recovery rules. Although these exercises may seem relatively straightforward in a simplified fact pattern such as Example 6, it is not hard to see how these exercises would become far more difficult in fact patterns where FT has hundreds of assets with multiple changes in ownership, either though shareholder-level sales or new investment. Indeed, as noted above, the Treasury rejected a similar tracing method when it enacted the predecessor to the current unified loss provisions of the consolidated return regulations.[84] If the Treasury thought a tracing method for U.S.-owned assets was not

underlying the shares of those non-U.S. Shareholders would have made the already formidable challenges in tracing built-in gain even more daunting.

[84] *See* footnote 38 of Appendix A and accompanying text.

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administrable, it is reasonable to assume that a tracing method for foreign-owned assets will also not be administrable. Moreover, it would require a determination not only of built-in gain at a time when a U.S. Shareholder acquires shares in a CFC from a non-U.S. Shareholder but potentially also whether that built-in gain had been recognized when a subsequent U.S. Shareholder acquires shares from the first U.S. Shareholder. The first U.S. Shareholder may have had no reason to calculate the built-in gain if the first U.S. Shareholder did not receive any distributions from the CFC during its period of ownership and did not sell its CFC stock at a gain.[85]

Moreover, the rule would only apply to any built-in gain recognized and not included in income under Sections 951 or 951A. To the extent so included in income, the amounts included would be reflected in PTEP and, accordingly, would not result in dividends or a DRD upon distribution to the U.S. Shareholder. As such, the recognized built-in gain would not be subject to the Built-In Gain Rule.

Given the above, it is worth considering which types of E&P arising from built-in gain might give rise to E&P to which the Built-In Gain Rule might apply. There would appear to be four such potential categories:

a) Income offset by tested losses of other CFCs of the shareholder that acquired the CFC with built-in gain (the "**BIG CFC**");

b) Income offset by other NDTIR of the shareholder that acquired the BIG CFC;

c) Income that is subject to a high rate of non-U.S. tax and for which a Section 954(b)(4) high-tax election is made ("**high-tax election income**"); and

d) Assets giving rise to FOGEI.

As regards the first two categories, the offsetting of the income arising from the recognition of the built-in gain largely would be attributable to other attributes that the acquiring shareholder had, rather than from any attribute of the built-in gain assets per se. Indeed, these attributes might

[85] If the first U.S. Shareholder did not recognize gain on the sale of its shares to the second U.S. Shareholder, then there would be no amount recharacterized as a dividend under Section 1248. In these circumstances where there is no actual or deemed dividend, there would be no need for the first U.S. Shareholder to determine built-in gain, built-in gain recognition or types of E&P. But the second U.S. Shareholder would nevertheless inherit those attributes and, accordingly, would need to be able to determine the amounts thereof in order to determine its Section 1059(g) E&P and non-Section 1059(g) E&P amounts. Moreover, as in the case of other Section 1059(g) E&P issues discussed in Appendix B, any Section 1059(g) E&P attributable to built-in gain arising while a non-U.S. Shareholder held the shares and recognized while a U.S. Shareholder held the shares should be allocated only to those shares. Hence, in the fact pattern in Example 6, only E&P attributable to the 60 percent of any built-in gain existing in FT's assets at the time USSH acquired its FT shares from FSH should be allocated to the shares held by USSH and only E&P attributable to 10 percent of any built-in gain existing in FT's assets at the time USSH2 acquired its FT shares from FSH should be allocated to the shares held by USSH2.

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have otherwise offset other income the E&P from which would not have been subject to Proposed Section 1059(g).[86] As such, it is questionable that the correct solution to the issue, if it is perceived to be an issue, is to build the complex architecture into the tax system that would be required to address this issue through Proposed Section 1059(g). As regards high-tax election income, it would not seem to be a common fact pattern that taxpayers would plan into a transaction that would result in significant non-U.S. tax as a means of generating E&P that would be subject to the 100-percent Section 245A DRD upon repatriation. As regards the fourth item, asset gain treated as FOGEI is exempt from U.S. taxation because it is immobile and usually subject to high foreign income tax rates and, thus, generally does not pose base erosion concerns that need to be addressed by the GILTI regime.[87]

In addition, many of the issues that may arise from CFC built-in gain, are present regardless of whether there is a distribution of the E&P attributable to the recognition of that gain.[88] Of course, that does not mean that including a Built-In Gain Rule would fail to pick up at least some cases.[89] Nevertheless, we question whether the complexity required to make Proposed Section 1059(g) workable as regards the recognition of any not-currently-taxed built-in gain (*e.g.*, regarding the tracing of various built-in gain items) can be justified by the seemingly narrow set of circumstances to which it would actually apply. We therefore support the exclusion of the Built-In Gain Rule reflected in Proposed Section 1059(g).

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[86] For example, assume USP owns CFC1 ($100 tested income) and CFC2 ($100 tested loss), and acquires FT with $100 built-in gain. If FT's built-in gain is recognized, USP is required to use part of its tested loss to offset the FT built-in gain, even though USP could have used the entire tested loss to offset CFC1's tested income, the E&P from which would not have been subject to Proposed Section 1059(g).

[87] *See* T.D. 9902 (Jul. 23, 2020) (citing S. Comm. on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, S. Print. No. 115-20, at 371 (2017)).

[88] *See, e.g.*, Erin Cleary, Michael L. Schler, and Robert B. Williams, Jr., Sales by U.S. Companies of Non-U.S. Businesses, Practicing Law Institute Cross-Border M&A Tax Planning 2023: Doing Worldwide Deals From the Office 2-3 Days Per Week, slides 70-80 (February 14, 2023). We also note that if a Built-In Gain Rule were adopted, an additional complexity would arise in the case where, in addition to recognizing built-in gain, the BIG CFC also has other gross income, as well as expenses or losses. In that case, how the expenses or losses should be allocated between the built-in gain and other gross income would need to be determined in order to be able to determine the amount of the CFC's E&P attributable to the recognized built-in gain.

[89] *See id*.

Appendix A – Other Relevant Background[1]

This Appendix A discusses a number of provisions of the Code and the Regulations that are necessary background for a full understanding of the issues discussed in the Report and the implementation of a system to address the concerns at which Proposed Section 1059(g) appears to be aimed.

A. E&P In General

E&P is a corporate tax attribute that determines the amount of a distribution to a shareholder that is treated as a dividend.[2] The U.S. tax system generally taxes a dividend as ordinary income and, depending on the circumstances, a dividend received by a corporate shareholder may be eligible for a DRD.

Sections 301(c) and 316 generally define "dividend" by reference to a corporation's E&P when a distribution is made and, therefore, the corporate decision to declare a distribution to its shareholders determines *when* and, in many cases, *how* its shareholders are subject to U.S. tax with respect to the distribution. To the extent a distribution is out of a corporation's E&P, the recipient shareholder has dividend income.[3] Under Section 316(a), a distribution of a dividend is made out of the corporation's current year E&P, then out of its most recently accumulated E&P post-February 28, 1913.[4] Similarly, where a corporation has a deficit in E&P for any year, that deficit is applied against and reduces E&P first for the immediately preceding year, and then for the year immediately preceding that year, and so on.[5] If a distribution is in excess of a corporation's E&P, the excess first reduces and is applied against the shareholder's basis in the stock (*i.e.*, such excess is treated as a return of capital) and, to the extent in excess of basis, the distribution is treated as

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[1] All terms used in this Appendix A and not otherwise defined herein have the meaning ascribed to them in the Report or in Appendices B or C.

[2] As an exception to this general notion, PTEP is both a shareholder-level and corporate-level attribute. Another exception (as discussed in Part III.B. of the Report) is that Section 1248 traces E&P to particular shares for purposes of recharacterizing certain gains upon dispositions of stock in a foreign corporation as dividend income. Both systems, however, have their complexities and uncertainties and the Treasury has been working on revised PTEP regulations for several years now to, among other things, address additional issues presented for the PTEP regime by the enactment of the TCJA.

[3] Section 301(c)(1).

[4] Section 316(a).

[5] *See* Rev. Rul. 74-550, 1974-2 C.B. 209 (addressing the application of E&P deficits for purposes of determining from what E&P dividends are considered paid for foreign tax credit purposes); Rev. Rul. 87-72, 1987-2 C.B. 170 (same). However, we note that after 1986, foreign corporations were only required to track a post-1986 undistributed E&P pool for purposes of determining E&P and indirect foreign tax credits under former Section 902. Thus, after 1986 annual layers of E&P generally were no longer tracked for purposes of determining foreign tax credits unless they related to pre-1987 taxable years.

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gain from the sale or exchange of property.[6] For purposes of the Report, this Appendix A and Appendices B and C, we refer to distributions in excess of E&P, whether treated as a return of capital or as gain, as "**non-dividend distributions**".

E&P does not reflect unrealized appreciation or depreciation with respect to a corporation's assets. A distribution reflecting unrealized appreciation can be treated as a return of capital or result in gain recognition even though the distribution would be treated as a dividend if the appreciation in the underlying assets were realized. Conversely, a distribution during a period when there is unrealized depreciation can be treated as a dividend even though the distribution would be treated as a return of capital or result in gain recognition if the depreciation in the underlying assets were realized.

As a corporate-level attribute, subject to certain exceptions (*e.g.*, Section 338 elections), E&P is generally unaffected by shareholder-level transactions. When a person sells stock in a corporation that is not subject to Section 1248 (discussed in Part III.B. of the Report) or Section 304, the character of the gain or loss is capital, regardless of whether the corporation has E&P earned while the disposing shareholder was a shareholder, and the E&P remains an attribute of the acquired corporation. When a person acquires corporate stock from another shareholder, it does not do so with a clean slate; it acquires the cumulative E&P history of the corporation attributable to all prior owners of the stock. Similarly, when a person makes an investment directly into a corporation in exchange for newly issued stock, that new investment attracts an allocable share of all of the corporation's E&P even though that E&P was earned prior to the new investment being made. As a result, if a person acquires stock of a corporation with accumulated E&P, post-acquisition distributions of the pre-existing E&P result in current dividend income to the acquiring shareholder and create built-in loss with respect to newly acquired stock (by reducing the value of the corporation by the amount of the distribution). Thus, the shareholder's "acquisition" of an interest in the corporation's existing E&P can result in a timing and character mismatch to the shareholder: the shareholder recognizes current dividend income, notwithstanding there has not been an economic return *on* its investment, and the shareholder has ordinary income and may have capital loss (on a subsequent sale of the stock) that offset economically but do not offset for U.S. tax purposes.

Although corporate shareholders are subject to the same timing and character mismatch consequences as individuals, the DRD regimes available to corporations (discussed in Section C) may eliminate or substantially mitigate the ultimate U.S. tax results of these mismatches. As discussed below, the peculiarities of the E&P regime are exacerbated with respect to CFCs, notwithstanding that CFCs generally compute their E&P using the same rules as domestic corporations.[7]

[6] Sections 301(c)(2) and (3).

[7] Section 964(a).

B. CFC E&P

Sections 951-965 ("**Subpart F**") establish an anti-deferral regime that requires U.S. Shareholders of a CFC to currently take into account in determining their U.S. federal income tax liability their *pro rata* shares of certain income of the CFC, regardless of whether the CFC distributes property to such shareholders. Specifically, Section 951(a) requires a U.S. Shareholder to include in its gross income a CFC's Subpart F income, and Section 951A(a) requires a U.S. Shareholder to include in its gross income the global intangible low-taxed income ("**GILTI**") attributable to its CFCs (Section 951(a) and Section 951A(a), each a "**Subpart F Inclusion**").[8]

Sections 959 and 961 provide that PTEP is not again taxed when distributed to the U.S. Shareholder (or its successor in interest) that had such Subpart F Inclusion.[9] Section 959 excludes from a U.S. Shareholder's gross income distributions of PTEP and provides that distributions of PTEP that are excluded from a U.S. Shareholder's gross income are not "dividends" for U.S. federal income tax purposes.[10] Section 961 adjusts a U.S. Shareholder's basis in the stock of a CFC to prevent double taxation by increasing the basis for Subpart F Inclusion amounts, and prevents the reduction of built-in gain (or the creation or increase of built-in loss) by reducing basis

[8] Subpart F income is generally limited to passive income received by a CFC in the form of certain dividends, interest, rents, and royalties, and income related to certain sales and services. *See* Sections 952 and 954. A U.S. Shareholder's GILTI is equal to its net CFC tested income for a taxable year over its net deemed tangible income return ("**NDTIR**") for such year. Section 951A(b). "**Net CFC tested income**" means, with respect to any U.S. Shareholder for any taxable year, the aggregate of the shareholder's *pro rata* share of the tested income over the tested loss of each CFC with respect to which the shareholder is a U.S. Shareholder. Section 951A(c)(1). A CFC's "**tested income**" ("**tested loss**") for any taxable year is the amount by which its gross income, determined without regard to certain items of exempt income (*e.g.*, foreign oil and gas extraction income (as defined in Section 907(c)(1)) ("**FOGEI**")) and income otherwise subject to U.S. federal income tax (*e.g.*, subpart F income), exceeds (is exceeded by) the deductions properly allocable thereto under Section 954(b)(5). Section 951A(c)(2). NDTIR means, with respect to any U.S. Shareholder for any taxable year, the excess of (i) 10 percent of the aggregate of such shareholder's *pro rata* share of the "**qualified business asset investment**" ("**QBAI**") (*i.e.*, the average of the corporation's aggregate basis as of each quarter end in certain tangible property used in a trade or business of the corporation and with respect to which a deduction is allowable under Section 167) of each CFC for which the shareholder is a U.S. Shareholder for that year, over (ii) the shareholder's *pro rata* share of the aggregate net tested interest expense of such CFCs. Section 951A(b)(2). A U.S. Shareholder may also be required to include in income a CFC's E&P attributable to certain investments in United States property. *See* Sections 951(a) and 956.

[9] For a detailed description of the legislative history of Sections 959 and 961, see the 2015 NYSBA Tax Section 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).

[10] Distributions of amounts previously included under Section 951A, discussed below, generally should 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).

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when the U.S. Shareholder receives a distribution of PTEP.[11] A U.S. Shareholder recognizes gain if it receives a distribution of PTEP in excess of its stock basis in the distributing CFC.[12]

The TCJA added the GILTI rules to the Code to transform the U.S. tax system from a worldwide deferral system, with limited exceptions for Subpart F income and CFC investments in certain U.S property, to a worldwide inclusion system, with a limited exception for routine returns on CFC investments in tangible property and certain other items.[13] In connection with this transformation, the TCJA also added Section 965 to the Code, which imposed a transition tax on the post-1986, pre-2018 deferred foreign income of a CFC and other 10 percent-owned foreign corporations (net of foreign E&P deficits), by treating such deferred foreign income as Subpart F income of such foreign corporations in the last taxable year of such foreign corporations beginning before January 1, 2018. E&P earned prior to 1987 ("**pre-1987 E&P**") was not subject to the transition tax.

C. Taxation of Subsidiary Distributions

1. Domestic Subsidiary Distributions - DRDs

The domestic DRD, currently provided in Section 243, was first enacted in 1935.[14] Dividends received by corporate shareholders from domestic corporations are entitled to a DRD, the amount of which varies depending on the percentage of stock owned by such shareholder. Currently, for corporate shareholders that own less than 20 percent of the stock, by vote or value, of the dividend paying corporation, the deduction is 50 percent; for shareholders that own at least 20 percent, the deduction is 65 percent; and for shareholders that are members of the same affiliated group as the payor, the deduction is 100 percent.[15] To obtain the 100-percent DRD, the E&P distributed must be from earnings of the distributing corporation from a taxable year, each day of which the distributing corporation and distributee shareholder were members of the same

[11] Sections 961(a) and (b). The basis adjustments under Section 961(a) and (b) are made on a share-by-share basis. However, unlike Section 1248 (discussed in Part III.B. of the Report), PTEP is not attributed to individual shares and is instead part of the general E&P pool. Section 961(c) authorizes the Secretary to issue regulations providing for basis adjustments by reason of a Subpart F Inclusion to stock in a lower-tier CFC owned by upper-tier CFC for purposes of determining the amount included in a U.S. Shareholder's gross income under Section 951(a). The Treasury has not yet issued regulations under Section 961(c).

[12] Section 961(b)(2).

[13] These other items include FOGEI, certain "high-taxed" income of a CFC for which an election (a "**high-tax election**") is made to not currently include such income in a U.S. Shareholder's income, and tested income of CFCs offset by tested losses of other CFCs. *See* Section 951A(c)(2)(A)(i)(V); Regulations Section 1.951A-2(c)(7).

[14] The intercorporate DRD system can be dated almost to the origins of the tax law. *See* Bittker & Eustice, Federal Income Taxation of Corporations & Shareholders, ¶5.05.

[15] Sections 243(a)(1), (3) and 243(c). For tax years beginning before January 1, 2018, the deductions were 70 and 80 percent, instead of 50 and 65 percent. The TCJA reduced the deduction rates, effective for tax years beginning after December 31, 2017.

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affiliated group ("**qualifying E&P**").[16] For purposes of making this determination, a distributing corporation must maintain a separate account of any E&P to which it succeeds (*e.g.*, as a result of the E&P carryover rules of Section 381(a) from a predecessor corporation), and thus, such E&P is segregated from qualifying E&P.[17] Regulations Section 1.243-4(a)(6) provides an ordering rule, following the principles of Regulations Section 1.316-2(a), to determine from what year's E&P a dividend is made. The dividend is made first out of E&P of the taxable year which includes the date on which the dividend is distributed, second out of the E&P accumulated for the immediately preceding taxable year, third out of the E&P accumulated for the second preceding taxable year, and so on.[18] A deficit in an E&P account for a year reduces the most recently accumulated E&P account in a prior year, and then the immediately preceding year to that year, and so on.[19]

Section 245 likewise provides for a 50-percent and a 65-percent DRD for certain dividends paid by certain 10 percent-owned foreign corporations doing business in the United States or receiving dividends from 80 percent-owned domestic corporations, as well as a 100-percent DRD for dividends paid by wholly-owned foreign corporations that have only effectively connected income.

Section 246 applies limitations to the DRDs under Sections 243, 245 and 245A (discussed below). Section 246(c), enacted in 1958,[20] denies the DRDs under Sections 243 and 245 where the stock in question is not held for more than 45 days during the 91-day period beginning on the

[16] Section 243(b)(1). The E&P must be from a year end after December 31, 1963, each day of such year the distributing corporation (or predecessor corporation) and the corporation receiving the dividends must have been members of the same affiliated group as they are on the day the dividends are received, and an election under Section 1562 relating to multiple surtax elections must not have been in effect for such year. *See* Regulations Section 1.243-4(a)(2).

[17] *See* Regulations Section 1.243-4(a)(4). Where both qualifying and non-qualifying E&P exist within the same year, distributions from E&P for that year are treated as made proportionally from the qualifying and non-qualifying E&P. *See* Regulations Section 1.243-4(a)(6) and (a)(7), Example 5.

[18] *See* Regulations Section 1.243-4(a)(6).

[19] *See* Regulations Section 1.243-4(a)(7), Example 5. Regulations Section 1.1297-1(c)(4)(iv) also references the principles of Regulations Section 1.243-4(a)(6) with respect to a deficit in an E&P account for a prior year in determining from what year's E&P a dividend from a related person is treated as distributed, for purposes of classifying the dividend as passive or active when testing a corporation's status as a passive foreign investment company.

[20] *See* S. Rep. No. 1983, 85th Cong., 2d Sess. 28-29, 139-140 (1958).

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date which is 45 days before the ex-dividend date.[21] A taxpayer's holding period for purposes of Section 246(c) is determined under the rules of Section 1223, other than paragraph (3) thereof.[22]

2. CFC Distributions

Section 959(c) provides E&P ordering rules for CFC distributions that supersede the general ordering rules of Section 316(a) governing distributions. Section 959 divides E&P into three categories and generally provides that E&P will be treated as distributed: (i) first, under Section 959(c)(1), out of PTEP attributable to amounts previously included in gross income under Section 951(a)(1)(B),[23] (ii) second, under Section 959(c)(2), out of PTEP attributable to amounts included under Section 951(a)(1)(A),[24] and (iii) finally, under Section 959(c)(3), out of other E&P (*i.e.*, E&P arising from previously untaxed income of the CFC).[25]

The TCJA introduced Section 245A, which generally provides for a 100-percent DRD (the "**Section 245A DRD**") with respect to the foreign-source portion of any dividend received from a specified 10-percent owned foreign corporation (an "**STFC**") by a domestic corporation that is a U.S. Shareholder with respect to such STFC. An STFC is a foreign corporation in which a domestic corporation owns, directly, indirectly or by attribution, 10 percent or more of the voting power or value of the foreign corporation[26] (other than a foreign corporation which is a passive foreign investment company with respect to the domestic corporation and which is not a CFC).[27]

The "**foreign-source portion**" of a dividend is the amount that bears the same ratio to the dividend as the "**undistributed foreign earnings**" do to the "**undistributed earnings**" of the STFC.[28] For this purpose, undistributed earnings are the E&P of the STFC as of the close of the

[21] Section 246(c)(1)(A). For dividends on certain preferred stock, the holding period is 90 days in the 181-day period beginning on the date which is 90 days before the ex-dividend date. In addition, Section 246(c)(1)(B) provides that no deduction shall be allowed in respect of any dividend on any share of stock to the extent that the taxpayer is under an obligation (under a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property. The holding period is also tolled where the holder's risk of loss is diminished. *See* Section 246(c)(4).

[22] *See* Section 246(c)(3)(B); Section 1223.

[23] PTEP attributable to the former Section 956A excess passive asset rules is also included in the first category.

[24] After giving effect to the TCJA, Section 951(a)(1)(A) now has several subcategories and such subcategories might or might not be treated differently from one another when applying the ordering rule of Section 959(c).

[25] *But see* I.R.S. Notice 2019-01, 2019-02 I.R.B. 275 (announcing regulations will be issued that will prioritize PTEP attributable to Section 965).

[26] Section 245A(b). This 10 percent ownership test is contained in the definition of U.S. Shareholder under Section 951(b), which includes direct and indirect ownership and ownership through attribution.

[27] Section 245A(b)(2). Section 246(a) also provides that the deduction allowed by Section 245A does not apply to dividends received from a tax-exempt corporation.

[28] Section 245A(c)(1).

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STFC's taxable year in which the dividend is distributed without diminution by reason of any dividends distributed during the taxable year.[29] An STFC's undistributed foreign earnings are undistributed earnings that are neither (i) income described in Section 245(a)(5)(A) (generally, effectively connected income that is subject to U.S. income tax)[30] nor (ii) dividends described in Section 245(a)(5)(B), determined without regard to Section 245(a)(12) (generally, dividends received from a domestic corporation which is at least 80 percent owned, directly or indirectly, by the STFC).

Under Section 246, the requisite holding period for the Section 245A DRD is substantially longer – 365 days in the 761-day period – than the holding period for the Section 243 and Section 245 DRD.[31] Section 246(c)(5)(B) prescribes special additional rules for purposes of applying the holding period requirement of Section 246(c)(1) with respect to Section 245A, providing that the taxpayer shall be treated as holding the stock referred to in Section 246(c)(1) for any period only if (i) the STFC referred to in Section 245A(a) is an STFC at all times during such period and (ii) the taxpayer is a U.S. Shareholder with respect to such STFC at all times during such period.

D. Basis Reduction Provisions

1. Consolidated Returns - ULR

Regulations Section 1.1502-32 provides a system of adjustments to the basis of the stock in a subsidiary ("**S**") owned by another member ("**M**") of a group filing a consolidated federal income tax return, to take into account distributions made by S, and items of income, gain, deduction and loss of S taken into account in the consolidated group income.[32] All distributions with respect to the S stock, including distributions under Section 301 and 356(a)(2), reduce M's basis in S.[33]

To prevent the duplication of losses, Regulations Section 1.1502-36 provides a unified set of rules that apply when M disposes of a share of S at a loss (the "**ULR**"). The ULR is aimed at preventing the consolidated return provisions from reducing a group's consolidated taxable income

[29] Section 245A(c)(2). The method for calculating the foreign corporation's E&P is "substantially similar" to that used for the calculation of earnings and profits of domestic corporations. *See* Section 964(a), Section 986(b).

[30] A DRD may be available with respect to the dividends attributable to these amounts under Section 245.

[31] *See* Section 246(c)(1), (c)(5).

[32] Regulations Section 1.1502-32(a)(1). The adjustments are reflected either at the end of the consolidated return year, or on an interim basis, if needed. Regulations Section 1.1502-32(b)(1)(i).

[33] Regulations Section 1.1502-32(b)(3)(v).

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through the creation and recognition of noneconomic losses in the stock of S, and to prevent members from obtaining more than one tax benefit from a single economic loss.[34]

The ULR is the conceptual successor to prior regulations initially issued in the wake of the repeal of the *General Utilities* doctrine in 1986, to address, among other things, so called "son of mirrors" transactions, whereby M could recognize a loss upon disposing of the stock of S, as a result of the basis increase in the S stock from the recognition of income or gain with respect to built-in gain assets (*i.e.*, assets with gain that is arguably reflected in M's basis in the S shares).[35] Initially, the Service responded to this concern with Notice 87-14, which described regulations to be promulgated that would have denied an adjustment to M's basis in its S stock reflecting any built-in gain in S's assets at the time M acquired S.[36] This approach reflected a decision at the time to prevent investment adjustments from the recognition of built-in gain in S's assets from either creating or increasing loss, or reducing or eliminating gain on the disposition of S stock. Such an approach would require a complex tracing method, whereby all of S's assets would need to be valued at the time it joined a consolidated group.[37] However, the Treasury ultimately rejected the tracing method when it adopted Regulations Section 1.1502-20 (a predecessor to the current ULR provisions) due to the concern with administrability of such an approach.[38] In addition, the

[34] Regulations Section 1.1502-36(a)(2).

[35] *See* Bittker & Eustice: *Federal Income Taxation of Corporations & Shareholders*, ¶13.425[c]. *See also* Michael L Schler, *Consolidated Return Loss Disallowance: Conceptual Issues*, 95 Tax Notes 899, 900 (2002).

[36] 1987-1 C.B. 445. *See* Michael L Schler, *Consolidated Return Loss Disallowance: Conceptual Issues*, 95 Tax Notes 899. For a detailed description of the history of the development of the consolidated return loss disallowance rules, see 2007 NYSBA Tax Section Report No. 1138, *Report on Proposed Consolidated Return Stock Loss Regulations* (December 19, 2007), and 2003 NYSBA Tax Section Report No. 1029, Report on Temporary Regulation § 1.337(d)-2T and Proposed Regulation § 1.1502-35 (February 28, 2003).

[37] *See* Don Leatherman, *Why Rite Aid is Wrong*, 52 Am. U. L. Rev., 811, 847 (2003).

[38] *See* REG-157711-02, 2007-1 C.B. 537 (Jan. 23, 2007) (noting that "[t]he IRS found that the difficulties encountered, by taxpayers and the government alike, in administering §1.337(d)-2 as a tracing-based rule were overwhelmingly greater than those encountered in administering it as a presumption-based rule under the basis disconformity method permitted under Notice 2004-58" and, by contrast to the tracing regimes for Sections 382(h) and 1374, "[t]he tracing regimes appropriate for those sections . . . do not present compliance and administrative concerns of the scope and magnitude presented by a tracing regime appropriate for GU repeal in the consolidated setting for at least three reasons", including the limited time period for which tracing is required (5 and 10 years, respectively, under such sections)); TD 8294, 1990-1 C.B. 66, 69-70 (March 14, 1990) (noting that the Treasury undertook an intensive study to reconcile the consolidated return regulations and the intent of Congress in repealing the *General Utilities* doctrine, and that although the most accurate method of eliminating losses from the recognition of built-in gain would be to eliminate positive basis adjustments under the investment adjustment rules from earnings attributable to the recognition of built-in gain, this tracing approach would impose tremendous administrative burdens on both taxpayers and the Service); TD 8364, 1991-2 C.B. 43 (September 19, 1991). *See also* Michael Schler, *Consolidated Return Loss Disallowance: Conceptual Issues*, 95 Tax Notes 899 (discussing the numerous complications with tracing).

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final rules did not attempt to increase gain on sale of S stock by the amount of recognized gain in acquired built-in gain assets.[39]

2. Section 1059

Section 1059 was enacted in 1984 to curtail the benefits of transactions that took advantage of the DRD rules to create non-economic stock losses in so-called "dividend-strip" transactions. In a typical transaction, a domestic corporation would make a portfolio investment in stock of another corporation shortly before the stock became ex-dividend (*i.e.*, while the value of the stock included the value of the dividend) and then sell the stock at a loss because the dividend reduced the fair market value, but not the basis, of the purchased stock.[40] The purchaser would recognize ordinary income for the dividend received and then claim a DRD for the dividend as well as a capital loss on the subsequent stock sale.[41] As a result, to the extent the capital loss was utilizable to offset capital gain of the domestic corporation, a net tax arbitrage benefit could be achieved.

Congress believed the results of dividend-strip (and similar) transactions were inappropriate, viewing the purchase of extraordinary dividend-paying stock as the acquisition of two assets: the right to receive the dividend and the stock itself.[42] To address this concern, Congress determined that the basis of the stock should be reduced to reflect the portion of the "extraordinary dividend" that was not subject to tax (the nontaxed portion) and provided for the basis reduction if a corporation both (i) received an extraordinary dividend with respect to a share of stock, and (ii) disposed of the stock before it held the share for more than one year.[43] The basis reduction was made on a share-by-share basis at the beginning of the ex-dividend date.[44]

Under Section 1059, the term extraordinary dividend means any dividend with respect to a share of stock if the amount of such dividend equals or exceeds the threshold percentage of the

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[39] The preamble explains that the rule "…has no impact in situations in which basis increases resulting from the recognition of built-in gain do not create (or contribute to) an overall loss on the sale. This aspect of the rule will in many cases permit the parent to shelter post-acquisition appreciation in stock of an acquired subsidiary." 55 FR 9426-01, at 9429; 1990-1 C.B. 66 (March 14, 1990). Thus, the preamble explanation is focused on the difference between noneconomic stock loss (which violates *General Utilities* repeal because it can offset the asset gain) and noneconomic reduction of stock gain (which arguably does not because the gain it reduces or eliminates is duplicative of inside asset gain that remains subject to corporate-level tax).

[40] Certain straddle-like transactions were used by taxpayers to achieve results that were similar to dividend-strip transactions. In these transactions, taxpayers would purchase dividend-paying stock and sell short similar securities (*e.g.*, convertible bonds) that were not "substantially identical" to the dividend-paying stock. H. Rep. No. 432(II), 98th Cong. 2d Sess., at 1185-86 (1984).

[41] *Id*.

[42] *Id.* at 1186.

[43] Section 1059(a) (1984).

[44] Section 1059(d)(1) (1984).

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taxpayer's adjusted basis in such share of stock. The term threshold percentage generally means 5 percent in the case of stock which is preferred as to dividends and 10 percent in the case of any other stock (the "**Threshold Percentage**").[45] The "nontaxed portion" of an extraordinary dividend was defined as the excess of the amount of such dividend over the taxable portion of a dividend.[46] The "taxable portion" of a dividend was defined as the portion of such dividend includible in gross income, reduced by the amount of any deduction allowable with respect to such dividend under Sections 243 or 245.[47] Section 1059 deferred gain recognition for the amount by which the nontaxable portion of an extraordinary dividend exceeded the basis of the stock until the taxpayer disposed of the stock.[48]

In 1986, two years after enactment, Congress determined that Section 1059 was an inadequate deterrent because taxpayers could obtain the tax benefits of dividend-strip transactions by waiting one year to sell extraordinary dividend-paying stock.[49] Congress had believed that the holding period would be meaningful because it would subject taxpayers to market risk during the period; however in light of the substantial tax arbitrage benefits, it proved to be an insufficient restriction.[50] Congress amended Section 1059 by replacing the original holding period condition with a condition that the taxpayer hold extraordinary dividend-paying stock for more than two years as of the dividend announcement date (the "**Section 1059 Holding Period Requirement**").[51]

Congress also added a category of transactions that give rise to *per se* extraordinary dividends, irrespective of whether the applicable Threshold Percentage is exceeded or whether the Section 1059 Holding Period Requirement is satisfied.[52] Specifically, these transactions included partial liquidations, non-*pro rata* redemptions, and redemptions that would not have been treated as a dividend if Section 304(a) had not applied (a "**Section 1059(e)(1) Dividend**").[53] In addition,

[45] For purposes of determining whether the Threshold Percentage has been satisfied, any dividends paid within an 85-day period are treated as one dividend. Section 1059(c)(3)(A). In addition, dividends paid within the same 365-day period are treated as extraordinary dividends if the aggregate dividend exceeds twenty percent of the taxpayer's basis in the stock with respect to which the dividend is paid. Section 1059(c)(3)(B).

[46] Section 1059(b)(1).

[47] Section 1059(b)(2).

[48] Section 1059(a)(2) (1986).

[49] S. Rep. No. 313, 99th Cong. 2d Sess., at 249 (1986).

[50] *Id*. at 249, n. 12.

[51] H Rep. No. 841, 99th Cong. 2d Sess., at 164 (1986) (Conf. Rep.).

[52] Section 1059(e)(1) (1986). Congress intended that the nontaxed portion of these *per se* extraordinary dividends reduce basis without regard to whether the distribution is less than the Threshold Percentage or whether the two-year holding period is met. *See* Staff Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 285 (May 4, 1987).

[53] Section 1059(e)(1)(A) (1986). Under Section 1059(e)(1)(B), dividend equivalent reorganizations were treated as redemptions for purposes of applying Section 1059(e)(1)(A).

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Congress included a special relief provision that exempted a distribution that otherwise would constitute an extraordinary dividend from the scope of Section 1059 (unless such distribution were a Section 1059(e)(1) Dividend), so long as the distributee had held the stock of the distributing corporation for the entire period the distributing corporation had been in existence (including any predecessor corporation), the E&P was accumulated only during that period, and the application of the exception would not be inconsistent with the purposes of the extraordinary dividend rules (the "**Since Formation Exception**").[54]

However, in 1988 Congress specified that the Since Formation Exception does not apply where, for example, any of the E&P of the distributing corporation is attributable to gain on property attributable to transfers of property, or E&P, of a corporation that is not a "**qualified corporation**".[55] Thus, Congress clarified that the application of the Since Formation Exception was intended to permit distributions without basis reduction (even when the distributions exceeded the Threshold Percentage or were announced within the two-year holding period), only when the E&P supporting the dividend could only have been attributable, directly or indirectly, to the shareholder receiving the dividend.[56]

In 1988, Congress also amended Section 1059(e)(2), which narrowed the scope of dividends qualifying for exemption from status as an "extraordinary dividend" (a "**Qualifying**

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[54] *See* Section 1059(d)(7) (1986) (subsequently changed to Section 1059(d)(6) when the then Section 1059(d)(5) was struck in 1988); Staff Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 286 (May 4, 1987).

[55] Section 1059(d)(6)(B)(ii)(II) (1988). A "**qualified corporation**" is defined as any corporation (including a predecessor corporation) with respect to which the taxpayer holds directly or indirectly during the entire period of such corporation's existence, at least the same ownership interest as it holds in the distributing corporation. *See* Section 1059(d)(6)(B) (1988).

[56] *See* Joint Committee on Taxation, Description of the Technical Corrections Act of 1988, at 41 (March 31, 1988). The JCT further explained that:

> [The Since Formation Exception would] not apply if any more than a de minimis part of the earnings and profits derived directly or indirectly from another corporation (*e.g.*, through a dividend distribution, a transaction described in sec. 381, a sale of assets received in a section 332 liquidation or other carryover basis transaction, or by virtue of the consolidated return regulations increasing the earnings and profits of the corporation that is paying the dividend on account of earnings and profits of another corporation which is a subsidiary) in which the original shareholder did not at all times hold at least as great an interest as such shareholder's interest in the distributing corporation at the time of the distribution.
>
> However, the fact that the distributing corporation directly or indirectly received de minimis amounts of earnings and profits from other entities (such as non-extraordinary dividends received from temporary portfolio investments of funds), would not generally be expected to preclude the application of the [Since Formation Exception]. See *id.* at 42.

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Dividend").[57] Prior to the change, a Qualifying Dividend was defined by reference to Section 243(b)(1), which was a dividend from a member of the same affiliated group of corporations, made from certain E&P of the distributing corporation, and for which a 100-percent DRD was available. The amendment restricted Qualifying Dividends to those that are not paid from E&P which either (i) was earned by the distributing corporation during a period it was not a member of the affiliated group (a "**Non-Affiliation Year**"),[58] or (ii) is attributable to gain on property which accrued during a period the corporation holding the property was not a member of the affiliated group ("**Non-Affiliated Asset Appreciation**"). Congress expected that the application of this provision would be narrow, given the overlap with the existing consolidated return provisions.[59] For example, a distribution during a consolidated return year out of E&P accumulated during a prior year when the distributing corporation was affiliated with the distributee, but did not file a consolidated return, would not constitute an extraordinary dividend so long as the E&P was not attributable to appreciation in assets from a Non-Affiliation Year.[60]

In 1997, Congress amended Section 1059 to delete the provision allowing for deferral of gain recognition for the amount by which the nontaxable portion of an extraordinary dividend exceeded the basis of the stock. This change was made at the same time as amendments to address taxpayer planning to access the DRD rules in dividend-equivalent redemptions, in some cases on account of the Section 318 option rules.[61] While the legislative history to Section 1059 does not describe why Congress chose to end deferral for Section 1059 gain, Congress may have wanted to

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[57] PL 100–647, November 10, 1988, 102 Stat 3342. Prior to the amendment, a Qualifying Dividend included all qualifying dividends within the meaning of Section 243(b)(1).

[58] *See* footnote 82 in the Report for a discussion of why this rule was felt to be necessary with respect to pre-affiliation E&P even though such E&P generally would not be eligible for a 100-percent DRD in any event.

[59] *See* Joint Committee on Taxation, Description of the Technical Corrections Act of 1988, at 42-43 (March 31, 1988). The Senate report noted that:

> [i]t is understood that, in most instances, the consolidated return regulations achieve results that are consistent with the purposes of the extraordinary dividend rules. For example, the regulations require a negative basis adjustment in the stock of a subsidiary to the extent the distribution represents pre-affiliation earnings and profits of the subsidiary. A negative adjustment is not required with respect to all dividend distributions, however.

S. Rep. No. 445, 100th Cong. 2d Sess., at 44 (1988).

[60] *See* Joint Committee on Taxation, Description of the Technical Corrections Act of 1988, at 42-43. "However, to the extent results produced under the consolidated return regulations are inconsistent with the purposes and principles of [Section 1059(e)], it is intended that a basis reduction may be required under [Section 1059]", despite not being mandated under the consolidated return regulations. *See id*.

[61] H. Rep. No. 220, 105th Cong. 1st Sess., at 525-56 (1997) (Conf. Rep.).

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prevent taxpayers from indefinitely deferring gain recognition for Section 302 redemptions by retaining a small amount of shares in the redeeming corporation.[62]

Thus, Section 1059 essentially treats the nontaxable portion of an extraordinary dividend as a distribution of property subject to Sections 301(c)(2) and (3), notwithstanding that the distributing corporation has E&P.

The enactment of the Section 245A DRD increased the role and importance of Section 1059 by extending its application to dividends of untaxed foreign earnings paid by an STFC. Section 245A was added to the list of provisions in Section 1059 that result in a nontaxed portion of an extraordinary dividend.

3. Section 961

As discussed in Section B, Sections 961(b) and (c) provide rules for adjusting basis of the stock in a CFC where PTEP is distributed by that CFC.

The TCJA also added Section 961(d), by which a domestic corporate U.S. Shareholder that receives a Section 245A DRD must reduce its basis in the stock of the STFC (but not below zero) by the amount of the Section 245A DRD for purposes of calculating the amount of any loss resulting from the disposition of the stock of the STFC in a subsequent taxable year.[63] Thus, Section 961(d) applies only to prevent loss recognition, and not to situations where a future gain in CFC stock is reduced as a result of a previous Section 245A DRD. However, Section 961(d) does not apply to the extent the basis of the STFC stock had been reduced under Section 1059.

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[62] *See* H. Rep. No. 148, 105th Cong. 1st Sess., at 459-60, fn. 17 (1997) (noting the Seagram Corporation's intent to rely on the Section 318 option rules to treat a stock redemption by the DuPont Corporation as a dividend-equivalent redemption); *see also* Sheppard, "Can Seagram Bail Out of DuPont without Capital Gain Tax," 95 TNT 75–4 (Apr. 10, 1995) (discussing the DRD and basis consequences of the DuPont-Seagram transaction).

[63] The legislative history of the TCJA explains that Congress intentionally limited the application of Section 961(d) to the recognition of subsequent losses on stock sales (rather than a reduction in any future gain).

> A participation exemption system could provide double tax benefits in certain circumstances. In particular, a distribution from a foreign subsidiary that is eligible for a DRD would reduce the value of the foreign subsidiary, reducing any built-in gain or increasing any built-in loss in the shareholder's stock of the subsidiary. Reducing gain in this manner is consistent with the application of [S]ection 1248(a) (or [S]ection 964(e)) to recharacterize gain as a dividend for which a DRD may be allowed. Increasing loss in this manner, however, creates a double U.S. tax benefit for receiving a tax-free distribution from a foreign subsidiary.

Committee on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, 115th Cong. 1st Sess. at 360 (S. Prt. No. 115-20).

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Appendix B - Allocation Issue

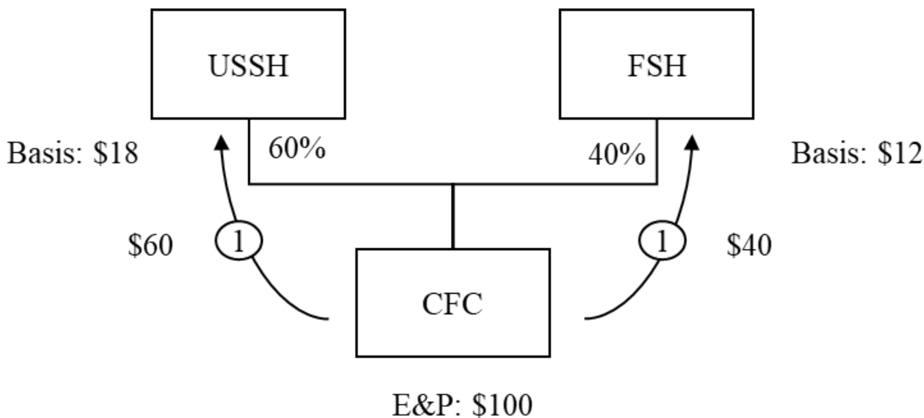
As discussed in Part VI.A. of the Report, if Proposed Section 1059(g) is intended to require tracing of E&P to particular shares (rather than just applying a shareholder account methodology), as the literal wording of Proposed Section 1059(g) would suggest, then there would appear to be at least two different ways to implement this tracing. The two approaches addressed in this appendix – the Pro Rata Approach and the Tracing Approach – are illustrated through a number of examples below. Where more than one Pro Rata Approach or Tracing Approach is possible and would lead to different results, those different results are also explored.[1]

As is illustrated by the below examples, there is a correlation between the degree of complexity of any approach and its ability to achieve a "correct" result in all circumstances. The judgment that would need to be made if Proposed Section 1059(g) were enacted in its current form is what degree of complexity is appropriate to achieve the desired level of "correctness".

A. Split Ownership and Transfers of Ownership Examples[2]

We begin with a basic split ownership case.

Example 7: Split Ownership



[1] The numbering of the examples in this Appendix B continue from the numbering of the examples in the Report, and hence begin with Example 7. All terms used in this Appendix B and not otherwise defined herein have the meaning ascribed to them in the Report or in Appendices A or C.

[2] Under either a Pro Rata or a Tracing Approach, one additional factor to be addressed in guidance would be the method to use to divide E&P for a taxable year when ownership of a CFC changes in the middle of a year. The examples in this Appendix B focus on more fundamental issues and, for simplicity, do not address mid-year changes.

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- CFC has 100 shares outstanding.
- USSH has owned 60 shares of CFC stock and unrelated FSH has owned the remaining 40 shares of CFC stock since CFC's formation on 1/1 Year 1.
- USSH has an $18 basis in its CFC shares, and FSH has a $12 basis in its CFC shares.
- In Year 1, CFC generates $100 of untaxed E&P.
- In Year 5, CFC makes a $100 *pro rata* distribution, $60 to USSH and $40 to FSH.[3]

Pro Rata Approach

In this Example 7, under Proposed Section 1059(g), $40 of CFC's E&P (the Non-U.S. Shareholder Period E&P) would be Section 1059(g) E&P and $60 (the remainder) would be non-Section 1059(g) E&P. If the Pure Pro Rata Approach described in Part VI.A. of the Report is applied, then the rules of Section 316 (which generally do not differentiate between types of E&P) would be hewed to as closely as possible. Accordingly, in the above example, $24 of the $60 distributed to USSH would be Section 1059(g) E&P and $36 would be non-Section 1059(g) E&P. As a result, in Year 5, Proposed Section 1059(g) would require USSH to reduce its basis in its CFC stock by $18 to $0 and recognize gain of $6.[4]

The result under the Pure Pro Rata Approach seems odd and overly punitive. Had USSH instead wholly owned another CFC that earned $60 of untaxed E&P during the same period and distributed all of that E&P to USSH in Year 5, USSH would not have been subject to Section 1059 and, accordingly, would have incurred no current basis reduction or gain recognition with respect to its $60 distribution; USSH would have a $60 dividend eligible for the 100-percent Section 245A DRD. It is not clear what policy goal would be achieved by disadvantaging USSH for earning income through a CFC partially owned by a non-U.S. shareholder, compared to earning the same income through a wholly owned CFC.

Moreover, because USSH's *pro rata* share of the CFC earnings would have resulted in Subpart F or GILTI inclusions (assuming the CFC earnings were of the type subject to such

[3] As discussed in footnote 15 in the Report, in all examples in the Report and the appendices (including this Appendix B) it is assumed that a CFC has no E&P and no E&P deficit, except as otherwise noted in the example. Accordingly, in this Example 7, CFC has no E&P and no E&P deficit for Years 2 through 5.

[4] FSH would be treated as receiving $16 of Section 1059(g) E&P. But, unless FSH is treated as eligible for a DRD with respect to that E&P, FSH would not be subject to any basis reduction or gain recognition under Section 1059. Even if FSH were required to reduce its basis in its CFC stock by $16 and to recognize gain to the extent the reduction is in excess of basis, FSH and its shareholders may be indifferent to such consequences where FSH is neither a U.S. corporation nor a CFC. In the remaining examples in this Appendix B, and in the examples in Appendix C, we focus solely on the consequences to U.S. Shareholders.

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regimes), where there is split ownership, USSH still ought to be entitled to the Section 245A DRD with respect to the CFC's untaxed earnings. Earnings that were never subject to the Subpart F or GILTI regimes are the apparent focus of Proposed Section 1059(g), not income that was subject to each regime but went untaxed.[5]

By contrast, under the Pooled Pro Rata Approach described in Part VI.A. of the Report, pools of E&P would be tracked. One pool would consist of Section 1059 E&P and the other pool would consist of non-Section 1059(g) E&P. Upon a distribution, non-Section 1059(g) E&P would be allocated solely to U.S. Shareholders, up to the amount of the distribution, *pro rata* based on U.S. Shareholder ownership at the time of the distribution and without regard to whether a particular U.S. Shareholder owned shares when such non-Section 1059(g) E&P was generated. Similarly, non-U.S. Shareholders would be allocated a *pro rata* share of the Section 1059(g) E&P based on non-U.S. Shareholder ownership at the time of the distribution and without regard to whether a particular non-U.S. Shareholder owned shares when the Section 1059(g) E&P was generated. To the extent dividends paid to U.S. Shareholders exceed the available pool of non-Section 1059(g) E&P or dividends paid to non-U.S. Shareholders exceeded the available pool of Section 1059(g) E&P, any remaining E&P would be allocated *pro rata* to all shareholders.

Applying the Pooled Pro Rata Approach to Example 7, all $60 of CFC's non-Section 1059(g) E&P would be allocated to USSH, an outcome we believe is more in tune with the policy of Proposed Section 1059(g) than the Pure Pro Rata Approach discussed above. In all of the following examples, the Pooled Pro Rata Approach will result in U.S. Shareholders, in the aggregate, receiving the CFC's non-Section 1059(g) E&P. As the following examples will demonstrate, however, the Pooled Pro Rata Approach will not consistently produce the "correct" result seen in Example 7, and instead will cause distortions between and among U.S. Shareholders. Nevertheless, the Pooled Pro Rata Approach is a clear upgrade on the Pure Pro Rata Approach, which rarely, if ever, will produce (in our view) equitable results.

Tracing Approach

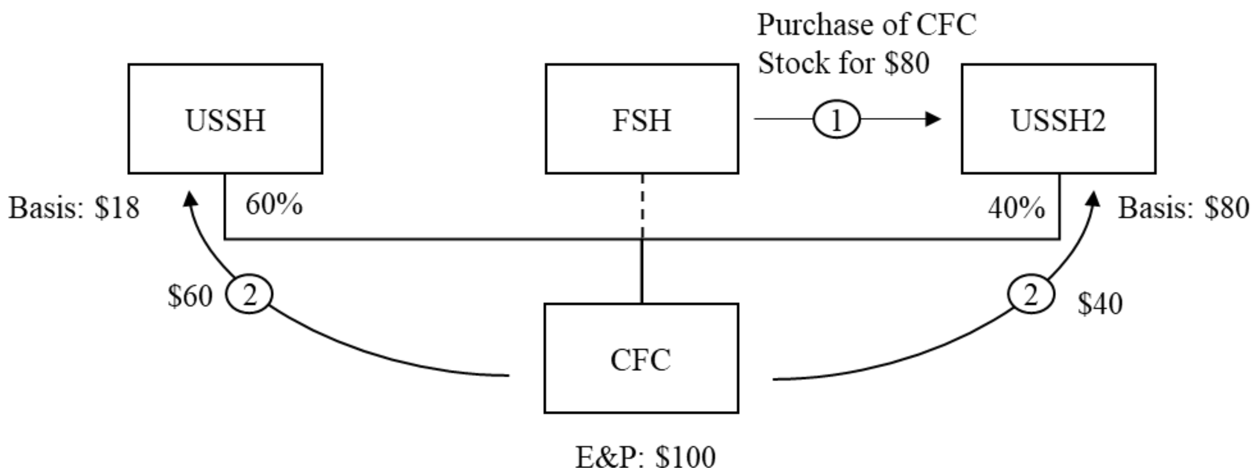
If a Tracing Approach is applied, all of the Section 1059(g) E&P is treated as distributed to FSH, and USSH is treated as receiving all of the non-Section 1059(g) E&P, leaving USSH indifferent from a tax perspective between earning income though a wholly owned CFC or through a CFC partially owned by a non-U.S. Shareholder.

On these simplified facts, a Tracing Approach seems to produce a much more sensible and logical result than the Pure Pro Rata Approach (and, on these simplified facts, the same result as the Pooled Pro Rata Approach). Implementing a Tracing Approach, however, involves much more

[5] This is consistent with the approach taken in Regulations Section 1.245A-5, which limits the application of the Section 245A DRD to distributions of E&P previously subject to the Subpart F and GILTI regimes.

complexity than does applying a Pro Rata Approach. That complexity is created in part (but by no means only) by the fact that if a Tracing Approach is applied then it must continue to be applied across changes in share ownership, as demonstrated by Example 8.[6]

Example 8: Third Party Sales



- Same as Example 7, but in Year 2, when CFC has a value of $200, FSH sells its 40 percent interest in CFC to USSH2 for $80.
- In Year 5, CFC makes a $100 *pro rata* distribution, $60 to USSH and $40 to USSH2.

Pro Rata Approach

As in Example 7, if a Pure Pro Rata Approach is applied, $24 of the $60 distributed to USSH would be Section 1059(g) E&P and $36 would be non-Section 1059(g) E&P. As a result,

[6] The Pooled Pro Rata Approach will, in some instances, produce the same result as a Tracing Approach, without the added complexity of attributing particular E&P (as compared to pools of E&P) to shareholders across changes in share ownership. As noted in subsequent examples, however, it does so at the cost of commingling E&P with the result that a U.S. Shareholder that owns shares that have always previously been owned by a non-U.S. Shareholder can receive distributions of non-Section 1059(g) E&P and a U.S. Shareholder that has always owned the shares with respect to which it is receiving a distribution can receive Section 1059(g) E&P. In this respect the Pooled Pro Rata Approach shares some traits in common with the Modified Silo Tracing Approach discussed later in this Appendix B, but results in the re-allocation of non-Section 1059(g) and Section 1059(g) E&P in more instances. (*See* Examples 8, 13 and 15, which illustrate the differences between a Pooled Pro Rata Approach and the Modified Silo Tracing Approach where shares owned by a U.S. Shareholder were previously owned by a non-U.S. Shareholder.) As such, as is the case in all approaches discussed in this Appendix B, there will be a trade off between "getting it right" and "getting it simple", with the appropriate balance being a decision anyone implementing Proposed Section 1059(g), or a similar system, will be required to make.

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as in Example 7, in Year 5, USSH would be required to reduce its basis in its CFC stock by $18 to $0 under Proposed Section 1059(g) and recognize gain of $6. Of the $40 distributed to USSH2, $16 would be treated as Section 1059(g) E&P and $24 would be non-Section 1059(g) E&P. Accordingly, USSH2 would reduce its $80 basis in its 40 CFC shares by $16 to $64. But presumably the value of the stock held by USSH2 would decrease by the full $40, from $80 to $40. Consequently, application of the Pure Pro Rata Approach in Example 8 would result in USSH losing basis and having gain as a result of being treated as receiving a distribution of Section 1059(g) E&P, even though no non-U.S. Shareholder ever held such stock. Meanwhile, USSH2, which owns shares formerly solely owned by a non-U.S. Shareholder, would be able to shelter up to $24 of future appreciation from tax by virtue of being allocated $24 of non-Section 1059(g) E&P. Preventing USSH2 from obtaining this result seems to be the goal of Proposed Section 1059(g).

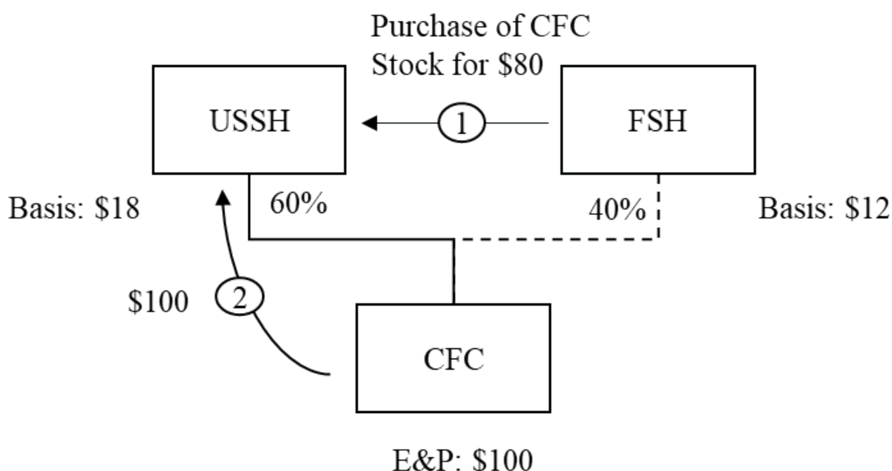
On these facts, a Pooled Pro Rata Approach leads to the same result as a Pure Pro Rata Approach because the distribution in the aggregate exhausts both the non-Section 1059(g) E&P pool and the Section 1059(g) E&P pool. If instead, the distribution were limited to $60, both USSH and USSH2 would receive solely non-Section 1059(g) E&P under the Pooled Pro Rata Approach with no resulting basis reduction to either. But it would nevertheless lead to the allocation of non-Section 1059(g) E&P away from USSH to USSH2 and the corresponding ability of USSH2 to shield future gain from taxation. Moreover, absent the earning of any additional E&P by CFC, any further distributions would result in USSH receiving Section 1059(g) E&P even though its shares had never been held by a non-U.S. Shareholder.

Tracing Approach

As described in connection with Example 7, we believe USSH should not be treated as receiving any of the $40 Section 1059(g) E&P attributable to the stock formerly owned by FSH. From that premise, it follows that if Proposed Section 1059(g) were pursued, and a Tracing Approach were applied, the $40 distributed to USSH2 must be treated as made entirely out of Section 1059(g) E&P. That is, under a Tracing Approach, USSH2 must inherit the E&P attributable to the shares acquired from FSH. As a result, USSH2 would be treated as receiving a $40 distribution of Section 1059(g) E&P with respect to its 40 CFC shares and would reduce its basis in those shares from its initial purchased basis of $80 to $40. USSH, on the other hand, as in Example 7, would be treated as receiving a $60 distribution out of non-Section 1059(g) E&P with respect to its 60 shares in CFC. That $60 distribution would not be subject to Section 1059 and, accordingly, would have no impact on USSH's basis in its CFC shares and USSH would not recognize any gain as a result of the distribution.[7]

[7] For simplicity, except where otherwise noted, this Appendix B does not examine other tracing issues that already arise under current law where USSH recognizes gain on the sale of a portion of its FT stock that is treated in whole or

Example 9: Cross-Shareholder Sales[8]



- Same as Example 7, but in Year 2 FSH sells its 40 percent interest in CFC to USSH, rather than USSH2, for $80.
- In Year 5, CFC makes a $100 distribution to USSH.

Pro Rata Approach

Application of either the Pure Pro Rata Approach or the Pooled Pro Rata Approach would result in the same consequences as regards USSH's 60 historic shares in CFC as application of those approaches in Examples 7 and 8. An application of the Pure Pro Rata Approach or the Pooled Pro Rata Approach to the 40 shares in CFC acquired by USSH from FSH would result in the same consequences to USSH as regards those shares as application of those approaches to USSH2 in Example 8. As a result, USSH would have the same basis reduction and gain recognition as regards its 60 historic CFC shares as in Examples 7 and 8 and the same ability to shelter up to $24 of future appreciation in the 40 shares acquired from FSH as USSH2 would have in Example 8. In each case, regardless of which Pro Rata Approach is applied, on these facts USSH's $18 basis in its 60 historic shares would be reduced from $18 to $0 under Proposed

in part as a dividend under Section 1248 or any interaction of those tracing issues with any Tracing Approach discussed herein.

[8] Example 9 is essentially the same as Example 4 discussed briefly in the Report, which is similar to Example 1 in the Report (if FSH had owned 100 percent of CFC since formation and sold 100 percent rather than 40 percent of CFC to USSH in Year 2), and the same results and issues discussed below as regards USSH's acquisition of a 40-percent interest from FSH would apply, *mutatis mutandis*, as regards an acquisition of a 100-percent interest with respect to the workings of a Pro Rata Approach or a Tracing Approach.

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Section 1059(g), and USSH would recognize gain of $6, and USSH would reduce its $80 cost basis in the 40 newly acquired shares by $16 (to $64)).

We believe that such results are no more palatable when USSH owns both the 60 historic CFC shares and the 40 CFC shares formerly held by FSH than where USSH owns only the 60 historic CFC shares and USSH2 owns the 40 shares formerly held by FSH.

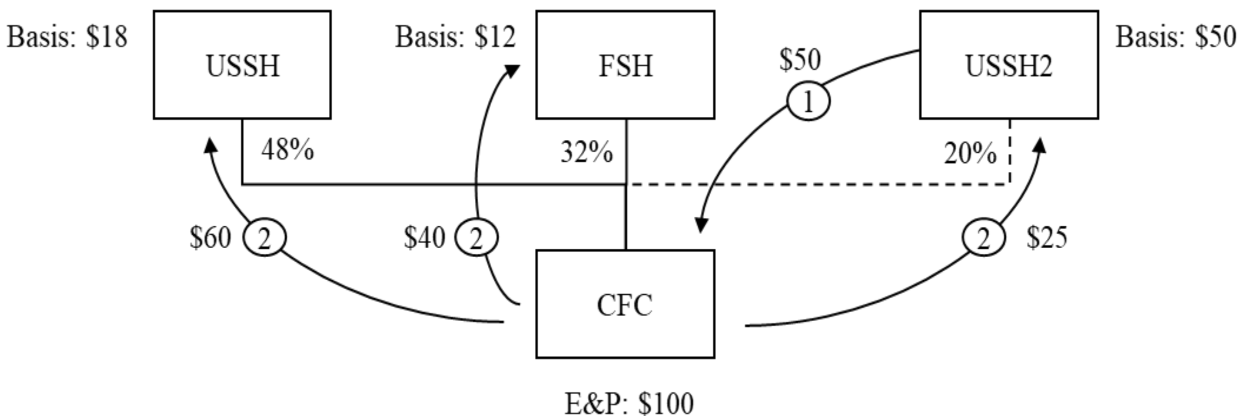
Tracing Approach

Under a Tracing Approach, USSH would be treated as receiving $40 of Section 1059(g) E&P on the shares it acquired from FSH and $60 of non-Section 1059(g) E&P on the shares it always owned. As a result, the distribution would have no impact on USSH's basis in the 60 shares in CFC it always owned, and USSH would recognize no gain on those shares. Like USSH2 in Example 8, USSH would reduce its $80 basis in the 40 CFC shares it acquired from FSH to $40.

B. Post-Formation Direct Investment Example

Having addressed a few basic scenarios involving shares held since formation and changes in ownership in those shares, we now turn to the more difficult issue of potential approaches under Proposed Section 1059(g) to post-formation direct investments in a CFC.

Example 10: Post-Formation Direct Investment



- Same as Example 7, but at the beginning of Year 2 (when CFC has a value of $200), USSH2 contributes $50 to CFC in exchange for 25 shares.

- After the contribution, USSH owns 48 percent of CFC (60 out of 125 shares), FSH owns 32 percent of CFC (40 out of 125 shares) and USSH2 owns 20 percent of CFC (25 out of 125 shares).

- In Year 5, CFC makes a $125 distribution (rather than the $100 distribution in Example 7), $60 to USSH, $40 to FSH, and $25 to USSH2.

Pro Rata Approach

Applying the Pure Pro Rata Approach to these facts, USSH would receive a dividend of $48 and a non-dividend distribution of $12, FSH would receive a dividend of $32 and a non-dividend distribution of $8, and USSH2 would receive a dividend of $20 and a non-dividend distribution of $5. The portion of the distribution treated as a dividend to each of USSH, FSH and USSH2 would consist of 60 percent non-Section 1059(g) E&P and 40 percent Section 1059(g) E&P with respect to each of the shares in CFC they own, resulting in a basis reduction of 40 percent of the dividend amount on each of those shares owned by USSH and USSH2 under Proposed Section 1059(g) (and gain to the extent the reduction is in excess of basis). Accordingly, USSH would receive a dividend of $28.80 of non-Section 1059(g) E&P (60 percent of $48), $19.20 of Section 1059(g) E&P (40 percent of $48), and a non-dividend distribution of $12 ($60 aggregate distribution less aggregate dividends of $48). USSH would reduce its $18 basis in its 60 CFC shares by an aggregate of its non-dividend distribution ($12) and its Section 1059(g) E&P received ($19.20) and would recognize a gain of $13.20 (the difference between $31.20 and its $18 basis). USSH2 would receive a dividend of $12 of non-Section 1059(g) E&P (60 percent of $20), $8 of Section 1059(g) E&P (40 percent of $20), and a non-dividend distribution of $5 ($25 aggregate distribution less aggregate dividend of $20), and would reduce its $50 basis in its 25 CFC shares by $13 (the sum of its $5 non-dividend distribution and its $8 Section 1059(g) E&P distribution) to $37. As with the prior examples, the Pure Pro Rata Approach does not reach a result that seems consistent with the policy of Proposed Section 1059(g).

Under the Pooled Pro Rata Approach, the $60 of non-Section 1059(g) E&P is first allocated among the U.S. Shareholders, *pro rata* based on their ownership percentage. Ignoring FSH's 40 shares, USSH owns 60 out of a total of 85 shares (or approximately 70.6 percent) and USSH2 owns 25 out of a total of 85 shares (or approximately 29.4 percent). Thus, USSH is treated as receiving a dividend of approximately $42.35 of non-Section 1059(g) E&P, and USSH2 is treated as receiving a dividend of the remaining approximately $17.65 of non-Section 1059(g) E&P. That $60 represents a distribution to shareholders owning 68 percent of the CFC shares. FSH, as the shareholder of 32 percent of the CFC shares, would be treated as receiving an allocation, *pro rata* with the U.S. Shareholders, of approximately $28.24 ($28.24/$88.24 equals approximately 32 percent) of Section 1059(g) E&P, leaving approximately $11.76 Section 1059(g) E&P to then be allocated *pro rata* across the three shareholders. USSH would be allocated approximately $5.65 (48 percent), FSH would be allocated approximately $3.76 (32 percent), and USSH2 would be allocated approximately $2.35 (20 percent) of the remaining $11.76 of Section 1059(g) E&P. That leaves $25 of the distribution unaccounted for – that is, the portion of the aggregate distribution in excess of E&P. This $25 non-dividend distribution is allocated *pro rata* among all shareholders under the Pooled Pro Rata Approach. Accordingly, USSH receives a non-dividend distribution of $12, reducing its basis in its 60 CFC shares by an aggregate of $12, plus its $5.65 Section 1059(g)

E&P received, leaving USSH with an approximately 35 cent basis in its CFC shares. USSH2 receives a non-dividend distribution of $5, reducing its $50 basis in its 25 CFC shares by an aggregate of $5, plus its $2.35 Section 1059(g) E&P received, to $42.65. The result differs from the Pure Pro Rata Approach, yet still does not seem to fully address the concerns motivating Proposed Section 1059(g).

<u>Tracing Approach</u>

How a Tracing Approach should be applied in the case of post-formation direct investments is unclear. Several possible alternatives exist.

In Example 10, USSH2 acquires 25 shares directly from CFC that have not been held at a time that any E&P was earned. In its purest form (a Full Tracing Approach), under these facts the $125 distribution would be treated as a $60 dividend of non-Section 1059(g) E&P to USSH and a $40 dividend of Section 1059(g) E&P to FSH, consistent with the E&P underlying the shares owned by each shareholder. That is, a Full Tracing Approach would, in effect, create silos of E&P under each share determined by reference to whether the share was outstanding at the time the E&P was earned and would characterize the E&P in each silo as Section 1059 E&P or non-Section 1059 E&P based on whether a U.S. Shareholder or a non-U.S. Shareholder owned the shares at the time the E&P was earned. Once E&P was allocated to a share silo, it would never shift from that share's silo to another share's silo.

On the above facts, a Full Tracing Approach would result in USSH2 receiving a $25 non-dividend distribution. While the Full Tracing Approach might be attractive as a conceptual matter, in that it prevents any shareholder from receiving Section 1059(g) E&P on shares to which the Section 1059(g) E&P was not attributable when earned, it would involve a substantial deviation from the current E&P rules of the Code.

Moreover, a Full Tracing Approach as described above would impact the allocation of non-Section 1059(g) E&P among USSH and USSH2 in this Example 10, a result that is not required to ensure that no Section 1059(g) E&P is received on shares to which such E&P is not attributable. Said another way, setting aside the $40 of Section 1059(g) E&P (which should be allocated to the FSH shares under Proposed Section 1059(g)), there is nothing in Proposed Section 1059(g) that would require changing the regular Code E&P *pro rata* allocation rules as regards allocations of non-Section 1059(g) E&P. Rather all that is required is that E&P be traced separately with respect to all shares that have different Section 1059(g) E&P and non-Section 1059(g) E&P characteristics. Under an approach that applies the normal E&P allocation rules of the Code subject to this restraint (a Silo Tracing Approach), all shares would be sorted into various share silos depending on their underlying E&P. All shares that have only been owned by U.S. Shareholders and, accordingly, have only underlying non-Section 1059(g) E&P (or would have such E&P if the shares had underlying E&P) would be sorted into one share silo. Similarly, all shares that had only been owned by non-U.S. Shareholders and, accordingly, have only underlying

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Section 1059(g) E&P (or would have only underlying Section 1059(g) if the shares had underlying E&P) would be sorted into a separate share silo. Lastly, all shares having identical layers of non-Section 1059(g) E&P and Section 1059(g) E&P would be sorted into their own separate share silos.[9]

Applying the Silo Tracing Approach to the facts in this Example 10, both the USSH shares and the USSH2 shares would be in the same share silo and there would be $60 of non-Section 1059(g) E&P in this silo. Accordingly, applying the normal E&P allocation rules of the Code within this silo, USSH would be treated as receiving a dividend of approximately $42.35 of non-Section 1059(g) E&P (or 60/85 of the $60 total non-Section 1059(g) E&P) and a non-dividend distribution of approximately $17.65, resulting in USSH reducing its $18 basis in its 60 CFC shares to approximately 35 cents. USSH2 would be treated as receiving a dividend of approximately $17.65 of non-Section 1059(g) E&P (or 25/85 of the $60 total non-Section 1059(g) E&P) and a non-dividend distribution of approximately $7.35, resulting in USSH2 reducing its $50 basis in its 25 CFC shares to approximately $42.65.[10]

On the other hand, the shares owned by FSH would be in their own separate share silo and would have underlying Section 1059(g) E&P of $40. Thus, the full $40 distributed to FSH would be treated as a dividend out of Section 1059(g) E&P.

While the application of the Silo Tracing Approach hews closer to the general E&P rules of the Code than does the Full Tracing Approach, it would still result in some shareholders (here, FSH) receiving solely dividend income while other shareholders (here, USSH and USSH2) receive some non-dividend distributions. If this disproportionate dividend/non-dividend distributions among shares across share silos was thought to be undesirable, a further modification to a Silo Tracing Approach could be adopted. Under this modification (a Modified Silo Tracing Approach), E&P would be shifted among share silos to the extent (and only to the extent) necessary to prevent disproportionate per share dividends (and thus per share non-dividend distributions) while maintaining differentiated distributions of Section 1059(g) E&P to non-U.S. Shareholders and non-Section 1059(g) E&P to U.S. Shareholders to the greatest extent possible. In this Example 10, the 68 percent of the CFC shares in the combined USSH and USSH2 share silo have been

[9] As a result, there would only be one share silo with respect to shares that had only ever been owned by U.S. Shareholders and one share silo with respect to shares that had only ever been owned by non-U.S. Shareholders, but there could be numerous share silos of shares that had mixed ownership over time because there are multiple possible combinations of differing share ownership periods between U.S. and non-U.S. Shareholders.

[10] Note that the Silo Tracing Approach would permit USSH2 in Example 10 to receive a dividend out of non-Section 1059(g) E&P earned under USSH's shares, and thereby get a dividend eligible for the 100-percent Section 245A DRD rather than a non-dividend distribution. But that is merely the application of current law to a fact pattern in which a U.S. Shareholder owns stock in a CFC and another U.S. Shareholder makes a post-formation direct investment in that CFC and is the same result that would ensue under a Pooled Pro Rata Approach. Nothing in Proposed Section 1059(g) would change that result nor require any basis reduction with respect to USSH2's shares as regards this "shifted" E&P to the extent that basis reduction was not already required by current law.

allocated 60 percent ($60 of the total of $100) of the E&P in CFC, while the 32 percent of the CFC shares in the FSH share silo have been allocated 40 percent ($40 of the total of $100) of the E&P in CFC. To solve this disproportionality, $8 of E&P (which is Section 1059(g) E&P) would be shifted from the FSH share silo to the USSH/USSH2 share silo. As a result of this $8 shift in Section 1059(g) E&P, under the normal Code rules for E&P allocation USSH would be allocated approximately $5.65 (60/85 multiplied by $8) and USSH2 would be allocated approximately $2.35 (25/85 multiplied by $8). Because $0 of non-Section 1059(g) E&P would be shifted out of the USSH/USSH2 share silo, the allocation of non-Section 1059(g) E&P between USSH and USSH2 would be the same as under the Silo Tracing Approach. Finally, because $8 of additional E&P is now in the USSH/USSH2 share silo, $8 fewer in total non-dividend distributions would be made to USSH and USSH2 (USSH would receive $5.65 less and USSH2 would receive $2.35 less). FSH, on the other hand, would receive an $8 non-dividend distribution and a $32 dividend from Section 1059(g) E&P.[11]

While this Modified Share Tracing Approach may be viewed by some as doing less violence to the general E&P allocation rules of the Code than a Silo Tracing Approach, it can also result in shares that at no time have been owned by non-U.S. Shareholders receiving distributions

[11] Some might argue that, in the facts of Example 10, USSH2 has in effect bought a portion of each of USSH's and FSH's existing investments, and the form of the transaction should be so recast for purposes of determining Proposed Section 1059(g) E&P allocations. This recast would result in yet another possible Tracing Approach. Under this "over-the-top" recast, 10 of USSH2's 25 shares would be part of an FSH/USSH2 50 share silo containing $40 of Section 1059(g) E&P and 15 of USSH2's 25 shares would be part of a USSH/USSH2 75 share silo containing $60 of non-Section 1059(g) E&P. Accordingly, the $125 distribution would be treated as made $50 on the FSH/USSH2 50 share silo, resulting in USSH2 receiving an $8 Section 1059(g) E&P dividend (10/50 times $40) and a $2 non-dividend distribution (10/50 times $10) on its 10 shares in that silo. The remaining $75 distribution would be treated as made on the USSH/USSH2 75 share silo, resulting in USSH receiving a $48 (60/75 times $60) non-Section 1059(g) E&P dividend and a $12 (60/75 times $15) non-dividend distribution on its 60 shares in that silo and USSH2 receiving a $12 (15/75 times $60) non-Section 1059(g) E&P dividend and a $3 (15/75 times $15) non-dividend distribution on its 15 shares in that silo. Over-the-top recasts are not without precedent where the form of a transaction is uncertain. *See, e.g.*, Regulations Section 1.358-6 (adopting an over-the-top methodology for determining stock basis in certain triangular reorganizations). That said, transactions involving in-form new investments have often been respected as such even in cases where the investments have in short order been distributed to the pre-existing shareholders. *See, e.g.*, Rev. Rul. 68-55, 1968-1 C.B. 140; (A's contribution of cash to newly formed Y in exchange for Y shares, and X's contribution of assets to Y in exchange for Y shares and cash, treated as subject to Section 351(b) and not recast as over-the-top sale of assets or stock by X to A) and Rev. Rul. 75-447; 1975-2 C.B. 113 (redemption of stock followed by issuance of stock to a new shareholder treated in accordance with its form and not recast as an over-the-top sale). In addition, in other areas where per share tracing of E&P is undertaken, such as Section 1248, there is no indication that a direct investment is recast as an over-the-top transfer for E&P tracing purposes. Moreover, this over-the-top recast raises questionable results when the assets transferred are not cash or other non-stock assets but rather stock in another entity. *Cf.* the reorganization discussion with respect to Example 11, below. Accordingly, the remainder of this Appendix B does not further discuss over-the-top recasts, and it is assumed that such recasts are not adopted for determining E&P allocations for purposes of Proposed Section 1059(g).

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of Section 1059(g) E&P – an anomaly that does not occur under a Silo Tracing Approach.[12]

Similar to the post-formation direct investment issue discussed above, an issue also arises as to how E&P deficits should be treated in future years where not all shareholders are sharing proportionally in E&P for prior years. Under a Silo Tracing Approach, just as particular shares could have a non-dividend distribution when others have dividends, certain shares must be able to have E&P deficits even where that deficit has not fully offset all the E&P of the CFC. The Modified Silo Tracing Approach eliminates this issue with respect to post-formation direct investments by ensuring that all shares of the same class have the same proportionate amount of E&P. As a result, under a Modified Silo Tracing Approach, a deficit in E&P would not result in some shares having an E&P deficit while other shares have remaining E&P.[13]

C. Reorganization Examples

Similar E&P allocation issues to those presented by post-formation direct investments can arise in the context of reorganizations, as demonstrated by the below examples.

[12] The Modified Silo Tracing Approach can also result in shares that were at no time owned by U.S. Shareholders receiving distributions of non-Section 1059(g) E&P. For instance, if in Example 10 the new investment were made by FSH2, a new foreign shareholder, rather than USSH2, the shares owned by FSH and FSH2 would be treated as their own share silo and, under the Modified Silo Tracing Approach, non-Section 1059(g) E&P would be shifted from the USSH share silo to the FSH/FSH2 share silo.

[13] *See* Appendix C for a further discussion of E&P and E&P deficit ordering issues.

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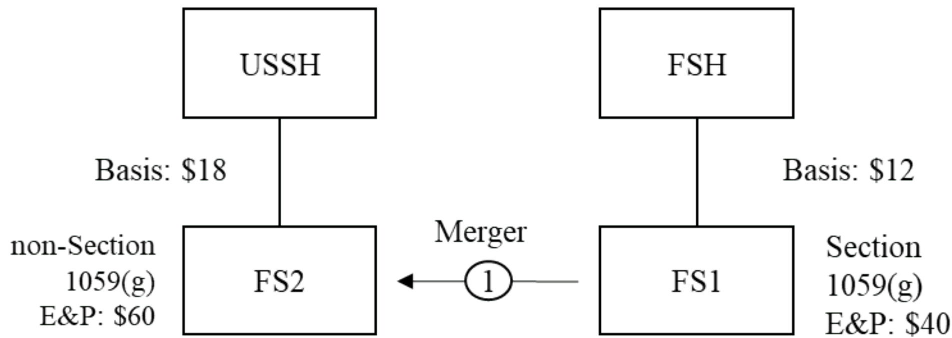
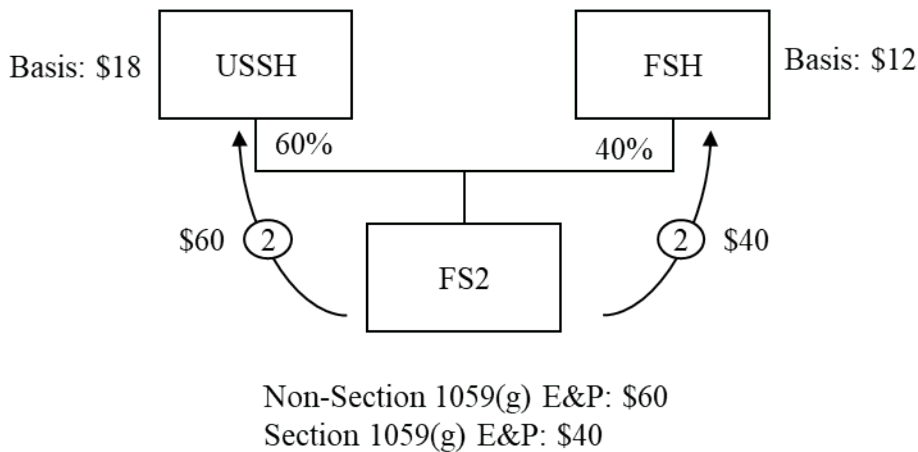
Example 11: Basic Reorganization





- FSH owns 40 shares in FS1, which is 100 percent of FS1's outstanding shares. FSH has a $12 basis in the 40 FS1 shares, and FS1 has $40 of Year 1 Section 1059(g) E&P.

- USSH owns 60 shares in FS2, which is 100 percent of FS2's outstanding shares. USSH has an $18 basis in the 60 FS2 shares, and FS2 has $60 of Year 1 non-Section 1059(g) E&P.

- In Year 4, when the value of FS1 is $80 and the value of FS2 is $120, FS1 merges into FS2 in a Section 368(a) reorganization, with FS2 inheriting FS1's E&P and FSH receiving 40 FS2 shares in exchange for its 40 FS1 shares.

- FSH takes a $12 basis in the 40 FS2 shares it receives in exchange for its 40 FS1 shares and USSH retains an $18 basis in its 60 FS2 shares that it has owned since FS2's formation.

- In Year 7, unrelated to the merger, FS2 makes a $100 distribution *pro rata* to USSH and

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FSH.

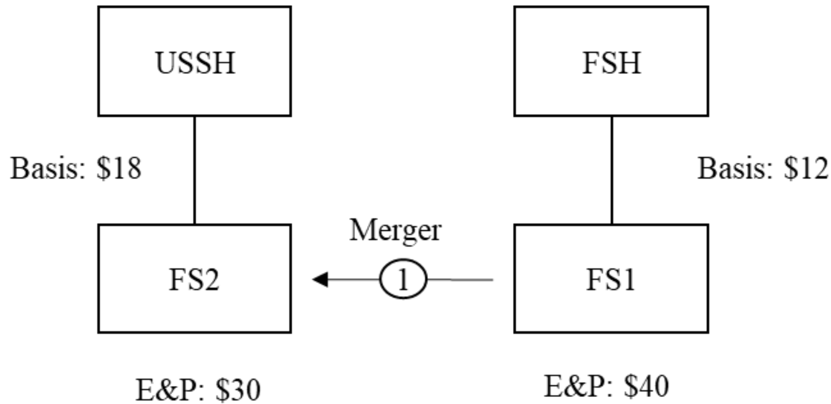
Pro Rata Approach

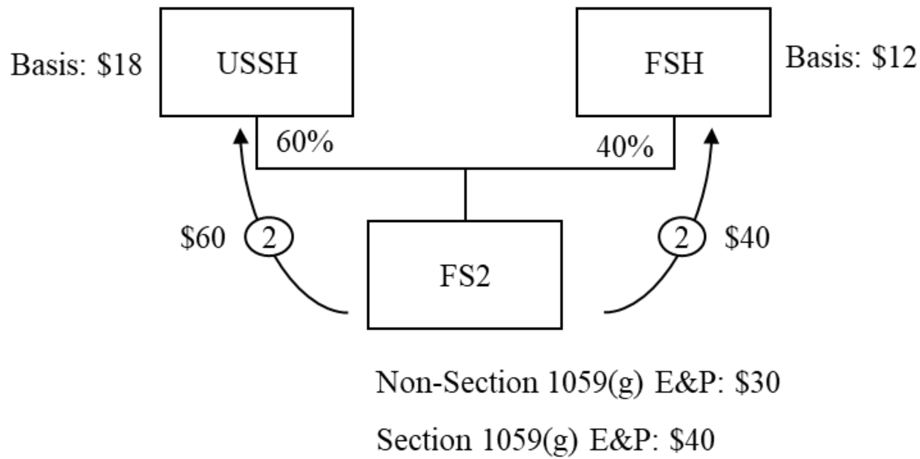
Under the Pure Pro Rata Approach, the results would be the same as in Example 7. The E&P of FS1 and FS2 (both the non-Section 1059(g) E&P and the Section 1059(g) E&P) generally would be treated as being distributed proportionally to each of USSH and FSH. Employing the Pooled Pro Rata Approach in this Example 11, however, would cause all $60 of the non-Section 1059(g) E&P to be allocated to the lone U.S. Shareholder, USSH, producing the same result as under the Pooled Pro Rata Approach in Example 7. As discussed immediately below, employing a Tracing Approach would have the same outcome on these facts as the Pooled Pro Rata Approach.

Tracing Approach

Under a Full Tracing Approach or Silo Tracing Approach, the $60 distribution to USSH should be treated as made solely from non-Section 1059(g) E&P, and the $40 distribution to FSH should be treated as made solely from Section 1059(g) E&P (because the E&P underlying FSH's FS2 shares should be treated as being the Section 1059(g) E&P attributable to FSH's FS1 shares prior to the reorganization). Under a Modified Silo Tracing Approach, the same result should follow because no shifting of E&P is needed on these facts to ensure that no dividend is paid on some shares while a non-dividend distribution is made on other shares.

Example 12: Reorganization with Disproportionate E&P





- FSH owns 40 shares in FS1, which is 100 percent of FS1's outstanding shares. FSH has a $12 basis in the 40 FS1 shares, and FS1 has $40 of Year 1 Section 1059(g) E&P.

- USSH owns 60 shares in FS2, which is 100 percent of FS2's outstanding shares. USSH has an $18 basis in the 60 FS2 shares, and FS2 has $30 of Year 1 non-Section 1059(g) E&P.

- In Year 4, when the value of FS1 is $80 and the value of FS2 is $120, FS1 merges into FS2 in a Section 368(a) reorganization, with FS2 inheriting FS1's E&P and FSH receiving 40 FS2 shares in exchange for its 40 FS1 shares.

- FSH takes a $12 basis in the 40 FS2 shares it receives in exchange for its 40 FS1 shares

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and USSH retains an $18 basis in its 60 FS2 shares that it has owned since FS2's formation.

- In Year 7, unrelated to the merger, FS2 makes a $100 distribution *pro rata* to USSH and FSH.

In Example 11, the facts were carefully chosen to have E&P in proportion to the values of the shares of each of the corporations (FS1 and FS2). In that case (which is likely to be rare), all of the Pro Rata Approaches and the Tracing Approaches would result in dividends proportional among all shares (although the Pure Pro Rata Approach would result in different types of E&P going to USSH and FSH than would the other approaches). Outside of that case, however, the Full Tracing Approach and Silo Tracing Approach would not produce proportional dividends. Example 12 shows a more realistic case, where the values of the stock in FS1 and FS2 are not proportional to the E&P of each.

In Example 12, FS2 has $30 of E&P (instead of $60). In this case, FS1 would have twice as much E&P relative to the value of its shares as does FS2 and, as a result, after the merger, any shares received in FS2 attributable to shares in FS1 would have twice as much Section 1059(g) E&P allocated to them as the non-Section 1059(g) E&P allocated to the historical FS2 shares.

<u>*Pro Rata Approach*</u>

On these revised facts, under a Pure Pro Rata Approach, each dollar distributed to USSH and FSH would be comprised 3/7ths of non-Section 1059(g) E&P and 4/7ths of Section 1059(g) E&P until the total distributions reached $70, at which point all further distributions would be non-dividend distributions.

Under a Pooled Pro Rata Approach, the first $50 distributed would be treated as consisting of $30 of non-Section 1059(g) E&P being distributed to USSH and $20 of Section 1059(g) E&P being distributed to FSH. The next $20 of distributions would result in $12 of Section 1059(g) E&P being treated as distributed to USSH and $8 of Section 1059(g) E&P being treated as being distributed to FSH. Like the Pure Pro Rata Approach, the Pooled Pro Rata Approach would result in any distribution in excess of $70 being treated as non-dividend distributions to both USSH and FSH.

<u>*Tracing Approach*</u>

On these revised facts, under any of the Tracing Approaches, the first $50 of distributions would be treated in the same manner as under the Pooled Pro Rata Approach – $30 of non-Section 1059(g) E&P would be treated as being made to USSH and $20 of Section 1059(g) E&P would be treated as being made to FSH. As regards distributions in excess of $50, on these facts the Modified Silo Tracing Approach would also result in the same outcome as under the Pooled Pro Rata Approach – the next $20 of distributions would be treated as a distribution of $12 of Section 1059(g) E&P to USSH and $8 of Section 1059(g) E&P to FSH, and all amounts in excess of this

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incremental $20 of distributions would be treated as non-dividend distributions to both USSH and FSH.

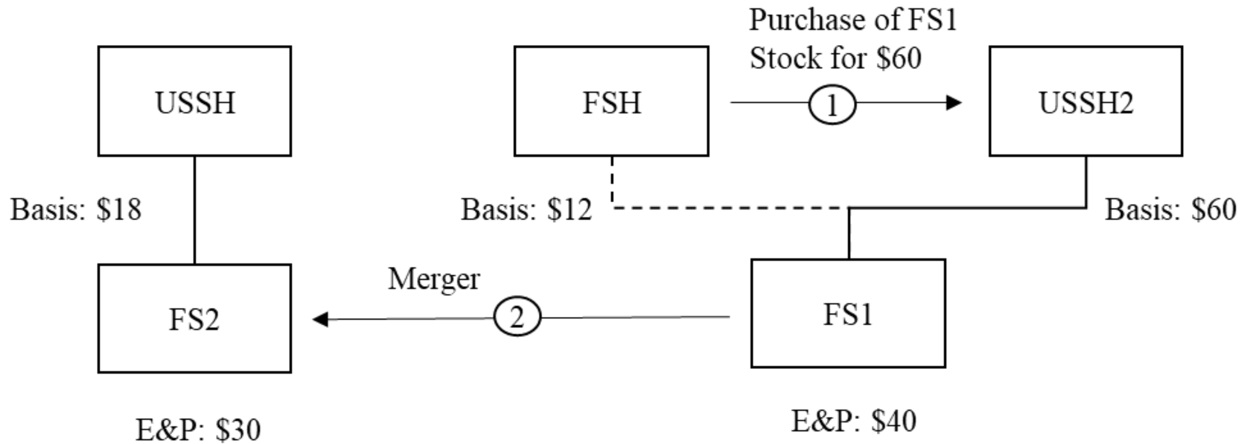
Under the Full Tracing Approach or the Silo Tracing Approach, however, any distributions in excess of $50 would be treated as non-dividend distributions to USSH. As regards FSH, any distribution in excess of $50 would be treated as distributions of Section 1059(g) E&P until the remaining $20 of Section 1059(g) E&P was exhausted and then as non-dividend distributions. That is, both the Full Tracing Approach and the Silo Tracing Approach would ensure that USSH never is treated as receiving a distribution of E&P attributable to FSH's ownership in FS1.

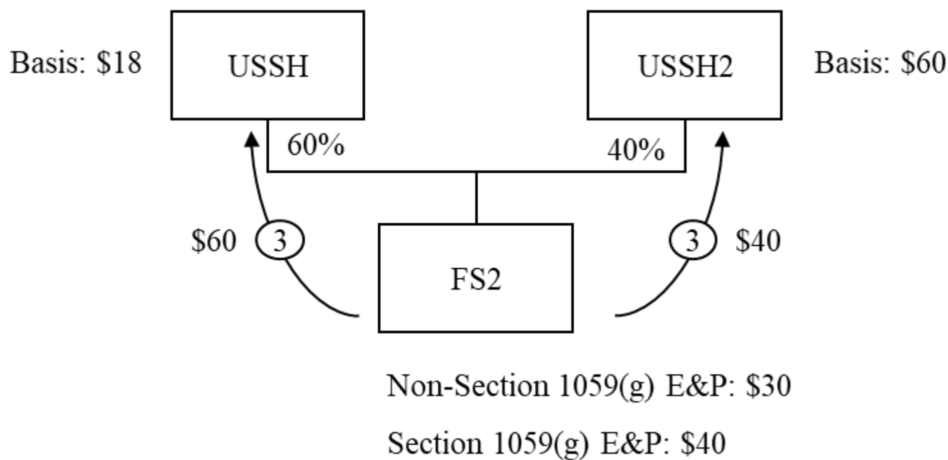
USSH may be largely indifferent on these facts as to whether the Pooled Pro Rata Approach, the Modified Silo Tracing Approach, the Silo Tracing Approach or the Full Tracing Approach is applied. In all cases, USSH's basis in its FS2 shares would be reduced by the amount of any distribution on those shares in excess of $30. Under the Full Tracing Approach or Silo Tracing Approach, that reduction would occur under Section 301(c)(2); under the Pooled Pro Rata Approach and the Modified Silo Tracing Approach, it would occur under Proposed Section 1059(g). And in all cases, gain would be recognized to the extent that the basis reduction exceeded basis. But note that a Silo Tracing Approach or Full Tracing Approach would not need Proposed Section 1059(g) to address the shift in E&P among shares (there would be no shift). Indeed, it is the shift that occurs under current law and the potential to reduce built-in gain in shares to which the E&P is shifted that in part creates the issue that Proposed Section 1059(g) is evidently attempting to address.[14]

[14] On the other hand, if USSH was attempting to reduce the amount of gain in its FS2 stock under current law in anticipation of transferring its FS2 shares out from under the U.S. tax net to eliminate residual U.S. tax imposed on FS2's future earnings, this rationale may be significantly mooted once Pillar 2 is implemented and non-U.S. taxes imposed on FS1 and FSH are potentially increased.

Example 13: Sale Preceding Reorganization

The facts are the same as in Example 12 but now USSH2 rather than FSH owns the stock of FS1 at the time of the merger of FS1 into FS2.





- FSH owns 40 shares in FS1, which is 100 percent of FS1's outstanding shares. FSH has a $12 basis in the 40 FS1 shares, and FS1 has $40 of Year 1 Section 1059(g) E&P.

- USSH owns 60 shares in FS2, which is 100 percent of FS2's outstanding shares. USSH has an $18 basis in the 60 FS2 shares, and FS2 has $30 of Year 1 non-Section 1059(g) E&P.

- At the end of Year 2, FSH sells its FS2 shares to USSH2 for $60.

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- In Year 4, when the value of FS1 is $80 and the value of FS2 is $120, FS1 merges into FS2 in a Section 368(a) reorganization, with FS2 inheriting FS1's E&P and USSH2 receiving 40 FS2 shares in exchange for its 40 FS1 shares.
- USSH2 takes a $60 basis in the 40 FS2 shares it receives in exchange for its 40 FS1 shares and USSH retains an $18 basis in its 60 FS2 shares that it has owned since FS2's formation.
- In Year 7, unrelated to the merger, FS2 makes a $100 distribution *pro rata* to USSH and FSH.

Pure Pro Rata Approach

On these facts, the result under the Pure Pro Rata Approach is the same in Example 12, substituting USSH2 for FSH and USSH2's $60 basis for FSH's $12 basis, with USSH2 receiving the same amount of Section 1059(g) E&P and non-Section 1059(g) E&P as FSH would in Example 12.

Pooled Pro Rata Approach

Under the Pooled Pro Rata Approach, the results are significantly different than in Example 12. Under that approach, all E&P of post-merger FS2 is divided into a non-Section 1059(g) pool and a Section 1059(g) E&P pool, with the amount in each pool then going proportionally to USSH and USSH2 on these revised facts. Hence, unlike in the case where the FS1 shares were held by FSH at the time of the merger into FS2 and FS2 shares were held by FSH at the time of the subsequent distribution, in this case the non-Section 1059(g) E&P is allocated between USSH and USSH2, even though all of the non-Section 1059(g) E&P was earned during the period that USSH held its shares in FS2 and none of it was earned with respect to the shares owned by USSH2. More specifically, in this case, the first $30 of distributions by FS2 would be treated as USSH receiving $18 of non-Section 1059(g) E&P and USSH2 receiving $12 of Section 1059(g) E&P. The next $40 of distributions by FS2 would be treated as a distribution of $24 of Section 1059(g) E&P to USSH and $16 of Section 1059(g) E&P to USSH2. And any distributions in excess of $70 would be treated as a non-dividend distribution to both USSH and USSH2. Thus, in this case, USSH2 is treated as receiving a distribution of $12 of non-Section 1059(g) E&P under the Pooled Pro Rata Approach, despite having bought shares previously owned solely by a foreign person.

Tracing Approach

The results under any Tracing Approach are the same as in Example 12, substituting USSH2 for FSH and USSH2's $60 basis for FSH's $12 basis, with USSH2 receiving the same amount of non-Section 1059(g) E&P (*i.e.*, $0) and Section 1059(g) E&P (*i.e.*, $40) as FSH would in Example 12.

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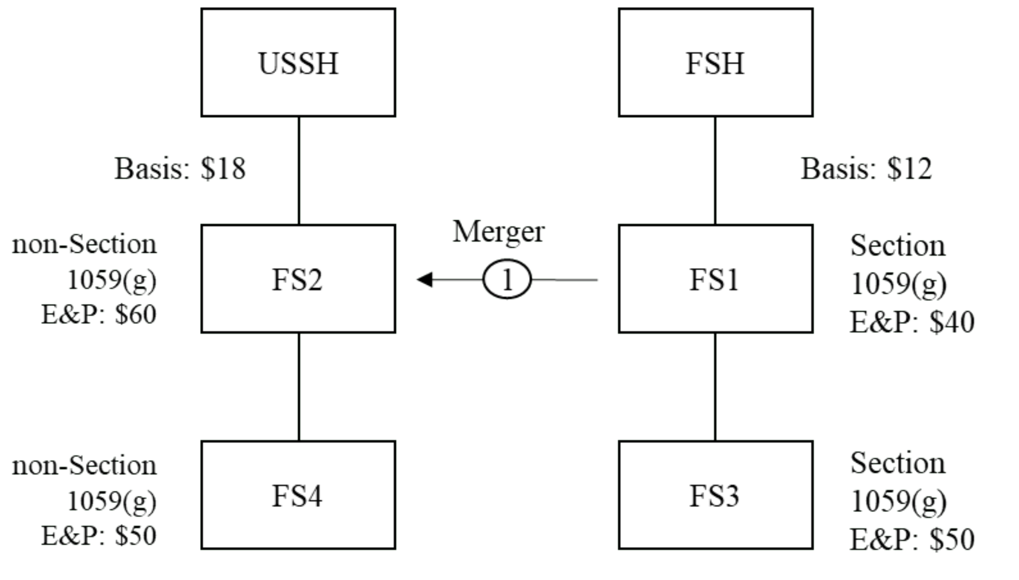
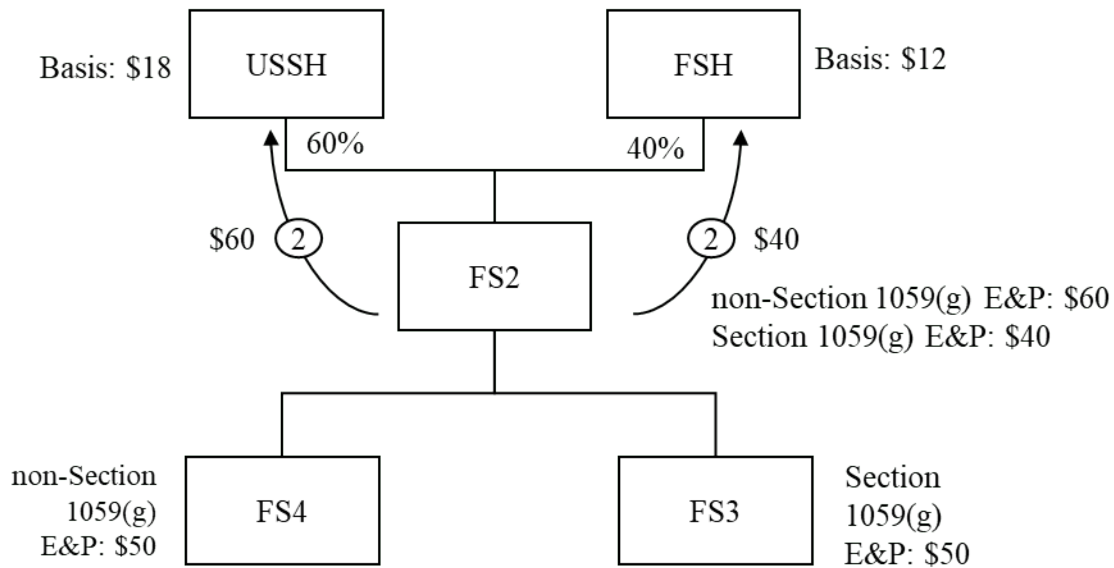
Example 14: Complex Reorganization





- Same as Example 11 but, in addition, FS1 wholly owns FS3, which has $50 of Year 1 Section 1059(g) E&P, and FS2 owns FS4, which has $50 of Year 1 non-Section 1059(g) E&P.

- Upon the merger of FS1 into FS2, FS2 continues to wholly own both FS3 and FS4.

- As in Example 11, following and unrelated to the merger, FS2 makes a $100 distribution

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pro rata to USSH and FSH.

Pro Rata Approach

Without more, the results under the Pure Pro Rata Approach would be the same in Example 14 as in Example 11. Depending, however, on whether distributions are made to FS2 from FS3 or FS4, or both, and the timing of distributions from FS2 to USSH and FSH compared to distributions from FS3 and FS4 to FS2, the percentage of each dollar of dividend received by USSH and FSH consisting of non-Section 1059(g) E&P and Section 1059(g) E&P could change versus Example 11. But in all cases, the percentage of Section 1059(g) E&P and non-Section 1059(g) E&P received on each FS2 share held by USSH and FSH would be the same.

Applying the Pooled Pro Rata Approach produces the same outcome as such approach applied to Example 11 – USSH is treated as receiving the entire $60 of non-Section 1059(g) E&P. If amounts are distributed from FS3 or FS4, or both, to FS2 before amounts are distributed from FS2 to USSH and FSH, then pools of Section 1059(g) E&P and non-Section 1059(g) E&P may become disproportionate. Where disproportionality of pools occur, USSH would be treated as receiving distributions of non-Section 1059(g) E&P and FSH would be treated as receiving distributions of Section 1059(g) E&P until one of the pools is exhausted. Thereafter, distributions would be treated as made proportionally to USSH and FSH out of the remaining pool until that pool is exhausted. Thereafter, all distributions would be treated as non-dividend distributions to both USSH and FSH.

Tracing Approach

Without more, the result in Example 14 is the same as in Example 11 under each of the Tracing Approaches. But things become complex quickly when distributions are made from FS3 or FS4, or both, to FS2. Under the Full Tracing Approach and the Silo Tracing Approach, all the existing E&P of FS3 should be attributed to FSH and all the FS4 E&P should be attributed to USSH. Both of these Tracing Approaches would accommodate that attribution by treating either FSH or USSH, as applicable, as receiving a non-dividend distribution when there is no more E&P at the FS2 level that is attributed to the relevant share silo that the shareholder holds, even if the other shareholder is being treated as receiving an E&P distribution.

The Modified Silo Tracing Approach, on the other hand, would shift E&P between USSH's shares and FSH's shares, or vice versa, to always ensure that neither shareholder receives a non-dividend distribution unless both do. On these facts, that produces the same result as the Pooled Pro Rata Approach. Therefore, like under the Pooled Pro Rata Approach, which category of E&P is treated as distributed to USSH and FSH under the Modified Silo Tracing Approach would

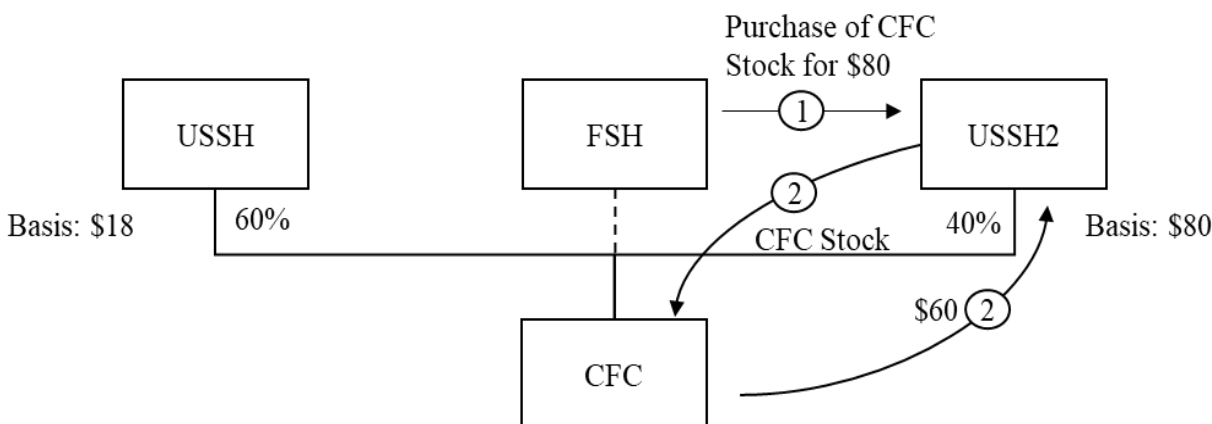
depend on the ordering of distributions from FS3 and FS4 to FS2. Whether USSH or FSH is treated as receiving a non-dividend distribution under the Full Tracing Approach or the Silo Tracing Approach would also depend on that ordering.

The sensitivity of the Pro Rata Approaches and the Tracing Approaches to the ordering of distributions from lower tier-subsidiaries is inherent to some extent in the current Code rules for allocating E&P, which generally do not recognize lower-tier E&P until distributed. But that sensitivity (and the complexity of addressing that sensitivity) is exacerbated under Proposed Section 1059(g) if a Pooled Pro Rata Approach or a Tracing Approach is adopted.

D. Redemption Example

Additional issues regarding the appropriate application of Proposed Section 1059(g) are created by stock redemptions treated as distributions to which Section 301 applies under Section 302(d). These additional issues are explored in Example 15 below.

Example 15: Redemptions



- Same facts as in Example 8, but rather than a $100 distribution in Year 5, assume that in Year 5 the value of CFC is $300 and CFC redeems one half of USSH2's 40 percent interest in CFC for $60.

- After the redemption, USSH2 owns 25 percent (20 out of the remaining 80) of CFC's shares and USSH owns 75 percent (60 out of the remaining 80) of CFC's shares.

The redemption's impact on CFC's E&P under the regular Code E&P rules would depend on whether Section 302(a) or Section 302(d) applies to the redemption. Assume Section 302(d)

applies.[15]

Pro Rata Approach

Under current law, the full $60 would be treated as a dividend paid by CFC to USSH2, and CFC would reduce its E&P by $60. Under the Pure Pro Rata Approach the $60 would consist of $36 (60 percent of $60) of non-Section 1059(g) E&P and $24 (40 percent of $60) of Section 1059(g) E&P.[16] Any subsequent distributions would access CFC's remaining E&P ($40), 25 percent to USSH2 and 75 percent to USSH, with each distribution to each shareholder consisting of 60 percent non-Section 1059(g) E&P and 40 percent Section 1059(g) E&P. Any distribution in excess of this remaining E&P would be treated as a non-dividend distribution. Under the Pooled Pro Rata Approach, all $60 of the non-Section 1059(g) E&P would be treated as distributed to USSH2 in the redemption transaction, even though USSH2 owns no shares that generated non-Section 1059(g) E&P. This result not only shifts non-Section 1059(g) E&P from USSH to USSH2, but does so on a priority basis, with the result that, upon a later distribution, USSH would receive only Section 1059(g) E&P (assuming no further E&P is generated).

Tracing Approach

Note that on the above facts the effect under current law is to shift E&P underlying the shares owned by USSH to the shares owned by USSH2 to make up for the shortfall in E&P underlying USSH2's shares compared to the amount treated as a dividend arising from the Section 302(d) redemption.[17] That shift becomes greater as the value of CFC's shares relative to their underlying E&P increases and less as it decreases. Indeed, if the value of CFC's shares fell below the shares' underlying E&P, less E&P would be allocated to a share in a Section 302(d) redemption than its underlying E&P and there would be excess E&P that would then be reallocated among the

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[15] Section 302(d) applying on these facts is unlikely absent USSH and USSH2 being related. Nevertheless, Section 302(d) is assumed to apply here in order to demonstrate certain of the issues that would arise under such circumstances. As in all examples in the Report and the appendices (including this Appendix B), Section 304 is assumed not to apply to any sales among shareholders.

[16] Because the redemption is non-*pro rata* among shareholders, it would be a redemption to which Section 1059(e)(1)(A) applies. *See* Section 1059(e)(1)(A)(ii). Accordingly, the $60 dividend will result in an equivalent basis reduction or gain recognition, as applicable, regardless of whether the underlying E&P is or is not Section 1059(g) E&P. We do not address herein which shares held by USSH2 have a basis reduction/gain recognition. The answer to that question turns on both whether Section 1059(e)(1)(A)(iii) also applies with respect to the redemption and what one's views are regarding on which shares distributions are treated as occurring in a Section 302(d) redemption. *See* the NYSBA Tax Section Report No. 1112, *Report on Basis Recovery in a Dividend Equivalent Redemption* (Jun. 13, 2006); and the NYSBA Tax Section Report No. 1316, *Report on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions Involving Corporate Stock or Securities* (Feb. 6, 2015).

[17] In the redemption, the redeemed shares are accessing $60 of CFC E&P even though the amount underlying the shares owned by USSH2 is only $40 (and the amount underlying the shares redeemed is only $20).

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remaining shares.

How should this Section 302(d) transaction be treated under a Tracing Approach? Under a Full Tracing Approach or a Silo Tracing Approach, the only E&P accessible with respect to the USSH2 shares redeemed would be the E&P underlying shares in the same share silo (*i.e.*, the E&P in the 40 CFC share silo owned by USSH2). Because the aggregate amount of E&P underlying USSH2's shares is $40, the $60 distribution to USSH2 resulting from the redemption of half its shares should be treated as a dividend of $40 under Section 301(c)(1) and a return of capital/gain of $20 under Section 301(c)(2)/(3).[18] Going forward, there would be no E&P underlying the 20 remaining CFC shares owned by USSH2 (unless further E&P were earned by CFC) and no E&P would be shifted from USSH's 60 share silo to USSH2's 20 share silo. But perhaps USSH2's 20 share silo and USSH's 60 share silo should be combined into one silo on these post-redemption facts since there is no longer any Section 1059(g) E&P underlying either share silo and all shares are owned by U.S. Shareholders.

Things get murkier under a Modified Silo Tracing Approach. Under that approach, E&P is shifted among silos to the extent (and only to the extent) necessary to ensure no shares in one silo receive a dividend while shares in other silos receive a non-dividend distribution. Literally, that is not happening in the redemption – only the shares in the USSH2 share silo are receiving any distributions. Accordingly, under one theory, no shift is required and the redemption results in a $40 Section 1059(g) E&P dividend and a $20 non-dividend distribution on the USSH2 shares. Then, assuming the remaining 20 USSH2 shares and the 60 USSH shares are not combined into one silo, as noted above, and there was a $60 *pro rata* distribution made by CFC, $15 of the $60 underlying the USSH share silo (all of which would be non-Section 1059(g) E&P) would be shifted to the USSH2 share silo to prevent the $60 distribution from resulting in a dividend being paid on shares in the USSH share silo while shares in the USSH2 share silo receive non-dividend distributions. Alternatively, perhaps $20 should be shifted from the USSH share silo to USSH2 share silo on day one to prevent any of the $60 of redemption proceeds from being treated as a non-dividend distribution while there is still E&P remaining at CFC. In this scenario, after the distribution there would be $40 of E&P underlying USSH's 60 share silo in CFC and none underlying USSH2's 20 remaining share silo in CFC. Assuming USSH's 60 share silo and USSH2's remaining 20 share silo in CFC are not then combined into one share silo, upon a subsequent $40 distribution by CFC, $10 of E&P would be shifted from the USSH share silo to the USSH2 share silo. Yet another approach would be forward looking and would shift $30 from USSH's share silo to USSH2's share silo immediately before the redemption. That shift would both ensure that there is no non-dividend distribution at a time that CFC still has E&P and proactively prevent any future *pro rata* distributions from also producing that result by ensuring upfront that post-redemption there is no disproportionality in E&P between the USSH share silo

[18] For a discussion of which share's basis is reduced with respect to the $40 dividend, see footnote 16 above. A similar issue arises as regards the $20 treated as a non-dividend distribution.

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and USSH2 share silo (again, assuming those shares are not combined post-redemption in one share silo).

The choice between (i) shifting $20 on "day one" and $10 later only if and when there is a further distribution, and (ii) shifting $30 upfront, is not merely mechanics. It will affect what portion of the redemption distribution is treated as being from Section 1059(g) E&P and what portion is treated as being from non-Section 1059(g) E&P, as well as the amount and type of E&P underlying the 20 remaining USSH2 shares immediately after the redemption. If only $20 is shifted at the outset, then the $60 redemption proceeds will consist of $20 of non-Section 1059(g) E&P and $40 of Section 1059(g) E&P, and there will be no E&P underlying the 20 remaining CFC shares held by USSH2 immediately after the redemption. On the other hand, if the entire $30 is shifted first, then, under the normal E&P allocation rules of the Code, the $60 redemption proceeds will consist of approximately $25.71 of non-Section 1059(g) E&P ($30 multiplied by $60/$70) and approximately $34.29 of Section 1059(g) E&P ($40 multiplied by $60/$70).[19] And after the redemption there would be approximately $4.29 of non-Section 1059(g) E&P and $5.71 of Section 1059(g) E&P underlying the 20 remaining CFC shares held by USSH2.

[19] These calculations assume that all distributions from the same-year layer of E&P are treated as made proportionally out of each type of E&P in that layer. For a discussion of this point and other possibilities, see the discussion in Appendix C.

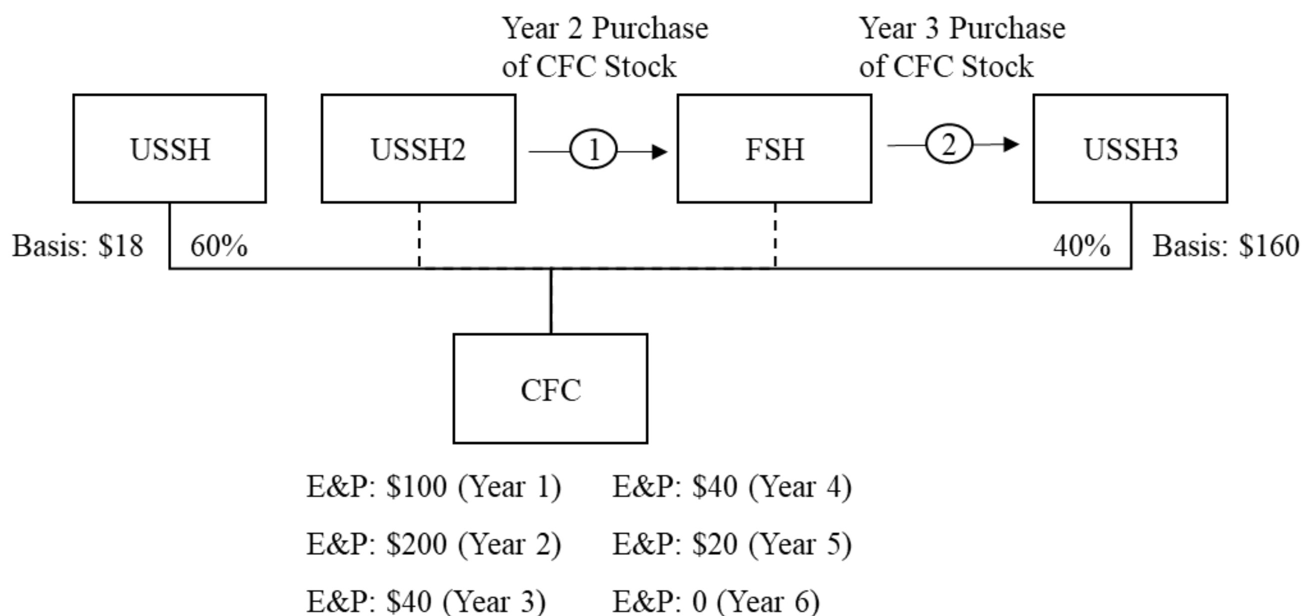
Appendix C - Ordering Issue

As noted in Part VI.B. of the Report, if a Pro Rata Approach or a Tracing Approach were adopted for allocating E&P, an additional issue that would need to be addressed is the order in which E&P is treated as being accessed. This issue is further explored in this Appendix C through a number of examples below.[1]

A. Distributions of E&P

Consider first the following example in which there are multiple ownership changes, creating layers of different types of E&P with respect to certain shares but not with respect to other shares.

Example 16: Multiple Changes in Ownership



- USSH has owned 60 percent of the stock in CFC (60 shares), and unrelated USSH2 has owned the remaining 40 percent of the stock in CFC (40 shares), since the formation of CFC on 1/1 of Year 1. USSH has a basis of $18 in its 60 CFC shares.

[1] To avoid confusion, the numbering of the examples in this Appendix C follow on from the numbering of the examples in Appendix B (and hence starts with Example 16). All terms used in this Appendix C and not otherwise defined herein have the meaning ascribed to them in the Report or in Appendices A or B.

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- In Year 1, CFC generates $100 of untaxed E&P.
- On 1/1 in Year 2, USSH2 sells its 40 shares in CFC to unrelated FSH in a transaction in which no gain or loss is recognized.
- In Year 2, CFC generates an additional $200 of untaxed E&P.
- On 1/1 of Year 3, CFC has a value of $400 and FSH sells its 40 shares in CFC to unrelated USSH3 for $160.
- CFC generates an additional $40 of untaxed E&P in Year 3 and an additional $40 of untaxed E&P in Year 4.
- In Year 5, CFC generates an additional $20 of untaxed E&P.
- In Year 6, CFC earns no additional income and distributes $250, $150 to USSH and $100 to USSH3.

In this Example 16, under Proposed Section 1059(g), $80 of the $400 total E&P is Section 1059(g) E&P because that E&P is "the portion of [E&P] that is properly attributable" to stock owned by non-U.S. Shareholders at the time the E&P was earned (that is, 40 percent of the $200 earned in Year 2). But, as demonstrated in the prior examples, determining what portion of the $250 distributed ($150 to USSH and $100 to USSH3) is treated as a distribution of Section 1059(g) E&P depends on whether a Pro Rata Approach or Tracing Approach to E&P allocation is adopted.

Pro Rata Approach

A Pure Pro Rata Approach would hew as closely as possible to the current rules generally applicable to distributions of E&P. As such, first the types of E&P in each yearly layer being accessed would be determined. Then a proportionate amount of each type of E&P in that layer would be distributed on each share of CFC regardless of who owns that share or who owned it in the past. Accordingly, the $250 distribution would be treated as: $20 from the Year 5 E&P layer, $40 from the Year 4 E&P layer, $40 from the Year 3 E&P layer and $150 from the $200 Year 2 E&P layer. One hundred percent of all E&P in the Years 3 through 5 layers are non-Section 1059(g) E&P, and 60 percent of the E&P in the Year 2 layer is non-Section 1059(g) E&P and 40 percent is Section 1059(g) E&P. Accordingly, the aggregate $150 dividend received by USSH would be comprised of $60 of non-Section 1059(g) E&P from the Year 3 through 5 E&P layers, $54 of non-Section 1059(g) E&P from the Year 2 layer and $36 of Section 1059(g) E&P from the Year 2 layer. As for USSH3, its $100 aggregate dividend would be comprised of $40 of non-Section 1059(g) E&P from the Years 3 through 5 E&P layers, $36 of non-Section 1059(g) E&P from the Year 2 E&P layer and $24 of Section 1059(g) E&P from the Year 2 E&P layer. As a result, applying the Pure Pro Rata Approach to Proposed Section 1059(g) would result in USSH

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reducing its basis in its 60 CFC shares from $18 to zero and recognizing gain of $18, and USSH3 reducing its basis in its 40 CFC shares from $160 to $136.

As with the Pure Pro Rata Approach, the question presented under a Pooled Pro Rata Approach is whether non-Section 1059(g) E&P and Section 1059(g) E&P should be divided into separate pools on a year-by-year E&P layering basis or on an aggregate basis. If done on a year-by-year basis, the result would be the same as the Pure Pro Rata Approach for amounts distributed out of Year 3 through 5 E&P ($100), all of which is non-Section 1059(g) E&P, but would differ for Year 2 E&P on the above facts. In Year 2, there is $80 of Section 1059(g) E&P (40 percent of $200) and $120 of non-Section 1059(g) E&P (60 percent of $200), and $150 of that E&P is accessed in making the $250 aggregate distribution. Under the Pooled Pro Rata Approach, even applying a year-by-year approach, $120 of the E&P distributed from the Year 2 layer would be treated as non-Section 1059(g) E&P and the remaining $30 would be treated as Section 1059(g) E&P. Hence, in the aggregate, USSH would receive only $18 of Section 1059(g) E&P (60 percent of $30) and would reduce its basis its 60 CFC shares from $18 to zero. USSH3 would receive only $12 of Section 1059(g) E&P and would reduce its basis its 40 CFC shares from $160 to $148.

Given the goal of the Pooled Pro Rata Approach, which is to give all non-Section 1059(g) E&P to U.S Shareholders before they receive any Section 1059(g) E&P, this year-by-year approach seems very questionable. Much more sensible, and the approach assumed in the remainder of this Appendix C, is to apply the Pooled Pro Rata Approach on aggregated E&P basis. Under this approach, there would be a pool of $320 of non-Section 1059(g) E&P and a pool of $80 of Section 1059(g) E&P and the entire $250 of Year 6 distribution would be sourced from the $320 non-Section 1059(g) E&P pool.

Tracing Approach

In Example 16, there is the same aggregate dollar amount of E&P underlying each share of CFC stock. Only the composition of the E&P in some layers is different. As such, the Modified Silo Tracing Approach would not shift E&P between share silos and would produce the same result as a Full Tracing Approach or Silo Tracing Approach. The question is what should that result be?

Because USSH has no Section 1059(g) E&P in its share silo, under any ordering rule, none of the $150 distribution to USSH would be from Section 1059(g) E&P under a Tracing Approach. As regards USSH3, however, it is unclear under Proposed Section 1059(g) how much of USSH3's $100 distribution should be treated as being from the Section 1059(g) E&P layers (and, accordingly, by how much USSH3 would be required to reduce its basis in its CFC stock or recognize gain, as applicable, under Proposed Section 1059(g)), assuming a Tracing Approach is applied.

There are several options available. One approach would be to follow the general Section 316 sequential ordering rules. Under this "**sequential ordering**" rule, current year E&P within a

share silo would be prioritized with any excess treated as made out of the most recently accumulated E&P within that silo. On these facts, the $100 distribution to USSH3 would be comprised as follows: $8 from Year 5 E&P, $16 from Year 4 E&P, $16 from Year 3 E&P, and $60 from Year 2 E&P. Accordingly, $60 of the $100 distribution to USSH3 (the Year 2 E&P with respect to the CFC shares then owned by FSH and now owned by USSH3) would be treated as made from Section 1059(g) E&P and the remaining $40 would be treated as made from non-Section 1059(g) E&P.

A second approach would be to view the $160 of E&P in USSH3's share silo in the aggregate and treat the $100 distribution to USSH3 as made proportionally out of all of the E&P in USSH3's share silo. Because 50 percent of USSH3's total E&P pool consists of Section 1059(g) E&P and 50 percent consists of non-Section 1059(g) E&P, one-half of the $100 distribution to USSH3, or $50, would be treated as being from Section 1059(g) E&P under this "**proportional ordering"** rule.

Under a third approach, all distributions would be treated as made first out of non-Section 1059(g) E&P and then as out of Section 1059(g) E&P. Under this "**non-Section 1059(g) E&P first ordering**" rule, $80 of the distribution to USSH3 would be treated as being from non-Section 1059(g) E&P, with the remaining $20 made from USSH3's Section 1059(g) E&P.

A fourth approach would prioritize Section 1059(g) E&P. Under this "**Section 1059(g) E&P first ordering**" rule, $80 of the $100 of E&P distributed to USSH3 would be treated as being from Section 1059(g) E&P and $20 would be treated as being from non-Section 1059(g) E&P.

The chart below sets forth the various E&P ordering results summarized above under a Tracing Approach as regards USSH3.

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Background					Sequential		Proportional		non-1059(g) E&P First		1059(g) E&P First	
Yr.	CFC SHs.	CFC Untaxed E&P	USSH3 E&P Pool	Dist. to USSH3	1059(g) E&P	non-1059(g) E&P	1059(g) E&P	non-1059(g) E&P	1059(g) E&P	non-1059(g) E&P	1059(g) E&P	non-1059(g) E&P
5	USSH and USSH3	20	8	100	0	8	0	5	0	8	0	8
4	USSH and USSH3	40	16	0	0	16	0	10	0	16	0	12
3	USSH and USSH3	40	16	0	0	16	0	10	0	16	0	0
2	USSH and FSH	200	80	0	60	0	50	0	20	0	80	0
1	USSH and USSH2	100	40	0	0	0	0	25	0	40	0	0
Total		***400***	***160***	***100***	***60***	***40***	***50***	***50***	***20***	***80***	***80***	***20***

The sequential ordering rule has the advantage of involving the least deviation from current rules applicable outside of Section 1059(g). In addition, in certain other cases where ordering of different types of E&P is relevant, sequential ordering is applied. For example, a 100-percent Section 243 DRD is permitted where distributions are made out of post-affiliation earnings but not out of pre-affiliation earnings. The regulations under Section 243 apply the sequential ordering rules of Section 316. To illustrate, assume a corporation had a layer of affiliation E&P, followed by a layer of non-affiliation E&P, followed thereafter by a layer of affiliation E&P. Under these facts, dividends would be treated as coming out of the second layer after the first layer was

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exhausted, and hence would not be eligible for the 100-percent Section 243 DRD, even though there were remaining E&P in the third layer eligible for the 100-percent Section 243 DRD.[2]

Nevertheless, there is precedent for modifying the Section 316 E&P ordering rules in certain circumstances involving cross-border distributions. For example, as discussed in the Report, the Section 245A-5 Regulations provide that certain earnings that would otherwise be entitled to the Section 245A DRD are denied the benefit of that deduction if they arise from certain "**extraordinary dispositions**". Under those regulations, dividends are sourced first from "**non-extraordinary disposition E&P**" (which is not subject to the generally adverse extraordinary disposition rules of the Section 245A regulations) and then from E&P attributable to extraordinary dispositions.[3]

A non-Section 1059(g) E&P first ordering approach also would correspond to the treatment of PTEP under current law. Under the PTEP rules, distributions generally are treated as made first out of PTEP and then out of non-PTEP E&P (which, under the law in effect at the time the rules were established, generally was advantageous to the recipient). Moreover, adopting a non-Section 1059(g) first ordering rule would be consistent with how we believe a Pooled Pro Rata Approach and the Pre-Sale Basis Reduction Rule (discussed in Part V of the Report) should be applied, if either of these was adopted.

That said, there are other cross-border tax areas in which proportional ordering has been adopted. For example, for purposes of Section 245A, the foreign-source portion of a dividend paid by an STFC is determined by reference to the ratio that the STFC's undistributed foreign earnings bears to its total undistributed earnings.[4] Also, prior to the TCJA, a domestic corporation's deemed-paid foreign tax credits under Section 902 were determined by pooling all of a foreign corporation's post-1986 E&P and treating the foreign income taxes paid by the foreign corporation as proportionally attributable to any distributions made out of that pool.[5]

Nevertheless, we recommend that a non-Section 1059(g) E&P first ordering approach to accessing E&P be applied, regardless of what approach is adopted to allocating E&P to a CFC's shareholders, be it a Pre-Sale Basis Reduction Rule[6] (or some similar rule), a Pooled Pro Rata

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[2] This fact pattern is likely to be very uncommon. Nevertheless, the ordering rule provided in the Section 243 regulations regarding such circumstances is as stated in the text. *See* Regulations Section 1.243-4(a)(4).

[3] *See* Regulations Section 1.245A-5(c)(2). *See also* footnote 52 in the Report.

[4] *See* Section 245A(c).

[5] *See* Regulations Section 1.904-5(c)(4). *Cf.* Regulations Section 1.243-4(a)(6) and (a)(7) Example 5 (prorating E&P qualifying for the 100 percent DRD for affiliated earnings and E&P not so qualifying where both types of E&P exist in the same year).

[6] For a discussion of ordering rules in the context of the Pre-Sale Basis Reduction Rule and Section 1248, see the discussion in Part V.A. of the Report with respect to "stacking".

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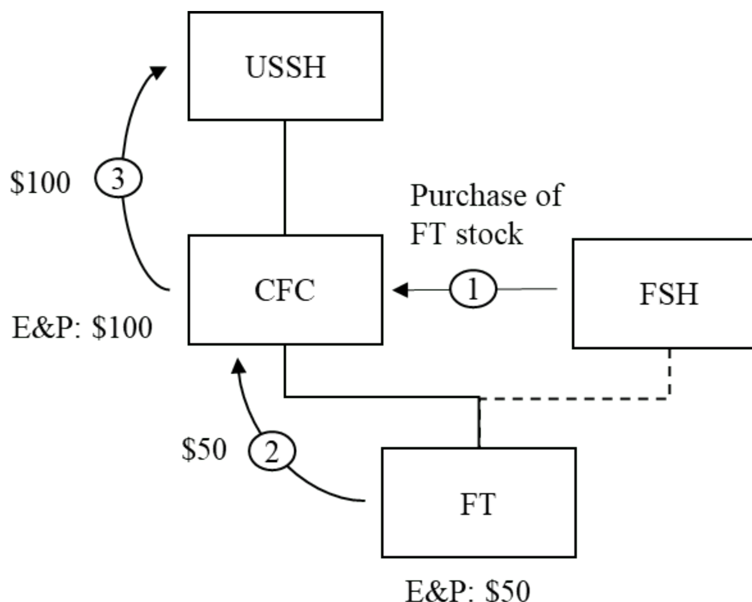
Approach or a Tracing Approach.

One final example further illustrates the need for an E&P access ordering rule if Proposed Section 1059(g) is pursued.

Example 17: Tiered CFC Distributions[7]



- USSH has owned CFC since its formation on 1/1 of Year 1.
- CFC purchases all the stock of FT on 1/1 Year 3, when FT has $50 of E&P. Assume that USSH does **not** make a Section 338(g) election with respect to the purchase.
- After the purchase, but during Year 3, FT makes a $50 distribution to CFC that is eligible for Section 954(c)(6) look-through treatment and is not tested income under Section 951A(c)(2)(A)(i)(IV).
- CFC earns $100 of current year E&P from operations during Year 3 (*i.e.*, without regard to the distribution received from FT).
- CFC in turn makes a $100 distribution to USSH that is eligible for a Section 245A DRD.

[7] Example 17 is a more complex version of Example 3 discussed briefly in the Report, and similar principles and issues under a Pro Rata Approach and a Tracing Approach would apply with respect to that example as apply to this Example 17 if less than all of the existing E&P were distributed in that example.

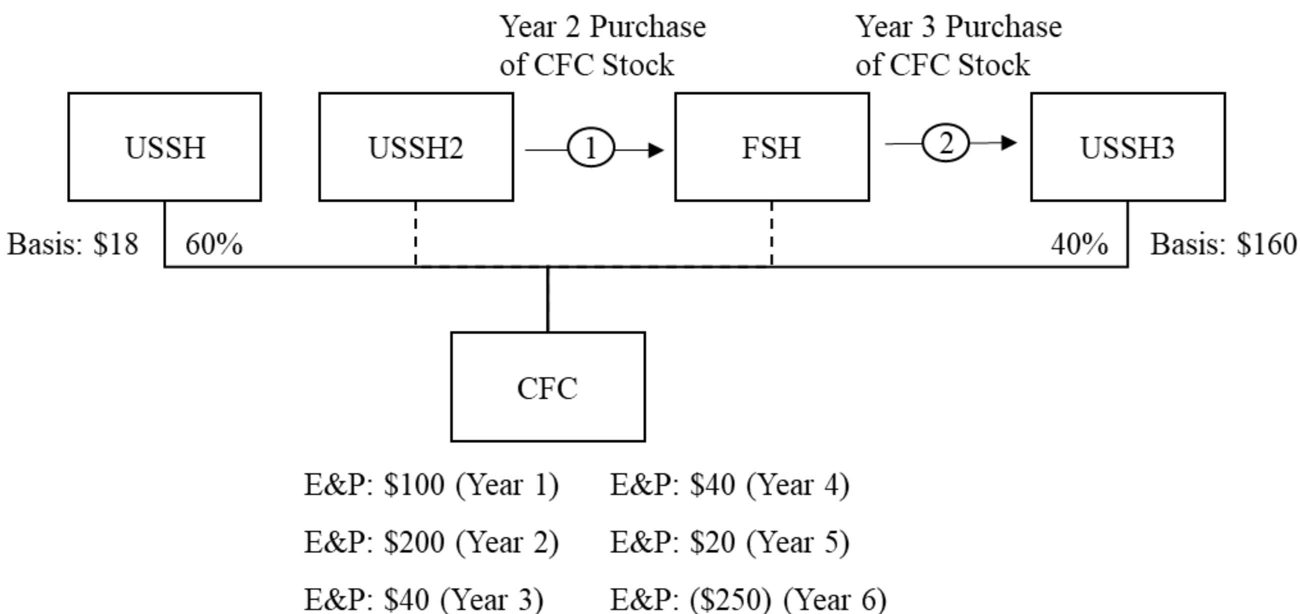
Under the HW&M Proposal, the FT to CFC dividend arguably would have allowed FT's $50 of Non-CFC Period E&P to escape the ambit of Section 1059(g). The CFC-to-CFC Rule in Proposed Section 1059(g) would eliminate that gap and prevent USSH from avoiding the Section 1059(g) E&P taint with respect to the $50 E&P at FT. Under the CFC-to-CFC Rule, the $50 received by CFC would be treated as $50 of Section 1059(g) E&P of CFC. That E&P, like the $100 of E&P generated by CFC in Year 3, would be current year E&P.

Under a non-Section 1059(g) E&P first ordering rule, the full $100 distribution to USSH would be exempt from the application of Proposed Section 1059(g). Under a Section 1059(g) E&P first ordering rule, $50 of the distribution would be subject to Proposed Section 1059(g) and $50 would not. And under a proportional ordering rule, $33.33 of the distribution would be subject to Proposed Section 1059(g); the remaining $66.67 would not. Rules under Section 316 provide no guidance here because all of the E&P is current year E&P.

B. E&P Deficits

When both Section 1059(g) E&P and non-Section 1059(g) E&P underly particular shares in a CFC, a question also arises as to how E&P deficits in later years should be applied against layers of E&P in the earlier years.

Example 18: E&P Deficits and Multiple E&P Layers



- Same facts as Example 16, except in Year 6 CFC has an E&P deficit of $250 and, in Year 7 when CFC has no further E&P or E&P deficit, CFC makes a $100 distribution pro rata

to USSH and USSH3.

Pro Rata Approach

Under a Pure Pro Rata Approach, which follows current law, the Year 6 E&P deficit would apply against earlier year E&P layers sequentially, starting with the most recent E&P layer first (a "**sequential deficit ordering**" rule).[8] Under this method, the $250 E&P deficit in Year 6 would offset the $20 E&P in Year 5, next the $40 of E&P in Year 4, then the $40 of E&P in Year 3, and last $150 of the $200 of E&P in Year 2. As a result, the $100 distribution would be sourced out of the remaining E&P in Years 2 and 1, applying whatever ordering rules are chosen under Section A.

Presumably, under a Pooled Pro Rata Approach, the same methodology would be applied for E&P deficits as is applied under a Pure Pro Rata Approach. That said, an argument could be made that because non-Section 1059(g) E&P is accessed first for distributions under the Pooled Pro Rata Approach and all the shares are owned by U.S. Shareholders at the time the E&P deficit arises, a "same type first deficit ordering" rule (discussed and defined immediately below) should be applied, resulting in a reduction of non-Section 1059(g) E&P first.

Tracing Approach

The above-described sequential deficit ordering rule is relatively simple and easy to administer and could also be applied if a Tracing Approach is adopted with respect to Proposed Section 1059(g). And a similar sequential deficit ordering approach is followed in some other areas where different types of E&P are distinguished.[9] Other choices are possible, however. For example, an argument could be made that an E&P deficit should take on the same character in the year it arises as would E&P arising in that year and should first offset E&P in the relevant share silo of that same type before offsetting E&P of a different type (a "**same type first deficit ordering**" rule). Because there is only one type of E&P in the share silo for the shares held by USSH, applying a same type first rule to E&P deficit absorption would not change the outcome as regards the E&P layers in the share silo for the shares owned by USSH. As regards USSH3, however, had E&P been earned in Year 6, the E&P allocated to the shares owned by USSH3 would have been non-Section 1059(g) E&P. Accordingly, under a same type first deficit ordering rule,

[8] Regulations Section 1.316-2(b).

[9] *See, e.g.*, Regulations Section 1.243-4(a)(6) ("A deficit in an earnings and profits account for any taxable year shall reduce the most recently accumulated earnings and profits for a prior year in such account."); Regulations Section 1.902-2(a)(1) ("For purposes of computing foreign income taxes deemed paid under §1.902-1(b) with respect to dividends paid by a first- or lower-tier corporation, when there is a deficit in the post-1986 undistributed earnings of that corporation and the corporation makes a distribution to shareholders that is a dividend or would be a dividend if there were current or accumulated earnings and profits, then the post-1986 deficit shall be carried back to the most recent pre-effective date taxable year of the first- or lower-tier corporation with positive accumulated profits computed under [S]ection 902.").

the E&P in the Year 1 layer in the share silo for USSH3's shares, which is non-Section 1059(g) E&P, would be offset before any Year 2 E&P in that share silo. As a result, the $60 E&P deficit that would have offset Year 2 E&P underlying USSH3's shares in CFC under the sequential deficit ordering rule would first offset the $40 of Year 1 non-Section 1059(g) E&P in USSH3's share silo and then would only offset $20 of the $80 of Year 2 Section 1059(g) E&P in that silo. In sum, if a same type first deficit ordering rule was applied, when the dust settles USSH would have $30 of Year 2 non-Section 1059(g) E&P and $60 of Year 1 non-Section 1059(g) E&P in the share silo for its shares in CFC, and USSH3 would have $60 of Year 2 Section 1059(g) in its share silo and no other E&P layers.

Depending on which of the above approaches is applied, the $100 distribution would then be sourced out of the remaining E&P, in whatever layers the E&P remains, applying whatever ordering rules are chosen under Section A.

C. Mismatched Layers and the Modified Silo Tracing Approach

As discussed above, depending on how E&P deficits are applied under a Tracing Approach, certain layers in one share silo can have an amount of E&P that is less than the amount of E&P in the same layer in another share silo. This mismatching of layers across share silos can also arise where entities are combined in Section 381 transactions and the two entities have differing amounts of E&P in their various E&P layers. Even where the aggregate amount of E&P in each share silo is the same, these layer mismatches create a further issue as to how a Modified Silo Tracing Approach should be applied.

One possibility is for each share to access E&P only in its own silo, using whatever ordering rule for accessing E&P is decided upon under Section A. Only once all E&P in a share silo has been exhausted would E&P be shifted from another silo. This "**aggregate E&P application**" of the Modified Silo Tracing Approach would conform the Modified Silo Tracing Approach to the Silo Tracing Approach to the greatest extent possible without violating the principle of the Modified Silo Tracing Approach that there be no non-dividend distributions on some shares while there are still dividends being received by other shares of the same class.

A more restrictive approach would be to apply the Modified Silo Tracing Approach on a layer-by-layer basis. Under this "**layer-by-layer E&P application**" of a Modified Silo Tracing Approach, E&P would be shifted among shares in different silos in the same layer to make sure no E&P of another layer was accessed by a share in one silo before all E&P in that layer across all share silos has been exhausted. The following example illustrates the difference between these two applications.[10]

[10] Of course, there may be more than two share silos in various fact patterns. Two silos are used in this example for the sake of simplicity.

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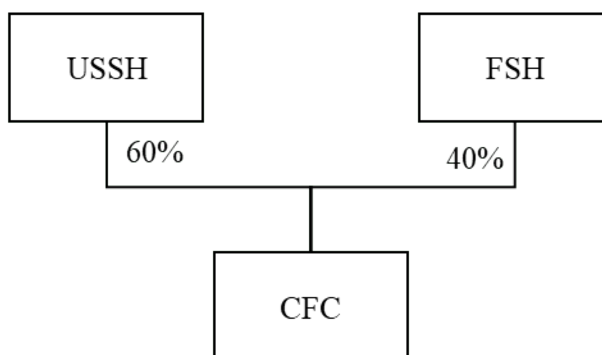
Example 19: Mismatched Layers, Same Aggregate Proportional E&P



	USSH's CFC Shares		FSH's CFC Shares	
Year	**Section 1059(g) E&P**	**non-Section 1059(g) E&P**	**Section 1059(g) E&P**	**non-Section 1059(g) E&P**
1	$70	0	0	$20
2	0	$45	$100	0
3	0	$65	0	0

- USSH owns 60 shares of CFC with $70 of underlying Section 1059(g) E&P in Year 1, $45 of non-Section 1059(g) E&P in Year 2, and $65 of non-Section 1059(g) E&P in Year 3.

- FSH owns the remaining 40 shares of CFC with $20 of underlying non-Section Section 1059(g) E&P in Year 1, $100 of Section 1059(g) E&P in Year 2 and $0 of E&P in Year 3.[11]

Under an aggregate E&P application of a Modified Silo Tracing Approach, no shifts of E&P would occur because there would never be a distribution of E&P on the shares owned by FSH at a time when there was not a proportionate distribution of E&P on the shares owned by USSH. But to achieve this result, E&P must be accessed from different layers underlying the 40 CFC shares owned by FSH (the FSH silo) than the layers underlying the 60 CFC shares owned by USSH (the USSH silo). For example, assume CFC makes a $100 distribution *pro rata* to USSH and FSH. As regards USSH, that would access $60 of the $65 of non-Section 1059(g) E&P in the Year 3 layer underlying the USSH silo. But there is no E&P in the Year 3 layer underlying the FSH silo, so $40 of the Year 2 E&P underlying the FSH silo must be accessed.

Under a layer-by-layer E&P application of a Modified Silo Tracing Approach, E&P would be shifted between the USSH silo and the FSH silo in each of the three years. More specifically, $26 of non-Section 1059(g) E&P (or 40 percent of the total E&P for Year 3, the amount necessary to have proportional E&P between the USSH silo and the FSH silo in Year 3) would be shifted

[11] These disparate E&P layers and mixtures were chosen solely for the sake of illustration. Such layers and mixtures might arise by virtue of certain share ownership changes and entity mergers, for example.

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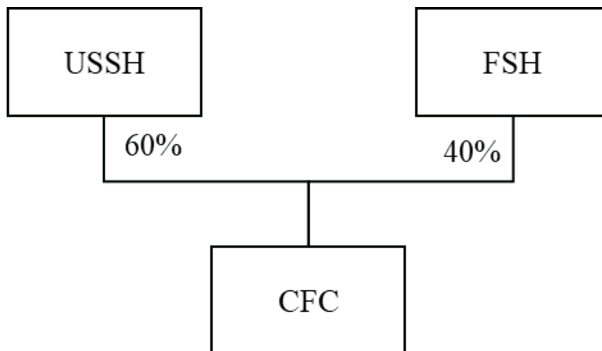
from the USSH silo to the FSH silo for Year 3, $42 of Section 1059(g) E&P would be shifted from the FSH silo to the USSH silo for Year 2 (such that USSH would have $87, or 60 percent, of the total E&P for Year 2), and $16 of Section 1059(g) E&P would be shifted from the USSH silo to the FSH silo for Year 1 (such that FSH would have $36, or 40 percent, of the total E&P for Year 1).

On these facts, a layer-by-layer application of a Modified Silo Tracing Approach would result in an aggregate of $26 Section 1059(g) E&P being shifted from the FSH silo to the USSH silo (which is $42 of Section 1059(g) E&P shifted from the FSH to the USSH share silo in Year 2, less $16 of Section 1059(g) E&P shifted from the USSH to the FSH share silo in Year 1), which is $26 more than under an aggregate E&P application (in which there is no shifting of E&P between share silos).

Now we examine a case where the aggregate E&P in each silo is not proportional.

Example 20: Mismatched Layers, Different Aggregate Proportional E&P



	USSH's CFC Shares		FSH's CFC Shares	
Year	Section 1059(g) E&P	non-Section 1059(g) E&P	Section 1059(g) E&P	non-Section 1059(g) E&P
1	$25	0	0	$20
2	0	$45	$100	0
3	0	$65	0	0

- Same facts as Example 19, except the E&P in Year 1 underlying the 60 shares of CFC stock owned by USSH is $25 of Section 1059(g) E&P (rather than $70 of Section 1059(g) E&P).

The analysis under a layer-by-layer application of a Modified Silo Tracing Approach would be the same as in Example 19, except that, for Year 1, $2 of non-Section 1059(g) E&P would be shifted from the FSH silo to the USSH silo (rather than $26 of Section 1059(g) E&P being shifted from the USSH silo to the FSH silo), such that USSH would have $27, or 60 percent, of the total E&P for Year 1. Distributions would then be treated as made under whatever ordering rule was decided upon under Section A. On the revised facts, an aggregate of $42 of Section

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1059(g) E&P would be shifted from the FSH silo to the USSH silo (reflecting the Year 2 shifting of Section 1059(g) E&P from the FSH to the USSH share silo noted above).

There may be several ways of implementing an aggregate E&P application of a Modified Silo Tracing Approach on the facts of this Example 20. The simplest way would be to follow whatever ordering rule was decided upon under Section A as regards each silo until all E&P is exhausted in one silo and then any remaining E&P in the non-depleted silo would be shifted to the depleted silo in the amount necessary to achieve proportionality going forward. On the facts of this Example 20, the USSH silo is the "short silo". There is aggregate E&P of $135 in that silo, so a total distribution of $225 can be made before that silo is exhausted (*i.e.*, $225 multiplied by 60 percent equals $135). Applying normal Section 316 ordering rules with respect to each silo for the sake of illustration, when the USSH silo is exhausted there would still be $10 of remaining E&P in the Year 2 layer of the FSH silo, all of which is Section 1059(g) E&P. Of this $10, $6 would be shifted to the USSH silo. Accordingly, in the aggregate, USSH would receive $36 more of Section 1059(g) E&P in this Example 20 under a layer-by-layer E&P application than under an aggregate E&P application on these facts.[12]

[12] Other ways of shifting E&P under an aggregate E&P application where there is mismatched E&P in silos may also be possible. For example, the shift might be made as of day one and the $18 shift from the FSH silo to the USP silo could be taken out of any layer or combination thereof in the FSH silo so long as the total added up to $18.

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