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Report No. 1512
April 16, 2025

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Re: NYSBA Tax Section Report No. 1512 - Report on Proposed Regulations Regarding Previously Taxed Earnings and Profits

Dear Ms. Leonard, Ms. Krause and Mr. De Mello:

Please see attached Report No. 1512 of the Tax Section of the New York State Bar Association, which discusses and provides comments and recommendations on the proposed regulations (the "**Proposed Regulations**") issued by the Department of the Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**") on December 2, 2024, under sections 959 and 961 and certain other provisions of the Internal Revenue Code (the "**Code**") regarding previously taxed earnings and profits ("**PTEP**") of foreign corporations and related basis adjustments.

The relevant provisions of the Code generally are intended to prevent duplicative taxation when PTEP that has previously been taxed to U.S. shareholders of certain foreign corporations is distributed, or otherwise realized by the U.S. shareholders.

The Report, in Parts I and II, provides an introduction and summary of our principal recommendations. Part III provides, as background, a summary of the PTEP rules and the Proposed Regulations, and Part IV contains a detailed discussion of our comments and recommendations.

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,

Andrew Walker
Chair

Enclosure

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Report No. 1512

New York State Bar Association Tax Section

Comments on Proposed Regulations Regarding Previously Taxed Earnings and Profits

April 16, 2025

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Comments on Proposed Regulations Regarding Previously Taxed Earnings and Profits

I. INTRODUCTION

This Report[1] provides the comments and recommendations of the Tax Section of the New York State Bar Association ("**NYSBA**") on the proposed regulations (the "**Proposed Regulations**") issued by the Department of the Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**") on December 2, 2024, under sections 959 and 961 and certain other provisions of the Internal Revenue Code (the "**Code**") regarding previously taxed earnings and profits ("**PTEP**") of foreign corporations and related basis adjustments.[2]

The Proposed Regulations address several issues that have arisen in the application of the PTEP rules, particularly as a result of the changes made by the Tax Cuts and Jobs Act of 2017 (the "**TCJA**")[3] and the subsequent guidance issued by Treasury and the IRS. The Proposed Regulations also introduce new rules and concepts that affect the PTEP accounting and reporting for foreign corporations and their shareholders.

We appreciate the efforts of Treasury and the IRS to provide comprehensive and timely guidance on the PTEP rules, which are complex and have important implications for the U.S. taxation of foreign income. We also acknowledge the challenges and trade-offs involved in designing and implementing such guidance in a coherent and administrable manner.

In this Report, we offer our observations and suggestions on various aspects of the Proposed Regulations, with the aim of enhancing their clarity, consistency, and fairness. We also identify certain areas where we believe further guidance or clarification would be helpful or necessary. Part II of this Report provides a summary of our principal recommendations. Part III provides background on the PTEP rules and the Proposed Regulations, and Part IV contains a detailed discussion of our comments and recommendations.

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[1] The principal authors of this Report are Kristen Gamboa, Ansgar Simon and Wade Sutton. This Report reflects comments and contributions from Kim Blanchard, Andy Braiterman, Michael Caballero, Casey Caldwell, Kevin Jacobs, Steve Massed, Cory O'Neill, Amit Sachdeva, Michael Schler, Vikram Sharma, Stephen Shay, Raymond Stahl, Shun Tosaka, Andrew Walker, Gordon Warnke, and Libin Zhang.

[2] 89 Fed. Reg. 95362 (Dec. 2, 2024).

[3] P.L. 115-97 (2017).

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

The following is a summary of the principal recommendations in this Report.

1. The comment period to the Proposed Regulations should be reopened. We appreciate the lengthy deliberation and significant effort that Treasury and the IRS have invested in drafting these Proposed Regulations over the last seven years. The issues addressed in the Proposed Regulations are difficult, especially in light of the need to integrate several statutory provisions that were drafted at various points over the last 60 years and therefore often do not fit together cohesively. In order to provide the tax community with an opportunity to provide thoughtful feedback on these rules, therefore, the comment period should be reopened for a significant period of time (e.g., at least an additional six months) that is more commensurate with the time spent by Treasury and the IRS debating and drafting the Proposed Regulations.

2. Treasury and the IRS should consider options to simplify the Proposed Regulations. The Proposed Regulations are complex are require significant record keeping. Serious consideration should be given to simplification options that would not prejudice the interests of the government (e.g., permitting U.S. shareholders to make consent dividend elections, similar to the mechanism provided in section 565).

3. Final regulations should permit covered shareholders to avoid the recognition of gain under section 961(b)(2) to the extent of the shareholder's aggregate basis in its shares of the CFC within the same class; alternatively, permit covered shareholders to suspend gain that otherwise would be recognized under section 961(b)(2) with respect to low-basis shares to the extent of aggregate basis so long as the covered shareholder continues to hold high-basis shares. Consolidated groups should be treated as a single covered shareholder for purposes of the aggregate basis recovery or gain suspension approach.

4. Final regulations should narrow the last-clear chance rule applicable to negative section 961(c) basis such that (i) it does not apply where the basis is eliminated in a section 332 liquidation and (ii) negative section 961(c) basis may be netted against positive adjusted basis in a transaction in which property ceases to qualify as a section 961(c) ownership unit.

5. Sections 959(b) and 961(c) should apply at the U.S. shareholder level, which is consistent with the statutory text and existing regulations, and not at the CFC-level, which is the approach taken in the Proposed Regulations. The Preamble expresses concerns about allocations of CFC-level expenses to PTEP, but as a practical matter this will rarely occur under current law, and – to the extent it does occur – it (i) does not seem problematic and (ii) is an issue that would be more appropriately addressed under operative Code sections,

such as sections 904, 954(b)(5), and 951A(c)(2)(A)(ii), if at all. Furthermore, a U.S. shareholder-level approach to these provisions would minimize the amount of information sharing that would be required between U.S. shareholders as compared to a CFC-level approach.

6. The final regulations should provide that taxpayers not only have to apply a reasonable method to determine the amount and character of PTEP resulting from the acquisition of a foreign corporation from a deemed covered shareholder, but also that taxpayers must apply reasonable efforts to determine an entity's PTEP amounts and character. If the taxpayer is unable to determine the extent to which such corporation's E&P is PTEP after using reasonable efforts, the final regulations should provide that such E&P is treated as section 959(c)(3) E&P.

7. The final regulations should provide a default rule allowing successor U.S. shareholders to treat an acquired foreign corporation's E&P as section 959(c)(3) E&P where multiple foreign intervening owners exist.

8. The final regulations should provide a default rule allowing small shareholders to treat an acquired foreign corporation's E&P as section 959(c)(3) E&P where publicly traded shares of a foreign corporation are acquired from any shareholder.

9. Section 78 dividends arising from section 960(b) PTEP should be treated as a distribution of PTEP. Alternatively, if Treasury and the IRS decline to treat the section 78 dividend as eligible for PTEP treatment, then section 961(b)(1) should not apply to reduce stock basis attributable to such amounts since the statute only applies to amounts excluded from gross income under section 959(a).

10. Coordinate the application of section 986(c) with respect to "mirrored" section 961(c) PTEP. Where section 961(c) causes stock gain recognized by a CFC to be characterized as "mirrored PTEP" the regulations should prevent the duplication of section 986(c) gain or loss. A simple and administrable approach to achieve this goal would be to provide that one of the sets of PTEP (*e.g.*, the upper-tier mirrored PTEP) does not give rise to section 986(c) items.

11. Losses attributable to section 961(c) basis should not be limited to gains from the stock of the same corporation. These losses should be allowable to adjust a U.S. shareholder's inclusion under section 951(a) in the same manner as any capital loss recognized by a controlled foreign corporation.

12. Clarifications and corrections should be made with respect to the determination of section 956 amounts and the application of section 959(f).

III. BACKGROUND

A. Controlled Foreign Corporations

A United States person ("**U.S. person**") generally is taxed currently on its share of certain income of a controlled foreign corporation ("**CFC**") of which it is a United States shareholder ("**U.S. shareholder**"). A CFC is a foreign corporation that is owned more than 50 percent, by vote or value, by U.S. shareholders on any day during the taxable year of such foreign corporation.[4] A U.S. shareholder, in turn, is a U.S. person that owns directly or indirectly under section 958(a) (or constructively under section 958(b)) 10 percent or more of either the total combined voting power of all classes of stock entitled to vote of such foreign corporation or the total value of shares of all classes of stock of such foreign corporation.[5]

B. Subpart F and GILTI Inclusions

Section 951(a) provides that a U.S. shareholder of a CFC that owns directly or indirectly (under section 958(a)) stock in the CFC on the last day in the taxable year on which such corporation was a CFC includes in its gross income its pro rata share of the CFC's subpart F income (as defined in section 952(a)) (such inclusion, a "**subpart F inclusion**"). A U.S. shareholder's pro rata share of a CFC's subpart F income is generally determined based on its proportionate share of a hypothetical distribution of all the current year earnings and profits ("**E&P**") of the CFC.[6]

Similarly, section 951A requires each U.S. shareholder of a CFC to include in gross income its global intangible low-taxed income (such inclusion, a "**GILTI inclusion**") for the taxable year. In computing its GILTI inclusion, a U.S. shareholder must take into account its pro rata share of each "tested item" of all its CFCs (e.g., tested income and tested loss).[7] In general, a U.S. shareholder's pro rata share of any tested item is determined under rules similar to those for determining the shareholder's pro rata share of subpart F income.[8]

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[4] Section 957(a).

[5] Section 951(b). The ownership thresholds for CFC and U.S. shareholder status are modified by section 953(c)(1) for certain insurance companies. A U.S. person includes a citizen or resident of the United States, a domestic partnership, a domestic corporation, and an estate that is not a foreign estate, and certain trusts. Section 957(c). Domestic partnerships and S corporations are not, however, treated as U.S. shareholders for purposes of subpart F or GILTI inclusions. See Treas. Reg. § 1.958-1(d).

[6] Section 951(a)(1); Treas. Reg. §§ 1.951-1(b)(1)(i), (e)(1). The term E&P, as used herein, is determined under section 312, as modified by section 964(a) in the context of a foreign corporation.

[7] Sections 951A(c)(1)(A), (B); Treas. Reg. § 1.951A-1(c). The regulations define "tested items" as "tested income, tested loss, qualified business asset investment, tested interest expense, or tested interest income." Treas. Reg. § 1.951A-1(f)(5).

[8] Section 951A(e)(1); Treas. Reg. § 1.951A-1(d); see also section 951(a)(2); Treas. Reg. §§ 1.951-1(b), (e).

A GILTI inclusion is treated like a subpart F inclusion for purposes of several Code provisions, including sections 959, 961, and 962.[9] Thus, unless otherwise specified herein, any description of the rules that apply to a subpart F inclusion also apply to a GILTI inclusion.

C. PTEP and Basis Adjustments

Sections 959 and 961 were enacted as part of the Revenue Act of 1962, which introduced the subpart F regime to prevent U.S. persons from deferring U.S. tax on certain income earned through foreign corporations. The House and Senate Reports explained that sections 959 and 961 were designed to avoid double taxation of amounts that had been previously included in gross income by a U.S. shareholder under section 951(a) and to ensure consistent treatment of distributions with respect to CFC stock, section 956 inclusions, and dispositions of CFC stock. The Reports also indicated that the Secretary of the Treasury was authorized to prescribe regulations to implement the provisions and to prevent the multiple inclusion of any item in income.[10]

Section 959(a) prevents double taxation by excluding distributions of PTEP by a CFC to a U.S. shareholder (or a successor in interest) from gross income.[11] Section 959(a) further prevents the application of sections 951(a)(1)(B) and section 956 (relating to investments in U.S. property) to the extent of the shareholder's PTEP with respect to the CFC. Section 959(d) provides that any distribution excluded from gross income under section 959(a) is treated as a distribution that is not a dividend for all purposes of the Code, except that the distribution reduces the CFC's E&P.[12]

Section 959(a) applies not only to a U.S. shareholder who has recognized a GILTI or subpart F inclusion, but also to any U.S. person that acquires from a U.S. shareholder stock in a foreign corporation with respect to which the shareholder has had an inclusion (such U.S. person, a "**section 959 successor**"). A section 959 successor may claim an exclusion from gross income under section 959(a) on PTEP distributions only to the extent the section 959 successor establishes to the satisfaction of the Service its right to the exclusion.[13]

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[9] See Section 951A(f)(1)(A) (providing that a GILTI inclusion is treated in the same manner as a subpart F inclusion for purposes of applying sections 168(h)(2)(B), 535(b)(10), 851(b), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4)).

[10] See Sen. Rep. No. 87-1881, at 2452 (1962); H.R. Rep. No. 87-1447, at 1200 and 1336 (1962).

[11] A distribution of PTEP may give rise to foreign currency gain or loss under section 986(c), however, as described below in Part III.G.

[12] In a general sense, the PTEP rules approximate the results that would occur if a CFC distributed all of its earnings annually to its shareholders, followed by a recontribution of the proceeds by the shareholders to the CFC. Under that model, those earnings would be capitalized into share basis, which would permit a tax-free return of capital at a future date under section 301(c)(2).

[13] Treas. Reg. § 1.959-1(d).

Regulations originally promulgated in 1965 prescribe detailed information that a section 959 successor must furnish to the Service to establish its right to an exclusion.[14]

Section 959(b) excludes from gross income of an upper-tier CFC any distribution of PTEP received from a lower-tier CFC for purposes of applying section 951(a) to determine the subpart F inclusion of the U.S. shareholder who was previously taxed on the PTEP (or a successor in interest).

Section 959(d), which treats a distribution subject to section 959(a) as distribution that is not a dividend, does not apply for purposes of section 959(b). In other words, distributions of PTEP between CFCs are still dividends for all purposes of the Code. For that reason, some commenters have debated whether a distribution of PTEP under section 959(b) gives rise to tested income subject to GILTI inclusion where the distribution does not meet the exception contained in section 951A(c)(2)(A)(i)(IV) and Treas. Reg. § 1.951A-2(c)(1)(iv) for dividends received from related persons (i.e., if a CFC receives a distribution of PTEP from an unrelated CFC that does not qualify for the exclusion from tested income for related party dividends).[15] However, such dividends meet another exception: Section 951A(c)(2) provides an exception for amounts that are taken into account in determining a CFC's subpart F income. A distribution of PTEP to a CFC described in section 959(b) from an unrelated CFC would not meet the exceptions to foreign personal holding company income for same-country or look-through dividends under sections 954(c)(3) and (c)(6), respectively, because the payor would not be related to the payee. Therefore, the dividend would be "taken into account" in determining the CFC recipient's subpart F income under section 952, notwithstanding that section 959(b) then excludes such amounts for purposes of determining a U.S. shareholder's subpart F inclusion under section 951(a). As discussed in Part III.J.2, the Proposed Regulations adopt a different approach to this issue but arrive at the same result.

Section 959(c) provides rules for allocating distributions and section 956 amounts to three categories of the CFC's E&P: (1) PTEP attributable to section 956 amounts, (2) PTEP attributable to subpart F or GILTI inclusions, and (3) untaxed earnings. Section 959(f) provides rules for allocating section 956 amounts to PTEP and untaxed earnings and an

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[14] *Id.*

[15] See NYSBA Report No. 1496 on Notice 2024-16 and Guidance Related to Section 961 and Certain Inbound Nonrecognition Transactions (2024), 4 at note 11 and Douglas Poms, *The Elusive Nature of Code Sec. 961(c) Basis in a Post-TCJA Multiverse*, INT'L TAX J., Sept.-Oct. 2022, at 57-58. A recent advice memorandum from the IRS Office of Chief Counsel argues that a CFC may not claim a dividends-received deduction under section 245A(a) and Treas. Reg. § 1.952-2. A.M. 202436010 (July 31, 2024). Thus, in the view of the IRS, section 959(b) is the sole mechanism to exclude these dividends from a CFC's subpart F income. Whether section 245A(a) applies to these dividends is beyond the scope of this Report.

ordering rule that applies the section 959 rules first to actual distributions and then to section 956 amounts.[16]

Section 959(e) provides that any amount included in gross income as a dividend under section 1248 (treating certain gain from sales or exchanges of stock in foreign corporations as dividend income) is treated as if it were a subpart F inclusion for purposes of applying section 959 and 960(c) to such earnings.

D. Section 961

Section 961 contains rules for adjusting a U.S. shareholder's basis in CFC stock to reflect CFC inclusions and PTEP distributions.[17] Section 961(a) provides for an increase in a U.S. shareholder's basis in the stock of a CFC, or in the property by reason of which the shareholder is considered to own such stock, by the amount required to be included in the shareholder's gross income under section 951(a) with respect to such stock. Pursuant to section 951A(f)(1)(A), section 961(a) also applies to GILTI inclusions.

Section 961(b)(1) provides for a decrease in the basis of the CFC stock or other property by the amount of any PTEP distribution excluded from gross income under section 959(a). This subsequent basis decrease effectively mirrors the basis increase created under section 961(a) with respect the PTEP when a subpart F or GILTI inclusion is first included in gross income. If a distribution of PTEP exceeds a U.S. shareholder's basis in the distributing CFC stock, section 961(b)(2) provides that the excess amount is treated as gain from the sale or exchange of property, similar to the result under section 301(c)(3).

Section 961(c) provides for regulations that make basis adjustments similar to those made under section 961(b) to the stock of a lower-tier CFC owned by an upper-tier CFC (or certain other CFCs in the chain of ownership) for the purpose of determining the amount included under section 951(a) in the gross income of a U.S. shareholder or a successor in interest.[18] These basis adjustments apply only for purposes of determining the subpart F income of the U.S. shareholder or a successor in interest, and not for any other purpose, such

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[16] The Omnibus Budget Reconciliation Act of 1993 modified the determination of the amount includible in a U.S. shareholder's gross income as a result of a CFC's investments in U.S. property under section 956 and clarified the ordering rule under section 959(f). P.L. 103-66, Sec. 13231(c).

[17] These rules are analogous in some respects to other investment adjustment rules, such as the consolidated return rules in Treas. Reg. § 1.1502-32 and the partnership basis adjustment rules contained in section 705 and the underlying regulations.

[18] The Taxpayer Relief Act of 1997 added section 961(c) to provide for basis adjustments in lower-tier CFCs to prevent double taxation of PTEP in transactions involving dispositions of CFC stock and enacted section 964(e) to treat gain realized by one CFC on the sale of shares of a lower-tier CFC as a dividend to the extent that it would have been so treated under section 1248 if the CFC were a U.S. person. P.L. 105-34, Sec. 1112(b)(1).

as the calculation of E&P.[19] The reference in section 961(c) to "adjustments similar to the adjustments provided by" sections 961(a) and (b) does not appear to incorporate the requirement to recognize gain under section 961(b)(2).[20]

E. Section 960(b)

Section 901 provides domestic corporations and individuals double tax relief through a foreign tax credit with respect to foreign income taxes that are directly paid or accrued by the taxpayer. Section 960 provides for indirect or "deemed paid" foreign tax credits to domestic corporations for certain taxes paid or accrued by a CFC.[21] Sections 960(a) and (d), for example, provide for foreign tax credits with respect to certain foreign income taxes that are "properly attributable" to amounts included in a corporate U.S. shareholder's income under section 951(a) or 951A(a), respectively.

Sections 960(a) and (d) only apply to taxes that are attributable to a subpart F or GILTI inclusion by a corporate U.S. shareholder and paid or accrued by the CFC in the same taxable year in which the inclusion occurs. However, foreign income taxes may be imposed on the CFC's earnings in a taxable year ending after the GILTI or subpart F inclusion year. For example, withholding taxes may be imposed on a distribution of PTEP from one CFC to another. Section 960(b) addresses this timing issue by providing for a credit on the later imposed foreign income taxes. Specifically, section 960(b)(1) permits a domestic corporation receiving a distribution of PTEP from a CFC to claim a foreign tax credit for the foreign income taxes deemed paid by the CFC that are "properly attributable" to the PTEP, provided that such taxes have not otherwise been deemed paid under section 960 in the taxable year or any previous year.[22] Section 960(b)(2) addresses PTEP distributions from one CFC to another under section 959(b). It provides that the recipient CFC shall be deemed to have paid an amount of the payor CFC's foreign income taxes that are attributable to the PTEP and have not been deemed paid in the current or any prior taxable year, thus preserving the taxpayer's ability to later claim credits under section 960(b) when that PTEP is later distributed to a U.S. shareholder.

The determination of the amount of foreign income taxes deemed paid under section 960(b) currently is governed by Treas. Reg. § 1.960-3. Foreign income taxes are properly

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[19] The Gulf Opportunity Zone Act of 2005 extended the basis adjustments provided under section 961(c) to "the basis of stock in any other controlled foreign corporation by reason of which the United States shareholder is considered under section 958(a)(2) as owning the stock" of the CFC that gave rise to the subpart F inclusion. P.L. 109-135, Sec. 409(b).

[20] The Proposed Regulations, however, do incorporate section 961(b)(2) gain into the section 961(c) rules.

[21] An individual U.S. shareholder may make an election under section 962, which permits the taxpayer to claim credits under section 960 in the same manner as if it were a domestic corporation. This provision is described in more detail below.

[22] Section 960(c) may increase a taxpayer's foreign tax credit limitation under section 904 when section 960(b) applies to a distribution of PTEP.

attributable to a section 959 distribution if they are from the same PTEP group and section 904 category.[23] These accounts are maintained on an annual basis. The amount of taxes deemed paid is determined based upon the distributee's proportionate share of such taxes. No other foreign income taxes are considered properly attributable to a section 959 distribution.

F. Section 962

A section 962 election is intended to put an electing individual U.S. shareholder in a similar position from a U.S. tax perspective as if the individual had owned the CFC through a domestic corporation.[24] To accomplish this result, an electing U.S. shareholder is taxed at corporate tax rates rather than individual tax rates on all its CFC inclusions with respect to its CFCs for the taxable year in which the election is in effect.[25] Further, as discussed above, an electing U.S. shareholder may claim foreign tax credits for income taxes deemed paid under sections 960(a) and 960(d) with respect to such inclusions.[26]

The primary benefit of a section 962 election—the ability for an electing individual U.S. shareholder to avail itself of the lower corporate rate and an indirect foreign tax credit—is deferral. These benefits are largely reversed when the E&P that gave rise to the electing U.S. shareholder's CFC inclusion are distributed to the shareholder or the stock of a CFC is sold. Specifically, while a CFC inclusion of an electing U.S. shareholder creates PTEP in the amount of the inclusion, when that PTEP is distributed to the shareholder, section 962(d) provides that the distribution will, notwithstanding section 959(a), be included in the electing U.S. shareholder's gross income to the extent the PTEP exceeds the amount of U.S. federal income tax previously paid by the U.S. shareholder on the income to which the election applied. In other words, the E&P of a CFC equal to the amount of U.S. federal income tax

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[23] Treas. Reg. § 1.960-1(d)(3)(ii). PTEP groups generally are categories of PTEP that relate to the way in which PTEP was created. For example, there are separate PTEP groups relating to section 956 inclusions under section 951(a)(1)(B), inclusions under section 951A(a), and the application of section 959(e) to a section 1248 amount. The PTEP group categories are listed in Treas. Reg. § 1.960-3(c)(3).

[24] See S. Rep. No. 1881, 87th Cong., 2d Sess. (1962) at 92-93 ("The purpose of this provision is to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad."). Although a section 962 election permits an individual U.S. shareholder to claim the benefits of the section 250 deduction with respect to GILTI and indirect foreign tax credits under section 960, the shareholder is ineligible to claim a deduction under section 245A(a), which is sensible given the construct of an individual investing in a CFC through a domestic corporation.

[25] Section 962(a)(1); Treas. Reg. § 1.962-2(c)(1); see also section 951A(f)(1)(A) and Treas. Reg. § 1.951A-5(b)(1) (treating a U.S. shareholder's GILTI inclusion the same as a subpart F inclusion for the purposes of section 962). An electing U.S. shareholder is also allowed a section 250 deduction for any GILTI inclusion and any amount included in income under section 78 with respect to the GILTI inclusion. Treas. Reg. § 1.962-1(b)(2)(i).

[26] Section 962(a)(2) and Treas. Reg. § 1.962-1(b)(2)(i).

previously paid on the CFC inclusions is excluded from the U.S. shareholder's income under section 959(a) in order to approximate the result that would have occurred if the shareholder had owned the CFC through a domestic corporation, where the taxes paid would reduce the E&P of the domestic corporation and, consequently, the taxable dividend under section 316 paid to the shareholder. The E&P of a CFC attributable to the CFC inclusions that exceeds these taxes is taxable given that such amounts would have resulted in a taxable dividend under section 316 if the CFC were owned by a domestic corporation that distributed such amounts to the individual U.S. shareholder.[27] Further, any increase in the electing U.S. shareholder's basis in its CFC stock under section 961(a) is limited to the amount of U.S. federal income tax paid by the shareholder by reason of the section 962 election (such basis adjustment, "section 962 basis").[28] Thus, the CFC earnings that gave rise to the CFC inclusion generally would, once repatriated to the electing U.S. shareholder, all generally be subject to the same aggregate amount of U.S. federal income tax as if the shareholder had owned the CFC stock through a domestic corporation.[29]

G. Section 986(c)

If a U.S. shareholder has a different functional currency from the functional currency of its CFC, or a lower tier CFC has a different functional currency from its higher tier CFC, exchange rate fluctuations between the time of the income inclusion under section 951(a) or section 951A(a) and the time of the actual distribution subject to section 959 can give rise to foreign currency gains or losses.

Section 986(c)(1) requires recognition of foreign currency gain or loss to account for foreign exchange rate movements between the time PTEP is created and when it is actually distributed to a U.S. shareholder. The amount of gain or loss determined under section 986(c)(1) is treated as ordinary income or loss from the same sources as the inclusion that

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[27] See also Treas. Reg. § 1.962-3(a), (b)(1)(i)-(ii). As section 962(d) and Treas. Reg. § 1.962-3(a) provide that the amount of the taxable section 962 E&P distribution is included in gross income, the general rules applicable to distributions of E&P under section 301 apply to distributions of taxable section 962 E&P.

[28] This basis adjustment protects against double taxation solely with respect to the nontaxable portion of a section 962 U.S. shareholder's PTEP in the same manner as section 959(a). Section 961(a) (second sentence) and Treas. Reg. § 1.961-1(a)(2). Similarly, if an electing U.S. shareholder is required to reduce its basis upon a distribution of PTEP under section 961(b)(1), the reduction will not exceed an amount equal to the amount of the excludible E&P distributed and any foreign taxes paid with respect to such excludible E&P. Treas. Reg. § 1.961-2(a)(2).

[29] This parity exists only if the dividend received by the electing U.S. shareholder from its CFC qualifies for the preferential rates for qualified dividend income under section 1(h)(11). If a dividend is not eligible for QDI treatment, the aggregate U.S. income tax paid by an electing U.S. shareholder with respect to its CFCs would be higher than if the shareholder owned their CFCs through a domestic corporation. See *Smith v. Comm'r*, 151 T.C. 41 (2018) (ruling that a section 962 election does not render a dividend from a Hong Kong corporation to an individual U.S. shareholder a qualified dividend within the meaning of section 1(h)(11)(B) by creating a deemed domestic corporate intermediate owner).

gave rise to the associated PTEP.[30] In general, subpart F and GILTI inclusions are determined based on the average foreign exchange rate for the relevant taxable year.[31] Section 961 basis adjustments are made with respect to this amount. Section 986(c) gain or loss is determined based on the difference between the spot rate on the date of the distribution and the rate used when the income was included.

H. Tracking PTEP Accounts and Notice 2019-1

Annual tracking of PTEP in separate categories is necessary to apply sections 960(b) and 986(c) on an annual basis. Similar tracking is required to apply the tax credit disallowance provisions of sections 965(g), 245A(d), and 245A(e)(3) with respect to PTEP arising under section 965 (the mandatory repatriation tax), section 959(e) (relating to section 1248), and section 245A(e)(3) (relating to hybrid dividends received by a controlled foreign corporation), respectively.[32]

Issued at the end of 2018, Notice 2019-1 announced rules to maintain annual PTEP accounts in sixteen PTEP groups and separate section 904 categories.[33] Notice 2019-1 also required that PTEP attributable to section 965 be distributed first, as opposed to the last-in, first out approach that typically applies to distributions of E&P under sections 959(c) and 316(a).

Finally, Notice 2019-1 states that in order for section 959(a) to apply to a distribution it must have been supported by E&P that would have otherwise supported a dividend under section 316. This language suggests that Treasury and the IRS may view a section 959(a) distribution as never having dividend status by virtue of section 959(d), which as discussed above, treats a distribution subject to section 959(a) as not a dividend for all purposes of the

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[30] Section 986(c)(2) provides the Secretary with the authority to deal with distributions of PTEP through tiers of foreign corporations.

[31] See sections 989(b)(3) and 986(b). An important exception applies with respect to PTEP resulting from an inclusion under section 965 (i.e., the mandatory repatriation tax enacted as part of the TCJA and which was subject to constitutional challenge in *Moore v. United States*, 602 U.S. 572 (2024)). Since the repatriation tax was generally determined as of December 31, 2017, the foreign exchange rate applicable on that date is used to determine section 986(c) gain or loss under Treas. Reg. § 1.986(c)-1(a). Additionally, section 986(c) gain or loss is reduced to reflect the effective tax rate that applied to create the PTEP (e.g., as a result of the deduction under section 965(c) or deficits under section 965(b)). Treas. Reg. § 1.986(c)-1(b)-(c).

[32] Whether section 965(g)'s foreign tax credit "haircut" applies to PTEP taxes is an open question. FedEx Corporation recently won a summary judgement motion on this issue in the U.S. District Court for the Western District of Tennessee. *FedEx Corporation v. United States*, No. 2:20-cv-02794-SHM-tmp (Feb. 13, 2025).

[33] 2019-2 I.R.B. 275. To be clear, the requirement to maintain annual PTEP accounts in various income categories existed prior to the issuance of Notice 2019-1.

Code.[34] Nevertheless, the text of section 959 itself indicates that dividend status is required in order for section 959(a) to apply. Section 959(c) provides that "section 316(a) shall be applied" in a specified manner. Section 316, in turn, defines the term "dividend." Thus, in order to break a potentially self-negating circularity, a dividend must first occur in order to apply section 959(a) and then, after having applied that provision, section 959(d) would then treat the distribution as not a dividend for other purposes of the Code.

I. Section 78 Dividends

Section 78 provides that where a U.S. shareholder claims a foreign tax credit with respect to deemed paid taxes, the shareholder is deemed to receive a dividend in the amount of such taxes. Historically, section 78 was intended to ensure that U.S. shareholders were taxed on a pre-tax basis with respect to foreign income that was eligible for a foreign tax credit, thus preserving branch-subsidiary parity and preventing a simultaneous deduction and credit for the same foreign income taxes.

For example, if a U.S. shareholder wholly owned a CFC that earned $100x of subpart F income subject to $28x of foreign income tax, the shareholder's subpart F inclusion would be $72x (i.e., since the foreign income taxes are deductible at the CFC level, the net foreign base company income of the CFC would be $72x). If the U.S. shareholder could credit $28x of foreign income taxes under section 960(a), it would effectively receive a double benefit by deducting and crediting the same $28x of tax. Section 78 addresses this issue by deeming the U.S. shareholder to have received a $28x dividend attributable to the foreign income taxes.[35] The U.S. shareholder therefore recognizes $100x of total income, against which a credit of $28x may be claimed.[36]

Section 78 was amended by the TCJA, which added references to sections 960(b) and 960(d). The revised section provides that the amount of taxes deemed paid under sections 960(a), (b) or (d) "shall be treated for purposes of this title (other than sections 245 and 245A) as a dividend received by such domestic corporation from the foreign corporation."[37] Section 960(d) deems taxes to be paid if they are properly attributable to a GILTI inclusion. Section 960(b), as discussed above, applies to taxes that are properly attributable to PTEP.

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[34] A similar inference could be drawn from the phrasing contained in the Proposed Regulations, which define a "covered distribution" (i.e., a distribution eligible for PTEP treatment) as "any distribution made by a foreign corporation with respect to its stock to the extent that the distribution is a dividend (as defined in section 316), *determined without regard to section 959(d)*." Prop. Treas. Reg. § 1.959-4(c)(1).

[35] Revenue Act of 1962, P.L. 87-834.

[36] The taxpayer's ability to claim foreign tax credits may be limited under section 904 and other provisions.

[37] The effective date of the reference to section 245A in section 78 has been the subject of recent litigation. See, e.g., *Varian Med. Systems, Inc. v. Comm'r,* 163 T.C. No. 4 (2024) (ruling that section 245A applied to a section 78 dividend that was deemed paid after 2017 but in a taxable year beginning on or before December 31, 2017).

The legislative history does not explain the rationale for including references to section 960(b) in section 78 other than as part of a general clean-up effort to reflect the repeal of section 902 and thereby ensure that section 78 only applied to deemed paid foreign tax credits under section 960.[38]

J. The Proposed Regulations

The Proposed Regulations address various issues associated with PTEP, such as how PTEP accounts are maintained at the CFC and U.S. shareholder level, PTEP distributions to U.S. shareholders under section 959(a) and to CFCs under section 959(b), basis adjustments under section 961(a) and (c) and certain additional basis adjustments to property through which a U.S. shareholder indirectly owns the stock of a CFC, successor rules, and several other provisions. The preamble states that a second set of future regulations will address additional issues not covered by the proposed regulations, such as "nonrecognition transactions, redemptions, transactions to which section 964(e) applies, and structures where CFCs are partners in a partnership."[39] This additional set of regulations will also include the regulations described in Notice 2024-16, which was the subject of our prior Report Number 1496.[40]

The Proposed Regulations establish rules for annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to a covered shareholder's ownership of stock in a CFC.[41] A covered shareholder for this purpose is any United States person other than a domestic partnership or S corporation.[42] Partnerships and S corporations are instead treated as aggregates of their owners (i.e., the same manner in which these entities are treated for purposes of subpart F and GILTI inclusions).[43] The definition of a covered shareholder is not limited to U.S. shareholders, within the meaning of section 951(b), because section 959(a) can apply to any U.S. person regardless of their quantum of ownership (e.g., where a U.S. person becomes a successor in interest with respect to the PTEP of a U.S. person that was a U.S. shareholder).

An annual PTEP account is determined with respect to a covered shareholder for each taxable year of the foreign corporation and in separate section 904 categories. The annual PTEP account is maintained in the foreign corporation's functional currency pursuant to section 986(b). The PTEP account is further subdivided into ten PTEP groups and two subcategories. This detailed tracking facilitates the application of section 959(c)'s last-in,

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[38] H. Rept. 115-466 at 628.

[39] 89 Fed. Reg. 95,366.

[40] *Supra*, n. 15.

[41] Prop. Treas. Reg. § 1.959-2(b)(1).

[42] Prop. Treas. Reg. § 1.959-1(b).

[43] The regulations do not provide guidance with respect to, and request comments on, foreign trusts and estates.

first-out rule and the various rules for determining foreign currency gain or loss and foreign tax credits.

Dollar basis pools track the basis of a covered shareholder in a foreign corporation's PTEP in U.S. dollars, which is used to determine foreign currency gain or loss under section 986(c). PTEP tax pools track the U.S. dollar amount of foreign income taxes associated with a foreign corporation's PTEP with respect to a covered shareholder, and such taxes are assigned to a creditable PTEP tax group to the extent eligible to be deemed paid under section 960(b).[44] The creditable PTEP tax group tracks foreign income taxes that are eligible to be deemed paid under section 960(b). Furthermore, together, dollar basis and the U.S. dollar amount of associated foreign income taxes determine basis reductions under section 961 for distributions of PTEP.

The Proposed Regulations track foreign income taxes associated with PTEP in a shareholder-specific manner,[45] which is different than the approach taken in current final regulations under Treas. Reg. § 1.960-3. This shareholder-specific approach is intended to ensure that PTEP taxes are only associated with the shareholder to whom the PTEP and associated taxes relate in multiple shareholder structures.

1. Section 959(a) – CFC-to-covered-shareholder distributions

The Proposed Regulations provide detailed rules for excluding PTEP distributions from the income of a covered shareholder or CFC under section 959(a) or section 959(b), respectively.[46] Proposed Treasury Regulation § 1.959-4(b)(1) provides that PTEP distributed to a covered shareholder is excluded from the covered shareholder's gross income under section 959(a).[47] The PTEP distribution does not increase a corporate covered shareholder's E&P.[48]

The Proposed Regulations treat each PTEP account as a single account with respect to each covered shareholder. Thus, a PTEP account is not associated with specific shares of stock held by a U.S. shareholder (or successor in interest), as was the case under the 2006 proposed regulations. As a consequence, PTEP may be distributed with respect to any share of stock owned by the covered shareholder, regardless of whether the associated inclusion under section 951(a) or 951A(a) was with respect to those shares.[49]

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[44] See Prop. Treas. Reg. § 1.959–2(b)(1) and (4)(ii).

[45] Prop. Treas. Reg. § 1.959-2(b)(1) and (4).

[46] Prop. Treas. Reg. § 1.959-4.

[47] This proposed rule does not apply to PTEP relating to the taxable section 962 PTEP subgroup.

[48] Prop. Treas. Reg. § 1.312-8(c). Since a U.S. shareholder's E&P is increased as a result of an inclusion under section 951(a) or section 951A(a), this rule prevents double counting of a corporate U.S. shareholder's E&P attributable to CFC income.

[49] Prop. Treas. Reg. §§ 1.959-2 through -4.

2. Section 959(b) – CFC-to-CFC PTEP distributions

With respect to a CFC's distribution of PTEP to another CFC, Prop. Treas. Reg. § 1.959-4(b)(2)(i) provides that the distribution is excluded from the recipient CFC's gross income for purposes of determining its subpart F income and tested income or loss, provided that the distribution relates to the PTEP account of a covered shareholder of the distributing CFC and the covered shareholder is a U.S. shareholder with respect to both CFCs.[50]

Section 959(b) applies by its terms to a distribution of PTEP from one CFC to another. The mandatory repatriation tax of section 965(a), however, applied to "specified foreign corporations," which includes controlled foreign corporations and any foreign corporation with respect to which one or more domestic corporations was a U.S. shareholder. To prevent double taxation of PTEP resulting from section 965 and attributable to a non-CFC specified foreign corporation, the Proposed Regulations extend the application of section 959(b) to PTEP distributions from such non-CFCs, pursuant to the authority under section 965(o).[51]

Applying the section 959(b) gross income exclusion at the CFC-level is a change from the existing statute and regulations, which exclude such amounts from the gross income of the CFC for purposes of applying section 951(a) to a U.S. shareholder. The preamble explains that this new approach is intended to avoid distortions in the allocation of expenses at the CFC level and to accurately track PTEP with respect to the covered shareholder to which it belongs in split ownership situations.

The split ownership issue was addressed in Rev. Rul. 82-16, in which a U.S. shareholder owned 70 percent of the stock of an upper-tier CFC, with the remaining 30 percent owned by non-U.S. persons.[52] The upper-tier CFC owned 100 percent of the stock of a lower-tier CFC, which generated $100x of subpart F income. This subpart F income resulted in a subpart F inclusion and PTEP to the U.S. shareholder of $70x. In a subsequent taxable year, the lower-tier CFC distributed $200x to the upper-tier CFC. To prevent potential double taxation to the U.S. shareholder, the revenue ruling grossed up the amount of PTEP that was deemed distributed to the upper-tier CFC from $70x to $100x. Thereby, the U.S. shareholder's pro rata share of this amount (i.e., 70% of $100x) was excluded from gross income for purposes of applying section 951(a).

The Proposed Regulations eschew the approach taken in Rev. Rul. 82-16, which would be complex to administer in light of the enactment of section 951A, pursuant to which a GILTI inclusion may be determined on the basis of a U.S. shareholder's pro rata share of

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[50] These PTEP distributions increase the recipient CFC's E&P under section 312, but not for purposes of the current year E&P limitation under section 952(c)(1)(A). Prop. Treas. Reg. §§ 1.312-6(b) and 1.952-1(c)(4).

[51] Prop. Treas. Reg. § 1.959-4(b)(2)(ii).

[52] 1982-1 C.B. 106.

tested items from multiple CFCs.[53] Furthermore, the revenue ruling's gross-up approach may be distortive where there are multiple U.S. shareholders that do not share in a CFC's PTEP pro rata.[54]

Instead, the Proposed Regulations introduce new rules that apply section 959(b) at the CFC level and then modify the rules for allocating subpart F income to ensure that the benefit of excluded PTEP is allocated solely to the covered shareholders to which the PTEP belongs. For example, as applied to the facts of Rev. Rul. 82-16, the Proposed Regulations would exclude $70x of the $200x distribution from the CFC's gross income, for purposes of determining its subpart F income. Of the remaining $130x of subpart F income, the Proposed Regulations would effectively specially allocate $30x of subpart F income to the minority shareholder, with the remaining $100x of subpart F income split between the shareholders using the traditional waterfall approach (i.e., $70x and $30x).

These results are achieved through the following technical mechanics. Proposed Treasury Regulation § 1.951-2 identifies "covered items," which are items of gross income of an upper-tier CFC attributable to distributions or gains with respect to stock of a lower-tier CFC, and associates those items with a specific covered shareholder. Proposed Treasury Regulation § 1.951-1(c) in turn allocates subpart F income of the CFC to U.S. shareholders in a manner that ensures that covered items are allocated to the covered shareholders to which they were assigned. Specifically, the Proposed Regulations allocate subpart F income with respect to a covered item as a preliminary step before applying the traditional subpart F income allocation rules in Treas. Reg. § 1.951-1(e).[55] Only covered items that give rise to subpart F income are allocated in this manner. These covered items are allocated on an item-by-item basis in a manner consistent with the way the covered items were assigned to covered shareholders under Prop. Treas. Reg. § 1.951-2. Any remaining subpart F income that is not related to covered items is allocated under existing Treas. Reg. § 1.951-1(e) (*i.e.*, the traditional "waterfall" approach). The preamble states that the Proposed Regulations should not affect the allocation of subpart F income or tested items that are not related to a covered item.[56]

The Preamble states that the application of section 959(b) at the CFC level is intended to avoid distortions that could occur when expenses are allocated to CFC gross income. According to the Preamble, applying section 959(b) at the CFC level ensures that CFC-level expenses, such as interest expense, are solely allocated and apportioned to non-PTEP gross income. This approach generally favors taxpayers since it will have the effect of using expenses to offset gross income that may qualify as tested income or subpart F income. The Preamble notes, however, that this approach may be adverse to domestic corporate

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[53] 89 Fed. Reg. 95,371.

[54] This potential distortion is described in Part IV.E.1 below.

[55] Prop. Treas. Reg. § 1.951-1(c)(1).

[56] 89 Fed. Reg. 95,391.

shareholders to the extent it reduces E&P that may have been eligible for the dividends-received deduction under section 245A(a).[57]

The Preamble requests comments on the proper method of apportioning deductions to distributions that do not wholly-qualify as PTEP. Furthermore, the preamble requests comments on whether deductions should be allocable and apportionable to PTEP and, if so, whether U.S. shareholders should receive basis to make up for the loss of a deduction as a result of the allocation and apportionment to PTEP.

Finally, the preamble requests comments on an alternative approach that would apply section 959(b) at the U.S shareholder level. Under this approach, distributions of PTEP may be characterized as giving rise to subpart F income at the CFC level (provided exceptions such as section 954(c)(6) do not apply), and adjustments are made to reduce the U.S. shareholder's subpart F inclusion under section 951(a) to the extent attributable to the distribution of PTEP. The preamble adds that comments on this alternative approach should address whether a CFC's deductions should be allocated and apportioned to gross income of the CFC that does not give rise to an inclusion at the shareholder-level under section 959(b) or 961(c) or whether CFC-level provisions (*e.g.*, section 954(c)(6)) should apply to such income and, if so, how the associated E&P should be tracked for purposes of section 959(c).

3. First-Tier Basis Adjustments under Section 961(a) and (b)

Section 961 provides for adjustments to a U.S. Shareholder's tax basis in stock of a CFC (1) on account of inclusion in gross income under Section 951(a) and 951A(a),[58] which result in basis increases,[59] and (2) on account of distributions that are excluded from gross income of the U.S. shareholder as a distribution of PTEP under Section 959(a), which result in basis decreases.[60]

Section 961(a) and (b) specifically apply to U.S. shareholders and CFCs where the U.S. shareholder directly own shares of stock of the CFC. The provisions also apply to property through which a U.S. shareholder indirectly owns stock of a CFC, such as an interest

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[57] For U.S. shareholders that are domestic corporations, E&P eligible for section 245A(a) may be preferable to PTEP given that the basis reduction under section 961(d) (applicable to section 245A distributions) is more limited than the basis reduction required under section 961(b)(1) (applicable to PTEP). The former provision only reduces basis "solely for purposes of determining loss" on a disposition of stock, whereas the latter provision reduces basis on a dollar-for-dollar basis with respect to PTEP distributions. On the other hand, section 245A(d) disallows foreign tax credits attributable to a section 245A(a)-eligible distribution, whereas taxes imposed on a PTEP distribution may be eligible for foreign tax credits under section 901 or 960(b).

[58] Section 951A(f)(1).

[59] Section 961(a) and Prop. Treas. Reg. § 1.961-3.

[60] Section 961(b) and Prop. Treas. Reg. § 1.961-4.

in a partnership that owns a CFC. The regulations refer to such shares or other property collectively as "**Section 961(a) ownership units.**"[61]

In applying section 961(b)(2) to a distribution of PTEP described in section 959(a), the Proposed Regulations require a basis reduction equal to the dollar basis and associated foreign income taxes of the PTEP with respect to the covered shareholder that received the distribution.[62] The reduction under section 961(b) with respect to creditable PTEP taxes is in tension with the Proposed Regulations' treatment of such taxes under sections 78 and 960(b). Specifically, the Proposed Regulations do not treat the section 78 gross up attributable to these PTEP taxes as a "covered distribution" of PTEP eligible for exclusion under section 959(a). Section 961(b)(1) only applies to amounts that are excluded from a U.S. person's income under section 959(a). The Preamble's rationale for this treatment of PTEP taxes is policy based:

> Associated foreign income taxes are taken into account for this purpose because when foreign income taxes are allocated and apportioned to PTEP, the foreign income taxes reduce the PTEP and the dollar basis of the PTEP…. As a result, the sum of the dollar basis and associated foreign income taxes of PTEP represent the amount by which basis was increased under section 961 when the PTEP was generated. However, the associated foreign income taxes (which represent PTEP that was eliminated by foreign income taxes) reduce adjusted basis only to the extent the covered shareholder is allowed a credit under section 901 for those taxes…. Consequently, associated foreign income taxes ultimately give rise to either a credit or an amount equivalent to a deduction (in the form of retained adjusted basis, which, in turn, will produce a lesser amount of gain or an additional amount of loss on a subsequent sale of the section 961(a) ownership unit relative to the gain or loss that would result if adjusted basis were reduced by associated foreign income taxes).[63]

If the basis reduction under section 961(b)(1), exceeds the amount of the U.S. shareholder's basis in a share, the shareholder recognizes gain under Prop. Treas. Reg. § 1.961-4(b). Gain treated as recognized with respect to a section 961(a) ownership unit,

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[61] Prop. Treas. Reg. § 1.961-1(b), cross referencing Prop. Treas. Reg. § 1.961-2(d)(1).

[62] Prop. Treas. Reg. § 1.961-4(b)(2)(i) and (ii).

[63] 89 Fed. Reg. at 95,379. By reducing a covered shareholder's basis with respect to its CFC, the Proposed Regulations would ensure that the U.S. shareholder is taxed with respect to the section 78 dividend attributable to PTEP taxes. In other words, the regulations would eliminate a potential deduction from the stock basis that could ultimately offset the income inclusion with respect to the section 78 dividend.

derivative ownership unit, or section 961(c) ownership unit is treated as gain from a sale or exchange of such ownership unit occurring concurrently with the basis reduction.[64]

4. Lower-Tier Basis Adjustments under Section 961(c)

Section 961(c) provides basis adjustments in the shares of a lower-tier CFC that are similar to the basis adjustments made under section 961(a) with respect to first-tier CFCs or other property through which a U.S. shareholder owns a CFC.[65] The Proposed Regulations define a "section 961(c) ownership unit" as a share of stock of a foreign corporation directly owned by a CFC and indirectly owned by one or more covered shareholders.[66] A CFC receives section 961(c) basis in the section 961(c) ownership unit, which is maintained on a shareholder-specific basis.[67] As explained below, this section 961(c) basis may be positive or negative and is taken into account in determining subpart F or tested income of a CFC upon a sale, exchange or other disposition of the section 961(c) ownership unit.[68]

Section 961(c) basis is increased by the amount of subpart F or GILTI income that is included in the gross income of the U.S. shareholder with respect to the stock of the lower-tier foreign corporation. Section 961(c) basis is decreased by the dollar basis pool of the PTEP that is excluded from a CFC's gross income under section 959(b) and, like section 961(a) basis, the PTEP taxes associated with the distribution.[69] Section 961(c) basis is also adjusted for foreign currency gain or loss recognized by a U.S. shareholder under section

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[64] Prop. Treas. Reg. § 1.961-4(f)(1). There are various questions about the character and source of this gain, including whether section 1248(a) may apply. A "derivative ownership unit" is a share of stock of a foreign corporation directly owned by a partnership and indirectly owned by one or more covered shareholders or a partnership interest directly owned by another partnership and through which one or more covered shareholders indirectly own shares of a foreign corporation. The rules applicable to derivative ownership units are not discussed in this Report but may be addressed in a future report.

[65] Section 961(c) provides for such adjustments to be made "[u]nder regulations prescribed by the Secretary."

[66] Prop. Treas. Reg. § 1.961-1(b). Although a "section 961(c) ownership unit" is defined by reference to the stock of a foreign corporation, the Proposed Regulations only provide for section 961(c) basis with respect to the stock of a CFC that is owned by another CFC, which is consistent with the statutory language. The preamble notes that Treasury and the IRS are studying whether section 961(c) should be extended to other circumstances.

[67] Prop. Treas. Reg. § 1.961-2(e)(2).

[68] Section 961(c) basis does not affect the amount of a CFC's E&P or gross income. 89 Fed. Reg. 95,377.

[69] Prop. Treas. Reg. § 1.961-4(d)(2)(i) and (ii). From a policy perspective, the reduction of section 961(c) basis attributable to PTEP taxes in the section 959(b) context is more defensible than in the section 959(a) context under the Proposed Regulations because these CFC-to-CFC distributions do not give rise to taxable income under section 78, whereas the Proposed Regulations exclude section 78 dividends from the definition of a covered distribution, even where the section 78 amount relates to section 960(b) deemed paid foreign tax credits. See discussion in Part IV.G of this Report.

986(c) and for certain nonrecognition transactions involving the stock of the lower-tier foreign corporation.[70]

Like first-tier CFC basis, the Proposed Regulations require gain to be recognized under the principles of section 961(b)(2) where a CFC distributes PTEP under section 959(b) that is in excess of section 961(c) basis.[71] In contrast to section 961(a) basis, however, the Proposed Regulations provide that section 961(c) basis can become negative, subject to certain limitations, in lieu of gain recognition.[72]

Negative section 961(c) basis arises when the amount of distributions that are excluded from gross income under section 959(b) exceeds the amount of section 961(c) basis the U.S. shareholder has with respect to the stock of the lower-tier foreign corporation. Negative section 961(c) basis is treated as an attribute of the CFC that directly owns the stock of the lower-tier foreign corporation, and has no effect on the CFC's adjusted basis in the stock or any other asset of the CFC. Negative section 961(c) basis applies only for the purposes prescribed in the section 961 regulations, and does not affect the amount of the CFC's gross income or E&P.[73]

Negative section 961(c) basis can arise in any situation in which the upper tier CFC has insufficient section 961(c) basis in the stock of the lower-tier CFC. This includes a situation in which the upper-tier CFC has adjusted basis in lower-tier stock equal to the amount of the exclusion under section 959(b), but no section 961(c) basis, such as following an acquisition of a lower-tier CFC. To illustrate, assume that CFC1, wholly owned by USP, purchases all the shares of CFC2 from a U.S. seller in a section 1001 sale for $200. CFC2 has $100 PTEP when acquired by CFC1. As a result of the acquisition, CFC1 would have adjusted basis in its CFC2 stock of $200, but no section 961(c) basis in such stock. In the year following the acquisition, CFC2 earns no subpart F or tested income, and makes a distribution of $100 to CFC1. As a result of the distribution, CFC1 would be required to reduce its section 961(c) basis in CFC2 to negative $100 under Prop. Reg. § 1.961-4(d)(2)-(3).

The Proposed Regulations implement section 961(c) in a similar manner to section 959(b) by applying the exclusion of gain at the CFC level through a multi-step process. The CFC would first determine the amount of gain recognized with respect to the transferred stock ("**covered gain**"), without regard to section 961(c) basis or any loss recognized on the transferred stock, and before applying any dividend recharacterization rules under section

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[70] See Prop. Treas. Reg. § 1.961-5.

[71] Prop. Treas. Reg. § 1.961-4(d). As with section 961(b)(2) gain, there are open questions regarding the character and source of this gain, including whether section 964(e) may apply to such gain.

[72] Prop. Treas. Reg. § 1.961-4(d)(3).

[73] Prop. Treas. Reg. § 1.961-10(b)(4) (cross-referencing Prop. Treas. Reg. § 1.961-4(f)(3)).

964(e) or other provisions.[74] The CFC would then assign a portion of the covered gain to each covered shareholder based on the rules contained in Prop. Treas. Reg. § 1.951-2 (the rules that also apply to assign covered distributions to shareholders).[75] The CFC would then apply its positive section 961(c) basis with respect to a covered shareholder to reduce the covered shareholder's share of the covered gain, subject to a limitation in nonrecognition transactions.[76] Any gain offset by section 961(c) basis in the hands of the CFC is characterized as PTEP in the hands of the CFC and excluded from gross income for purposes of determining the CFC's subpart F income and tested income.[77] If section 961(c) basis would result in a loss, that loss may only be used to offset gains with respect to stock of the same corporation.

Foreign income taxes with respect to gain that is offset by section 961(c) basis may be allocated to Mirrored PTEP and added to a U.S. shareholder's PTEP tax pool under Treas. Reg. § 1.959-3, but only if the taxes accrue in the same U.S. taxable year as the sale.[78] In the case of a CFC with a U.S. taxable year that differs from the foreign taxable year (e.g., a November 30 U.S. taxable year versus a calendar foreign taxable year), these taxes may not be allocated to PTEP and thus may be lost to the extent they are allocated and apportioned to the residual category (i.e., untaxed earnings) or an income category with insufficient amounts to generate a subpart F or GILTI inclusion under Prop. Treas. Reg. § 1.960-1 and Treas. Reg. § 1.861-20.[79] A more appropriate outcome would be to relate back the foreign income taxes to the PTEP generated from the stock gain, even if the taxes accrue in a subsequent taxable year.

If the CFC has negative section 961(c) basis, the CFC recognizes gain under section 961(c) to the extent that the CFC would recognize additional gain or less loss with respect to the transferred shares if the CFC's regular basis in the shares were reduced by the amount of

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[74] Prop. Treas. Reg. § 1.961-9(c)(1). A priority rule provides that section 961(c) applies prior to the application of section 964(e). Thus, any gain that is offset by section 961(c) is not again subject to section 964(e) at the CFC level. *Id.* at -9(c)(2).

[75] Prop. Treas. Reg. § 1.961-9(d)(1).

[76] Prop. Treas. Reg. § 1.961-9(d)(2). The amount of positive section 961(c) basis that is taken into account is limited to the excess of the amount of positive section 961(c) basis that would be taken into account by a covered shareholder without regard to the nonrecognition limitation over the share of the covered shareholders gain that is realized but not recognized by the CFC with respect to the transferred stock. Thus, in a nonrecognition transaction in which no boot is received, no positive section 961(c) basis is taken into account.

[77] Prop. Treas. Reg. § 1.961-9(d)(3). Any PTEP resulting from the application of section 961(c) at the CFC level generally is treated as having the same character and dollar basis as the PTEP of the CFC whose shares were transferred. The Proposed Regulations refer to this PTEP as "**Mirrored PTEP**," which is determined under the rule in Treas. Reg. § 1.961-9(f)(2).

[78] Prop. Treas. Reg. § 1.959-6(b).

[79] A U.S. shareholder does not have a subpart F or GILTI inclusion that would cause foreign taxes to be deemed paid under section 960(a) or (d), respectively, if the foreign income taxes, which are deductible at the CFC level, exceed the amount of the CFC's income in the relevant category.

its negative section 961(c) basis.[80] Thus, in a fully taxable transaction, the CFC would typically recognize gain equal to all its negative section 961(c) basis. A similar rule applies if a section 961(c) ownership unit ceases to be a section 961(c) ownership unit immediately after a transaction. In such case, the CFC recognizes gain equal to all the negative section 961(c) basis associated with the section 961(c) ownership unit. This gain, if any, is assigned to the covered shareholder to which it relates.

5. PTEP Successor Rules

a) General PTEP Successors in Interest

Under current law, a U.S. person that acquires shares in a foreign corporation from another person can succeed to any PTEP attributable to the shares to the extent the U.S. person provides certain information on a statement attached to its return as required by regulations.[81] In that case, the U.S. acquiror has the benefit of the PTEP even though a different U.S. person was taxed on the underlying CFC income. The successor rules can apply when the U.S. person acquires the foreign corporate shares from any person, and thus do not require the U.S. person to acquire the shares directly from the U.S. shareholder that recognized the underlying CFC inclusion in order to succeed to the PTEP attributable to the shares. The current successor rules do not define the term "acquisition" for purposes of the successor rules.

In general, the Proposed Regulations would provide new rules for determining the extent to which PTEP transfers when shares of a CFC are transferred, which would replace the existing successor PTEP regulations. As under the current regulations, the successor PTEP rules generally would apply to any relevant U.S. person that acquires shares of a foreign corporation, without regard to whether the U.S. person is a U.S. shareholder or the corporation is a CFC, although the Proposed Regulations would exclude U.S. partnerships from the successor PTEP rules.[82]

The Proposed Regulations would apply to a shareholder that directly or indirectly acquires a foreign corporation in a "general successor transaction," which is defined as a transfer of ownership of a CFC directly or indirectly owned by a covered shareholder to another covered shareholder.[83] Although the successor rules would apply to most transactions involving a change of ownership of foreign corporate shares directly or indirectly

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[80] Prop. Treas. Reg. § 1.961-10(c).

[81] Treas. Reg. § 1.959-1(d).

[82] Prop. Treas. Reg. § 1.959-7(b)(1), which applies to general successor transactions, refers to a "covered shareholder," as defined in Prop. Treas. Reg. § 1.959-1(b). This second rule excludes domestic partnerships. The preamble states that an acquisition giving rise to a general successor transaction may be "direct or indirect," however. 89 Fed. Reg. 95,374. Thus, it appears that a partnerships acquisition of CFC stock may give rise to a general successor transaction to certain partners of the partnership.

[83] Prop. Treas. Reg. § 1.959-7(b)(1).

owned by a covered shareholder, they would not apply with respect to shares of a foreign corporation acquired by a U.S. person in any of the following transactions: (1) the issuance of stock or partnership interests; (2) redemptions of stock or liquidating distributions in redemption of a partnership interest; and (3) any transfer of stock of a foreign corporation, or any property through which the corporation is owned, if such stock or other property is substituted basis property (*i.e.*, the transfer is pursuant to a nonrecognition transaction).[84]

Under the Proposed Regulations, some or all of the transferor's PTEP would transfer to the acquirer along with any PTEP created as a result of the application of section 1248 to the disposition.[85] Further, in situations in which less than all of a transferor's shares are transferred, the proposed rules would determine the extent to which PTEP transfers based on a hypothetical distribution of the transferor's PTEP immediately before the relevant transaction, other than PTEP created by reason of any current-year inclusions of the transferor with respect to shares that it retains.[86] Additionally, the proposed rules generally would apply a pro rata approach for determining the dollar basis and associated foreign income taxes of PTEP that transfers to an acquiror.[87]

b) Deemed Covered Shareholders

The Proposed Regulations also would address situations in which a U.S. person acquires the shares of the foreign corporation from a person other than a U.S. Shareholder, including when there is intervening ownership of the shares by a foreign person.[88] When a covered shareholder sells stock of a foreign corporation to a foreign person, the foreign person is a "**deemed covered shareholder**" that succeeds to the PTEP of the seller.[89] If the foreign person subsequently sells the stock of the foreign corporation to a covered shareholder, the purchaser succeeds to any PTEP with respect to the seller.

The Proposed Regulations would require the acquiring U.S. person to use a "reasonable method" to determine the amount and character of PTEP that would transfer from the seller, taking into account the adjustments to PTEP accounts generally required under the Proposed Regulations that would have occurred during the period of intervening foreign ownership if the shares had been owned by a hypothetical U.S. Shareholder (*i.e.*, the amount of PTEP is not "frozen" during the intervening period of foreign ownership).[90]

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[84] Prop. Treas. Reg. § 1.959-7(b)(2).

[85] Prop. Treas. Reg. § 1.959-7(c).

[86] Prop. Treas. Reg. § 1.959-7(d)(1).

[87] Prop. Treas. Reg. § 1.959-7(e)-(f).

[88] Prop. Treas. Reg. § 1.959-7(g)(1).

[89] A foreign corporation can also become a deemed covered shareholder by acquiring stock from another deemed covered shareholder.

[90] Prop. Treas. Reg. § 1.959-7(g)(2).

IV. RECOMMENDATIONS

A. Extend the Comment Period with respect to the Proposed Regulations

After the enactment of the TCJA, PTEP took on a more significant role in the international tax system. Previously, subpart F income represented relatively small amounts of the income of CFCs.[91] Following the enactment of the mandatory repatriation tax under section 965 and GILTI under section 951(a), most CFC income was subject to tax under subpart F (i.e., sections 951 and 951A).[92] In light of the increased importance of PTEP in the post-TCJA international tax system, both taxpayers and the government viewed additional guidance under sections 959 and 961 as a priority. Treasury and the IRS added proposed regulations addressing PTEP to the 2018-2019 Priority Guidance Plan on November 8, 2018. The Proposed Regulations were issued on December 2, 2024, representing more than six years of careful study and drafting on the part of the government. The Proposed Regulations requested comments by March 3, 2025.

This lengthy period may have been due, in part, to the fact that the statutory rules dealing with CFC earnings have been enacted at various times since 1962 and are not well coordinated. For example, the rules applicable to lower-tier PTEP basis under section 961(c), which were enacted in 1997, do not address the treatment of such basis for purposes of determining a CFC's E&P, which raises difficult questions with respect to the treatment of such E&P for purposes of the dividends-received deduction under section 245A(a), which was enacted in 2017. Similarly, the aggregate approach to GILTI and subpart F income with respect to partnerships adopted in post-TCJA regulations[93] has exacerbated concerns regarding whether a partnership may claim tax basis in the stock of a CFC where its direct or indirect partners have experienced a GILTI or subpart F inclusion. These and other issues have made difficult the task of crafting a coherent and administrable set of rules governing PTEP.

Although the scope of the Proposed Regulations is narrow in a certain sense, the topics addressed therein are complex and wide ranging. Given the timing of the release of the Proposed Regulations at the end of 2024 and the length of the comment period, comment letters will not be able to address all of the issues raised in the preamble as areas of study and requests for comments. For example, this Report does not address the interactions of the

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[91] For example, estimates based on Statistics of Income data indicated that subpart F income represented approximately 15 percent of the E&P of CFCs for the 2002 taxable year. See Melissa Redmiles and Jason Wenrich, *A History of Controlled Foreign Corporations and the Foreign Tax Credit* at 134, available at https://www.irs.gov/pub/irs-soi/historycfcftc.pdf (last checked February 25, 2025).

[92] IRS SOI data indicates that nearly 90 percent of CFC earnings in 2021 were PTEP. See https://www.irs.gov/statistics/soi-tax-stats-controlled-foreign-corporations (last checked Feb. 25, 2025).

[93] See Treas. Reg. § 1.958-1(d).

PTEP rules with subchapter K, including the rules applicable to derived basis and the interactions with provisions such as sections 732, 734 and 743.

Treasury and the IRS would benefit from additional thoughtful views on these and other matters. To encourage the tax community to devote time and resources to providing these comments, we believe that the comment period should be extended for a period commensurate with the time spent by the government in drafting and deliberating regarding the Proposed Regulations. We suggest that the comment period should be extended for an additional six months. An extension of the comment period would not be unprecedented. In December of last year, for example, the comment period for the proposed CAMT regulations was extended.[94] In light of the recent executive order announcing a regulatory freeze pending review by a department or agency head appointed or designated by the President, it may be the case that an extended comment period does not cause a delay in issuing final regulations.[95]

Although we recognize that extending the comment period could delay the applicability of the PTEP rules (including a potential second tranche of guidance addressing additional issues), we believe the benefits of additional comments would justify the delay. Taxpayers have made do with the existing rules for the past seven years and, in our experience, do not seem inclined to adopt the Proposed Regulations early. Furthermore, once finalized, it may be decades before the rules are amended or revisited. These observations suggest that getting the rules right in the first instance based on robust feedback from the tax community is more important than issuing the rules quickly.

We are mindful of the perception that the IRS may not argue positions in litigation that are inconsistent with proposed regulations.[96] To prevent extending a potential whipsaw to the government from a lengthened comment period, therefore, any guidance announcing an extension should explicitly state that the IRS would not be prevented from arguing a position contrary to the proposed regulations prior to their finalization and applicability date.

B. Consider Options to Simplify the Proposed Regulations

The Proposed Regulations are complex and require significant record keeping with respect to PTEP, including by maintaining annual accounts in each separate section 904 category (and further subdivided into ten PTEP groups), dollar basis pools and PTEP tax

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[94] 89 Fed. Reg. 96,143 (Dec. 4, 2024).

[95] Regulatory Freeze Pending Review (Jan. 20, 2025), *available at* https://www.whitehouse.gov/presidential-actions/2025/01/regulatory-freeze-pending-review (last checked Feb. 25, 2025).

[96] See, e.g., Internal Revenue Manual 32.1.1.2.2(3) ("If there are no final or temporary regulations currently in force addressing a particular matter, but there are proposed regulations on point, the Office of Chief Counsel generally should look to the proposed regulations to determine the office's position on the issue. The Office of Chief Counsel ordinarily should not take any position in litigation or advice that would yield a result that would be harsher to the taxpayer than what the taxpayer would be allowed under the proposed regulations.")

pools. Additionally, in order to accurately track PTEP for purposes of allocating and apportioning expenses and allocating subpart F income to U.S. shareholders, information reporting may be required among unrelated direct or indirect owners of a CFC in order to construct and maintain the CFC's tax attributes. Finally, the deemed covered shareholder rules may require acquirors of a foreign corporation to engage in a forensic exercise to reconstruct the foreign corporation's PTEP history.

For certain taxpayers, this reporting burden may be significant relative to the ultimate amounts of tax at issue. Treasury and the IRS, therefore, should study options to simplify the PTEP rules in ways that are not adverse to the government's interests, either as part of a future legislative proposal or through an elective regime. For example, future regulations could provide certain taxpayers with an election to deem PTEP to be distributed from and recontributed to a CFC in each year in which it is earned (*i.e.*, a consent dividend election similar to the mechanism provided under section 565). PTEP would be thereby eliminated from E&P and converted into tax basis that could be recovered (after the distribution of untaxed E&P) under section 301(c)(2). Taxpayers may prefer to make this election where the downsides of making it are outweighed by the benefit of reduced administrative complexity.[97] Furthermore, the election could be limited to relatively simple structures, such as wholly-owned CFCs, or wholly and directly owned CFCs, and be revocable only with the consent of the Commissioner.

The combined pool election is a positive step toward simplification, as it simplifies PTEP accounting by converting annual layers of dollar basis and PTEP tax pools into a combined pool. This election should be further liberalized, though, by eliminating the consistency requirement, which may prevent taxpayers from making the election in unforeseen circumstances. In addition, consideration should be given to expanding the scope of the election to the annual PTEP accounts themselves, as opposed to solely the dollar basis and PTEP tax pools.

C. Gain under Section 961(b)(2)

1. Tax Basis and PTEP Distributions under the Proposed Regulations

As discussed above, the Proposed Regulations treat the PTEP account as a single aggregate shareholder account. PTEP is not associated with specific shares of stock held by a U.S. shareholder (or successor). As a result, when a CFC makes a pro rata distribution to a covered shareholder in respect of the shareholder's section 961(a) ownership units, the distribution will be treated as, first, a distribution of PTEP to the extent of the covered shareholder's various PTEP accounts in respect of all section 961(a) ownership units, in the order provided under the Proposed Regulations under section 959. This is so regardless of the amount of basis that the covered shareholder has in a particular share of stock in respect

[97] Downsides may include the potential loss of section 960(b) foreign tax credits and the inability to recognize section 986(c) losses with respect to future distributions that would have otherwise qualified as PTEP distributions.

of which the distribution of PTEP is made and whether the income that originally gave rise to the PTEP was included in respect of such shares.

Specifically, a distribution of PTEP excluded from gross income under section 959(a) (and Prop. Treas. Reg. § 1.959-4) (including any foreign income taxes associated with the PTEP for which the covered shareholder is allowed a foreign tax credit under section 960(b)) reduces the adjusted tax basis in the section 961(a) ownership unit on which the distribution was made.[98] To the extent the amount of the distribution attributable to a specific section 961(a) ownership unit exceeds the adjusted tax basis of that unit, the covered shareholder recognizes gain with respect to that section 961(a) ownership unit under the Proposed Regulations.[99]

Because a distribution in respect of a given class of stock generally must be made pro rata among all the shares of such class as a matter of corporate law, this can result in a covered shareholder recognizing gain on a distribution by a CFC even though the aggregate adjusted tax basis in all shares of the CFC owned by the covered shareholder exceeds the amount of PTEP as well as the amount of the distribution, and even though the distribution is made entirely out of the CFC's current or accumulated E&P.

> Example 1. A domestic parent (USP) owns all of the stock of a foreign corporation (CFC1). USP initially capitalizes CFC1 with $400x of cash in exchange for 10 shares of common stock ("**Block 1**"), and CFC1 purchases all of the assets of two foreign target corporations, operating Business A and Business B respectively. Business A is not successful, while Business B generates earnings, and in the first five years of their operation, the combined businesses generate $600x of section 951A(a) inclusion by USP. At the end of year 5, CFC1's fair market value has decreased to $200x. At the beginning of year 6, USP invests an additional $200x for 10 additional shares of CFC1 common stock ("**Block 2**"). During year 6, CFC1 earns income that is not subject to tax under sections 951 or 951A. In year 7, CFC1's fortunes change, and it makes a distribution of $500x in respect of its common stock. Accordingly, USP receives a distribution of $25x in respect of each share of its CFC1 common stock as a corporate law matter.

The shares of stock that USP holds in CFC1 are section 961(a) ownership units, and USP is a covered shareholder.[100] The basis in each share of common stock of Block 1 in the hands of USP is adjusted for the aggregate $600x income inclusion by $60x (its GILTI

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[98] Prop. Treas. Reg. § 1.961-4(b)(2). A section 961(a) ownership unit is defined in Prop. Treas. Reg. § 1.961-2(c) as "a share of stock of a foreign corporation directly owned by a covered shareholder, or an interest in a partnership directly owned by a covered shareholder and through which the covered shareholder owns stock of a foreign corporation."

[99] Prop. Treas. Reg. § 1.961-4(b)(2)(iii).

[100] Prop. Treas. Regs. §§ 1.961-2(c) and 1.959-1(b). In this regard, the section 961(a) ownership unit refers to a "share" of stock, indicating that the shares are not aggregated with respect to each shareholder or even class of stock owned by a shareholder under the Proposed Regulations.

inclusion per share) to $100x from $40x (its initial basis per share).[101] For each share in Block 2, by contrast, USP's adjusted tax basis relevant at the time of the $500 distribution is $20x. Thus, the $25x distribution reduces the adjusted tax basis for each Block 1 share from $100x to $75x; and for each Block 2 share from $20x to $0, while the excess distribution of $5x per Block 2 share requires USP to recognize gain. This is so regardless of the fact that USP has aggregate tax basis in its CFC1 stock ($1,200x) and PTEP ($600x) in excess of the total distribution.[102]

The preamble to the Proposed Regulations does not attempt to reconcile this result with the policy and purpose of sections 959 and 961, which is to allow the U.S. shareholder to repatriate E&P previously included in income without additional U.S. tax. It is also a deliberate and marked departure from the 2006 Proposed Regulations,[103] which in effect allowed for basis "sharing" to avoid the result illustrated by Example 1.[104] That said, the language of section 961(b)(1) is ambiguous and it is reasonable to read the provision as requiring share-by-share basis recovery. The provision states that a basis reduction shall apply to "the … stock … with respect to which a United States shareholder or a United States person receives an amount which is excluded from gross income under section 959(a)." The term "stock" in this sentence could be read to apply separately to each share of stock.[105] Alternatively, the term may refer to all of the equity owned by a covered shareholder or all of the equity within a particular class of shares.[106] In light of this ambiguity and the grant of regulatory authority in section 961(b), we believe policy considerations should inform the manner in which basis is recovered under section 961(b)(2). Specifically, as described

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[101] Prop. Treas. Regs. § 1.961-3(b) and (c)(1). The original $400x investment in exchange for 10 shares resulted in a per share basis of $40x, which is thereafter increased by $60x (i.e., the $600x income inclusion allocated to the ten shares).

[102] In other words, USP has invested total capital of $600x in the CFC and received section 961(a) share basis increases of $600x for an aggregate share basis of $1,200x. In contrast, had USP sold all of its CFC1 shares, then any capital gain and loss recognized with respect to the shares could be netted, assuming that section 1248(a) did not apply to treat a portion of the gain as ordinary dividend income.

[103] 71 Fed. Reg. 51,155 (Aug. 29, 2006), *withdrawn*, 87 Fed. Reg. 63,981 (Oct. 21, 2022). On the other hand, section 961(b)(1) does require a reduction to "the adjusted basis of stock or other property with respect to which a United States shareholder or a United States person receives an amount which is excluded from gross income under section 959(a)." This language does suggest a share-by-share approach to PTEP recovery, but at the same time does not specify exactly how basis should be recovered.

[104] Prop. Regs. (2006) § 1.961-3(a)(1).

[105] In this regard, the language of section 961(b)(1) is similar to the language of sections 301(c)(2) and (3), which also refers to basis reductions to "stock." The U.S. Court of Appeals for the Fourth Circuit has interpreted this language as requiring share-by-share basis recovery. *Johnson v. United States*, 435 F.2d 1257 (4th Cir.1971), *rev'g* 303 F.Supp.1 (E.D. Va. 1969).

[106] See Section 1368, which provides the basis reduction rule for distributions "with respect to ...stock" of an S corporation. Under regulations, aggregate basis recovery is permitted in this case, as discussed below.

further below, a covered shareholder should be able to access all of its basis in a CFC's shares within a particular class before recognizing gain under section 961(b)(2).

Treasury and the IRS have indicated, however, that the basis sharing under the 2006 Proposed Regulations facilitated recognition of non-economic losses, and that they were withdrawn to "help prevent possible abuse or other misuse … such as inappropriate basis adjustments in certain stock acquisitions to which section 304(a)(1) applies."[107] In addition, Treasury and the IRS indicated a preference to follow the general basis rules under section 301(c)(3) and *Johnson v. United States*,[108] pursuant to which basis is not shared among shares of stock (or blocks of shares) on distributions.[109]

In many cases, a U.S. shareholder may be able to use self-help to avoid the results illustrated above. In the circumstances described in Example 1 above, for example, USP could have made a capital contribution of $200x with respect to the outstanding stock, without an issuance of additional stock.[110] A single block of 10 shares would have continued to exist, and each share of this single block would have increased its adjusted tax basis to $120x, resulting from the initial investment of $40x per share, GILTI inclusions of $60x per share and an additional capital contribution of $20x per share.[111]

In addition to being an inadequate solution to the problem, however, this self-help potential reveals a flaw in the Proposed Regulations; economically equivalent transactions that can be distinguished solely on grounds of formalities of corporate law can lead to markedly different U.S. federal income tax consequences.[112] The issuance of additional

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[107] 87 Fed. Reg. 63,981 (Oct. 21, 2022). Under the 2006 proposed regulations, PTEP and basis could be shifted through redemptive dividend-equivalent transactions under section 302(d) and 304. When this occurred, PTEP basis would shift to the redeemed shareholder automatically to correspond with the PTEP received in the transaction and, predictably, could create built in losses in stock. The proposal advocated here would not create losses, however, because basis is only recovered or shifted to the extent necessary to prevent gain under section 961(b)(2).

[108] *Johnson, supra* note 105.

[109] See preamble to Proposed Regulations, 89 Fed. Reg. at 95379. See also Andrew Velarde, *IRS Could Modify PTEP Regs' Basis Adjustment Rules*, 2025 TAX NOTES TODAY FOREIGN 11-2.

[110] Certain foreign jurisdictions, however, may require an issuance of stock, even if only a nominal amount. Self-help may also be limited where shares are held by two different members of the same consolidated group.

[111] Section 358(a)(1)(A) and Rev. Rul. 82-112, 1982-1 C.B. 59 (providing that a contribution of shares to the capital of a corporation resulted in the basis of the contributed shares being allocated to the remaining shares). Similar issues arise in circumstances in which the stock of one corporation is contributed to another, under Treas. Reg. § 1.358-2(a)(2).

[112] For the position that formalistic distinctions should not give rise to taxable income, see *Eisner v. Macomber*, 252 US 189, 40 S Ct 189 (1919). Treasury and the IRS expressed this view when Prop. Regs. §§ 1.301-2(e) and 1.358-2(g)(3) (Jan. 16, 2009) were withdrawn: "The chief concern raised by

shares generally has been appropriately considered a "meaningless gesture" in other types of transactions, where a transaction otherwise does not affect a shareholder's proportionate interest in the stock of a corporation, such as contributions to the capital of a wholly owned subsidiary or certain so-called "cash D" reorganizations.[113]

Having different blocks of CFC stock for different contributions to the CFC's capital, rather than one block of stock with a tax basis reflecting several contributions to capital, is of course meaningful upon a sale of the stock or in determining the character of a distribution under section 301 as a dividend, return of capital or capital gain distribution.[114] To the extent it is not possible to reconcile the *Johnson* approach with the policy underlying section 959 and 961, the subpart F policies should take precedence for transactions within the purview of subpart F. In its preamble to the 2006 Proposed Regulations, Treasury and the IRS appeared to concur:

> The purpose of section 959 is to prevent double taxation of amounts that have been previously included in gross income by a United States shareholder under section 951(a) and, importantly, to *prevent such double taxation at the earliest possible time*.[115]

The Proposed Regulations do not achieve this policy, however, by expanding the concept of a single, shareholder-level PTEP account to a consolidated group while applying the rules to "separate member" basis in CFC shares. Members of a consolidated group are treated as a single shareholder for purposes of distributions of PTEP subject to section 959. The treatment of a consolidated group as in effect a single covered shareholder is, of course, consistent with the approach to subpart F under the consolidated return regulations. For example, consolidated groups determine tested income, tested loss and qualified business asset investment, and the foreign-tax credit limitation on a consolidated basis.[116] The PTEP accounts are similarly treated as an attribute of the group under the Proposed Regulations.[117]

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commenters was that the approach taken in the 2009 Proposed Regulations represented an unwarranted departure from current law as a result of which minor changes to an overall business transaction could cause meaningful changes to the tax consequences, thereby elevating the form of the transaction over its substance." Withdrawal of Notice of Proposed Rulemaking, 84 Fed. Reg. 11,686 (March 28, 2019).

[113] See, e.g., Treas. Reg. § 1.368-2(l); *Lessinger v. Commissioner*, 872 F.2d 519 (2d Cir. 1989), rev'g 85 T.C. 824 (1985); *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983); *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir.), cert. denied, 368 U.S. 836 (1961) (Section 351, where contribution is to a wholly owned subsidiary); *James Armour, Inc. v. Comm'r*, 43 TC 295, 307 (1964) (Type D reorganization); *Wilson v. Comm'r*, 46 TC 334 (1966) (same); Rev. Rul. 70-240, 1970-1 CB 81 (same); or Rev. Rul. 85-164, 1985-2 CB 117 (basis and holding periods must be allocated pro rata, not by designation to specific exchanges). But see sections 108(e)(6) and (8).

[114] See *Johnson, supra* note 105.

[115] Preamble to 2006 Proposed Regulations, 71 Fed. Reg. 51,155, 51,159 (2006) (emphasis added).

[116] See Treas. Regs. §§ 1.1502-4 and 1.1502-51.

[117] Prop. Treas. Regs. § 1.1502-59(a)(3).

Where different members of a consolidated group own shares in a given CFC but have different tax bases in their CFC stock, however, the unitary consolidated PTEP account can have the same effect under section 961(b)(2) as for a single taxpayer with the ownership of separate blocks of stock with different tax bases vis-à-vis unitary taxpayer-level PTEP accounts.

> Example 2. USP is the parent of a consolidated group. USS1 and USS2 are domestic corporations that are wholly owned by USP and members of the USP consolidated group. CFC1 is a CFC, and USS1 and USS2 are both U.S. shareholders of CFC1. Each of USS1 and USS2 owns 1 share of CFC1's only class of stock. In year 5, CFC1 makes a distribution of $250x per share when USS1 has an adjusted tax basis of $1,000x in its share of CFC1 stock, USS2 has an adjusted tax basis of $200x, and the USP consolidated group has a PTEP account with respect to CFC1 of $600x.

As in Example 1, the entire distribution is a distribution of PTEP under section 959(a), as the PTEP accounts of the consolidated group with respect to CFC1 exceed the aggregate amount that CFC1 distributes to members of the USP consolidated group. USS1 will decrease its tax basis in its CFC1 shares by $250x to $750x. USS2 will reduce its basis in its CFC1 share by $200x to $0 and recognize section 962(b)(2) gain equal to the excess of the $250x distribution over its $200x pre-distribution basis in its CFC1 stock, i.e., $50x. As was the case with the single taxpayer in Example 1, as applied to a consolidated group this result also is not consistent with the policy underlying sections 959 and 961 that E&P that were previously included in income should not incur additional U.S. tax when repatriated.

2. Basis Sharing/Shifting under the 2006 Proposed Regulations

The 2006 Proposed Regulations would have avoided the results of Examples 1 and 2 under the currently Proposed Regulations by requiring a covered shareholder to maintain PTEP accounts "with respect to each share of stock it owns" (directly or indirectly) in a foreign corporation.[118] "Share-specific" PTEP accounts could be combined only with respect to shares in a single block of stock (within the meaning of Treas. Reg. § 1.1248-2(b)).[119] Under the 2006 Proposed Regulations, if a CFC made a distribution to a covered shareholder out of its PTEP, and if the shareholder had more than one share of stock (or blocks of shares) with different associated PTEP accounts with at least one of the PTEP accounts less than the share's pro rata portion of the PTEP distribution, then PTEP from the PTEP accounts associated with other shares would be shifted, pro rata based on the amounts of the PTEP accounts, to the shortfall share(s). The shifted amounts of PTEP would then be used up by the PTEP distribution, and the "shortfall" shares would end up with associated PTEP

[118] Prop. Treas. Reg. (2006) § 1.959-1(d)(1).

[119] *Id.*

accounts of $0. There would be no tracing of the history of these PTEP account adjustments. Once a shift had occurred, it would not later be reversed.[120]

Under the 2006 Proposed Regulations, tax basis would automatically follow these PTEP account adjustments, i.e., the basis in a shortfall share would be increased and the basis in a share with a PTEP account that was reduced on account of the PTEP Account adjustment would be reduced, in each case by the amount of adjustment with respect to the PTEP accounts associated with the share.[121] The distribution of PTEP that prompted the PTEP account adjustment in the first place would immediately reduce the shifted tax basis again.[122] As a result, section 961(b)(2) gain could be recognized by a U.S. shareholder on a PTEP distribution by a CFC in respect of a share of the CFC's stock only to the extent that the aggregate PTEP accounts of the U.S. shareholder (or consolidated group) with respect to the CFC exceeded the aggregate tax bases of the U.S. shareholder (or consolidated group) in the shares.

In Example 1, under the 2006 Proposed Regulations, $250x of PTEP account would have to be shifted from the shares in Block 1 to the shares in Block 2 because each share of Block 2 stock has a $0 share-specific PTEP account. The shares of Block 1, by contrast, have a sufficient PTEP Account associated with them to allow for this shift. Thus, the Block 1 shares will end up with a remaining basis of only $500x, reflecting a reduction of $250x on account of their own PTEP inclusion and an additional $250x on account of a PTEP account shift to the Block 2 shares. The Block 2 shares will end up with remaining tax basis of $200x, reflecting a shift from the Block 1 shares of $250x and the corresponding reduction of the shifted PTEP account and tax basis to reflect their $250x share of the PTEP distribution. The Block 2 shares thus have the same basis as before the distribution, which may give rise to a built-in loss.

A share-by-share determination was arguably consistent with the language of section 961(b)(2), which refers to PTEP basis adjustments of "the stock or other property with respect to which [the distribution] is received," and we have discussed a tracing approach in our report on the 2006 Proposed Regulations.[123] But section 959, by contrast, refers only to a single "interest" of a U.S. Shareholder in the CFC, and PTEP accounts are arguably not to be maintained on a share-by-share basis. The tracing approach, accordingly, was not uncontroversial, but together with the PTEP account and tax basis shift, it implemented the section 959 policy that achieving tax-free PTEP distributions should take precedence.

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[120] Prop. Treas. Reg. (2006) §§ 1.959-3(f) and -3(e)(2)(ii).

[121] Prop. Treas. Reg. (2006) § 1.961-1(b)(1).

[122] Prop. Treas. Reg. (2006) § 1.961-3.

[123] New York State Bar Association Tax Section, *Report No. 1321 On 2006 Proposed Regulations Regarding the Exclusion from Income Of Previously Taxed Earnings Under Section 959 And Related Basis Adjustments Under Section 961* (March 30, 2015), at 54-55.

3. Basis Consequences of Distributions by S corporations

A similar problem of coordinating distributions with basis adjustments arises with respect to stock of an S corporation. A shareholder of an S corporation increases its adjusted tax basis in each share of stock of an S corporation by its pro rata portion of amounts includible in its income on a per share, per day basis.[124] The tax basis is then reduced by the amount of any distribution to the shareholder and certain pass-through items, but not below zero.[125] Basis decreases are likewise made on a pro rata, per share basis. However, if the amount distributed in respect of a share exceeds its basis, the basis of other shares held by the shareholder that have basis in excess of the pro rata portion of the distribution is reduced (not below zero). The decrease of the tax basis of the other shares is applied in proportion to the remaining basis of each of the excess basis shares.[126] The language of section 1367(a)(2) resembles that of section 961(b)(1) in that it refers to a reduction in "[t]he basis of each shareholder's stock in an S corporation."[127]

The use of tax basis of other shares under the Regulations issued under section 1367 have a similar effect as the PTEP account adjustments under the 2006 Proposed Regulations, but with an important difference. The 2006 Proposed Regulations shifted basis from shares when the portion of the PTEP distribution attributable to certain shares exceeded the PTEP account, if and to the extent that other shares had a sufficient associated PTEP account. Thus, tax basis shifted regardless of the actual tax basis of the shares to which a portion of the PTEP account and associated basis was shifted.

This approach resulted in a preservation of basis in a block of shares with an insufficient PTEP account to the extent the basis was not associated with PTEP, regardless of whether those shares were otherwise high-basis or low-basis shares. The preserved basis could then be employed in a further loss-recognition transaction, as indicated in the preamble.[128] Basis shifting under section 1367 by contrast does not occur by reference to associated E&P, but only to the extent that the distribution exceeds the actual tax basis of the low-basis shares. Retaining basis while having other shares provide basis to avoid section 961(b)(2) would thus not be possible. The shares or block of shares to which basis is provided would always end up with a basis of $0 as it would always have to exhaust its own basis before additional basis is provided by other shares.

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[124] Sections 1367(a)(1) and 1377(a)(1); Treas. Reg. § 1.1367-1(b).

[125] Section 1367(a)(2)(A); Treas. Reg. § 1.1367-1(c)(1).

[126] Treas. Reg. § 1.1367(a)-1(c)(3)

[127] Emphasis added.

[128] 89 Fed. Reg. 95,362, 92379 (December 2, 2025).

Shifting basis (if available) only to the extent needed to avoid section 961(b)(2) gain is in our view consistent with the purpose of section 959 "to prevent such double taxation at the earliest possible time,"[129] while limiting such basis shifting to the necessary minimum.[130]

We therefore recommend that Treasury and the IRS adopt this S corporation approach to section 961(b)(2), *i.e.*, allow shifting of available excess tax basis from high-basis to low-basis shares but only if, and to the extent that, in a PTEP distribution, section 961(b)(2) gain would otherwise be recognized with respect to low-basis shares. This basis shifting approach would be limited to shares of the same class with respect to which the PTEP distribution was received.

If adopted, the basis shift approach should be coextensive with the sharing of the PTEP account. Accordingly, in a consolidated group, members should be permitted to shift basis among the members as they share a single PTEP account. Basis shifting, however, would have collateral effects in a consolidated group. It may be appropriate, for instance, to "tier-up" and "tier down" basis shifting between two members of a group if they are not directly owned by the same immediate parent. Such a basis shift might in effect be analogized to a property transfer, i.e., as distribution of PTEP, to the extent in excess of the basis of low-basis shares held by Member 1, as if made to Member 2 and then distributed by Member 2 and intermediate parents up to the lowest-tier common parent corporation of both Member 1 and Member 2, follow by a contribution of the excess PTEP amount down the chain to Member 1.[131]

4. Section 961(b)(2) Gain Suspension

If a basis shifting approach akin to the subchapter S approach were not adopted, we recommend consideration of an approach under which section 961(b)(2) gain with respect to shares of stock may be temporarily suspended by a taxpayer, or a member of a consolidated group, that is a covered shareholder with respect to a foreign corporation, if there is sufficient available tax basis in other shares. The low-basis shares would in effect use the aggregate basis in the stock of the corporation to avoid the recognition of section 961(b)(2) gain unless and until the basis from the other shares is no longer available, i.e., until either a transaction requires (some amount of) tax basis recovery with respect to any of the affected shares or the

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[129] Preamble to 2006 Proposed Regulations, 71 Fed. Reg. 51,155, 51,159 (2006) (emphasis added).

[130] In this Report, we refer to the S corporation approach to basis recovery as basis "shifting" to reflect the fact that basis is, in effect, shifted from high basis shares to zero basis shares in order to prevent the recognition of gain from a distribution of previously taxed earnings. One might also refer to this approach as "aggregate basis recovery." However, as stock basis is determined and recovered on a share-by-share basis, referring to "basis shifting" seems to more clearly reflect the underlying mechanics of the S corporation approach.

[131] See, e.g., *Sammons v. Comm'r*, 472 F2d 449 (5th Cir 1972), *affg. in part, revg. in part and remanding* T.C. Memo. 1971-145; *Stinnett's Pontiac Serv., Inc. v. Commissioner*, 730 F.2d 634 (11th Cir. 1984), *affg.*, T.C. Memo. 1982-314; *Gilbert v. Comm'r*, 74 TC 60 (1980)

high-basis shares and the low-basis shares are no longer owned by the same taxpayer or, in the case of a consolidated group, a member in the same consolidated group.

In this way, the priority of tax-free repatriation of PTEP under sections 959 and 961 could be maintained so long as the involved shares remain related in the manner required for maintaining unified PTEP accounts. Because the implied basis shifts are intended to be temporary, they only suspend any gain for section 961(b)(2) purposes. For this reason, the history of basis shifting would have to be traced in order to allow for a recognition of the suspended gain when a transaction occurs that takes precedence over the policy underlying section 959 and 961.

In this way, a temporary basis shift enables the suspension of the gain that otherwise would have been recognized under section 961(b)(2) under the share-by-share approach of the Proposed Regulations (or in cases where PTEP is shared within a consolidated group).

The remainder of this section will outline in more detail the operation of the gain suspension through temporary basis shifting approach, and the following section will discuss whether and how in a variety of typical corporate transactions the suspended gain should be recognized.

More specifically, as an alternative to permanent basis shifting from the high-basis shares (or a member affiliate in a consolidated group with high-basis shares) to low-basis shares (or an affiliate with low-basis shares), we propose that to the extent of available basis of high-basis shares the section 961(b)(2) gain with respect to the excess of a PTEP distribution over the tax-basis of low-basis shares on which the PTEP distribution made be suspended. Because this suspended section 961(b)(2) gain may later be recognized if the basis of the high-basis shares is no longer "accessible" (e.g., because of a sale of those shares to an unrelated party), the section 961(b)(2) suspended gain would have to be traced to the high-basis shares from which the basis is "borrowed."

Thus, so long as a U.S. shareholder with several blocks of stock in a CFC has an aggregate tax basis equal to, or greater than, its PTEP account at the time of a PTEP distribution, the U.S. Shareholder would not recognize any section 961(b)(2) gain on the PTEP distribution by that CFC. Similarly, if the aggregate amount of basis in the stock of a CFC with respect to which several members of a consolidated group are U.S. Shareholders exceeds the aggregate amount of a PTEP distribution to the members of the consolidated group, no member will recognize section 961(b)(2) gain with respect to the distribution.

Once section 961(b)(2) gain has been suspended, the U.S. Shareholder (in case there are several blocks of stock) or the consolidated group (if the temporary basis shift is between members) will need to maintain an account with respect to both the shares for which the gain is suspended and the shares that had available basis for suspending the gain. The basis available for purposes of suspending section 961(b) gain is the excess (if any) of the aggregate adjusted tax basis (of the U.S. Shareholder or the consolidated group, as applicable) over the aggregate amount of basis recovered in a PTEP distribution. This excess is the "Available section 961(b) Basis", which cannot be less than zero.

To illustrate: in Example 1 above, before the PTEP distribution, USP has Available Section 961(b) Basis of $750x, which is the sum of $750x (the excess of tax basis over the PTEP distribution with respect to Block 1 ($750x) and $0 (the excess of tax basis over the PTEP distribution with respect to Block 2). USP has sufficient tax basis with respect to Block 1 for the attributable portion of the PTEP distribution ($250x), with a post-distribution tax basis of $750x. For Block 2, however, USP would recognize $50x of section 961(b)(2) gain absent any suspension on account of Available section 961(b) Basis. Because the Available Section 961(b)(2) Basis ($750x) exceeds the potential section 961(b)(2) gain with respect to Block 2 ($50x), the entire $50x of potential gain from the excess PTEP distribution can be suspended, and the remaining Available Section 961(b) Basis is reduced to $700x before any future PTEP distribution.

The mechanism of using Available Section 961(b) Basis solely for purposes of suspending section 961(b) gain should not affect other provisions of the Code. Specifically, "accessing" Available Section 961(b) Basis does not affect the adjusted tax basis of the underlying CFC shares. Accordingly, it also does not affect basis for purposes of the investment adjustment rules of section 1.1502-32 of the Treasury Regulations and should not require any other adjustments under the consolidated return rules.

When high-basis shares that contributed to Available Section 961(b)(2) Basis are sold or otherwise no longer part of the same PTEP account, the suspended section 961(b)(2) gain may have to be recognized. This is not necessarily always the case, however, as there may be sufficient Available Section 961(b) Basis without the disposed of high-basis shares.

> Example 3. Domestic parent (USP) owns 50% of the stock of a controlled foreign corporation (CFC1), with the remainder held by an unrelated domestic corporation. USP initially capitalized CFC1 with $400x of cash in exchange for 10 shares of common stock ("**Block 1**"), with the remainder acquired by the unrelated corporation. In a scenario like Example 1, CFC1 generates in the first 5 years of its operation earnings that give rise to a $600x GILTI inclusion to USP under section 951A(a). At the end of year 5, CFC1's fair market value has decreased to $400x. At the beginning of year 6, USP invests an additional $200x for 10 additional shares of CFC1 common stock ("Block 2") and owns two-thirds of the stock of CFC1. During year 6, CFC1 earns exempt income, and in year 7, CFC1 makes a distribution of $750x in respect of its common stock (but CFC1 still does not derive any subpart F or tested income, subpart F income or otherwise). Accordingly, USP receives a distribution of $25x in respect of each share of is CFC1 common stock.
>
> At the beginning of year 8, USP purchases 5 of the 10 shares of stock in CFC1 owned by the unrelated party for $400x ("**Block 3**"), with USP now owning 25 of the 30 outstanding shares of stock of CFC1. At the beginning of year 9, USP sells all the shares of Block 1 to an unrelated person for $2,000x.

For year 7, prior to the $25x per share distribution of PTEP by CFC1, USP's adjusted tax basis in Block 1 is $1,000x, reflecting the $600x tested income inclusion over the first five years, and USP's adjusted tax basis in Block 2 is $200x. As a result of the distribution, the adjusted tax basis in Block 1 is reduced by $250x to $750x. The basis in Block 2 is

reduced by $200x to $0 and $50x of section 961(b)(2) gain (i.e., the amount by which the PTEP distribution exceeds USP's adjusted tax basis in Block 2) is suspended as the Available Section 961(b) Basis (from Block 1) is $750x.

In year 9, USP recognizes gain of $1,250x with respect to the sale of Block 1, i.e., the excess of the proceeds of $2,000x over its adjusted tax basis of $750x.[132] The fact that Block 2 used Available Section 961(b) Basis from Block 1 does not affect USP's adjusted tax basis in Block 1. However, USP would recognize suspended section 961(b)(2) gain unless some or all of the tax basis in Block 3 could be accessed as Available Section 961(b)(2) Basis even though USP did not own Block 3 at the time of the PTEP distribution that gave rise to the suspended section 961(b)(2) gain. This will depend, in various scenarios, on how the following questions are answered:

- Should Available Section 961(b)(2) Basis be limited to the amount of basis created as a result of basis increases under section 961(a)?

- If additional CFC shares are acquired after the PTEP distribution that gave rise to suspended section 961(b)(2) gain, should their tax basis be added to Available Section 961(b)(2) Basis (presumably as of the time of the relevant PTEP distribution), should the amount of Available Section 961(b)(2) Basis be limited to the acquired PTEP account or the PTEP account at the time of the PTEP distribution that gave rise to the suspended section 961(b)(2) gain, or should it be zero?

- Should a contribution with respect to shares with a suspended section 961(b)(2) gain reduce the amount of the suspended gain and not create additional basis?

- Should a later subpart F or tested income inclusion reduce any suspended section 961(b)(2) gain and, accordingly, not result in a basis increase under section 961(a) with respect to the shares with the suspended section 961(b)(2) gain?

It is worth nothing that the suspended gain approach may result in less gain on a disposition of high basis stock than the basis shifting approach.

> Example 4. Domestic Parent (USP) owns three shares of the single class stock of a controlled foreign corporation (CFC1), with respect to which USP is a United States shareholder. USP has a tax basis of $0 in share 1, and $100x in each of share 2 and share 3. At the start of Year 1, USP has a PTEP account of $150x with respect to CFC1. In Year 1, CFC1 distributes $30x to USP. USP has $200x of Available Section 961(b) Basis. Accordingly, the $10x section 961(b)(2) gain with respect to share 1 is suspended, and the tax basis in each of

[132] For the sake of simplicity, the consequences under section 1248 are ignored, as they should not affect USP's tax basis in Block 2 or Block 3.

share 2 and share 3 is reduced by $10x (their respective share of the $30x PTEP distribution) to $90x, but not on account of the gain suspension. In Year 2, USP sells share 3 for $120x, recognizing $30x of gain. However, the suspended gain with respect to share 1 is not recognized because the Available Section 962(b) Basis from share 2 alone, without taking into account the basis from share 3, (i.e., $100x) exceeds the PTEP distribution with respect to share 1 and share 2 (i.e., $20x).

This results in less gain than would have been recognized under basis shifting. Under basis shifting, the basis of each of share 2 and share 3 would be reduced by an additional $5x to $85x on account of the basis that shifts to avoid the recognition of section 961(b)(2) gain with respect to share 1. Accordingly, the Year 2 sale of share 3 would have resulted in gain of $35x, effectively accelerating the suspension of gain with respect to share 1.

5. Reduction and recognition of suspended Section 961(b)(2) gain in connection with inclusions and distributions under Section 961(a) and (b)

With respect to the last question, it could be argued that suspended section 961(b)(2) gain should be removed whenever (and to the extent that) the taxpayer includes income under section 951(a) or 951A(a) with respect to the suspended gain shares and, accordingly, would otherwise increase its tax basis in the shares. To the extent that the suspended section 961(b)(2) gain is removed, basis of the affected shares would not be increased under section 961, i.e., there would in effect be an offsetting simultaneous section 961(a) increase (on account of the income inclusion) and section 961(b)(1) decrease (on account of the removal of the suspended section 961(b)(2) gain). While this appears to reverse the order between the distribution of PTEP and the inclusion under section 951(a) or 951A(a), this is consistent with not recognizing income with respect to a PTEP distribution so long as the taxpayer or consolidated group has sufficient Available Section 961(b)(2) Basis at the time of the original distribution and there is no other event that takes precedence over the section 959 policy.

This may provide a benefit on a taxable disposition of the high-basis shares as less gain is recognized while suspended section 961(b)(2) gain is not recognized. In effect, under the basis shifting approach this would be equivalent to a shift back of basis to the shares from which the shift originated, thus potentially giving a result that is better than under the basis shifting approach.

By contrast, suspended section 961(b) gain should be recognized to the extent that an additional distribution of PTEP is made that reduces the tax basis of high-basis shares so that the suspended gain exceeds Available Section 961(b)(2) Basis (after PTEP distributions with respect to the high-basis shares). If there are multiple blocks with suspended section 961(b)(2) gain, the administratively least burdensome approach would be to reduce the suspended section 961(b)(2) gain pro rata.

Apart from simplifying the tracking of Available Section 961(b)(2) Basis, allowing for contributions of cash or the acquisition of new shares after the distribution that lead to the gain suspension to restore Available Section 961(b)(2) Basis is less persuasive. It seems inconsistent with the approach as a suspension of gain at the time of the distribution and

would allow taxpayer opportunities for more actively managing Available Section 961(b)(2) Basis, e.g., on later sales of shares that have provided such basis and whose sale would otherwise result in a recognition of the suspended gain.

6. Recognition of suspended Section 961(b) gain in connection with corporate transactions

Section 961(b) gain is suspended only if there is Available Section 961(b)(2) Basis from covered shareholders that share a PTEP account. Thus, if any corporate transactions such as sales, distributions, or other exchanges of the shares or the covered shareholder that owns the separate shares or blocks of shares occur such that the Available Section 961(b)(2) Basis as of the time of the PTEP distribution that supported the suspension of section 961(b)(2) gain is no longer available, the suspended gain would have to be recognized. The remainder of this section explores potential mechanics of such a restoration in more detail.

Single Taxpayer. Suspended section 961(b)(2) gain should be recognized when the shares with respect to which the gain was suspended are sold or disposed of in a taxable exchange. However, if they are sold together with high-basis shares that provided Available Section 961(b)(2) Basis, the transferee may step into the shoes of the transferor in the same manner as it acquires the PTEP account under section 959(a). We believe, however, that this would be inconsistent with the fact that a taxable disposition is a recognition event in which the purchaser does not step into the shoes of the seller with respect to tax attributes (i.e., a sort of suspended gain in some of the shares) and would otherwise not reflect the correct amount of total gain recognized by the seller.

If shares that contributed to the Available Section 961(b) Basis are sold, suspended Section 961(b) gain could continue to be supported by Available Section 961(b)(2) Basis of other CFC shares that the selling covered shareholder continues to own (if any).

Suspended Section 961(b)(2) gain should not be recognized on a sale or disposition of the stock of the single domestic corporation that is the covered shareholder, regardless of whether the transfer is a taxable sale (including a taxable distribution) or a tax-free reorganization described in Section 368, contribution to a controlled corporation described in Section 351(a), or distribution of a controlled corporation described in Section 355(a), provided that gain is not otherwise recognized by the covered shareholder. Suspended Section 961(b) gain is in that case treated like any other tax attribute of the covered shareholder. Where inside gain of the covered shareholder is recognized, however, as would be the case where a Section 338 election is made, any suspended Section 961(b)(2) gain should be recognized. Suspended Section 961(b)(2) gain should likewise be recognized in an outbound asset reorganization, as the reorganization is a taxable disposition of the assets of the covered shareholder.

Consolidated Group. In the case of a sale or taxable exchange of CFC shares by a member of a consolidated group, suspended Section 961(b) gain should be triggered only if the sale or exchange is with a non-member. Any transaction within the consolidated group should not impact the Available Section 961(b)(2) Basis, as any loss attributable to the transferred shares that might reduce the Available Section 961(b)(2) would be deferred under

the intercompany transaction rules in Treas. Reg. § 1.1502-13. It may be necessary, however, to provide appropriate tracing in order to ensure that the appropriate member recognizes any suspended Section 961(b)(2) gain if, at a later time, shares with the suspended Section 961(b)(2) gain or those that contribute to the Available Section 961(b)(2) Basis were to leave the consolidated group or any deferred loss attributable to the intercompany shares were triggered, and to coordinate with the intercompany transactions rules of section 1.1502-13 of the Treasury Regulations.

In the case of a sale or taxable exchange of shares with suspended Section 961(b) gain to a non-member, the consequences should be the same as described above for sales or exchanges by a stand-alone corporate covered shareholder. If shares are sold that contributed to Available Section 961(b)(2) Basis, suspended Section 961(b) gain should be recognized only to the extent that the consolidated group lacks sufficient remaining Available Section 961(b) Basis from other shares.

If stock of a member (including a member that is a parent of a subgroup) is transferred and the member (and the subgroup, if applicable) remains a member of the same consolidated group, suspended Section 961(b) gain should not be triggered, provided that any loss attributable to the transferred shares is suspended under the intercompany transaction rules. This is so regardless of whether the transfer is a taxable transaction (subject to Section 1.1502-13 of the Treasury Regulations) or a tax-free transaction.

In the case of a separation of a subgroup from the consolidated group, both the disposing consolidated group (without the subgroup) and the disposed-of subgroup (1) will have to determine (i) their separate Available Section 961(b) Basis and (ii) their separate suspended Section 961(b)(2) gain that would have to be hypothetically recognized absent Available Section 961(b)(2) Basis and (2) should be required to recognize suspended Section 961(b)(2) gain only to the extent, if any, that their respective separate suspended Section 961(b)(2) gain exceeds their separate Available Section 961(b) Basis. The separation mechanics in a consolidated group should apply regardless of whether the separation is the result of a disposition that is a taxable stock sale or exchange or a tax-free transaction (such as a reorganization under Section 368, Section 355 distribution, or Section 351 contribution to a controlled corporation). The same treatment should apply if instead of a subgroup a single member leaves the consolidated group.

If the disposition is a qualified stock purchase with respect to which a Section 338(h)(10) election is made, however, the general rule applicable to sales of CFC shares by a covered shareholder described above should apply to each member with respect to which the election is made. An outbound asset reorganization should likewise be treated as a taxable sale of the CFC shares held by the member whose assets are transferred in the reorganization.

Liquidations. Whether suspended Section 961(b)(2) gain is recognized in connection with a liquidating distribution should depend on whether the liquidation is described in Section 331 or qualifies under Section 332.

A Section 331 liquidation is a taxable disposition and, accordingly, should trigger the recognition of suspended Section 961(b) gain with respect to all shares.

By contrast, there is no need to trigger suspended Section 961(b)(2) gain recognition in a Section 332 liquidation involving domestic corporations. The distributee corporation should step into the shoes of the liquidating corporation in the same manner as it does with other tax attributes.[133] As the Available Section 961(b)(2) Basis and the suspended Section 961(b)(2) loss remain in the hand of a single taxpayer or consolidated group, there is no specific reason to terminate the gain suspension and trigger the Section 961(b)(2) gain. Furthermore, a section 332 liquidation of the CFC whose shares have suspended Section 961(b)(2) basis and Available Section 961(b)(2) basis should not trigger gain.[134]

An outbound liquidation, however, should trigger the suspended Section 961(b) gain because it is treated as a taxable transaction under section 367(e)(2).[135] Consistent with the overall treatment of an outbound liquidation, the distributing corporation in its role as a covered shareholder should be treated as exchanging the shares of the relevant CFC in a taxable transaction. Accordingly, as described above, the liquidating corporation should trigger the entire suspended Section 961(b) gain with respect to any CFC shares that it directly owns.

D. Negative Section 961(c) Basis Taxation

As discussed above, the Proposed Regulations under section 961(c) allow for the creation of both negative section 961(c) basis and negative derived basis with respect to property units owned by a CFC or partnership, respectively.[136]

The Proposed Regulations would provide rules for recognizing gain in certain situations where such negative basis exists in either a section 961(c) or derivative basis property unit.[137] Specifically, the Proposed Regulations would provide for gain to be recognized under two scenarios. First, gain may be triggered in any transaction in which a partnership's common basis or CFC's adjusted basis in a property unit is relevant for determining gain or loss.[138] Such transactions would include dispositions by sale, exchange, or distribution of the property unit.[139] The gain recognized under the first scenario would

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[133] See Section 381(a).

[134] This is consistent with the approach taken with respect to excess loss accounts in the consolidated return context. See Treas. Reg. §§ 1.1502-19 and 1.1502-32.

[135] Treas. Regs. § 1.367(e)-2(b)(1). We do not believe that the exception for properties used in a U.S. trade or business of the liquidating corporation and the distributee corporation should apply. See Treas. Regs. § 1.367(e)-2(b)(2).

[136] The term "property unit" includes a section 961(c) ownership unit and a derivative ownership unit. Prop. Treas. Reg. § 1.961-2(b).

[137] Prop. Treas. Reg. § 1.961-10(a).

[138] Prop. Treas. Reg. § 1.961-10(b)(1) and (c)(1).

[139] REG-105479, 89 Fed. Reg. 95362, 95388 (Dec. 2, 2024). Technically, this rule applies to any transaction "involving the section 961(c) ownership unit." The term "involving" is ambiguous in this context and should be clarified.

generally reflect income that would exist (or reduction of loss) if common basis or adjusted basis were reduced by the negative basis (*i.e.*, essentially replicating the result that would occur if the common basis or adjusted basis were reduced by negative basis).[140]

Second, the Proposed Regulations provide that gain is recognized where a property unit loses its status as a derivative ownership unit or section 961(c) ownership unit and would treat the CFC or partnership as recognizing gain as a result.[141] The preamble to the Proposed Regulations contemplates various transactions in which a section 961(c) or derivative ownership unit would cease to exist.[142] For example, a property ownership unit may cease to exist because of a transfer by a partnership of a derivative ownership unit to a non-CFC foreign corporation in an exchange to which section 351 applies, a distribution by a CFC of a section 961(c) ownership unit to a domestic corporation in a transaction to which sections 332 and 337 apply,[143] or a transaction in which an upper-tier foreign corporation ceases to be a CFC.[144]

Under each of the two scenarios, the gain recognized is allocated pro rata to the covered shareholders based on their relative negative derived basis or negative section 961(c) basis.[145] This allocation prevents a covered shareholder from disproportionately benefiting from the common basis or adjusted basis that permitted the creation of the negative basis. Further, once gain is recognized pursuant to Prop. Treas. Reg. § 1.961-10, the pre-existing negative derived basis or negative section 961(c) basis is eliminated concurrently with the transaction.[146]

While not explicitly stated in the preamble to the Proposed Regulations, the rules in Prop. Treas. Reg. § 1.961-10 appear to serve two purposes. First, the rules ensure that negative section 961(c) basis is taken into account when relevant for U.S. tax purposes, preventing taxpayers from receiving an unintended benefit that would otherwise occur absent

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[140] Prop. Treas. Reg. § 1.961-10(b)(2)(i) and (c)(2)(i). The amount of the gain recognized is equal to the additional amount of gain, plus the lesser amount of loss (expressed as a positive amount), that the CFC or partnership would have recognized in the transaction if, immediately before the transaction, the CFC's adjusted basis or partnership's common basis of the section 961(c) or derived ownership unit were reduced by all negative section 961(c) or derived basis of the section 961(c) or derived ownership unit. The gain is characterized in the same manner as gain recognized under Prop. Treas. Reg. § 1.961-4(d) and (f), except that the gain does not create subpart F or tested income at the CFC level. Prop. Treas. Reg. § 1.961-10(c)(4). Therefore, the characterization of the gain appears to be relevant to determining the source and foreign tax credit category of the income recognized at the U.S. shareholder level under Prop. Treas. Reg. § 1.961-11(b).

[141] Prop. Treas. Reg. § 1.961-10(b)(2)(ii) and (c)(2)(ii).

[142] 89 Fed. Reg. 95362, 95388.

[143] *Id.*

[144] *Id.*

[145] Prop. Treas. Reg. § 1.961-10(b)(3) and (c)(3).

[146] Prop. Treas. Reg. § 1.961-10(b)(5) and (c)(5).

these rules. For example, the first set of rules ensure that the negative section 961 basis is taken into account in any situation in which basis in the CFC is relevant for purposes of determining the tax consequences of a transaction.[147] On the other hand, the second set of rules appears to ensure that the negative section 961 basis is accounted for before the ownership unit ceases to be a section 961(c) ownership unit or a derivative ownership unit. Specifically, because negative derived basis and negative section 961(c) basis can only exist with respect to a derivative ownership unit and a section 961(c) ownership unit, respectively, the cessation transaction is arguably the "last clear chance" for the taxpayer to take the negative basis into account. As a result, the rules in Prop. Treas. Reg. § 1.961-10 ultimately trigger gain equal to the full amount of negative basis when the section 961(c) ownership unit or derivative ownership unit ceases to be treated as such.

While there are situations in which this last clear chance rule is appropriate, there are several situations where uneconomic gain may result, as illustrated in the examples below.

> Example 5: A covered shareholder, US1, directly owns all the shares of F1, a foreign corporation, and F1 owns all 100 outstanding shares of the single class of stock in F2, another foreign corporation. The F2 shares owned by F1 are section 961(c) ownership units. F1 has adjusted basis of $20x and negative section 961(c) basis of $20x in its F2 stock. F1 liquidates into US1 in a tax-free section 332 liquidation. After the liquidation, US1 takes a carryover basis in its F2 shares equal to the $20x of adjusted basis F1 had in the F2 shares. In addition, because of F1's liquidation, the F2 shares cease to be section 961(c) ownership units. As a result, under Prop. Treas. Reg. § 1.961-10(c)(2)(ii), F1 would be required to recognize gain of $20x, which is equal to the negative section 961(c) basis that F1 had in its F2 stock.[148]
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> Example 6: A covered shareholder, US1, directly owns all the shares of F1, a foreign corporation, and F1 owns all 100 outstanding shares of the single class of stock in F2, another foreign corporation. The F2 shares owned by F1 are section 961(c) ownership units. F1 has adjusted basis of $20x and negative section 961(c) basis of $20x in its F2 stock. F2 liquidates into F1 in a tax-free section 332 liquidation. Because of F2's liquidation, the F2 shares cease to be section 961(c) ownership units. Under Prop. Treas. Reg. § 1.961-10, F1 would

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[147] 89 Fed. Reg. 95362, 95387.

[148] Prop. Treas. Reg. § 1.961-10 is arguably inconsistent with the approach taken in Notice 2024-16. Notice 2024-16 allowed the section 961(c) basis to be treated as adjusted basis for tax purposes in certain inbound transactions. However, the Proposed Regulations restrict the section 961(c) attribute to being "limited purpose" basis, preventing it from being used to offset the adjusted basis in stock. This approach contrasts with the government's stance in Notice 2024-16, which provided more flexibility by permitting the section 961(c) basis to become adjusted basis, thereby offering broader applicability for tax purposes. See e.g., Notice 2024-16; NYSBA Tax Section, Report No. 1496: *supra* n. 15.

be required to recognize gain of $20x, which is equal to the negative section 961(c) basis that F1 had in its F2 stock.

As illustrated by these examples, the Proposed Regulations would require gain recognition even where adjusted basis in the property unit exists and provides no mechanism to offset the negative basis with the adjusted basis instead of recognizing gain.

We acknowledge that, if the government adopted the gain suspension approach with respect to section 961(b) discussed above, Prop. Treas. Reg. § 1.961-10 will apply to fewer transactions.[149] Regardless, because the application of these rules may result in uneconomic gain, Treasury should modify the rules in several ways. For example, the final regulations should provide that, in a section 332 liquidation, the negative section 961(c) basis should be eliminated, in the same way an excess loss account ("**ELA**") is eliminated in those transactions.[150] Thus, in a transaction like Example 6, no gain recognition should be required.

Further, the final regulations should provide that, in any transaction in which a section 961(c) ownership unit or a derivative ownership unit ceases to be treated as such (*e.g.,* a distribution of lower-tier CFC stock to the United States shareholder or transfer to a non-CFC), the negative basis should be netted against other basis prior to the transfer. We believe such a rule would both prevent taxpayers from recognizing uneconomic gains, while ensuring that taxpayers are not permitted to receive an unintended benefit by not otherwise taking into account the negative section 961 basis. Further, we believe that, while there are certain fact patterns where it may be difficult to implement such an offsetting rule (*e.g.,* where a CFC has multiple U.S. shareholders and basis is not shared pro rata between shareholders), taxpayers should still be afforded the opportunity to offset basis, even if just in limited fact patterns, such as where the relevant CFC has a single covered shareholder (or covered shareholders that are members of the same consolidated group).[151]

To illustrate the application of this recommendation, if this rule were to apply to Example 5 above, F1 would not recognize gain as a result of the negative section 961(c) basis in its F2 stock; rather US1's basis in the F2 stock acquired would be zero after netting the negative section 961(c) basis against the adjusted basis in the shares. Permitting the negative basis to offset adjusted basis both prevents US1 from ultimately recognizing uneconomic gain and ensures that US1 does not receive an unintended benefit (*e.g.,* by retaining adjusted basis in the F2 stock of $20, while not otherwise recognizing gain or offsetting adjusted basis), which could occur if the negative basis was not otherwise taken into account.

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[149] Any gain suspension approach adopted for purposes of section 961(b) should also be adopted, to the greatest extent possible, for purposes of section 961(c).

[150] See Treas. Reg. § 1.1502-19(b)(2)(i) (addressing the nonrecognition income or gain from a taxpayer's ELA when liquidated in a section 332 liquidation).

[151] We would expect this ownership structure to cover the majority of cases.

Finally, we note that, in the preamble to the Proposed Regulations, Treasury noted that it is "studying to what extent this set of rules should be narrowed or eliminated in future guidance if a rule is adopted that converts one type of basis into another type (for example, a rule that converts derived basis into section 961(c) basis or section 961(c) basis into adjusted basis in a nonrecognition transaction)."[152] While we understand that Treasury may narrow or eliminate the rules in Prop. Treas. Reg. § 1.961-10 upon the subsequent issuance of additional section 961 regulations, we believe that it is imperative to modify the rule in the final regulations, rather than waiting to address this issue in later guidance. Importantly, if the rules of Prop. Treas. Reg. § 1.961-10 are not narrowed upon finalization, there could be a significant period (*i.e.,* between finalization of Prop. Treas. Reg. § 1.961-10 and the subsequent issuance of additional section 961 regulations) during which taxpayers would be required to recognize uneconomic gains because of certain transactions involving section 961(c) ownership units and derivative ownership units. Such a temporary rule would result in disparate treatment between similarly situated taxpayers, which could be avoided by adopting the recommendations above. Accordingly, we recommend Prop. Treas. Reg. § 1.961-10 be narrowed in the final regulations.

E. CFC-Level versus U.S.-Shareholder Level Approach to Sections 959(b) and 961(c)

As described above, the Proposed Regulations apply sections 959(b) and 961(c) at the CFC-level. For example, when a CFC makes a dividend distribution to another CFC, it is characterized as PTEP subject to section 959(b) or untaxed E&P in the hands of the CFC receiving the dividend for purposes of characterizing the CFC's income as subpart F income or tested income.[153] Similarly, when a CFC disposes of the stock of another CFC with respect to which there is section 961(c) basis, any gain on the CFC shares that is offset by the section 961(c) basis is characterized as PTEP in the hands of the selling CFC and excluded from gross income for purposes of determining the CFC's subpart F income and tested income.[154] As a consequence of excluding these items from gross income at the CFC-level, the Proposed Regulations would amend the rules for allocating subpart F and tested income to U.S. shareholders in order to ensure that items are properly allocated to the shareholders to which these items belong, resulting in a multi-step process under Prop. Treas. Reg. §§ 1.951-1 and -2.

The Proposed Regulations' CFC-level approach to these provisions is in tension with the statutory text. Section 959(b) states that a distribution of PTEP received by a CFC shall not "be also included in the gross income of another controlled foreign corporation … for

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[152] 89 Fed. Reg. 95362, 95388. This future guidance may include regulations described in Notice 2024-16.

[153] Prop. Treas. Reg. § 1.959-4(b)(2)(i).

[154] Prop. Treas. Reg. § 1.961-9(b). By treating gain that is offset by section 961(c) basis as excluded from gross income for purposes of determining a selling CFC's gross income, the Proposed Regulations apply section 951A(f)(1) in a counterintuitive manner in order to prevent such gain from qualifying as tested income, as discussed above in Part III.J.4.

purposes of the application of section 951(a) to such other controlled foreign corporation with respect to such United States shareholder." Section 951(a) applies at the U.S.-shareholder level; it determines a U.S. shareholder's subpart F *inclusion* attributable to its ownership of a CFC. Subpart F *income*, on the other hand, is defined by section 952(a), which applies at the CFC level. Similarly, section 961(c) applies "*only* for the purposes of determining the amount included under section 951 in the gross income of such United States shareholder."[155] Thus, these provisions reduce a U.S. shareholder's income inclusion under 951(a) as opposed to changing the character of the dividend income or gain at the CFC-level.[156]

This U.S.-shareholder level approach has important collateral consequences, as illustrated by the following example:

> Example 7. A, a U.S. individual, owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. The CFC2 stock has $0 of regular tax basis and $40x of basis under section 961(c) that is attributable to A. CFC1 sells the stock of CFC2 to an unrelated party for $100x. CFC2 has no E&P and, therefore, section 964(e), which can recharacterize gain on shares as dividend income in a manner similar to section 1248(a), does not apply to the sale.
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> Under a U.S. shareholder-level approach, CFC1 would be treated as earning $100x of subpart F income from the gain, which would ordinarily be included in A's gross income under section 951(a). However, section 961(c) would adjust A's subpart F inclusion under section 951(a) to $60x to account for the $40x of section 961(c) basis in the CFC2 shares attributable to A.
>
> Under the CFC-level approach adopted by the Proposed Regulations, CFC1 would recognize only $60x of subpart F income and $40x of PTEP that is excluded from gross income in determining CFC1's subpart F income.

One key distinction between the Proposed Regulations' CFC-level approach and the statutory U.S. shareholder-level approach is whether the GILTI exception contained in section 951A(c)(2)(A)(i)(II) applies to exclude the gain from tested income. That provision excludes "any gross income taken into account in determining the subpart F income of such corporation" from tested income under section 951A(a). As described above, "subpart F income" is defined in section 952 and is determined at the CFC level. Thus, under the U.S.-shareholder approach to section 961(c) described above, the entire $100x of gain with respect

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[155] Italics added. See also Douglas Poms, *The Elusive Nature of Code Sec. 961(c) Basis in a Post-TCJA Multiverse*, *supra* n. 15 and Prae Kriengwatana, Marty Collins, and Matt Brown, *Most Thought §961(c) Was on the Sidelines During TCJA*, 49 TAX MGMT. INT'L J. 499 (2020).

[156] Treasury and the IRS have analyzed similar language in recent guidance and adopted a U.S. shareholder-based approach to qualified deficits. T.D. 9882 (Dec. 18, 2019) ("Under section 952(c)(1)(B), a qualified deficit reduces the amount of subpart F income of a CFC that a U.S. shareholder includes in its gross income under section 951(a)(1)(A) but does not reduce the subpart F income of the CFC.")

to CFC2's shares would be treated as subpart F income in CFC1's hands and would therefore be excluded from CFC1's tested income for purposes of applying section 951A.

Under the Proposed Regulations' CFC-level approach, however, only $60x of the gain would qualify for this exclusion. Thus, the regulations pursue a different approach under section 951A(f) to ensure that shareholders are not double taxed with respect to the $40x of gain that is offset by section 961(c) basis. Section 951A(f)(1)(A) provides that "any global intangible low-taxed income included in gross income … shall be treated in the same manner as an amount included under section 951(a)(1)(A)" for purposes of certain Code sections, such as sections 959 and 961.[157] In other words, if a U.S. shareholder has a GILTI inclusion, the inclusion is treated as if it were a subpart F inclusion for purposes of applying other provisions of the Code. The Preamble states that these rules "should be interpreted as allowing references to section 951(a) in section 959 to be treated as including a reference to section 951A(a)." In other words, the Preamble argues that section 959 and 961(c)'s exclusions for purposes of applying section 951(a) should equally apply for purposes of determining whether a shareholder has an inclusion under section 951A(a). The statute does not support this interpretation. It only addresses the consequences of having a GILTI inclusion and not whether a GILTI inclusion occurs in the first place.

The preamble suggests four reasons for adopting its CFC-level approach to sections 959(b) and 961(c): (1) the gross-up approach adopted by Rev. Rul. 82-16 (described below) is unworkable in circumstances with multiple covered shareholders, (2) treating a CFC's gross income as PTEP at the CFC level prevents distortive allocation and apportionment of the CFC's expenses that are not current year taxes, (3) the CFC-level approach ensures that the corporate level E&P accounts are properly maintained under section 959(c), and (4) a CFC-level approach ensures that taxes are properly attributed to PTEP for purposes of applying section 960(b). Each of these points is discussed in further detail below.

1. Rev. Rul. 82-16's Gross-up Approach to Section 959(b)

Rev. Rul. 82-16 addressed the application of section 959(b) to a distribution received by a CFC with multiple shareholders.[158] In the ruling, a U.S. shareholder owned 70% of the stock of an upper-tier CFC, with the remaining stock owned by non-U.S. persons. The upper-tier CFC owned all the stock of a lower-tier CFC, which earned $100x of subpart F income. This subpart F income gave rise to a $70x subpart F inclusion (and, consequently, PTEP) to the U.S. shareholder. In a later year, the lower-tier CFC distributed $200x to the upper-tier CFC.[159] To prevent double taxation of the U.S. shareholder, the ruling effectively grossed up the amount of the distribution treated as PTEP under section 959(b), such that $100x (rather

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[157] Additionally, section 951(a)(1)(B) provides the Secretary with authority to expand the application of section 951A(f)(1)(A) to other Code sections "in any case in which the determination of subpart F income is required to be made at the level of the controlled foreign corporation."

[158] 1982-1 C.B. 106.

[159] But for section 959(b), the distribution would have resulted in subpart F income to the upper-tier CFC.

than $70x) was excluded from the upper-tier CFC's subpart F income. Thereby, the U.S. shareholder was only allocated subpart F income of $70x arising from the distribution, which was the U.S. shareholder's pro rata share of the $200x distribution ($140x) that was not PTEP as to the shareholder ($70x).

The preamble notes that the gross-up approach described in Rev. Rul. 82-16 is not workable where there are multiple shareholders with non-pro rata PTEP accounts. For example, suppose the facts of Rev. Rul. 82-16 were changed slightly such that the 30% interest in the upper-tier CFC were owned by a U.S. shareholder who did not have PTEP attributable to either CFC.[160] In that case, the 30% U.S. shareholder should be allocated $60x of subpart F income as a result of the $200x distribution by the lower-tier CFC. However, the gross up approach would treat the upper-tier CFC as receiving $100x of PTEP with respect to the lower-tier CFC, such that the 30% U.S. shareholder would only be allocated $30x of subpart F income from the distribution (i.e., 30% multiplied by the $100x portion of the lower-tier dividend that was not treated as PTEP). In other words, the revenue ruling could provide the minority U.S. shareholder with a windfall.[161]

The Proposed Regulations' CFC-level approach would avoid this concern by characterizing a $70x portion of the $200x distribution as PTEP that is excluded from gross income in determining subpart F income. The remaining $130x covered distribution is allocated to the U.S. shareholders under Prop. Treas. Reg. § 1.951-2(c) such that the 70% U.S. shareholder receives a pro rata share of $70x of subpart F income and the 30% U.S. shareholder receives a pro rata share of $60x of subpart F income from the upper-tier CFC using the multi-step pro rata share rules contained in Prop. Treas. Reg. § 1.951-1(c).

The same result could be achieved using a shareholder-level approach to section 959(b). Under that approach to the facts of Rev. Rul. 82-16, the entire $200x distribution would be characterized as subpart F income to the upper-tier CFC and tentatively allocated to each U.S. shareholder using the existing pro rata share rules, such that the 70% U.S. shareholder's pre-section 959(b) pro rata share would be $140x. Section 959(b) would then apply to reduce the 70% U.S. shareholder's subpart F inclusion under section 951(a) from $140x to $70x to account for its prior inclusion of $70x of subpart F income.[162]

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[160] This could result, for example, if the minority U.S. shareholder had acquired its interest from the foreign owners in a year prior to the distribution. The fact that this second U.S. shareholder would not qualify as a successor with respect to PTEP highlights that the deemed covered shareholder rules in Prop. Treas. Reg. § 1.959-7(g) can be arbitrary in that they only apply where stock was first owned by a U.S. shareholder that experienced a GILTI or subpart F inclusion.

[161] In light of the look-through exception to foreign personal holding company income for dividends in section 954(c)(6), this potential windfall may be academic in most circumstances.

[162] If, alternatively, the entire $200x distribution were excluded from the upper-tier CFCs subpart F income (e.g., by reason of section 954(c)(6)), no adjustment would be necessary under section 959(b) to reduce the U.S. shareholder's inclusion under section 951(a) with respect to such income because the distribution of PTEP would not have created an incremental subpart F inclusion.

2. Allocating and Apportioning Expenses within a CFC

Another concern discussed in the preamble that may have led the IRS and Treasury to adopt a CFC-level approach to sections 959(b) and 961(c) was the potential for distortive allocation and apportionment of CFC's expenses. The preamble states:

> For example, in a case where some, but not all, of a distribution received by a CFC is PTEP, an amount of the CFC's deductible interest expense could reduce the non-PTEP portion of the distribution…. This may result in a benefit if the non-PTEP portion would give rise to subpart F income or tested income, but otherwise may not be beneficial if the interest deductions reduce section 959(c)(3) E&P and thus the potential for a dividends received deduction under section 245A.[163]

Before addressing the Preamble's request for comments, we make two preliminary points. First, other than with respect to foreign-income taxes, a CFC's deductions have never reduced a U.S. shareholder's PTEP accounts, even where these expenses are allocated to distributions of PTEP. Rather, the allocation and apportionment of a CFC's expenses is a separate exercise from maintaining PTEP accounts. The preamble appears in places to suggest that these two concepts are related.[164] This has never been the case, and the two concepts should not be confused.

Second, the circumstances involving an allocation and apportionment of interest expense to any distribution received by a CFC, including a PTEP distribution, will be very rare. Under Treas. Reg. § 1.861-9(f)(3), a CFC allocates and apportions its interest expense under one of two methods: the asset method or the modified gross income method. In general, interest expense is not apportioned to distributions under either method. Under the asset method, interest expense is apportioned based on the average value of the CFC's assets. A distribution of PTEP – and a dividend more generally – is not an asset. Furthermore, although stock of a foreign subsidiary, which may give rise to a dividend, is taken into account under the asset method, in the case of a 10 percent-owned foreign corporation, the stock is characterized based on the assets of the lower tier-subsidiary as determined under Treas. Reg. § 1.861-12(c) and not based on the income generated by such stock (i.e., dividends).[165] Under the gross income method, the CFC's interest expense is apportioned based on the CFC's gross income. If the CFC owns stock in a 10 percent-owned foreign corporation, that subsidiary corporation's earnings (reduced by its own interest expense) are included in the owner CFC's modified gross income for this purpose. This tiering of gross

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[163] Preamble at 95,371 (internal citations omitted).

[164] See *id.* ("For example, comments are requested on whether deductions that are not current year taxes, such as deductible interest expense, should be allocated and apportioned to, *and therefore reduce, the CFC's PTEP*.") (emphasis added).

[165] Treas. Reg. § 1.861-9(g)(4). Similar analysis would apply under the asset method with respect to gain from the stock of a subsidiary, including gain that may be offset by section 961(c) basis. That gain is not an asset and is not taken into account in characterizing the stock under the asset test.

income continues down the chain for each subsidiary. To prevent double counting of income that was already taken into account in this tiering mechanism, the regulation provides that a higher-tier foreign corporation should disregard "any dividends or other payments received from the lower-tier corporation other than interest income."[166] Thus, a dividend, including a distribution of PTEP, from a controlled foreign corporation should not be taken into account by a CFC in apportioning interest expense under the modified gross income method.[167] Under the Proposed Regulations, section 959(b) generally only applies with respect to a distribution by one CFC to another.[168] Thus, we believe the likelihood that a distribution of PTEP would attract an allocation and apportionment of interest expense is very unlikely.

Nevertheless, certain expenses may be allocated and apportioned to a CFC's gross income, including dividend income received from another CFC. For example, under Treas. Reg. § 1.861-8, expenses other than those for which there is a specific apportionment method under the regulations[169] generally are apportioned based on a method that reflects to the factual relationship between the deductions and gross income. In certain cases, this method may be on the basis of all of the taxpayer's gross income. In our experience, the category of expenses that may be allocated to dividend income is relatively small. This now brings us to the question of how such expenses should be allocated and apportioned when the gross income includes PTEP.

The Proposed Regulations effectively shift these deductions to non-PTEP gross income: "a CFC's deductions that are not current year taxes are not allocated and apportioned under section 861 to PTEP."[170] This approach is typically favorable to taxpayers in that it ensures that the benefit of the deduction is allocated to gross income that is not excluded for purposes of applying section 951(a) to a U.S. shareholder. The Preamble notes, however, that the approach may be detrimental to certain taxpayers if the deductions reduce

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[166] Treas. Reg. § 1.861-9(j)(2)(ii)(A).

[167] Gain from the disposition of the stock of a lower-tier foreign corporation, however, is not eligible for this exclusion from gross income under the modified gross income method. In certain circumstances, a lower-tier foreign corporation's gross income may tier up to an upper-tier CFC, notwithstanding a sale of the lower-tier CFC. To the extent that the subsidiary's gross income tiers up to an upper-tier foreign corporation, therefore, the gross income is effectively double counted. This issue should be addressed outside of the PTEP context by amending Treas. Reg. § 1.861-9(j)(2)(ii)(A) to also exclude gain with respect to a subsidiary's shares where the subsidiary's gross income is taken into account under the modified gross income method.

[168] The Proposed Regulations do apply section 959(b) in the case of a distribution by a specified foreign corporation under section 965, which may not qualify as a CFC.

[169] The section 861 regulations provide specific apportionment methodologies for certain categories of income, including interest (-9T through -13T), stewardship (-8(e)(4)(ii)), and research and experimentation expenses (-17). Expenses that are not subject to a specific apportionment methodology (e.g., advertising, rent, and general and administrative expenses) are subject to the general allocation and apportionment method under Treas. Reg. § 1.861-8.

[170] Preamble at 95,371. See Treas. Reg. § 1.960-1(c)(1)(ii) and Prop. Treas. Reg. § 1.959-6(d)(1).

gross income that would otherwise be eligible for the section 245A(a) dividends-received deduction when distributed to a U.S. shareholder.[171]

One of the unusual aspects of this approach is that it causes the allocation and apportionment of expenses at the CFC level to depend on the identity of the CFC's direct or indirect owners, as illustrated in the following example.

> Example 6. CFCX has three equal shareholders, A, B and C, each of whom is a domestic individual. CFCX owns 100% of the stock of CFCY. During Year 1, CFC earns gross income from two sources, a $360x dividend from CFCY that is treated as PTEP under section 959(b) and $40x of interest income received from an unrelated bank that is foreign personal holding company income under section 954(c). CFCX incurs $4x of accounting fees relating to the preparation and audit of its statutory financial statements. Under Treas. Reg. § 1.861-8(b) and (c), these accounting fees are allocated and apportioned to all gross income on a pro rata basis.
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> Under Prop. Treas. Reg. § 1.959-6(d)(1), no deductions (other than deductions for current year taxes) "may be allocated or apportioned under section 861 to [the PTEP] of the foreign corporation." Thus, the entire $4x of accounting fees are allocated solely to the interest income, such that CFCX earns $36 of subpart F income and each of A, B and C includes in gross income their $12x pro rata share of CFCX's gross income.
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> *Alternative Facts.* Suppose that only A and B are U.S. individuals and C is a non-U.S. individual such that only $240x of the dividend from CFCY to CFCX (i.e., two-thirds of $360x) is treated as PTEP governed by section 959(b).[172] In that case, the remaining $120x of the dividend income would be included in gross income for purposes of allocating and apportioning the accounting expense, such that only $1x of the accounting expense would be allocated to the interest income (i.e., $4x of accounting expense multiplied by $40x of interest income divided by $160x of non-PTEP gross income). As a result, CFCX would

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[171] For domestic corporate U.S. shareholders, E&P that is eligible for section 245A(a) may be preferable to E&P that may be excluded under section 959 because the basis adjustments applicable to the former category under section 961(d) apply in more limited circumstances than the basis reductions under section 961(b). Specifically, section 961(d) applies "solely for purposes of determining loss on any disposition of stock of [the] foreign corporation [that paid the section 245A(a) eligible dividend]." On the other hand, section 245A(d) disallows foreign tax credits with respect to foreign taxes attributable to section 245A(a) distributions, whereas section 960(b) allows deemed paid foreign tax credits with respect to PTEP distributions.

[172] For purposes of these alternative facts, we have assumed that C (a non-U.S. person) is not a "deemed covered shareholder" under Prop. Treas. Reg. § 1.959-7(g) (e.g., a non-U.S. person that acquires an interest in a CFC from a covered shareholder). Whether deemed covered shareholder status should impact the allocation and apportionment of CFC expenses (as would occur with respect to a covered shareholder) is unclear under the Proposed Regulations. If it were relevant, then the informational difficulties discussed immediately below would be greatly magnified.

have $39 of subpart F income, with each of A and B being allocated a pro rata share of 13x.[173]

In the example above, CFCX must know information about its shareholders in order to correctly allocate and apportion its expenses under the Proposed Regulations. For example, the CFC must know whether its direct or indirect shareholders are U.S. shareholders that have had GILTI or subpart F inclusions. There is currently no reporting mechanism to provide this information from direct or indirect owners to a CFC, and even if one could be put in place it would depend upon the accuracy of another person's tax reporting. Furthermore, owner-to-CFC reporting would not be useful in the context of a current year PTEP distributions because a U.S. shareholder would likely not have filed a tax return at the time the CFC was determining how to allocate and apportion expenses for the same taxable year. We recommend against implementing an owner-to-CFC reporting regime.

Without owner-to-CFC reporting, a CFC could not accurately determine whether a distribution is PTEP on its own. That determination would require the CFC to know whether its direct or indirect owners were U.S. shareholders, which involves indirect and constructive ownership rules under sections 958(a) and (b). In the case of GILTI, the CFC would be unable to reconstruct whether a given U.S. shareholder had an inclusion under section 951A because the inclusion potentially depends on attributes of multiple CFCs owned by the U.S. shareholder. Finally, the exercise would require determining whether a U.S. shareholder was a successor with respect to a prior covered shareholder.[174]

For the reasons described above, any approach to allocating and apportioning expenses within a CFC that requires the CFC to determine whether gross income is subject to section 959(b) or 961(c) would be very difficult to administer and, therefore, should be avoided.

Instead, we propose that foreign corporations should allocate and apportion expenses to gross income like any other taxpayer using the rules and principles of Treas. Reg. §§ 1.861-8 through -17 (that is, in a manner that does not take into account whether an amount is subject to section 959(b) or 961(c)). Thus, even if a dividend distribution is excluded from a CFC's gross income for purposes of applying section 951(a) to a U.S. shareholder, that dividend should not be excluded from gross income for purposes of allocating expenses to the CFC's gross income under sections 953(b)(4) (insurance income) and 954(b)(5) (foreign personal holding company income) and thus determining the CFC's subpart F income under

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[173] If C were instead a U.S. person with respect to which the CFCY distribution was not PTEP and the distribution would otherwise result in subpart F income (e.g., as a result of section 245A(e) with respect to a tiered hybrid dividends), then the outcome of this example would be that $2x of subpart F income that should have been allocated to C will be shifted to A and B.

[174] As noted in footnote 172, this informational difficulty would be compounded if the allocation of CFC level expenses was impacted by a "deemed covered shareholder" under Prop. Treas. Reg. § 1.959-7(g).

section 952. Thereby, a CFC will be able to reliably and uniformly allocate and apportion its expenses without any information from or about its U.S. shareholders.

The Preamble notes concerns about treating "covered items" as gross income for purposes of allocating and apportioning a CFC's expenses. Specifically, the Preamble suggests that allocating expenses to these covered items would waste the deduction by allocating an expense to an item (e.g., a section 959(b) dividend) that would otherwise not be taxed at the U.S.-shareholder level. So be it. As a practical matter, for the reasons described above, this circumstance will not occur for most taxpayers in significant amounts.[175] Moreover, disregarding whether an item is PTEP would permit the CFC to allocate and apportion its expenses using a universal, outcome-agnostic approach that does not require a complex and burdensome information reporting regime from direct and indirect shareholders to CFCs.

3. Section 959(c) Accounts

One important caveat to the recommendation above is that the allocation of expenses (other than current year taxes) should have no impact on section 959(c) accounts. The section 959(c) accounts used to track PTEP and untaxed E&P should be maintained independently, as the following example illustrates.

> Example 9. USP owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. CFC2 has section 959(c)(2) E&P of $100x (i.e., generally, E&P attributable to an inclusion under section 951(a) or 951A). As of the beginning of the year, CFC1 has no E&P, but receives a dividend subject to section 959(b) from CFC2 of $100x. CFC1 also incurs a $15x expense that is allocated and apported to all of CFC1's gross income (e.g., rental expense with respect to CFC1's office space). Under Treas. Reg. § 1.861-8, the entire $15x expense is allocated and apportioned to the dividend. Under section 959(b), the dividend does not give rise to a subpart F inclusion to USP.

In the example above, the receipt of the distribution from CFC2 should increase CFC1's section 959(c)(2) account by $100x. The $15x deduction, although allocated and apportioned to the distribution of PTEP, should not reduce CFC1's section 959(c)(2) earnings. Rather, it should reduce CFC1's E&P described in section 959(c)(3) (i.e., untaxed earnings) from zero to negative $15x. In other words, the PTEP accounts in section 959(c)(1) or (2) should never be reduced by non-tax expenses, even if those expenses are allocable to distributions of PTEP or gain sheltered by section 961(c) basis for other purposes (e.g., determining foreign personal holding company income under section 954(c)).

This approach is not novel. For example, in Rev. Rul. 86-131, a domestic corporation (P) owned a CFC (FX1), which in turn acquired another CFC (FX2) in a taxable transaction. In 1985, FX1 distributed all of its FX2 stock to P, at which time the stock had a fair market

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[175] As described above, interest expense is not allocated to any dividend from a subsidiary, including one described in section 959(b).

value of 50x dollars but an adjusted basis of 100x dollars. By the end of 1985, FX1 had PTEP accounts under section 959(c)(1) of $40x and section 959(c)(2) of $40x. The revenue ruling addressed how FX1's E&P should be adjusted under sections 959 and 312(a)(3) to reflect the distribution of depreciated property to its domestic shareholder. The ruling reduced the PTEP accounts by $50x, the amount of the dividend under section 316 (determined before the application of section 959(d)). Thus, the $40x section 959(c)(1) account was reduced to zero, and the $40x section 959(c)(2) account was reduced to $30x. The remaining $50x E&P reduction under section 312(a)(3) was allocated entirely to the untaxed earnings account under section 959(c)(3). A similar rule can be found in current Treas. Reg. § 1.959-3(c), which provides that a deficit in E&P shall only reduce untaxed earnings described in section 959(c)(3).[176]

These rules may be generalized as follows: the aggregate of a U.S. shareholder's PTEP accounts generally should be increased by amounts included in a U.S. shareholder's gross income under section 951(a) or 951A and generally should be reduced by dividend distributions described in section 959(a).[177] As described above, CFC expenses should be allocated and apportioned without regard to whether gross income is treated as PTEP, and the PTEP accounts described in section 959(c) should be maintained independently of how expenses are allocated. The Preamble's suggestion that the allocation of expenses could impact section 959(c) accounts may have mixed these two concepts.

4. Current Year Taxes Allocable to PTEP and Section 960(b)

The discussion above focused on the allocation and apportionment of expenses other than current year taxes. Current year foreign income tax expense is treated differently than other expenses under current law and the Proposed Regulations, however. Specifically, those taxes may be allocated and apportioned to PTEP with a resulting decrease to PTEP accounts in section 959(c)(1) and (2), as illustrated by the following example:

> Example 10. DC, a domestic corporation, owns 100 percent of the stock of CFC1, which in turn owns 100 percent of the stock of CFC2. During Year 1, CFC2 earns $100x of gross subpart F income that is subject to foreign income tax of $15x. This $15x of tax expense reduces CFC2's net subpart F income to $85x, which is allocated to DC under section 951(a). DC is eligible to claim a deemed paid credit of $15x with respect to the foreign income taxes under section 960(a) and includes $15x in gross income under section 78, with the result that DC's total gross income attributable to CFC2 is $100x.
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> DC's PTEP account with respect to CFC2, however, is only $85x, which is the amount included in DC's taxable income under section 951(a). In other words,

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[176] Analogously, Notice 2019-1 acknowledged that where a shareholder experiences an inclusion under section 951A(a) in excess of a corporation's current year E&P, section 959(c)(3) may be reduced (potentially below zero) to ensure that the CFC's total E&P equals the sum of its section 959(c) accounts. This rule is now contained in Prop. Treas. Reg. § 1.959-2(d)(3).

[177] See Prop. Treas. Reg. § 1.959-3(c) for rules adjusting PTEP accounts.

the $15x inclusion under section 78 does not generate PTEP, which is supportable from a policy perspective given that this value has been paid to a foreign government and is not available for distribution to the U.S. shareholder. Furthermore, DC's tax basis in its CFC1 stock increases by $85x under section 961(a), and DC receives $85x of tax basis with respect to its indirectly owned CFC2 stock under section 961(c).

In Year 2, CFC2 distributes $85x to CFC1. The distribution is subject to a foreign withholding tax of $10x. This tax expense is allocated to the distribution of PTEP such that CFC1's section 959(c)(2) PTEP is $75x (i.e., increased by the $85x distribution and decreased by the $10x withholding tax allocated thereto pursuant to Prop. Treas. Reg, § 1.959-3(c)(1)). CFC1 thereafter distributes $75x to DC. DC is eligible for a $10x foreign tax credit under section 960(b) with respect to the foreign withholding tax imposed on the distribution from CFC2 to CFC1 and is deemed to receive a $10x dividend under section 78. DC's PTEP account with respect to CFC1 is reduced to zero as a result of the $75x distribution.

As illustrated above, PTEP is reduced by the amount of current year taxes allocated to a distribution of PTEP (or PTEP deemed to arise as a result of gain sheltered by section 961(c)). This has been the historic approach with respect to taxes going back to the 1965 regulations. Nevertheless, there is nothing in the statute that suggests that this must be the case. Rather, section 959(a) provides:

> For purposes of this chapter, the E&P of a foreign corporation **attributable to amounts** which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when—
>
> **such amounts** are distributed to,
>
> or **such amounts** would, but for this subsection, be included under section in the gross income of, such shareholder …
>
> be again included in the gross income of such United States shareholder (or of such other United States person). The rules of subsection (c) shall apply for purposes of paragraph (1) of this subsection and the rules of subsection (f) shall apply for purposes of paragraph (2) of this subsection.

In other words, once an amount has been included in income under section 951(a) or 951A(a), section 959(a) suggests that taxes should not reduce a U.S. shareholder's entitlement to PTEP. This Report is not recommending that current taxes should not be allocated to and reduce PTEP accounts, however. That would be a significant change relative to more than 60 years of practice and would require detailed study before adoption. Consideration would need to be given to how the section 959(c) accounts should be maintained under such approach, the interaction with the E&P limitations contained section 952(c), coordination of section 959(c) accounts for section 78 gross ups attributable to section 960(b) foreign tax credits, among other issues. Nevertheless, not reducing PTEP accounts with respect to these taxes would reduce or eliminate the need for information sharing

between direct or indirect CFC shareholders and thereby provide a significant simplification benefit. For this reason, the idea should be carefully studied as part of the finalization of the Proposed Regulations.

5. Conclusion

In light of the foregoing discussion, Treasury and the IRS should reconsider the Proposed Regulations' approach to sections 959(b) and 961(c) by adopting an approach that applies at the U.S. shareholder level. There are multiple benefits to such an approach. It is consistent with the statutory text, does not require rewriting the rules for allocating subpart F income, does not require a novel reading of section 951A(f) to avoid double taxation under GILTI, and ensures that expenses can be allocated without detailed information from or about direct and indirect owners of a CFC.

F. PTEP Successor Rules

As discussed in Part III.J.5, the Proposed Regulations would provide rules for the automatic transfer of PTEP to covered shareholders. Importantly, these rules would apply not only when foreign corporation stock is acquired from another U.S. person, but also (i) when stock of a former CFC is acquired from an intervening foreign owner (*i.e.*, a deemed covered shareholder); and (ii) when less than 10 percent shareholders ("**small shareholders**") acquire publicly traded shares of a foreign corporation. We recommend the final regulations be modified, as described below, to address each of these situations.

1. Deemed covered shareholder rules

In the case of an acquisition from a deemed covered shareholder, the Proposed Regulations would provide that a taxpayer must make reasonable efforts to determine the amount and character of PTEP that would transfer from the deemed covered shareholder, including taking into account any adjustments to PTEP that may have occurred during the period of intervening foreign ownership. Notably, the requirement to recreate a foreign corporation's PTEP accounts exists even if there have been multiple intervening foreign owners and regardless of the amount of time that has passed since the foreign corporation was owned by a U.S. person.

As support for this rule, the preamble to the Proposed Regulations points to the plain language of section 959(a), which applies to any U.S. person "who acquires from any person" a U.S. shareholder's interest in a foreign corporation. The preamble explains that, because this language does not condition its application on acquiring such stock *from* a U.S. shareholder, it applies both to acquisitions from U.S. shareholders as well as from intervening foreign owners of the foreign corporation.[178]

The preamble to the Proposed Regulations provides an example illustrating the purpose of the deemed covered shareholder rule. In the example, a nonresident alien

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[178] *Id.*

individual acquires the stock of a foreign corporation from a covered shareholder, and subsequently, an individual covered shareholder acquires the stock from the nonresident alien individual.[179] The preamble explains that, in the absence of a section 338(g) election, the foreign corporation's PTEP could become section 959(c)(3) E&P (*i.e.,* untaxed E&P) without the deemed covered shareholder rule. Converting the PTEP into untaxed E&P could result in a subsequent distribution of such E&P being inappropriately subject to U.S. taxation a second time when distributed. The preamble also notes that treating the E&P as PTEP prevents the E&P from being inappropriately converted into untaxed E&P that may be eligible for a section 245A dividends received deduction ("**DRD**") in the context of a domestic corporate covered shareholder.[180] Having untaxed E&P that is eligible for a section 245A DRD may be more beneficial than PTEP in certain situations, including where there is insufficient basis in the ownership chain to reduce under section 961 or where the taxpayer wishes to sell built-in gain stock and convert such gain under section 1248 to take advantage of a section 245A DRD.

While the current final section 959 regulations do not specifically address intervening foreign ownership, the 2006 Proposed Regulations provided rules addressing the carryover of PTEP in these situations. Unlike the approach taken in the Proposed Regulations, the rules in the 2006 Proposed Regulations provided that PTEP accounts attributable to stock in a foreign corporation transferred to a foreign person were "preserved" during the period of foreign ownership.[181] Thus, under these rules, a U.S. shareholder that acquired foreign corporation stock from a foreign owner would become a successor-in-interest to the foreign corporation's PTEP that existed at the time of the original transfer to the foreign person. The 2006 Proposed Regulations would not have required the acquiring U.S. shareholder to make any adjustments to the foreign corporation's PTEP accounts to take into account activity that occurred during the intervening foreign ownership.[182]

The preamble to the Proposed Regulations explains the departure from this simpler approach adopted in the 2006 Proposed Regulations. The preamble explains that an approach that "freezes" PTEP during periods of intervening foreign ownership would allow taxpayers to "inappropriately separate a foreign corporation's PTEP from its E&P and give rise to double taxation or other distortions."[183] Specifically, Treasury and the IRS appear to be

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[179] *Id.*

[180] As described in footnote 171, untaxed E&P may be a preferable CFC attribute relative to PTEP for domestic corporations.

[181] 71 FR 51155, 51157 (Aug. 29, 2006).

[182] Prop. Reg. § 1.959-1(d)(2)(ii) (Aug. 29, 2006).

[183] 89 Fed. Reg. 95362, 95375 (Dec. 2, 2024).

concerned with taxpayers engaging in planning in which taxpayers would take advantage of the period of foreign ownership to artificially inflate section 959(c)(3) E&P.[184]

While a rule that attempts to preserve an entity's U.S. tax attributes may be desirable, this deemed covered shareholder rule presents practical difficulties in many situations in which the required information either no longer exists or in situations where taxpayers may not have the ability to obtain such information. This practical complexity is further amplified by the fact that the rule has no limit on how far back in time taxpayers are required to assess in order to recreate a foreign corporation's PTEP accounts. The longer a foreign entity has been held by an intervening foreign owner, the more difficult it is to both establish the pre-acquisition PTEP accounts and make subsequent adjustments to such accounts for activity that occurred during the foreign owner's ownership period. In fact, the prior U.S. shareholder may no longer have the information to establish the starting PTEP account balances or may not respond to requests for such information. Further, the deemed cover shareholder rule would apply even if there were multiple intervening foreign owners of the foreign corporation stock. In a situation in which a foreign entity had multiple intervening foreign owners, it would be difficult to obtain the necessary information to recreate a foreign entity's PTEP accounts as the information is not likely be something a foreign owner would track.[185]

Accordingly, the final regulations should be narrowed to take into account complexities taxpayers may face when attempting to recreate PTEP accounts of a foreign entity acquired from a deemed covered shareholder. In particular, the final regulations should provide that taxpayers not only have to apply a *reasonable method* to determine the amount and character of PTEP resulting from the acquisition of a foreign corporation from a deemed

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[184] *Id*. The preamble includes an example of a transaction that could lead to such a distortion:

> For example, under such an alternative, a covered shareholder could transfer the stock of an upper-tier foreign corporation that owns stock of a lower-tier foreign corporation with PTEP to a nonresident alien individual, the lower-tier foreign corporation could distribute all its E&P to the upper-tier foreign corporation without affecting its PTEP, and then the stock of the upper-tier foreign corporation could be transferred to another individual covered shareholder that would succeed to the PTEP that remains with the lower-tier foreign corporation even though it has no E&P. If the form of the transaction were respected for Federal income tax purposes, the result would be that a distribution by the upper-tier foreign corporation would not be sourced from PTEP and the transferred PTEP of the lower-tier foreign corporation could be distributed only to the extent that the lower-tier foreign corporation earns section 959(c)(3) E&P.

[185] Relatedly, the operation of the deemed covered shareholder rule is unclear in circumstances in which the deemed covered shareholder has preexisting ownership of the foreign corporation or acquires new shares of the foreign corporation. Given that that PTEP is generally an attribute of the covered shareholder that is not specific to shares under section 959(a), it appears that any shares owned or later acquired by the deemed covered shareholder would be eligible to receive distributions of PTEP, regardless of whether those shares were owned by a predecessor covered shareholder. This point should be clarified in final regulations.

covered shareholder, but also that taxpayers must apply *reasonable efforts* to determine an entity's PTEP amounts and character.

If a taxpayer is unable to establish a foreign entity's PTEP balances after reasonable efforts, the final regulations should provide a default rule for the treatment of the entity's E&P. There are at least two potential default rules that could apply: (1) all of the foreign entity's E&P could be deemed to be PTEP or (2) all of the foreign entity's E&P could be deemed to be section 959(c)(3) E&P (*i.e.,* untaxed E&P). Of the two options, the first would be particularly challenging for acquiring U.S. shareholders due to the complexity involved in tracking PTEP accounts as required under the Proposed Regulations. Specifically, because PTEP must be categorized, annually, within both a section 904 category and within the 10 PTEP categories and the associated foreign currency gain or loss and foreign tax credit considerations of such PTEP must be determined, we believe that a default rule that treats all of an acquired foreign corporation's E&P as PTEP would be difficult for taxpayers to implement and for the IRS to monitor and administer.

With respect to the second option, we understand that Treasury and the IRS may not prefer to allow a taxpayer to, by default, treat all of a foreign corporation's E&P as untaxed E&P. In particular, as discussed above, Treasury and the IRS have indicated in the preamble to the Proposed Regulations that they are concerned that taxpayers will take advantage of periods of foreign intervening ownership to artificially inflate their untaxed E&P, which could allow taxpayers to engage in transactions in which they could take advantage of the section 245A dividends received deduction.[186] While we understand Treasury's concern, we note that it is not always preferable for a corporation's E&P to be untaxed. In fact, some shareholders may prefer for a foreign corporation's E&P to be PTEP. For example, an individual that is a U.S. shareholder may prefer PTEP over untaxed E&P because a distribution of PTEP would be excluded from its gross income, whereas a distribution of untaxed E&P would result in the recognition of income (*i.e.,* because individuals may not claim a section 245A dividends received deduction). Domestic corporate shareholders may prefer PTEP due to the ability to claim credits under section 960(b). Accordingly, a default rule that treats E&P as untaxed after reasonable efforts to determine its character should not necessarily be viewed as allowing taxpayers an unintended benefit or otherwise run afoul of the policy of sections 959 and 245A. Further, a default rule that would treat an acquired foreign corporation's E&P as untaxed E&P would be more administrable, and less burdensome to taxpayers, as the complexities inherent in determining PTEP amounts would be eliminated.

On balance, given the complexities inherent in a default rule deeming all of a foreign corporation's E&P to be PTEP, the final regulations should provide that, after taxpayers apply such reasonable methods and efforts, any amounts not determined to be PTEP may be treated as section 959(c)(3) E&P. Incorporating a "reasonable effort" element to the final regulations

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[186] 89 Fed. Reg. 95362, 95375. For example, taxpayers could distribute such untaxed E&P and claim a section 245A dividends received deduction or subsequently sell the foreign corporation stock and recharacterize gain on the sale as a section 245A-eligible dividend under section 1248.

balances the burdensome task of determining the amount of PTEP with Treasury and the IRS's concern of taxpayer's inappropriate treatment of earnings as section 959(c)(3) E&P.

Further, to account for the inherent difficulty in obtaining the necessary information required to determine a foreign entity's PTEP accounts where there are multiple intervening foreign owners, the final regulations should provide a default rule allowing successor U.S. shareholders to treat earnings from the acquired foreign corporation as section 959(c)(3) earnings where multiple foreign intervening owners exist.

2. Acquisitions of Publicly-Traded Stock by Small Shareholders

Similar to the Proposed Regulation's deemed covered shareholder rules, concerns with respect to the complexity and administrability of the successor rules in the Proposed Regulations also exist with respect to small shareholders. As discussed in Part III.J.5, above, under the Proposed Regulations, PTEP of a foreign corporation automatically transfers to any covered shareholder[187] in a general successor transaction, which would include a small shareholder's acquisition of publicly traded stock of a foreign corporation. Accordingly, where a small shareholder directly acquires publicly traded shares of a foreign corporation that has PTEP, such small shareholder would be treated as succeeding to the PTEP under the Proposed Regulations.

The application of the covered shareholder rules to small shareholders raises practical challenges. Specifically, a small shareholder that acquires shares of a publicly traded foreign corporation would be unlikely to be able to obtain the necessary information to determine a foreign corporation's PTEP accounts with respect to the publicly-traded foreign stock. For example, where stock is held in street name by a broker or institutional investor, the acquiring covered shareholder may be unable to identify the tax owner of the acquired shares and therefore, may not be able to obtain the any information to be able to determine the amount of the foreign corporation's PTEP to which it would succeed. Requiring a covered shareholder to determine PTEP amounts with respect to publicly-traded shares could also present fungibility concerns. Therefore, we recommend that an additional default rule be adopted to permit small shareholders to treat an acquired foreign corporation's E&P as section 959(c)(3) E&P where publicly traded shares are acquired.[188]

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[187] Prop. Treas. Reg. § 1.959-7(b)(1).

[188] Providing a special rule for small shareholders is not novel. For example, in the section 382 context, Treasury and the IRS provided special rules for small shareholders. See Treas. Reg. § 1.382-3(j). The preamble to the regulations explained that the special rule balanced the goal of reducing complexity while safeguarding section 382 policies. Notice of Proposed Rulemaking, 76 Fed. Reg. 72362, at 72363 (Dec. 16, 2011); see also NYSBA Report No. 1457 "Report on the Application of Section 382 to Foreign Corporations," (Jan. 18, 2022) (discussing the application of section 382 to small shareholders). As in the section 382 context, we believe a special rule for small shareholders acquiring publicly traded foreign corporation stock is warranted and that our recommendation appropriately balances reducing practical complexity with the purposes of section 959.

G. Section 78 Gross up Attributable to Section 960(b) Foreign Tax Credits

As discussed in Part III.I, section 78 was amended as part of the TCJA to remove references to section 902, which was repealed, and include a reference to section 960(b), the provision applicable to deemed paid foreign tax credits with respect to PTEP. The purpose for this change was not explained in the legislative history, and it has generated debate as to the proper treatment of section 78 dividends attributable to section 960(b) credits.

We recommend that Treasury and the Service issue guidance treating a section 78 gross-up relating to PTEP foreign tax credits deemed paid under section 960(b) as a distribution of PTEP that is excluded from gross income under section 959(a). The Proposed Regulations adopted the opposite approach, however, treating all section 78 amounts as excluded from the definition of a "covered distribution" to which section 959(a) can apply, even if they relate to section 960(b) credits.[189] The preamble to the Proposed Regulations provides the following rationale:

> [A] deemed dividend under section 78 is determined without regard to E&P (and does not represent a distribution of E&P to any shareholder)."[190] In this regard, section 959(a) refers to a distribution of previously taxed "E&P." Additionally, the preamble to regulations issued in 2019 provides an alternative rationale:
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> One comment requested that the final regulations make clear that, notwithstanding the amendment of section 78, deemed paid taxes are not treated as a section 78 dividend to the extent that the taxes are related to previously taxed E&P. The comment states that providing a section 78 dividend on these taxes is inappropriate given the purpose of section 78, and that no changes to the statutory language of section 78 should be needed to achieve this result based on the final regulations in effect before the enactment of the TCJA. Finally, the comment also requested changes to the example in proposed §1.960-1(f) to show the computation of deemed paid taxes of a U.S. shareholder under section 960(b)(1) and the application of section 78 to the deemed paid taxes.
>
> Because section 78 clearly states that taxes deemed paid under section 960(b) give rise to a section 78 dividend, the final regulations do not adopt the comment.[191]

Although the preambles raise legitimate questions regarding the meaning of the statutory text, compelling textual arguments can be made in favor of treating section 78 gross ups as PTEP where they relate to section 960(b) credits. For example, as discussed above in Part III.C, section 959(c) indicates that a distribution must qualify as a dividend under section

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[189] Prop. Treas. Reg. § 1.959-4(c)(1).

[190] 89 Fed. Reg. 95,371.

[191] T.D. 9882 (Dec. 2, 2019).

316 in order for section 959(a) to apply.[192] Section 78 deems a domestic corporate shareholder to receive a "dividend" for purposes of Title 26, and the term "dividend," in turn, is defined in section 316 as a corporate distribution to shareholders out of E&P described in section 316(a)(1) and (2). Transitively, therefore, section 78 deems a shareholder to receive a distribution of E&P. Section 78 is thus similar to other statutory provisions that can treat a transaction as a deemed dividend, such as section 304, notwithstanding that a corporation's earnings may not have been distributed.

The fact that foreign taxes reduce a CFC's E&P should not alter this conclusion. Where foreign income taxes are imposed on PTEP (e.g., as a result of a withholding tax imposed on a dividend subject to section 959(b)), the tax is imposed on earnings that have been previously taxed under section 951(a) or 951A(a). In effect, section 78 puts a domestic corporation in a similar place as if it, and not the CFC, had paid the foreign income taxes directly on these CFC earnings.

Furthermore, if the reduction to a CFC's E&P did create a concern, that concern would have existed prior to the amendment to section 78 as part of the TCJA. Under prior law, former section 960(a)(3) governed the treatment of deemed paid credits with respect to PTEP. That provision treated a distribution of PTEP as a dividend for purposes of applying former section 902, which provided deemed paid foreign tax credits with respect to dividends. Prior to the TCJA, section 78 applied for foreign income taxes deemed paid under section 902. Thus, section 78 applied, albeit indirectly, to deemed paid taxes with respect to PTEP under section 960(a)(3), notwithstanding that such taxes would have reduced the CFC's E&P. Prior regulations addressed this issue by excluding these deemed paid taxes from gross income. Former Treas. Reg. § 1.78-1(b) provided:

> Foreign taxes deemed paid by a domestic corporation under section 902(a) … shall not … be treated as a section 78 dividend where such taxes are imposed on certain distributions from the E&P of a controlled foreign corporation attributable to an amount which is, or has been, included in gross income of the domestic corporation under section 951.

Former Treas. Reg. § 1.960-3(b) provided:

> [A]ny taxes deemed paid by a domestic corporation for the taxable year pursuant to section 902(a) or section 960(a)(1) shall not be included in the gross income of such corporation for such year as a dividend pursuant to section 78 and §1.78-1 . . . on or with respect to an amount which is excluded from the gross income of such foreign corporation under section 959(b) … as distributions from the E&P of another controlled foreign corporation

[192] This point is confirmed by Notice 2019-1 and the Proposed Regulations, which provide that a "covered distribution" is "the distribution [of] a dividend (as defined in section 316), determined without regard to section 959(d)."

attributable to an amount which is, or has been, required to be included in the gross income of the domestic corporation under section 951.[193]

Subsequent legislative materials shed little light on these questions. The Joint Committee on Taxation's Blue Book to the TJCA provides:

> A technical correction to section 78 may also be necessary to reflect the intent to allow previously taxed income from lower-tier CFCs that give rise to deemed paid credits under section 960(b) to be distributed without additional U.S. taxation.[194]

Similarly, in 2019, Ways and Means Chairman Kevin Brady released a discussion draft of technical corrections to the TJCA, which included the removal of the reference to section 960(b) from section 78. Both of these materials indicate congressional intent to exclude section 78 dividends from gross income.

Separate from the textual arguments, policy considerations unequivocally favor treating these section 78 dividends as PTEP. To illustrate this point, we compare the approach in the Proposed Regulations with a PTEP approach.

> Example 11. DC, a domestic corporation, owns 100 percent of the stock of CFC1, which in turn owns 100 percent of the stock of CFC2. During Year 1, CFC2 earns $100x of gross subpart F income. DC's PTEP account with respect to CFC2 is $100x. Furthermore, DC's tax basis in its CFC1 stock increases by $100x under section 961(a), and DC receives $100x of tax basis with respect to its indirectly owned CFC2 stock under section 961(c).
>
> In Year 2, CFC2 distributes $100x to CFC1. The distribution is subject to a foreign withholding tax of $10x. This tax expense is allocated to the distribution of PTEP such that CFC1's section 959(c)(2) PTEP is $90x (i.e., increased by the $100x distribution and decreased by the $10x withholding tax allocated thereto pursuant to Prop. Treas. Reg, § 1.959-3(c)(1)). CFC1 thereafter distributes $90x to DC. DC is eligible for a $10x foreign tax credit under section 960(b) with respect to the foreign withholding tax imposed on the distribution from CFC2 to CFC1 and is deemed to receive a $10x dividend under section 78. DC's PTEP account with respect to CFC1 is reduced to zero as a result of the $90x distribution.

When CFC1 distributes $90x to DC, this amount is excluded from DC's gross income under section 959(a), and DC reduces its stock basis by this amount under section 961(b)(1) (i.e., the amount excluded from gross income under section 959(a)). Under the Proposed

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[193] As a technical matter, these regulations appear to have turned off section 78 with respect to these deemed paid taxes, as opposed to treating the section 78 dividend as a PTEP distribution. The effect is the same.

[194] JCS-1-18 (Dec. 2018) at 394 n. 1784.

Regulations, DC also must reduce its basis attributable to the $10x of PTEP taxes deemed paid under section 960(b), such that zero of the original $100x basis increase remains.[195] The Proposed Regulations also do not treat the $10x section 78 dividend resulting from section 960(b) as a "covered distribution" and, therefore, a distribution eligible for section 959(a). As a result, the $10x section 78 gross up would be included in DC's taxable income. In total, therefore, DC recognizes $110x of taxable income (i.e., a $100x subpart F inclusion and a $10x section 78 dividend attributable to section 960(b) taxes), receives $10x of foreign tax credits, and receives $90x of property (i.e., cash) without tax. In other words, DC has been overtaxed as an economic matter by $10x.

Alternatively, consider the results if a section 78 gross up attributable to section 960(b) credits were treated a distribution of PTEP. In that case, when CFC1 distributes $90x to DC, DC would be treated as receiving $100x of PTEP, $90x as a result of the actual distribution of property to DC and $10x as a result of the section 78 gross up attributable to the section 960(b) credits. This entire amount would be excluded from income under section 959(a), and, consequently, DC's stock basis in its CFC1 stock would be reduced by $100x, such that none of the basis generated under section 961(a) in Year 1 would remain.[196] Finally, DC's PTEP account with respect to CFC1 would be reduced from $90x to $0. Here, DC is taxed on $100x of gross income, receives $90x of cash and a $10x foreign tax credit. In other words, DC has been taxed on the appropriate amount of income.

This second alternative avoids double taxation and therefore should be the favored interpretation of section 78 absent a clear indication by Congress to the contrary.

H. Mirrored PTEP and Section 986(c) Double Counting

Section 961(c) basis is an attribute for limited purposes; it applies solely for purposes of determining a U.S. shareholder's inclusion under section 951(a) with respect to a CFC's gain from selling the shares of another CFC. Section 961(c) basis does not apply for purposes of determining the selling CFC's E&P, as illustrated by the following example:

> Example 11. DC, a domestic corporation, owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. The CFC2 shares have zero regular tax basis. In Year 1, CFC2 earns $60x of subpart F income, which results in $60x of section 961(c) basis with respect to its stock held by CFC1. In Year 2, CFC2 earns no other income, and CFC1 sells the CFC2 stock to a third party for $60x.

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[195] The Proposed Regulations take the position that the section 78 dividend is not subject to section 959(a); therefore, this basis reduction is not described by section 961(b)(1).

[196] In this alternative, because section 959(a) applies to $100x, the entire basis reduction is described by section 961(b)(1), which avoids the statutory concerns raised by the Proposed Regulations with respect to the $10x basis reduction attributable the section 960(b) foreign tax credits.

DC recognizes no subpart F income from the sale by virtue of section 961(c).[197] Nevertheless, CFC1's E&P would increase by $60x from the sale because the section 961(c) basis is not taken into account for purposes of sections 312 and 964(a).

As described in Part IV.F, DC may prefer to treat the $60x of E&P as eligible for section 245A(a). In some circumstances, that treatment could produce a windfall for DC. To prevent that outcome, the Proposed Regulations treat the $60x of earnings as PTEP on the basis that the earnings are "attributable to amounts which are, or have been, included in gross income under section 951(a) [or 951A(a)]." In this case, those "amounts" happen to have been earned by CFC2, the lower-tier CFC, but nonetheless the stock appreciation in CFC1's hands may be fairly said to be "attributable" to such income.

Once that upper-tier gain has been treated as PTEP, it is characterized generally in the same manner as the underlying PTEP that gave rise to the section 961(c) basis. Thus, in most cases, the PTEP will receive the same character as the PTEP that gave rise to the section 961(c) basis. This PTEP is referred to as "**Mirrored PTEP**."

Importantly for purposes of this discussion, Mirrored PTEP generally takes the same dollar basis as the underlying PTEP to which it relates.[198] That raises the possibility that a single economic item (e.g., foreign currency gain attributable to subsidiary earnings) could result in two section 986(c) items (e.g., section 986(c) gain with respect to the lower-tier PTEP and with respect to the Mirrored PTEP). This observation should concern Treasury and the IRS because the recognition of section 986(c) items is effectively elective. That is, section 986(c) gain or loss is only recognized when PTEP is distributed to a U.S. shareholder under section 959(a).[199]

Thus, Treasury and the IRS should provide that section 986(c) only applies with respect to the historic functional currency gain or loss of one of the two PTEP pools. In our view, the most administrable approach would be to apply section 986(c) to historic gains or losses of the lower-tier CFC's PTEP. The historic section 986(c) items with respect to the Mirrored PTEP could be eliminated by providing the selling CFC with a dollar basis in the Mirrored PTEP equal to the spot rate on the date of the sale.

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[197] As discussed in Part IV.E, the Proposed Regulations and the recommendation in this Report would apply different mechanics to reach this result. Furthermore, the conclusion that DC does not recognize subpart F income is premised on the conclusion that section 964(e)(4) does not apply to the sale of CFC2 stock, which the Proposed Regulations accomplish through a coordination rule in Prop. Treas. Reg. § 1.961-9(c)(2).

[198] Prop. Treas. Reg. § 1.961-9(g). Additionally, PTEP is determined by translating the positive section 961(c) basis in U.S. dollars into the functional currency of the seller based on the spot rate on the date of the sale.

[199] The ability to selectively recognize losses through remittances has garnered significantly more attention in section 987 than it has under section 986(c), but the concerns are conceptually similar.

I. Removing Limitations on Losses Attributable to Section 961(c) Basis

In certain circumstances, section 961(c) basis may create a loss with respect to shares (for the limited purpose of applying section 951(a) to a U.S. shareholder). The Proposed Regulations provide that this loss may only be utilized to offset gains with respect to the stock of the same foreign corporation.[200] The Preamble explains:

> Allowing section 961(c) basis in stock of a foreign corporation to only reduce a section 951 inclusion attributable to sales, exchanges, or other dispositions of stock of that foreign corporation is consistent with the language of section 961(c), with the result that only shares of stock of the same foreign corporation should be viewed as similar types of property for purposes of replicating the effect of netting under section 961(c).[201]

We do not infer such limitations from the statute. Rather, a capital loss attributable to section 961(c) basis should be eligible to reduce a section 951(a) inclusion attributable to capital gain recognized with respect to any property, which is the same result as would occur under section 961(a).

J. Clarifications with respect to sections 956 and 959(f)

Section 956 generally requires a U.S. shareholder of a CFC to include in gross income its share of the undistributed E&P of such CFC to the extent such CFC holds United States property. A section 956 inclusion is calculated as lesser of two amounts: (i) the excess, if any, of the U.S. shareholder's share of the United States property held by the CFC[202] over the E&P attributable to prior section 956 inclusions (or earnings which would have been so excluded but for the exclusion for certain PTEP)[203] or (ii) the U.S. shareholder's pro rata share of the CFC's applicable earnings. Applicable earnings, for this purpose, is the sum of the earnings described in sections 316(a)(1) and (2),[204] reduced by current year distributions and earnings described in section 959(c)(1) (i.e., earnings attributable to prior section 956 inclusions or PTEP amounts that would have resulted in such inclusions but for the exclusion in section 959(a)(2)).

As referenced above, section 959(a)(2) provides an exclusion for amounts that would otherwise give rise to a section 956 inclusions. Since section 959(c)(1) earnings are excluded from the definition of applicable earnings under section 956(a), as a practical matter the section 959(a)(2) exclusion applies to earnings described in section 959(c)(2) (i.e., earnings

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[200] Prop. Treas. Reg. § 1.961-11(e)(2)(ii).

[201] 89 Fed. Reg. 95,386.

[202] This U.S. property amount is determined based on quarterly averaging of the CFC's E&P basis, reduced by any liabilities to which the property is subject.

[203] PTEP described in section 959(c)(2) is excluded from the application of section 956 under section 959(a)(2).

[204] E&P deficits described in section 316(a)(1) are disregarded for this purpose.

attributable to a subpart F or GILTI inclusion). Section 959(f) provides ordering rules for purposes of applying the section 959(a)(2) exclusion. Section 959(f)(1) provides that, in determining the amounts that would have otherwise given rise to an inclusion under section 956, the section 956 amount is allocated first to PTEP described in section 959(c)(2) and then to untaxed earnings described in section 959(c)(3). Section 959(f)(2) further provides that actual distributions of earnings are taken into account before allocating the hypothetical section 956 amount for purposes of section 959.

Importantly for purposes of this discussion, the section 956 amount is determined independently from the application of section 959. Language in the preamble to the Proposed Regulations, however, has created some confusion in this regard:

> Thus, under section 959, a CFC's E&P for a taxable year of the CFC is first classified as PTEP to reflect any subpart F income inclusions or GILTI inclusions with respect to the CFC. Next, any distributions made by the CFC during the taxable year are allocated to PTEP (and such PTEP is reduced). Then, any section 956 amount with respect to the CFC is determined for the taxable year, which is allocated to remaining section 959(c)(2) PTEP (and such PTEP is reclassified as section 959(c)(1) PTEP). Finally, the CFC's E&P for the taxable year is classified as PTEP to reflect any inclusion under section 951(a)(1)(B).[205]

In other words, the preamble could be read to suggest that the determination of the section 956 amount interacts with the application of section 959. The Proposed Regulations, on the other hand, clearly indicate that the section 956 determination is a separate, initial step prior to the application of section 959.[206] To remove any confusion, therefore, the preamble description should be clarified.

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[205] 89 Fed. Reg. 95,363.

[206] Prop. Treas. Reg. § 1.959-5(b) ("A section 956 amount is the amount determined under section 956 and § 1.956-1with respect to a covered shareholder and a controlled foreign corporation. A section 956 amount is excluded from gross income in accordance with the rules described in paragraph (c) of this section."). Furthermore, Prop. Treas. Reg. § 1.959-1 defines section 956 amount by reference to Prop. Treas. Reg. § 1.959-5(c). The reference to paragraph (c) appears to be a typographical error and should refer to paragraph (b), quoted above.