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Report No. 1514
July 14, 2025

The Honorable Kenneth J. Kies
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William H. Long
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Andrew A. De Mello
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: NYSBA Tax Section Report No. 1514 - Report on Partnership Aspects of the Proposed PTEP Regulations

Dear Messrs. Kies, Long and De Mello:

Please see attached Report No. 1514 of the Tax Section of the New York State Bar Association, which provides additional comments on the proposed regulations issued by the Department of the Treasury and the Internal Revenue Service on December 2, 2024, under sections 959 and 961 and certain other provisions of the Internal Revenue Code, regarding previously taxed earnings and profits of foreign corporations and related basis adjustments.

The Tax Section previously submitted a report on the Proposed Regulations on April 16, 2025. On May 15, 2025, Treasury and the IRS reopened the comment period with respect to the Proposed Regulations. This Report addresses partnership issues raised by the Proposed Regulations.

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

cc:

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Report No. 1514

New York State Bar Association Tax Section

Comments on Partnership Aspects of the Proposed Regulations Regarding Previously Taxed Earnings and Profits

July 14, 2025

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I. Introduction

This Report[1] of the Tax Section provides additional 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 of 1986, as amended (the "**Code**"), regarding previously taxed earnings and profits ("**PTEP**") of foreign corporations and related basis adjustments.[2]

The Tax Section previously submitted a report on the Proposed Regulations on April 16, 2025 (the "**April 2025 Report**").[3] On May 15, 2025, Treasury and the IRS reopened the comment period with respect to the Proposed Regulations. This Report addresses partnership issues raised by the Proposed Regulations.

As summarized in the April 2025 Report, 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**")[4] and the guidance subsequently issued by Treasury and the IRS. The Proposed Regulations introduce new rules and concepts that affect the PTEP accounting and reporting in situations in which shares of foreign corporations are owned, directly and indirectly, through partnerships.

We reiterate our appreciation for the efforts of Treasury and the IRS to provide comprehensive and timely guidance on the PTEP rules and acknowledge the challenges and trade-offs involved in promulgating that guidance. We are especially appreciative of Treasury and the IRS adopting, in part, our recommendation in our April 2025 Report that the comment period with respect to the Proposed Regulations be reopened given the complex and important implications addressed by the Proposed Regulations.

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[1] The principal authors of this Report are Matt Donnelly, Kristen Gamboa, and Wade Sutton, with assistance from Yara Mansour. This Report reflects comments and contributions from Kimberly S. Blanchard, Tim Devetski, Ed Gonzalez, Michael L. Schler, Vikram Sharma, Eric B. Sloan, Shun Tosaka and Gordon Warnke.

[2] 89 Fed. Reg. 95362 (Dec. 2, 2024). Unless otherwise noted, references herein to "**section**" are to sections of the Code.

[3] New York State Bar Ass'n Tax Section, Report No. 1512, *Comments on Proposed Regulations Regarding Previously Taxed Earnings and Profits* (Apr. 16, 2025).

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

In this Report, we offer our observations and suggestions on partnership aspects of the Proposed Regulations, with the aim of enhancing their clarity, consistency, and fairness. Part II of this Report provides a summary of our principal recommendations. Part III provides background on the PTEP rules, the relevant partnership tax rules, and the Proposed Regulations, and Part IV contains a detailed discussion of our comments and recommendations.

II. Summary of Recommendations

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

1. Treasury and the IRS should consider ways to simplify the approach of the Proposed Regulations with respect to partnerships. As a general observation, the rule should adopt aggregate principles and an aggregate approach to partnerships where possible. Several of the more complex rules and more burdensome reporting requirements are the result of entity-based rules.

2. Consistent with recommendation 1, section 1248(a) should be applied at the partner level, not the partnership level, in particular for purposes of applying section 1248(d)(1) when a partnership disposes of the stock of a foreign corporation. We have previously recommended that section 1248(a) not be applied at the partnership level, and we reiterate that recommendation in this Report as applied to section 1248(d)(1).

3. The Proposed Regulations should provide section 961(c)-like basis for partnership interests held by CFCs. The Proposed Regulations should provide rules that prevent double taxation that could arise from the absence of such basis adjustments with respect to subpart F and GILTI inclusions.

4. The partnership basis adjustment rules in Prop. Treas. Reg. § 1.961-4 for section 961(a) and derivative ownership interests should be clarified with respect to PTEP distributions through tiers of partnerships. An additional example would likely resolve much of the uncertainty, and the Report walks through a proposed example (and the ways the Proposed Regulations could address the fact pattern).

5. The Proposed Regulations should extend the rules of Treas. Reg. § 1.743-1 to distributions relating to derived basis. Derived basis effectively displaces section 743(b) basis in circumstances in which section 743(b) would otherwise arise, and therefore the presence of derived basis should not put a taxpayer in a worse position than if the basis had arisen under section 743(b).

6. The Proposed Regulations' limitation on negative derived basis should be clarified to address the interaction with certain rules that impact the common basis used for computing the negative derived basis limitation.

7. Prop. Treas. Reg. § 1.961-2(d)(2) and -4 should be clarified as applied to partnerships. These rules generally address ownership units that are CFC stock but also apply to (and, as a result, introduce potentially unintended inconsistencies with the general treatment of) partnership interests.

8. Prop. Treas. Reg. § 1.961-8(b)-(d) should be clarified in certain mechanical respects as to how derived basis is taken into account upon the disposition of a lower-tier partnership, and the rules applicable to certain partial nonrecognition transactions should be clarified as applied to partnership nonrecognition transactions.

III. Background

A. Controlled Foreign Corporations; Subpart F and GILTI Inclusions; PTEP and Basis Adjustments; Section 961; and Section 960(b)

The April 2025 Report includes a summary of the relevant rules related to "**CFCs**," "**subpart F inclusions**" and "**GILTI inclusions**" of "**U.S. shareholders**," PTEP and related basis adjustments, and sections 959 and 961. Therefore, we do not repeat that summary and instead refer to the April 2025 Report for a description of those rules and those defined terms.

B. Section 961 and Partnerships: Current Regulations

Under Treas. Reg. § 1.961-1(a)(1) (finalized in 1965), a U.S. shareholder who owns (within the meaning of section 958(a)(2)) stock of a CFC by reason of owning a direct interest in a foreign partnership receives basis under section 961 in the interest in the foreign partnership in respect of subpart F inclusions. However, it is not clear under current Treasury Regulations under section 961 whether the foreign partnership receives a basis increase under section 961(a) in the stock of the CFC, whether section 959(a) applies to a subsequent distribution of the PTEP to the partnership, or how a subsequent distribution of PTEP by the CFC to the partnership affect the partners' basis in the partnership.[5] Following the finalization of Treas. Reg. § 1.958-1(d) (discussed below), which treats domestic partnerships in a manner similar to foreign partnerships for these purposes, these questions now also arise in the context of CFC stock owned through domestic partnerships.

[5] *See* Monte A. Jackel & Robert J. Crnkovich, *CFC Stock Held by Foreign Partnerships: Confusion Galore*, TAX NOTES 709 (Aug. 17, 2009).

Proposed regulations under section 961 promulgated in 2006 and withdrawn in 2022 did not address CFC stock owned through partnerships.[6]

C. Section 1248

Under section 1248(a), if a U.S. person sells or exchanges stock in a foreign corporation, and that person owns (within the meaning of section 958(a) or (b)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation at any time during the 5-year period ending on the date of the sale or exchange when the foreign corporation was a CFC, then the U.S. person's gain is recharacterized as a dividend to the extent of the foreign corporation's E&P attributable to such stock that were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a CFC.

However, E&P with respect to the stock sold or exchanged attributable to PTEP of a U.S. person is excluded with respect to such U.S. person to the extent the PTEP was not already excluded under section 959.[7]

Under section 959(e), any amount included in the gross income of any person as a dividend by reason of section 1248(a) or (f) is treated as an amount included in the gross income of such person under section 951(a)(1)(A) for purposes of sections 959 and 960(c).

The application of section 1248 to partnerships has been addressed by both IRS rulings and regulations. Notwithstanding the fact that a domestic partnership is no longer treated as owning stock of a foreign corporation within the meaning of section 958(a), the Treasury Regulations treat a domestic partnership as a United States person under section 7701(a)(30) and, therefore, a person to whom section 1248(a) applies.[8] Consequently, when a domestic partnership sells stock of a CFC, the partnership itself must determine the amount of gain recharacterized as a dividend under section 1248(a) to the extent of the CFC's relevant E&P, and this dividend amount is allocated to the partners under section 704 (and is separately stated and retains its character under section 702).

In certain circumstances, section 1248(a) applies differently to individuals, as opposed to other United States persons, which the IRS has addressed in the partnership context. In Rev. Rul.

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[6] 71 Fed. Reg. 51,155 (Aug. 29, 2006), *withdrawn*, 87 Fed. Reg. 63,981 (Oct. 21, 2022).

[7] Section 1248(d)(1).

[8] *Compare* Treas. Reg. § 1.958-1(d)(1) *with* § 1.958-1(d)(2)(iv).

69-124, for example, a domestic partnership owning 100 percent of a CFC sold the stock at a gain.[9] The IRS ruled that the partnership, as the United States person, was required by section 1248(a) to treat a portion of its gain as a dividend (equal to the CFC's accumulated E&P), and under section 702 the partners had to include their distributive shares of that deemed dividend in gross income. Notably, the partners in Rev. Rul. 69-124 were individuals, and the ruling confirmed that they could apply the individual tax limitation of section 1248(b) to the dividend income passed through to them from the partnership. Thus, the ruling applied section 702(b) principles to tax the individual partners as if they had directly earned the section 1248(a) income recognized by the partnership.

By contrast, if a foreign partnership sells CFC stock, the regulations treat the partners as selling their proportionate shares.[10] This rule would apply only where the indirect ownership of foreign corporation stock by U.S. partners is sufficient to treat the foreign corporation as a CFC and to treat a particular U.S. partner as a section 951(b) shareholder of the CFC. Thus, if stock of a foreign corporation is owned through a foreign partnership, the calculations under section 1248 are similar to the calculations under sections 951 and 951A.

D. Partnership-Related Regulations under Section 958 and Prior Recommendations

As noted in the preamble to the Proposed Regulations, before the TCJA, domestic partnerships were treated as owning stock of a foreign corporation for purposes of determining subpart F and GITLI inclusions, and therefore PTEP accounts and related basis adjustments were maintained and made at the partnership level.

Following the enactment of TCJA, Treasury and the IRS published final regulations treating a domestic partnership as an aggregate of its partners for purposes of determining GILTI and subpart F inclusions.[11] Under Treas. Reg. § 1.958-1(d), with certain exceptions, a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a); instead, the stock of a foreign corporation owned by a domestic partnership is treated as being owned proportionately by its partners. That aggregate-like rule does not apply (and the domestic partnership is treated as owning such stock) for certain specified purposes, including applying section 1248.

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[9] 1969-1 C.B. 203.

[10] Treas. Reg. § 1.1248-1(a)(4).

[11] 84 Fed. Reg. 29288 (June 21, 2019) (promulgating Treas. Reg. § 1.951A-1(e)); 87 Fed. Reg. 3648 (Jan. 25, 2022) (promulgating Treas. Reg. § 1.958-1(d)).

In a report dated September 18, 2019 (the "**September 2019 Report**"), we made a number of recommendations, including that then-Prop. Treas. Reg. § 1.958-1(d) be revised to extend the aggregate treatment of domestic partnerships to the application of section 1248(a).[12] The final regulations did not address those comments.[13]

E. Certain Relevant Partnership Tax Rules

1. Sections 742, 731, and 732

Section 742 provides that a partner acquiring a partnership interest other than by contribution (which is governed by section 722) has a basis in its partnership interest ("**outside basis**") determined under the general basis rules of subchapter O.

Under section 731(a)(1), gain is recognized upon a distribution of property by a partnership to a partner only to the extent that any distributed money and marketable securities exceeds the partner's outside basis immediately before the distribution, and loss is recognized only in certain distributions in liquidation of a partner's interest.[14]

Under sections 732(a)-(b), a partner takes the partnership's basis in distributed property (other than money and other than distributions in liquidation), limited to the partner's outside basis in its partnership (reduced by any money received in the distribution), and, in a liquidating distribution, the partner takes a basis in distributed property equal to the partner's outside basis in its partnership (reduced by any money received in the distribution). Any resulting basis allocations are performed under rules in section 732(c).

2. Sections 734(b) and 743(b)

Sections 734(b) and 743(b) apply on an elective basis (with one exception[15]) to keep partnership inside and outside basis the same—the rules allow partnerships to choose aggregate-

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[12] New York State Bar Ass'n Tax Section, Report No. 1423, *Report on June 2019 GILTI and Subpart F Regulations* (Sept. 18, 2019).

[13] In the preamble to the final regulations, Treasury and the IRS stated that the comments were beyond the scope of the rulemaking. 87 Fed. Reg. 3648, 3650 (Jan. 25, 2022). The Tax Section advocated for aggregate treatment of partnerships for purposes of subpart F more generally in a previous report as well. *See* New York State Bar Ass'n Tax Section, Report No. 1124, *Report on Differences in Tax Treatment of Domestic and Foreign Partnerships* (Jan. 3, 2007) (the "**January 2007 Report**").

[14] To recognize a loss, the partner must only receive money, unrealized receivables (as defined in section 751(c)) and/or inventory (as defined in section 751(d)), and the loss is computed as excess of the partner's outside basis over the sum of the money and the basis (under section 732) of the unrealized receivables and inventory distributed.

[15] *See infra* notes 16-17.

like treatment in the event of certain partnership transactions implicating partnership equity to mitigate disadvantageous income, gain, loss, and deduction timing outcomes that can result from the application of certain subchapter K provisions (sections 731(a), 732(a)-(b) and 742) that treat the partnership as an entity by assigning consequence to outside partnership basis.

When a partnership distributes property to a partner, section 734(b) applies to adjust the basis of the property retained by the partnership where either a section 754 election is in effect with respect to the partnership or the distribution gives rise to a substantial basis reduction.[16] Where applicable, section 734(b) gives rise to a basis step-up at the partnership level to the extent the distributee recognizes gain on the distribution or takes the distributed property with a lower basis than that at which the partnership held the property, and a basis step-down to the extent the distributee recognizes loss on the distribution or takes the distributed property with a higher basis than that at which the partnership held the property.

Upon a sale or exchange of a partnership interest, the transferee adjusts its basis in the partnership's assets under section 743(b) where either a section 754 election is in effect with respect to the partnership or there is a substantial built-in loss immediately after the transfer.[17] A basis adjustment under section 743(b) constitutes an adjustment to the basis of partnership property with respect to the transferee only, and no adjustment is made to the common basis of partnership property.[18]

In the case of tiered partnerships, upon the sale of an interest in an upper-tier partnership ("**UTP**"), section 743(b) applies to adjust the basis of the property of a lower-tier partnership ("**LTP**") in which UTP has an interest if both UTP and LTP have a section 754 election in effect.[19] As explained in Rev. Rul. 87-115, UTP's section 754 election "manifest[s] an intent to

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[16] Section 734(d)(1) provides that there is a "substantial basis reduction" with respect to a distribution if the sum of the amounts described in sections 734(b)(2)(A) (loss recognized by the distributee partner under section 731(a)(2) with respect to the distribution) and 734(b)(2)(B) (excess of the basis of the distributed property to the distributee (after applying section 732(b)) over its adjusted basis in the hands of the partnership immediately before the distribution) exceeds $250,000.

[17] Section 743(d)(1) provides that a partnership has a "substantial built-in loss" with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in the partnership property exceeds by more than $250,000 the fair market value of such property.

[18] Treas. Reg. § 1.743-1(j)(1).

[19] If either UTP or LTP does not have a section 754 election in effect, section 743(b) does not apply to adjust the basis of LTP's property with respect to the transferee.

be treated as an aggregate for purposes of sections 754 and 743" and therefore it is appropriate to treat the sale as a deemed sale of an interest in LTP.[20]

Under Treas. Reg. § 1.743-1(g)(1), a partner's section 743(b) basis adjustment with respect to an item of property is taken into account under section 732 if the partnership distributes the property to the partner. If the property were instead distributed to another partner, that other partner does not take the basis adjustment into account under section 732 (and the partner with the section 743(b) adjustment reallocates its adjustment among the remaining items of partnership property under Treas. Reg. § 1.755-1(c)).[21]

If a partner receives a distribution of property in liquidation of its interest (and, as a result, relinquishes to the remaining partners an interest in an item of property with respect to which the partner had a section 743(b) basis adjustment), the distributed property includes the partner's section 743(b) basis adjustment for the relinquished property (reallocated among the distributed properties under Treas. Reg. § 1.755-1(c)).[22] If the partner receives property or money with respect to which he has no section 743(b) basis adjustment and does not utilize his entire section 743(b) basis adjustment in determining the basis of the distributed property, the unused section 743(b) basis adjustment is applied as an adjustment to the basis of the partnership's retained property.[23]

F. Partnerships Under the Proposed Regulations

Our April 2025 Report includes a general description of the Proposed Regulations and therefore we refer to the April 2025 Report for that summary. The following summarizes the operative rules under the Proposed Regulations relevant to partnerships.

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[20] 1987-2 C.B. 163. *See also* Rev. Rul. 92-15, 1992-1 C.B. 215 (similarly making section 734(b) adjustments with respect to property owned by an LTP in the event of property distributions by a UTP and distributions of interests in an LTP by a UTP in circumstances in which both the UTP and the LTP have section 754 elections in place). Proposed regulations promulgated in 2014 would incorporate Rev. Rul. 87-115 and Rev. Rul. 92-15. 79 Fed. Reg. 3041 (Jan. 16, 2014).

[21] Treas. Reg. § 1.743-1(g)(2).

[22] Treas. Reg. § 1.743-1(g)(3).

[23] Treas. Reg. § 1.734-2(b).

1. Section 959 Proposed Regulations

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.[24] 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.

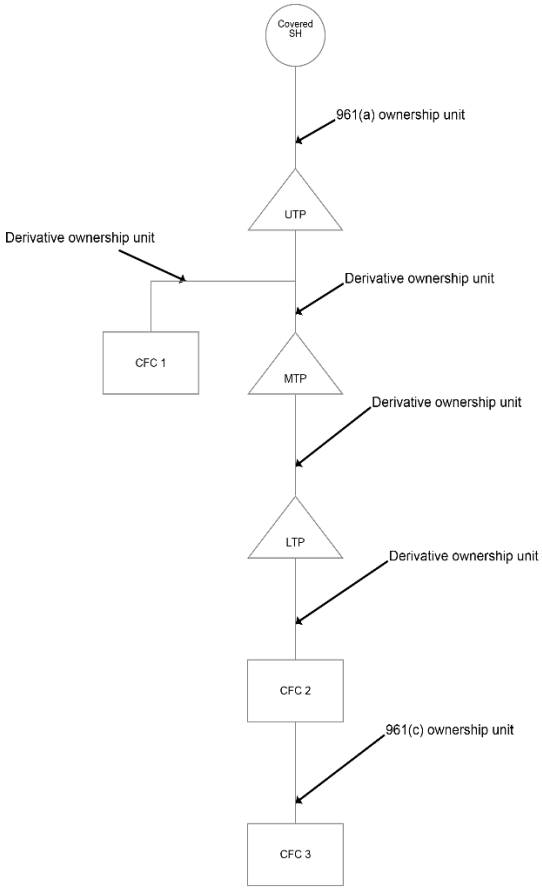
For purposes of the Proposed Regulations under section 959, Prop. Treas. Reg. § 1.959-1(b) treats stock of a foreign corporation held through a domestic partnership as being owned proportionately by the partners of the partnership. In the event of a distribution of PTEP from a CFC to a partnership (through which a covered shareholder is treated as owning the stock of the CFC), Prop. Treas. Reg. § 1.959-4(c)(3) provides that a partner's distributive share of a distribution that is a dividend is treated as a dividend made to the partner "for purposes of the section 959 regulations."

2. Section 961 Proposed Regulations

Section 961 provides for adjustments to a U.S. shareholder's tax basis in partnership interests by reason of which the U.S. shareholder is considered as owning (under section 958(a)(2)) stock of a CFC.[25] The Proposed Regulations create three different regimes for partnership basis adjustments under section 961, with the regime that applies hinging on the person that directly owns the relevant partnership interest. The following illustration depicts the three different types of ownership units in the Proposed Regulations under section 961.

[24] Section 959(a) also 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.

[25] Sections 951A(f)(1); 961(a)-(b).



a. Section 961(a) Ownership Units

Section 961(a) and (b) apply to a U.S. shareholder's direct interest in a partnership through which the U.S. shareholder indirectly owns stock of a CFC; the Proposed Regulations include such a directly held partnership interest in the definition of "**section 961(a) ownership units**"; basis adjustments with respect to partnership interests held directly by U.S. shareholders are governed by these rules. "**Covered shareholders**" (defined as any U.S. person other than a domestic partnership) are provided adjusted basis in section 961(a) ownership units.[26]

Prop. Treas. Reg. § 1.961-3 provides rules for determining the increase in adjusted basis of section 961(a) ownership units in respect of subpart F and GILTI inclusions. Prop. Treas. Reg. § 1.961-4 provides rules for determining the decrease in adjusted basis if a covered shareholder

[26] Prop. Treas. Reg. §§ 1.959-1(b); 1.961-2(c).

receives a distribution of PTEP that is excluded from its gross income under section 959(a).[27] If the basis reduction exceeds the amount of the U.S. shareholder's basis in its partnership interest, the shareholder recognizes gain under Prop. Treas. Reg. § 1.961-4(b). A special timing rule provides that basis reductions in section 961(a) ownership units (and derivative ownership units, discussed below) that are partnership interests are treated as made "concurrently with the adjustment under section 705 to such interest in the partnership by reason of the distribution giving rise to the basis reduction."[28]

b. Derivative Ownership Units

For interests in lower-tier partnerships (*i.e.*, circumstances in which a U.S. shareholder directly owns an interest in a UTP that itself directly owns an interest in an LTP, and the LTP directly owns interest in the CFC), UTP's interest in LTP is referred to as a "**derivative ownership unit**" and basis adjustments with respect to partnership interests held by UTP (or other LTPs that are themselves UTPs with the respect to other lower-tier LTPs) are governed by the derived ownership unit rules.[29]

A partnership is provided "**derived basis**" in a derivative ownership unit of an LTP. Derived basis (which may be positive or negative) is established and maintained separately with respect to each covered shareholder that owns the derivative ownership unit through only one or more partnerships. The preamble to the Proposed Regulations states: "Derived basis is intended to operate in a manner similar to a basis adjustment under section 743(b)."[30]

Derived basis generally is increased in the same manner as adjusted basis is increased with respect to section 961(a) ownership units.[31] Derived basis is decreased (but not below zero), starting with the lowest-tier partnership in a tiered partnership structure, by the dollar basis of the PTEP (and associated foreign income taxes) that were "received" with respect to the derived

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[27]Adjusted basis is reduced by the dollar basis and associated foreign income taxes of the PTEP received with respect to the section 961(a) ownership unit. Prop. Treas. Reg. § 1.961-4(b)(2)(i)-(ii).

[28] Prop. Treas. Reg. § 1.961-4(e)(2).

[29] LTP's interest in the CFC is also a derivative ownership unit.

[30] 89 Fed. Reg. 95362, 95377 (Dec. 2, 2024).

[31] A special rule provides that an increase to the derived basis of a derivative ownership unit indirectly owned by a foreign corporation cannot exceed the portion of the hypothetical distribution that would be distributed to the covered shareholder through only the derivative ownership unit and any interests in partnerships. Prop. Treas. Reg. § 1.961-3(f)(3).

ownership unit.[32] If the adjustment exceeds such positive derived basis, the reduction is next applied to reduce (not below zero) the covered shareholder's section 743(b) basis adjustment, and any further excess creates a negative derived basis account with respect to the covered shareholder, subject to a cap. Under the cap, negative derived basis is limited to the common basis of such derivative ownership unit "available with respect to the covered shareholder" (reduced by any negative section 743(b) basis adjustment that the covered shareholder has with respect to the derivative ownership unit).[33] For this purpose, the common basis that is "available with respect to the covered shareholder" is determined based apply the following fraction to the common basis:

$$\frac{\text{the amount of the tentative adjustment that would reduce basis below zero (without the negative derived basis limit)}}{\text{the sum of the numerator and any other tentative concurrent (negative) adjustments determined with respect to other covered shareholders}}$$

The Proposed Regulations do not address the interaction of derived basis with the rules of sections 731, 732 and 734; however, Treasury and the IRS sought comments on this interaction, "including whether derived basis with respect to a covered shareholder should be taken into account in the case of a distribution by a partnership of a derivative ownership unit to the covered shareholder or to another partner and whether derived basis should be taken into account in the case of distributions of other types of assets by a partnership."[34]

c. Section 961(c) Ownership Units

Finally, partnership interests owned by CFCs are not addressed by the Proposed Regulations, generally are not included in the definition of "**section 961(c) ownership units**," and are not addressed in the related rules that operate to adjust the basis of certain property owned by CFCs.

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[32] Prop. Treas. Reg. § 1.961-4(c)(2)(i).

[33] The rule is similar to a rule that was proposed in 1998, but not finalized, that would have permitted a partner's excess negative section 743(b) adjustment (*i.e.*, recovery of a negative section 743(b) adjustment that exceeded the partner's distributive share of depreciation or amortization deductions) to be applied against common partnership basis rather than result in an immediate income inclusion for the partner. 63 Fed. Reg. 4408 (Jan. 29, 1998).

[34] 89 Fed. Reg. 95362, 95384 (Dec. 2, 2024).

Section 961(c) provides that, under regulations, if a United States shareholder is treated under section 958(a)(2) as owning stock in a CFC that is owned by another CFC, "adjustments similar to the adjustments" provided by sections 961(a) and (b) are to be made to the basis of the lower-tier CFC stock in the hands of the direct upper-tier CFC (and the basis of any other upper-tier CFC stock (other than CFC stock governed by section 961(a)-(b)) by reason of which the United States shareholder is considered under section 958(a)(2) as owning such lower-tier CFC stock). Section 961(c) further provides that the section 961(c) basis adjustment in CFC stock is "only for the purposes of determining the amount included under section 951 in the gross income of such United States shareholder."[35] As noted in our April 2025 Report, 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).

Under the Proposed Regulations, only CFCs are provided "**section 961(c) basis**," which is defined as basis (which may be positive or negative) that is separately established and maintained with respect to each covered shareholder that owns the section 961(c) ownership unit.[36] The limited uses for, and the rules for increasing and decreasing basis with respect to, section 961(c) ownership units were discussed in the April 2025 Report.

In the preamble to the Proposed Regulations, Treasury and the IRS stated they are studying whether the section 961 basis in partnership interests owned by CFCs should be similar to derived basis or section 961(c) basis or have characteristics of both.[37]

3. Proposed Regulations and Section 1248

Where stock of a foreign corporation is owned through a domestic partnership, the Proposed Regulations generally reflect the position of Treasury and the IRS in Treas. Reg. §§ 1.951A-1(e) and 1.958-1(d) to apply section 1248(a) at the partnership level, and not at the partner level as with subpart F and GILTI inclusions.

With respect to derivative ownership units, the Proposed Regulations do not address the effect of derived basis under section 1248, although Treasury and the IRS stated they were

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[35] Section 961(c) also extends to "any other United States shareholder who acquires from any person any portion of the interest of such United States shareholder by reason of which such shareholder was treated as owning such stock, but only to the extent of such portion, and subject to such proof of identity of such interest as the Secretary may prescribe by regulations."

[36] Section 961(c) basis applies only for specified purposes and does not, for example, affect the amount of the CFC's gross income or the amount of its E&P. Prop. Treas. Reg. § 1.961-2(e)(2).

[37] 89 Fed. Reg. 95362, 95377 (Dec. 2, 2024).

studying this and other issues under section 1248 when stock of a foreign corporation is owned through a partnership.[38]

4. Other Partnership Issues

a. Application of *Johnson* to distributions on section 961(a) ownership units

Under the Proposed Regulations, a covered shareholder recognizes gain to the extent a distribution of PTEP exceeds the covered shareholder's adjusted basis in the section 961(a) ownership unit with respect to which the distribution was made.[39] The preamble to the Proposed Regulations explains, that the approach "is consistent with the approach in section 301(c)(3), pursuant to which basis is not shared among shares of stock on distributions. See also *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971)."[40]

As noted, section 961(a) ownership units also include "an interest in a partnership directly owned by a covered shareholder and through which the covered shareholder owns stock of a foreign corporation."[41] In contrast to stock, while a partner can have multiple interests in a partnership, a partner can only have a single adjusted basis in all its partnership interests issued by a partnership.[42]

b. Prop. Treas. Reg. § 1.961-8: Application of positive derived basis to covered shareholders' distributive shares of gain or loss

Prop. Treas. Reg. § 1.961-8 provides rules for applying positive derived basis to "covered shareholders' distributive shares" of gain or loss recognized by a partnership on a sale, exchange, or other disposition of derivative ownership units (*i.e.*, adjusting a covered shareholder's distributive share of gain or loss to reflect the positive derived basis associated with an asset).

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[38] *Id*. at 95384.

[39] Prop. Treas. Reg. § 1.961– 4(b)(2)(iii), (f)(1).

[40] 89 Fed. Reg. 95362, 95379 (Dec. 2, 2024). In our April 2025 Report, we recommended that the Proposed Regulations be revised to follow an approach akin to the 2006 Proposed Regulations and allow for PTEP to be distributed as a return of all adjusted basis arising under section 961(a) before triggering gain under section 961(b).

[41] Prop. Treas. Reg. § 1.961-2.

[42] *See, e.g.*, Rev. Rul. 84-53, 1984-1 C.B. 159 (holding that a partner with both a limited partner and general partner interest has a single adjusted basis in the partnership).

The rules in Prop. Treas. Reg. § 1.961-8 are "generally modeled after the rules in Treas. Reg. § 1.743-1" and intended to replicate the outcome that would occur on a sale, exchange, or other disposition if such basis were an additional amount of common basis taken into account in determining gain or loss allocable to the covered shareholder.[43]

A limitation applies in the case of gain or loss recognized in a "nonrecognition transaction," defined as "any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A."[44] In such a transaction, the positive derived basis taken into account is limited to the excess of the positive derived basis that would be taken into account by the covered shareholder over the covered shareholder's share of the gain realized but not recognized by the transferring partnership with respect to the transferred units.[45] As stated in the preamble to the Proposed Regulations: "In this way, positive derived basis is available for use only to the extent that, if the positive derived basis were additional common basis taken into account in determining gain allocable to the covered shareholder, such derived basis would reduce gain recognized with respect to the transferred units."[46]

c. Prop. Treas. Reg. § 1.961-10: Gain recognition for negative basis

Prop. Treas. Reg. § 1.961-10(a) provides for the recognition of negative derived basis as additional gain in "any transaction involving the derivative ownership unit (for example, a sale, exchange, or distribution under section 301(c)(2))."

Prop. Treas. Reg. § 1.961-10(b)(1) provides that 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 partnership would have recognized in the transaction if, immediately before the transaction, the partnership's common basis of the derivative ownership unit were reduced by all

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[43] 89 Fed. Reg. 95362, 95383 (Dec. 2, 2024).

[44] Prop. Treas. Reg. § 1.961-1(b); section 7701(a)(45).

[45] Prop. Treas. Reg. § 1.961-8(b)(2)(ii). The covered shareholder's share of such realized-but-not-recognized gain is determined by multiplying the amount of that gain of the transferring partnership by a fraction, the numerator of which is the covered shareholder's distributive share of gain recognized by the transferring partnership with respect to the transferred units (determined without regard to derived basis), and the denominator of which is the amount of gain recognized by the transferring partnership with respect to the transferred units (determined without regard to derived basis).

[46] 89 Fed. Reg. 95362, 95384 (Dec. 2, 2024). The rules generally follow the application of section 743(b) adjustments in section 351(b) transactions. *See* Treas. Reg. § 1.743-1(h)(2)(iv).

negative derived basis of the derivative ownership unit."[47] If the derivative ownership unit is not a derivative ownership unit immediately after the transaction, then all negative derived basis of the derivative ownership unit is recognized.[48]

The Proposed Regulations provide that a "pro rata portion" of the gain is allocated to each covered shareholder, determined by multiplying the amount of such gain by a fraction, the numerator of which is the negative derived basis with respect to the covered shareholder of the derivative ownership unit, and the denominator of which is the sum of all negative derived basis of the derivative ownership unit.[49] The gain is treated in the same manner as gain recognized under section 961(b)(2) and Prop. Treas. § 1.961-4(c), except that the gain is recognized concurrently with, but separate from, the transaction.[50]

IV. Recommendations

A. Consider Options to Simplify the Proposed Regulations

In our April 2025 Report, we observed that the Proposed Regulations are complex and require significant record keeping. For those reasons, we recommended that Treasury and the IRS should study options to simplify the PTEP rules in ways not adverse to the government's interests.

The Proposed Regulations with respect to partnerships are similarly complex and require (as discussed below) significant information sharing between covered shareholders who directly own interests in UTPs and the LTPs through which they indirectly own CFC stock. In situations in which the taxpayer (or related parties), do not control or exercise significant influence over the partnership, obtaining and sorting such information may be burdensome or commercially impracticable. The approach of the Proposed Regulations to partnership basis adjustments under

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[47] "Thus, for example, in a sale of the derivative ownership unit, the amount of the gain recognized is generally equal to the sum of all negative derived basis of the derivative ownership unit and, in a nonrecognition transaction, the amount of the gain recognized may be less than the sum of all negative derived basis of the derivative ownership unit." Prop. Treas. Reg. § 1.961-10(b)(1)(i).

[48] Prop. Treas. Reg. § 1.961-10(b)(1)(ii).

[49] Prop. Treas. Reg. § 1.961-10(b)(1)(iii).

[50] Prop. Treas. Reg. § 1.961-10(b)(1)(iv). The preamble explains that the gain is treated as separate from the transaction so that, for example, it does not give rise to basis adjustments under section 358 or 362 in a nonrecognition transaction. 89 Fed. Reg. 95362, 95388 (Dec. 2, 2024). Negative derived basis is concurrently eliminated to the extent it increases the amount of gain recognized. Prop. Treas. Reg. § 1.961-10(b)(1)(v).

section 961 is based on analogous adjustments under section 743(b);[51] however, adjustments under section 743(b) are typically significantly more complex—section 743(b) adjustments potentially affect every asset of the partnership and therefore compel the relevant reporting to be performed by the partnership. By contrast, section 961 adjustments generally affect only a single partnership asset and so the computations could reasonably be performed by covered shareholders (based on information provided to the covered shareholders by the partnership).

Treasury and the IRS's approach appears to be compelled by certain rules in the Proposed Regulations (discussed below) that rely on entity treatment of the intervening partnerships—including rules that effectively convert covered shareholder-specific section 961(a) adjusted basis and derived basis into common basis (then adjusted under section 705(a)(1)(B)) upon distributions by an indirectly held CFC, successor rules that require ongoing tracking of PTEP and accounting for section 961(b) gain following dispositions of CFC stock, and rules for allocating section 961(b) gain at the partnership level with respect to derivative ownership units.

The Proposed Regulations are silent as to whether derived basis, section 961(b) gain or related partnership-level computations would be "partnership-related items" within the meaning of section 6241(2)(B) and Treas. Reg. § 301.6241-1(a)(6)(ii), although it seems they are.[52] The specter of imputed underpayment assessments under section 6225 with respect to miscalculations of these new partnership-level calculations significantly increases the need for clarity regarding any partnership-level calculations.

An aggregate approach to partnerships in this regard would be more intuitive. Reconsideration of these entity-driven rules may allow a simpler regime that ensures covered shareholder compliance based solely on information reporting up the chain of ownership from LTPs to covered shareholders.

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[51] *See* Treas. Reg. § 1.743-1(k). The Proposed Regulations also lack any rule compelling a covered shareholder to provide information to the partnership (or any LTP) through which the covered shareholder owns the CFC stock, to permit the partnership(s) to maintain derived basis. If Treasury and the IRS retain a system that requires partnerships to report calculations based on partner-level inclusions and exclusions (and, in particular, if the resulting calculations are "partnership-related items" within the meaning of section 6241(2)(B), as discussed below), Treasury and the IRS should consider rules requiring that partners provide the partnership such information.

[52] *Compare* Treas. Reg. § 301.6241-1(a)(6)(v)(H) (treating section 743(b) adjustments as partnership-related items). *with* Treas. Reg. § 301.6241-1(a)(6)(iii) ("partner's adjusted basis is not with respect to the partnership because it is an item or amount shown in the partner's books or records that results after application of the Code to partnership-related items taking into account the facts and circumstances specific to that partner.").

If a more simplified approach is not adopted, and Treasury and the IRS adopt rules imposing the additional partner-to-partnership reporting, we recommend that Treasury and the IRS consider exceptions from such reporting for partnerships with *de minimis* U.S. partners.[53]

B. Apply Section 1248 at the Partner Level, not the Partnership Level

1. Background: Background: Section 1248 and the Purpose of the PTEP Exclusion

Section 1248(a) recharacterizes gain recognized with respect to certain foreign corporation's stock as a dividend. In general, if a U.S. person disposed of stock of a CFC (meeting a 10-percent ownership and five-year lookback tests), any gain is recharacterized as a dividend to the extent of the CFC's E&P accumulated while it was a CFC and while the stock was held by that person. Historically, the provision ensured that accumulated but untaxed foreign earnings, which would have been taxed as ordinary dividends if distributed, could not be converted into capital gains in connection with sale of the stock.

Prior to the TCJA, the application of section 1248 was often beneficial to corporate partners, as the rate of tax on dividends was no higher than the rate applied to capital gains, and dividend characterization brought with it the potential for foreign tax credits.[54] After the enactment of section 245A in the TCJA, section 1248 plays a different role for domestic corporate shareholders, who may be eligible for a 100-percent dividends-received deduction. Specifically, section 1248(j) provides, with respect to a domestic corporation that meets a one-year holding period requirement, that amounts treated as a dividend under section 1248(a) are treated as a dividend received for purposes of section 245A.

Under section 1248(d)(1), section 1248(a) does not apply with respect to E&P of the CFC that is attributable to amounts previously included in the gross income of the United States person by reason of subpart F or GILTI inclusions with respect to that stock, provided that those earnings have not been distributed as PTEP under section 959.[55] The exclusion of PTEP from

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[53] Moreover, pending guidance, it would be helpful for Treasury and the IRS to confirm that partnerships maintaining capital accounts under Treas. Reg. § 1.704-1 may rely on Treas. Reg. § 1.704-1(b)(2)(iv)(*q*) to account for PTEP distributions, and that miscalculations resulting from partner-level omissions will fall within the rule in Treas. Reg. § 1.704-1(b)(2)(iv)(*p*).

[54] Section 1248 dividend treatment can also give rise to qualified dividend income under section 1(h)(11) for individual shareholders and cause gain to be characterized as foreign source for foreign tax credit limitation purposes.

[55] By virtue of section 951A(f)(1), which treats GILTI inclusions as subpart F inclusions for specified purposes, section 1248(d)(1) also applies to inclusions under section 951A.

section 1248 recognizes that, given that such income has already been subject to tax and that the basis adjustments provided under section 961(a) effectively shield those earnings from double taxation, there is no reason to further apply section 1248 to such earnings.

Importantly, the PTEP exclusion in section 1248(d)(1) applies only to the person who included the subpart F or GILTI in gross income. As discussed further below, this limitation may pose difficulties in the context of domestic partnerships, that (as discussed above) are treated as United States persons to whom section 1248(a) may apply, but whose partners (and not the partnership itself) include subpart F and GILTI inclusions in gross income under the aggregate approach to partnerships under Treas. Reg. § 1.958-1(d).

2. Section 1248(d)(1) as Applied to a Domestic Partnership

This inconsistent treatment—aggregate treatment for subpart F and GILTI inclusion purposes, but entity treatment for section 1248(a) purposes—results in an incongruity with respect to section 1248(d)(1), the exclusion of PTEP from applicable earnings. A domestic partnership subject to section 1248(a) will include its partners' PTEP in available section 1248(a) E&P, simply because those inclusions were not made by "such person" (*i.e.*, the partnership). Depending on the identity of the partners, this could result in either over-taxation or nontaxation.

For example, where a partner of the domestic partnership is an individual, the inclusion of his or her PTEP in the partnership's applicable section 1248(a) earnings will generally convert capital gain to ordinary dividend income, which may not be eligible for qualified dividend treatment under section 1(h)(11). Specifically, any appreciation attributable to the partners' PTEP should be shielded from taxation via the derived basis rules. Thus, section 1248(a) would apply to any additional appreciation in the CFC shares that often would have otherwise qualified for capital gain treatment. Thereby, individuals are overtaxed when domestic partnerships do not apply section 1248(d)(1).

On the other hand, where the domestic partnership's partners are domestic corporations, the non-application of section 1248(d)(1) to the partners' PTEP results in a windfall to those partners. First, those partners would already exclude gain attributable to their PTEP by virtue of their derived basis under the Proposed Regulations. Furthermore, any additional appreciation that is recharacterized as a dividend under section 1248(a) at the partnership level may be eligible for the 100-percent dividends-received deduction under section 245A(a) when allocated to the partner. Thus, for every dollar of subpart F or GILTI inclusion by a partner that is a domestic corporation, there could potentially be two dollars of future exclusions (*i.e.*, derived basis under the Proposed Regulations and the section 245A dividends-received deduction).

Addressing these issues under section 1248 is even more urgent after the enactment of the law commonly known as the One Big Beautiful Bill Act (the "**OBBBA**"), which amended the pro rata share rule under section 951(a) for taxable years of foreign corporations beginning after December 31, 2025.[56] The OBBBA amendments under section 951(a) will necessitate amendments to the regulations under section 1248, providing Treasury and the IRS another opportunity to revisit these issues.

3. Potential Solutions

This Report suggests three potential solutions to the problem identified above in descending order of preference. First, as recommended in our September 2019 Report, domestic partnerships could be treated as aggregates of their partners for purposes of applying section 1248 in the same manner as foreign partnerships. Second, partners could be allowed to adjust their distributive share of a section 1248(a) amount recognized by a partnership to take into account each partner's specific tax attributes, such as PTEP and derived basis. Third, the partnership could apply section 1248(d)(1) by reference to its partner's PTEP. Each of these proposals is described in more detail below.

Our primary recommendation remains to treat domestic partnerships in the same manner as foreign partnerships for purposes of section 1248.[57] Thereby, a partnership would merely allocate an amount of gain to a partner upon the disposition of a CFC, and the partners would subsequently apply section 1248 to recharacterize this gain. This approach has applied historically with respect to foreign partnerships and is relatively straightforward and uncontroversial.

We observe that Treasury and the IRS have (and have used) regulatory authority to treat "domestic" partnerships as foreign partnerships in appropriate circumstances.[58] We also acknowledge that section 751(a), which can recharacterize the amount realized upon the disposition of a partnership interest as arising from the sale or exchange of property other than a capital asset, can apply where a partnership owns "stock in certain foreign corporations (as described in section 1248) … but only to the extent of the amount which would be treated as gain to which section [1248(a)] would apply if (at the time of the transaction described in this section

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[56] An Act to provide for reconciliation pursuant to title II of H. Con. Res. 14, Pub. L. No. 119-21, § 70352 (2025).

[57] *See supra* note 12 and accompanying text.

[58] *See generally* Treas. Reg. § 1.958-1(d); *see also* section 7701(a)(4) ("The term 'domestic' when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations."). In our January 2007 Report, we noted that this grant may have limitations.

or section 731 , 732, or 741, as the case may be) such property had been sold by the partnership at its fair market value."[59] Section 751(a) gain arising by reason of the partnership owning CFC stock is not specifically treated as a dividend under the language of section 751(a) or the Treasury Regulations, and therefore (as observed in our September 2019 Report) commentators do not believe a partner (whether or not a U.S. shareholder) with such section 751(a) gain is treated as receiving a dividend for other purposes of the Code.[60]

Therefore, one inference to be drawn from section 751(a) is that section 1248 does not by itself invoke aggregate treatment upon the sale of a partnership interest; otherwise, that portion of section 751(a) would be superfluous. Treasury and the IRS previously addressed this issue in their 2007 regulations regarding the application of section 1248 to stock held by foreign partnerships, indicating a view that sections 1248(g)(2)(B) and 751(a) effectively pre-empted aggregate treatment under section 1248 with respect to the disposition of foreign partnership interests.[61] As we summarized in our September 2019 Report, the results of this interpretation are peculiar and create inconsistent tax outcomes for different forms of economically indistinguishable transactions. Other reasonable interpretations of section 751(a) could lead to more rational results while leaving room for the application of section 751(a)—for example, the domestic partnership owning stock of a foreign corporation could be treated as a foreign partnership (under the same authority relied on to promulgate Treas. Reg. § 1.958-1(d)) for purposes of section 751(a) except to the extent a disposition by the partner of the underlying CFC stock would have been subject to section 1248(a) at the partner level.

As an alternative to the primary recommendation above, regulations could apply section 1248(a) at the domestic partnership level but require any partners to whom such section 1248(a) amount is allocated to adjust the application of section 1248(a) in their hands. For example, a partner to whom a section 1248(a) amount was allocated might be required to convert that section 1248 amount back into capital gain to the extent that the partners' PTEP with respect to

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[59] Section 751(c).

[60] In our September 2019 Report, we assumed the correctness of this interpretation for purposes of our discussion and recommendations. *See also* F. Scott Farmer, Gary R. Huffman, Monte A. Jackel & Brooke E. Hintmann, *Partnership Dispositions of Stock in Controlled Foreign Corporations*, 110 TAX NOTES 1319, at 1335-1336 (Mar. 20, 2006).

[61] T.D. 9345, 72 Fed. Reg. 41442, 41443 (July 30, 2007) ("A commentator noted that § 1.1248-1(a)(4) of the proposed regulations could be read to apply to the sale by a partner of its interest in a partnership holding the stock of a corporation. The Treasury Department and the IRS did not intend that interpretation because it would be contrary to section 1248(g)(2)(B). … Accordingly, § 1.1248-1(a)(4) in the final regulations is revised to clarify that a foreign partnership is treated as an aggregate for this purpose only when a foreign partnership sells or exchanges stock of a corporation.").

the CFC resulted in a section 1248 inclusion at the partnership level. This approach is loosely analogous to the approach taken in Rev. Rul. 69-124, in which section 1248(a) applied at the domestic partnership level but domestic partners were able to adjust the application of section 1248(a) to them (as a distributive share) as if they had directly engaged in the transaction.[62]

In determining how much of a section 1248(a) dividend should be recharacterized as gain in the partner's hands, we would recommend a "with and without" approach, such that section 1248(a) amounts are only recharacterized as gain in the partner's hands to the extent that that partner's PTEP directly resulted in the application of section 1248(a) to the partnership. In the case, in circumstances in which a CFC has untaxed E&P in excess of the gain in its shares held by a domestic partnership, no capital gain conversion of the section 1248(a) dividend would occur at the partner level.

Finally, section 1248(d)(1) could be applied at the domestic partnership level by accounting for its partners' PTEP. Although this approach would ameliorate the over- and non-taxation problems under section 1248(d)(1), we believe it may be difficult to administer from an information reporting perspective, as it would represent another partner item that would need to be reported to a partnership. This type of partner-to-partnership information reporting has already posed difficulty under current law, particularly with respect to the preparation of Schedules K-2 and K-3 (which may need to be prepared before a covered shareholder prepares its PTEP account information), and therefore is not our preferred approach. As discussed below, this type of partner-to-partnership information reporting is also a feature of other rules in the Proposed Regulations that we would recommend revising for similar reasons.

C. Provide Section 961(c)-Like Basis for Partnership Interests Held by CFCs

The Proposed Regulations set forth a complex scheme (discussed in more detail below) for adjusting basis in partnership interests for subpart F inclusions and PTEP distributions where the partnership interest is held directly by the covered shareholder (section 961(a) ownership interests) and where the partnership interest is held by a UTP that is itself ultimately owned directly (or via tiers of partnerships) by a covered shareholder.

The Proposed Regulations do not address adjustments to the basis of partnership interests held by CFCs, notwithstanding that such structures present the same "double inclusion" issues as

[62] In the preamble to the final regulations adopting Treas. Reg. § 1.958-1(d), Treasury and the IRS expressed some support for extending the approach in Rev. Rul. 69-124. T.D. 9960, 87 Fed. Reg. 3648, 3650 (Jan. 25, 2022) ("Future guidance, including the proposed PTEP regulations, may address the application of section 1248(b)(1)(A) and (d)(1) to transactions involving a domestic partnership's sale of a CFC, such as the transaction described in Rev. Rul. 69 -124, 1969-1 C.B. 203.").

can arise with respect to CFC stock held in tiered partnership structures and for which the Proposed Regulations' derived basis rules were developed. In the preamble to the Proposed Regulations, Treasury and the IRS stated they are studying whether the section 961 basis in partnership interests owned by CFCs should be similar to derived basis or section 961(c) basis or have characteristics of both.[63]

We recommend that CFCs be provided section 961 basis in partnership interests in a manner that generally parallels section 961(c) basis provided in lower-tier CFC stock. First, failure to provide any such basis adjustments in partnership interests held by CFCs could result in double inclusion of income to covered shareholders in a variety of circumstances. Second, we believe that, to be consistent with aggregate principles that should guide outcomes under the Proposed Regulations, the interposition of a partnership between an upper-tier CFC and a lower-tier CFC generally should not result in a materially different outcome than if the partnership were not so interposed. Introducing features to section 961 basis in partnership interests held by CFCs that would not be present in the basis of the stock of the underlying CFCs if held directly by an upper-tier CFC would likely create traps for the unwary or unintended tax planning opportunities.

By its terms, section 961(c) basis applies only for the purposes set forth in section 961(c) (determining amounts included in gross income of covered shareholders, and not for computing the CFC's gross income or earnings and profits), while the Proposed Regulations treat adjustments to derived basis as, in effect, convertible to section 705 basis (upon any PTEP distribution by the relevant CFC) and treat any gain recognized with respect to derived basis as a partnership item for purposes of section 705 (but not section 703 or 704), in each case at each tier in a tiered partnership structure.[64] Consistent with our recommendation in our April 2025 Report, we recommend that section 961 basis with respect to partnership interests owned by CFCs be taken into account only at the covered shareholder level (and not at the partnership or CFC level).[65]

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[63] 89 Fed. Reg. 95362, 95377 (Dec. 2, 2024).

[64] Prop. Treas. Reg. § 1.961-4(e)(2), (f)(2).

[65] This is consistent with our April 2025 Report, in which we recommended that section 961(c) basis also only be taken into account at the covered shareholder level (for purposes of computing subpart F inclusions) and not at the CFC level.

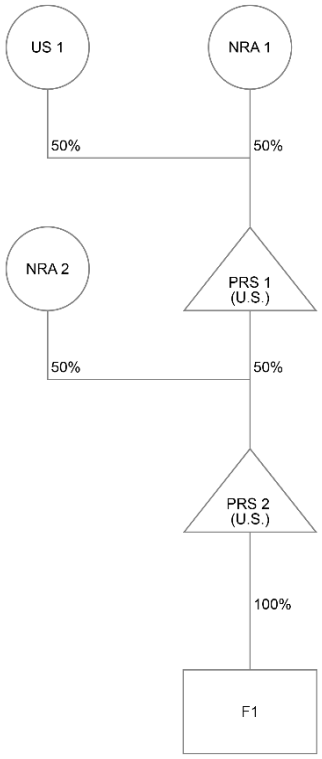
D. Clarify the Partnership Basis Adjustment Rules for Section 961(a) and Derivative Ownership Interests

The rules of Prop. Treas. Reg. § 1.961-3 and -4 govern adjustments to outside basis in partnership interests held directly by covered shareholders (section 961(a) ownership units) and partnership interests held in tiered partnership structures (derivative ownership units) with respect to subpart F and GILTI inclusions and PTEP distributions, but these rules do not comprehensively address the basis consequences of the transactions at issue and do not provide adequate coordination with the rules under sections 705 and 733. The issues are best illustrated using a relatively simple tiered partnership example.

Example[66]

> US1, a United States individual, and NRA1, a nonresident alien individual, own all the interests in PRS1, a domestic partnership. PRS1 and NRA2, a nonresident alien individual, own all the interests in PRS2, a domestic partnership. PRS2 owns all the shares of the single class of outstanding stock of F1, a foreign corporation. US1 and NRA1 are equal partners, as are PRS1 and NRA2.

[66] The example is derived from the facts of Prop. Treas. Reg. 1.961-12(c)(4)(iv). For ease of explanation, the example introduces a few additional facts (not included in Prop. Treas. Reg. § 1.961-12).



PRS2's common basis (before taking into account derived basis) in the shares of F1 is $0. In Year 1, F1 recognizes $100 of subpart F income, giving rise to $100 of E&P and a $25 subpart F inclusion with respect to US1 in Year 1. In Year 2, F1 distributes the $100 to PRS2. In Year 3, PRS2 distributes $50 to PRS 1. In Year 4, PRS1 distributes $25 to US1.

In Year 1, under Prop. Treas. Reg. § 1.961-3(b)-(c) (applying the hypothetical distribution in Prop. Treas. Reg. § 1.961-4(e)), the $100 of subpart F income gives rise to $25 of derived basis (with respect to US1) for PRS2 in its F1 stock, $25 of derived basis for PRS1 in its PRS2 interest, and $25 of adjusted basis for US1 in its PRS1 interest, all on the first day of Year 1.[67]

Under the Proposed Regulations, it is not entirely clear how section 961(b)(1) applies to the Year 2-4 distributions (from F1 to PRS, then from PRS2 to PRS 1, and, finally, from PRS1 to

[67] Prop. Treas. Reg. § 1.961-3(e)(1).

US1).[68] The discussion below uses the following labels to discuss the two different approaches that could be adopted under the Proposed Regulations.

1. "**Section 959 Model**": The Proposed Regulations could follow the fiction of the Proposed Regulations under section 959 and treat a distribution from F1 to PRS2 as being distributed onward through PRS2 to PRS1, and PRS1 to US1 for purposes of section 961(b)(1), resulting in (A) reductions in Year 2 to all relevant derived basis (*i.e.*, PRS2's derived basis in F1, and PRS1's derived basis in PRS2) and adjusted basis (US1's adjusted basis in PRS1) with respect to US1 and (B) tax-exempt income under section 705(a)(1)(B) at PRS2 and PRS1 for purposes of increasing the adjusted basis under section 705 in the interest in PRS2 held by PRS1 and the interest in PRS1 held by US1. In effect, upon a distribution by F1 to PRS2, a portion of the derived basis through every partnership tier would convert to adjusted basis under section 705, and subsequent actual distributions from PRS2 to PRS1, and PRS1 to US1, would result in basis adjustments through the operative rules of subchapter K (*i.e.*, sections 705 and 733).

2. "**Section 301(c) Model**": Alternatively, the Proposed Regulations could adjust section 961(b)(1) to track actual distributions in a manner similar to section 301(c) and reduce derived basis and adjusted basis only upon an actual distribution with the respect to the derivative ownership units or section 961(a) ownership units on which the distribution is made. This would follow the approach taken for purposes of adjusting basis for section 961(c) basis.[69]

Regardless of which approach Treasury and the IRS take in the final regulations, the example in Prop. Treas. Reg. 1.961-12(c)(4)(iv) should be expanded in a manner similar to the additional facts above to make clear exactly how the operative rules work in tiered partnership structures.

It seems the Proposed Regulations intended to adopt the Section 959 Model for purposes of applying section 961(b)(1) with respect to section 961(a) ownership interests and derivative ownership interests that are partnership interests, although the language of the Proposed Regulations is not fully supportive of that reading (for the reasons discussed below), and the potential corollary conclusions are not addressed. The following discussion explains the uncertain application of the Proposed Regulations to the above example.

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[68] *See also* Monte A. Jackel, *A Not-So-Peaceful Coexistence: Partnerships and Proposed PTEP Regs*, TAX NOTES (Jan. 13, 2025).

[69] *See* Prop. Treas. Reg. §§ 1.959-4(b)(2), 1.961-9.

Reducing PRS2's Derived Basis in F1

In Year 2, the distribution of $100 from F1 to PRS2 should reduce PRS2's derived basis (with respect to US1) in its F1 stock by $25 under Prop. Treas. Reg. § 1.961-4(c)(2). This would also be the case under either the Section 959 Model or the Section 301(c) Model. However, the result under the language of the Proposed Regulations is not clear.[70]

The preamble seems to endorse the Section 959 Model: "If, through a partnership or tiered partnerships, one or more covered shareholder partners are *treated as receiving PTEP that is excluded from gross income under section 959(a) and the proposed section 959 regulations*, then each such partnership's derived basis with respect to such covered shareholders of derivative ownership units is reduced to reflect the PTEP received with respect to the derivative ownership units."[71] However, the operative rule does not contain this language: it refers to amounts "receive[d]"—not amounts "treated as received"—through a partnership.[72] Under Prop. Treas. Reg. § 1.959-4(c)(3), the distribution from F1 to PRS2 is "treated as made" up the chain of partnerships (*i.e.*, by PRS2 to PRS1, and from PRS1 to US1) for purposes of section 959, but no rule treats those deemed distributions as made to US1 for purposes of section 961. Prop. Treas. Reg. § 1.961-4 explicitly cross-references Prop. Treas. Reg. § 1.959-4 for purposes of establishing the applicability of section 961 and determining the amount of the basis reduction, but not for purposes of deeming US1 to receive a distribution actually only received by PRS2. If the fiction of a deemed distribution under Prop. Treas. Reg. § 1.959-4 is intended to apply under Prop. Treas. Reg. § 1.961-4(c), this should be made clear.

On the other hand, the language of Prop. Treas. Reg. § 1.961-4(c) and the timing rules of Prop. Treas. Reg. § 1.961-4(e) seem to adopt the Section 301(c) Model. First, the operative language of Prop. Treas. Reg. § 1.961-4(c) governing adjustments to derived basis mirrors the

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[70] The operative rule triggering the adjustment to derived basis (Prop. Treas. Reg. § 1.961-4(c)(1)) states that it applies "[i]f, through a partnership, one or more covered shareholders *receive* [PTEP] that [is] excluded from the covered shareholders' gross income under section 959(a) and [Prop. Treas. Reg.] § 1.959-4." (Emphasis added.) PRS2 is not a covered shareholder, and in Year 2 US1 has not actually received the $25—the $25 remains at PRS2 at the end of Year 2. The rule in Prop. Reg. § 1.959-4(c)(3), which treats US1 as actually "receiving" a dividend in the amount of its distributive share of income reflecting that dividend for purposes of section 959, does not by its terms apply under section 961.

[71] Emphasis added. 89 Fed. Reg. 95362, 95380 (Dec. 2, 2024).

[72] Example 3(iii) in Prop. Treas. Reg. § 1.961-12 applies the rule as though a distribution received by a partnership were "treated as received" by its partners who are covered shareholders for purposes of section 961.

language of Prop. Treas. Reg. § 1.961-4(d) governing adjustments to section 961(c) basis,[73] and the rules of Prop. Treas. Reg. § 1.961-4(d) explicitly follow the Section 301(c) Model.[74] Second, Prop. Treas. Reg. § 1.961-10(c)(3) allocates section 961(b)(2) gain from the recognition of negative derived basis with respect to a partnership interest among covered shareholders separately at each partnership level in a tiered partnership structure, causing further consequences to the adjustments to derived basis (and the timing of such adjustments) resulting from partnership distributions at each partnership tier.[75]

If the Proposed Regulations intend to deem a distribution under Prop. Treas. Reg. 1.959-4(c)(3) to occur for purposes of the basis adjustments under Prop. Treas. Reg. § 1.961-4(c) (*i.e.*, follow the Section 959 Model), the Proposed Regulations should clarify that intention. If the intent is for such deemed distributions to occur for only limited purposes (*e.g.*, to convert derived basis to common basis, as discussed below), the limited scope of the deemed distributions under subchapter K should be clarified, *e.g.*, that such deemed distributions are not taken into account in computing the partners' capital accounts or treated as distributions for purposes of, *e.g.*, sections 704(c), 707, 737 or 751. As discussed below, certain provisions of Prop. Treas. Reg. § 1.961-10 would also need to be conformed.

Reducing PRS1's Derived Basis in PRS2

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[73] Prop. Treas. Reg. § 1.961-4(c)(1) and (2)(i) are triggered by and determined by reference to a covered shareholder "receiv[ing]" a distribution that is excluded from the covered shareholder's income, while Prop. Treas. Reg. § 1.961-4(d)(1) and (2)(i) are triggered by and determined reference to a CFC "receiv[ing]" a distribution that is excluded from the CFC's income, in each case under section 959 and Prop. Treas. Reg. § 1.959-4. Prop. Treas. Reg. § 1.959-4(c)(3), which deems a covered distribution to be made through tiers of partnerships, applies by its terms only for purposes of section 959 (and no rule deems such distributions to occur for purposes of section 961).

[74] *See supra* note 69. Prop. Treas. Reg. § 1.961-4(e) includes two timing rules—one for adjustments to adjusted basis, derived basis, and section 961(c) basis in CFC stock, and another for adjustments to adjusted basis and derived basis in partnership interests. That the timing rules differentiate on the basis of (and therefore reflect the existence of) the distributing entity tentatively implies that section 961(b)(1) applies only upon each separate actual distribution by each entity. Prop. Treas. Reg. § 1.961-4(e)(1). However, the timing rule for distributions by a CFC, which provides that the reduction to derived basis in a CFC "occurs concurrently with the distribution giving rise to the basis reduction," seems to require the Section 959 Model to operate properly. Otherwise, the reduction in the stock of F1 may not be triggered until Year 4, when US1 actually received a relevant distribution. Presumably "the distribution giving rise to the basis reduction" in this rule means "the distribution with respect to which the basis reduction was determined under Prop. Treas. Reg. § 1.961-4(b)(2)(i), (c)(2)(i), or (d)(2)(i), as applicable."

[75] In this regard, the allocation compelled under Prop. Treas. Reg. § 1.961-10(b)(3) (proportionate allocation) seems to conflict with the allocation compelled by Prop. Treas. Reg. § 1.961-4(f)(2) (separate allocation to the covered shareholder) compelled by Prop. Treas. Reg. § 1.961-10(c)(4). The rule at Prop. Treas. Reg. § 1.961-10(b)(3) seems especially unfortunate because it places the entire onus of tracking derived basis on LTPs; however, as noted below, under Prop. Treas. Reg. § 1.961-8, LTPs may face challenges collecting the information from UTPs necessary to compute this derived basis.

The consequences of following the Section 959 Model or the Section 301 Model become more significant when considering the adjustments and timing impact on PRS1's derived basis in its PRS2 partnership interest.

Under the Section 959 Model, the reduction in PRS2's basis in F1 results from a distribution treated as made from F1 to PRS2, and then from PRS2 to PRS1, implying that the reduction to PRS2's derived basis in F1 should result in a mirrored reduction to PRS1's derived basis in PRS2. However, the tiered partnership rule in Prop. Treas. Reg. § 1.961-4(c)(1) does not clearly adopt the Section 959 Model: "In the case of tiered partnerships, each tiered partnership's derived basis of derivative ownership units is adjusted as described in [Prop. Treas. Reg. § 1.961-4(c)(2)], starting with the partnership at the lowest tier." This could be read to mean that the reductions to PRS1's derived basis in PRS2 should tier up and apply in Year 2 at the same time that PRS2's derived basis in F1 is reduced (*i.e.*, the Section 959 Model). However, again, Prop. Treas. Reg. § 1.961-4(c)(2)(i) applies by reference to amounts "received" with respect to a derivative ownership unit. PRS1 does not "receive" a distribution from PRS2 in Year 2 (nor does US1 receive a distribution from PRS1) and the rule cannot be easily read to imply that a distribution received by the lowest-tier partnership (PRS2) is deemed made onward up the chain of partnerships to the covered shareholder (US1).[76]

Section 705 provides rules adjusting a partner's outside basis in respect of items of income, gain, loss, and deduction at the partnership level and for distributions by the partnership (by reference to section 733). As applied to the above example, Prop. Treas. Reg. § 1.961-4(e)(2) appears to provide that PRS1's derived basis in PRS2 is reduced (by $25) upon PRS2's receipt of the $100 distribution from F1—if one assumes the $25 received by PRS2 and excluded from its gross income under section 959 is treated as tax-exempt income for which PRS1 receives a basis adjustment under section 705(a)(1)(B).[77] In that case, Prop. Treas. Reg. § 1.961-4(c) effectively converts a portion of PRS1's derived basis in PRS2 into section 705 basis upon a distribution from F1 to PRS1. The preamble confirms this result: "A basis increase under section 705 for the distribution occurs at the same time as the reduction to derived basis, with the result that, in

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[76] *See supra* notes 74 and 75. Moreover, the timing rule for basis reductions with respect to partnerships seems to imply the Section 301(c) Model: "A reduction to basis of an interest in a partnership under [Prop. Treas. Reg. § 1.961-4(b) or (c)] is treated as made concurrently with the adjustment under section 705 to such interest in the partnership by reason of the distribution giving rise to the basis reduction." Prop. Treas. Reg. § 1.961-4(e)(2).

[77] The unfortunate circularity of this sentence may confuse the reader trying to parse the "distribution" triggering the reduction. The rule would be clearer if it referred to a reduction in the "derived basis" of an interest in the partnership, and the adjustment under section 705 being to the "adjusted basis" of such interest by reason of the "item of income resulting from" the distribution giving rise to "such derived" basis reduction. However, some circularity remains because the application of section 705(a) in this reading itself depends in the first instance on the application of section 961.

tiered partnership structures, derived basis of an upper-tier partnership in a lower-tier partnership interest is reduced and common basis in the lower-tier partnership interest is increased (the common basis, in turn, may be decreased in a distribution to the upper-tier partnership by the lower-tier partnership of the amounts that constituted the PTEP, for example)."[78] The Proposed Regulations should make clear that a distribution from F1 to PRS1 that is excluded from income of a partnership by reason of section 959 (or which triggers a reduction in the derived basis of partners in the partnership under section 961(b)(1)) is treated as tax-exempt income of the UTP for purposes of section 705(a)(1)(B).[79]

However, this language necessarily means that section 705 is applied separately at each partnership in a tiered partnership structure, which is consistent with a Section 301(c) Model, *i.e.*, that derived basis adjustments in tiered partnerships occur only as distributions are made up through—and trigger application of section 705—at each of the tiers (and not all at once by way of an immediate deemed distribution through all the tiers upon receipt of a distribution at the lowest-tier partnership, *e.g.*, the receipt of a distribution by PRS2 from F1).[80]

Reducing US1's Adjusted Basis in PRS1

As with PRS1's derived basis in PRS2, under the Section 959 Model, the reduction in PRS2's basis in F1 results from a distribution treated as made from F1 to PRS2, then from PRS2 to PRS1, and then from PRS1 to US1, implying that the reduction to PRS2's derived basis in F1 should result in a mirrored reduction to PRS1's derived basis in PRS2 and US1's basis in PRS1. However, as discussed above, the operative rule in the Proposed Regulations provides that a reduction to adjusted and derived basis requires US1 "receive" a covered distribution, and no rule in the Proposed Regulations deems US1 to "receive" the distribution received by PRS2 for purposes of section 961(b). Also, as with PRS1's derived basis in PRS2, the timing rule of Treas. Reg. § 1.961-4(e)(2) gives separate significance to the timing of the application of section 705(a)(1)(B) at each partnership, which implies application of a Section 301(c) Model.

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[78] 89 Fed. Reg. 95362, 95380 (Dec. 2, 2024).

[79] In the Proposed Regulations, section 705 basis arises explicitly only upon the recognition of gain at the partnership level under section 961(b)(2). Prop. Treas. Reg. § 1.961-4(f)(2).

[80] If the derived basis in PRS1's interest in PRS2 is immediately reduced upon PRS's receipt of a covered distribution from F1, it is not clear what "adjust[ment]" is contemplated by the last sentence of Prop. Treas. Reg. § 1.961-4(c)(2)(i) (describing bottom-up adjustments in tiered partnerships).

Recommendations

The express language of the preamble and certain mechanics in the Proposed Regulations seems to indicate that Prop. Treas. Reg. § 1.961-4(b)-(c) intends to follow the Section 959 Model and deem distributions to occur through tiers of partnerships for purposes of section 961(b). However, the operative language of the Proposed Regulations is not clear, and certain collateral consequences are left unaddressed. We recommend the Proposed Regulations clarify that the rules follow the Section 959 Model (in particular, with an example demonstrating the consequences under section 705 of the resulting deemed distribution).

E. Extend the Rules of Treas. Reg. § 1.743-1 to Distributions Relating to Derived Basis

As noted, the Proposed Regulations do not address the interaction of derived basis with the rules of sections 731, 732 and 734, including "whether derived basis with respect to a covered shareholder should be taken into account in the case of a distribution by a partnership of a derivative ownership unit to the covered shareholder or to another partner and whether derived basis should be taken into account in the case of distributions of other types of assets by a partnership."[81]

There are two principles that could inform the approach to distributions of property by partnerships—the principles of the section 743(b) regulations and the principles of the general successor transactions rules elsewhere in the Proposed Regulations.

First, the failure to provide derived basis with all the attributes of section 743(b) adjustments can adversely impact taxpayers holding CFC stock through partnerships in a manner inconsistent with subchapter K, which could create traps for the unwary. For example, under the Proposed Regulations, the presence of derived basis is taken into account in when making section 743(b) adjustments, meaning that positive derived basis can effectively displace section 743(b) basis adjustments.[82] Taxpayers should not get a worse result for having succeeded to derived basis than getting section 743(b) basis. Therefore, the regulations could adopt rules for adjusting derived basis upon partnership distributions that follow the principles of the section 743(b) regulations.[83] This approach is intuitive and administrable (even in the absence of more

[81] 89 Fed. Reg. 95362, 95384 (Dec. 2, 2024).

[82] Prop. Treas. Reg. § 1.961-5(d).

[83] *See generally* Treas. Reg. §§ 1.732-2(b); 1.743-1(g)(2)(ii); 1.734-2(b).

specific rules) and has the benefit of providing taxpayers and advisors a well-established set of principles upon which to analyze issues with respect to derived basis in partnership interests.

Second, distributions of property by partnerships are in certain circumstances economically identical to transactions between the partners themselves, which in certain circumstances would be treated as general successor transactions.[84] Nevertheless, the general succession transaction rules of Prop. Treas. Reg. § 1.959-7(b) exclude "a liquidating distribution in redemption of a partnership interest" or "a transfer of stock of a foreign corporation, or any property through which stock of a foreign corporation is owned, if such stock or property is substituted basis property."[85] There is no explanation for this exclusion in the preamble, but presumably these transactions are not treated as general successor transactions because derived basis and PTEP would transfer by operation of the rules that give rise to the transferred basis or exchanged basis, as applicable; in any case, we recommend Treasury and the IRS confirm this conclusion.

Consistent with the policy of sections 959 and 961, we recommend that the final regulations operate to keep the PTEP and derived basis with the covered shareholder that had the subpart F or GILTI inclusion that gave rise to the PTEP or derived basis. Therefore, we recommend that the regulations under section 743(b) (and the corresponding regulations under section 732 and 734(b)) serve as a starting point for developing such rules, as these rules contemplate the mechanics of subchapter K's substitute basis transactions and generally operate, in the event of property distributions by a partnership, to keep a section 743(b) adjustment with the partner to whom the section 743(b) adjustment arose to the greatest extent possible. However, section 743(b) is not a perfect analog because derived basis ultimately is traceable to a single item of property (*i.e.*, the CFC stock with respect to which a subpart F or GILTI inclusion arose), and mechanical application of section 743(b) principles could result in the movement of derived basis between a covered shareholder's derivative ownership units or between derivative ownership units owned (indirectly) by different covered shareholders in a manner that implicates the basis "sharing" that the Proposed Regulations elsewhere prohibit. As in our April 2025 Report, we observe that the overarching policy of section 959 and 961—avoidance of double taxation—should take precedence over concerns about such basis sharing. We note that Treasury and the IRS have expressed concern with basis shifting in the Proposed Regulations, and we support efforts to police abuse. However, we believe such abuse is better policed on a case-by-

[84] Transactions that are tantamount to taxable exchanges (*e.g.*, under section 704(c)(1)(B), 737 or 707) should be governed by the general successor transaction rules of Prop. Treas. Reg. § 1.961-5(c).

[85] "Substituted basis property" is defined in Prop. Treas. Reg. § 1.959-1 by reference to section 7701(a)(42).

case basis rather than by withholding generally applicable guidance needed principally by taxpayers and advisors in ordinary-course non-abusive situations.

We also recommend that partnership distributions should be treated under the section 959 and 961 regulations as transactions between partners only in circumstances in which subchapter K treats the transaction in such a manner or in which the outcome is otherwise directly inconsistent with another general successor transaction rule.[86] Given the complexity of these rules, we also recommend that Treasury and the IRS first promulgate any such rules in proposed form so that taxpayers have an opportunity to provide comments before they are finalized.

F. Clarify the Negative Basis Limitation on Derived Basis

As discussed above, derived basis is decreased (starting with the lowest-tier partnership in a tiered partnership structure) by the dollar basis of the PTEP (and associated foreign income taxes) that were "received" with respect to the derived ownership unit, but not below zero.[87] If the adjustment exceeds such positive derived basis, the reduction is next applied to reduce the covered shareholder's section 743(b) basis adjustment (not below zero) and any further excess creates a negative derived basis account with respect to the covered shareholder, subject to a cap.

Under the cap, negative derived basis is limited to the common basis of the derivative ownership unit "available with respect to the covered shareholder" (reduced by any negative section 743(b) basis adjustment that the covered shareholder has with respect to the derivative ownership unit). For this purpose, the common basis that is "available with respect to the covered shareholder" is generally determined based on a fraction that allocates the common basis proportionately (based on the amount of the applicable distributions) among partners receiving PTEP distributions that cause their derived basis to be negative. As explained in the preamble: "[A]lthough a partnership's common basis or a CFC's adjusted basis is available with respect to all covered shareholders in determining the amount by which derived basis or section 961(c) basis can be negative, a covered shareholder will generally be required to include in gross income any gain attributable to negative basis with respect to the covered shareholder."[88] This is a simple and administrable rule, and we applaud Treasury and the IRS for not imposing a more complex or burdensome regime on taxpayers.

However, a few aspects of the negative basis regime would benefit from clarification:

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[86] *See supra* note 84.

[87] Prop. Treas. Reg. § 1.961-4(c)(2)(i).

[88] 89 Fed. Reg. 95362, 95381 (Dec. 2, 2024).

- In the case of built-in loss property, section 704(c)(1)(C) generally requires allocation of items of built-in loss to the contributing partner and treats the other partners as though the property had a fair market value basis at the time of the contribution. It is not clear how Prop. Treas. Reg. § 1.961-4(c)(3) accords with section 704(c)(1)(C); presumably common basis available to non-contributing partners does not include section 704(c)(1)(C) basis.

- The Proposed Regulations should clarify the scope of events requiring recognition of negative derived basis under Prop. Treas. Reg. § 1.961-10(b)(2). In particular, Prop. Treas. Reg. § 1.961-10(b)(2) should be limited to events otherwise resulting in recognition of gain absent the application of Prop. Treas. Reg. § 1.961-10[89] and, in particular, should provide that subsequent reductions of common basis that were taken into account under Prop. Treas. Reg. § 1.961-4(c)(3) (*e.g.*, if the derivative ownership interest is a partnership interest, as a result of an allocation of deduction or loss) are disregarded under section 961.

- Unlike negative derived basis with respect to common basis (which is applied notionally and does not actually reduce common basis for any other purpose), Prop. Treas. Reg. § 1.961-4(c) actually reduces a partner's section 743(b) adjustments for excess negative adjustments to derived basis.[90] We believe section 743(b) adjustments should be treated in the same manner as common basis for this purpose and that negative derived basis should only notionally affect actual section 743(b) adjustments, *i.e.*, should only be taken into account upon a disposition. Actual reductions to section 743(b) adjustments could accelerate other items income to a partner before disposition of a partnership interest—for example, if the section 743(b) adjustment arises in a tiered partnership structure and tiers down (under Rev. Rul. 87-115) to depreciable partnership assets with respect to which a partnership has adopted the remedial allocation method under section 704(c), an actual reduction to a section 743(b) adjustment could expose a partner to allocations of remedial items of income under section 704(c) that might otherwise have been offset by the section 743(b) adjustment.

- Prop. Treas. Reg. §§ 1.961-4(c)(2)(iv) and -2(f)(2) provide that section 961(b)(2) gain of a partnership is allocated solely to the covered shareholder with respect to whom the

[89] The transactions constituting dispositions under Treas. Reg. § 1.1502-19(c) could serve as events triggering negative derived basis recognition, given the similarities between negative derived basis and excess loss accounts.

[90] The preamble states, with respect the negative derived basis mechanics, that "[t]hese rules do not affect the treatment or availability of a partnership's common basis … under any other provision of the Code (and, thus, for example, do not impact the application of section 704(c))." 89 Fed. Reg. 95362, 95381 (Dec. 2, 2024).

derived basis arose (and gives rise to section 705 basis) but also states the allocation "has no effect on any partnership's computation or allocation of any other item under section 703 or 704 or on the covered shareholder's capital account." The result is curious: Presumably this is because the Proposed Regulations assume that the distribution giving rise to the section 961(b)(2) gain is being accounted for separately under sections 703 and 704 (and the partnerships' capital accounts) and reflecting the section 961(b)(2) gain could result in double-counting; if this is correct, however, the same assumption would seem to require accounting for the entire PTEP distribution as section 705(a)(1)(B) tax-exempt income. An example illustrating how these rules operate would be helpful.

G. Clarify Prop. Treas. Reg. § 1.961-2(d)(2) and -4 As Applied to Partnerships

Prop. Treas. Reg. § 1.961-4(b)(2)(iii) provides that, in the event of a PTEP distribution, a covered shareholder recognizes gain to the extent a distribution of PTEP exceeds the covered shareholder's "adjusted basis in the section 961(a) ownership unit" with respect to which the distribution was made.[91] Prop. Treas. Reg. § 1.961-4(c) provides a similar rule for derived basis (after taking into account section 743(b) basis and any applicable negative derived basis limitation). As noted above, the preamble explains that the general approach "is consistent with the approach in section 301(c)(3), pursuant to which basis is not shared among shares of stock on distributions. See also *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971)."[92]

As noted, a "section 961(a) ownership unit" includes a partnership interest directly held by a covered shareholder, and a "derivative ownership unit" is defined to include "an interest in a partnership directly owned by another partnership and through which one or more covered shareholders own stock of a foreign corporation through only partnerships."[93] "Derived basis" is basis of a derivative ownership unit that must be established and maintained "separately with respect to each covered shareholder that owns the derivative ownership."[94]

While not entirely clear, by using the phrase "each derivative ownership unit" Prop. Treas. Reg. § 1.961-4(c) (and Prop. Treas. Reg. § 1.961-4 generally) seems to contemplate a covered shareholder having multiple derivative ownership units with respect to interests in a

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[91] Prop. Treas. Reg. § 1.961-4(f)(1).

[92] 89 Fed. Reg. 95362, 95379 (Dec. 2, 2024). In our April 2025 Report, we recommended that the Proposed Regulations be revised to allow for PTEP to be distributed as a return of all adjusted basis arising under section 961(a) before triggering gain under section 961(b).

[93] Prop. Treas. Reg. § 1.961-2(c), (d)(1).

[94] Prop. Treas. Reg. § 1.961-2(d)(2).

single partnership issuer. If this is correct, the definition of "derived basis" seems to then contemplate the covered shareholder having a separate derived basis with respect to each such derivative ownership unit.[95] In general, while a partner may have multiple interests in a partnership, it is well established that the principle of *Johnson* does not apply with respect to partnership interests and that a partner has only a single adjusted basis in all its partnership interests issued by a partnership.[96] If the Proposed Regulations intend such a significant departure from subchapter K principles, the Proposed Regulations should make that intention clear; we recommend that the rules for derived basis be clarified by dividing the regime into a separate set of rules governing partnership interests and rules governing CFC stock.

H. Clarify Prop. Treas. Reg. § 1.961-8(b)-(d)

As discussed above, if a UTP in which a covered shareholder directly holds an interest disposes of an interest in an LTP in which the UTP has positive derived basis, positive derived basis reduces the covered shareholder's distributive share of gain or loss allocated to it from a UTP.[97]

The Proposed Regulations are less clear about how positive derived basis is applied when an LTP disposes of an interest in a lower-tier partnership. In a tiered partnership structure in which a derivative ownership unit is disposed of by an LTP, Prop. Treas. Reg. § 1.961-8(d) provides that positive derived basis is taken into account only by the UTP in which the covered shareholder directly holds an interest and that each LTP is required to eliminate its positive derived basis (concurrent with the application of section 705) in an amount equal to the positive derived basis taken into account by the UTP. However, the operative rule of Prop. Treas. Reg. § 1.961-8(b)(2)(i) provides that: "A covered shareholder's distributive share of gain or loss with respect to transferred units (determined without regard to derived basis, and expressed as a negative amount in the case of a distributive share of loss) is adjusted by subtracting the transferring partnership's positive derived basis with respect to the covered shareholder of the transferred units." The rules conflict and there is no coordinating provision: Prop. Treas. Reg. § 1.961-8(b)(2)(i) explicitly states that the LTP disposing of an interest in a lower-tier partnership takes its positive derived basis into account, and Prop. Treas. Reg. § 1.961-8(d) says it does not.

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[95] However, per the discussion above, under the Section 959 Model, the reference to "each derivative ownership unit" could be interpreted to refer to each derivative ownership unit *in each tier* (*i.e.*, a single derivative ownership unit at each tier) that must be adjusted sequentially for the same single PTEP distribution from a CFC.

[96] *See, e.g.*, Rev. Rul. 84-53, 1984-1 C.B. 159.

[97] Prop. Treas. Reg. § 1.961-8(b)(2)(i), (c). The rule is subject to two limitations, one of which is discussed below.

As a practical matter, it is not clear how each LTP is to determine how much positive derived basis was taken into account by the UTP, particularly in circumstances in which the UTP and LTPs are not under common control. We recommend that Treasury and the IRS consider a system that allows, to the greatest extent possible, the covered shareholder (and not the partnership) to track and report the consequences of section 961 by requiring lower-tier partnerships to report information up to the covered shareholder, rather than requiring LTPs to attempt to solicit information from UTPs and covered shareholders.[98]

Finally, Prop. Treas. Reg. § 1.961-8(b) has a special rule that addresses the application of positive derived basis to nonrecognition transactions. In a nonrecognition transaction, the amount of positive derived basis that is taken into account by a covered shareholder is subject to a limit. The limit is intended "to replicate the effect of additional basis under the 'boot-within-gain' rule of section 351(b) or 356(a)(1), where additional basis might reduce the amount of gain realized but not the amount of gain recognized and that, as applied, "positive derived basis is available for use only to the extent that, if the positive derived basis were additional common basis taken into account in determining gain allocable to the covered shareholder, such derived basis would reduce gain recognized with respect to the transferred units."[99] The limit is computed by computing the covered shareholder's distributive share of realized (but not recognized) gain arising from the nonrecognition transaction,[100] and then only applying positive derived basis against recognized gain to the extent that such derived basis exceeds the covered shareholder's distributive share of such realized-but-unrecognized gain.

We recommend that this rule be clarified to limit its application to transactions governed by section 351(b) or section 356(a) because the "boot within gain" rule on which it is broadly based is not applicable in all nonrecognition transactions (*e.g.*, including transactions under section 721). [101]

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[98] *See supra* note 74 (discussing Prop. Treas. Reg. § 1.961-10(b)(3)).

[99] 89 Fed. Reg. 95362, 95384 (Dec. 2, 2024).

[100] Prop. Treas. Reg. § 1.961-8(b). The covered shareholder's share of the realized-but-not-recognized gain is determined by multiplying the amount of the unrecognized gain by a fraction, the numerator of which is the covered shareholder's distributive share of gain recognized by the transferring partnership with respect to the transferred units (determined without regard to derived basis), and the denominator of which is the amount of gain recognized by the transferring partnership with respect to the transferred units (determined without regard to derived basis). *Id.*

[101] *See supra* note 46 and accompanying text.