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Report No. 1518
December 2, 2025

The Honorable Scott Bessent
Secretary
Department of the Treasury
and
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Kenneth Kies
Assistant Secretary (Tax Policy)
Department of the Treasury
and
Acting Chief Counsel
Internal Revenue Service
1111 Constitution Avenue NW
Washington, DC 20224

Re: NYSBA Tax Section Report No. 1518 - Report on the Subpart F Pro Rata Share Rules and Merger and Acquisition Consideration

Dear Secretary Bessent and Assistant Secretary Kies:

Please find attached Report No. 1518 of the Tax Section of the New York State Bar Association. The Report provides certain comments and recommendations of the Tax Section on the rules governing a United States shareholder's pro rata share of a controlled foreign corporation's ("CFC's") subpart F income under Section 951 of the Internal Revenue Code and related provisions in light of the changes enacted by the One Big Beautiful Bill Act of 2025 (the "OBBBA"). Special consideration is given to the application of these rules to mergers and acquisitions of CFCs.

These changes move the rules away from a mechanical test that generally applies to a CFC's stockholders on the last day of its taxable year, shifting instead to a time- and ownership-based rule that more closely aligns a U.S. shareholder's inclusions with its economic entitlements with respect to the CFC. However, the statutory rules are general in nature, and

the statute directs the Secretary of the Treasury to issue regulations or other guidance necessary for the rules' implementation. This Report analyzes the pro rata share and related rules in light of these developments and includes recommendations for their implementation.

We appreciate your consideration of this 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

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Report No. 1518

New York State Bar Association Tax Section

The Subpart F Pro Rata Share Rules and Merger and Acquisition Considerations

December 2, 2025

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I. INTRODUCTION

This Report[1] provides the comments and recommendations of the Tax Section of the New York State Bar Association ("**NYSBA**") on the rules governing a United States shareholder's (a "**U.S. Shareholder**") pro rata share of a controlled foreign corporation's (a "**CFC**") subpart F income under Section 951 of the Internal Revenue Code (the "**Code**") and related provisions,[2] in light of the changes enacted by the One Big Beautiful Bill Act of 2025 (the "**OBBBA**").[3] Special consideration is given to the application of these rules to mergers and acquisitions of CFCs.

The subpart F rules were enacted by the Revenue Act of 1962 (the "**1962 Act**")[4] as a limited anti-deferral regime. However, the scope of CFC income subject to current U.S. taxation was significantly expanded with the enactment of the global intangible low tax income ("**GILTI**") rules by the Tax Cuts and Jobs Act of 2017 (the "**TCJA**"),[5] and expanded further with the OBBBA's net CFC tested income ("**NCTI**") rules.[6] Before the TCJA, domestic taxpayers were subject to income tax on dividends received from foreign corporations (other than in respect of previously taxed earnings and profits and subject to potential foreign tax credits). However, the scope of a domestic corporation's taxable dividend income from foreign subsidiaries was significantly narrowed by the TCJA. Moreover, the size and number of U.S. based multinational groups and mergers and acquisitions involving foreign corporations have grown substantially since the 1962 Act.

While the U.S. international tax system and its importance to domestic taxpayers have evolved since the 1962 Act, the statutory rules for determining a U.S. Shareholder's pro rata share of subpart F income and GILTI for a CFC's year largely remained the same. In some instances,

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1 The principal authors of this Report are Adam Kool and Joseph Tootle, with substantial contributions from Afshin Khan. This Report reflects comments and contributions from Kimberly Blanchard, Charles Cope, Tijana J. Dvornick, Lawrence Garrett, Edward E. Gonzalez, Arvind Ravichandran, Yaron Reich, David M. Schizer, Michael L. Schler, Eric B. Sloan, Wade Sutton, Shun Tosaka, Andrew Walker, Laura Williams, and Libin Zhang.

2 All Section references herein are to the Code, unless otherwise specified, and all references to "Treasury Regulation §" are to sections of the regulations promulgated under the Code. All uses of the term U.S. Shareholder herein refer to a United States shareholder, as defined in Section 951(b) of the Code, and all uses of the term CFC herein refer to a controlled foreign corporation, as defined in Section 957(a) of the Code.

3 One Big Beautiful Bill Act of 2025, Pub. L. No. 119-21, 139 Stat. 72 (2025).

4 Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 960 (1962).

5 Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017). See TCJA, 131 Stat. 2208 – 2216.

6 See Sections 951A and 250.

this left the pro rata share rules operating in a manner inconsistent with the broader scope of the U.S. international tax system's income inclusion rules, particularly where a CFC's stock ownership changes during its taxable year.

The OBBBA changes the pro rata share rules to address these inconsistencies. These changes move the rules away from a mechanical test that generally applies to a CFC's stockholders on the last day of its taxable year, shifting instead to a time- and ownership-based rule that more closely aligns a U.S. Shareholder's inclusions with its economic entitlements with respect to the CFC. However, the statutory rules are general in nature, and the statute directs the Secretary of the Department of the Treasury ("**Treasury**") to issue regulations or other guidance necessary for the rules' implementation.

This Report analyzes the pro rata share and related rules in light of these developments and includes recommendations for their implementation.

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

We recommend that Treasury adopt pro rata share allocation rules that allow taxpayers to apply either (i) a per diem approach with exceptions for extraordinary items or (ii) an interim closing of the books approach where a U.S. Shareholder's ownership of CFC stock changes during its taxable year. Although we acknowledge that important alterations will be necessary to capture key aspects of the Subpart F and NCTI regimes, we believe such a choice would be similar, at a high level, to those provided to partnerships under Treasury Regulation § 1.706-4, which allow taxpayers to either to prorate a partnership's items of income, gain, loss, deduction, and credits or close the books, subject to certain exceptions. We recommend that Treasury adopt rules that use simplifying conventions (e.g., calendar day, semi-monthly or monthly conventions) in the case of interim closings of the books in any given taxable year, similar to the approach found in Treasury Regulation § 1.706-4.[7] We further recommend that Treasury permit taxpayers to elect to close the taxable years of CFCs in certain circumstances, comparable to the election permitted pursuant to current Treasury Regulation § 1.245A-5.

[7] See Treas. Reg. § 1.706-4(c)(3)(i).

III. BACKGROUND

A. Subpart F Rules Pre-Tax Cuts and Jobs Act of 2017

Prior to 1962, domestic taxpayers[8] were taxed on income of their foreign corporate subsidiaries only when such income was distributed as a dividend, subject to potential foreign tax credits.[9]

The 1962 Act enacted subpart F of the Code to limit domestic taxpayers' ability to defer taxation of certain types of a CFC's income until distribution.[10] A primary purpose of subpart F was to limit deferral through the use of "tax haven" jurisdictions and related-party arrangements.[11] That is, subpart F was enacted as a system of limited anti-deferral, not a broadly applicable regime to tax the worldwide income of a domestic person earned indirectly through foreign corporations more generally.

Subpart F income includes certain insurance, passive-type and "base company" sales and services income that taxpayers can readily shift to a foreign corporation resident in a low- or no-tax jurisdiction.[12] A CFC's subpart F income is limited to the CFC's current earnings and profits ("**E&P**"), with special deficit coordination rules.[13]

Under the 1962 Act and until the enactment of the OBBBA, the subpart F rules provided that a U.S. Shareholder[14] of a CFC[15] must include in income his pro rata share of the CFC's subpart

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[8] See Sections 7701(a)(1), 7701(a)(4) and 7701(a)(14). Terms used but not otherwise defined herein shall have the meaning set forth in Section 7701(a) of the Code and the Treasury Regulations thereunder, to the extent applicable.

[9] See H.R. Rep. No. 1447, 87th Cong., 2d Sess. 62 (1962) ("**1962 House Report**"). See also S. Rep. No. 1881, 87th Cong., 2d Sess. 84 (1962) ("**1962 Senate Report**"). See, e.g., Sections 901, 902 and 904 of the Internal Revenue Code of 1954. Prior versions of the Internal Revenue Code also included foreign tax credit rules.

[10] 1962 Act, 76 Stat. 1006 – 1027.

[11] See 1962 House Report, 57 – 62. See also 1962 Senate Report, 78 – 80.

[12] *Id*. Section 952.

[13] See Section 952(c).

[14] Defined by the 1962 Act as a domestic person who owns, directly, indirectly or constructively, 10 percent or more of the total combined voting power of a CFC. 1962 Act, 76 Stat. 1007. The TCJA expanded the scope of such definition to also include domestic persons who so own 10 percent or more of the total value of shares of all classes of stock of such foreign corporation. TCJA, 131 Stat. 2218.

[15] Defined by the 1962 Act as any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned directly, indirectly or constructively, by U.S. Shareholders on any day during the taxable year of such foreign corporation. 1962 Act, 76 Stat. at 1017. The scope of such definition to also include foreign corporations of which more than 50 percent of the total value of the stock thereof

F income, if the shareholder owns, directly or indirectly, stock in the CFC on the last day of the CFC's taxable year on which it is a CFC (the "**Last Day Rule**").[16]

Corporate U.S. Shareholders with subpart F inclusions with respect to a CFC are deemed to have paid the CFC's foreign income taxes properly attributable to that income.[17] Domestic corporations that so elect may credit such foreign taxes against their tax liability associated with their foreign-source income, subject to certain separate category (or "basket") rules and other limitations.[18] Thus, the subpart F rules very generally seek to impose a "residual" U.S. tax.

The 1962 Act also enacted Section 1248 to limit domestic taxpayers' ability to realize, in the form of capital gain, certain of a CFC's undistributed income.[19] In general, Section 1248 recharacterizes gain on the sale of CFC stock by a U.S. Shareholder as a dividend to the extent of specified E&P.[20]

1. Pro Rata Share Rules

Before the OBBBA, a U.S. Shareholder's pro rata share of subpart F income was generally determined using (1) the Last Day Rule, (2) a hypothetical distribution approach and (3) a dividend-offset mechanic.

Under the hypothetical distribution approach of Section 951(a)(2)(A), a U.S. Shareholder's pro rata share is the amount that would have been distributed with respect to the stock the

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is so owned was added by the Tax Reform Act of 1986 (the "**1986 Act**"). Pub. L. No. 99-514, 100 Stat. 2085, 2556 – 2257 (1986). Special rules exist for foreign corporations earning certain insurance income. See Section 957(b).

[16] At the time, the foreign corporation must have been a CFC for an uninterrupted period of 30 days or more during its taxable year for the rule to apply. *Id*. at 1006. This requirement was removed by the TCJA, and now the rule applies if the foreign corporation is a CFC at any time during the taxable year. TCJA, 131 Stat. 2218. Section 951(b). Since 2019, domestic partnerships and S corporations are not treated as U.S. Shareholders for purposes of subpart F income or GILTI inclusions. See Treas. Reg. § 1.958-1(d).

[17] See Section 960. Section 960 was also enacted by the 1962 Act and has undergone periodic revisions as the U.S. international taxation system has evolved.

[18] See Sections 901 and 904.

[19] See 1962 Senate Report at 107.

[20] Section 1248 generally applies to U.S. persons who exchange stock in a foreign corporation, if such person owns, actually or constructively, 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation. For simplicity, and for purposes of demonstrating the relevance of the pro rata share rules to Section 1248, this Report generally refers to Section 1248 as applying to U.S. Shareholders of CFC stock.

shareholder owns, directly or indirectly, in the CFC if, on the last day in its taxable year on which the corporation is a CFC, it had distributed pro rata to its shareholders an amount that bears the same ratio to its subpart F income for the year as the portion of the year during which it was a CFC bears to the entire year.

Under the dividend-offset mechanic of Section 951(a)(2)(B), the U.S. Shareholder's pro rata share is reduced by the amount of dividends received by other persons with respect to the same stock, but only to the extent of the dividend that would have been received if the distribution by the CFC had been the amount that bears the same ratio to the subpart F income of such CFC for the taxable year as the portion of the year during which such shareholder did not own, directly or indirectly, such stock bears to the entire year.

Prior to the enactment of the TCJA, the dividend-offset mechanic prevented duplicative inclusion of the same earnings at the U.S. Shareholder level, as illustrated by the following example.

> Example 1. Assume FC1 (i) is a CFC for the entire taxable year, (ii) has $1,000 of subpart F income, no other taxable income and no foreign taxes for the year, (iii) has $1,000 of E&P for the year and no prior year E&P deficit, (iv) has a single class of common stock and (v) uses a calendar year. Assume US1, a domestic corporation, holds 100 percent of FC1's common stock on January 1 and sells all such stock to US2, also a domestic corporation, on June 30 for a $500 gain. Assume no extraordinary dividend under Section 1059 arises and that Section 245A is inapplicable. US1's $500 gain is treated as a dividend to US1 under Section 1248 and is subject to $105 of tax.[21] US2 holds all such stock through December 31, and FC1 makes no distributions. US2's subpart F inclusion from FC1 is $500 ($1,000 less the $500 dividend deemed received by US1) and is subject to $105 of tax. Together, US1 and US2 owe $210 of U.S. corporate income tax before applying any foreign tax credit.

2. Allocation of Subpart F Income and Tested Income/Loss Among CFC Stock

The existing Treasury Regulations allocate a CFC's subpart F income, tested income and tested loss among a CFC's shares of stock (and therefore among the CFC's U.S. Shareholders) based on a hypothetical distribution approach.

[21] This example and all other examples herein assume a domestic corporation is subject to U.S. corporate income tax at a 21 percent rate.

With respect to subpart F income, the Treasury Regulations implement the statutory hypothetical distribution approach first by computing each U.S. Shareholder's allocable E&P from the CFC for the year with respect to each share and class of CFC stock.[22] Consistent with the Last Day Rule, allocable E&P is associated with the stock itself, regardless of the amount of time that the last-day U.S. Shareholder held such stock. Distributions are not netted at this stage to avoid double counting, as the dividend-offset is subsequently applied.[23]

Allocable E&P is determined under Section 964 and applied pursuant to detailed rules, including to address CFC stock with different rights (*i.e.*, multiple classes). The subpart F income allocable to each share of CFC stock generally is the subpart F income for the taxable year, multiplied by the allocable E&P hypothetically distributable to such share, divided by the CFC's allocable E&P, in each case for the CFC's taxable year as determined on the last day thereof. A last-day U.S. Shareholder's hypothetical distribution amount generally includes subpart F income earned during any portion of the CFC's taxable year, even if such subpart F income was earned either before the U.S. Shareholder acquired the stock or after the shareholder disposed of the stock.[24]

Tested income and tested loss is allocated to a CFC's shares (and therefore to U.S. Shareholders) in a similar manner.[25]

B. The Tax Cuts and Jobs Act of 2017

The TCJA significantly altered the U.S. international tax system by enacting (i) the Section 245A participation exemption and (ii) the GILTI rules.

Under Section 245A, a domestic corporation that is a U.S. Shareholder of a "specified 10-percent owned foreign corporation" (a "**Specified 10% FC**") may deduct 100 percent of the foreign-source portion of dividends received from such foreign corporation, subject to a one-year holding period requirement and other limitations.[26] Section 245A has largely eliminated the

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[22] Treas. Reg. § 1.951-1(e). Note that, for such purposes, the CFC's allocable E&P generally is the greater of its E&P, as determined under Section 964, and the sum of its subpart F income and tested income, in each case for the taxable year. See Treas. Reg. § 1.951-1(e)(1)(ii).

[23] See *Id*. and Treas. Reg. § 1.951-1(b)(ii).

[24] See, e.g., Treas. Reg. § 1.951-1(b)(2) Examples (2) and (3).

[25] See Treas. Reg. § 1.951A-1(d).

[26] See generally Section 245A. See also Sections 246(a)(1) and 246(c)(5).

residual U.S. taxation of corporate U.S. Shareholders with respect to a foreign corporation's non-subpart F, non-GILTI income.

Under the GILTI rules, a domestic taxpayer is required to include its GILTI for the taxable year in a manner similar to the subpart F income pro rata share rules.[27] GILTI is the excess of the taxpayer's pro rata share of the "tested income" of each CFC owned, directly or indirectly, by the taxpayer and with respect to which the taxpayer is a U.S. Shareholder, over the "tested loss" of each such CFC, less a deemed intangible income return.[28] Tested income and tested loss generally are computed from each CFC's gross income reduced by allocable deductions and excluding, among other items, subpart F income and certain high-tax income.[29] GILTI is not limited by the earnings and profits of the applicable CFC. Corporate taxpayers may claim a Section 250 deduction (50 percent for 2025) and a deemed-paid credit for GILTI foreign taxes with a 20 percent haircut, subject to limitations.[30] GILTI has greatly expanded the scope of CFC income that is subject to residual U.S. taxation.

C. Potential For Double Non-Taxation and the Extraordinary Reduction Rules

The TCJA did not change the Last Day Rule or the other pro rata share rules. Combined with Section 245A, this created the opportunity for double non-taxation of a CFC's subpart F income and GILTI when CFC stock changes hands mid-year, as illustrated by the following example.

> Example 2. Assume the same facts as in Example 1. Assume that US1's ownership of FC1's common stock satisfies the required holding period and that dividends from FC1 otherwise qualify for Section 245A. US1's $500 gain is treated as a dividend to US1 under Section 1248. US1 deducts $500 from its taxable income and owes $0 of U.S. corporate income tax in respect of its sale of FC1. While US2 owes the same $105 of pre-foreign tax credit corporate income tax as in Example 1, $500 of FC1's subpart F income escapes U.S. taxation.

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27 See Section 951A(e). See also Treas. Reg. § 1.951A-1(d).

28 See Section 951A.

29 See Section 951A(c). See also Treas. Reg. § 1.951A-2(c)(7).

30 See Sections 901, 960(d) and 250(a)(1)(B).

Treasury identified such results as inconsistent with the U.S. international tax system and issued the extraordinary reduction rules to address them.[31] The extraordinary reduction rules apply to certain dispositions of stock of a CFC that is also a Specified 10% FC by a controlling Section 245A shareholder. A controlling Section 245A shareholder is a domestic corporation that is a U.S. Shareholder of, and that, together with certain related parties, owns directly or indirectly more than 50 percent (by vote or value) of the stock of, such CFC.[32] If the rules apply, the controlling Section 245A shareholder becomes ineligible to apply Section 245A to the CFC's dividends (including deemed dividends under Section 1248) for a taxable year in an amount equal to the lesser of (i) any such dividend and (ii) the controlling Section 245A shareholder's pro rata share of the CFC's subpart F income and tested income for such year, determined immediately before such sale and, critically, as though any such dividend did not reduce a U.S. Shareholder's pro rata share of such income under the dividend-offset mechanic of Section 951(a)(2)(B) when the Last Day Rule is applied.[33]

The rules also provide for an election to close the CFC's taxable year on the applicable disposition date, which, if made, results in the controlling Section 245A shareholder including its pro rata share of the CFC's subpart F income and tested income due to the application of the Last Day Rule on the date of such disposition.[34]

Applied to Example 2, US1's $500 Section 1248 dividend attributable to its sale of FC1's common stock to US2 mid-year would be ineligible for Section 245A, and the total pre-foreign tax credit corporate income tax owed by US1 and US2 would be $210, the same result as in Example 1.

D. The One Big Beautiful Bill Act of 2025

The OBBBA significantly alters (i) the pro rata share rules and (ii) the GILTI rules.

1. Pro Rata Share Rules

Effective for taxable years of foreign corporations beginning in 2026, the OBBBA replaces the Last Day Rule, hypothetical distribution approach and dividend-offset mechanic framework

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[31] See T.D. 9865, 84 Fed. Reg. 28,398, 28,402–03 (June 18, 2019) (explaining the concern and the mechanics) and Treas. Reg. § 1.245A-5 (as adopted by T.D. 9909 (Aug. 27, 2020)).

[32] See Treas Reg. § 1.245A-5(i)(2), -5(i)(21).

[33] See Treas. Reg. § 1.245A-5(b), -5(e)(1), -5(e)(2)(ii)(A).

[34] See Treas. Reg. § 1.245A-5(e)(3)(i).

with a time- and ownership-based rule to allocate subpart F income to U.S. Shareholders of a CFC.[35] Specifically, a U.S. Shareholder's pro rata share of a CFC's subpart F income for such taxable years is the amount of such income that is "attributable to" (i) the stock of such corporation owned, directly or indirectly, by the U.S. Shareholder (the "**ownership-based test**"), and (ii) any period of the CFC's taxable year during which any such stock is so owned by the U.S. Shareholder, such U.S. Shareholder was a U.S. Shareholder of such CFC, and such corporation was a CFC (the "**time-based test**").[36] What it means for subpart F income to be "attributable to" a period of the CFC's year is left undefined by the statute and is the primary subject of the remainder of this Report.

2. Transition Rule

The OBBBA also enacted a transition rule for 2025 to bridge the existing pro rata share rules to the effective date of the new time- and ownership-based rule (the "**Transition Rule**"). The Transition Rule provides that, except to the extent provided by the Secretary of the Treasury, a dividend paid (or deemed paid) by a CFC shall not be treated as a dividend for purposes of applying the dividend-offset mechanic of Section 951(a)(2)(B) if (i) such dividend (1) was paid (or deemed paid) on or before June 28, 2025 during the CFC's taxable year that includes such date and the last-day U.S. Shareholder did not own, directly or indirectly, the stock of such CFC during the portion of such taxable year on or before June 28, 2025, or (2) was paid (or deemed paid) after June 28, 2025 and before such CFC's first taxable year beginning after December 31, 2025, and (ii) such dividend does not increase the taxable income of a domestic person that is subject to U.S. federal income tax for the taxable year (including by reason of a dividends received deduction, an exclusion from gross income, or an exclusion from subpart F income).[37]

3. Regulatory Direction

The OBBBA also directs the Secretary of the Treasury to prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of the pro rata share rules, including regulations or other guidance allowing taxpayers to elect, or requiring taxpayers, to close the CFC's taxable year upon a direct or indirect disposition of stock of such CFC.[38]

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35 Section 951(a).

36 *Id*.

37 OBBBA, 139 Stat. 212.

38 Section 951(a)(4).

4. NCTI Rules

For taxable years beginning after 2025, the OBBBA alters the existing GILTI rules to increase the total CFC income that is subject to current taxation.[39] Namely, U.S. Shareholders of one or more CFC's will include their pro rata share of the CFCs' NCTI for the applicable taxable year, which is in excess of such CFCs' tested income over their tested loss, unreduced by any deemed intangible income return. Corporate taxpayers remain eligible for the Section 250 deduction (now 40 percent) and a deemed-paid foreign tax credit (now with a 10 percent haircut). These changes represent another increase in the scope of CFC income that is included by U.S. Shareholders on a current basis.[40] Like GILTI, a domestic taxpayer is required to include its NCTI for the taxable year in a manner similar to the subpart F income pro rata share rules, as amended by the OBBBA.

IV. RECOMMENDATIONS

A. Policy Considerations Regarding Changes to "Pro Rata" Sharing

1. Congressional Intent

While the Congressional record is limited with respect to the OBBBA's pro rata share rules, the purpose of such rules can be surmised by considering (i) the double non-taxation outcomes that arose under the Last Day Rule post-TCJA, (ii) the text of the statute and (iii) the U.S. international tax system's trend towards taxing a U.S. Shareholder's CFC income on a flow-through basis.

First, the new pro rata share rules undoubtedly were enacted to minimize or prevent the double non-taxation outcomes of mid-year CFC sales described in Part III.C above. There is no compelling policy rationale for the U.S. international tax system to promote double non-taxation, and the OBBBA's pro rata share rules effectively eliminate such outcomes described above. The Transition Rule accomplishes this by increasing the amount of subpart F income and GILTI that is included by the U.S. Shareholder that owns, directly or indirectly, stock of a CFC on the last day of such CFC's taxable year when certain mid-year sales have occurred. The post-2025 pro rata share rules accomplish this by ensuring that all U.S. Shareholders include their pro rata share

[39] See Sections 951A and 250.

[40] *Id*.

of subpart F income and NCTI for a taxable year, even if they do not own, directly or indirectly, stock in the CFC on the last day of its taxable year.

Second, the text of the statute makes it clear that eliminating such double non-taxation outcomes was not Congress's sole purpose. Congress could have addressed such double non-taxation concerns in a more narrow manner; for example, by either "turning off" Section 245A to a corporate U.S. Shareholder seller of CFC stock, similar to the extraordinary reduction rules, or by retaining the prior pro rata share rules and "turning off" the dividend-offset mechanic with respect to a buyer of CFC from such U.S. Shareholder's stock, similar to the Transition Rule. Congress instead chose a structural rewrite of the pro rata share rules.

Third, the OBBBA's enactment of the NCTI rules represents another step toward moving the U.S. international tax system away from a system of limited anti-deferral and toward a flow-through taxation regime. For example, the notional deduction for the deemed intangible return that reduces a U.S. Shareholder's GILTI is eliminated from the NCTI rules, and therefore NCTI inclusions will more closely align with a CFC's economic income compared to GILTI. Similarly, the OBBBA's pro rata share rules more closely resemble a flow-through taxation regime (i) by requiring subpart F and NCTI inclusions by any U.S. Shareholders throughout a taxable year, not just last-day U.S. Shareholders, and (ii) by allocating subpart F income and NCTI to the U.S. Shareholder that such income is "attributable to" under the time- and ownership-based rule.

Therefore, the apparent purpose of the OBBBA's pro rata share rules is to allocate CFC inclusions based on a U.S. Shareholder's economic entitlements, similar to a flow-through taxation regime. However, the OBBBA does not include a further allocation methodology, and largely left the implementation of the new pro rata share rules to Treasury.

2. Broader Policy Considerations

Moving on to broader policy considerations, implementing the new statutory language requires a balancing act between complexity, administrability, and coherence with other areas of the Code. The U.S. international tax system often compromises between precision and administrability, and numerous points of tension can be anticipated in implementing the new pro rata share rules.

As discussed below, the simplest and most administrable method of determining subpart F income and NCTI "attributable to" a U.S. Shareholder is the least precise method in terms of capturing the correct economics. Conversely, the most precise methods are the most complex and the least administrable. Given the existing complexity of the U.S. international tax system and

that the new pro rata share and NCTI rules are almost certain to increase the number of U.S. Shareholders that have CFC inclusions, administrability must be a key consideration in implementing the new pro rata share rules.

The U.S. international tax system both borrows from other areas of the Code and exists as an important part of a broader income taxation system. For example, the determination of a CFC's E&P begins in Subchapter C but is also a key component of determining a U.S. Shareholder's subpart F income and Section 1248 deemed dividend. Thus, the new pro rata share rules must be implemented in a manner that is consistent with such areas of the Code, as well as the foreign tax credit, previously taxed earnings and profits and basis rules, among others. Further, while the U.S. international taxation system is not a true flow-through taxation regime, it exists side-by-side with Subchapter K, Subchapter S and the consolidated return rules. Given the similar subject matter addressed by such regimes, they should inform the implementation of the new pro rata share rules.

B. Potential Methodologies for Determining Subpart F Income "Attributable To" a U.S. Shareholder Under Section 951

Taking into account the policy considerations described above, this Report discusses four different allocation approaches that Treasury may consider in drafting new regulations implementing the statutory amendments to Section 951. Ultimately, we recommend implementing regulations that permit taxpayers to choose between two such approaches: (i) a per diem approach with exceptions for extraordinary items or (ii) an interim closing of the books approach. This is most comparable to the rules of Section 706 relating to changes in ownership of partnerships during the course of a taxable year, but also finds support the S corporation rules, the consolidated group rules, and the Treasury Regulation § 1.245A-5 anti-abuse rules. Given our recommendation for taxpayer flexibility, we recommend that Treasury consider backstopping this approach with an anti-abuse rule. We further recommend that Treasury permit taxpayers to elect to close the taxable years of CFCs in certain circumstances, comparable to the election permitted pursuant to current Treasury Regulation § 1.245A-5.

1. Approach #1: Simple Per Diem

The first of the four approaches we discuss is the most administrable—simple per diem. Under this approach, all CFC income, gain, loss, deductions and credits for its taxable year could be calculated and allocated pro rata to each day of the year, and such daily items could then be allocated among each share of stock outstanding on the applicable day. This is the approach taken

by the Subchapter S rules, subject to an election to close an S Corporation's taxable year as discussed in Part IV.C below.[41]

In addition to being the most administrable approach, the per diem approach is also largely consistent with the existing pro rata share rules, which allocate subpart F income to shares based on allocable E&P and dividends associated with the applicable CFC stock for the entire year, without different accounting for portions thereof. However, where stock of a CFC changes hands mid-year, this failure to differentiate items incurred before or after the change of hands is arguably inconsistent with the statutory requirements of the new time-based rule. The time-based rule requires subpart F income "attributable to" the periods of the CFC's year during which a U.S. Shareholder held CFC stock to be included in such U.S. Shareholder's pro rata share. Consider the following:

> Example 3. Assume FC1 (i) is a CFC for the entire taxable year, (ii) has $1,000 of gross subpart F income (earned entirely in a transaction occurring on January 1), no other taxable income and no foreign taxes for the year, (iii) has $600 of E&P for the year and no prior year E&P deficit, (iv) has a single class of common stock and (v) uses a calendar year. Assume US1, a domestic corporation, holds 100 percent of FC1's common stock on January 1 and sells all such stock to US2, also a domestic corporation, on June 30 for cash. Assume FC1 incurs $400 of expenses before June 30, which are FC1's only expenses for the year and are deductible against FC1's gross subpart F income. Using a per diem approach, and before applying any potential limitation for E&P,[42] US1's pro rata share of FC1's subpart F income for the year is $300, despite both the subpart F income and current E&P arising before June 30. US2's pro rata share is also $300, despite receiving $0 of subpart F income during its ownership period.[43]

The disconnect between the U.S. Shareholders' pro rata shares of subpart F income and economic entitlements results from the application of the per diem approach as opposed to a more precise method of allocation.[44] This disconnect is comparatively detrimental to using a more precise pro rata share allocation methodology for at least three reasons.

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41 Section 1377.

42 Like the allocation of a CFC's subpart F income and NCTI, the allocation of a CFC's E&P raises complex considerations. Some of these considerations are discussed in Part IV.D herein. Examples 3 through 6 assume away these complexities for simplicity.

43 For simplicity, this example does not address the other tax consequences of the per diem approach to US1.

44 While Example 3 addresses only subpart F income, similar considerations exist for NCTI.

First, while taxpayers may attempt to remedy the post-tax consequences of the disconnect through their bargain–for instance, by decreasing the purchase price in Example 3–this involves a more complex and uncertain process than having simply been subject to a more precise allocation methodology. For example, remedying through the bargain may involve buyers and sellers (i) agreeing on a more precise allocation methodology, (ii) preparing pro forma tax returns based on that methodology (*i.e.*, for purposes of a "with and without" calculation), (iii) agreeing that these pro forma tax returns accurately reflected each U.S. Shareholder's post-tax position, which would be subject to significant confidentiality considerations and (iv) adjusting any proposed changes to the purchase price to account for the tax consequences of any such adjustment. Therefore, while a more precise pro rata share allocation methodology would make tax return preparation more complex than the per diem approach, it likely would reduce negotiation complexity and minimize potential disputes between buyers and sellers.

Second, the post-tax consequences of an imprecise allocation methodology distort the pre-tax economic incentives to buy or sell CFC stock. If both the potential buyer and seller of CFC stock are U.S. Shareholders who are subject to tax, then to the extent the buyer's pro rata share is greater than its economic entitlement to subpart F income, as in Example 3, the buyer would be less likely to increase its purchase price, and the seller would be less incentivized to sell. If the consequences are reversed, such that the seller's pro rata share is greater than its economic entitlement to subpart F income, the seller would be more incentivized to sell at a lower price to achieve tax savings. In addition, a U.S. Shareholder may have the opportunity to dispose of stock in a CFC to a buyer who is not sensitive to subpart F income or NCTI inclusions (including because the buyer is foreign, is U.S tax-exempt or is a U.S. taxpayer but is in an excess foreign tax credit position). Such a buyer may be more incentivized to buy CFC stock at a higher price than taxable U.S. Shareholders.

Third, for similar reasons, to the extent the CFC is influenced by its U.S. Shareholder(s), the post-tax consequences of an imprecise allocation methodology may distort the economic incentives for the CFC to earn subpart F income or NCTI, or incur associated expenses, during a taxable year in which a mid-year change in ownership is expected. For example, in a fact pattern similar to Example 3 and to the extent the buyer and seller attempt to remedy the post-tax consequences of the disconnect through their bargain, the seller may be incentivized to cause (and require the buyer to cause) the CFC to artificially alter the timing of post-closing transactions to limit the overall subpart F income inclusions of the seller.

2. Approach #2: Per Diem Approach with Exceptions for Extraordinary Items

The second approach we describe incorporates the basic concepts of a simple per diem approach but adds a layer of flexibility for extraordinary items. Items of income (and, with respect to NCTI, loss) that are not "extraordinary" would still be allocated to U.S. Shareholders under the per diem approach, but extraordinary items would be allocated to the portions of a CFC's taxable year in which they were incurred. This approach is taken in the Subchapter K and consolidated return rules, which do not allow extraordinary items to be prorated.[45]

Treasury Regulation § 1.706-4(e) and Treasury Regulation § 1.1502-76(b)(2)(ii)(C) offer detailed lists of extraordinary transactions that may be largely imported into the subpart F and NCTI regimes. These lists of extraordinary transactions include income, gain, loss or deduction associated with the disposition or abandonment of certain assets, changes in accounting methods, discharge of indebtedness, and similar transactions that rarely occur within the ordinary course of business. We believe that, similar to partnerships and consolidated groups, forthcoming Treasury Regulations should capture extraordinary items in a comprehensive manner for purposes of the pro rata share rules, with adjustments to reflect such rules' application to mid-year changes in CFC ownership. However, due consideration should be given to items that may be less appropriate to include in the CFC context. For example, Treasury Regulation § 1.706-4(e) offers taxpayers flexibility to agree on additional extraordinary items and to disregard extraordinary items that are sufficiently small, but similar exceptions do not apply in the consolidated return context. It is not clear that either exception is appropriate outside of Subchapter K's intentionally flexible framework.

Compared to the simple per diem approach, the per diem approach with exceptions for extraordinary items should more accurately tie the CFC's income or loss events to the U.S. Shareholders' ownership of CFC stock at any given time.

> Example 4. Assume FC1 (i) is a CFC for the entire taxable year, (ii) has $100 of non-extraordinary items of subpart F income, $50 of extraordinary items of subpart F income earned on December 1, no other taxable income and no foreign taxes for the year, (iii) has $150 of E&P for the year and no prior year E&P deficit, (iv) has a single class of common stock and (v) uses a calendar year. Assume US1, a domestic corporation, holds 100 percent of FC1's common stock on January 1 and sells all such stock to US2, also a domestic corporation, on June 30. Using the per diem approach with exceptions for extraordinary items, and before applying any potential

[45] See Treas. Reg. §§ 1.706-4(c)(e) and 1.1502-76(b)(2)(ii).

limitation for E&P, US1's pro rata share of FC1's subpart F income for the year is $50. This includes US1's pro rata share of the non-extraordinary items of income ($50) and none of the extraordinary items of income. US2's pro rata share of FC1's subpart F income is $100. This includes US2's pro rata share of the non-extraordinary items of income ($50) and US2's share of the CFC's extraordinary items of income ($50), all of which is allocated to US2, since it is incurred during the portion of FC1's taxable year during which US2 owned its FC1 stock.

The per diem approach with exceptions for extraordinary items reduces the disconnect between a U.S. Shareholder's ownership of CFC stock and its economic entitlements when there is a mid-year sale of such stock. However, this economic disconnect persists for CFCs with non-extraordinary items of income or loss that are incurred in a disproportionate but predictable manner across the taxable year. This economic disconnect for "seasonal" businesses is illustrated with a slight change to Example 4 above:

> Example 5. Assume the same facts as in Example 4, but that FC1's $100 non-extraordinary items of subpart F income are earned after June 30. US1's pro rata share of FC1's subpart F income for the year continues to be $50 (US1's pro rata share of the non-extraordinary items of subpart F income), even though none of such income was earned during US1's period of ownership. Conversely, US2's pro rata share of FC1's subpart F income continues to be $100, even though all $150 of FC1's items of income were incurred during US2's period of ownership.

Similar economic disconnects also continue to exist where there are planned CFC asset acquisitions or dispositions that do not constitute extraordinary items. Therefore, the potential need for taxpayers who buy or sell CFC stock to remedy these disconnects through their bargain, and the distorted economic incentives that result from a simple per diem approach discussed above, are reduced but not eliminated by the per diem approach with exceptions for extraordinary items.

3. Approach #3: Interim Closing of the Books

In contrast to the simplified methods contemplating some form of proration approach, an interim closing of the books approach prioritizes precision with less of an emphasis on administrability. Under this approach, the U.S. Shareholder's pro rata share of a CFC's subpart F income and NCTI would be calculated as if the CFC's taxable year ended on the date of the mid-

year change in ownership. A similar approach is also taken in the Subchapter K context, subject to certain simplifying conventions discussed below.[46]

> Example 6. Assume the same facts as in Example 3. FC1 is deemed to close its books at the end of June 30. Using an interim closing of the books approach, and before applying any potential limitation for E&P, US1's pro rata share of FC1's subpart F income for the year is $600 ($1000 of FC1's subpart F income earned on and before June 30 less $400 of expenses incurred during that period). US2's pro rata share of FC1's subpart F income for the year is $0.

Compared to the per diem approaches, the interim closing of the books approach more precisely matches U.S. Shareholders' pro rata shares with their economic entitlements from a CFC for a taxable year with a mid-year change in ownership, which accords with the apparent purpose of the new pro rata share rules. The approach has also proven to be generally acceptable to both taxpayers and Treasury for purposes of Subchapter K and the consolidated return rules, which accords with some of the broader policy considerations discussed in Part IV.A above.

Notably, an interim closing approach as applied in the Subpart F and NCTI context may differ in key respects from the pure flow-through approach applied in Subchapter K. In particular, the Subpart F rules require netting and aggregation of attributes (including corporate E&P) at the entity level in a manner that is not mandated by Subchapter K. These entity-level considerations mean that the interim closing approach for CFCs will not perfectly mirror an interim closing approach for partnerships. Nonetheless, we believe analogous concepts can be used as a foundation, with appropriate adjustments discussed in greater detail in Part IV.D, below.

From a policy perspective, the interim closing of the books approach is less administrable than the per diem approaches. For example, a CFC's accounting system may not permit interim closing of the books calculations on the date CFC stock changes hands. Accordingly, the Treasury Regulations implementing the pro rata share rules should include simplifying conventions to reduce the administrative burdens of mid-year sales of CFC stock. For example, Treasury Regulation § 1.706-4(c)(1) provides for a calendar day convention, semi-monthly convention and monthly convention. Generally speaking, under the calendar day convention, a change in ownership is deemed to occur at the end of the day on which the change actually occurs. Under the semi-monthly convention, a change in ownership is deemed to occur either at the end of the last day of the immediately preceding calendar month or in the middle of the calendar month in

[46] See Treas. Reg. §§ 1.706-4 and 1.1502-76(b)(2)(i).

which the ownership change occurs, depending on if the change occurs in the earlier half or later half of the current month. Under the monthly convention, the change is deemed to occur either at the end of the last day of the immediately preceding calendar month or on the last day of the calendar month in which the ownership change occurs, depending on if the change occurs in the earlier half or later half of the current month.

Similarly, Treasury Regulation § 1.1502-76(b)(2)(iii) permits a consolidated group that is otherwise using an interim closing of the books method to ratably allocate a group member's items taken into account in the month in such member's change in status. For example, such member may close its books both at the end of the preceding month and at the end of the month of the change, and ratably allocate its items (other than extraordinary items) from the month of the change.

We believe each of these conventions would be as useful in the subpart F and NCTI context as they have proven to be in the Subchapter K and consolidated group context.

4. Approach #4: Closing of the Taxable year

Section 951 of the Code, as amended by the OBBBA, states that the "Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the purposes of this subsection, including regulations or other guidance *allowing taxpayers to elect, or requiring taxpayers, to close the taxable year of a controlled foreign corporation* upon a direct or indirect disposition of stock of such corporation."[47]

Without further modification, a closing of the taxable year would effectively reflect an interim closing of the books approach (without any of the simplifying conventions discussed above clearly applying to simplify the required allocation of pre- and post-closing of the year items). Unlike a closing of the books approach, closing the taxable year of a CFC has ramifications beyond the allocation of subpart F income and NCTI to buyers and sellers of CFC stock—for example, ending the taxable year potentially impacts the amount of current E&P available to generate a subpart F inclusion, and it can accelerate subpart F income and NCTI inclusions and related tax filing obligations to all U.S. Shareholders, irrespective of whether they bought or sold stock of the applicable CFC. Viewed from this lens, adopting an approach requiring the ending of a taxable year seems to present the most definitive (and least flexible) methodology for measuring a U.S. Shareholder's pro rata share under Section 951.

[47] See Section 951(a)(4) (emphasis added).

It is important to note, however, that the closing of a taxable year does not necessarily lock Treasury or taxpayers into a single approach for allocating subpart F income or NCTI to the pre- and post-closing of the taxable years. For example, similar to the consolidated return rules discussed above, the Treasury Regulations implementing the new pro rata share rules could permit non-extraordinary items arising in the month of the closing of the taxable year to be allocated ratably to such periods.

C. Recommendation for Limited Elective Regime

As described above, each of the potential approaches to measuring a U.S. Shareholder's pro rata share presents benefits and drawbacks for both Treasury and taxpayers, and each approach may be more attractive or less attractive depending on a taxpayer's specific facts and circumstances. Treasury has confronted similar challenges across a number of different regimes within the Code and almost invariably has offered taxpayers some degree of electivity between allocation regimes. For example, the Subchapter K rules offer taxpayers largely unfettered flexibility to choose to apply an interim closing of the books method or a proration method with exceptions for extraordinary items (subject to agreement of the partners with respect to the proration method, simplifying convention and certain extraordinary items).[48] Similarly, the consolidated return rules generally contemplate an end of the taxable year when a member leaves a consolidated group, effectively providing for an interim closing method by default, while simultaneously offering taxpayers the opportunity to apply a proration method that takes into account extraordinary items. The Subchapter S rules default to a proration method for mid-year changes in ownership, but the Treasury Regulations permit an S corporation to end its taxable year where a shareholder terminates its interest therein, if all affected S corporation shareholders consent.[49] Finally, Treasury Regulation § 1.245A-5 generally permits taxpayers to avoid the application of the extraordinary reduction rules by ending the relevant CFC's taxable year (thus effectively providing for an interim closing of the books approach) if all direct and indirect U.S. Shareholders of the applicable CFC agree.[50] In each case, Treasury appears to acknowledge the practical challenges of allocating items of income, gain, loss, deduction and other relevant tax items across multiple periods, and therefore allows taxpayers significant discretion in implementing this allocation.

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[48] See Treas. Reg. § 1.706-4(f).

[49] See Treas. Reg. §1.1377-1(b).

[50] See Treas. Reg. §§ 1.245A-5(e)(3)(i)(A) and (e)(3)(i)(C)(2).

We believe that a similar degree of electivity should be afforded taxpayers in the context of the subpart F and NCTI regimes, and we recommend the Treasury Regulations implementing the new pro rata share rules (i) permit U.S. Shareholders and CFCs to choose between a per diem approach with exceptions for extraordinary items and an interim closing of the books approach and (ii) provide that either of these approaches may be selected with respect to each change of ownership of a CFC without the explicit requirement for consistency with respect to a single taxable year. This approach is comparable to the mid-year ownership change rules under Subchapter K, but also has similarities to the approaches under Subchapter S and the consolidated return rules. Therefore, taxpayers and Treasury can have confidence that these approaches have proven to be effective for mid-year ownership changes under comparable regimes. Moreover, using a similar approach for purposes of the new pro rata share rules as has been used in other areas of the Code reduces complexity for both taxpayers and Treasury.

Treasury should of course be wary of offering electivity in a manner that would encourage inappropriate tax planning.[51] However, we believe that so long as extraordinary items are taken into account as and when they occur (a feature of both the per diem approach with exceptions for extraordinary items and the interim closing of the books approach), opportunities for taxpayer planning are limited. In addition, taxpayer planning is likely limited to sales of CFCs with seasonal businesses or planned asset acquisitions or dispositions that do not constitute extraordinary items. As both Treasury and taxpayers can attest from the analogous regimes offering optionality to taxpayers, neither seasonality nor anticipated changes a business's asset composition have proven to be ripe areas for abusive planning. It is our experience that for more material transactions (e.g., the sale of a majority interest in a subsidiary or the disposition of substantially all of the assets of a business), taxpayers bargaining at arm's length almost invariably choose to apply an interim closing of the books approach or elect to end a taxable year when possible, rather than engaging in planning to move items as between two unrelated taxpayers. We anticipate this approach would continue with respect to sales of CFCs, even if the Treasury Regulations implementing the pro rata share rules follow permit the electivity recommended in this Report.

In addition to offering taxpayers the option to apply a per diem approach with exceptions for extraordinary items or an interim closing of the books approach, we recommend offering taxpayers the ability to end a CFC's taxable year in connection with a sufficiently meaningful change in the ownership of such CFC. As discussed above, ending a CFC's taxable year is not in and of itself an allocation method, but ending the taxable year of a CFC can be an efficient

[51] See the anti-abuse considerations discussed in Part IV.D below.

procedural mechanic that allows for the efficient administration of the U.S. international tax system. Moreover, it can allow for a clean break as between two taxpayers (or groups of taxpayers) that allows each to manage its own tax affairs without requiring significant cooperation regarding the year in which a change in ownership arises. Ending a CFC's taxable year also helps prevent post-transaction activities of a buyer group from impacting the tax reporting or tax liability of the pre-transaction owners. Indeed, taxpayers often already have the flexibility to make elections under Section 338(g) or the election permitted in Treasury Regulation § 1.245A-5 to end a taxable year in connection with a CFC's change in ownership, and where available taxpayers often so elect to maximize procedural and reporting efficiency. Allowing an additional avenue for ending a CFC's taxable year to address the new pro rata share rules would be entirely consistent with the regimes in place today.

D. Additional Considerations Regarding Allocation Methods

Following the selection of one or more allocation methodologies for purposes of the new pro rata share rules, Treasury and taxpayers must address a number of technical considerations in implementing such a methodology. In many cases, we believe that the existing framework for addressing a technical consideration can be used as an effective baseline for implementing a revised regime under Section 951. For example, at a high-level, approaches to foreign tax credits, previously taxed earnings and profits, and basis adjustments to a CFC do not appear to require full-scale revision and instead will likely require more modest revisions on the margins to address any new regulations under Section 951.[52] However, certain aspects of the subpart F and NCTI regimes may require more careful reconsideration. We highlight and discuss those matters below.

1. Allocation of Subpart F Income and NCTI to CFC Shares Outstanding During Segments

Under the existing Treasury Regulations, a CFC's subpart F income, tested income and tested loss generally is allocated to shares of the CFC's stock (and therefore to the CFC's U.S. Shareholders) using a hypothetical distribution approach based on the last-day ownership of such

[52] One potential exception requiring additional attention may be regulations issued under Section 961, which generally contemplates a basis adjustment for subpart F and NCTI inclusions at the close of the CFC taxable year in which the inclusion occurs. Treasury has specifically acknowledged in informal guidance that the existing Treasury Regulations under Section 961 rules, which by their terms require a basis increase at the end of a CFC's taxable year, should not be interpreted literally in the context of mid-year adjustments to basis to avoid double taxation. See, e.g., AM 2023-002 (Mar. 10, 2023). In light of the anticipated significant increase in mid-year inclusions under the subpart F and NCTI regimes, we strongly encourage Treasury to incorporate guidance regarding mid-year changes in ownership into definitive authority upon which taxpayers may rely.

stock.[53] As the Last Day Rule has been repealed, new Treasury Regulations will need to allocate such items among U.S. Shareholders on a segment-by-segment basis. We believe that the existing hypothetical distribution mechanics can largely be retained, including with respect to the treatment of multiple classes of stock. However, with respect to a CFC with a mid-year change in ownership, the hypothetical distribution approach should apply at the end of each segment, rather than on a last day basis.

2. Earnings and Profits and Subpart F

In considering a taxpayer's pro rata share of subpart F and NCTI, a key distinction between the two regimes arises—subpart F is fundamentally an entity-level regime, focusing on the income and E&P of a specific CFC, whereas NCTI acts more as a traditional flow-through regime in which each U.S. Shareholder of a CFC takes into account its pro rata share of the tested income and tested loss of all of the CFCs in which it owns a sufficient interest and aggregates the tested income and tested loss into a single NCTI inclusion. The NCTI regime lends itself to any of the allocation approaches described above with comparative flexibility. Whichever method is selected, a taxpayer generally would take into account the tested income and/or tested loss allocable to a given segment or taxable period and then aggregate these items with other NCTI inclusions.

Subpart F's entity-level determinations yield more questionable outcomes. There are significant complexities associated with determining a U.S. Shareholder's pro rata share of subpart F income from specific segments within a taxable year, which arise largely out of the subpart F regime's requirement that a CFC generate both subpart F income as well as current E&P. Where a CFC has current E&P but no subpart F income, there will be no inclusion under Section 951 with respect to that taxable year, and similarly where a CFC has subpart F income but no current E&P, no inclusion under Section 951 will arise in that taxable year.

a. Annualized v. Segmented Calculation of E&P

Under Subchapter C, E&P is largely an annualized concept. For example, if a corporation's E&P for a taxable year (computed as of the close of the year without regard to distributions during such year) are sufficient to cover all the distributions made during that year, then each distribution is a taxable dividend.[54] If the distributions made during the taxable year exceed the corporation's current E&P, then current E&P is allocated ratably to such distributions, irrespective of whether

[53] See Part III.A.2 above.

[54] See Treas. Reg. § 1.316-1.

they occurred before the E&P arose.[55] The E&P rules generally do not permit mid-year E&P calculations for purposes of classifying a corporation's distributions,[56] nor do they take into account changes in ownership of a corporation's stock.

This annualized concept can cause tension with the new pro rata share rules. Consider the following example:

> Example 7. Assume FC1 is a CFC. US1, a domestic corporation, holds 100 percent of FC1's common stock on January 1 and sells all such stock to US2, also a domestic corporation, on June 30. On January 1, FC1 incurs expenses of $250, which reduce FC1's current E&P by the same amount. On December 31, FC1 recognizes $250 of subpart F income, which increases FC1's current E&P by the same amount. Irrespective of which pro rata share allocation approach is used, neither US1 nor US2 have a Subpart F inclusion for the taxable year.

Viewed solely through the lens of the new pro rata share rules, US2's lack of a subpart F income inclusion is arguably inconsistent with such rules' apparent purpose of taxing U.S. Shareholders based on the economic entitlements associated with their CFC stock. Indeed, this apparent purpose would arguably be better served by deviating from an annualized determination of E&P to a segmented determination of E&P for purposes of the pro rata share rules. If the E&P determination were segmented mid-year, one can envision a scenario where US2 includes $250 of subpart F income, consistent with its economic entitlement to such income.

Viewed more broadly, however, we believe that the annualized determination is consistent with Congressional intent and the policy goals of the new pro rata share rules specifically and subpart F more generally.

With respect to Congressional intent, while the OBBBA revised the pro rata share rules specifically and the U.S. international system more broadly, it did not revise the E&P rules under Subchapter C or Section 964. If Congress intended for E&P to be determined on something other than an annualized basis, then Congress could have chosen to amend either set of rules. This implies that Congress believes the existing annualized E&P rules

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[55] See Treas. Reg. § 1.316-2(b).

[56] While current year E&P deficits generally are prorated annually, it is possible to allocate current year deficits taxable year if they can be associated with a specific accounting period therein. See Treas. Reg. § 1.316-2(b) (last sentence) and Rev. Rul. 74-164.

continue to address subpart F's role as a system of limited anti-deferral in a satisfactory manner.

With respect to the policy goals of the new pro rata share rules and subpart F, deviating from an annualized calculation of a CFC's E&P for purposes of the new pro rata share rules (e.g., by using a per diem approach with exceptions for extraordinary items or an interim closing of the books approach to allocate E&P to segments of a CFC's taxable year) raises difficult questions regarding the amount of subpart F inclusions and their allocation among a CFC's U.S. Shareholders. Regarding the amount of subpart F inclusions, consider the following example.

> Example 8a. Assume FC1 is a CFC. US1, a domestic corporation, holds FC1's common stock on January 1 and sells all such stock to US2, also a domestic corporation, on June 30. On January 1, FC1 recognizes $250 of subpart F income, but does not have any current E&P. On December 31, FC1 recognizes $250 of non-subpart F income, which increases FC1's current E&P by the same amount.

If the annualized concept of E&P allocation were disregarded and the closing of the books approach applied, such that all $250 of FC1's subpart F income and none of FC1's E&P were allocated to the first half of FC1's taxable year, then neither US1 nor US2 would recognize FC1's subpart F income in the year of such transfer.[57] This outcome arguably is inconsistent with subpart F's role as a system of limited anti-deferral. Regarding the allocation of subpart F inclusions among U.S. Shareholders, consider the following example.

> Example 8b. Assume FC1 is a CFC. US1, a domestic corporation, holds 50 percent of FC1's common stock on January 1 and sells all such stock to US2, also a domestic corporation, on June 30. US3, also a domestic corporation, holds the other 50 percent of FC1 stock for the entire year. On January 1, FC1 incurs expenses of $250, which reduce FC1's current E&P by the same amount. On December 31, FC1 recognizes $250 of subpart F income, which increases FC1's current E&P by the same amount.

If the annualized concept of E&P allocation were disregarded and the closing of the books approach applied, such that $250 of FC1's gross E&P were allocated to the latter half of FC1's taxable year, then each of US2 and US3 could recognize $125 of subpart F income. This outcome

[57] Section 952(c)'s recapture rule applies to prior *year* deficits.

aligns the apparent purpose of the pro rata share rules with US2's economic entitlement, but not so for US3. One could theorize that a methodology that allocates portions of a CFC's E&P solely among buyers and sellers of CFC stock on a segmented basis may ameliorate similar outcomes to U.S. Shareholders who hold CFC stock for the taxable year. However, it is far from clear whether such an approach is practicable or perhaps even possible, including due to the complexities that actual distributions and preferred classes of CFC stock would raise.

In summary, we propose that the allocation of subpart F income to the U.S. Shareholders of a CFC be based in the first instance on an annualized calculation of the total inclusion amount without regard to any changes in ownership of the CFC. Specifically, we believe that future regulations should begin the allocation of Section 951 inclusions by determining the annual inclusion required for all shareholders, and then allocate this inclusion among the various segments within a taxable year. We discuss this recommendation in greater detail in the immediately following section.

b. Proposed Multi-Step Process for Allocating Subpart F

Future guidance under Section 951 must resolve the tension between the annualized calculation of E&P and the new pro rata inclusion rules requiring taxpayers to take income into account with respect to portions of a taxable year. Although no specific methodology is perfect, we believe that following multi-step approach may achieve many of Congress's goals in amending Section 951 while minimizing potential distortions regarding the amount or timing of subpart F inclusions.

(i) Step 1: Determine Overall Section 951 Inclusion

In the first step of our proposed process, CFCs would determine the aggregate amount of current E&P and subpart F income without regard to separate segments, different classes of stock, or changes in ownership. That is, the CFC would determine the overall Section 951 inclusion amount for its taxable year. By beginning with an overall Section 951 inclusion amount, Treasury ensures that the CFC's U.S. Shareholders will recognize the same amount of subpart F income irrespective of whether there are multiple segments within a taxable year. We believe this approach limits the extent of abusive planning opportunities and traps for the unwary arising under the new pro rata share rules.

> Example 9a. Assume FC1 (i) is a CFC for the entire taxable year, (ii) has $100 of gross subpart F income and $50 of current E&P that is earned on or before March 31, none of which is extraordinary, (iii) has $100 of non-

subpart F income and $100 of additional current E&P in a period beginning on April 1 and ending December 31, (iv) has no other taxable income, no foreign taxes for the year and a single class of common stock, and (v) uses a calendar year. Assume US1, a domestic corporation, holds 100 percent of FC1's common stock on January 1 and sells all such stock to US2, also a domestic corporation, on March 31. For Step 1, CFC determines that it has a Section 951 inclusion amount of $100 (*i.e.*, the lesser of $100 of subpart F income and $150 of current E&P).

(ii) Step 2: Apply Taxpayer's Selected Allocation Method to Segments

After determining the overall Section 951 inclusion with respect to the CFC, the second step in our proposed process requires taxpayers to allocate both current E&P and subpart F income to each segment within the taxable year based on the taxpayer's allocation method (e.g., per diem approach with exceptions for extraordinary items or interim closing of the books).

Example 9b. Assume the facts are the same as in Example 9a. For Step 2, if the taxpayer utilizes a per diem approach with exceptions for extraordinary items, $37.50 of E&P and $25 of subpart F income would be allocated to the segment ending March 31, with the remaining $112.50 of E&P and $75 of subpart F income allocated to the post-March 31 segment. Using an interim closing of the books approach, $100 of subpart F income and $50 of current E&P would be allocated to the segment ending March 31, with $0 of subpart F income and $100 of current E&P allocated to the post-March 31 segment.[58]

(iii) Step 3: Allocate Current E&P and Subpart F Income to Shares within Segments

After allocating both current E&P and subpart F income to each segment, our proposed process then allocates these amounts to shares of the CFC's stock using a hypothetical distribution construct comparable to existing Treasury Regulations (including those addressing multiple classes). As discussed above, the hypothetical distribution would occur at the close of each segment within a taxable year. If there are multiple

[58] This example assumes that each calendar quarter is one quarter of the taxable year. On a per diem basis this assumption requires rounding for illustrative purposes.

classes, similar to the existing Treasury Regulations, subpart F income could be allocated to each share pro rata to such hypothetical distributions.[59]

> Example 10. Assume FC1 (i) is a CFC for the entire taxable year, (ii) has $500 of gross subpart F income and $100 of current E&P that is earned on or before March 31, (iii) has $200 of non-subpart F loss generating a $200 E&P deficit for the period beginning April 1 and ending June 30, (iv) has $300 of non-subpart F income generating $300 of current E&P for the period beginning July 1 and ending September 30, (v) has $400 of non-subpart F income generating $400 of current E&P for the period beginning October 1 and ending December 31, (vi) has no other taxable income and no foreign taxes for the year, (vii) has ten shares of common stock outstanding and a single share of preferred stock outstanding with a par value of $100 and a 12% annual coupon and (viii) uses a calendar year. Assume that there is a change in ownership of FC1 at the close of business on March 31, June 30, and September 30, resulting in four segments for the taxable year. Assume that FC1 uses an interim closing method for each segment.
>
> For Step 1, FC1 determines that the taxable year requires a $500 Section 951 inclusion amount (the lesser of $500 of subpart F income and annual current E&P of $600).
>
> For Step 2, FC1 allocates its subpart F income and current E&P using the interim closing of the books method, resulting in the first segment having $500 of subpart F income and $100 of current E&P, the second segment having a $200 E&P deficit, the third segment having $300 of current E&P, and the fourth segment having $400 of current E&P.
>
> For Step 3, FC1's subpart F income and current E&P is allocated among its shares for each segment. For the first segment, $3 of subpart F income and current E&P is allocated to the preferred share, and the remaining $497 of subpart F income is allocated to the common shares pro rata. For the second segment, the $200 E&P deficit is allocated to the common shares pro rata. For the third segment, $3 of current E&P is allocated to the preferred share and the remaining $297 is allocated to the common shares pro rata. For the fourth segment, $3 of current E&P is allocated to the preferred share and the remaining $397 is allocated to the common shares pro rata.

[59] See Treas. Reg. § 1.951-1(e)(3). See also Treas. Reg. § 1.951-1(e)(iii) Example (3).

(iv) Step 4: Allocate Subpart F Inclusion to Segments

After allocating both current E&P and subpart F income to each segment and share, the CFC then allocates the Section 951 inclusion amount within those segments. This allocation of the Section 951 inclusion amount is necessarily arbitrary to some extent because any given individual segment may not individually have both the current E&P and the subpart F income to support a current inclusion. However, we believe that allocating a CFC's annual Section 951 inclusion amount is consistent with subpart F's limited anti-deferral purpose, and that the most arbitrary outcomes can be avoided by utilizing the following process.

In the first part of this process, Section 951 inclusions are allocated pro rata to each segment with subpart F income in an amount equal to the lesser of the subpart F income allocable to the segment and the current E&P allocable to the segment. This ensures that Section 951 inclusions are first allocated to time periods that would have generated an inclusion on a standalone basis.

The next part of this process is an optional step that Treasury could consider. In this part, any remaining Section 951 inclusion could be allocated pro rata to the segments without subpart F income in an amount equal to the product of (1) the accrual on any preferred shares for such segment and (2) a fraction, the numerator of which is the CFC's annual Section 951 inclusion amount and the denominator of which is the CFC's positive E&P for the taxable year. A rationale for this part is to ensure that preferred accruals, which represent a priority claim to the CFC's income, receive a priority allocation of the CFC's subpart F inclusions to the extent of such accruals.

In the last part of the process, any remaining Section 951 inclusion would be allocated to segments without subpart F income pro rata based on positive E&P allocable to each such segment. A rationale for this approach is that the Section 951 inclusion is allocated to each remaining segment (and therefore the U.S. Shareholders owning CFC stock during each such segment) based on the CFC's earnings.

An example of this approach *without* the optional priority allocation of Section 951 inclusions to preferred stock is as follows.

> Example 11a. Assume the same facts as in Example 10.
>
> For Step 4, FC1 first allocates $100 of the Section 951 inclusion to the first segment in the taxable year (the lesser of the subpart F income and the current E&P allocable to the segment). FC1 then allocates the remaining $400 of Section 951 inclusion amount to the other three segments without

subpart F income based on their positive current E&P, resulting in $0 of Section 951 inclusion amount allocable to the second segment ($400 x $0/$700), $171.42 of Section 951 inclusion amount allocable to the third segment ($400 x $300/$700), and the remaining $228.58 of Section 951 inclusion to the fourth segment ($400 x $400/$700).

An example of this approach *with* the optional priority allocation of Section 951 inclusions to preferred stock is as follows.

Example 11b. Assume the same facts as in Example 10.

For Step 4, FC1 first allocates $100 of the Section 951 inclusion to the first segment in the taxable year (the lesser of the subpart F income and the current E&P allocable to the segment). FC1 then allocates $1.71 of the remaining Section 951 inclusion amount ($3 of preferred accrual multiplied by $400 of the remaining Section 951 inclusion dividend by $700 of positive E&P for the year) to each of the second, third and fourth segments. FC1 then allocates the remaining $394.87 of Section 951 inclusion amount to the other three segments without subpart F income based on their positive current E&P, resulting in $0 of Section 951 inclusion amount allocable to the second segment ($394.87 x $0/$700), $169.23 of Section 951 inclusion amount allocable to the third segment ($394.87 x $300/$700), and the remaining $225.64 of Section 951 inclusion to the fourth segment ($394.87 x $400/$700).

(v) Step 5: Allocate to Section 951 Inclusion to Shares Within Each Segment

After the Section 951 inclusion amount is allocated to each segment within a taxable year, our proposed process then allocates the inclusion to shares of the CFC's stock, and therefore any U.S. Shareholders holding such stock, using the hypothetical distribution approach discussed in Step 3. However, if the optional priority allocation of the Section 951 inclusion to the preferred step is used, the Section 951 inclusion allocated to the preferred shares in segments without subpart F income would be allocated and hypothetically distributed to such preferred shares, and the remainder of Section 951 inclusion in a segment would be allocated and hypothetically distributed the common shares as the second step.

3. Section 1248

Historically, Section 1248 largely operated as a safeguard to prevent taxpayers from converting what might have been dividend income associated with the E&P of foreign subsidiaries

into lower-taxed capital gains. Prior to the enactment of the GILTI regime, Section 1248 presented an important safeguard for the U.S. international tax system given that subpart F standing alone intentionally leaves broad categories of CFC income untaxed. Section 1248's role backing up the subpart F regime was especially important during times in which the corporate and/or individual tax rate applicable to ordinary income exceeded the rate applicable to capital gains. However, with the advent of the GILTI/NCTI regimes, the adoption of the qualified dividend income rules and the 100% dividends-received-deduction under Section 245A, Section 1248 serves a much more limited role. In practical terms, the vast majority of CFC earnings are taken into account on a current basis under the subpart F and NCTI regimes. Moreover, even where Section 1248 creates a deemed dividend, significant swaths of the taxpayer base often pay the same tax rate on the deemed dividend or may even prefer this outcome due to the application of Section 245A.

In light of the limited role played by Section 1248 in today's U.S. international tax system, we encourage Treasury to adopt rules under Section 1248 that minimize any distortion between the allocation of tax items under the pro rata share rules and the allocation of E&P for Section 1248 purposes, and we note Congress's relevant delegation of authority under Section 1248(a). We believe this would generally be achievable by requiring a CFC to adopt the same allocation methodologies for purposes of Section 1248 as are required or selected for purposes of the pro rata share rules.

4. Indirect Ownership in CFCs

As the subpart F and NCTI regimes continue to evolve to resemble more traditional flow-through regimes, Treasury must also grapple with the challenges associated with tiered ownership structures in which a U.S. Shareholder may have both direct and indirect interests in CFCs. Although the concept of tiered ownership is far from new in the U.S. international tax system, the Last Day Rule avoided many of the thornier concepts associated with mid-year changes in ownership and varying interests at different levels of ownership.

The most obvious analogy appears in the context of tiered partnerships. Congress, Treasury and taxpayers have all grappled with the challenges of multiple layers of entities within Subchapter K, and while guidance is somewhat limited, meaningful and important lessons can be gleaned. In particular, we would encourage Treasury to adopt rules analogous to Rev. Rul. 77-310[60] and aspects of the regulations proposed under Section 706 in 2015. At a high-level, these rules tend toward a look-through approach in which partners of the upper-tier partnership generally

[60] 1977-2 CB 217.

take into account items of the lower-tier partnership in a manner that is intended to approximate direct ownership in the lower-tier partnership. The 2015 proposed regulations also offered some degree of relief from an administrative perspective with respect to smaller interests in lower-tier entities, acknowledging the practical limitations on being able to acquire the necessary information from a lower tier entity. Under the 2015 proposed regulations, generally speaking, if an upper-tier partnership owned less than 10% of a lower-tier partnership, the upper-tier partnership was not required to apply a look-through approach in allocating lower-tier partnership items.[61] Although the 2015 proposed regulations were never finalized, they do provide a helpful baseline for considering analogous issues in the CFC context.

Mechanically, inclusions under subpart F and the NCTI regime are direct inclusions. In other words, the income from a lower-tier CFC does not need to actually be allocated through an upper-tier CFC before being allocated to a direct U.S. Shareholder. However, analogous issues arise when a person is a U.S. Shareholder of a lower-tier CFC by virtue of its interest in an upper-tier CFC and the U.S. Shareholder's interest in the upper-tier CFC changes (thereby changing its indirect interest in the lower-tier CFC). In such a case, the determination of the U.S. Shareholder's subpart F and NCTI inclusions will require a determination of its interest in the lower-tier CFC throughout the year, and these Subchapter K principles are likely to serve as a useful starting point for Treasury.

5. Standard for Taxable year End

In the event that Treasury offers taxpayers the flexibility to end a CFC's taxable year in connection with changes in ownership, Treasury must determine the precise standards for when such an election will be allowed. We note that in analogous circumstances a relatively low threshold has applied to determine when a taxpayer is allowed to close its taxable year. For example, in Treasury Regulation § 1.245A-5(e)(3), an election is permitted whenever there would otherwise be an "extraordinary reduction amount," which requires as little as a 5% decrease in a controlling shareholder's ownership. In the S corporation context, an elective closing of the taxable year is permitted in the event an S corporation shareholder's interest is terminated,

[61] We note that a de minimis exception may be less compelling in the context of subpart F or NCTI inclusions where inclusion shareholders are required to own, actually or constructively, at least 10% of the vote or value of the lower-tier CFC before subpart F or NCTI inclusions are required. However, given the administrative complexity associated with calculating an inclusion, Treasury may consider a higher de minimis threshold (e.g., 25% instead of the 10% utilized in the 2015 proposed regulations).

regardless of the size of that interest. Thus, even modest changes in ownership can potentially trigger an elective end of a taxable year.

In the context of the subpart F and NCTI regimes, we believe that a similarly low standard may be appropriate. The precise standard applicable is a matter of regulatory discretion, but we believe it may be appropriate to permit an elective ending of the taxable year upon either (1) a person becoming or ceasing to become a U.S. Shareholder or (2) a transfer of 10% or more of a CFC's stock within a CFC's taxable year. Consideration may also be given to a standard tied to changes in a controlling U.S. Shareholder's ownership interest in a CFC (comparable to standards applied to a controlling section 245A shareholder pursuant to Treasury Regulation § 1.245A-5), but it is not clear that control is an important feature for purposes of the subpart F and NCTI rules—it appears the Treasury Regulation § 1.245A-5 rules are grounded in the potential for abusive transactions orchestrated by controlling shareholders, and the same concerns regarding abusive planning are not necessarily present for ordinary course changes in ownership.[62] For purposes of any standard that may be applied, we recommend disregarded related party transfers—transferring CFC equity among related parties (especially in tax-free transactions) potentially invites abusive planning while offering limited administrative benefits given the CFC ownership remains with the same beneficial owners.

Separate from the mechanical standards for when a potential change in the taxable year should be permitted, Treasury may also consider whether some level of protection for minority shareholders is appropriate. Such an approach has analogs in both of the elective tax-year end regimes described above—for Treasury Regulation § 1.245A-5(e) purposes all U.S. Shareholders who hold a direct or indirect interest in the CFC must consent to the election,[63] and in the case of an S corporation all affected S corporation shareholders must consent to the election.[64] In the context of the subpart F and NCTI regimes, we believe that a slightly more lenient standard is appropriate given that the only inclusion shareholders will own, actually or constructively, at least 10% of the vote or value of a CFC and therefore we recommend that such consent may be agreed or authorized among the U.S. Shareholders within the constituent documents of the CFC, analogous to the election to adopt a proration method in accordance with Treasury Regulation § 1.706-4(f). To the extent minority shareholders desire to prevent an ending of a tax year, such a

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62 However, see the discussion below regarding anti-abuse considerations more generally.

63 See Treas. Reg. § 1.245A-5(e)(3).

64 See Treas. Reg. § 1.1377-1(b)(2).

prohibition could be reflected in the corporate charter or a shareholders' agreement governing the actions of the CFC.[65]

6. Anti-Abuse Considerations

In light of the recommendations in this Report to offer significant taxpayer flexibility in allocating income and ending a CFC's taxable year, we suggest that Treasury consider a targeted anti-abuse rules to avoid inappropriate taxpayer planning. We suggest that heightened scrutiny be applied with respect to related party transfers, where the choice to use a per diem approach with exceptions for extraordinary items or an interim closing of the books approach may result in taxpayers taking advantage of electivity to inappropriately shift items of income within a group.

However, outside of the related party context, we acknowledge that some level of taxpayer planning is implicit in any election, and we note that in analogous contexts (*i.e.*, Subchapter K, Subchapter S, the consolidated returns, rules and Treasury Regulation § 1.245A-5) a mere decrease in overall tax liability of the parties is not sufficient to constitute an abusive transaction subject to challenge. A more targeting anti-abuse rule may focus on transactions undertaken with a principal purpose of decreasing a taxpayer's overall federal income tax liability. Where unrelated taxpayers are otherwise purchasing or selling interests in a CFC for valid non-tax business reasons and elect one allocation regime over another, we believe that either Treasury should presume that such a transaction is not abusive or exclude such transactions entirely from the scope of any anti-abuse rule. We would expect that an anti-abuse rule would capture an election to apply a specific allocation method within a taxable year, and would also apply with respect to an election to affirmatively end a CFC's taxable year.

Additionally, as noted above, the new pro rata share rules appear to largely preempt and address much of the abusive tax planning originally targeted by Treasury Regulation § 1.245A-5. However, we acknowledge that it is possible that taxpayers may seek to utilize Section 245A in certain circumstances to mitigate or eliminate inclusions under Section 951 by eliminating available current E&P. Therefore, an anti-abuse rule under Section 245A may be appropriate, even if Treasury Regulation § 1.245A-5 in its current form is overly expansive. Nonetheless, given that Section 951 no longer includes the dividend-offset mechanic to measure U.S. Shareholders' subpart F income inclusions, opportunity for abuse is clearly more limited as compared to prior law. However, we believe that any more narrowly constructed anti-abuse rule is more properly

[65] We note that this is comparable to other elections with respect to CFCs that could potentially impact minority inclusion shareholders (e.g., an election pursuant to Section 338(g)).

within the ambit of new regulations under Section 245A and therefore beyond the scope of this Report.