



## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[REG-105479-18]

RIN 1545-BO61

### Previously Taxed Earnings and Profits and Related Basis Adjustments

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations regarding previously taxed earnings and profits of foreign corporations and related basis adjustments. The proposed regulations affect foreign corporations with previously taxed earnings and profits and their shareholders.

**DATES:** Written or electronic comments and requests for a public hearing must be received by **[INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

**ADDRESSES:** Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-105479-18) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the **“Comments and Requests for a Public Hearing”** section.

Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically or on paper to its public docket. Send paper submissions to: CC:PA:01:PR (REG-105479-18), room

5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations generally, Elena M. Madaj at (202) 317-3576; concerning the portions of the proposed regulations relating to section 1502, Jeremy Aron-Dine at (202) 317-6847; concerning the portions of the proposed regulations relating to partnerships, Jennifer N. Keeney at (202) 317-6850; and concerning submissions of comments and requests for a public hearing, contact the Publications and Regulations Section of the Office of Associate Chief Counsel (Procedure and Administration) by email at *publichearings@irs.gov* (preferred) or by telephone at (202) 317-6901 (not toll-free numbers).

## **SUPPLEMENTARY INFORMATION:**

### **Authority**

This document contains proposed additions and amendments to 26 CFR part 1 (proposed regulations) under sections 959 and 961 and certain other provisions of the Internal Revenue Code (Code) regarding previously taxed earnings and profits (PTEP). As discussed in the Explanation of Provisions, the primary provisions of the proposed regulations are issued pursuant to the express delegations of authority under sections 245A(g), 743(b), 904(d)(7), 951A(f)(1)(B), 960(f), 961(a) through (c), 965(o), 986(c)(2), 989(c), and 1502. The proposed regulations are also issued pursuant to the express delegation of authority under section 7805(a).

### **Background**

#### **I. Scope**

The Background describes PTEP, including provisions giving rise to PTEP and provisions regarding the treatment of PTEP, and related guidance and issues under existing law. Any term used but not defined in this preamble has the meaning given to it in the proposed regulations.

## II. PTEP

### A. Overview

Sections 959 and 961 are intended to operate in tandem to prevent double taxation of PTEP, which is earnings and profits (E&P) of a foreign corporation described in section 959(c)(1) or (c)(2). Section 959 designates amounts of E&P as PTEP based on amounts included, or treated as included, in gross income with respect to the foreign corporation under section 951(a).

The remainder of this part II of the Background summarizes provisions giving rise to PTEP, provisions regarding the treatment of PTEP, and existing regulations under sections 959 and 961.

### B. Provisions giving rise to PTEP

#### 1. Section 951(a)

Section 951(a)(1)(A) requires a United States shareholder (as defined in section 951(b) or, if applicable, section 953(c)(1)(A)) of a foreign corporation to include in gross income its pro rata share of the corporation's subpart F income (as defined in section 952) for a taxable year of the corporation (subpart F income inclusion), if the corporation is a controlled foreign corporation (CFC) (as defined in section 957(a) or, if applicable, section 957(b) or 953(c)(1)(B)) at any time during the taxable year and the shareholder owns (within the meaning of section 958(a)) stock of the corporation on the last day of the taxable year on which the corporation is a CFC (last relevant day). Pursuant to section 951(a)(1)(B), the United States shareholder is generally required to also include in gross income its amount determined under section 956 (section 956 amount) for the taxable year of the foreign corporation (section 956 inclusion). This amount represents an effective repatriation of E&P and is computed based on certain United States property held by the corporation. Ownership of stock within the meaning of section 958(a) means stock owned directly and stock owned indirectly through foreign entities,

including domestic partnerships to the extent treated as foreign partnerships under §1.958-1(d)(1) (discussed in part III.B of the Background). For purposes of the remainder of this preamble, a reference to stock ownership means stock owned within the meaning of section 958(a).

Section 951(a)(2) determines a United States shareholder's pro rata share of a foreign corporation's subpart F income by first allocating a portion of such subpart F income to the United States shareholder, and then reducing such allocation in accordance with section 951(a)(2)(B) to take into account certain distributions where ownership of the stock of the foreign corporation is acquired by the United States shareholder during the corporation's taxable year. See §1.951-1(b). Subpart F income allocated to a United States shareholder before the application of section 951(a)(2)(B) is computed by multiplying the subpart F income by a fraction, the numerator of which is the portion of the foreign corporation's hypothetical distribution described in §1.951-1(e) that would be distributed with respect to the shareholder's stock of the corporation, and the denominator of which is the amount of such hypothetical distribution. See §1.951-1(e). The amount of the hypothetical distribution is equal to the foreign corporation's allocable E&P, which is generally the corporation's E&P for the taxable year (not reduced by distributions during the year). See §1.951-1(e)(1)(ii).

A special rule under section 245A(e) treats certain hybrid dividends received by a CFC as subpart F income of the receiving CFC for purposes of section 951(a)(1)(A). Similarly, section 964(e)(4) treats certain gain from a sale of stock of a foreign corporation by a CFC as subpart F income of the selling CFC for purposes of section 951(a)(1)(A). Consequently, a United States shareholder of such a receiving CFC or selling CFC includes in gross income under section 951(a)(1)(A) its pro rata share of such subpart F income.

## 2. Section 951A(a)

Pursuant to section 951A(a), a United States shareholder of a CFC is required to include in gross income its global intangible low-taxed income (GILTI inclusion). See §1.951A-1(b). A United States shareholder's GILTI inclusion is determined by taking into account the shareholder's pro rata share of tested items (as defined in §1.951A-1(f)(5)) of CFCs in which the shareholder owns stock, such as tested income, tested loss, and qualified business asset investment. See §1.951A-1(c). A United States shareholder's pro rata share of a CFC's tested items is determined in the same manner as a pro rata share of subpart F income under section 951(a)(2), subject to certain modifications. See §1.951A-1(d).

Section 951A(f)(1)(A) provides that a GILTI inclusion is treated in the same manner as a subpart F income inclusion for purposes of applying certain provisions of the Code, including sections 959 and 961. Section 951A(f)(1)(B) grants the Secretary authority to provide rules for applying section 951A(f)(1)(A) to other provisions of the Code in any case in which the determination of subpart F income is required to be made at the level of the CFC.

### 3. Section 1248(a) or (f)

Section 1248(a) requires a United States person that satisfies certain ownership requirements with respect to stock in a foreign corporation to include gain recognized on a sale or exchange of stock in such foreign corporation in gross income as a dividend, to the extent of the E&P of the foreign corporation attributable to the stock (including E&P of certain lower-tier foreign corporations pursuant to section 1248(c)(2), but not including PTEP pursuant to section 1248(d)(1)). Section 1248(f) provides similar rules for certain distributions in nonrecognition transactions.

Section 959(e) treats an amount included in gross income of any person as a dividend under section 1248(a) or (f) as an amount included in gross income under section 951(a)(1)(A), for purposes of section 959.

#### 4. Section 965

The transition tax imposed under section 965 as part of the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054 (2017) (the Act) increased the subpart F income of certain foreign corporations and treated such foreign corporations as CFCs for purposes of section 951 (if not already the case). Section 965(a) and (e).

Consequently, a United States shareholder of such a foreign corporation generally included in gross income under section 951(a)(1)(A) its pro rata share of such additional subpart F income, subject to reduction under section 965(b) for certain E&P deficits attributable to stock of other foreign corporations owned by the shareholder.

For purposes of section 959, the transition tax also treated the amount of a reduction to a United States shareholder's inclusion with respect to a foreign corporation under section 965(b) as an amount included in the shareholder's gross income with respect to the foreign corporation under section 951(a). Section 965(b)(4)(A).

#### C. Provisions regarding the treatment of PTEP

##### 1. Gross Income Exclusions Under Section 959

Section 959 prevents double taxation by excluding PTEP from gross income of United States persons and CFCs. See H.R. Rep. No. 87-1447, at A101-102 (1962).

Section 959(a) provides that, when PTEP of a foreign corporation is distributed to, or would otherwise be included under section 951(a)(1)(B) in gross income of, a United States shareholder whose inclusion under section 951(a) gave rise to the PTEP, the PTEP is excluded from the United States shareholder's gross income. Under successor rules within section 959(a), the exclusion extends to any other United States person who acquires from any person any portion of the United States shareholder's interest in the foreign corporation (subject to any proof of identity rules that may be prescribed by the Secretary).

Section 959(b) applies for purposes of section 951(a) and provides that, when PTEP of a CFC is distributed through a chain of ownership described under section 958(a), the PTEP is excluded from the gross income of another CFC in the chain for purposes of applying section 951(a) to such CFC with respect to the United States shareholder whose inclusion under section 951(a) gave rise to the PTEP. Under successor rules within section 959(b), the exclusion extends to any CFC of any other United States shareholder who acquires from any person any portion of the United States shareholder's interest in the CFC (subject to any proof of identity rules that may be prescribed by the Secretary).

Section 959(c) treats PTEP as distributed before E&P that is not PTEP. It does so by allocating distributions first to PTEP described in section 959(c)(1) (PTEP resulting from a section 956 inclusion or PTEP that have been excluded under section 959(a)(2)), then to PTEP described in section 959(c)(2) (all other PTEP), and finally to non-PTEP (section 959(c)(3) E&P).

For purposes of section 959, section 951A(f)(1) treats the portion of a United States shareholder's GILTI inclusion that is allocated to a CFC in the same manner as a subpart F income inclusion.

Section 959(f) allocates a section 956 amount first to PTEP described in section 959(c)(2) and then to section 959(c)(3) E&P, taking into account distributions made by the foreign corporation. A section 956 amount is not allocated to PTEP described in section 959(c)(1) because, under section 956(a) and (b)(1), that PTEP is taken into account in determining the section 956 amount.

Thus, under section 959, a CFC's E&P for a taxable year of the CFC is first classified as PTEP to reflect any subpart F income inclusions or GILTI inclusions with respect to the CFC. Next, any distributions made by the CFC during the taxable year are allocated to PTEP (and such PTEP is reduced). Then, any section 956 amount with

respect to the CFC is determined for the taxable year, which is allocated to remaining section 959(c)(2) PTEP (and such PTEP is reclassified as section 959(c)(1) PTEP). Finally, the CFC's E&P for the taxable year is classified as PTEP to reflect any inclusion under section 951(a)(1)(B).

## 2. Basis Adjustments Under Section 961

Section 961 describes rules that provide for basis increases to reflect amounts included in gross income under section 951(a) and basis reductions and gain recognition to reflect distributions of PTEP. Basis increases prevent undistributed PTEP of a foreign corporation from giving rise to gain or a subpart F income inclusion of a covered shareholder, and thus additional tax, in a sale or exchange of stock of the foreign corporation or property through which such stock is owned. See H.R. Rep. No. 87-1447, at A106 (1962); H.R. Rep. No. 105-148, at 529-30 (1997). Basis reductions and gain recognition prevent double benefits that would otherwise arise (for example, by ensuring a distribution of PTEP does not create a loss in the stock or other property on which the distribution is made because of basis provided under section 961 for the inclusion that gave rise to the PTEP).

Section 961(a) provides that, under regulations prescribed by the Secretary, a United States shareholder's basis in its stock in a CFC, and basis in property through which it owns such stock, is increased by the amount included in the shareholder's gross income under section 951(a) with respect to such stock or property.

Section 961(b)(1) provides that, under regulations prescribed by the Secretary, when a United States shareholder or a United States person receives an amount that is excluded from gross income under section 959(a), the basis of the stock or other property with respect to which the amount is received is reduced by the amount so excluded. To the extent that an amount excluded from gross income under section 959(a) exceeds the basis of the stock or other property with respect to which it is



received, section 961(b)(2) treats the amount as gain from the sale or exchange of property.

Section 961(c) provides that, under regulations prescribed by the Secretary, if a United States shareholder owns stock in a CFC that is owned by another CFC, then adjustments similar to the adjustments provided by section 961(a) and (b) are made to the basis of such stock, and the basis of stock in any other CFC through which the United States shareholder owns the stock of the first mentioned CFC, but only for the purposes of determining the amount included under section 951 in the gross income of such United States shareholder. Under successor rules within section 961(c), basis adjustments carry over to any other United States shareholder who acquires from any person any portion of the interest of the United States shareholder by reason of which the shareholder was treated as owning the relevant CFC stock (subject to any proof of identity rules that may be prescribed by the Secretary). Section 961(c) further provides that the adjustments described in section 961(c) do not apply to any stock owned by the United States shareholder to which a basis adjustment applies under section 961(a) or (b).

For purposes of section 961, section 951A(f)(1) treats the portion of a United States shareholder's GILTI inclusion that is allocated to a CFC in the same manner as a subpart F income inclusion.

Section 1.965-2(f)(1) generally provides that basis is not increased under section 961 to reflect PTEP resulting from section 965(b), but §1.965-2(f)(2) permits taxpayers to elect to make certain basis adjustments.

### 3. Foreign Currency Gain or Loss Under Section 986(c)

Section 986(c)(1) requires the recognition of foreign currency gain or loss with respect to distributions of PTEP attributable to movements in exchange rates between the date of the income inclusion that gave rise to the PTEP and the distribution of the

PTEP. Section 986(c)(1) further provides that such foreign currency gain or loss is treated as ordinary income or loss from the same source as the associated income inclusion. Section 986(c)(2) provides that the Secretary shall prescribe regulations with respect to distributions of PTEP through tiers of foreign corporations. Section 989(c) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the subpart that includes section 986 (subpart J of part III, subchapter N, chapter 1, subtitle A of the Code).

Notice 88-71, 1988-2 C.B. 374 (1988 notice), provides guidance regarding foreign currency gain or loss with respect to PTEP and announced an intent to issue regulations consistent with the guidance. Under the 1988 notice, such foreign currency gain or loss is determined with respect to each separate category of income listed in section 904(d)(1) pursuant to a formula and is recognized immediately before certain sales or exchanges of stock of a foreign corporation with respect to undistributed PTEP of the foreign corporation. See *also* §1.985-5(e)(2) (requiring a United States shareholder to recognize foreign currency gain or loss when a CFC changes its functional currency to the U.S. dollar); §1.367(b)-2(j)(2)(i) (application of section 986(c) to certain nonrecognition).

Section 1.986(c)-1 addresses foreign currency gain or loss with respect to distributions of PTEP resulting from section 965. The rules provide that foreign currency gain or loss with respect to PTEP resulting from section 965(a) is determined based on movements in the exchange rate between December 31, 2017, and the time such PTEP is distributed, and that any such gain or loss recognized is reduced in the same proportion as the reduction by a section 965(c) deduction amount (as defined in §1.965-1(f)(42)) of the section 965(a) inclusion amount (as defined in §1.965-1(f)(38)) that gave rise to the PTEP. The rules also provide that section 986(c) does not apply with respect to distributions of PTEP resulting from section 965(b).

#### 4. Foreign Income Taxes Under Sections 164(a), 901(a), and 960(b)

Section 164(a) generally provides that a taxpayer is allowed a deduction for certain foreign income taxes paid or accrued by the taxpayer.

Section 901(a) generally provides that a taxpayer choosing to credit foreign income taxes is allowed a credit for certain foreign income taxes paid or accrued by the taxpayer plus, in the case of a domestic corporation, the taxes deemed to have been paid by the domestic corporation under section 960.

Section 960(b) applies for purposes of sections 901 through 909 (relating to the foreign tax credit). Section 960(b)(1) provides that, if PTEP distributed by a CFC to a corporate United States shareholder of the CFC is excluded from gross income under section 959(a), the United States shareholder is deemed to have paid the foreign income taxes that are properly attributable to the PTEP and that have not already been deemed paid by a domestic corporation. Similarly, section 960(b)(2) provides that, if PTEP distributed by a CFC to another CFC is excluded from gross income under section 959(b), the recipient CFC is deemed to have paid the foreign income taxes that are properly attributable to the PTEP and that have not already been deemed paid by a domestic corporation. Section 960(f) provides that the Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of section 960. Section 904(d)(1) provides that certain provisions including section 960 apply separately with respect to certain categories of income, and section 904(d)(7) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate for the purposes of section 904(d).

For purposes of determining the amount of foreign income taxes deemed paid, §1.960-3 requires the establishment and maintenance of foreign corporation-level accounts that track a foreign corporation's PTEP and foreign income taxes associated with the PTEP. Those regulations adopt a system of accounting for PTEP in annual

accounts for each separate section 904 category (as defined in §1.960-1(b)(23)) and further segregate each annual account among ten PTEP groups.

Section 965(g) and §1.965-5 disallow a percentage (referred to as the applicable percentage, as defined in §1.965-5(d)) of any credit or deduction for foreign income taxes associated with PTEP resulting from section 965(a) or (b). Section 245A(d) and §1.245A(d)-1 disallow the entirety of any credit or deduction for foreign income taxes associated with PTEP resulting from income inclusions by reason of section 245A(e)(2) (regarding hybrid dividends) or certain income inclusions by reason of section 964(e)(4) (regarding sales of stock of a foreign corporation by a CFC). Sections 245A(g) and 965(o) provide that the Secretary shall prescribe such regulations or other guidance as may be necessary or appropriate to carry out the provisions of sections 245A and 965, respectively.

#### 5. Election Under Section 962

Section 962(a) provides that, under regulations prescribed by the Secretary, an individual United States shareholder may elect to be taxed at domestic corporate rates on amounts included in the individual's gross income under section 951(a) and that those amounts are treated as taken into account by a domestic corporation for purposes of applying the relevant provisions of section 960. The election also applies to amounts included in the individual's gross income under section 951A(a) because, for purposes of section 962, such amounts are treated in the same manner as a subpart F income inclusion. See section 951A(f)(1). The purpose of section 962 generally is to equate an individual's tax burden with respect to certain earnings of a CFC with the tax burden the individual would have had if the individual were to own the CFC through a domestic corporation. See S. Rep. No. 87-1881, at 92-93 (1962).

To carry out this purpose, section 962(d) generally subjects PTEP to an additional level of taxation when distributed. It does so by, notwithstanding section

959(a)(1), requiring that the distributed PTEP be included in gross income to the extent it exceeds the amount of tax paid on the amounts to which the election under section 962 applied.

Section 961(a) also carries out this purpose by, in the case of an election under section 962, limiting a basis increase for an income inclusion to which the election applied to the amount of tax paid by the individual with respect to the income inclusion. Additionally, in a distribution of PTEP, section 961(b)(1) limits a basis decrease to the amount that is excluded from gross income under section 959(a) after the application of section 962(d).

## 6. Section 1411

Section 1411 generally imposes a 3.8 percent tax on the net investment income of certain individuals, trusts, and estates. Under section 1411(c)(1) and §1411-4(a), net investment income includes certain income from dividends and net gain from the disposition of property. Section 1.1411-10 provides, in relevant part, rules regarding the application of section 1411 to individuals, trusts, and estates that own stock of a CFC, and §1.1411-10(g) allows an election with respect to a CFC to treat amounts included in income under section 951(a) with respect to the CFC as net investment income for purposes of §1.1411-4(a)(1)(i). See *also* §1.951A-5(b)(1) (treating a GILTI inclusion in the same manner as a subpart F income inclusion for purposes of applying section 1411). If the election provided under §1.1411-10(g) is made, a distribution of E&P that is not treated as a dividend pursuant to section 959(d) is generally not treated as a dividend for purposes of section 1411(c)(1)(A)(i) and §1.1411-4(a)(1)(i). See §1.1411-10(c)(1)(i)(B). If the election provided under §1.1411-10(g) is not made, however, net investment income could reflect value attributable to PTEP, either when the PTEP is distributed or when a United States shareholder directly or indirectly disposes of stock of the CFC. Thus, if no election is made, a distribution of E&P that is not treated as a

dividend pursuant to section 959(d) is nevertheless a dividend for purposes of determining net investment income under section 1411(c)(1)(A)(i) and §1.1411-4(a)(1)(i), provided the distribution is attributable to amounts that are or have been included in gross income under section 951(a) in a taxable year beginning after December 31, 2012. See §1.1411-10(c)(1)(i)(A)(1). For purposes of calculating gain on the disposition of stock of a CFC, basis adjustments under section 961(a) and (b) are similarly not taken into account for section 1411 purposes in the absence of the election. See §1.1411-10(d)(1).

D. Regulations under sections 959 and 961

The current regulations under sections 959 and 961 were issued in 1965 and have not been updated to reflect certain statutory changes (for example, the enactment of section 961(c)). The regulations also do not address a number of issues relating to the operation of sections 959 and 961.

In 2006, the Treasury Department and the IRS issued a notice of proposed rulemaking (71 FR 51155) (2006 proposed regulations) to provide more complete rules and address various open issues under sections 959 and 961 and related provisions.

In 2018, the Treasury Department and the IRS issued Notice 2019-01, 2019-02 I.R.B. 275 (2019 notice), which announced an intent to withdraw the 2006 proposed regulations and issue a new notice of proposed rulemaking under sections 959 and 961 to address certain issues arising from the Act. The 2019 notice described rules for the maintenance of PTEP accounts and other aspects relating to the operation of section 959 and requested comments on certain topics. The Treasury Department and the IRS received several written comments in response to the 2019 notice. In 2022, the Treasury Department and the IRS formally withdrew the 2006 proposed regulations (87 FR 63981).

As indicated in the 2019 notice, changes made by the Act had a significant impact on the role of PTEP and how it functions within the U.S. tax system and, in certain cases, exacerbated the need to address longstanding issues. Thus, in addition to the need for updated and more complete rules as contemplated in the 2006 proposed regulations, the issuance of new regulations requires consideration of multiple issues raised by the Act. Certain significant considerations about the role of PTEP in the current U.S. tax system are summarized below.

First, the Act significantly increased the types of income that give rise to PTEP, several of which involve specific rules and limitations to determine foreign currency gain or loss and the availability of foreign tax credits. Giving effect to the various rules and limitations introduced by the Act requires a detailed accounting system to track PTEP in new groups, and to ensure those rules and limitations are appropriately applied by taxpayers and can be administered by the IRS.

The Act also substantially increased the amount of PTEP in the U.S. tax system. In many cases, a considerable portion of a CFC's income has been (or will be) subject to tax under section 951(a)(1)(A) or 951A(a), including by reason of the transition tax imposed under section 965, and thus only the residual amount of the CFC's income constitutes section 959(c)(3) E&P.

At the same time, the Act introduced section 245A, which in certain cases allows a domestic corporation to claim a dividends received deduction for section 959(c)(3) E&P. As a result, unlike before the Act where section 959(c)(3) E&P generally was subject to U.S. tax (with a possible foreign tax credit in some cases) when repatriated to the domestic corporation, such E&P may now generally be repatriated without U.S. tax to a recipient domestic corporation. Nonetheless, there are important distinctions between section 959(c)(3) E&P and PTEP – in particular, the section 245A deduction generally allows E&P to be distributed without a corresponding basis reduction (but see

sections 961(d) and 1059), whereas a distribution of PTEP reduces basis (or gives rise to gain) in accordance with section 961(b). Therefore, PTEP may not be preferable to section 959(c)(3) E&P and taxpayers might take inappropriate positions to maximize the existence of section 959(c)(3) E&P. For example, a taxpayer may wish to claim a section 961 basis increase for an amount included in gross income but apply the section 245A deduction on a distribution of the corresponding E&P so that such E&P is repatriated tax-free without any basis reduction under section 961(b). To prevent this type of planning, it is critical for the system to properly maintain the PTEP character of that E&P so that section 961(b) applies when the E&P is distributed.

Existing rules governing PTEP also do not adequately address structures where a United States shareholder owns only a portion of the stock in an upper-tier CFC that owns stock in a lower-tier CFC. In particular, there are no rules prescribing the manner in which basis under section 961(c) functions in these non-wholly owned structures. Further, after the enactment of section 951A in the Act, it is much more likely for United States shareholders to have disparate amounts of PTEP with respect to the same CFC because a United States shareholder's GILTI inclusion is determined based on items attributable to all the stock of CFCs owned by the United States shareholder, and this can raise issues about how section 959(b) applies in distributions of the PTEP (such as the issues discussed in part II.D.1.ii of the Explanation of Provisions). Thus, changes in the Act have compounded already existing complexities with respect to the treatment of PTEP and basis in stock in non-wholly owned structures.

Finally, existing rules do not sufficiently address the operation of the PTEP provisions with respect to domestic partnerships (or certain S corporations) in light of the enactment of section 951A and the extension of aggregate treatment to such entities in determining inclusions under both sections 951(a) and 951A(a) (as discussed in part III.A of the Background). Moreover, certain unresolved issues, such as whether



a partnership obtains basis in stock of a CFC to account for PTEP, which had previously been limited to foreign partnerships, now apply equally to domestic partnerships (and certain S corporations).

### III. Other Guidance and Issues

#### A. Regulations under section 958

Before the Act, domestic partnerships (and S corporations by operation of section 1373(a)) were treated as owning stock of a foreign corporation for purposes of determining inclusions in gross income under section 951(a), and, thus, PTEP accounts under section 959 were maintained, and related basis adjustments under section 961 were made, at the partnership level.

Following the enactment of section 951A in the Act, in 2019 the Treasury Department and the IRS published final regulations treating a domestic partnership (and certain S corporations) as an aggregate of its partners for purposes of applying section 951A and related provisions. TD 9866, 84 FR 29288. That is, partners do not take into account a distributive share of a section 951A inclusion with respect to the domestic partnership and its CFCs, but instead are treated as proportionately owning the stock of those CFCs, with the result that (as with foreign partnerships) income inclusions under section 951A are determined directly (and solely) by partners that are United States shareholders with respect to a CFC. Subsequently, in 2022, the Treasury Department and the IRS published §1.958-1(d) which, consistent with the approach adopted under section 951A, extends the aggregate treatment of domestic partnerships to section 951. TD 9960, 87 FR 3648.

Under §1.958-1(d), for purposes of sections 951, 951A, and 956(a), as well as any provision that specifically applies by reference to those sections (or regulations issued under those sections), a domestic partnership is generally not treated as owning stock of a foreign corporation under section 958(a), and stock of a foreign corporation

owned by the domestic partnership is instead treated in the same manner as stock of a foreign corporation owned by a foreign partnership under section 958(a)(2) and §1.958-1(b). Accordingly, because sections 959 and 961 specifically apply by reference to sections 951 and 951A (in the latter case, as a result of section 951A(f)(1)(A)), aggregate treatment of domestic partnerships applies for purposes of sections 959 and 961 pursuant to §1.958-1(d). Regulations do not, however, specifically address the application of sections 959 and 961 with respect to domestic partnerships or their partners under §1.958-1(d).

#### B. Regulations under section 1502

Section 1502 authorizes the Secretary to prescribe regulations for an affiliated group of corporations that join in filing (or that are required to join in filing) a consolidated return (consolidated group, as defined in §1.1502-1(h)) to clearly reflect the U.S. tax liability of the consolidated group and to prevent avoidance of such tax liability. For purposes of carrying out those objectives, section 1502 also permits the Secretary to prescribe rules that may be different from the provisions of chapter 1 of subtitle A of the Code that would apply if the corporations composing the consolidated group filed separate returns. Pursuant to these rules, members of a consolidated group are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. *See, for example*, §1.1502-13(a)(2).

Regulations issued under section 1502 address the application of certain provisions of subpart F in the context of consolidated groups. *See, for example*, §1.1502-51 (application of section 951A to consolidated groups); §1.1502-80(j) (addressing determination of section 951(a)(2)(B) reduction for distributions under section 959(b) for purposes of sections 951(a)(1)(A) and 951A(a)). However, regulations do not address the application of sections 959 and 961 with respect to a consolidated group or its members.

## **Explanation of Provisions**

### **I. Scope**

The proposed regulations provide rules addressing core aspects of the PTEP system, including rules that address longstanding issues under sections 959 and 961, account for new provisions and amendments under the Act, and implement the 1988 notice and 2019 notice. Future guidance will address certain issues not addressed in the proposed regulations, for example, issues involving nonrecognition transactions, redemptions, transactions to which section 964(e) applies, and structures where CFCs are partners in a partnership. See *also* Notice 2024-16, 2024-5 I.R.B. 622 (announcing intent to issue proposed regulations addressing the treatment of section 961(c) basis in certain transactions in which a domestic corporation acquires stock of a CFC in a liquidation described in section 332 or an asset reorganization described in section 368(a)(1)). Future guidance may also address any issues regarding the interaction of the proposed regulations with existing rules under other provisions.

### **II. Section 959 Regulations**

#### **A. Overview**

The proposed regulations under section 959 provide rules for PTEP accounting (both at the shareholder-level and foreign corporation-level), exclusions from gross income, and related determinations and adjustments.

#### **B. PTEP accounting (proposed §1.959-2)**

##### **1. Shareholder-Level Accounts**

###### **i. In general**

Integral to the proposed regulations are annual PTEP accounts, dollar basis pools, and PTEP tax pools, which are established and maintained by a covered shareholder with respect to a foreign corporation in which the shareholder owns stock. See proposed §1.959-2(b)(1). These are integral aspects of the PTEP system because

they ensure proper tracking of amounts described under provisions of the Code such as sections 959(a), 986(c), and 960(b). These rules are issued pursuant to the express delegations of authority under sections 245A(g), 904(d)(7), 960(f), 965(o), and 989(c).

A covered shareholder means any United States person, other than a domestic partnership. See proposed §1.959-1(b); see *also* part VIII.A of the Explanation of Provisions (providing that an S corporation is generally treated in the same manner as a domestic partnership). Domestic partnerships are excluded from this definition because they are treated as aggregates of their partners in determining stock ownership for purposes of section 959 (discussed in part III.A of the Background). A covered shareholder is not limited to a United States shareholder because the exclusion under section 959(a) is not limited to United States shareholders. For example, section 959(a) applies to any United States person who acquires from any person an interest in a foreign corporation with PTEP.

## ii. Annual PTEP accounts

Annual PTEP accounts track a foreign corporation's PTEP with respect to a covered shareholder. See proposed §1.959-2(b)(1). These accounts represent PTEP distributable exclusively to the covered shareholder (or a successor), directly or indirectly through tiers, on any stock of the foreign corporation.

Each annual PTEP account relates to a single taxable year of the foreign corporation and a single section 904 category, and PTEP within an annual PTEP account is maintained in the foreign corporation's functional currency and assigned among ten PTEP groups and two subgroups. See proposed §1.959-2(b)(2). Tracking PTEP on an annual basis is necessary to apply the "last-in, first-out" rule for distributions of PTEP in section 959(c), and PTEP is maintained in the foreign corporation's functional currency pursuant to section 986(b). Tracking PTEP by section

904 category and by PTEP groups is necessary to implement rules determining foreign currency gain or loss and foreign tax credits with respect to PTEP.

The ten PTEP groups fall within two categories – section 959(c)(2) PTEP groups and section 959(c)(1) PTEP groups. See proposed §1.959-2(b)(2)(i). The section 959(c)(2) groups separately track PTEP resulting from subpart F income inclusions, GILTI inclusions, application of section 965(a) or 965(b), or income inclusions to which section 245A(d) applies (PTEP resulting from section 245A(e)(2) or certain PTEP resulting from section 959(e) (concerning section 1248) or section 964(e)(4) (concerning certain dispositions of foreign stock)). The section 959(c)(1) PTEP groups correspond to the section 959(c)(2) PTEP groups and account for the reclassification of PTEP pursuant to section 959(a)(2). PTEP arising from section 956 inclusions is combined with reclassified PTEP arising from subpart F income inclusions.

The two subgroups track PTEP arising from income inclusions of certain covered shareholders. See proposed §1.959-2(b)(2)(ii). One subgroup tracks PTEP arising from an income inclusion of an individual and includible in gross income under section 962(d) when distributed in a distribution to which section 959(a) would otherwise apply (taxable section 962 PTEP). The second subgroup tracks PTEP arising from an income inclusion of an individual, estate, or trust that would be includible in net investment income under section 1411(c) when distributed (that is, the election under §1.1411-10(g) is not made and, thus, the income inclusion giving rise to the PTEP was not taken into account in determining net investment income).

Additionally, for PTEP resulting from the application of section 965(a) or (b), an adjusted applicable percentage must be maintained, which tracks the percentage of a credit or deduction for foreign income taxes associated with PTEP that is disallowed under §1.965-5. See proposed §1.959-2(b)(2)(iii)(A). Similarly, for PTEP resulting from the application of section 965(a), a section 965(c) deduction percentage must be

maintained, which tracks the percentage of foreign currency gain or loss with respect to PTEP that is not recognized under §1.986(c)-1. See proposed §1.959-2(b)(2)(iii)(B). The adjusted applicable percentage and the section 965(c) deduction percentage are tracked by section 904 category. Each is determined using a single weighted average across that section 904 category, which is intended to reduce the compliance burden and facilitate administrability in cases in which the applicable percentage or section 965(c) deduction amount differs with respect to PTEP in the section 904 category by not requiring the separate tracking of those percentages or amounts. See *also* part IX.B.3. of the Explanation of Provisions (describing transition rules for the initial determination of the adjusted applicable percentage and section 965(c) deduction percentage).

### iii. Dollar basis pools and PTEP tax pools

Dollar basis pools track the basis in U.S. dollars of a foreign corporation's PTEP with respect to a covered shareholder, and such dollar basis is used to determine foreign currency gain or loss under section 986(c). See proposed §1.959-2(b)(1). PTEP tax pools track the U.S. dollar amount of foreign income taxes associated with a foreign corporation's PTEP with respect to a covered shareholder, and such taxes are assigned to a creditable PTEP tax group to the extent eligible to be deemed paid under section 960(b). See proposed §1.959-2(b)(1) and (4)(ii). The creditable PTEP tax group tracks foreign income taxes that are eligible to be deemed paid under section 960(b).

Furthermore, together, dollar basis and the U.S. dollar amount of associated foreign income taxes determine basis reductions under section 961 for distributions of PTEP. See *also* part III.C.2 of the Explanation of Provisions.

Tracking foreign income taxes associated with PTEP in a shareholder-specific manner (consistent with how PTEP is tracked) differs from the approach under existing §1.960-3 (and the 1988 notice), which tracks such taxes only at the CFC-level (without

regard to the shareholder whose PTEP account was reduced by the taxes). This new approach ensures that, in structures involving multiple covered shareholders, foreign income taxes are associated with PTEP with respect to a particular covered shareholder and do not include foreign income taxes that were imposed on PTEP with respect to another covered shareholder. Thus, in a distribution of PTEP to a covered shareholder, the covered shareholder's basis is reduced under section 961(b) by the foreign income taxes that are (i) associated with (and consequently reduced) PTEP with respect to the covered shareholder, and (ii) deemed paid by the covered shareholder. This method is intended to prevent each covered shareholder from incurring double taxation on a single item of income, by ensuring that a covered shareholder is able to take into account the foreign income taxes associated with the PTEP with respect to the covered shareholder.

Generally, dollar basis pools and PTEP tax pools are maintained on a year-by-year basis, with one pool for each PTEP group within each annual PTEP account. See proposed §1.959-2(b)(3) and (4). Maintenance of separate dollar basis pools for each PTEP group prevents the commingling of dollar basis of PTEP that is subject to different rules with respect to the recognition of foreign currency gain or loss under section 986(c). Maintenance of separate PTEP tax pools for each PTEP group prevents the commingling of foreign income taxes for which the related PTEP is subject to different rules regarding the applicability of section 960(b).

Under an exception intended to simplify PTEP accounting, a covered shareholder may elect to combine dollar basis pools and PTEP tax pools across years. See proposed §1.959-2(c). In such a case, each dollar basis pool and PTEP tax pool relates to PTEP assigned to a single PTEP group and a single section 904 category (without regard to the taxable years to which the PTEP relates). See proposed §1.959-2(b)(3) and (4). This election is consistent with a comment in response to the 2019

notice that recommended allowing taxpayers to pool dollar basis across years within section 904 categories.

If a covered shareholder elects to combine dollar basis pools and PTEP tax pools across years, the election applies to the covered shareholder's dollar basis pools and PTEP tax pools with respect to each foreign corporation in which the covered shareholder owns stock. See proposed §1.959-2(c)(1). This ensures consistent treatment by not permitting a covered shareholder to maintain combined pools with respect to some foreign corporations but not others. A combined pool election may be revoked only with the consent of the Commissioner. See proposed §1.959-2(c)(2).

## 2. Foreign Corporation-Level Accounts

Foreign corporation-level accounts track a foreign corporation's PTEP and associated foreign income taxes (corporate PTEP accounts and corporate PTEP tax pools, respectively). See proposed §1.959-2(d)(1) and (d)(2). A corporate PTEP account and corporate PTEP tax pool each relate to a single covered shareholder, and PTEP or foreign income taxes within such an account are assigned to section 904 categories and PTEP groups (as is the case in shareholder-level accounts). These accounts reflect that PTEP and associated foreign income taxes are foreign corporation-level attributes (which, as discussed in part II.B.1 of the Explanation of Provisions, are tracked in a shareholder-specific manner). These accounts also are necessary to allocate and apportion current year taxes paid or accrued by a foreign corporation among the relevant statutory and residual groupings of the foreign corporation, as discussed in part II.F of the Explanation of Provisions, as well as for computations under section 956, which take into account E&P described in section 959(c)(1). Finally, as with shareholder-level accounts, these rules are issued pursuant to the express delegations of authority under sections 245A(g), 904(d)(7), 960(f), 965(o), and 989(c).



A corporate PTEP account relating to a covered shareholder represents all PTEP within the covered shareholder's annual PTEP accounts with respect to the foreign corporation (therefore, unlike shareholder-level accounts, a corporate PTEP account does not relate to a single taxable year of the foreign corporation). Similarly, a corporate PTEP tax pool for a covered shareholder represents all foreign income taxes within the covered shareholder's PTEP tax pools with respect to the foreign corporation. Thus, as a covered shareholder's annual PTEP accounts and PTEP tax pools with respect to a foreign corporation are adjusted, the foreign corporation-level accounts (including the PTEP groups within the accounts) are also adjusted.

The proposed regulations do not provide rules for maintaining a foreign corporation-level account for section 959(c)(3) E&P because the Treasury Department and the IRS are studying whether such E&P should be separately computed with respect to each covered shareholder in certain instances and related issues (for example, coordination with section 1248). For example, assume a case in which US1 and US2, each a covered shareholder, own 60% and 40%, respectively, of the stock of CFC1, a foreign corporation. CFC1 has \$75x and \$0 of PTEP with respect to US1 and US2, respectively, but only \$50x of total E&P as a result of incurring a deficit in E&P after generating the PTEP. Under a shareholder-specific approach to computing CFC1's section 959(c)(3) E&P, such E&P would be negative \$45x with respect to US1 ( $\$50x \times 60\% - \$75x$ ) and \$20x with respect to US2 ( $\$50x \times 40\% - \$0$ ). Under a non-shareholder-specific approach to computing section 959(c)(3) E&P, CFC1's section 959(c)(3) E&P would be negative \$25x ( $\$50x - \$75x$ ).

The proposed regulations clarify that a foreign corporation's E&P is determined independently of the foreign corporation's PTEP. See proposed §1.959-2(d)(3). For example, in a distribution by a foreign corporation with respect to its stock, section 316 determines the extent to which the distribution is made out of the foreign corporation's

E&P, and section 959 determines the extent to which the portion that is made out of E&P is a distribution of PTEP. See *also* proposed §1.959-10(c)(2)(iii) (*Example 2, alternative facts*, regarding a distribution of built-in loss property). Additionally, as in the example in the preceding paragraph, the proposed regulations clarify that a foreign corporation's E&P may be less than the foreign corporation's PTEP because a loss does not reduce PTEP.

#### C. Shareholder-level account adjustments (proposed §1.959-3)

##### 1. In General

The proposed regulations describe the adjustments made to a covered shareholder's annual PTEP accounts (including PTEP groups within those accounts and, if applicable, relevant percentages for section 965 PTEP and PTEP subgroups), dollar basis pools, and PTEP tax pools with respect to a foreign corporation. See proposed §1.959-3. The rules for making these adjustments are issued pursuant to the express delegations of authority under sections 245A(g), 904(d)(7), 986(c)(2), 960(f), 965(o), and 989(c).

These adjustments reflect income inclusions and transactions related to a taxable year of the foreign corporation, and the adjustments preserve the character of the foreign corporation's PTEP with respect to the covered shareholder (for example, the taxable year, section 904 category, and PTEP group to which PTEP relates). In applying these rules to tiers of foreign corporations, the adjustments are applied successively from the lowest-tier foreign corporation to the highest-tier foreign corporation. See proposed §1.959-3(g).

An adjustment to annual PTEP accounts is treated as made at one of three points in time (each of which is discussed below in this part II.C of the Explanation of Provisions), which determines when PTEP becomes (or ceases to be) available for distribution to the covered shareholder: (i) at the beginning of the first day of the foreign

corporation's taxable year, (ii) concurrently with the transaction giving rise to the adjustment, or (iii) at the end of the last day of the foreign corporation's taxable year. See proposed §1.959-3(f). An adjustment to dollar basis pools and PTEP tax pools is treated as made concurrently with the related adjustment to annual PTEP accounts.

## 2. Beginning of Year Adjustments

Three types of PTEP are added to annual PTEP accounts at the beginning of the foreign corporation's taxable year (even if, for example, the determination of the amount giving rise to the PTEP occurs at the end of such taxable year). This timing ensures that PTEP generated or received during the taxable year is available for distribution as of the start of the taxable year, consistent with sections 316(a)(2) and 959(c) (which determine dividend treatment and the application of section 959(a) or (b) based on E&P for the taxable year).

The first type is PTEP arising from the covered shareholder's subpart F income inclusion or GILTI inclusion with respect to the foreign corporation for the taxable year. See proposed §1.959-3(c)(1)(i) and (ii). To reflect the addition of this PTEP, basis equal to the U.S. dollar amount of the income inclusion giving rise to the PTEP is added to related dollar basis pools. See proposed §1.959-3(d)(1)(i).

The second type is PTEP with respect to the covered shareholder that is distributed to the foreign corporation during the taxable year (discussed in part II.D of the Explanation of Provisions). See proposed §1.959-3(c)(1)(iii). To reflect the addition of this PTEP, the dollar basis and associated foreign income taxes of the PTEP are added to related dollar basis pools and PTEP tax pools, and such taxes are assigned to the creditable PTEP tax group to the extent the foreign corporation is deemed to pay the taxes under section 960(b)(2) and proposed §1.960-3(c). See proposed §1.959-3(d)(1)(ii), (e)(1)(i). Further, the PTEP is reduced by current year taxes allocated and apportioned to the PTEP (that is, by foreign income taxes imposed on the PTEP and

paid or accrued by the foreign corporation in the taxable year, as distinguished from foreign income taxes described in the preceding sentence, which were paid or accrued by another foreign corporation in a prior distribution of the PTEP). See proposed §1.959-3(c)(1)(v); see *also* part II.F of the Explanation of Provisions (rules for allocating and apportioning current year taxes to PTEP). Such current year taxes reduce related dollar basis pools and are added to related PTEP tax pools, where the taxes are assigned to the creditable PTEP tax group to the extent the foreign corporation is a CFC and a credit for the taxes is not disallowed or suspended at the level of the CFC. See proposed §1.959-3(d)(1)(iii), (e)(1)(ii).

The third type is PTEP with respect to the covered shareholder that results from the application of the foreign corporation's section 961(c) basis to gain recognized by the foreign corporation during the taxable year (discussed in part III.E of the Explanation of Provisions). See proposed §1.959-3(c)(1)(iv). To reflect the addition of this PTEP, the dollar basis of the PTEP is added to related dollar basis pools. See proposed §1.959-3(d)(1)(ii). Further, current year taxes allocated and apportioned to the PTEP reduce the PTEP, reduce related dollar basis pools, and are added to related PTEP tax pools, where (like in a distribution) the taxes are assigned to the creditable PTEP tax group to the extent the foreign corporation is a CFC and a credit for the taxes is not disallowed or suspended at the level of the CFC. See proposed §1.959-3(d)(1)(iii), (e)(1)(ii).

### 3. Time of Transaction Adjustments

Three types of PTEP are added to, or removed from, annual PTEP accounts concurrently with the relevant transaction occurring during the foreign corporation's taxable year.

The first type is PTEP distributed by the foreign corporation during the taxable year. See proposed §1.959-3(c)(1)(vi). To reflect the removal of this PTEP, the dollar

basis and associated foreign income taxes of the PTEP are removed from related dollar basis pools and PTEP tax pools. See proposed §1.959-3(d)(1)(iv), (e)(1)(iii).

The second type is PTEP arising from gain recognized by the covered shareholder on the sale or exchange of stock during the taxable year that is recharacterized and included in gross income as a dividend under section 1248 by reason of E&P attributed to stock of the foreign corporation under section 1248. See proposed §1.959-3(c)(1)(vii); see *also* section 959(e). This timing prevents iterative computations that could result if the PTEP were available for distribution earlier in the taxable year. To reflect the addition of this PTEP, basis equal to the U.S. dollar amount of the income inclusion giving rise to the PTEP is added to related dollar basis pools. See proposed §1.959-3(d)(1)(i). The Treasury Department and the IRS are studying whether a foreign corporation's PTEP should similarly be increased to reflect gain treated as a dividend under section 964(e)(1) by reason of E&P of the foreign corporation, which amount generally increases the selling CFC's PTEP, and welcome comments on whether increasing the foreign corporation's PTEP would be appropriate notwithstanding the duplicative result (that is, PTEP would be in the selling CFC and the foreign corporation whose E&P gave rise to the dividend).

The third type is PTEP that transfers from (or to) the covered shareholder under section 959's successor rules (discussed in part II.G of the Explanation of Provisions). See proposed §1.959-3(c)(1)(viii), (ix). To reflect the removal (or addition) of this PTEP, the dollar basis and associated foreign income taxes of the PTEP are removed from (or added to) related dollar basis pools and PTEP tax pools. See proposed §1.959-3(d)(1)(iv) and (v), (e)(1)(iii) and (iv).

#### 4. End of Year Adjustments

Two types of adjustments are made at the end of the foreign corporation's taxable year. These adjustments relate to the covered shareholder's section 956 amount with respect to the foreign corporation for the taxable year.

First, PTEP to which the section 956 amount is allocated (which, as discussed in part II.E of the Explanation of Provisions, is excluded from the covered shareholder's gross income under section 959(a)(2)) is reassigned within annual PTEP accounts from section 959(c)(2) PTEP groups to section 959(c)(1) PTEP groups. See proposed §1.959-3(c)(1)(x). To reflect the reclassification, the dollar basis and associated foreign income taxes of the PTEP are moved from dollar basis pools and PTEP tax pools relating to section 959(c)(2) PTEP groups to dollar basis pools and PTEP tax pools relating to section 959(c)(1) PTEP groups. See proposed §1.959-3(d)(1)(vi), (e)(1)(v).

Next, PTEP arising from the portion of the section 956 amount included in the covered shareholder's gross income under section 951(a)(1)(B) is added to annual PTEP accounts. See proposed §1.959-3(c)(1)(xi). In addition, an amount of basis equal to the U.S. dollar amount of the section 956 inclusion giving rise to the PTEP is added to related dollar basis pools. See proposed §1.959-3(d)(1)(i).

Further, additional rules address cases where the covered shareholder acquires ownership of stock of the foreign corporation on or after the last relevant day of the foreign corporation's taxable year (that is, the last day of such taxable year on which the foreign corporation is a CFC) and a portion of a section 956 amount of a United States shareholder is attributable to such stock. See proposed §1.959-3(c)(4). Under these rules, PTEP of the foreign corporation that has transferred to the covered shareholder but to which such portion of the section 956 amount is ultimately allocated (discussed in part II.E of the Explanation of Provisions) is reclassified from section 959(c)(2) PTEP groups to section 959(c)(1) PTEP groups. Moreover, the foreign corporation's PTEP

with respect to the covered shareholder is increased to reflect the inclusion in income by the United States shareholder of such portion of the section 956 amount.

D. Distributions of PTEP (proposed §1.959-4)

1. Application of Exclusions

i. In general

The proposed regulations provide rules regarding the exclusions from gross income under section 959(a)(1) and (b) for PTEP that is distributed to a covered shareholder or a CFC. See proposed §1.959-4; see *also* part II.D.2 of the Explanation of Provisions (determining distributed PTEP).

Under the section 959(a)(1) exclusion, PTEP distributed to a covered shareholder, other than taxable section 962 PTEP, is excluded from the covered shareholder's gross income. See proposed §1.959-4(b)(1); see *also* section 962(d) and proposed §1.312-8(c) (domestic corporation's receipt of PTEP does not increase E&P, discussed in part VIII.I of the Explanation of Provisions).

Under the section 959(b) exclusion, PTEP distributed by a CFC to another CFC is excluded from the recipient CFC's gross income for purposes of determining the recipient CFC's subpart F income and tested income or tested loss, provided that the PTEP relates to a covered shareholder that is a United States shareholder in both CFCs. See proposed §1.959-4(b)(2); see *also* §1.312-6(b) (the distribution generally increases the recipient CFC's E&P) and proposed §1.952-1(c)(4) (the distribution does not increase the recipient CFC's current year E&P for purposes of the limitation in section 952(c)(1)(A), discussed in part VIII.I of the Explanation of Provisions).

Applying the section 959(b) exclusion for purposes of determining the recipient CFC's tested income or tested loss prevents double taxation (and thus is consistent with the policy of section 959) in cases where the distribution is not a related party dividend described in section 951A(c)(2)(A)(i)(IV) and therefore could otherwise result in tested

income. The Treasury Department and the IRS are of the view that this approach, which is issued under the express delegation of authority in section 951A(f)(1)(B), is consistent with section 951A(f)(1)(A) (treating an inclusion under section 951A(a) in the same manner as an inclusion under section 951(a)(1)(A) for purposes of section 959), which should be interpreted as allowing references to section 951(a) in section 959 to be treated as including a reference to section 951A(a).

Applying the section 959(b) exclusion only to PTEP distributed by a CFC to another CFC is consistent with the statute. However, under the express delegation of authority in section 965(o), the proposed regulations provide a special rule pursuant to which a specified foreign corporation (as defined in §1.965-1(f)(45)(i)(B)) that is not a CFC is treated as a CFC for purposes of applying the section 959(b) exclusion to section 965 PTEP distributed by the specified foreign corporation, which ensures that the section 959(b) exclusion applies to such PTEP when received by a CFC. See proposed §1.959-4(b)(2)(ii). The Treasury Department and the IRS are studying the application of section 959(b) to other PTEP distributed by a foreign corporation that is not a CFC (for example, in a case where the foreign corporation was a CFC when the PTEP was generated but is no longer a CFC when the PTEP is distributed).

Irrespective of whether the section 959(b) exclusion applies to PTEP distributed to a foreign corporation, the PTEP remains PTEP and, in a subsequent distribution, may be excluded from gross income under section 959(a)(1) or (b). See proposed §§1.959-2 and 1.959-3 (describing shareholder-level annual PTEP accounts and related adjustments with respect to a foreign corporation without regard to CFC status). This treatment is required to give effect to section 959(a), which does not depend on the CFC status of any intermediary entities through which a covered shareholder ultimately receives PTEP.



## ii. Split-ownership structures

Under the proposed regulations, the section 959(b) exclusion applies at the CFC-level by excluding a distribution of PTEP from the recipient CFC's gross income for certain purposes. In structures where stock of a CFC is not all owned by a single United States shareholder, the application of the section 959(b) exclusion at the CFC-level could, absent special rules, result in all United States shareholders of the CFC sharing any benefits of the exclusion (rather than just the United States shareholder to which the excluded PTEP relates) and partial double taxation to the United States shareholder to which the excluded PTEP relates (to the extent the exclusion benefits other United States shareholders).

Guidance issued before the Act generally used a "gross-up" mechanism to address this issue. Rev. Rul. 82-16, 1982-1 C.B. 106, considered a scenario where a United States shareholder owned 70% of the stock of an upper-tier CFC, with the remaining 30% owned by non-United States shareholders, and the upper-tier CFC owned all the stock of a lower-tier CFC. The lower-tier CFC earned \$100x of subpart F income, which gave rise to a \$70x subpart F income inclusion and, thus, \$70x of PTEP with respect to the United States shareholder. In a later year, the lower-tier CFC distributed \$200x to the upper-tier CFC. The ruling concluded that section 959(b) looks to the total amount of E&P of the lower-tier CFC that caused the United States shareholder's subpart F income inclusion, with the result that section 959(b) excluded \$100x (rather than \$70x) from the upper-tier CFC's subpart F income in applying section 951(a) to the United States shareholder. Conversely, a \$70x exclusion under section 959(b) would have caused the upper-tier CFC to have an additional \$30x of subpart F income from the distribution, which would have led to a \$21x ( $\$30x \times 70\%$ ) subpart F income inclusion for the United States shareholder even though its share of the distribution was all attributable to PTEP.

However, a gross-up mechanism raises certain issues. For example, computing a gross-up may be complex or burdensome in light of the increased prevalence of PTEP that is not pro rata with respect to United States shareholders following the Act (for instance, PTEP resulting from a GILTI inclusion, which is not determined solely by reference to a particular CFC). Additionally, a gross-up mechanism could result in the need for different determinations of a CFC's subpart F income (and tested income or tested loss) for different United States shareholders of the CFC, which is inconsistent with the way that these types of income are treated under existing regulations for other purposes of the Code such as the expense allocation rules or foreign tax credit rules.

Accordingly, instead of a gross-up mechanism, the proposed regulations coordinate the section 959(b) exclusion with revisions to the pro rata share rules of section 951(a) (discussed in part IV.C of the Explanation of Provisions). Under this approach, a CFC's subpart F income is determined with respect to all shareholders by excluding the same amount of PTEP received by the CFC, and United States shareholders' pro rata shares of the CFC's subpart F income are computed in a manner so that any benefits of the application of the section 959(b) exclusion to PTEP with respect to a United States shareholder generally inure only to that United States shareholder. For instance, if two United States shareholders own equal interests in a CFC, and the CFC receives a distribution half of which is PTEP with respect to one United States shareholder (because there is PTEP with respect to the United States shareholder at least equal to its share of distribution) and the other half of which gives rise to subpart F income (because there is no PTEP with respect to the other United States shareholder and no exception from subpart F income applies), then only the United States shareholder with respect to which there is no PTEP has a pro rata share of the subpart F income resulting from the distribution.

The Treasury Department and the IRS are of the view that the approach in the proposed regulations appropriately carries out the shareholder-specific nature of section 959(b) (that is, excluding PTEP with respect to a United States shareholder from a CFC's gross income for purposes of the application of section 951(a) to the CFC with respect to the United States shareholder). Additionally, this approach conforms with the approach for applying section 961(c) which, under the proposed regulations (as discussed in part III.E of the Explanation of Provisions), also provides for a gross income exclusion at the CFC-level that is coordinated with the section 951(a) pro rata share rules to ensure its benefits generally inure only to the appropriate United States shareholder.

iii. Issues involving allocation rules under section 861

The approach in the proposed regulations discussed in part II.D.1.ii of the Explanation of Provisions (applying the section 959(b) exclusion, as well as section 961(c), at the CFC-level) can lead to issues involving the rules of section 861 for allocating and apportioning deductions because a CFC's deductions that are not current year taxes are not allocated and apportioned under section 861 to PTEP. See §1.960-1(c)(1)(ii) and proposed §1.959-6(d)(1).

For example, in a case where some, but not all, of a distribution received by a CFC is PTEP, an amount of the CFC's deductible interest expense could reduce the non-PTEP portion of the distribution. See *also* proposed §1.951-1(h)(2)(ii)(C) (*Example 1, alternative facts*). This may result in a benefit if the non-PTEP portion would give rise to subpart F income or tested income, but otherwise may not be beneficial if the interest deductions reduce section 959(c)(3) E&P and thus the potential for a dividends received deduction under section 245A. Comments are requested on how to appropriately allocate and apportion deductions of a CFC when some, but not all, of a distribution (or gain recognized) is PTEP.

For example, comments are requested on whether deductions that are not current year taxes, such as deductible interest expense, should be allocated and apportioned to, and therefore reduce, the CFC's PTEP. Under this approach, to the extent PTEP with respect to a United States shareholder is reduced by deductions that are not current year taxes, the shareholder could be allowed to retain an equivalent amount of adjusted basis in property directly owned by the shareholder and on which the remaining PTEP is ultimately distributed, with the result that the shareholder would receive a benefit equivalent to a deduction (similar to the result discussed in Part III.C.2.ii of the Explanation of Provisions in the case of foreign income taxes that are associated with PTEP but not credited under section 901).

Comments are also requested on whether, as an alternative to the approach in the proposed regulations, sections 959(b) and 961(c) should apply at the shareholder-level. Under this type of approach, instead of section 959(b) preventing a distribution to a CFC from giving rise to subpart F income (as it has historically been interpreted, but with respect to a particular shareholder), section 959(b) would generally reduce a United States shareholder's pro rata share of the CFC's subpart F income, to the extent attributable to distributed PTEP. Furthermore, section 961(c) would apply in a similar manner in the case of a CFC's gain from a sale or other disposition of stock of a foreign corporation. Comments should address whether a CFC's deductions that are not current year taxes, such as deductible interest expense, should be allocated and apportioned to gross income of the CFC that does not give rise to an inclusion at the shareholder-level under section 959(b) or 961(c) or whether CFC-level provisions (such as section 954(c)(3) or (c)(6) or 964(e)(1)) apply to such income and, if so applied, whether the E&P from the income should be treated as section 959(c)(3) E&P or PTEP to ensure that the CFC-level and shareholder-level provisions interact appropriately.

## 2. Determining Distributed PTEP

i. Covered distributions

For a distribution to be considered a distribution of PTEP under section 959, the proposed regulations first require that the distribution be a covered distribution, which is generally defined as any distribution made by a foreign corporation with respect to its stock to the extent that the distribution is a dividend (as defined in section 316), determined without regard to section 959(d). See proposed §1.959-4(c)(1). While a covered distribution may include deemed distributions treated as dividends (for example, distributions under section 304), a covered distribution does not include an amount treated as a dividend by reason of section 78, 367(b), 964(e)(1), or 1248. A deemed dividend under section 78 is determined without regard to E&P (and does not represent a distribution of E&P to any shareholder), and deemed dividends under the other provisions, regardless of whether they constitute deemed distributions of E&P, are determined by excluding PTEP (apart from §1.367(b)-2(j)(2)(ii), which separately provides for a deemed distribution of PTEP in certain nonrecognition transactions, and §1.367(b)-3(g)(1), which separately provides for a deemed distribution of E&P, including PTEP, in certain inbound nonrecognition transactions described in §1.367(b)-3). The proposed regulations do not address the treatment of dividends arising under section 356(a)(2) as covered distributions, which will be addressed in future guidance regarding reorganizations (although no inference is intended as to the treatment of such dividends under current law). See proposed §1.959-4(c)(2).

Comments on the 2019 notice asserted that a distribution of PTEP should not depend on the existence of E&P that would result in a dividend under section 316, stating that section 959(c) requires applying section 316 separately to sections 959(c)(1), (c)(2), and (c)(3) in determining whether there is sufficient E&P under section 316 to support a distribution of E&P under that paragraph. Comments noted that the approach described in the 2019 notice was contrary to section 959(a) and inconsistent

with the policy of section 959 to facilitate the repatriation of PTEP. The Treasury Department and the IRS remain of the view described in the 2019 notice under which the reference to section 316(a) in section 959(c) indicates that, under the statute, a distribution of PTEP cannot occur unless there is sufficient current or accumulated E&P to support what would otherwise be a dividend under section 316. This reading of the statute is consistent with the principle underlying section 959 that PTEP represents a type of E&P. Thus, the proposed regulations do not adopt the comments.

ii. Analyzing covered distributions

The proposed regulations provide rules for determining the extent to which PTEP is distributed in a covered distribution. See proposed §1.959-4(d). Under these rules, each covered shareholder first determines its share of the covered distribution, which is the portion of the covered distribution that is made to the covered shareholder or any portion of the covered distribution that is made to an upper-tier foreign corporation and assigned to the covered shareholder under proposed §1.951-2 (discussed in part IV.B of the Explanation of Provisions). See proposed §1.959-4(d)(1). For this purpose, the portion of a covered distribution that is made to a partnership, or that is treated as made to the partnership in the case of tiered partnerships, is treated as made to the partnership's partners in accordance with their respective distributive shares of such portion. See proposed §1.959-4(c)(3). Thus, if a covered shareholder is a partner in an upper-tier partnership, the covered shareholder's share of a covered distribution would include a portion of the covered distribution that is made to a lower-tier partnership because an amount of the covered distribution made to the lower-tier partnership would be treated as made to the upper-tier partnership by reason of the upper-tier partnership being a partner in the lower-tier partnership and, in turn, an amount of the covered distribution treated as made to the upper-tier partnership would be treated as made to

the covered shareholder by reason of the covered shareholder being a partner in the upper-tier partnership.

Next, each covered shareholder allocates its share of the covered distribution to the distributing foreign corporation's PTEP with respect to the covered shareholder, to the extent thereof and in accordance with the composition rules described in part II.D.2.iii of the Explanation of Provisions, and then allocates any remaining portion of such share to the distributing foreign corporation's section 959(c)(3) E&P. See proposed §1.959-4(d)(2) and (e)(1). For this purpose, the distributing foreign corporation's PTEP is determined immediately before the covered distribution (and thus includes PTEP resulting from a subpart F income inclusion or GILTI inclusion for the distributing foreign corporation's taxable year in which the covered distribution is made because such PTEP is added to the covered shareholder's annual PTEP accounts at the beginning of the taxable year).

Further, because the amount of a covered shareholder's share of a covered distribution is determined on an aggregate basis rather than on a share-specific basis, the proposed regulations treat a pro rata portion of all PTEP distributed in each covered shareholder's share of the covered distribution as distributed with respect to each share of stock of the distributing foreign corporation on which the covered shareholder's share of the covered distribution is made. See proposed §1.959-4(d)(4); see *also* proposed §1.959-10(c)(1) (*Example 1*). In this way, basis adjustments resulting from distributed PTEP can be made on each share of stock of the foreign corporation in accordance with section 961 and, if applicable, PTEP of a recipient foreign corporation can be increased.

### iii. Composition rules

As discussed in part II.C of the Background, different types of PTEP can have different tax effects, including with respect to foreign currency gain or loss under section 986(c) or deemed paid taxes under section 960(b). Thus, once a covered shareholder

has identified the portion of its share of a covered distribution that is allocated to PTEP, it is necessary to determine the specific PTEP that is distributed. The proposed regulations include composition rules for this purpose. See proposed §1.959-4(d)(3) and (e)(2) through (5); see *also* proposed §1.959-10(c)(2) (*Example 2*).

Under these composition rules, PTEP is sourced from section 959(c)(1) PTEP groups before section 959(c)(2) PTEP groups and then from each group within the section 959(c)(1) PTEP groups or section 959(c)(2) PTEP groups, respectively, on a “last-in, first-out” basis, subject to a priority rule for PTEP resulting from section 965 (section 965 priority rule). See proposed §1.959-4(e)(2), (3). Additionally, PTEP that otherwise has the same priority is sourced first from PTEP that is not taxable section 962 PTEP and then from taxable section 962 PTEP, consistent with the rules currently in §1.962-3. See proposed §1.959-4(e)(4). Lastly, PTEP that has the same priority is sourced on a pro rata basis. See proposed §1.959-4(e)(5).

The section 965 priority rule sources PTEP in section 959(c)(1) PTEP groups first from the reclassified section 965(a) PTEP group, then from the reclassified section 965(b) PTEP group, and finally from the remaining section 959(c)(1) PTEP groups. See proposed §1.959-4(e)(2)(ii). Similarly, for PTEP in section 959(c)(2) PTEP groups, the section 965 priority rule sources such PTEP first from the section 965(a) PTEP group, then from the section 965(b) PTEP group, and finally from the remaining section 959(c)(2) PTEP groups. See proposed §1.959-4(e)(2)(iii). The section 965 priority rule, which is issued under the express delegation of authority in section 965(o), is consistent with the 2019 notice and is intended to simplify PTEP recordkeeping and IRS administration.

Comments on the 2019 notice stated that the section 965 priority rule (as described in the notice) would be a departure from the last-in, first-out approach for sourcing distributions from E&P, and also argued that there is no suggestion in section



965 or its legislative history that such a departure was intended or is necessary or appropriate. Other comments asserted that the policy for the section 965 priority rule was unclear, stating that a pure last-in, first-out approach does not impose additional burdens on taxpayers because once a taxpayer has determined its section 965 PTEP the additional burden of maintaining that information is minimal. Further, even if the section 965 priority rule simplifies PTEP recordkeeping, comments noted that this may be outweighed by the reduction in foreign tax credits under section 960(b) that accompanies distributions of section 965 PTEP. Another comment noted that the section 965 priority rule would adversely affect certain individuals who made section 962 elections and are economically compelled to distribute their PTEP every year to pay taxes arising under section 951(a) because it would accelerate the distribution of PTEP that is not excluded from gross income under section 962(d). Given these concerns, and because the section 965 priority rule departs from the longstanding approach in existing §1.959-3(b), comments requested that taxpayers be able to elect to apply a last-in, first-out approach with no prioritization of section 965 PTEP.

The Treasury Department and the IRS continue to be of the view that the section 965 priority rule will simplify PTEP recordkeeping and IRS administration in the future by eventually eliminating section 965 PTEP (which, as noted in part II.C of the Background requires specific and detailed rules to apply sections 960(b) and 986(c)) and reducing the overall number of PTEP groups that need to be tracked. The Treasury Department and the IRS are of the view that, on balance, this benefit outweighs the concerns raised in comments. Additionally, the section 965 priority rule is within the scope of the authority delegated to the Treasury Department and the IRS to administer section 965, including through sections 965(o) and 7805(a). Further, the proposed regulations do not adopt comments suggesting that taxpayers be allowed to not apply the section 965

priority rule because this would undermine the simplification and burden reduction policy of the rule.

iv. Dollar basis and associated foreign income taxes rules

The proposed regulations provide a pro rata approach for determining the dollar basis and associated foreign income taxes of PTEP distributed in a covered shareholder's share of a covered distribution. See proposed §1.959-4(e)(3), (f) and (g). Under this approach, the portion of a dollar basis pool or PTEP tax pool, as applicable, attributed to distributed PTEP is determined based on the percentage that such PTEP represents of all PTEP relating to the dollar basis pool or PTEP tax pool. As discussed in part II.B.1.iii of the Explanation of Provisions, dollar basis pools and PTEP tax pools are maintained separately within each annual PTEP account for each PTEP group unless a combined pool election is in effect, in which case each dollar basis pool and PTEP tax pool relates to PTEP assigned to a single PTEP group and a single section 904 category (without regard to the taxable years to which the PTEP relates).

E. PTEP to which a section 956 amount is allocated (proposed §1.959-5)

The proposed regulations provide rules regarding the exclusion from gross income under section 959(a)(2) for PTEP that would otherwise be included under section 951(a)(1)(B). See proposed §1.959-5; *see also* proposed §1.959-10(c)(4) (*Example 4*). Under these rules, a covered shareholder allocates its section 956 amount (that is, the amount determined under section 956 and §1.956-1 with respect to the covered shareholder and a CFC) first to the CFC's PTEP that is with respect to the covered shareholder and assigned to section 959(c)(2) PTEP groups, to the extent thereof and in accordance with the principles of the composition rules for distributions of PTEP, and then allocates any remaining portion of such section 956 amount to the CFC's section 959(c)(3) E&P. See proposed §1.959-5(c)(1) and (d)(1).

For purposes of these rules, the CFC's PTEP is determined on the last relevant

day of the CFC's taxable year to which the section 956 amount relates (that is, the last day of such taxable year on which the foreign corporation is a CFC). See proposed §1.959-5(d)(2). However, the CFC's PTEP is reduced to the extent it is distributed on or after the last relevant day to ensure that the section 956 amount is allocated only to section 959(c)(2) PTEP that remains after accounting for all covered distributions during the CFC's taxable year, in accordance with section 959(f)(2). Moreover, the PTEP is determined without regard to any transfer of PTEP from the covered shareholder to a successor covered shareholder on (or after) the last relevant day, thereby ensuring that section 959(c)(2) PTEP that exists with respect to the covered shareholder when the covered shareholder's ownership of stock of the CFC is determined for purposes of sections 951(a)(1)(B) and 956 may be taken into account for purposes of section 959(a)(2).

As with distributions of PTEP, the proposed regulations use a pro rata approach to determine the dollar basis and associated foreign income taxes of PTEP to which a section 956 amount is allocated. See proposed §1.959-5(e) and (f).

F. Allocating and apportioning current year taxes to PTEP (proposed §1.959-6)

The proposed regulations provide rules for the application of §1.861-20 to allocate and apportion current year taxes to the statutory groupings (as generally described in §1.861-8(a)(4)) of PTEP of a foreign corporation. See proposed §1.959-6(b) (describing the statutory groupings for purposes of proposed §1.959-6 as the corporate PTEP accounts of the foreign corporation described in proposed §1.959-2(d)(1)). These rules are issued pursuant to the express delegations of authority under sections 245A(g), 904(d)(7), 960(f), and 965(o).

Under the proposed regulations, current year taxes are generally associated with PTEP to the extent the foreign corporation pays or accrues such taxes with respect to PTEP arising by reason of a PTEP realization event that occurs in the same taxable

year. See proposed §1.959-6(b); see *also* proposed §1.959-10(c)(3) (*Example 3*). A PTEP realization event occurs if there is a distribution of PTEP or gain recognized on a sale, exchange, or other disposition of foreign stock that is treated as PTEP as a result of the application of section 961(c) basis. Current year taxes that are paid or accrued with respect to a PTEP realization event that occurs in a different taxable year may not be associated with PTEP of a foreign corporation (consistent with the rule in current §1.960-1(d)(3)(ii)(B)). See proposed §1.959-6(b) and 1.960-1(d)(3)(ii)(B).

Proposed §1.959-6(c) provides rules relating to the application of the allocation and apportionment rules in §1.861-20. Current year taxes (in the foreign corporation's functional currency) are allocated and apportioned to each corporate PTEP account of the foreign corporation that is increased during the taxable year as the result of a PTEP realization event by applying the rules in §1.861-20 and treating PTEP with respect to each covered shareholder arising by reason of a PTEP realization event as an amount of dividend income (in the case of a distribution of PTEP) or gain from the sale, exchange, or other disposition of foreign stock (in the case of PTEP resulting from the application of section 961(c) basis). See proposed §1.959-6(c) for purposes of identifying the corresponding U.S. item under §1.861-20(b) through (c). While certain United States shareholders (taking into account the application of §1.958-1(d)) must take into account a pro rata share of a CFC's subpart F income and tested income (or loss), the CFC's deductions are not divided into pro rata shares allocable to particular shareholders, and instead, must be allocated and apportioned to gross income of the CFC before the determination of each United States shareholder's pro rata share of subpart F income and tested income (or loss). As a result, because deductions must be allocated and apportioned to a CFC's income (rather than being allocated directly to United States shareholders), it is necessary to allocate and apportion current year taxes with respect to the statutory groupings of PTEP of the foreign corporation, which the

proposed regulations provide are the corporate PTEP accounts described in proposed §1.959-2(d)(1).

The proposed regulations also clarify other aspects of allocations of deductions involving PTEP. In particular, the proposed regulations provide that no deductions, other than current year taxes, may be allocated and apportioned to the statutory groupings of PTEP of a foreign corporation (consistent with the rule in current §1.960-1(c)(1)(ii)). See proposed §1.959-6(d)(1). See *also* the request for comments in Part II.D.1.iii of the Explanation of Provisions on an approach that would also allocate and apportion deductions, other than current year taxes, to PTEP.

Finally, the proposed regulations provide that current year taxes paid or accrued by a foreign corporation that are denominated in a currency other than the functional currency of the foreign corporation are translated into the functional currency of the foreign corporation at the spot rate on the day on which the current year taxes are paid or accrued. See proposed §1.959-6(d)(2). This currency translation rule applies for purposes of (i) making certain adjustments to accounts maintained under section 959 and the proposed regulations in the foreign corporation's functional currency and (ii) allocating and apportioning functional currency amounts at the level of the foreign corporation.

#### G. General successor transactions (proposed §1.959-7)

##### 1. In General

If there is an acquisition of stock of a foreign corporation that results in a change of ownership of stock of the foreign corporation, successor rules in section 959 generally transfer the foreign corporation's PTEP with respect to the covered shareholder that relinquishes ownership of stock of the foreign corporation to the covered shareholder that acquires ownership of the stock. See section 959(a) (applying the rules of section 959(a) to any other United States person who acquires any portion

of a United States shareholder's interest in a foreign corporation from any person); section 959(b) (similarly applying to any other United States shareholder who acquires any portion of a United States shareholder's interest in a CFC from any person). These successor rules generally ensure that PTEP is not subject to U.S. tax again in the hands of the acquiring covered shareholder when received in a distribution, even though that shareholder did not own the stock of the foreign corporation when the PTEP was generated and therefore did not have the inclusion that gave rise to the PTEP. Additionally, the rules ensure that E&P retains its PTEP status and thus remains subject to the rules under sections 959 and 961, rather than reverting to section 959(c)(3) E&P and potentially becoming eligible for a deduction under section 245A without a reduction in basis.

The proposed regulations address certain transactions subject to the successor rules in section 959, which the proposed regulations refer to as general successor transactions. See proposed §1.959-7(b)(1); see *also* part III.C.4 of the Explanation of Provisions (discussing rules for section 961(c) basis in general successor transactions). A general successor transaction occurs when a covered shareholder (successor covered shareholder) acquires ownership of stock of one or more foreign corporations (each, an acquired foreign corporation) that, immediately before the transaction, is owned by another covered shareholder (transferor covered shareholder). The acquisition may be direct or indirect. For example, a sale of stock of a foreign corporation by a covered shareholder (or by an upper-tier foreign corporation owned by the covered shareholder) to another covered shareholder (or to an upper-tier foreign corporation owned by such other covered shareholder) is a general successor transaction.

However, a general successor transaction is determined without regard to any portion of an acquisition of ownership of stock of a foreign corporation that results from

any of the following: (i) an issuance of stock or a partnership interest, (ii) a redemption of stock (within the meaning of section 317(b)) or a liquidating distribution in redemption of a partnership interest, or (iii) 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. See proposed §1.959-7(b)(2). For example, an exchange of stock of a foreign corporation solely for stock of another foreign corporation in an exchange under section 351(a) or 354(a), or as part of an exchange described in section 361, is not a general successor transaction because such stock is substituted basis property, even if covered shareholders' ownership of stock of the foreign corporation changes in the exchange. Alternatively, to the extent stock of a foreign corporation is not substituted basis property in such transactions (for example, if basis in the stock is determined under section 301(d) or 358(a)(2)), then the acquisition of ownership of stock of the foreign corporation is a general successor transaction. The Treasury Department and the IRS intend to issue additional rules regarding the transfer of PTEP in acquisitions that are not general successor transactions and proposed §§1.959-8 and 1.959-9 are reserved for this purpose. In these acquisitions, the Treasury Department and the IRS are considering adding a rule as part of finalization of the proposed regulations providing that, for any period before those additional rules apply and after existing §1.959-1(d) (successor in interest rules) is removed upon finalization of the proposed regulations, PTEP will transfer automatically (that is, without any requirement to submit proof of identity to the IRS) in accordance with the statute and consistent with the manner in which PTEP transfers in general successor transactions (as discussed in part II.G.2 of the Explanation of Provisions). The Treasury Department and the IRS request comments on this potential rule.

## 2. Categories of Transferred PTEP

The proposed regulations provide that two categories of an acquired foreign corporation's PTEP transfer from the transferor covered shareholder to the successor covered shareholder (and thus become PTEP with respect to the successor covered shareholder) in a general successor transaction. See proposed §1.959-7(c); see also §1.959-10(c)(5) (*Example 5*). For both categories of PTEP, the transfer is not subject to any requirement to submit proof of identity to the IRS (in contrast to current §1.959-1(d)) and, thus, the transfer occurs automatically, although taxpayers should maintain sufficient records to substantiate the transfer on examination. See also §1.245A-5(c)(4) (automatically transferring certain shareholder-level accounts in certain acquisitions of stock); §1.245A(e)-1(d)(4)(iii) (similar). The automatic transfer ensures that E&P retains PTEP status and, therefore, will be excluded from income under section 959 and give rise to basis reductions under section 961 in subsequent distributions.

The first category of PTEP that transfers is PTEP of the acquired foreign corporation with respect to the transferor covered shareholder, as determined immediately before the general successor transaction. However, if the general successor transaction occurs before the last relevant day of the acquired foreign corporation's taxable year, certain current year PTEP does not transfer because such current year PTEP relates to shares of stock either retained by the transferor covered shareholder or acquired by the transferor covered shareholder concurrently with or after the general successor transaction. See proposed §1.959-7(c)(1). Only a pro rata portion of this PTEP (called general successor PTEP) transfers, and the amount is determined based on the percentage of a hypothetical distribution by the acquired foreign corporation that would be made with respect to the stock of the corporation acquired by the successor covered shareholder. See proposed §1.959-7(d). In this way, distributions made by the acquired foreign corporation after the general successor



transaction will generally be allocated to PTEP to the same extent the distributions would be so allocated if the general successor transaction did not occur.

The second category of PTEP that transfers is PTEP resulting from the application of section 1248 to gain recognized by the transferor covered shareholder in the general successor transaction. See proposed §1.959-7(c)(2). Because section 1248 only applies to the extent of E&P of the acquired foreign corporation that is attributable to the stock being sold or exchanged in the general successor transaction, the Treasury Department and the IRS determined that it is appropriate for PTEP described in this category (called section 959(e) successor PTEP) to transfer in the general successor transaction. The transfer of all PTEP arising under section 1248 in a sale or exchange of a foreign corporation is consistent with existing guidance. See Rev. Rul. 90-31, 1990-1 C.B. 147.

Like for distributions, the proposed regulations use a pro rata approach to determine the dollar basis and associated foreign income taxes of general successor PTEP. See proposed §1.959-7(e)(1) and (f)(1). The dollar basis of section 959(e) successor PTEP is the U.S. dollar amount of the income inclusion giving rise to the PTEP. See proposed §1.959-7(e)(2). There are no associated foreign income taxes with respect to section 959(e) successor PTEP because the PTEP is newly created PTEP to which foreign income taxes will not yet have been allocated and apportioned. See proposed §1.959-7(f)(2).

### 3. Deemed Covered Shareholder

Section 959(a) applies to any other United States person “who acquires from any person” any portion of a United States shareholder’s interest in a foreign corporation. See *also* section 959(b) (similarly applying to an acquisition from “any person”). Accordingly, if there is an acquisition of stock of a foreign corporation, section 959 does

not condition a transfer of the foreign corporation's PTEP on whether the transfer is by or from a covered shareholder (or United States shareholder).

For example, if a nonresident alien individual acquires ownership of all the stock of a foreign corporation that has PTEP from a covered shareholder and another covered shareholder subsequently acquires ownership of all the stock from the individual, then, absent an election under section 338(g), the foreign corporation's PTEP transfers to the second covered shareholder. This prevents double taxation of the PTEP and ensures that PTEP does not become section 959(c)(3) E&P (potentially eligible for a dividends received deduction under section 245A(a)). However, existing guidance does not clearly address whether the amount of PTEP that transfers is reduced for transactions during the individual's ownership period (for example, for E&P distributed by the foreign corporation to the individual).

To address the transfer of a foreign corporation's PTEP among covered shareholders where there is intervening foreign ownership, the proposed regulations treat any stock of a foreign corporation not owned by a covered shareholder as owned by a single hypothetical person that is deemed to be a covered shareholder (the deemed covered shareholder). See proposed §1.959-7(g). Under these rules, the deemed covered shareholder is treated in the same manner as a covered shareholder for purposes of transferring PTEP under section 959, and a reference to a covered shareholder includes the deemed covered shareholder. See proposed §1.959-7(g)(1). Thus, in the example described in the preceding paragraph, the foreign corporation's PTEP transfers in the first acquisition from the first covered shareholder to the deemed covered shareholder (who is a hypothetical person treated as owning all the stock of the foreign corporation owned by the nonresident alien individual). Then, in the second acquisition, the foreign corporation's PTEP, adjusted using a reasonable method to reflect transactions during the deemed covered shareholder's ownership period (for

example, reductions for distributions), transfers from the deemed covered shareholder to the second covered shareholder. See §1.959-7(g)(2). In cases where there are no previous covered shareholders or PTEP, the deemed covered shareholder rules have no effect.

The Treasury Department and the IRS are of the view that alternative approaches such as “freezing” a foreign corporation’s PTEP during periods in which its stock is not owned by a covered shareholder could inappropriately separate a foreign corporation’s PTEP from its E&P and give rise to double taxation or other distortions. For example, under such an alternative, a covered shareholder could transfer the stock of an upper-tier foreign corporation that owns stock of a lower-tier foreign corporation with PTEP to a nonresident alien individual, the lower-tier foreign corporation could distribute all its E&P to the upper-tier foreign corporation without affecting its PTEP, and then the stock of the upper-tier foreign corporation could be transferred to another individual covered shareholder that would succeed to the PTEP that remains with the lower-tier foreign corporation even though it has no E&P. If the form of the transaction were respected for Federal income tax purposes, the result would be that a distribution by the upper-tier foreign corporation would not be sourced from PTEP and the transferred PTEP of the lower-tier foreign corporation could be distributed only to the extent that the lower-tier foreign corporation earns section 959(c)(3) E&P.

The Treasury Department and the IRS recognize that shareholders of a foreign corporation may not track PTEP of the foreign corporation that transfers to the deemed covered shareholder. In these cases, a covered shareholder that eventually succeeds to the PTEP must determine the amount and character of the PTEP, including by reconstructing transactions that affected the PTEP while the foreign corporation was under foreign ownership. This reconstruction is similar to other determinations that shareholders must make in certain acquisitions of stock of a foreign corporation for

which an election under section 338(g) is not made, for example determinations regarding the foreign corporation's basis in assets or its E&P. The use of a single deemed covered shareholder to represent all foreign ownership of a foreign corporation is intended to ease the burden of this reconstruction by focusing only on whether and how PTEP moves under foreign ownership rather than, for example, by attributing portions of PTEP to each shareholder that is a nonresident alien individual and separately analyzing such portions. The Treasury Department and the IRS welcome comments about how to decrease the compliance burden and improve the administrability of this regime while still ensuring that the correct amount and character of PTEP is transferred from one covered shareholder to another even when there is intervening foreign ownership. For instance, the Treasury Department and the IRS welcome comments on whether a majority United States shareholder of a CFC should be permitted or required to track PTEP that transfers from a minority United States shareholder of that CFC to the deemed covered shareholder.

### III. Section 961 Regulations

#### A. Overview

As discussed in part II.C.2 of the Background, section 961 authorizes regulations that provide for basis increases to reflect income inclusions under section 951 and basis reductions and gain recognition to reflect distributions of PTEP. Generally, the purpose of basis increases is to prevent PTEP of a foreign corporation from giving rise to additional U.S. tax in a sale or exchange of stock of the foreign corporation or property through which such stock is owned (for example, an interest in a partnership) when the stock or other property is sold before the PTEP is distributed. The purpose of basis reductions and gain recognition is to prevent double benefits from the basis increases provided under section 961.

Thus, the proposed regulations under section 961 adjust the basis in shares of stock of a foreign corporation owned by a covered shareholder, and the basis in any items of property through which the covered shareholder owns stock of the foreign corporation, to reflect the foreign corporation's PTEP with respect to the covered shareholder (for example, to reflect income inclusions giving rise to the PTEP or distributions of the PTEP). Unlike annual PTEP accounts, basis adjustments under the proposed regulations are specific to a share of stock or other item of property, consistent with each item of property having separate basis under the Code. Timing of basis adjustments generally matches the timing of related adjustments to annual PTEP accounts. Further, the proposed regulations under section 961 provide rules for different types of basis under section 961, including the tax consequences of the basis, and are issued pursuant to the express delegations of authority in section 961(a), (b), and (c).

As discussed in part III.A of the Background, a covered shareholder does not include a domestic partnership because a domestic partnership is treated as an aggregate of its partners in determining stock ownership for purposes of section 961. See proposed §1.961-1(b); see *also* part VIII.A of the Explanation of Provisions (providing that an S corporation is generally treated in the same manner as a domestic partnership). As also discussed in part III.A of the Background, under section 958(a) stock ownership means stock owned directly and stock owned indirectly through foreign entities, including domestic partnerships to the extent treated as foreign partnerships under §1.958-1(d)(1). Thus, the adjustments provided for by the proposed section 961 regulations also apply at the partner level to covered shareholders that own stock of a foreign corporation through one or more domestic (or foreign) partnerships. See part III.B.3 of this Explanation of Provisions for a discussion of basis provided in stock of a foreign corporation directly owned by a partnership.

## B. Types of property units and basis (proposed §1.961-2)

### 1. In General

Under the proposed regulations, the type of basis provided in an item of property depends on whether the direct owner of the item is a covered shareholder, partnership, or CFC. This is because when the direct owner of an item of property is a partnership or CFC, covered shareholder-specific basis is necessary so that the benefits of basis provided in the item to reflect income inclusions of a covered shareholder inure only to that shareholder. Additionally, section 961(c) provides that the basis in the case of an item of property directly owned by a CFC only applies for the purposes of determining the amount included under section 951 in the gross income of a United States shareholder. Specific rules are therefore needed with respect to basis adjustments for property owned by a CFC to reflect the limited purposes of basis under section 961(c).

Thus, the proposed regulations set forth rules for three types of property (each referred to as a property unit) and basis: (i) section 961(a) ownership units and adjusted basis, which is provided to a covered shareholder, (ii) derivative ownership units and derived basis, which is provided to a partnership and is covered shareholder-specific, and (iii) section 961(c) ownership units and section 961(c) basis, which is provided to a CFC and is covered shareholder-specific. See proposed §1.961-2; see *also* proposed §1.961-12(c) (*Example 1*). Each type of basis is maintained in U.S. dollars to ensure that basis reductions for a distribution of PTEP are commensurate with prior basis increases reflecting the income inclusion giving rise to the PTEP, regardless of movements in exchange rates (with any such movements taken into account under the rules for recognizing foreign currency gain or loss pursuant to section 986(c)).

### 2. Section 961(a) Ownership Units and Adjusted Basis

A section 961(a) ownership unit is a share of stock of a foreign corporation directly owned by a covered shareholder, or a partnership interest directly owned by a

covered shareholder and through which the covered shareholder owns stock of a foreign corporation. See proposed §1.961-2(c). For example, if a covered shareholder directly owns an interest in a partnership and the partnership owns (directly or indirectly) stock of a foreign corporation, the partnership interest is a section 961(a) ownership unit. A covered shareholder is provided adjusted basis in a section 961(a) ownership unit.

### 3. Derivative Ownership Units and Derived Basis

A derivative ownership unit is a share of stock of a foreign corporation directly owned by a partnership and owned (indirectly) by one or more covered shareholders through only one or more partnerships (for example, not through a foreign corporation), or a partnership interest directly owned by another partnership and through which one or more covered shareholders own stock of a foreign corporation through only partnerships. See proposed §1.961-2(d)(1). For example, if a covered shareholder directly owns an interest in a partnership and the partnership directly owns shares of stock of a foreign corporation, each share of stock of the foreign corporation is a derivative ownership unit (and the interest in the partnership is a section 961(a) ownership unit). If, instead, the partnership is a lower-tier partnership an interest in which is directly owned by an upper-tier partnership and the covered shareholder directly owns an interest in the upper-tier partnership, the upper-tier partnership's interest in the lower-tier partnership is also a derivative ownership unit along with each share of stock of the foreign corporation directly owned by the lower-tier partnership (and the interest in the upper-tier partnership directly owned by the covered shareholder is a section 961(a) ownership unit).

A partnership is provided derived basis in a derivative ownership unit, which is maintained separately with respect to each covered shareholder that owns the derivative ownership unit through only one or more partnerships. See proposed §1.961-

2(d)(2). Derived basis may be positive or negative and is treated as an attribute of the partnership but has no effect on the partnership's common basis in the derivative ownership unit (that is, the partnership's basis that is shared among all partners) or any other asset of the partnership. See part III.C of the Explanation of Provisions for a discussion of adjustments to derived basis, including the allowance of negative derived basis. Derived basis is intended to operate in a manner similar to a basis adjustment under section 743(b). See parts III.D and F of the Explanation of Provisions for the tax consequences of derived basis.

#### 4. Section 961(c) Ownership Units and Section 961(c) Basis

A section 961(c) ownership unit is a share of stock of a foreign corporation directly owned by a CFC and owned (indirectly) by one or more covered shareholders. See proposed §1.961-2(e)(1). For example, if a covered shareholder directly owns stock of an upper-tier CFC and the upper-tier CFC directly owns shares of stock of a lower-tier foreign corporation, each share of stock of the lower-tier foreign corporation owned by the upper-tier CFC is a section 961(c) ownership unit.

A CFC is provided section 961(c) basis in a section 961(c) ownership unit, which is maintained separately with respect to each covered shareholder that owns the section 961(c) ownership unit. See proposed §1.961-2(e)(2). Section 961(c) basis may be positive or negative and is treated as an attribute of the CFC that generally is taken into account on the sale, exchange, or other disposition of the section 961(c) ownership unit, but has no effect on the CFC's adjusted basis in the section 961(c) ownership unit or any other asset of the CFC. See part III.C of the Explanation of Provisions for a discussion of adjustments to section 961(c) basis, including the allowance of negative section 961(c) basis. Section 961(c) basis applies only for the purposes prescribed in the section 961 regulations and, therefore, does not affect the amount of the CFC's



gross income or E&P. See parts III.E through G of the Explanation of Provisions for the tax consequences of section 961(c) basis.

## 5. Certain Basis Not Addressed

### i. Section 961(c) basis and non-CFCs

Consistent with the statutory language of section 961(c), the proposed regulations provide for basis under section 961(c) only with respect to stock of a CFC that is directly owned by another CFC. Although a section 961(c) ownership unit is defined as a share of stock of a foreign corporation directly owned by a CFC, section 961(c) basis adjustments are generally made only with respect to section 961(c) ownership units that are shares of stock in a CFC, as discussed in part III.C of the Explanation of Provisions. See proposed §1.961-3 (basis increases for income inclusions); proposed §1.961-4(d) (basis reductions for distributions); proposed §1.961-5(b) (adjustments for foreign currency gain or loss). The Treasury Department and the IRS are studying whether, and to what extent, basis adjustments may or should also be made under section 961(c) in cases where stock of a CFC is owned by a covered shareholder through a foreign corporation that is not a CFC or where a CFC owns stock of a foreign corporation that used to be a CFC.

A CFC's section 961(c) basis with respect to a covered shareholder in stock of a lower-tier foreign corporation that is provided under the proposed regulations when that lower-tier foreign corporation was a CFC continues to exist, however, if that lower-tier foreign corporation ceases to be a CFC (a share of stock of the lower-tier foreign corporation is a section 961(c) ownership unit regardless of CFC status). Thus, for example, section 961(c) basis in stock of a foreign corporation that was a CFC but ceases to be a CFC may transfer to another covered shareholder in a general successor transaction and become section 961(c) basis with respect to that covered shareholder. See proposed §1.961-5(c) (discussed in part III.C.4 of the Explanation of

Provisions). Similarly, a CFC's positive section 961(c) basis in stock of a foreign corporation that was a CFC but ceases to be a CFC may be applied to certain gain recognized by the CFC with respect to stock of that foreign corporation. See proposed §1.961-9 (discussed in part III.E of the Explanation of Provisions).

ii. Partnership interests owned by foreign corporations

Under the proposed regulations, a property unit does not include a share of stock of a foreign corporation or a partnership interest to the extent the share of stock or partnership interest is directly owned by a partnership and the interests of such partnership are owned by foreign corporations (including CFCs). Nor does a property unit include a partnership interest directly owned by a foreign corporation. For example, assume a covered shareholder directly owns all the stock of two upper-tier CFCs, the upper-tier CFCs are the only direct partners in a partnership, and the partnership directly owns all the stock of a lower-tier CFC. In such a case, neither the shares of stock of the lower-tier CFC directly owned by the partnership, nor the upper-tier CFCs' interests in the partnership, are property units. The Treasury Department and the IRS are studying whether the basis that should be provided in these items of property should be similar to derived basis or section 961(c) basis or have characteristics of both. Thus, the proposed regulations do not address the extent to which section 961 provides basis in such items.

C. Basis adjustments (proposed §§1.961-3, 1.961-4, and 1.961-5)

1. Basis Increases for Certain Income Inclusions

i. In general

To reflect a covered shareholder's income inclusions under sections 951(a) and 951A(a) for a taxable year of a CFC, the proposed regulations provide rules to increase the basis of property units that are shares of stock of the CFC owned by the covered shareholder and the basis of any property units through which the covered shareholder

owns such stock. See proposed §1.961-3(b); see *also* proposed §1.961-12(c) (*Example 2*). For this purpose, a reference to basis means adjusted basis of the covered shareholder in the case of a section 961(a) ownership unit, derived basis with respect to the covered shareholder in the case of a derivative ownership unit, and section 961(c) basis with respect to the covered shareholder in the case of a section 961(c) ownership unit.

Generally, the basis of each property unit is increased by the amount that would be distributed with respect to the property unit in a hypothetical distribution by the CFC equal to the U.S. dollar amount of the covered shareholder's income inclusions (hypothetical distribution rule). See proposed §1.961-3(c)(1) and (4); see *also* part III.C.1.ii of the Explanation of Provisions (discussing additional rules that apply in the case of a midyear transaction). The hypothetical distribution is treated as made through all tiers to the covered shareholder on the last relevant day of the CFC's taxable year (taking into account only stock or other property owned by the covered shareholder). See proposed §1.961-3(e). In this way, under the grant of regulatory authority in section 961, a property unit is generally provided an amount of basis matching the amount by which basis of the property unit is reasonably expected to be reduced under section 961 when PTEP resulting from the income inclusions is subsequently distributed to the covered shareholder. The amount of basis provided to a particular property unit will generally equal the covered shareholder's income inclusion attributable to that property unit, but the amount may differ in certain cases.

For example, consider a case where the covered shareholder owns all the stock of the CFC, with such stock consisting of a single preferred share with a \$10x preference and common stock. The CFC has \$100x of E&P for its taxable year, consisting of \$90x of subpart F income, \$0 of tested income or tested loss, and \$10x of other income. The covered shareholder includes \$90x in gross income under section

951(a)(1)(A) (under §1.951-1, \$9x of the inclusion is attributable to the preferred share and the remaining \$81x is attributable to the common stock), and, consequently, the CFC's PTEP with respect to the covered shareholder increases by \$90x. While only \$9x of the covered shareholder's \$90x income inclusion is attributable to the preferred share, the proposed regulations increase the basis of the preferred share by \$10x and the basis of the common stock by the remaining \$80x. This approach takes into account that, of the first \$10x of PTEP distributed by the CFC to the covered shareholder, that amount is likely to be distributed on the preferred share. And, if the basis adjustments to the preferred share were to instead match the income inclusion attributable to that share (\$9x), the covered shareholder would receive a \$10x distribution on the preferred share, thus potentially giving rise to gain under section 961(b)(2) in an amount equal to that difference. The proposed regulations prevent that result by adjusting the basis in the preferred share by \$10x. The Treasury Department and the IRS request comments on this approach, including whether there are ways to improve the accuracy of allocating basis to a property unit without undue complexity and additional compliance and administrative burden, and without creating the possibility of inappropriate results.

However, if the CFC distributes PTEP with respect to the covered shareholder before the last relevant day of the CFC's taxable year, the policies underlying the hypothetical distribution rule (matching basis with distributed PTEP) are better carried out by using such actual distributions (rather than a hypothetical distribution on the last relevant day) to allocate basis increases among property units, particularly when there are midyear transactions (though where there is no midyear transaction the two approaches generally produce the same results). Thus, an actual distribution rule applies in these cases and consequently reduces the amount that can give rise to a

basis increase pursuant to the hypothetical distribution rule. See proposed §1.961-3(c)(3).

The actual distribution rule applies in chronological order to distributions of the CFC's PTEP with respect to the covered shareholder, and in each case generally increases basis of a share of stock of the CFC on which the distribution is made by the amount of the reduction required under section 961 to such basis by reason of the distribution. See proposed §1.961-3(d)(2). However, basis increases to stock of the CFC under the actual distribution rule cannot exceed the U.S. dollar amount of the covered shareholder's income inclusions, excluding for this purpose an income inclusion under section 951(a)(1)(B) because such inclusion does not give rise to PTEP that could be distributed before the last relevant day of the CFC's taxable year. Additionally, the actual distribution rule applies only to distributions on stock of the CFC that the covered shareholder owns on the last relevant day because the covered shareholder's income inclusions with respect to the CFC are attributable only to that stock.

Basis increases to stock of the CFC under the actual distribution rule "tier up" through property units through which the covered shareholder owns such stock, based on how the PTEP that is actually distributed would be further distributed in a hypothetical distribution made at the time of the actual distribution. See proposed §1.961-3(d)(3). The Treasury Department and the IRS considered alternative approaches to tiering such as analyzing the extent to which PTEP is further distributed before the last relevant day, but those approaches could give rise to additional complexity and burden. For instance, the approaches could require rules tracing distributed PTEP through tiers of foreign corporation and coordinating applications of the actual distribution rule at each tier. The Treasury Department and the IRS welcome comments on the actual distribution rule, including whether there are ways to improve

the accuracy of tiering without undue complexity and additional compliance and administrative burden.

Generally, each basis increase under the hypothetical distribution rule or actual distribution rule is treated as made at the beginning of the first day of the CFC's taxable year or, if later, at the beginning of the first day in the taxable year on which the covered shareholder owns the property unit. See proposed §1.961-3(d)(1), (e)(1). In this way, the timing of a basis increase generally matches when PTEP to which the basis is attributable could first be distributed on the property unit. Additionally, the portion of a basis increase for a section 951(a)(1)(B) inclusion is treated as made at the end of the last day of the taxable year, subject to a special rule. See proposed §1.961-3(e)(1). The special rule applies where a property unit that will receive a basis increase for the section 951(a)(1)(B) inclusion is transferred before the end of the taxable year (but on or after the last relevant day of the taxable year), and in such a case accelerates the basis increase to the property unit so that it is treated as made immediately before the transfer, thereby ensuring that the basis is available in determining the tax consequences of the transfer. See proposed §1.961-3(e)(4).

## ii. Midyear transactions

Additional rules address unique timing considerations for basis increases when a midyear transaction occurs during the taxable year of a CFC. See proposed §1.961-3(c)(2). A midyear transaction represents any transaction occurring before the last relevant day of the taxable year that changes the covered shareholder's ownership structure of the CFC (for example, an exchange of the covered shareholder's stock of the CFC or an issuance of stock of the CFC to the covered shareholder).

In the case of a midyear transaction, a basis increase under the hypothetical distribution rule or actual distribution rule is treated as made at the earliest time during the CFC's taxable year at which the same ownership structure is in place as the

ownership structure when the relevant hypothetical or actual distribution is made. See proposed §1.961-3(d)(1), (e)(1). Thus, for a basis increase under the actual distribution rule, if the distribution is made before all midyear transactions, the basis increase is treated as made at the beginning of the first day of the CFC's taxable year; on the other hand, if the distribution is made after a midyear transaction, the basis increase is treated as made immediately after the most recent midyear transaction preceding the distribution. This approach is intended to prevent distortions, including possible duplication of basis in certain cases.

For example, assume a covered shareholder (US1) directly owns all the stock of two CFCs (CFC1 and CFC2) on January 1 of year 1. On June 30 of year 1, US1 exchanges all the stock of CFC1 solely for stock of CFC2 in an exchange described in section 351(a) (which is a midyear transaction with respect to CFC1 and CFC2). CFC1 makes no distributions during its taxable year ending on December 31 of year 1, and US1 has a \$100x subpart F income inclusion with respect to CFC1 for that taxable year. Thus, under the hypothetical distribution rule, US1 increases its adjusted basis in its stock of CFC2 by \$100x and CFC2 increases its section 961(c) basis with respect to US1 in its stock of CFC1 by \$100x. However, basis could be inappropriately duplicated if the \$100x basis increase in the stock of CFC1 were treated as made on January 1 of year 1, which would be the case absent the section 351 exchange. This could occur if US1's basis in its stock of CFC2 were to both be increased under the hypothetical distribution rule and take a basis under section 358(a) reflecting the basis increase in the stock of CFC1 under the hypothetical distribution rule. To address this, special timing rules treat the \$100x basis increase in each of the stock of CFC1 and stock of CFC2 as made immediately after the section 351 exchange, which is the first time during CFC1's taxable year at which the same ownership structure is in place as the

ownership structure on the last relevant day of the taxable year (when the hypothetical distribution determining the basis increase is made).

## 2. Basis Reductions and Gain Recognition for Distributions

### i. In general

As discussed in part II.C.2 of the Background, section 961(b)(1) provides for reductions to the basis of stock or other property with respect to which a covered shareholder receives PTEP excluded from its gross income under section 959(a), with amounts in excess of such basis resulting in gain under section 961(b)(2). Section 961(c) indicates that the Secretary should issue regulations providing for adjustments similar to those in section 961(b) with respect to PTEP received by a CFC and amounts in excess of section 961(c) basis.

In order to implement the statutory language of section 961, the proposed regulations provide rules for reducing basis and recognizing gain with respect to property units to reflect distributions of PTEP. See proposed §1.961-4; see *also* proposed §1.961-12(c)(3) (*Example 3*). These rules describe the amounts of adjustments, limitations on basis reductions, and treatment of gain under section 961, which can differ depending on the type of property unit for which the basis is being adjusted. The adjustments are treated as made concurrently with the distribution if the property unit is stock of a foreign corporation or, if the property unit is an interest in a partnership, concurrently with an adjustment to the partnership interest under section 705 resulting from the distribution. See proposed §1.961-4(e) and (f)(1).

### ii. Adjustments to section 961(a) ownership units

If a covered shareholder receives a distribution of PTEP that is excluded from its gross income under section 959(a) (that is, PTEP other than taxable section 962 PTEP), then the covered shareholder's adjusted basis of each section 961(a) ownership unit is generally reduced by the dollar basis and associated foreign income taxes of the



PTEP received with respect to the section 961(a) ownership unit. See proposed §1.961-4(b)(2)(i) and (ii). Associated foreign income taxes are taken into account for this purpose because when foreign income taxes are allocated and apportioned to PTEP, the foreign income taxes reduce the PTEP and the dollar basis of the PTEP, as discussed in part II.C.2 of the Explanation of Provisions. As a result, the sum of the dollar basis and associated foreign income taxes of PTEP represent the amount by which basis was increased under section 961 when the PTEP was generated.

However, the associated foreign income taxes (which represent PTEP that was eliminated by foreign income taxes) reduce adjusted basis only to the extent the covered shareholder is allowed a credit under section 901 for those taxes. See proposed §1.961-4(b)(2)(i). Consequently, associated foreign income taxes ultimately give rise to either a credit or an amount equivalent to a deduction (in the form of retained adjusted basis, which, in turn, will produce a lesser amount of gain or an additional amount of loss on a subsequent sale of the section 961(a) ownership unit relative to the gain or loss that would result if adjusted basis were reduced by associated foreign income taxes). The Treasury Department and the IRS are of the view that this prevents double taxation of PTEP but are studying whether the policies of section 245A(d) or 965(g) (denying a credit or deduction for foreign income taxes) should require reducing adjusted basis for associated foreign income taxes of PTEP resulting from section 245A(e) or 965.

Further, to the extent the required reduction to adjusted basis of a section 961(a) ownership unit exceeds such adjusted basis, the covered shareholder is treated as recognizing gain from a sale or exchange of the section 961(a) ownership unit, in accordance with section 961(b)(2). See proposed §1.961-4(b)(2)(iii) and (f)(1). Basis of another section 961(a) ownership unit (for example, another share of stock of the foreign corporation) cannot be used to reduce gain under section 961(b)(2), which 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).

Moreover, unlike the approach described in the 2006 proposed regulations, basis attributable to section 961 does not shift from one share to another share when PTEP is distributed with respect to the other share. The Treasury Department and the IRS are of the view that a shifting approach could give rise to inappropriate results, is not required by section 961 (which increases basis for income inclusions without any indication that such basis must or should remain tied to the PTEP resulting from the income inclusion), and would depart from analogous provisions like section 358 (which, for example, increases basis for contributions to capital without subsequently shifting such basis to follow distributions of capital). Further, the approach in the proposed regulations is consistent with the share-by-share approach in the current regulations under section 961. See §1.961-2(b) and (c).

As an example of inappropriate results that could arise from basis shifting, assume a covered shareholder owns all the stock of a foreign corporation with PTEP and contributes money to the corporation in exchange for a newly-issued share of stock, and the corporation subsequently distributes the PTEP, including on the newly-issued share. If a portion of the basis that had been provided under section 961(a) for the PTEP were to shift from the original shares to the newly-issued share as a result of the distribution, then that basis would be added on top of the existing fair market value basis in the newly-issued share (by an amount equal to the amount of PTEP distributed on that share), which could produce a noneconomic loss in the newly-issued share. Additionally, as indicated in the document withdrawing the 2006 proposed regulations (87 FR 63981), the Treasury Department and the IRS are aware of transactions in which taxpayers have taken positions that basis shifting produces large uneconomic

losses, and the IRS may challenge such positions and other positions giving rise to abuse or inappropriate results.

iii. Adjustments to derivative ownership units

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. See proposed §1.961-4(c)(1); see *also* part II.D.2.ii of the Explanation of Provisions (portion of a covered distribution that is made to a partnership, or that is treated as made to the partnership in the case of tiered partnerships, is treated as made to the partnership's partners in accordance with their respective distributive shares of such portion). Specifically, starting with the partnership at the lowest tier, the partnership's derived basis with respect to each covered shareholder partner of each derivative ownership unit is generally reduced by the dollar basis and associated foreign income taxes of the PTEP with respect to the covered shareholder that is treated as received by the covered shareholder through the partnership with respect to the derivative ownership unit. See proposed §1.961-4(c)(2)(i) and (ii). 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 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).

However, to the extent the required reduction to derived basis with respect to a covered shareholder of a derivative ownership unit exceeds the derived basis (for

example, because a partnership purchased stock of a CFC and thus has no derived basis with respect to the derivative ownership unit), the excess first reduces the covered shareholder's positive section 743(b) basis adjustment of the derivative ownership unit (if any), but not below zero. See proposed §1.961-4(c)(2)(iii). Thus, this rule, by treating the positive section 743(b) basis adjustment in the same manner as adjusted basis specific to the covered shareholder, is consistent with §1.743-1(j) (regarding the effect of a basis adjustment under section 743(b)). Then, any remaining portion of the excess reduces the derived basis below zero, subject to a limitation. See *id.* As discussed in part III.C.2.v of the Explanation Provisions, this limitation is intended to prevent reductions to derived basis of the derivative ownership unit from having the effect of reducing the partnership's total basis (measured for this purpose by netting common basis and all negative derived basis) of the derivative ownership unit below zero.

Finally, to the extent the required reduction to derived basis with respect to a covered shareholder of a derivative ownership unit exceeds the amount of positive derived basis, positive section 743(b) basis, and negative derived basis created, the partnership is treated as recognizing gain from a sale or exchange of the derivative ownership unit. See proposed §1.961-4(c)(2)(iv). The gain is allocated by the partnership solely to the covered shareholder and is taken into account in adjusting basis under section 705, but it has no effect on any partnership's computations or allocations of any other items under section 703 or 704 or on the covered shareholder's capital account. See proposed §1.961-4(f)(2).

#### iv. Adjustments to section 961(c) ownership units

If a CFC receives a distribution of PTEP, then the CFC's section 961(c) basis with respect to each covered shareholder of each section 961(c) ownership unit is generally reduced by the dollar basis and associated foreign income taxes of the PTEP

with respect to the covered shareholder that is received with respect to the section 961(c) ownership unit. See proposed §1.961-4(d)(2)(i) and (ii).

To the extent the required reduction to section 961(c) basis with respect to a covered shareholder of a section 961(c) ownership unit exceeds such section 961(c) basis (for example, because a CFC purchased stock of another CFC and thus has no section 961(c) basis with respect to the section 961(c) ownership unit or a portion of the distributed PTEP is section 965(b) PTEP), the excess reduces the section 961(c) basis below zero, subject to a limitation. See proposed §1.961-4(d)(2)(ii). As discussed in part III.C.2.v of the Explanation of Provisions, this limitation is intended to prevent reductions to section 961(c) basis of the section 961(c) ownership unit from having the effect of reducing the CFC's total basis (measured for this purpose by netting adjusted basis and all negative section 961(c) basis) of the section 961(c) ownership unit below zero. Then, any remaining portion of the excess is treated as gain recognized by the CFC from a sale or exchange of the section 961(c) ownership unit, and such gain is assigned from the CFC solely to the covered shareholder. See proposed §1.961-4(d)(2)(iii). Gain recognized by a CFC under this rule applies only for purposes of determining amounts included in gross income of United States shareholders under proposed §1.961-11 (discussed in part III.G. of the Explanation of Provisions) because section 961(c) applies only for limited purposes. See proposed §1.961-4(f)(3). Therefore, the gain does not affect the CFC's items of gross income for purposes of section 952 or 951A or its E&P.

The Treasury Department and the IRS are of the view that the gain recognition rules described in this part III.C.2 of the Explanation of Provisions appropriately prevent use of the same basis more than once, provide similar outcomes for similar transactions at different tiers, and ensure the tax consequences of the gain are covered shareholder-specific. Any alternative approach that did not require gain recognition under section

961(b)(2) and (c) for amounts in excess of basis would necessarily have to narrow the application of section 961(c) basis (discussed in part III.E of the Explanation of Provisions), with the result that section 961(c) basis would not be available for use in a section 301(c)(3) transaction and, in a sale, might be available for use only to the extent of undistributed PTEP.

Consider the following examples illustrating that the proposed regulations provide a consistent approach ensuring that distributions appropriately reduce basis or result in the recognition of gain. First, assume US1, a covered shareholder, directly owns the single share of outstanding stock of CFC1, a newly formed foreign corporation. For simplicity, assume US1 has \$0 basis in its stock in CFC1. In year 1, CFC1 generates \$100x of PTEP with respect to US1, which increases US1's adjusted basis of the share of stock of CFC1 from \$0 to \$100x. In year 2, CFC1 makes a \$100x distribution out of E&P and, in year 3, CFC1 makes a \$100x distribution that is not out of E&P. In this case, the year 2 distribution is tax-free (that is, the distribution is excluded from US1's gross income under section 959(a) but reduces US1's adjusted basis in its stock of CFC1 under section 961(b)(1)), and the year 3 distribution requires US1 to recognize \$100x of gain under section 301(c)(3). Alternatively, assume CFC1 generates a deficit in E&P in year 2 and generates E&P in year 3, with the result that the year 3 distribution, but not the year 2 distribution, is out of E&P. In such a case, the year 2 \$100x distribution is tax-free under section 301(c)(2) by reason of US1's adjusted basis pursuant to section 961(a), and the year 3 \$100x distribution requires US1 to recognize \$100x of gain under section 961(b)(2), which appropriately prevents a double use of basis.

Now assume instead that CFC2, a foreign corporation directly owned by US1, directly owns the single share of stock of CFC1 (rather than US1), CFC2's adjusted basis of the share of stock of CFC1 is \$0, and CFC2's section 961(c) basis with respect

to US1 of the share of stock of CFC1 is increased from \$0 to \$100x to reflect the \$100x of PTEP generated by CFC1 with respect to US1. In that case, if CFC1's year 2 distribution is out of E&P, the year 2 distribution is tax-free under sections 959 and 961 and the year 3 distribution requires CFC2 to recognize \$100x of gain under section 301(c)(3), which US1 will generally include in gross income under section 951(a). Alternatively, if the year 3 distribution is out of E&P instead of the year 2 distribution, the year 2 distribution is tax-free by reason of CFC2's section 961(c) basis and the year 3 distribution requires CFC2 to recognize \$100x of gain pursuant to section 961(c), which US1 will generally include in gross income under the rules described in part III.G of the Explanation of Provisions.

v. Limitations on negative derived basis and negative section 961(c) basis

As discussed in parts III.C.2.iii and iv of the Explanation of Provisions, a partnership's derived basis or a CFC's section 961(c) basis with respect to a covered shareholder of a property unit can be reduced below zero (and therefore result in negative basis instead of triggering immediate gain recognition) as a result of a distribution of PTEP with respect to the property unit, subject to a limitation. The concept of negative section 961(c) basis stems from the language of section 961(c) (providing "adjustments similar to the adjustments" of section 961(a) and (b), "but only for the purposes of determining the amount included under section 951"), which contemplates section 961(c) basis replicating the outcomes that would occur for section 951 purposes if the CFC's adjusted basis could be increased or reduced under section 961(a) or (b). In this way, negative section 961(c) basis can be conceptualized as a reduction to adjusted basis that has no tax effect until a transaction relevant for purposes of section 951 occurs with respect to the property unit. Negative derived basis follows the same concept.

Under the limitation, a distribution can reduce (or further reduce) derived basis or section 961(c) basis below zero only to the extent of the amount of the partnership's common basis or the CFC's adjusted basis of the property unit that is available with respect to the covered shareholder (determined as described in the next paragraph). See proposed §1.961-4(c)(3)(i) and (d)(3)(i). In the case of a partnership, the amount of common basis available with respect to the covered shareholder is reduced by the covered shareholder's negative section 743(b) basis adjustment of the derivative ownership unit (if applicable). See proposed §1.961-4(c)(3)(i).

The common basis or adjusted basis available with respect to the covered shareholder is determined by first computing the partnership's common basis or the CFC's adjusted basis of the property unit, reduced, as applicable, by all negative derived basis or all negative section 961(c) basis of the property unit (regardless of the covered shareholders to which the negative basis relates). See proposed §1.961-4(c)(3)(ii) and (d)(3)(ii). This amount represents the partnership's common basis or the CFC's adjusted basis that is potentially available to reduce derived basis or section 961(c) basis of the property unit below zero. To address concurrent adjustments with respect to multiple covered shareholders, the partnership's available common basis or the CFC's available adjusted basis is then multiplied by a fraction. The fraction determines the basis available with respect to a covered shareholder based on relative amounts by which derived basis or section 961(c) basis with respect to the covered shareholders would be reduced below zero without limitation.

The Treasury Department and the IRS are of the view that allowing, but limiting the amount of, negative basis in this way has the effect of permitting the partnership's common basis or CFC's adjusted basis of the property unit to be reduced to, but not below, zero. These rules do not affect the treatment or availability of a partnership's



common basis or a CFC's adjusted basis under any other provision of the Code (and, thus, for example, do not impact the application of section 704(c)).

The Treasury Department and the IRS considered other approaches to the limitation such as looking to a covered shareholder's share of common basis or adjusted basis, based on the percentage of the interests in the partnership (using §1.743-1(d) principles, for example) or the stock of the CFC that is owned by the covered shareholder. However, those approaches would give rise to additional complexity and burden because, for example, they could require rules adjusting negative basis with respect to a covered shareholder to the extent that an issuance reduces the covered shareholder's share of common basis or adjusted basis. Further, as discussed in part III.F of the Explanation of Provisions, rules requiring gain recognition in transactions involving negative basis adequately prevent a covered shareholder from disproportionality benefiting from common basis or adjusted basis because gain recognized by a partnership or a CFC under those rules is allocated or assigned to covered shareholders based on relative amounts of negative basis with respect to the covered shareholders. Thus, although 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.

The Treasury Department and the IRS request comments on the approach to limiting negative basis in the proposed regulations, including alternative methods for determining the amount of a partnership's common basis or a CFC's adjusted basis available with respect to a covered shareholder for this purpose.

### 3. Basis Adjustments for Foreign Currency Gain or Loss

To reflect foreign currency gain or loss recognized under section 986(c) by a covered shareholder with respect to a foreign corporation's PTEP in a general successor transaction or other transaction not including a distribution of PTEP (see proposed §1.986(c)-1, discussed in part V of the Explanation of Provisions), the proposed regulations provide rules to adjust the basis of property units that are shares of stock of the foreign corporation owned by the covered shareholder. These adjustments "tier up" through any property units through which the covered shareholder owns such stock, with the result that the basis of such property units is also adjusted. See proposed §1.961-5(b)(1). For purposes of these rules, a reference to basis means adjusted basis of the covered shareholder in the case of a section 961(a) ownership unit, derived basis with respect to the covered shareholder in the case of a derivative ownership unit, and section 961(c) basis with respect to the covered shareholder in the case of a section 961(c) ownership unit. These rules are issued pursuant to the express delegations of authority under sections 965(o) and 989(c) (as well as those under sections 961(a), (b), and (c), as described in part III.A. of the Explanation of Provisions).

The amount of the basis adjustments is equal to the amount of net foreign currency gain or loss. See proposed §1.961-5(b)(2). This is determined by comparing the sum of all foreign currency gain and the sum of all foreign currency loss that the covered shareholder recognizes with respect to the foreign corporation's PTEP in the transaction under section 986(c), without regard to limitations on the recognition of such foreign currency gain or loss for PTEP resulting from section 965.

Generally, the basis of each property unit is increased by the property unit's share of net foreign currency gain or is reduced by the property unit's share of net foreign currency loss, as applicable, determined in each case based on a hypothetical distribution by the foreign corporation equal to all PTEP of the foreign corporation with

respect to which the covered shareholder recognizes (or, but for limitations for PTEP resulting from section 965, would recognize) foreign currency gain or loss in the transaction. See proposed §1.961-5(b)(3) and (4). The basis adjustments are treated as made immediately before the transaction (and therefore are taken into account in the transaction). See proposed §1.959-5(b)(4). Additionally, like in the case of distributions of PTEP, a reduction to basis can reduce derived basis or section 961(c) basis below zero and can result in gain recognition with respect to a property unit. See *id.*

These basis adjustments are consistent with the 1988 notice and prevent foreign currency gain or loss with respect to PTEP, which is recognized at the covered shareholder-level under section 986(c), from also being taken into account with respect to property units sold or exchanged in the transaction (which might otherwise occur if basis of the property units were not adjusted to reflect movements in exchange rates between the time of the income inclusion that gave rise to the PTEP (and basis) and the time of the transaction). The adjustments to basis are determined without regard to the limitations on the recognition of foreign currency gain or loss with respect to PTEP resulting from section 965, which ensures that such unrecognized foreign currency gain or loss does not result in a commensurate amount of gain or loss with respect to property units sold or exchanged in the transaction. See *also* part V.B of the Explanation of Provisions (discussing rules under which foreign currency gain or loss with respect to PTEP resulting from section 965(a) is reduced based on the section 965(c) deduction percentage, and no foreign currency gain or loss is recognized for PTEP arising under section 965(b)).

#### 4. Successor Basis

##### i. In general

If there is an acquisition of stock of a foreign corporation that results in a change of ownership of stock of the foreign corporation, successor rules in section 961(c)

generally transfer the foreign corporation's section 961(c) basis with respect to the covered shareholder that relinquishes ownership of stock of the foreign corporation to the covered shareholder who acquires ownership of the stock. See section 961(c) (prescribed adjustments to basis in CFC stock also apply to any United States shareholder that acquires from any person any portion of the interest of a United States shareholder by reason of which such shareholder was treated as owning CFC stock). These rules generally ensure that undistributed PTEP of a lower-tier foreign corporation does not give rise to additional U.S. tax in the hands of the acquiring covered shareholder when stock of the corporation is later sold by an upper-tier CFC, even though the covered shareholder did not own such stock when the PTEP was generated and section 961(c) basis was increased. These successor basis rules are issued pursuant to the express delegation of authority under section 743(b) (as well as the express delegation of authority under section 961(c), as described in part III.A. of the Explanation of Provisions).

The proposed regulations set forth rules for transferring section 961(c) basis in a general successor transaction, as well as for transferring a partnership's derived basis if the general successor transaction involves an acquisition of an interest in a partnership (acquired partnership). See proposed §1.961-5(c). These rules generally provide parity between derived basis and section 961(c) basis in a general successor transaction and, in the case of an acquired partnership, ensure that the successor covered shareholder succeeds to derived basis (as compared to an approach that attempted to replace all or a portion of derived basis with a section 743(b) basis adjustment, which would require an election under section 754 to be in effect or a substantial built-in loss). The Treasury Department and the IRS intend to issue additional rules regarding the transfer of section 961(c) basis and derived basis (as well as the transfer of PTEP) in acquisitions that are not general successor transactions. In these acquisitions, the Treasury Department and

the IRS are considering adding a rule as part of finalization of the proposed regulations that, similar to the potential rule discussed in part II.G.1 of the Explanation of Provisions, provides that section 961(c) basis and derived basis transfer automatically in periods before those additional rules apply.

In a general successor transaction, a portion of an acquired partnership's derived basis or acquired foreign corporation's section 961(c) basis with respect to the transferor covered shareholder of a property unit transfers to the successor covered shareholder and therefore becomes with respect to the successor covered shareholder. Thus, to reflect the general successor transaction, derived basis or section 961(c) basis is increased (or reduced) by the basis that transfers to (or from) the covered shareholder, and those adjustments are treated as made concurrently with the general successor transaction. See proposed §1.961-5(c)(1) and (2)(iii). The amount of basis that transfers may be a positive or negative amount and is equal to a pro rata portion of the derived basis or section 961(c) basis of the property unit immediately before the general successor transaction, plus any increase, or minus any decrease, to the basis for foreign currency gain or loss recognized under section 986(c) in the general successor transaction (discussed in part V of the Explanation of Provisions). See proposed §1.961-5(c)(2)(i) and (ii).

The pro rata portion is determined based on the percentage, by value, of the transferor covered shareholder's interests in the acquired partnership or acquired foreign corporation that the successor covered shareholder acquires in the general successor transaction. See proposed §1.961-5(c)(2)(i). This approach is intended to transfer derived basis or section 961(c) basis commensurate with the percentage change of the transferor covered shareholder's indirect interests in the partnership's common basis or foreign corporation's adjusted basis by reason of the general successor transaction. The Treasury Department and the IRS are of the view that

alternative approaches – such as transferring an amount of derived basis or section 961(c) basis equal to the amount of PTEP that transfers in the general successor transaction – could give rise to inappropriate outcomes or undue complexity where derived basis or section 961(c) basis is not equal to the PTEP that transfers in the general successor transaction.

ii. Deemed covered shareholder

Consistent with the deemed covered shareholder rules discussed in part II.G.3 of the Explanation of Provisions, the proposed regulations provide that the deemed covered shareholder is treated in the same manner as a covered shareholder in determining the transfer of derived basis or section 961(c) basis. See proposed §1.961-5(c)(3)(i). Thus, for example, if a covered shareholder owns all the stock of an upper-tier CFC, the upper-tier CFC directly owns all the stock of a lower-tier CFC, and the covered shareholder sells a portion of its stock of the upper-tier CFC to a nonresident alien individual, then a portion of the upper-tier CFC's section 961(c) basis in the stock of the lower-tier CFC transfers from the seller covered shareholder to the deemed covered shareholder. The proposed regulations further provide that, to the extent the deemed covered shareholder is treated as owning stock of any foreign corporation that is not otherwise a CFC, the foreign corporation is treated as a CFC for purposes of determining section 961(c) basis that transfers to or from the deemed covered shareholder. See proposed §1.961-5(c)(3)(ii). This is intended to allow for section 961(c) basis to transfer from the deemed covered shareholder to a subsequent covered shareholder (as properly adjusted under the proposed section 961 regulations) even if both an upper-tier foreign corporation and the lower-tier foreign corporation in which the upper-tier foreign corporation directly owns stock cease to be CFCs during the period in which the stock of the foreign corporations is considered owned by the deemed covered shareholder.

In cases where basis of a derivative ownership unit or section 961(c) ownership unit transfers from the deemed covered shareholder to a covered shareholder, the covered shareholder must use a reasonable method to determine the amount of transferred basis. See proposed §1.961-5(c)(3)(iii). The proposed regulations provide that such method must take into account adjustments to basis with respect to the deemed covered shareholder that would have been made under the proposed regulations if the basis were with respect to a covered shareholder during the time that it was with respect to the deemed covered shareholder.

Like in the context of the deemed covered shareholder rules for purposes of transferring PTEP, the Treasury Department and the IRS welcome comments on this regime.

### iii. Coordination with section 743(b)

In certain general successor transactions in which an acquired partnership has a section 754 election in effect or a substantial built-in loss as defined under section 743(d), property of the acquired partnership will receive a section 743(b) basis adjustment with respect to the successor covered shareholder. Accordingly, the proposed regulations take into account derived basis that transfers to the successor covered shareholder in calculating the overall section 743(b) basis adjustment and its allocation among the acquired partnership's assets with respect to the successor covered shareholder. See proposed §1.961-5(d). In transactions involving multiple tiers of acquired partnerships, this coordination rule applies to each acquired partnership.

## 5. Basis Adjustments for Deemed Dividends under Section 1248(c)(2) or 964(e)(1)

The Treasury Department and the IRS are studying whether basis under section 961 should be increased to reflect gain treated as a dividend under section 1248(c)(2) or 964(e)(1). For example, to the extent gain recognized by a covered shareholder on a

sale of stock of a first-tier CFC is treated as a dividend under section 1248(c)(2) by reason of E&P of a third-tier CFC (and therefore gives rise to PTEP under section 959(e)), the Treasury Department and the IRS are considering whether (and to what extent) the first-tier CFC's and second-tier CFC's section 961(c) basis can and should be increased to reflect the resulting PTEP. The Treasury Department and the IRS request comments on this topic.

D. Tax consequences of positive derived basis (proposed §1.961-8)

1. In General

The rules for a partnership's positive derived basis with respect to a covered shareholder are generally intended to replicate the outcome that would occur on a sale, exchange, or other disposition of the derivative ownership unit if such basis were an additional amount of common basis taken into account in determining gain or loss allocable to the covered shareholder. These rules are generally modeled after the rules in §1.743-1.

Under the proposed regulations, in a sale, exchange, or other disposition by a partnership (transferring partnership) of one or more derivative ownership units (transferred units), each partner's distributive share of gain or loss recognized by the transferring partnership is first determined under section 704 without regard to positive derived basis (but with regard to any section 743(b) basis adjustment with respect to the partner). See proposed §1.961-8(b)(1). Then, positive derived basis is applied to each covered shareholder's distributive share of such gain or loss, in an amount equal to the transferring partnership's positive derived basis with respect to the covered shareholder of the transferred units, subject to two limitations (discussed in part III.D.2 of the Explanation of Provisions). See proposed §1.961-8(b)(2)(i); see *also* proposed §1.961-12(c)(4) (*Example 4*). This application of positive derived basis can decrease a



distributive share of gain, increase a distributive share of loss, or convert a distributive share of gain to a distributive share of loss.

The application of positive derived basis to a covered shareholder's distributive share is generally treated as an application of positive derived basis by the transferring partnership. See proposed §1.961-8(b)(1). However, if the covered shareholder owns the transferred units through tiered partnerships, only the partnership in which the covered shareholder directly owns an interest is treated as applying the positive derived basis).

To coordinate with section 705, the proposed regulations provide that adjusted basis of a partnership interest directly owned by the covered shareholder is adjusted under section 705 after taking into account the partnership's application of positive derived basis to the covered shareholder's distributive share of gain or loss with respect to the transferred units. See proposed §1.961-8(c). On the other hand, in tiered partnership structures, an upper-tier partnership's common basis in a lower-tier partnership interest is adjusted under section 705 without regard to the application of positive derived basis to the covered shareholder's distributive share. See proposed §1.961-8(d). Additionally, an upper-tier partnership's derived basis with respect to the covered shareholder in a lower-tier partnership interest (starting at the lowest-tier if there is more than one lower-tier partnership) is concurrently reduced (or gain is recognized, as applicable) by the amount of positive derived basis applied to the covered shareholder's distributive share. In this way, an upper-tier partnership's derived basis in a lower-tier partnership interest is replaced with common basis under section 705 (which may be decreased under section 705(a)(2) when the lower-tier partnership makes a distribution).

## 2. Limitations

As discussed in part III.D.1 of the Explanation of Provisions, the amount of positive derived basis applied to a covered shareholder's distributive share of gain or loss with respect to transferred units is equal to the transferring partnership's positive derived basis with respect to the covered shareholder of the transferred units, subject to two limitations. See proposed §1.961-8(b)(2)(i).

The first limitation applies in nonrecognition transactions 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. See proposed §1.961-8(b)(2)(ii). Under this limitation, the amount of positive derived basis applied to the covered shareholder's distributive share is equal to the excess of the amount of positive derived basis with respect to the covered shareholder of the transferred units over the covered shareholder's share of the gain realized but not recognized by the transferring partnership with respect to the transferred units (determined without regard to derived basis). 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.

To illustrate this limitation, assume US1, a covered shareholder, directly owns a 50 percent interest in PRS1, a partnership, and PRS1 directly owns the single share of outstanding stock of F1, a foreign corporation. The fair market value of the share is \$150x. PRS1's common basis of the share is \$100x, and PRS1's derived basis with respect to US1 of the share is \$15x. PRS1 exchanges the share for \$120x of stock and \$30x of money in a reorganization described in section 368(a)(1)(D), recognizing \$30x of gain on the exchange under section 356(a)(1) (the lesser of the \$30x of money received and the \$50x of gain in the stock of F1) and therefore \$20x of the \$50x of

realized gain is not recognized due to the boot limitation in section 356(a)(1). US1's distributive share of the recognized gain is \$15x ( $\$30x \times 50\%$ ), determined without regard to derived basis. Under the limitation in the proposed regulations, only \$5x of positive derived basis is applied to such distributive share (thus, \$10x of the \$15x of derived basis is not available for use). The \$5x is computed as the excess of \$15x (the amount of positive derived basis with respect to US1 without regard to the limitation), over \$10x ( $\$20x \times 50\%$ , which represents US1's share of the realized-but-not-recognized gain). Accordingly, US1's distributive share of gain taking into account derived basis is \$10x (US1's \$15x distributive share of gain without regard to derived basis over \$5x of positive derived basis available under the limitation). This \$10x represents the amount of gain that would be recognized under section 356(a)(1) and allocated to US1 if such were determined based on \$75x of value (50% of each of the \$120x of stock consideration and \$30x of money) and \$65x of basis (50% of the \$100x of common basis, increased by the \$15x of derived basis).

Under the second limitation, positive derived basis can increase or create a distributive share of loss only if the transferring partnership recognizes, or would recognize, loss on the sale, exchange, or other disposition of the transferred units and a current deduction in respect of the loss is, or would be, allowable. See proposed §1.961-8(b)(2)(iii). Thus, for example, positive derived basis cannot create a distributive share of loss if the gain recognized with respect to the transferred units is pursuant to section 301(c)(3).

### 3. Certain Scenarios Not Addressed

The proposed regulations do not address the interaction of derived basis with the rules regarding distributions by a partnership (for example, sections 732 and 734). The Treasury Department and the IRS request 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.

The proposed regulations also do not address the effect of derived basis under the dividend recharacterization rules of section 1248. The Treasury Department and the IRS are studying this and other issues with respect to the application of section 1248 when stock of a foreign corporation is owned through a partnership (for example, the manner in which section 1248(d)(1) applies to exclude PTEP in determining deemed dividend treatment), and welcome comments on these issues.

#### E. Tax consequences of positive section 961(c) basis (proposed §1.961-9)

##### 1. In General

As discussed in part III.B.4 of the Explanation of Provisions, a CFC's section 961(c) basis applies only for the purposes prescribed in the section 961 regulations and thus does not affect the amount of the CFC's gross income or E&P. Under the rules in the proposed regulations for the tax consequences of positive section 961(c) basis, gain to which positive section 961(c) basis is applied is treated as PTEP that is generally excluded from the CFC's gross income under section 961(c) (section 961(c) exclusion). See proposed §1.961-9. The proposed regulations describe the section 961(c) exclusion, the application of section 961(c) basis to gain, and the PTEP that results from such application (including the character of the PTEP).

##### 2. Section 961(c) Exclusion

###### i. In general

The section 961(c) exclusion operates in a similar manner to the section 959(b) exclusion. It provides that PTEP resulting from the application of a CFC's section 961(c) basis to gain recognized by the CFC is excluded from the CFC's gross income for purposes of determining the CFC's subpart F income and tested income or tested

loss, provided that the PTEP relates to a covered shareholder that is a United States shareholder in the CFC. See proposed §1.961-9(b); see *also* part III.E.3 of the Explanation of Provisions (determining PTEP resulting from section 961(c) basis).

The Treasury Department and the IRS are of the view that E&P attributable to gain to which section 961(c) basis is applied gives rise to PTEP. Section 959(a) refers to E&P of a foreign corporation that is “attributable to amounts which are, or have been, included in gross income under section 951(a) [or 951A(a)].” Gain recognized by an upper-tier foreign corporation on the disposition of stock of a lower-tier foreign corporation may likewise reflect amounts included in gross income under section 951(a) or 951A(a) with respect to the lower-tier foreign corporation and, thus, give rise to E&P that is attributable to such amounts. Because section 961(c) basis reflects amounts included in gross income under section 951(a) or 951A(a), the application of section 961(c) basis to such gain means that the resulting E&P is attributable to an amount included in gross income under section 951(a) or 951A(a) in accordance with the language of section 959(a). Additionally, treating the resulting E&P as PTEP (rather than section 959(c)(3) E&P) prevents double non-taxation and double taxation and provides symmetry between distributions and dispositions involving foreign stock, as discussed in part III.E.2.ii of the Explanation of Provisions.

The proposed regulations apply the section 961(c) exclusion for purposes of determining a CFC’s tested income or tested loss pursuant to the express delegation of authority in section 951A(f)(1)(B), which prevents double taxation and is therefore consistent with the policy of section 961. Additionally, this approach is consistent with section 951A(f)(1)(A) (treating an inclusion under section 951A(a) in the same manner as an inclusion under section 951(a)(1)(A) for purposes of section 961), which should be interpreted as allowing references to section 951 in section 961(c) to be treated as including a reference to section 951A(a). This approach is also consistent with a

comment received in response to the 2019 notice, which requested clarification that section 961(c) basis applies for purposes of determining tested income, noting that some comments asserted that section 961(c) basis only applies in determining a CFC's subpart F income. See *also* TD 9866, 84 FR 29288, 29298 (describing similar comments received in response to proposed regulations under section 951A).

Further, the application of the section 961(c) exclusion at the CFC-level is coordinated with the pro rata share rules of section 951(a) (discussed in part IV.C of the Explanation of Provisions). Under this approach, a CFC's subpart F income is determined with respect to all shareholders by excluding the same amount of PTEP resulting from section 961(c) basis of the CFC, and United States shareholders' pro rata shares of the CFC's subpart F income are computed in a manner so that any benefits of the application of the section 961(c) exclusion to PTEP with respect to a United States shareholder generally inure only to that United States shareholder. For instance, if two United States shareholders own equal interests in a CFC and, on a sale of foreign stock by the CFC, the CFC recognizes gain half of which is treated as PTEP with respect to one United States shareholder (because there is positive section 961(c) basis with respect to the United States shareholder at least equal to its share of the gain) and the other half of which gives rise to subpart F income (because there is no section 961(c) basis with respect to the other United States shareholder and no exception from subpart F income applies), then only the United States shareholder with respect to which there is no section 961(c) basis has a pro rata share of the subpart F income resulting from the sale.

Lastly, by applying section 961(c) at the CFC-level, the proposed regulations provide symmetry between sections 959(b) and 961(c), which are companion provisions with a common purpose. Thus, PTEP is generally treated the same under the proposed regulations regardless of whether it arises from a distribution or disposition involving

stock of a foreign corporation. As indicated in part II.D.1.iii of the Explanation of Provisions, the Treasury Department and the IRS request comments on the CFC-level approach in the proposed regulations, including alternative approaches providing symmetry between sections 959(b) and 961(c) (such as a shareholder-level approach), or whether symmetry is necessary under the statute.

ii. Considerations in treating sheltered E&P as PTEP

The Treasury Department and the IRS considered treating a CFC's E&P that is sheltered from tax by positive section 961(c) basis with respect to a covered shareholder as section 959(c)(3) E&P. However, such an approach could give rise to double non-taxation or double taxation. Moreover, treating sheltered E&P as PTEP provides symmetry between distributions and dispositions involving foreign stock because both E&P to which annual PTEP accounts are applied and E&P to which section 961(c) basis is applied are treated as PTEP.

For example, double non-taxation could occur if the sheltered E&P were to subsequently give rise to a dividend for which the covered shareholder is allowed a dividends received deduction under section 245A (including as a result of a disposition pursuant to section 1248(j)). In that case, the taxable portion of any unrealized appreciation in stock of the CFC, to the extent attributable to unrealized appreciation in the CFC's assets, could be reduced by the amount of the dividend (because the dividend reduces the value of the CFC stock without a corresponding basis reduction or, in a disposition of stock, because gain attributable to the appreciation is recharacterized as a dividend). See *also* TD 9866, 84 FR 29288, 29298 (discussing this concern and requesting comments). This would result in double non-taxation when combined with the covered shareholder's adjusted basis (increased under section 961(a)) in its top-tier CFC stock, which generally would not be reduced when section 959(c)(3) E&P is distributed with respect to the stock. Treating the sheltered E&P as PTEP prevents this

outcome because section 961 reduces basis for distributions of PTEP (thereby preventing double benefits) and, in a disposition, PTEP is not taken into account under section 1248.

In a case where the covered shareholder is not eligible for a section 245A deduction (for example, because the covered shareholder is an individual), the covered shareholder would generally include the sheltered E&P in gross income when distributed by the CFC if the sheltered E&P were treated as section 959(c)(3) E&P. This would represent double taxation with respect to the E&P that gave rise to the section 961(c) basis because such E&P was taxed under section 951(a) or 951A(a) when earned and would in effect be taxed again when the sheltered E&P is distributed to the covered shareholder. Although the covered shareholder's adjusted basis under section 961(a) in its top-tier CFC stock would generally not be reduced for the distribution of the sheltered E&P, there would nevertheless be double taxation until or unless that basis can be utilized, and even in that case there may be a character mismatch. See *also* TD 9866, 84 FR 29288, 29298 (requesting comments on the extent to which adjustments should be made to the operation of section 961(c) to minimize the potential for the same item of income being subject to tax more than once); 2006 proposed regulations, 71 FR 51155, 51162 (noting similar concerns). Treating the sheltered E&P as PTEP prevents this outcome because a distribution of PTEP to a covered shareholder is generally excluded from gross income under section 959(a).

The Treasury Department and the IRS also considered treating sheltered E&P as section 959(c)(3) E&P but reducing basis (including the covered shareholder's adjusted basis in its top-tier CFC stock) to the extent the sheltered E&P is eligible for a section 245A deduction. However, this approach is not being proposed because it would raise other issues, including the timing of the basis reduction (either immediately upon



creation of sheltered E&P, which may later cause excess taxation, or only upon distribution of sheltered E&P, which would require additional tracking), and would not address the double taxation issue for covered shareholders that do not qualify for a section 245A deduction.

### 3. Application of Section 961(c) Basis to Gain and Resulting PTEP

#### i. In general

The rules for applying a CFC's positive section 961(c) basis with respect to a covered shareholder are generally intended to replicate the outcome that would occur on a sale, exchange, or other disposition of the section 961(c) ownership unit if such basis were an additional amount of adjusted basis taken into account in determining gain allocable to the covered shareholder under section 951.

Under the proposed regulations, in a sale, exchange, or other disposition by a CFC of one or more section 961(c) ownership units that are shares of stock of a single foreign corporation (transferred units), the CFC first determines gain recognized with respect to the transferred units (covered gain). See proposed §1.961-9(c)(1). Covered gain is determined on an aggregate basis with respect to all transferred units, without regard to section 961(c) basis or loss recognized on any transferred unit (and before any application of section 964(e) or other dividend recharacterization provisions). Then, portions of the covered gain are assigned to covered shareholders under proposed §1.951-2 (the same rules that assign covered distributions, discussed in part IV.B of the Explanation of Provisions), and this determines a covered shareholder's share of the covered gain. See proposed §1.961-9(d)(1).

Next, positive section 961(c) basis is applied (on an aggregate basis) to each covered shareholder's share of the covered gain, in an amount equal to the CFC's positive section 961(c) basis with respect to the covered shareholder of the transferred units (but not in excess of such share), and subject to a limitation in nonrecognition

transactions (similar to the limitation rule that applies to derived basis discussed in part III.D.1 of the Explanation of Provisions). See proposed §1.961-9(d)(2), (e). This application of positive section 961(c) basis characterizes the covered shareholder's share of the covered gain as PTEP with respect to the covered shareholder, and that PTEP is generally excluded from the CFC's gross income for purposes of determining its subpart F income and tested income or tested loss. See proposed §1.961-9(b), (d)(3); see *also* proposed §1.961-12(c)(5) (*Example 5*).

An aggregate approach to applying positive section 961(c) basis allows positive section 961(c) basis of a transferred unit to be applied to a portion of the covered shareholder's share of the covered gain that is recognized with respect to another transferred unit. For example, in a case where there are two transferred units, one of which is sold at a loss but has positive section 961(c) basis with respect to the covered shareholder and the other of which is sold at a gain but has no section 961(c) basis with respect to the covered shareholder, positive section 961(c) basis in the first transferred unit will be applied to gain recognized with respect to the second transferred unit (and, to the extent so applied, the gain will be treated as PTEP and will be reduced only by any foreign income taxes allocated and apportioned to the PTEP). Aggregating positive section 961(c) basis in this manner is intended to replicate the effect of netting gains and losses on similar types of property in determining a CFC's subpart F income. See section 954(c)(1)(B) (foreign personal holding company income includes the portion of gross income that consists of the excess of gains over losses from the sale or exchange of certain property). Although aggregation differs from the share-by-share approach under section 961 to adjusting basis (including for purposes of determining the consequences of distributions of PTEP), it provides a simpler and more direct way of achieving the same effect as a share-by-share approach to the use of positive section 961(c) basis that allows excess section 961(c) basis on a particular share to be applied

to gain recognized on another share of stock in the same foreign corporation for which there is not sufficient section 961(c) basis to fully offset the gain. See also part III.E.4 of the Explanation of Provisions (discussing a rule allocating PTEP to shares of stock in order to facilitate the application of dividend recharacterization provisions like section 964(e)).

The proposed regulations, however, do not allow positive section 961(c) basis of transferred units in excess of the covered shareholder's share of the covered gain to be applied to other covered gain or to create a loss that reduces subpart F income or tested income. Allowing section 961(c) basis in stock of a foreign corporation to only reduce a section 951 inclusion attributable to sales, exchanges, or other dispositions of stock of that foreign corporation is consistent with the language of section 961(c), with the result that only shares of stock of the same foreign corporation should be viewed as similar types of property for purposes of replicating the effect of netting under section 961(c). Unused positive section 961(c) basis, however, may be applied to gain recognized pursuant to section 961(c), provided the gain is recognized with respect to stock of the foreign corporation to which the section 961(c) basis relates, as discussed in part III.G of the Explanation of Provisions.

## ii. Character and dollar basis of resulting PTEP

As discussed in part II.C of the Background, the character of PTEP (for example, the taxable year, section 904 category, and PTEP group to which the PTEP relates) must be tracked to ensure the proper application of provisions regarding the treatment of PTEP. Accordingly, the proposed regulations provide rules for determining the character of a CFC's PTEP with respect to a covered shareholder that results from the application of positive section 961(c) basis to the covered shareholder's share of covered gain (section 961(c) PTEP). See proposed §1.961-9(d)(3) and (f)(1). Generally, the effect of these rules is to duplicate undistributed PTEP of lower-tier

foreign corporations by having the PTEP “tier up” into the CFC, but without reducing PTEP of the lower-tier foreign corporations, and this effect is analogous to the effect of section 964(e)(1) (“tiering-up” certain section 959(c)(3) E&P of lower-tier foreign corporation in certain sales or exchanges of stock by a CFC).

The proposed regulations generally adopt a mirroring approach, which provides that section 961(c) PTEP takes the same character as PTEP that transfers from the covered shareholder under section 959 or is eliminated (for example, by reason of an election under section 338(g)) in the sale, exchange, or other disposition of the transferred units (referred to as mirrored PTEP). See proposed §1.961-9(f)(2); see also proposed §1.961-12(c)(5) (*Example 5*). Mirrored PTEP is increased for foreign income taxes associated with such transferred or eliminated PTEP because those taxes relate to PTEP to which section 961(c) basis used in the transaction is attributable. The mirroring rule is intended to identify (and duplicate) PTEP to which section 961(c) basis used in the transaction is attributable in an administrable manner that does not impose undue burden on taxpayers. Alternative approaches that were considered include requiring section 961(c) basis to be established and maintained with the same characterizations with which annual PTEP accounts are established and maintained (so that section 961(c) PTEP could be characterized based on section 961(c) basis, portions of would relate to each PTEP group). However, the view of the Treasury Department and the IRS is that those approaches would be unduly burdensome because they would substantially increase the information required to be tracked under section 961(c).

In some cases, section 961(c) PTEP may be less than mirrored PTEP. This could occur, for example, if a foreign corporation’s assets depreciate in value before the transaction or if mirrored PTEP consists of PTEP attributable to section 965(b) (which does not increase section 961(c) basis). In that case, section 961(c) PTEP takes the

same character as a pro rata portion of mirrored PTEP. In other words, the mirroring rule applies but mirrored PTEP is pro rata reduced to equal section 961(c) PTEP.

In other cases, section 961(c) PTEP may exceed mirrored PTEP. This could occur if section 961(c) basis used in the transaction is attributable to PTEP that was distributed before the transaction in a manner different than how the PTEP was expected to be distributed when the section 961(c) basis was provided. In that case, the mirroring rule applies to the extent of mirrored PTEP, with a “lookback” rule applying to the portion of section 961(c) PTEP that is not characterized under the mirroring rule (excess section 961(c) PTEP). See proposed §1.961-9(f)(3). Under the lookback rule, excess section 961(c) PTEP takes the same character as lookback PTEP, which is PTEP that resulted from income inclusions under sections 951(a) and 951A(a) of the covered shareholder attributable to the transferred units (including stock of a lower-tier foreign corporation owned through the transferred units) during a 36-month lookback period (without any reduction for foreign income taxes imposed on that PTEP). The lookback rule is intended to provide an administrable method to approximate PTEP that should be viewed as duplicated in the transaction, while minimizing taxpayer burden in the limited cases where section 961(c) PTEP exceeds mirrored PTEP. Like under the mirroring rule, lookback PTEP is pro rata reduced to equal excess section 961(c) PTEP if excess section 961(c) PTEP is less than lookback PTEP.

If excess section 961(c) PTEP is greater than lookback PTEP, the portion of excess section 961(c) PTEP that is not characterized under the lookback rule is characterized as PTEP relating to the section 245A(d) PTEP group, the taxable year in which the transaction occurs, and the general category under section 904(d)(1)(D). See proposed §1.961-9(f)(4). The Treasury Department and the IRS are of the view that this rule is a necessary consequence of balancing compliance and administrative burden with precision under the mirroring rule and lookback rule, and that alternative

characterizations could inappropriately incentivize transactions intended to distribute PTEP to which section 961(c) basis used in the transaction is attributable in a manner different than the manner in which the PTEP was expected to be distributed when the section 961(c) basis was provided.

Finally, the proposed regulations provide that the dollar basis of section 961(c) PTEP is equal to the U.S. dollar amount of section 961(c) basis giving rise to the PTEP. See proposed §1.961-9(g). Because section 961(c) basis is adjusted to take into account foreign currency gain or loss recognized in the transaction (as discussed in part III.C.3 of the Explanation of Provisions), any foreign currency gain or loss subsequently recognized with respect to the section 961(c) PTEP is determined by reference to the time the section 961(c) PTEP comes into existence.

#### 4. Coordination with Dividend Recharacterization Provisions

The proposed regulations provide two rules to coordinate with provisions of the Code or regulations that would treat covered gain, in whole or in part, as a dividend. The first rule provides that such dividend recharacterization provisions do not apply to the portion of covered gain that is PTEP. See proposed §1.961-9(c)(2). Thus, for example, section 961(c) basis applies and characterizes covered gain as PTEP before the application of section 964(e) (treating gain recognized by a CFC on the sale or exchange of stock in a foreign corporation as a dividend in certain cases), similar to how adjusted basis must be taken into account to determine gain recognized before applying section 964(e).

The second rule allocates PTEP resulting from section 961(c) basis to transferred units. See proposed §1.961-9(d)(5) and (h). This rule is intended to facilitate the application of dividend recharacterization provisions by providing certainty about the amount of gain with respect to a particular transferred unit that is treated as PTEP, which otherwise might be unclear in light of the aggregation component in

applying positive section 961(c) basis (discussed in part III.E.3.i of the Explanation of Provisions).

Further, the Treasury Department and the IRS are studying other issues involving dividend recharacterization provisions (for example, the application of section 1248(d)(1) in section 964(e) transactions) and may address these issues in future guidance.

F. Gain recognition in transactions involving property units with negative basis (proposed §1.961-10)

To account for negative derived basis and negative section 961(c) basis, the proposed regulations provide rules that treat a partnership or CFC as recognizing gain with respect to a property unit. See proposed §1.961-10. These rules are consistent with the theory of negative basis described in part III.C.2.v the Explanation of Provisions, which provides that negative basis is akin to a reduction to common basis or adjusted basis that only has a tax effect when the common basis or adjusted basis becomes relevant to determining taxable income in a transaction.

One set of rules applies in any transaction in which a partnership's common basis or CFC's adjusted basis of a property unit is relevant in determining gain or loss recognized with respect to the property unit – for example, a sale or exchange of the property unit or a distribution under section 301(c)(2) on the property unit. See proposed §1.961-10(b)(1) and (c)(1); see *also* proposed §1.961-12(c)(6) and (7) (*Examples 6 and 7*). In these cases, the partnership or CFC is treated as recognizing gain with respect to the property unit to the extent of the additional amount of gain, plus the lesser amount of loss, that it would have recognized in the transaction if its common basis or adjusted basis of the property unit were reduced by all negative derived basis or negative section 961(c) basis of the property unit. In this way, negative basis gives rise to gain that reflects income that would exist or counteracts loss that would not exist if common basis or adjusted basis were reduced by the negative basis, thereby

replicating the outcome that would occur in the transaction if common basis or adjusted basis were so reduced.

So, for example, in a sale of a property unit, negative basis of the property unit generally gives rise to an equal amount of gain. In contrast, in a distribution under section 301(c)(2) with respect to a property unit or an exchange of a property unit under section 351, negative basis of the property unit gives rise to an amount of gain equal to the gain that would have been recognized under section 301(c)(3) or 351(b), as applicable, if common basis (in the case of a partnership) or adjusted basis (in the case of a CFC) were reduced by all negative basis of the property unit.

Another set of rules applies in any transaction in which a property unit loses its status as a derivative ownership unit or section 961(c) ownership unit. This could occur, for example, as a result of a transfer by a partnership of a derivative ownership unit to a foreign corporation in an exchange to which section 351 applies, or a distribution by a CFC of a section 961(c) ownership unit to a domestic corporation in a transaction to which sections 332 and 337 apply. See proposed §1.961-10(b)(2)(ii) and (c)(2)(ii). This could also occur if an upper-tier foreign corporation ceases to be a CFC, in which case shares of stock of a lower-tier foreign corporation directly owned by the upper-tier foreign corporation would no longer be section 961(c) ownership units. In these cases, the partnership or CFC is treated as recognizing gain with respect to the property unit to the extent of all negative derived basis or negative section 961(c) basis of the property unit, and this addresses a concern that the negative basis might otherwise not be taken into account. The Treasury Department and the IRS are studying to what extent this set of rules should be narrowed or eliminated in future guidance if a rule is adopted that converts one type of basis into another type (for example, a rule that converts derived basis into section 961(c) basis or section 961(c) basis into adjusted basis in a nonrecognition transaction).



A portion of gain recognized by a partnership or CFC under these rules is allocated by the partnership or assigned from the CFC, as applicable, to each covered shareholder by multiplying the gain by the percentage of the aggregate negative basis of the property unit that is negative basis with respect to the covered shareholder. See proposed §1.961-10(b)(3) and (c)(3). This approach treats the gain (which may be less than the aggregate negative basis of the property unit) as relating pro rata to the negative basis with respect to each covered shareholder, thereby preventing a covered shareholder from disproportionality benefiting from common basis or adjusted basis that enabled the creation of negative basis (as discussed in part III.C.2.v of the Explanation of Provisions) and ensuring the tax consequences of negative basis are specific to the covered shareholder to which the negative basis relates.

Additionally, the gain is treated in the same manner as gain recognized in connection with distributions of PTEP in excess of basis (discussed in part III.C.2.iii and iv of the Explanation of Provisions), which reflects that the negative basis giving rise to the gain arose as a result of prior distributions of PTEP. See proposed §1.961-10(b)(4) and (c)(4). Thus, the gain applies for all purposes of the Code in the case of a partnership and, in the case of a CFC, is recognized pursuant to section 961(c) and applies only for purposes of determining amounts included in gross income of United States shareholders under the rules discussed in part III.G of the Explanation of Provisions. Further, the gain is treated as separate from the transaction and therefore, for example, does not give rise to basis adjustments under section 358 or 362 in a nonrecognition transaction.

Lastly, after determining gain required to be recognized under these rules, negative derived basis or negative section 961(c) basis that causes the gain to be recognized is eliminated concurrently with the transaction. See proposed §1.961-10(b)(5) and (c)(5). Thus, if the covered shareholder continues to own the property unit

(for example, if the transaction is a section 301(c)(2) distribution), then such negative basis will cease to be taken into account with respect to the covered shareholder and, if the transaction is a general successor transaction, then the negative basis will not be taken into account with respect to the successor covered shareholder.

G. United States shareholder inclusions for gain recognized under section 961(c) (proposed §1.961-11)

1. In General

The proposed regulations provide rules requiring United States shareholders of a CFC to include in gross income their allocated portions of the CFC's section 961(c) income. See proposed §1.961-11; see *also* proposed §1.961-12(c)(8) (*Example 8*). A CFC's section 961(c) income is, for a taxable year of the CFC, all gain recognized by the CFC pursuant to section 961(c) for amounts in excess of basis or by reason of a trigger of negative section 961(c) basis (as discussed in parts III.C.2.iv, C.3, and F of the Explanation of Provisions).

These rules are intended to ensure section 961(c) income is taken into account (and thus has a tax consequence) at the covered shareholder-level such that section 961(c) basis is treated in the same manner as adjusted basis in directly held CFC stock or derived basis (where, for example, amounts in excess of basis under section 961 are always taken into account at the covered shareholder-level). Specifically, a United States shareholder owning stock of a CFC on the last relevant day of a taxable year of the CFC must include in gross income its allocated amount of the CFC's section 961(c) income for that taxable year. See proposed §1.961-11(b). The amount so allocated to a United States shareholder is the sum of any portions of such section 961(c) income assigned to the United States shareholder under the section 961 regulations (adjusted, if applicable, for transfers of stock of the CFC, as discussed in part III.G.2 of the Explanation of Provisions), reduced by any loss that the CFC is treated as recognizing

under section 961(c) with respect to the United shareholder. See proposed §1.961-11(c).

This loss under section 961(c) is equal to the CFC's positive section 961(c) basis with respect to the United States shareholder of section 961(c) ownership units sold, exchanged, or disposed of by the CFC in the taxable year, but only to the extent the positive section 961(c) basis is not applied to covered gain, and subject to two limitations. See proposed §1.961-11(e). Under the first limitation, positive section 961(c) basis can create or increase a loss under section 961(c) only if the CFC recognizes, or would recognize, loss on the sale, exchange, or other disposition and a current deduction in respect of the loss is, or would be, allowable. Under the second limitation, positive section 961(c) basis can create or increase a loss under section 961(c) only to the extent of the amount of section 961(c) income that both is otherwise allocable to the United States shareholder and relates to stock of the same foreign corporation to which the positive section 961(c) basis relates. This is consistent with the same foreign corporation limitation for applying positive section 961(c) basis to covered gain (discussed in part III.E.3.i of the Explanation of Provisions).

The United States shareholder includes its allocated amount of section 961(c) income in gross income in its taxable year in which or with which the CFC's taxable year ends, and the allocated amount is treated in the same manner as an amount included in gross income under section 951(a)(1)(A) for purposes of applying sections 961 and 989(b). See proposed §1.961-11(b). Thus, under section 961, the inclusion increases basis in the United States shareholder's stock of the CFC and any property units through which the United States shareholder owns stock of the CFC, consistent with how a subpart F income inclusion increases basis. The inclusion does not increase the CFC's PTEP, however, because the section 961(c) income does not give rise to E&P at the level of the CFC, and thus there is no amount related to the inclusion satisfying

section 959's description of PTEP (E&P attributable to amounts which are, or have been, included in gross income under section 951(a)). Moreover, increasing basis but not PTEP helps to ensure that gain is not recognized on subsequent distributions of PTEP the distribution of which gave rise to the section 961(c) income.

## 2. Adjustments for Transfers of CFC Stock

The proposed regulations provide additional rules in allocating a CFC's section 961(c) income for a taxable year if stock of the CFC is transferred during the taxable year. See proposed §1.961-11(d). These rules are necessary because gain comprising section 961(c) income is assigned to covered shareholders at the time of the transaction giving rise to the gain (for example, a distribution in excess of basis) but, due to a transfer of stock of the CFC, a covered shareholder to which a portion of the gain is assigned may not own stock of the CFC stock on the last relevant day of the CFC's taxable year.

One set of rules applies if the CFC is an acquired foreign corporation in a general successor transaction that occurs during the taxable year. See proposed §1.961-11(d)(1). In such a case, if the general successor transaction occurs before the last relevant day of the taxable year, then a pro rata portion of section 961(c) income that is recognized before the general successor transaction and assigned to the transferor covered shareholder is treated as instead assigned to the successor covered shareholder. Alternatively, if the general successor transaction occurs on or after the last relevant day of the taxable year, then a pro rata portion of section 961(c) income that is recognized after the general successor transaction and assigned to the successor covered shareholder is treated as instead assigned to the transferor covered shareholder. In both cases, the pro rata portion is determined based on the percentage of the CFC's section 961(c) basis that transfers in the general successor transaction.

A second set of rules applies the principles of the first set of rules to transactions, other than general successor transactions, in which the CFC's section 961(c) basis is transferred to another covered shareholder. See proposed §1.961-11(d)(2).

#### IV. Section 951 Regulations

##### A. Overview

The proposed regulations under section 951 provide two coordinated sets of rules regarding the assignment and allocation of covered items, which are gross income of a foreign corporation consisting of covered distributions or covered gains. One set applies at the foreign corporation-level to assign covered items to covered shareholders, with these rules identifying the portions of covered items to which attributes specific to a covered shareholder (PTEP or section 961(c) basis) may be applied to exclude such portions under section 959(b) or 961(c). See proposed §1.951-2 (discussed in part IV.B of the Explanation of Provisions). The other set applies at the shareholder-level to allocate a CFC's subpart F income to United States shareholders, with these rules ensuring that the CFC's subpart F income attributable to covered items is allocated consistently with how the covered items were assigned under the first set of rules. See proposed §1.951-1(c) (discussed in part IV.C of the Explanation of Provisions).

##### B. Foreign corporation-level rules for assigning covered items (proposed §1.951-2)

###### 1. In General

The proposed regulations assign portions of a foreign corporation's covered items to covered shareholders that own stock of the foreign corporation during the foreign corporation's taxable year in which the covered items are received or recognized by the foreign corporation. See proposed §1.951-2(b). The assignments are done on a covered-item-by-covered-item basis, in each case first by assigning the covered item

under a general assignment rule, and then by adjusting assignments for any general successor transactions.

## 2. General Assignment Rule

The general assignment rule assigns a pro rata portion of a covered item of a foreign corporation to each covered shareholder that owns stock of the foreign corporation on the last relevant day of the foreign corporation's taxable year in which the covered item is received or recognized by the foreign corporation (that is, the last day of such taxable year on which the foreign corporation is a CFC). See proposed §1.951-2(c)(1); see *also* proposed §1.951-2(h)(3)(i) (*Example 1*). The pro rata portion is determined based on the percentage of the foreign corporation's allocable E&P for the taxable year that would be allocated to the covered shareholder in the hypothetical distribution described in §1.951-1(e), applied by treating allocable E&P as equal to the greater of the foreign corporation's E&P for the taxable year and all covered items of the foreign corporation. See proposed §1.951-2(d). By applying §1.951-1(e) in this way, the general assignment rule is consistent with the principles of the pro rata share rules under section 951(a). See §1.951-1(e).

## 3. Adjustments for General Successor Transactions

A foreign corporation that is an acquired foreign corporation in a general successor transaction that occurs before the last relevant day of a taxable year of the foreign corporation may receive or recognize a covered item before the general successor transaction (pre-transaction covered item). In that case, the general successor transaction could preclude PTEP or section 961(c) basis with respect to the transferor covered shareholder from being applied to the covered item (as a result of reducing the allocation of the foreign corporation's E&P to the covered shareholder in the hypothetical distribution described in §1.951-1(e) and therefore reducing the

covered shareholder's assignment under the general assignment rule). This could inappropriately separate PTEP and basis from the appropriate covered shareholder.

To illustrate this issue, assume US1 is a covered shareholder and each of CFC1 and CFC2 is a CFC with a calendar taxable year. On January 1 of year 1, US1 owns all the stock of CFC1, and CFC1 owns all the stock of CFC2. On June 30 of year 1, CFC2 makes a \$100x covered distribution to CFC1, which immediately makes a \$100x covered distribution to US1. On September 30 of year 1, US1 sells all its stock of CFC1 to US2, an unrelated covered shareholder in what constitutes a general successor transaction. Without regard to the covered distributions, CFC2 has \$100x of PTEP with respect to US1 (relating to the prior year) and CFC1 has \$0 of PTEP.

Under the general assignment rule, the entire \$100x of the covered distribution received by CFC1 would be assigned to US2 (the covered shareholder owning all the stock of CFC1 on December 31 of year 1, the last relevant day of CFC1's taxable year). As a result, no PTEP would be applied to either covered distribution (and each covered distribution would reduce the distributing CFC's section 959(c)(3) E&P by \$100x).

The proposed regulations include additional rules to address this issue. Specifically, the additional rules increase the portion of a pre-transaction covered item that otherwise (without the additional rules) would be assigned to the transferor covered shareholder and correspondingly decrease the portions of the item that otherwise (without the additional rules) would be assigned to connected covered shareholders. See proposed §1.951-2(e); *see also* proposed §1.951-2(h)(3)(ii) (*Example 2*). A connected covered shareholder means the successor covered shareholder (or any other covered shareholder owning the stock acquired in the general successor transaction, in the case of back-to-back general successor transactions, for example) and any covered shareholder related to such covered shareholder (determined under section 267(b) or 707(b)). See proposed §1.951-2(g).

Thus, in the example above, the additional rules assign all the covered distribution received by CFC1 to US1 (rather than to US2, a connected covered shareholder), and \$100x of CFC2's PTEP with respect to US1 is applied to the covered distribution (which, in turn, increases CFC1's PTEP with respect to US1 by \$100x). As a result, that covered distribution is treated in the same manner as if the sale had not occurred, and \$100x of CFC1's PTEP with respect to US1 is then available to be (and in fact is) distributed by CFC1 to US1. If, instead, CFC1 did not make a covered distribution before the sale, then \$100x of PTEP of CFC1 with respect to US1 would transfer from US1 to US2 in the sale.

Subject to two limitations, the increase to the transferor covered shareholder's assignment is equal to the additional amount of the pre-transaction covered item that would have been assigned to the transferor covered shareholder if the date on which the covered item is received or recognized were the last relevant day and the hypothetical distribution for purposes of the general assignment rule were treated as made immediately before the covered item is received or recognized. See proposed §1.951-2(e)(2)(i). In this way, the transferor covered shareholder's assignment of a pre-transaction covered item is, as illustrated above, generally consistent with what would have been its assignment if the general successor transaction and any subsequent transactions that change the ownership of stock of the acquired foreign corporation (for example, issuances of stock by the acquired foreign corporation) had not occurred.

With the limitations, the increase applies only to the extent it results in additional PTEP or section 961(c) basis with respect to the transferor covered shareholder being applied to the pre-transaction covered item, and the increase cannot exceed the portions of the covered item that otherwise (without the additional rules) would be assigned to connected covered shareholders. See proposed §1.951-2(e)(2)(iii). Thus, the additional rules only shift an assignment of gross income identified under the



principles of section 951(a) as allocable to covered shareholders that bear a defined relationship to the transferor covered shareholder (through the general successor transaction or relatedness). The Treasury Department and the IRS are of the view that this approach reasonably balances the policies of the general assignment rule (following the principles of section 951(a)) and the additional rules (assuring the tax consequences of PTEP and basis remain with the appropriate covered shareholder).

The corresponding decrease applies, first, to assignments of connected covered shareholders owning, on the last relevant day, stock acquired in the general successor transaction and, next, to assignments of other connected covered shareholders, in each case on a pro rata basis. See proposed §1.951-2(e)(3) and (4). With this ordering, assignments of such other connected covered shareholders are decreased only if their ownership of stock of the acquired foreign corporation increases after the general successor transaction. The Treasury Department and the IRS are of the view that applying the additional rules to such other connected covered shareholders maintains the integrity of the additional rules (for example, by preventing issuances to covered shareholders related to the successor covered shareholder from reducing the application of the additional rules, as could otherwise occur because the issuances would have the effect of reducing the successor covered shareholder's assignment under the general assignment rule, which, in turn, would limit the increase to the transferor covered shareholder's assignment).

Similar additional rules apply if a foreign corporation is an acquired foreign corporation in a general successor transaction that occurs on or after the last relevant day of a taxable year of the foreign corporation and the foreign corporation receives or recognizes a covered item after the general successor transaction. See proposed §1.951-2(e)(2)(ii). In these cases, the additional rules increase the portion of such an item that otherwise (without the additional rules) would be assigned to the successor

covered shareholder, generally by correspondingly decreasing the portion of the item that otherwise (without the additional rules) would be assigned to the transferor covered shareholder. See *also* proposed §1.951-2(h)(3)(iii) (*Example 3*).

C. Shareholder-level rules for allocating subpart F income (proposed §1.951-1)

Under §1.951-1 (and as discussed in part II.B.1 of the Background), a CFC's subpart F income is allocated to each United States shareholder of the CFC based on a fraction, the numerator of which is the United States shareholder's share of the CFC's allocable E&P, and denominator of which is the CFC's allocable E&P. See §1.951-1(e). The amount of subpart F income so allocated to a United States shareholder is the United States shareholder's pro rata share of the foreign corporation's subpart F income, subject to certain adjustments. See §1.951-1(b); see *also* §1.951A-1(d) (determining pro rata shares of tested income in the same manner).

If a CFC's subpart F income attributable to covered items were allocated to United States shareholders in the same manner, the income might be allocated differently than how the covered items were assigned at the CFC-level as part of determining the extent to which the covered items are PTEP excluded from the CFC's gross income under section 959(b) or 961(c). See *also* proposed §1.951-2 (assignment rules, discussed in part IV.B of the Explanation of Provisions). This could cause the tax consequences of PTEP or section 961(c) basis to not be specific to the United States shareholder to which such attribute relates, which would be inconsistent with the shareholder-specific nature of sections 959(b) and 961(c) and could result in partial double taxation to the United States shareholder.

For instance, assume two unrelated United States shareholders are assigned equal portions of covered gain recognized by a CFC, with the half assigned to one United States shareholder characterized as PTEP excluded from the CFC's gross income under section 961(c) (because there is positive section 961(c) basis with

respect to the United States shareholder at least equal to such shareholder's share of the covered gain) and the half assigned to the other United States shareholder characterized as subpart F income (because there is no section 961(c) basis with respect to the other United States shareholder and no exception from subpart F income applies). In such a case, the Treasury Department and the IRS are of the view that allocating half of the subpart F income from the covered gain to each United States shareholder would be inconsistent with sections 951(a) and 961(c), as doing so would cause the United States shareholders to share both any benefits of the section 961(c) exclusion and any detriments of the inclusion in subpart F income.

To address this, the proposed regulations modify §1.951-1 so that a CFC's subpart F income attributable to covered items is separately allocated to United States shareholders. See proposed §1.951-1(c)(1); see *also* proposed §1.951-1(h)(2)(ii) (*Example 1*). Subpart F income attributable to covered items is determined on a covered-item-by-covered-item basis, and in each case is the portion of the covered item that is included in the CFC's foreign base company income (adjusted net foreign base company income as defined in §1.954-1(a)(5)) or insurance income (adjusted net insurance income as defined in §1.954-1(a)(6)). See proposed §1.951-1(c)(2)(i). The proposed regulations facilitate these determinations by treating each portion of gross foreign base company income (as defined in §1.954-1(a)(2)) that consists of a covered item as a single item of income. See proposed §1.954-1(c)(1)(iii)(C).

Subpart F income attributable to a covered item is allocated to United States shareholders consistently with how the covered item was assigned at the CFC-level as part of determining the extent to which the covered item is PTEP excluded from the CFC's gross income under section 959(b) or 961(c). Specifically, subpart F income attributable to a covered item is allocated to each United States shareholder based on a fraction, the numerator of which is the portion of the covered item that is both assigned

at the CFC-level to the United States shareholder and included in the CFC's adjusted gross foreign base company income or adjusted gross insurance company income (as defined in §1.954-1(a)(3) or (6)), and the denominator of which is the portion of the covered item that is included in adjusted gross foreign base company income or adjusted gross insurance company income. See proposed §1.951-1(c)(2)(ii). In this way, a United States shareholder's pro rata share of subpart F income attributable to a covered item is the subpart F income that results from the United States shareholder's assigned portion of the covered item.

Then, remaining subpart F income (that is, subpart F income not attributable to covered items) is allocated pro rata to United States shareholders in accordance with existing §1.951-1. Specifically, such subpart F income is allocated to each United States shareholder based on a fraction, the numerator of which is the United States shareholder's share of the CFC's allocable E&P (determined under §1.951-1(e)), and the denominator of which is the CFC's allocable E&P. See proposed §1.951-1(c)(2)(iii).

Thus, under the proposed regulations, the effect of sections 959(b) and 961(c) on allocations under section 951(a) is limited to ensuring that any benefits of the application of the relevant exclusion to a portion of a covered item, or any detriments of an inclusion of such portion in subpart F income, generally inure only to the United States shareholder to which the portion was assigned in determining the extent to which the portion is excludable PTEP. Accordingly, under the proposed regulations, sections 959(b) and 961(c) do not affect the allocation of subpart F income attributable to gross income not eligible for exclusion under those sections. Similarly, the proposed regulations do not affect the allocation of tested items under section 951A. See proposed §1.951A-1(d) (pro rata shares of tested income, tested loss, and qualified business asset investment are determined in the same manner as the determination of pro rata shares of subpart F income not attributable to covered items); *see also*

§1.951A-1(d)(5) and (6) (pro rata shares of tested interest expense and tested interest income determined by reference to pro rata shares of tested income and tested loss, as applicable).

An alternative approach that treated the allocation of subpart F income attributable to covered items as altering the manner in which other income of the CFC is allocated would require broader revisions to §1.951-1. Under this type of approach, a CFC would be treated as having four types of allocable income, which together would equal allocable E&P: subpart F income, tested income, excludable PTEP income (that is, PTEP that is distributed to, or results from section 961(c) basis of, the CFC and is excluded from the CFC's gross income under section 959(b) or 961(c), reduced by current year taxes allocated and apportioned thereto), and residual income (equal to the excess of the CFC's E&P for the taxable year over the sum of the other types of income). A United States shareholder's share of the CFC's allocable E&P would be treated as first relating to income attributable to covered items, with any remaining portion of the share treated as relating on a pro rata basis to all other income. However, this approach would generally produce the same results as the approach in the proposed regulations, except in cases where a deductible item (other than current year taxes) disproportionately reduces a covered item (because some, but not all, of the covered item is excludable PTEP and thus the deduction reduces only the non-PTEP portion of the covered item). Moreover, the Treasury Department and the IRS are of the view that sections 959(b) and 961(c) do not require such an approach.

Lastly, the Treasury Department and the IRS request comments on whether additional rules are warranted for allocating tested items in cases where a covered item is excluded from subpart F income by reason of section 954(b)(3)(A)'s de minimis rule and may consequently give rise to tested income (which, under the proposed

regulations, would be allocated under the rules for subpart F income not attributable to covered items).

## V. Section 986(c) Regulations (proposed §1.986(c)-1)

### A. Overview

The proposed regulations under section 986(c) describe the circumstances in which a covered shareholder recognizes foreign currency gain or loss with respect to PTEP and provide rules for determining the amount of gain or loss that is recognized. These rules are issued pursuant to the express delegations of authority under sections 986(c)(2), 965(o), and 989(c). See *also* part VIII.F of the Explanation of Provisions (proposing to withdraw or studying whether to withdraw provisions regarding foreign currency gain or loss in §§1.985-5 and 1.985-7).

### B. Circumstances in which foreign currency gain or loss is recognized

Under the proposed regulations, a covered shareholder recognizes foreign currency gain or loss under section 986(c) with respect to PTEP in two circumstances. See proposed §1.986(c)-1(b)(1). The first circumstance is when PTEP is distributed to the covered shareholder (including PTEP treated as received through a partnership). The second circumstance is when PTEP ceases to be with respect to the covered shareholder (for example, as a result of being transferred to another covered shareholder in a general successor transaction or eliminated as a consequence of an election under section 338(g)). These rules, which are generally consistent with the 1988 notice, provide parity between distributions of PTEP and dispositions of foreign stock that in each case present the last opportunity for the covered shareholder to recognize foreign currency gain or loss with respect to PTEP.

The proposed regulations provide that no foreign currency gain or loss is recognized in a distribution of PTEP to a foreign corporation. See proposed §1.986(c)-1(c). In these cases, the Treasury Department and the IRS are of the view that

preserving the dollar basis of the PTEP (through adjustments to shareholder-level dollar basis pools) is the appropriate application of section 986(c) at the time of the distribution, with such dollar basis then determining foreign currency gain or loss when the PTEP is subsequently distributed to the covered shareholder.

Foreign currency gain or loss is also generally not recognized (and dollar basis is preserved) when PTEP transfers in a transaction other than a general successor transaction (for example, a transfer of stock of a CFC by a domestic corporation to a non-consolidated domestic corporation in a section 351 transaction). See proposed §1.986(c)-1(b)(5); *but see* §1.367(b)-2(j)(2)(i). This rule limits the ability to recognize foreign currency gain or loss in nonrecognition transactions or other transactions where gain or loss is generally not recognized. Comments are requested on this rule and, more generally, whether foreign currency gain or loss should not be recognized and thus deferred in sales or other transactions involving related parties.

Foreign currency gain or loss recognized with respect to PTEP is recognized concurrently with the transaction requiring recognition of such gain or loss. See proposed §1.986(c)-1(b)(4). Additionally, the foreign currency gain or loss is treated as ordinary income or loss from the same source and relating to the same section 904 category as the income inclusion that gave rise to the PTEP (consistent with the rule in §1.904-4(p) for distributions of PTEP). See *also* proposed §1.961-5(b) (adjusting basis for foreign currency gain or loss recognized in a transaction other than a distribution, as discussed in part III.C.3 of this Explanation of Provisions).

#### C. Determining foreign currency gain or loss

Foreign currency gain or loss with respect to PTEP is determined by translating the PTEP (which is denominated in the foreign corporation's functional currency) into U.S. dollars at the spot rate on the day of the transaction requiring recognition of such gain or loss and subtracting from that U.S. dollar amount the dollar basis of the PTEP.

See proposed §1.986(c)-1(b)(2); *see also* proposed §1.959-10(c)(2) (*Example 2*). A positive difference is foreign currency gain and the absolute value of a negative difference is foreign currency loss.

As a result, foreign currency gain or loss with respect to PTEP is based on movements in exchange rates between the time of the income inclusion giving rise to the PTEP (translated pursuant to the appropriate exchange rate) or, if applicable, the most recent prior transfer of the PTEP (treated as the deemed distribution described in section 986(c)(1)), and the date of the transaction requiring recognition of such gain or loss (treated as the actual distribution described in section 986(c)(1)).

#### D. Limitations

Consistent with existing §1.986(c)-1 (discussed in part II.C.3 of the Background of this preamble), only a portion of foreign currency gain or loss with respect to PTEP resulting from section 965(a) is recognized, based on the section 965(c) deduction percentage with respect to the PTEP, and no foreign currency gain or loss is recognized with respect to PTEP resulting from section 965(b). See proposed §1.986(c)-1(b)(3)(i) and (ii). Further, no foreign currency gain or loss is recognized with respect to taxable section 962 PTEP because such PTEP is included in gross income pursuant to section 962(d) and, therefore, the foreign currency gain or loss is accounted for in gross income. See proposed §1.986(c)-1(b)(3)(iii).

#### VI. Section 960 Regulations (proposed §§1.960-1 and 1.960-3)

Current §§1.960-1 and 1.960-2 provide rules for computing the amount of foreign income taxes deemed paid under section 960(a) and (d), and current §§1.960-1 and 1.960-3 provide rules for computing the amount of foreign income taxes deemed paid under section 960(b). The PTEP accounting rules under proposed §1.959-2 replace the rules in current §1.960-3 that describe a CFC's PTEP, and the rules allocating and apportioning current year taxes to PTEP in proposed §1.959-6 replace the rules in



current §1.960-1 for purposes of applying section 960(b). Other rules relating to PTEP that are included in current §§1.960-1 and 1.960-3 have also been replaced by rules in the proposed regulations under section 959 to ensure conformity and proper tracking of amounts described in sections 959 and 960(b). Current §§1.960-1 through 1.960-3, as modified by proposed §§1.960-1 and 1.960-3, will generally continue to describe how deemed paid taxes are computed under section 960, and incorporate updates to coordinate those rules with the proposed regulations under sections 959 and 961.

Proposed §1.960-1 limits the rules in §1.960-1 to the computation of deemed paid taxes under section 960(a) and (d). To this end, proposed §1.960-1 treats a CFC's PTEP arising by reason of a PTEP realization event during its taxable year as gross income in a residual income group, rather than as gross income in a PTEP group. See proposed §1.960-1(d)(2)(ii)(D). However, proposed §1.959-6 provides specific rules for allocating and apportioning current year taxes arising by reason of a PTEP realization event that occurred during a taxable year to the statutory groupings of PTEP of a foreign corporation. Additionally, proposed §1.959-2 generally provides rules for tracking the foreign income taxes associated with PTEP. See parts II.F and II.B of the Explanation of Provisions for a discussion of proposed §§1.959-6 and 1.959-2, respectively. Finally, proposed §1.960-1(d)(3)(ii)(B) (consistent with current §1.960-1(d)(3)(ii)(B)) provides specific rules for assigning foreign gross income to the statutory and residual groupings of income of a CFC when the CFC pays or accrues current year taxes with respect to a PTEP realization event that occurs in a different U.S. taxable year. Proposed §1.960-1 also includes changes to current §1.960-1 to conform with the approach and terminology used in the proposed regulations under sections 959 and 961 and in proposed §1.960-3.

Proposed §1.960-3 provides rules for determining foreign income taxes that are deemed paid under section 960(b) with respect to the receipt of a distribution of PTEP,

primarily by reference to PTEP tax pools. In particular, the foreign income taxes that are properly attributable to a distribution of PTEP are the foreign income taxes removed from the corporate PTEP tax pools of the distributing CFC under proposed §1.959-2(d)(2) and the PTEP tax pools of the covered shareholder under §1.959-3(e)(1)(iii) (that is, the foreign income taxes associated with the distributed PTEP under proposed §1.959-4), but only to the extent the foreign income taxes are in the creditable PTEP tax group immediately before the distribution.

These rules are issued pursuant to the express delegation of authority under section 960(f).

#### VII. Section 1502 Regulations (proposed §1.1502-59)

The proposed regulations provide rules specific to members of a consolidated group. See proposed §1.1502-59. These rules are issued pursuant to the express delegation of authority under section 1502.

The proposed regulations provide that members of a consolidated group are treated as a single covered shareholder for purposes of section 959 and the regulations thereunder. See proposed §1.1502-59(c). This approach is consistent with guidance on the application of other international tax rules to consolidated groups (for example, §§1.1502-50, 1.1502-51, and 1.1502-80(j)).

Consequently, a consolidated group maintains only a single set of annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to a foreign corporation whose stock is owned by one or more members. These annual PTEP accounts track the foreign corporation's PTEP with respect to the group and thus, for example, determine whether a covered distribution received by any member of the group from the foreign corporation is a distribution of PTEP.

This application of single-entity treatment is important to ensure the proper reflection of the consolidated group's income. Without the application of single-entity

treatment for purposes of shareholder-level PTEP accounting, a consolidated group effectively could elect in or out of PTEP distributions by changing the structure through which it owns stock of foreign corporations. For example, assume that a member of a consolidated group (M1) owns all the stock of CFC and has a subpart F income inclusion of \$100x in year 1 with respect to CFC. Absent single-entity treatment, M1, and not the consolidated group, would have \$100x of PTEP in its annual PTEP accounts with respect to CFC. In year 2, the first \$100x of covered distributions from CFC would be characterized as distributions of PTEP. However, if another member (M2) made a contribution to CFC at the beginning of year 2 in exchange for 50% of the stock of CFC, only the first \$100x of covered distributions to M1, and no covered distribution to M2, would be characterized as a distribution of PTEP. Therefore, if CFC made a pro rata covered distribution of \$100x, only \$50x would be characterized as PTEP. Applying single-entity treatment thus ensures that changes in the location of ownership of foreign stock within a consolidated group do not change the group's characterization of a distribution by the foreign corporation.

In contrast, the proposed regulations incorporate a mix of single- and separate-entity treatment for purposes of section 961 in order to prevent basis shifting between members. See proposed §1.1502-59(d); see *also* part III.C.2.ii of the Explanation of Provisions (describing how, outside of the consolidated group context, basis cannot be shared among section 961(a) ownership units even if owned by the same covered shareholder). The proposed regulations respect each member's separate basis in its directly held property units, and adjustments to the basis of section 961(a) ownership units are thus computed on a separate-entity basis. Consequently, a distribution of PTEP may result in the recognition of gain under section 961(b)(2) if the distributee member has insufficient basis in a section 961(a) ownership unit. The Treasury Department and the IRS are of the view that an approach like that in the 2006 proposed

regulations, in which one member may access basis belonging to another member, would create opportunities for inappropriate tax planning by shifting basis among members in a way that does not reflect the economics of the members' investments.

For indirectly held property units (for example, lower-tier CFC stock), a consolidated group is treated as a single covered shareholder. For example, a partnership has only a single derived basis in a derivative ownership unit with respect to a group, and, similarly, a CFC has only a single section 961(c) basis in a section 961(c) ownership unit with respect to a group and increases to derived basis and section 961(c) basis generally are computed on a single-entity basis. However, the proposed regulations also include rules to prevent basis shifting among members with respect to these property units, because member shareholders may have different bases in these property units under other rules (for example, under section 743(b)). When computing reductions in basis to derivative ownership units or section 961(c) ownership units, the proposed rules provide that the group basis of the relevant property unit is allocated to the member shareholders, the basis reduction is computed separately for each member (and may trigger gain if there is insufficient basis), and then the basis is recombined.

The proposed regulations also provide rules for corporations that become or cease to be members of a consolidated group. See proposed §1.1502-59(e). These rules generally implement single-entity treatment by mirroring the principles that would apply if members of the group were divisions of a single corporation. For example, if a shareholder of a foreign corporation joins a consolidated group, solely for purposes of applying sections 959 and 961, the transaction is treated as if the group directly acquired the stock in the foreign corporation. Similarly, if a shareholder of a foreign corporation ceases to be a member of a consolidated group, solely for purposes of applying sections 959 and 961, the transaction is treated as if the group directly disposed of the stock in the foreign corporation.

When the proposed regulations are finalized, the Treasury Department and the IRS intend to conform the terminology in §1.1502-80(j) (treating a consolidated group as a single United States shareholder for purposes of applying section 951(a)(2)(B) to distributions of PTEP from one CFC to another) to match these regulations, and may relocate that rule to §1.1502-59.

## VIII. Miscellaneous Provisions

### A. S corporations

Consistent with section 1373(a), the proposed regulations generally treat an S corporation in the same manner as a domestic partnership and thus as not a covered shareholder. See proposed §§1.959-1(c)(1) and 1.961-1(c)(1). When this treatment applies, each owner of the S corporation maintains annual PTEP accounts, dollar basis pools, and PTEP tax pools (as applicable) with respect to a foreign corporation in which the S corporation owns stock (rather than the S corporation itself). Also, like domestic partnerships, an S corporation is provided derived basis in a derivative ownership unit directly owned by the S corporation.

Notwithstanding the general rule that an S corporation is not treated as a covered shareholder, an exception provides that an S corporation is a covered shareholder for any taxable year of the S corporation for which the S corporation is treated as an entity separate from its owners in determining stock ownership for purposes of section 951(a) or 951A(a). See proposed §§1.959-11(d) and 1.961-13(c); see *also* part IX.B.5 of the Explanation of Provisions (describing transition rules applicable to domestic partnerships, including S corporations). Thus, the exception applies if the S corporation has made an election described in §1.958-1(e), as proposed to be amended at 87 FR 3890 (Jan. 25, 2022), or section 3.02 of Notice 2020-69, 2020-39 I.R.B. 604.

Accordingly, an S corporation is a covered shareholder if such election is in effect and

the S corporation thus includes amounts in gross income under sections 951(a) and 951A(a).

Where the exception applies to an S corporation (and thus both the S corporation and its owners are covered shareholders), rules relating to distributions of PTEP, derived basis (of a partnership that is owned by the S corporation), and section 961(c) basis (of a CFC that is owned by the S corporation) apply to the S corporation in its capacity as a covered shareholder before those rules apply to an owner of the S corporation. See proposed §§1.959-11(d) and 1.961-13(c). For example, a covered distribution made to the S corporation is first a distribution of the distributing foreign corporation's PTEP with respect to the S corporation, and then, to the extent remaining, a distribution of the distributing foreign corporation's PTEP with respect to owners of the S corporation.

#### B. Passive foreign investment companies

The proposed regulations do not address passive foreign investment companies (PFICs) (as defined in 1297(a)) or a PFIC's earnings and profits described in section 1293(c). The Treasury Department and the IRS are studying issues involving PFICs, including coordination of sections 959 and 1293(c), and may address these issues in future guidance.

#### C. Foreign trusts and foreign estates

For purposes of determining ownership under section 958(a)(2), stock owned by a foreign trust (within the meaning of section 7701(a)(31)(B)) described in sections 671 through 679 (relating to grantors and others treated as substantial owners) is treated as being owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock. See §1.958-1(b). Similarly, stock owned by any other foreign trust (not described in sections 671 through 679) or a foreign estate (within the meaning of section 7701(a)(31)(A)) is

treated as being owned proportionately by its beneficiaries. *See id.* Consistent with section 961(a) and (b), which provide for adjustments to the basis of property of a United States shareholder by reason of which the shareholder is considered under section 958(a)(2) as owning stock of a CFC, the current regulations under section 961 provide for adjustments to a United States shareholder's basis in a beneficial interest in a foreign trust or foreign estate through which the United States shareholder owns stock of a CFC. *See* §§1.961-1 and 1.961-2.

The proposed regulations, however, do not address the operation of sections 959 and 961 with respect to foreign trusts (thus, for example, if a covered shareholder owns stock of a CFC through a foreign trust, the proposed regulations do not address the treatment of a covered distribution received by the foreign trust from the CFC or basis in the covered shareholder's interest in the foreign trust or the trust's stock of the CFC). The Treasury Department and the IRS are studying the manner in which section 959 should be applied in these structures to ensure that PTEP distributed to a covered shareholder through a foreign trust is properly excluded from the covered shareholder's gross income. Comments are requested on the treatment of foreign trusts under section 959, including whether treatment similar to a foreign corporation or partnership is appropriate or would impose significant burdens on such trusts, their owners, or beneficiaries. Comments are also requested on the appropriateness and effect of providing basis adjustments under section 961 in structures involving these entities as well as the interaction between these provisions and the rules in section 643(i) that treat certain loans from foreign trusts as distributions.

Comments are likewise requested on how foreign estates, which are also not addressed in the proposed regulations, should be treated for purposes of sections 959 and 961.

#### D. Section 962

Consistent with section 962(d), the proposed regulations do not exclude taxable section 962 PTEP that is distributed to a covered shareholder from the shareholder's gross income. See proposed §1.959-4(b)(1). Similarly, consistent with section 961(a) and (b), the proposed regulations do not increase or reduce adjusted basis or derived basis for taxable section 962 PTEP. See proposed §§1.961-3(f)(2) and 1.961-4(b)(1), (c)(1). However, the proposed regulations apply the section 959(b) exclusion to, and provide section 961(c) basis for, taxable section 962 PTEP to prevent further tax on such PTEP in distributions to, or dispositions of stock by, a CFC. See proposed §§1.959-4(b)(2) and 1.961-3. Thus, taxable section 962 PTEP is generally subject to an additional level of taxation only in distributions to a covered shareholder or dispositions of section 961(a) ownership units or derivative ownership units.

Under the proposed regulations, PTEP retains its character as taxable section 962 PTEP in a general successor transaction and thus may transfer from a transferor covered shareholder to a successor covered shareholder. Likewise, taxable section 962 PTEP may be reflected in PTEP resulting from section 961(c) basis. In this way, the proposed regulations are consistent with the requirement in section 962(d) that taxable section 962 PTEP be included in gross income when distributed because it has not been sufficiently taxed.

Further, the proposed regulations remove §1.962-3 because the proposed regulations generally incorporate the rules in §1.962-3. See, *for example*, proposed §1.959-4. The proposed regulations, however, do not incorporate §1.962-3(b)(3)(iv), which describes the application of a foreign corporation's E&P deficit to taxable section 962 PTEP, and §1.962-3(b)(4), which provides that §1.962-3 does not apply to a distribution of section 962 PTEP treated as in exchange for stock. The Treasury Department and the IRS request comments on these rules, including whether they continue to be needed and, if so, their interaction with these regulations.



#### E. Currency translation

In applying the proposed regulations in certain cases, an amount must be translated into a currency different than the currency in which it is denominated. For example, in a distribution of PTEP to a foreign corporation, the PTEP must be translated into the functional currency of the recipient foreign corporation (if the recipient foreign corporation and distributing foreign corporation have different functional currencies) so that the PTEP can be added to annual PTEP accounts with respect to the recipient foreign corporation (which are maintained in the recipient foreign corporation's functional currency). As an additional example, in applying section 961(c) basis to a CFC's covered gain, the section 961(c) basis (which is maintained in U.S. dollars) must be translated into the CFC's functional currency if the CFC does not use the U.S. dollar as its functional currency. Accordingly, the proposed regulations provide currency translation rules where relevant. *See, for example*, proposed §§1.951-2(f), 1.959-3(c)(5), 1.959-6(d)(2), and 1.961-9(e)(3). The Treasury Department and the IRS welcome comments on these rules.

#### F. Section 985

When a CFC changes its functional currency to the U.S. dollar, §1.985-5(e)(2) requires a United States shareholder of that CFC to recognize foreign currency gain or loss with respect to PTEP under section 986(c) as if all of the PTEP were distributed to the United States shareholder immediately before the change. No rules currently require recognition of foreign currency gain or loss with respect to PTEP when a CFC with a functional currency other than the U.S. dollar distributes PTEP to a CFC with a functional currency that is the U.S. dollar, nor does §1.985-5(e)(2) apply when a CFC changes its functional currency to a currency other than the U.S. dollar. As a result, current law requires recognizing foreign currency gain or loss on PTEP deemed

distributed to a CFC immediately before it converts its functional currency to the U.S. dollar but not immediately after.

As noted in part V.A of this Explanation of provisions, the rules in the proposed regulations for recognizing foreign currency gain or loss with respect to PTEP require recognizing such gain or loss in distributions of PTEP to a covered shareholder and dispositions of foreign stock because those circumstances present the last opportunity for the covered shareholder to recognize foreign currency gain or loss with respect to the PTEP. In the case of a distribution of PTEP to a foreign corporation, the dollar basis is preserved, which in turn preserves the appropriate application of section 986(c) until one of the circumstances noted in the previous sentence occurs. The Treasury Department and the IRS are of the view that the appropriate time to recognize foreign currency gain or loss should not depend on whether and when a CFC changes its functional currency, nor on the functional currencies involved. The proposed regulations provide a comprehensive system for determining and tracking the dollar basis of PTEP (through dollar basis pools, PTEP groups, and annual PTEP accounts), as well as for using these accounts to determine foreign currency gain or loss when appropriate. To the extent the rule in §1.985-5(e)(2) was supported by concerns that having a U.S. dollar basis in PTEP that are measured in the U.S. dollar might create administrative difficulties or lead to the undercounting of foreign currency gain or loss, the Treasury Department and the IRS are of the view that the comprehensive system promulgated in the proposed regulations alleviates that concern. *See, for example*, part V of this Explanation of Provisions for rules determining currency gain and loss. Finally, the Treasury Department and the IRS are also concerned that the rule in §1.985-5(e)(2) may permit taxpayers to inappropriately accelerate foreign currency loss by deeming a distribution of such PTEP to a CFC that then changes its functional currency to the U.S. dollar. Accordingly, the proposed regulations withdraw the rule in §1.985-5(e)(2).

For similar reasons, the Treasury Department and the IRS are studying whether §1.985-7(c)(3), which requires certain adjustments by a United States shareholder related to foreign currency gain or loss with respect to PTEP in cases involving dollar approximate separate transactions method of accounting, should be modified.

G. Qualified deficit transition rule for domestic partnerships (including S corporations)

Under the qualified deficit rule of section 952(c)(1)(B), a United States shareholder's pro rata share of any prior-year E&P deficit of a CFC may generally be used to reduce the United States shareholder's subpart F income inclusion with respect to the CFC to the extent such deficit is attributable to the same qualified activity as the activity that gives rise to the current year subpart F income of the CFC (and has not already been taken into account under section 952(c)(1)(B)). For this purpose, the United States shareholder's pro rata share of any prior-year E&P deficit is the lesser of the amount determined (under rules similar to section 951(a)(2)) at the close of the current taxable year or at the close of the taxable year in which the deficit arose. Section 952(c)(1)(B)(iv).

As described in part III.A of the Background, because a domestic partnership was previously treated as an entity for purposes of including amounts in income under section 951(a)(1)(A) with respect to CFCs it owned, the domestic partnership would have been entitled to utilize those CFCs' qualified deficits to reduce its subpart F income inclusions. However, under §1.958-1(d), a domestic partnership is now generally treated as an aggregate of its partners for purposes of determining which United States shareholder has a subpart F income inclusion with respect to a CFC. To accommodate this aggregate approach for domestic partnerships, and like the transition rule for partnership-level accounts described in proposed §1.959-11(e) and part IX.B.5 of the Explanation of Provisions, the proposed regulations provide a transition rule that ensures a prior-year E&P deficit of a CFC is taken into account by a domestic

partnership's United States shareholder partners for taxable years of the CFC to which §1.958-1(d) applies to the domestic partnership. See proposed §1.952-1(c)(5).

Under the transition rule, a United States shareholder that owns stock of a CFC through an interest in a domestic partnership on the transition date (which is the last day of the first taxable year of the CFC to which §1.958-1(d) applies to the domestic partnership) takes into account its assigned portion of any prior-year E&P deficit of the CFC that arose before the application of §1.958-1(d) in determining the shareholder's pro rata share of a prior-year E&P deficit under section 952(c)(1)(B)(iv)(II). See proposed §1.952-1(c)(5)(i). The United States shareholder's assigned portion is determined based on liquidation rights as of the transition date. See proposed §1.952-1(c)(5)(ii); see *also* part IX.B.5 of the Explanation of Provisions (discussing a similar concept used in pushing out annual PTEP accounts, dollar basis pools, and PTEP tax pools to partners). The United States shareholder's pro rata share of the prior-year E&P deficit as of the close of the taxable year in which section 952(c)(1)(B) would apply to reduce its subpart F income inclusion is determined by reference to the United States shareholder's ownership of the stock of the CFC at such time.

As with the proposed regulations generally, an S corporation is treated in the same manner as a domestic partnership for purposes of applying this transition rule. See section 1373(a) and part VIII.A of the Explanation of Provisions. However, unlike domestic partnerships, an S corporation may have elected to defer the application of §1.958-1(d) and maintain entity treatment for purposes of section 951(a)(1)(A), in which case the transition rule may not apply until such election ceases to have effect. See part VIII.A of the Explanation of Provisions.

The transition rule generally applies with respect to taxable years of foreign corporations beginning on or after the date the proposed regulations are finalized in a Treasury Decision, although taxpayers are permitted to apply the transition rule to

earlier taxable years if certain consistency requirements are satisfied and the period of limitations on assessment is open for those taxable years under section 6501. See proposed §1.952-1(c)(5)(iii).

#### H. Anti-avoidance rules

The proposed regulations include anti-avoidance rules. See proposed §§1.959-1(d) and 1.961-1(d). Under these rules, appropriate adjustments are made if a transaction, series of transactions, plan, or arrangement is engaged in with a principal purpose of avoiding the purposes of section 959 or 961 or the regulations thereunder. These rules are intended to address transactions that are designed to produce double-nontaxation by, for instance, converting distributions of E&P from PTEP (which generally may be received tax-free under section 959 but requires a basis reduction under section 961) to section 959(c)(3) E&P (which may be received tax-free under other provisions and may not require a basis reduction) or vice versa.

For example, assume a corporate covered shareholder owns all the stock of a foreign corporation and the foreign corporation has PTEP with respect to the corporate covered shareholder. If an individual who would have purchased newly issued shares in the foreign corporation instead purchases shares from the corporate covered shareholder with a principal purpose of succeeding to a portion of the foreign corporation's PTEP with respect to the corporate covered shareholder's PTEP and with the expectation that at some point in the future the corporate covered shareholder will contribute the proceeds to the foreign corporation (thus achieving the individual's intended effect of acquiring newly issued shares, while also transferring the PTEP from the corporate covered shareholder to the individual), appropriate adjustments may be made to disregard the transfer of PTEP. The result would be the same if the transaction was entered into with a principal purpose of reducing the foreign corporation's PTEP with respect to the corporate covered shareholder.

## I. Clarifications and other matters

The proposed regulations clarify that a distribution of PTEP does not increase the E&P of a recipient domestic corporation (because the E&P of a domestic corporation is increased for, and at the time of, an inclusion giving rise to PTEP, and distributions to which sections 959 and 961(b) apply are described in section 312(f)(2)). See proposed §§1.312-6(f) and 1.312-8(c). No inference is intended as to the treatment under these provisions of other amounts a domestic corporation includes in its gross income as a result of ownership of stock in a foreign corporation, such as inclusions with respect to a PFIC, and the Treasury Department and IRS continue to consider these issues. Additionally, the proposed regulations clarify that, solely for purposes of the limitation in section 952(c)(1)(A), PTEP received by, or resulting from section 961(c) basis of, a CFC is not included in the CFC's current year E&P. See proposed §1.952-1(c)(4). This treatment is consistent with §1.952-1(c)(3) (*Example 1*) and coordinates sections 952(c), 959(b), and 961(c) so that PTEP does not have the effect of increasing subpart F income.

The proposed regulations also provide that, for purposes of section 163(j), PTEP received by, or resulting from section 961(c) basis of, a foreign corporation does not give rise to tentative taxable income (because the income that gave rise to the PTEP has already been taken into account), and this rule is issued under the express delegation of authority in section 163(j)(8)(B). See proposed §1.163(j)-7(g)(2). Moreover, the proposed regulations revise §1.951-1(a)(1) to reflect the repeal of provisions relating to foreign base company shipping income and foreign investments in less developed countries and move the examples in §1.951-1(e)(7) to a separate example paragraph.

The proposed regulations modify §1.905-3(b)(2)(ii) to clarify that if a foreign tax redetermination impacts the characterization or amount of a distribution or inclusion in

any other year, that year is an affected year for which a redetermination of U.S. tax is required. This is a conforming change relating to the timing and ordering rules in the proposed regulations, which could, in certain situations, result in a foreign tax redetermination impacting the characterization or amount of a distribution or inclusion not only in a subsequent year, but in a prior year.

## IX. Applicability Dates and Transition Rules

### A. Applicability dates

#### 1. General Applicability Date and Application to 2019 Notice Years

The proposed regulations would generally apply to taxable years of foreign corporations beginning on or after the date the proposed regulations are finalized in a Treasury Decision and to taxable years of persons for which such taxable years of foreign corporations are relevant (general applicability date). *See, for example,* proposed §§1.951-1(i), 1.951-2(i), 1.959-12(b), 1.960-7(c), 1.961-14(b), 1.986(c)-1(e), and 1.1502-59(g).

Notwithstanding the general applicability date, portions of the proposed section 959 regulations relating to rules described in the 2019 notice would apply before the general applicability date to taxable years of United States shareholders (and successors in interest) ending after December 14, 2018, and taxable years of foreign corporations ending with or within those taxable years, as described in the 2019 notice (2019 notice years). *See* proposed §1.959-12(c). For this purpose, taxpayers are required to apply to 2019 notice years the rules in proposed §§1.959-1(c) (treatment of S corporations), 1.959-2 (accounting of PTEP), 1.959-3 (adjustments to shareholder-level accounts and, consequently, foreign-corporation level accounts), 1.959-4(e) and 1.959-5(d) (allocation of distributions and section 956 amounts), and the relevant definitions in 1.959-1(b) (collectively, the 2019 notice provisions). Consistent with the 2019 notice, PTEP is treated as distributed under section 959 to the extent the

distribution constitutes a dividend under section 316 (determined without regard to section 959(d)). Additionally, because taxpayers may have maintained PTEP groups in accordance with the groups described in the 2019 notice, taxpayers may use those PTEP groups for 2019 notice years instead of the PTEP groups listed in proposed §1.959-2. Furthermore, neither the portions of proposed §§1.959-2 and 1.959-3 relating to PTEP tax pools, corporate PTEP tax pools, adjusted applicable percentages, and section 965(c) deduction percentages, nor the portions of proposed §§1.959-3 through 1.959-5 and 1.959-7 relating to the timing of adjustments and determinations, are 2019 notice provisions, and, therefore, taxpayers are not required to apply these provisions to 2019 notice years.

Apart from the 2019 notice provisions, the proposed regulations would apply before the general applicability date only if taxpayers choose to apply the proposed regulations early in accordance with the rules described in part IX.A.2 of the Explanation of Provisions.

## 2. Early Application Option

Taxpayers would be permitted to choose to apply the proposed regulations in their entirety to taxable years of foreign corporations beginning before the general applicability date (such years to which the regulations are applied, the early application years) if certain conditions prescribed in proposed §1.959-12(d) are satisfied (early application option). *See, for example*, proposed §§1.951-1(i), 1.951-2(i), 1.960-7(c), 1.961-14(b), 1.986(c)-1(e), and 1.1502-59(g). The early application option would satisfy, and therefore supersede, the required application of the 2019 notice provisions if the first early application year precedes, or is the same as, the first 2019 notice year. *See* proposed §1.959-12(c).

Under the early application option, taxpayers must apply the proposed regulations, as finalized, in their entirety to an early application year and all succeeding



early application years, all taxable years of covered shareholders for which the early application years are relevant, and all taxable years of related foreign corporations (determined under section 267(b)) that end on or after the later of the last day of the first early application year and the first day on which the foreign corporations are related. See proposed §1.959-12(d)(2). Further, all taxable years of covered shareholders for which the early application years are relevant must be open under section 6501, which each covered shareholder must confirm in a written statement to the foreign corporation that also provides the covered shareholder's consent to apply the proposed regulations before the general applicability date. See proposed §1.959-12(d)(3) and (4). These conditions are intended to promote consistency and administrability.

## B. Transition rules

### 1. In General

To facilitate the initial application of the proposed regulations, the proposed regulations include transition rules under section 959 for establishing and conforming accounts under section 959, as well as rules under section 961 for establishing derived basis and section 961(c) basis. These rules also address particular transition issues relating to the treatment of domestic partnerships (including S corporations).

### 2. Annual PTEP Accounts, Dollar Basis Pools, and Corporate PTEP Accounts

As of the beginning of the first taxable year of a foreign corporation to which the proposed section 959 regulations apply pursuant to the 2019 notice or the early application option, a reasonable method must be used to establish annual PTEP accounts, dollar basis pools, and corporate PTEP accounts in accordance with proposed §1.959-2, including to reflect any prior adjustments that would have been made under the principles of proposed §§1.959-2 through 1.959-5 and 1.959-7. See proposed §1.959-11(b)(1) and (2)(i). Additionally, adjustments must be made to account for the transition tax under section 965. See proposed §1.959-11(b)(3).

In establishing these accounts, any existing accounts of a covered shareholder must be conformed to the requirements of proposed §1.959-2. See proposed §1.959-11(b)(2)(i). Further, in the case of existing accounts tracking PTEP or dollar basis in multi-year pools, a reasonable method to conforming the accounts includes an approach consistent with the rules in the 2019 notice. See proposed §1.959-11(b)(2)(ii).

Lastly, a reasonable method used to establish annual PTEP accounts, dollar basis pools, and corporate PTEP accounts must be consistently applied by the covered shareholder with respect to all foreign corporations in which the covered shareholder owns stock. The same method must also be applied by all covered shareholders that join in filing a federal income tax return (for example, domestic corporations that file a consolidated federal income tax return in cases where the early application option does not apply). See proposed §1.959-11(b)(2)(i). In cases where there are multiple covered shareholders of a foreign corporation, corporate PTEP accounts of a foreign corporation are established based on the reasonable method applied by each covered shareholder. Thus, for example, assume US1, a covered shareholder, owns all the stock of CFC1 and 40% of the stock of CFC2, and that both CFC1 and CFC2 are foreign corporations. The remaining 60% of the stock of CFC2 is owned by US2, a covered shareholder unrelated to US1. US1 must consistently use a reasonable method for establishing its annual PTEP accounts and dollar basis pools with respect to CFC1 and CFC2, and US2 must use a reasonable method for its own determination of those accounts with respect to CFC2. CFC1's corporate PTEP accounts would then reflect the annual PTEP accounts of US1, and CFC2's corporate PTEP accounts would then reflect the annual PTEP accounts of US1 and US2.

### 3. PTEP Tax Pools, Corporate PTEP Tax Pools, and Section 965 Related Amounts

As of the beginning of the first taxable year of a foreign corporation to which the proposed section 959 regulations apply pursuant to the general applicability date or the

early application option, the proposed regulations require the establishment of PTEP tax pools, corporate PTEP tax pools, adjusted applicable percentages, and section 965(c) deduction percentages reflecting the foreign corporation's PTEP. See proposed §1.959-11(c)(1).

PTEP tax pools and corporate PTEP tax pools are established by adding a pro rata portion of the foreign corporation's PTEP group taxes (prior-law PTEP group taxes) with respect to PTEP groups (prior-law PTEP group), as those terms are defined in current §1.960-3, to each PTEP tax pool with respect to the foreign corporation. See proposed §1.959-11(c)(2). This is determined by multiplying the prior-law PTEP group taxes by a fraction, the numerator of which is the balance of the prior-law PTEP group that is PTEP relating to the PTEP tax pool, and the denominator of which is the balance of the prior-law PTEP group.

An adjusted applicable percentage is established with respect to all the foreign corporation's PTEP resulting from section 965 within a covered shareholder's annual PTEP accounts relating to the same section 904 category by calculating a weighted average of the applicable percentages with respect to the PTEP (as defined in §1.965-5(d)). See proposed §1.959-11(c)(3). A section 965(c) deduction percentage is established with respect to all the foreign corporation's PTEP resulting from section 965(a) within a covered shareholder's annual PTEP accounts relating to the same section 904 category by calculating a weighted average of the percentages for which foreign currency gain or loss recognized under section 986(c) with respect to distributions of the PTEP would be reduced under current §1.986(c)-1. See proposed §1.959-11(c)(4).

#### 4. Derived Basis of Partnerships and Section 961(c) Basis

As of the beginning of the first taxable year of a foreign corporation to which the proposed section 961 regulations apply pursuant to the general applicability date or the

early application option, a partnership's derived basis or a CFC's section 961(c) basis of a property unit is established based on the amount of basis that would exist in the property unit if the principles of the applicable proposed section 961 regulations were to have applied for all prior periods, determined using a reasonable method. See proposed §1.961-13(b)(1), (2), and (3). The reasonable method must be consistently applied to each foreign corporation owned by the partnership or CFC and with respect to each covered shareholder that owns an interest in the partnership or stock in the CFC. For this purpose, the establishment of section 961(c) basis includes replacing any existing basis under section 961(c) in the property unit, to the extent a foreign corporation took the position under current law that it was afforded such basis, with section 961(c) basis as prescribed in the proposed section 961 regulations.

The rule for establishing derived basis applies to foreign partnerships and is also applicable to domestic partnerships (including S corporations) to the extent that aggregate treatment applies with respect to the domestic partnership under §1.958-1(d) or former §1.951A-1(e)(1) (as in effect before TD 9960, 87 FR 3648) before the application of the proposed section 961 regulations. However, in the case of a domestic partnership, the amount of any derived basis does not take into account amounts included in income by the domestic partnership or any lower-tier domestic partnership for periods in which aggregate treatment does not apply. For example, if a domestic partnership directly owns stock in a CFC, the domestic partnership's derived basis is determined without regard to any subpart F income inclusion of the domestic partnership attributable to the CFC in a period before §1.958-1(d) applies to the domestic partnership, which instead gives rise to adjusted basis of the domestic partnership under section 961(a). See part IX.B.5 of the Explanation of Provisions for a discussion of the treatment of such basis under the proposed regulations, which is not

converted into derived basis as a result of §1.958-1(d) applying to the domestic partnership.

The proposed regulations also provide that a specified foreign corporation that is not otherwise a CFC is treated as a CFC for purposes of applying the principles of proposed §1.961-3 to an income inclusion under section 951(a)(1)(A) that arises by reason of section 965(a). See proposed §1.961-13(b)(4). This rule is intended to clarify that basis increases are made to stock of a foreign corporation for inclusions arising under section 965(a) regardless of CFC status. However, no basis increases are afforded under section 961 for PTEP attributable to section 965(b). See section 965(b)(4)(A) (providing that the amount of the reduction described in section 965(b) is treated as included in gross income under section 951(a) only for purposes of applying section 959).

The transition rules for the establishment of derived basis and section 961(c) basis are intended to facilitate the application of the rules governing such basis under the proposed regulations and should not be interpreted in a manner that results in a double benefit. To ensure this result, the proposed regulations provide that derived basis or section 961(c) basis is increased to reflect an income inclusion under section 951(a)(1)(A) or 951A(a) only to the extent such an increase would not duplicate basis at the level of the partnership or CFC to reflect the income inclusion. See proposed §1.961-13(b)(5). Thus, for example, if a foreign partnership was provided basis with respect to stock in a foreign corporation under §1.965-2(h)(5)(ii) for an income inclusion, no derived basis is provided to the foreign partnership under the proposed regulations for the inclusion (and any existing basis under §1.965-2(h)(5)(ii) in the property unit remains and, thus, is not converted to derived basis). As an additional example, if a CFC previously claimed basis under section 961(c) for an income inclusion, section 961(c) basis is provided to the CFC under the proposed regulations for the inclusion

only to the extent the previously-claimed-basis has not been used (and, therefore, can be replaced with section 961(c) basis pursuant to the proposed regulations).

#### 5. Treatment of Domestic Partnerships (Including S Corporations)

For taxable years of a domestic partnership (including an S corporation by operation of section 1373(a)) to which §1.958-1(d)(1) does not apply, the domestic partnership is treated as an entity separate from its owners in determining stock ownership for purposes of section 951(a) and therefore is required to include amounts in gross income under section 951(a). In these cases, foreign corporations may have PTEP with respect to the domestic partnership and the domestic partnership may have been provided basis under section 961(a). Moreover, in a case where former §1.951A-1(e)(1) (as in effect before TD 9960, 87 FR 3648) treated the domestic partnership as an aggregate of its partners for purposes of applying section 951A and related provisions, both the domestic partnership and its partners may be United States shareholders with income inclusions attributable to the same CFC.

The proposed regulations address the treatment of domestic partnerships before the application of §1.958-1(d)(1) by, in these cases, treating the domestic partnership as a covered shareholder. See proposed §§1.959-11(d) and 1.961-13(c). In addition, rules regarding distributions of PTEP, derived basis (of a partnership that is owned by the domestic partnership), and section 961(c) basis (of a CFC that is owned by the domestic partnership) apply to the domestic partnership in its capacity as a covered shareholder before those rules apply to covered shareholders that own interests in the domestic partnership. See proposed §§1.959-11(d) and 1.961-13(c). In this way, the PTEP and basis afforded with respect to a domestic partnership as a covered shareholder are taken into account before looking to the PTEP and basis with respect to covered shareholders that own interests in the partnership. In addition to providing a rule for coordinating the operation of these provisions in the interim period before

§1.958-1(d)(1) applies, this rule should reduce the amount of PTEP and basis of a domestic partnership that ultimately must be converted to be with respect to covered shareholders that own interests in the partnership when §1.958-1(d) applies.

Once both §1.958-1(d)(1) and the proposed regulations apply to a domestic partnership (and, consequently, the domestic partnership is no longer a covered shareholder), the proposed regulations convert the domestic partnership's accounts described in proposed §1.959-2 (annual PTEP accounts, dollar basis pools, and PTEP tax pools) to accounts with respect to covered shareholders owning interests in the domestic partnership, including the deemed covered shareholder to the extent any interest in the domestic partnership is not owned by a covered shareholder. See proposed §1.959-11(e). Similarly, the proposed regulations convert a CFC's section 961(c) basis with respect to the domestic partnership to section 961(c) basis with respect to covered shareholders owning interests in the domestic partnership (including the deemed covered shareholder). See proposed §1.961-13(d). Additionally, because another partnership may have derived basis with respect to the domestic partnership (for example, if the domestic partnership owns an interest in a foreign partnership that owns stock of a CFC, with the foreign partnership having derived basis with respect to the domestic partnership), the proposed regulations likewise convert the other partnership's derived basis to derived basis with respect to covered shareholders owning interests in the domestic partnership. See *id.*

The conversion of the domestic partnership's annual PTEP accounts, dollar basis pools, and PTEP tax pools is based on liquidation rights and occurs once the proposed regulations apply to the domestic partnership (either pursuant to the general applicability date or the early application option) or, if later, once §1.958-1(d) first applies to the domestic partnership (including, in the case of S corporations, because an election not to apply §1.958-1(d) ceases to have effect). See proposed §1.959-

11(e)(2)(i)(B). Because the conversion of accounts under these rules depends on when §1.958-1(d) first applies to a particular domestic partnership, the rules may apply at different times in cases where stock of a foreign corporation is owned through tiers of domestic partnerships.

The conversion of derived basis or section 961(c) basis is determined consistently, and occurs concurrently, with the conversion of the accounts under section 959. See proposed §1.961-13(d)(2)(i) and (3)(i). The proposed regulations do not convert basis previously provided to the domestic partnership under section 961(a) into derived basis, nor do the proposed regulations affect prior basis adjustments made under section 705. Thus, for example, if a domestic corporation owns an interest in a foreign partnership, and that foreign partnership owns an interest in a domestic partnership that owns stock of a CFC, the proposed regulations do not alter the treatment of basis provided to the domestic partnership in its CFC stock under section 961(a) or the related basis afforded to the foreign partnership in its domestic partnership interest under section 705.

## **Special Analyses**

### **I. Regulatory Planning and Review -- Economic Analysis**

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

### **II. Paperwork Reduction Act**

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) generally requires that a Federal agency obtain the approval of the Office of Management and Budget before collecting information from the public, whether such collection of information is



mandatory, voluntary, or required to obtain or retain a benefit. There are no additional information collection requirements associated with the proposed regulations.

### III. Regulatory Flexibility Act

When an agency issues a rulemaking proposal, the Regulatory Flexibility Act (5 U.S.C. chapter 6) (RFA) requires the agency to prepare and make available for public comment an initial regulatory flexibility analysis that will describe the impact of the proposed rule on small entities. See 5 U.S.C. 603(a). Section 605 of the RFA provides an exception to this requirement if the agency certifies that the proposed rulemaking will not have a substantial economic impact on a substantial number of small entities. A small entity is defined as a small business, small nonprofit organization, or small governmental jurisdiction. See U.S.C. 601(3) through (6).

The Treasury Department and the IRS do not expect that the proposed regulations will have a significant economic impact on a substantial number of small entities within the meaning of sections 601(3) through (6) of the RFA. The proposed regulations provide guidance on issues regarding sections 959 and 961 and related provisions but do not change the economic impact of the existing regulations or impose any new costs on small entities. It is unlikely the proposed regulations will affect a substantial number of small businesses due to the significant resources and investment required to engage in the type of foreign operations to which the proposed regulations are relevant. However, because there is a possibility of significant economic impact on a substantial number of small entities, an initial regulatory flexibility analysis for the regulation is provided below. The Treasury Department and the IRS request comments from the public on the number of small entities that may be impacted and whether that impact will be economically significant.

Pursuant to section 7805(f) of the Code, the proposed regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses.

A. Reasons why the action is being considered

The proposed regulations update the core aspects of the PTEP system in a manner that addresses both longstanding issues and more recent issues (such as those arising under the Act), thereby reducing potential uncertainty under the existing regulations, ensuring consistent outcomes across taxpayers and economically similar transactions, and preventing double taxation and double non-taxation. These updates to the PTEP system involve PTEP accounting, the application of section 959(b), the application of section 961 as to certain property owned by a partnership, the application of section 961(c), and rules coordinating sections 951(a), 959(b), and 961(c).

The proposed regulations described in part II of the Explanation of Provisions establish covered shareholder-specific PTEP accounts, and this accounting prevents inappropriate outcomes that could arise under an alternative approach in light of the Act (such as share-specific accounting) while ensuring a covered shareholder the benefit of PTEP relating to it. This covered shareholder-specific accounting applies to the other aspects of the PTEP system – namely, sections 986(c) and 960(b) – and ensures consistency across the PTEP system. The proposed regulations also provide rules under sections 959(b) and 951 that address longstanding issues that arise in certain split-ownership structures (that is, structures in which stock of a CFC is not all owned by a single United States shareholder), which issues were exacerbated by the Act.

The proposed regulations described in part III of the Explanation of Provisions provide guidance addressing longstanding issues under section 961. That is, the proposed regulations provide rules to adjust the basis in shares of stock of a foreign corporation owned indirectly by a covered shareholder through only one or more

partnerships, and the basis under section 961(c) in shares of stock of a foreign corporation owned by a CFC, to reflect the foreign corporation's PTEP with respect to the covered shareholder. Additionally, the proposed regulations, as discussed in part III.E of the Explanation of Provisions, provide rules treating E&P generated by gain to which section 961(c) is applied as PTEP. This approach ensures consistent outcomes across economically similar transactions regardless of how a foreign corporation's PTEP is monetized (whether through a distribution to which section 959(b) applies or a disposition to which section 961(c) applies), and, by treating the E&P as PTEP, reflects the policy of sections 959 and 961 and prevents both double taxation and double non-taxation.

The proposed regulations, as discussed in part IV of the Explanation of Provisions, provide rules under section 951 that work in tandem with sections 959(b) and 961(c) to perfect the approach discussed in the preceding paragraphs. These rules comprise two sets of rules, one applying at the foreign corporation-level and one applying at the shareholder-level, that together ensure that attributes like PTEP and section 961(c) basis are allocated to the appropriate shareholder, consistent with the shareholder-specific nature of sections 959(b) and 961(c).

**B. Objectives of, and legal basis for, the proposed regulations**

The proposed regulations are intended to provide guidance addressing core aspects of the PTEP system and significant statutory changes since the current regulations were finalized. The legal basis for these regulations is contained in various sections of the Code, including sections 959, 960, 961, 965, 986, and 7805.

**C. Small business entities to which these regulations will apply**

Because an estimate of the number of small businesses affected is not currently feasible, this initial regulatory flexibility analysis assumes that a substantial number of small businesses will be affected. However, as noted above, the Treasury Department

and the IRS believe that it is unlikely the proposed regulations will affect a substantial number of small businesses due to the significant resources and investment required to engage in the type of foreign operations to which the proposed regulations are relevant. The Treasury Department and the IRS do not expect that these regulations will affect a substantial number of small nonprofit or small governmental jurisdictions.

D. Projected reporting, recordkeeping, and other compliance requirements

In certain cases, the proposed regulations require information that currently is tracked at the foreign corporation-level to also be tracked at the shareholder-level.

E. Duplicate, overlapping, or relevant Federal rules

The proposed regulations would replace portions of existing regulations. The Treasury Department and the IRS are not aware of any Federal rules that duplicate, overlap, or conflict with these regulations.

F. Alternatives considered

The Treasury Department and the IRS considered alternatives including alternatives to treating E&P generated by gain to which section 961(c) applies as PTEP. One alternative, as discussed in part III.E.2.ii of the Explanation of Provisions, involved treating such E&P as section 959(c)(3) E&P. However, this approach was not adopted because it could lead to double taxation or double non-taxation, while also creating dissymmetry between distributions (E&P to which annual PTEP accounts apply is PTEP) and dispositions involving foreign stock (E&P to which section 961(c) basis applies is not PTEP). The proposed regulations, by providing certainty regarding longstanding issues under section 961(c), reduce economic burden, and, by protecting the policies underlying sections 959 and 961, ensure a covered shareholder the benefit of PTEP relating to it; this represents the approach with the least economic impact.

The Treasury Department and the IRS also considered alternatives to the proposed rules under section 951 that work in tandem with sections 959(b) and 961(c).

But the alternatives either could not provide the certainty or the consistency of the approach in the proposed regulations or could not properly protect against double taxation or double non-taxation.

The proposed regulations, and the PTEP system generally, apply uniformly to large and small business entities. The Treasury Department and the IRS are of the view that such an approach is necessitated by the statutory scheme; in other words, a small business exception could undermine the provisions comprising the PTEP system. Accordingly, there is no viable alternative to the proposed regulations for small entities.

#### IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. The proposed regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

#### V. Executive Order 13132: Federalism

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The proposed regulations do not have federalism implications, do not impose substantial direct compliance costs on State and local governments, and do not preempt State law within the meaning of the Executive order.

#### **Comments and Requests for a Public Hearing**

Before the proposed regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “**ADDRESSES**” section. In addition to the comments specifically requested in the Explanation of Provisions, the Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any comments submitted will be made available at [www.regulations.gov](http://www.regulations.gov) or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits written comments. Requests for a public hearing are encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**.

### **Statement of Availability of IRS Documents**

Any IRS Revenue Procedures, Revenue Rulings, Notices, or other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at [www.irs.gov](http://www.irs.gov).

### **Drafting Information**

The principal authors of these regulations are Karen R. Li, Elena M. Madaj and Chadwick Rowland, Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

### **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

### **Proposed Amendments to the Regulations**

Accordingly, the Treasury Department and the IRS propose to amend 26 CFR part 1 as follows:

### **PART 1--INCOME TAXES**

**Paragraph 1.** The authority citation for part 1 is amended by revising the entry for §1.951-1, adding entries in numerical order for §§1.951-2, 1.959-1 through 1.959-12, and 1.961-1 through 1.961-13, revising the entry for §1.986(c)-1, and adding an entry in numerical order for §1.1502-59 to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

\* \* \* \* \*

Sections 1.951-1 and 1.951-2 also issued under 26 U.S.C. 951, 959, and 961.

\* \* \* \* \*

Sections 1.959-1 through 1.959-12 also issued under 26 U.S.C. 245A(g), 904(d)(7), 951A(f)(1)(B), 959, 960(f), 962, 965(o), 986, 986(c)(2), 989(c), and 1373.

\* \* \* \* \*

Sections 1.961-1 through 1.961-13 also issued under 26 U.S.C. 743(b), 959, 961 and 961(a), (b), and (c), 965(o), and 1373.

\* \* \* \* \*

Section 1.986(c)-1 also issued under 26 U.S.C. 962, 965(o), 986 and 986(c)(2), and 989(c).

\* \* \* \* \*

Section 1.1502-59 also issued under 26 U.S.C. 959, 960, 961, 986, and 1502.

\* \* \* \* \*

**Par. 2.** Section 1.163(j)-7 is amended by:

1. Revising paragraph (g)(2); and
2. Adding a sentence to the end of paragraph (m)(2).

The revision and addition read as follows:

**§1.163(j)-7 Application of the section 163(j) limitation to foreign corporations and United States shareholders.**

\* \* \* \* \*

(g) \* \* \*

(2) *Treatment of certain dividends and previously taxed earnings and profits.* For purposes of computing the ATI of a relevant foreign corporation for a taxable year, the following amounts are (without duplication) subtracted from tentative taxable income--

(i) Any dividend included in gross income that is received from a related person, within the meaning of section 954(d)(3), with respect to the distributee; and

(ii) Any previously taxed earnings and profits that are distributed to the foreign corporation in a covered distribution (determined under §1.959-4) or that result from the application of section 961(c) basis to covered gain recognized by the foreign corporation (determined under §1.961-9).

\* \* \* \* \*

(m) \* \* \*

(2) \* \* \* Paragraph (g)(2)(ii) of this section applies to a taxable year of a foreign corporation that begins on or after [date of publication of final regulations in the ***Federal Register***] or is an early application year (as described in §1.959-12(d)) and to a taxable year of a person for which such taxable year of that foreign corporation is relevant.

\* \* \* \* \*

**Par. 3.** Section 1.245A(d)-1 is amended by:

1. Revising the first sentence of paragraph (c)(22); and

2. For each paragraph listed in the table, removing the language in the

“Remove” column wherever it appears and adding in its place the language in the “Add” column:

Paragraph	Remove	Add
(d)(2)(i)	section 951A PTEP (as defined in §1.960-3(c)(2)(viii)) in a single annual PTEP account (as defined in §1.960-3(c)(1))	previously taxed earnings and profits assigned to the section 951A PTEP group (as defined in §1.959-1(b)) within a single annual PTEP account (as defined in §1.959-1(b))



(d)(2)(ii)(B)	section 951A PTEP	previously taxed earnings and profits assigned to the section 951A PTEP group
(d)(3)(i)	section 951A PTEP (as defined in §1.960-3(c)(2)(viii)) in a single annual PTEP account (as defined in §1.960-3(c)(1))	previously taxed earnings and profits assigned to the section 951A PTEP group (as defined in §1.959-1(b)) within a single annual PTEP account (as defined in §1.959-1(b))
(d)(3)(ii)(B)	section 951A PTEP	previously taxed earnings and profits assigned to the section 951A PTEP group
(d)(4)(i)	section 951(a)(1)(A) PTEP (as defined in §1.960-3(c)(2)(x)) in a single annual PTEP account (as defined in §1.960-3(c)(1))	previously taxed earnings and profits assigned to the section 951(a)(1)(A) PTEP group (as defined in §1.959-1(b)) within a single annual PTEP account (as defined in §1.959-1(b))
(d)(4)(i)	section 951(a)(1)(A) PTEP	previously taxed earnings and profits assigned to the section 951(a)(1)(A) PTEP group
(d)(4)(ii)(B)(1) through (3), and (D)	section 951(a)(1)(A) PTEP	previously taxed earnings and profits assigned to the section 951(a)(1)(A) PTEP group

The revision reads as follows:

**§1.245A(d)-1 Disallowance of foreign tax credit or deduction.**

\* \* \* \* \*

(c) \* \* \*

(22) \* \* \* The term *section 245A(d) PTEP* means previously taxed earnings and profits assigned to a section 245A(d) PTEP group or a reclassified section 245A(d) PTEP group (each as defined in §1.959-1(b)). \* \* \*

\* \* \* \* \*

**Par. 4.** Section 1.312-6 is amended by adding paragraph (f) to read as follows:

**§1.312-6 Earnings and profits.**

\* \* \* \* \*

(f) An amount included in a corporation's gross income under section 951(a) or 951A(a) for a particular period is taken into account in computing the corporation's earnings and profits for that period. *See also* §1.312-8(c) (domestic corporation's receipt of previously taxed earnings and profits does not increase earnings and profits). This paragraph (f) applies to a taxable year of a corporation beginning on or after [date of publication of final regulations in the ***Federal Register***]. This paragraph (f) also applies to a taxable year of a domestic corporation that is a shareholder in a foreign corporation, if a taxable year of the foreign corporation that is an early application year (as described in §1.959-12(d)) ends with or within the taxable year of the domestic corporation.

**Par. 5.** Section 1.312-8 is amended by adding paragraph (c) to read as follows:

**§1.312-8 Effect on earnings and profits of receipt of tax-free distributions requiring adjustment or allocation of basis of stock.**

\* \* \* \* \*

(c) Previously taxed earnings and profits that are distributed to a domestic corporation in a covered distribution (determined under §1.959-4) do not increase the corporation's earnings and profits. *See* §§1.959-4 and 1.961-4 for rules excluding distributed previously taxed earnings and profits from gross income and reducing basis. *See also* §1.312-6(f) (sections 951(a) and 951A(a) inclusions increase earnings and profits). This paragraph (c) applies to a taxable year of a domestic corporation beginning on or after [date of publication of final regulations in the ***Federal Register***]. This paragraph (c) also applies to a taxable year of a domestic corporation that is a shareholder in a foreign corporation, if a taxable year of the foreign corporation that is an early application year (as described in §1.959-12(d)) ends with or within the taxable year of the domestic corporation.

**Par. 6.** Section 1.743-1 is amended by adding paragraphs (d)(4) and (j)(7) to read as follows:

## **§1.743-1 Optional adjustment to basis of partnership property.**

\* \* \* \* \*

(d) \* \* \*

(4) *Coordination with derived basis.* See §1.961-5(d) for a rule coordinating the application of this paragraph (d) with derived basis that transfers to a transferee.

\* \* \* \* \*

(j) \* \* \*

(7) *Covered distributions treated as previously taxed earnings and profits.* See §1.961-4(c)(2)(iii) for rules regarding the use of a positive basis adjustment under section 743(b) upon the receipt of a covered distribution that is treated as previously taxed earnings and profits with respect to certain direct or indirect partners of the partnership.

\* \* \* \* \*

## **§1.861-20 [Amended]**

**Par. 7.** Section 1.861-20 is amended by:

1. In paragraph (a), adding the language “1.959-6,” after the language, “1.904-6,”;
2. In paragraph (d)(2)(ii)(B), adding the language “§1.959-6(c) and” before the language “§ 1.960-1(d)(3)(ii)”, and removing the language “income groups or PTEP groups” and adding the language “previously taxed earnings and profits and to income groups, respectively,” in its place;
3. In paragraph (d)(3)(i)(B)(1), adding the language “§1.959-6(c) and” before the language “§ 1.960-1(d)(3)(ii)”, and removing the language “income groups or PTEP groups” and adding the language “previously taxed earnings and profits and to income groups, respectively,” in its place; and
4. In paragraph (g)(6)(i), removing the language “section 965(a) PTEP (as

defined in §1.960-3(c)(2)(vi)) in a single annual PTEP account (as defined in § 1.960-3(c)(1))” and adding the language “previously taxed earnings and profits assigned to the section 965(a) PTEP group (as defined in §1.959-1(b)) within a single annual PTEP account (as defined in §1.959-1(b))” in its place.

#### **§1.904-6 [Amended]**

**Par. 8.** Section 1.904-6 is amended by:

1. In paragraph (e)(2), removing the language “§1.959-1” and adding the language “§1.959-4” in its place, adding the language “(as defined in §1.959-1(b))” after “annual PTEP account”, and removing the language “§1.960-3(c)” and adding the language “§1.959-1(b)” in its place;
2. Removing paragraph (e)(3);
3. Redesignating paragraph (e)(4) as new paragraph (e)(3);
4. In newly redesignated paragraph (e)(3)(i), removing the language “(e)(4)(ii)” and adding the language “(e)(3)(ii)” in its place; and
5. In newly redesignated paragraph (e)(3)(ii)(C), removing the language “(e)(4)(ii)(B)” and adding the language “(e)(3)(ii)(B)” in its place.

#### **§1.905-3 [Amended]**

**Par. 9.** Section 1.905-3 is amended by:

1. In paragraph (a), removing the language “PTEP group taxes (as defined in § 1.960-3(d)(1))” and adding the language “a tax pool described in §1.959-2(b)(4) or (d)(2)” in its place;
2. In the fifth sentence of paragraph (a), removing the language “PTEP group taxes” and adding the language “a tax pool described in §1.959-2(b)(4) or (d)(2)” in its place;
3. In the last sentence of paragraph (a), removing the language “PTEP group taxes” and adding the language “a tax pool described in §1.959-2(b)(4) or

(d)(2)” in its place; and

4. In the last sentence of paragraph (b)(2)(ii), removing the language “subsequent”.

#### **§1.905-4 [Amended]**

**Par. 10.** Section 1.905-4 is amended by, in paragraph (c)(6), removing the language “PTEP group taxes (as defined in §1.960-3(d)(1))” and adding the language “a tax pool described in §1.959-2(b)(4) or (d)(2)” in its place.

**Par. 11.** Section 1.951-1 is amended by:

1. Removing the introductory text of paragraph (a), revising paragraphs (a)(1) and (2), and adding headings for paragraphs (a)(3) and (4);
2. In the introductory text of paragraph (b)(1), removing the language “(a)(2)(i)” and “(e)” and adding the language “(a)(1)(i)” and “(c)” in their places, respectively;
3. Adding paragraph (c);
4. Revising the heading for paragraph (e) and revising paragraph (e)(1)(i);
5. In paragraph (e)(1)(ii)(A), adding the language “and not reduced by distributions during the year” immediately before the semicolon;
6. In paragraph (g)(1), adding the language “(or, if applicable pursuant to section 953(c)(1)(A), any stock of such foreign corporation)” immediately before the period;
7. Revising paragraph (h);
8. Redesignating paragraph (e)(7) as paragraph (h)(1) and revising the heading and introductory text of newly redesignated paragraph (h)(1);
9. In newly redesignated paragraph (h)(1)(i)(I), adding the language “covered items (within the meaning of paragraph (c)(3) of this section),” immediately after the language “neither”;

10. In newly redesignated paragraphs (h)(1)(ii) through (viii), removing the language “(e)(1) of this section” wherever it may appear and adding the language “(c)(1) of this section” in its place;

11. In newly redesignated paragraph (h)(1)(viii)(A), removing the language “(e)(7)(vii)(A) of this section” and adding the language “(h)(1)(vii)(A) of this section” in its place;

12. Adding paragraph (h)(2); and

13. Adding paragraph (i).

The revisions and additions read as follows:

**§1.951-1 Amounts included in gross income of United States shareholders.**

(a) \* \* \*

(1) *Section 951(a) inclusions.* If a foreign corporation is a controlled foreign corporation (within the meaning of section 957 or, if applicable, section 953(c)(1)(B)) at any time during a taxable year of the foreign corporation, every person who is a United States shareholder (as defined in section 951(b) and paragraph (g) of this section) of the foreign corporation at any time during such taxable year and owns (within the meaning of section 958(a)) stock in the foreign corporation on the last day in such taxable year on which the foreign corporation is a controlled foreign corporation shall, for the United States shareholder’s taxable year in which or with which such taxable year of the foreign corporation ends, include in gross income the sum of--

(i) The United States shareholder’s pro rata share (determined under paragraph (b) of this section) of the foreign corporation’s subpart F income (as defined in section 952) for the taxable year of the foreign corporation; and

(ii) The amount determined under section 956 with respect to the United States shareholder for the taxable year of the foreign corporation, but only to the extent not excluded from gross income under section 959(a)(2) and §1.959-5.

(2) *Currency translation.* See section 989(b) for translating an amount included in income under this section into U.S. dollars.

(3) *Characterization of inclusion in determining a personal holding company.* \* \* \*

(4) *Certain stock ownership rules.* \* \* \*

\* \* \* \* \*

(c) *Pro rata share of subpart F income--*(1) *In general.* For purposes of paragraph (b) of this section, a United States shareholder's pro rata share of the foreign corporation's subpart F income for the taxable year of the foreign corporation is the sum of all subpart F income allocated to the United States shareholder in accordance with the rules described in paragraph (c)(2) of this section. Under those rules, subpart F income attributable to covered items (that is, subpart F income attributable to certain distributions and certain gain with respect to stock) is separately allocated, in each case consistently with how the covered item is assigned at the foreign corporation-level under §1.951-2 as part of determining the extent to which attributes specific to the United States shareholder (that is, previously taxed earnings and profits or section 961(c) basis) are applied to exclude the covered item from the foreign corporation's subpart F income under section 959(b) or 961(c). Then, subpart F income not attributable to covered items is allocated based on the United States shareholder's share of the foreign corporation's allocable earnings and profits (as determined under paragraph (e) of this section). See paragraphs (c)(3) and (h) of this section for definitions and examples, respectively.

(2) *Rules for allocating subpart F income--*(i) *Determine subpart F income attributable to each covered item.* First, determine the subpart F income of the foreign corporation attributable to each covered item, computed as the portion of the covered item that is included in foreign base company income (as defined in §1.954-1(a)(5)) or insurance income (as defined in §1.954-1(a)(6)). See §1.951-2(b) for the definition of a

covered item.

(ii) *Allocate subpart F income attributable to each covered item.* Second, allocate to the United States shareholder a pro rata portion of the subpart F income attributable to each covered item, determined by multiplying such subpart F income by a fraction. The numerator of the fraction is the portion of the covered item that is both assigned to the United States shareholder under §1.951-2 and included in adjusted gross foreign base company income (as defined in §1.954-1(a)(3)) or adjusted gross insurance company income (as defined in §1.954-1(a)(6)), and the denominator of the fraction is the portion of the covered item that is included in adjusted gross foreign base company income or adjusted gross insurance company income. However, if the denominator of the fraction would be zero, then the fraction is considered to be zero.

(iii) *Allocate subpart F income not attributable to covered items.* Third, allocate to the United States shareholder a pro rata portion of all subpart F income of the foreign corporation not attributable to covered items, determined by multiplying all such subpart F income by a fraction. The numerator of the fraction is the portion of the foreign corporation's hypothetical distribution described in paragraph (e) of this section that would be distributed with respect to the stock of the corporation that the United States shareholder owns (within the meaning of section 958(a)), and the denominator of the fraction is the amount of such hypothetical distribution.

(3) *Definitions.* For purposes of this paragraph (c), the term *covered item* has the meaning provided in §1.951-2(b).

\* \* \* \* \*

(e) *Hypothetical distribution*--(1) \* \* \*

(i) *Hypothetical distribution and hypothetical distribution date.* For a taxable year of a controlled foreign corporation, the hypothetical distribution described in this paragraph (e) (*hypothetical distribution*) is a distribution treated as made by the



corporation with respect to stock of the corporation owned by all shareholders of the corporation in an amount equal to the corporation's allocable earnings and profits for the taxable year, on the last day of the taxable year on which the corporation is a controlled foreign corporation (*hypothetical distribution date*).

\* \* \* \* \*

(h) *Examples--(1) Examples not involving covered items.* The following examples illustrate the application of paragraphs (c) and (e) of this section in cases not involving covered items.

\* \* \* \* \*

(2) *Examples involving covered items.* The following examples illustrate the application of paragraphs (c) and (e) of this section in cases involving covered items.

(i) *Assumed facts.* For purposes of the examples in this paragraph (h)(2), unless otherwise indicated, the following facts are assumed:

(A) US1 and US2 are unrelated domestic corporations that are covered shareholders. Neither US1 nor US2 is a member of a consolidated group (as defined in §1.1502-1(h)).

(B) F1, F2, and F3 are foreign corporations, each of which is a controlled foreign corporation and uses the British pound (£) as its functional currency.

(C) Each entity uses the calendar year as its taxable year, and no entity has a short taxable year.

(D) To the extent a covered item received or recognized by a foreign corporation is previously taxed earnings and profits, the covered item is excluded in determining the foreign corporation's subpart F income and tested income or tested loss under section 959(b) and §1.959-4 or section 961(c) and §1.961-9, as applicable.

(E) To the extent a covered item received or recognized by a foreign corporation is not previously taxed earnings and profits, the covered item is--

(1) In the case of a covered distribution, excluded in determining the foreign corporation's subpart F income and tested income or tested loss under sections 954(c)(6) and 951A(c)(2)(A)(i)(IV); and

(2) In the case of covered gain, included in the foreign corporation's foreign personal holding company income (as defined in section 954(c)) and then its adjusted gross foreign base company income (as defined in §1.954-1(a)(3)) either because section 964(e)(1) does not apply or because section 964(e)(4) applies.

(F) The only reductions to adjusted gross foreign base company income (as defined in §1.954-1(a)(3)) are for deductions under §1.954-1(a)(4). Thus, there are no reductions by reason of section 952(c) (subpart F income limited to current earnings and profits) or section 954(b)(4) (exception for certain income subject to high foreign taxes).

(G) To the extent a covered item received or recognized by a foreign corporation is excluded in determining the foreign corporation's subpart F income and tested income or tested loss as described in this paragraph (h)(2)(i), the listed exclusion is not necessarily the only applicable exclusion.

(ii) *Example 1: Subpart F income attributable to covered items--(A) Facts--(1) In general.* US1 and US2 each directly own 50% of the single class of outstanding stock of F1. F1 directly owns all the outstanding stock of each of F2 and F3. For F1's taxable year ending on December 31 of year 3, F1's gross income consists of two covered items, which are a £60x covered distribution received from F2 and £40x of covered gain recognized with respect to stock of F3. US1 and US2 are assigned equal portions of each covered item under §1.951-2. The entirety of US1's assigned portion of each covered item is previously taxed earnings and profits (because, in the case of the covered distribution, £30x of F2's previously taxed earnings and profits with respect to US1 is applied to US1's assigned portion and, in the case of the covered gain, £20x of F1's section 961(c) basis with respect to US1 is applied to US1's assigned portion). None of US2's assigned portion of either covered item is previously taxed earnings and profits (because F2 has no previously taxed earnings and profits with respect to US2 and F1 has no section 961(c) basis with respect to US2). F1 has no deductions for the taxable year.

(2) *Subpart F income.* For F1's taxable year ending on December 31 of year 3, F1 has £20x of subpart F income consisting of foreign base company income (adjusted net foreign base company income as defined in §1.954-1(a)(5)), which in turn consists of foreign personal holding company income (as defined in section 954(c)). Table 1 in

this paragraph (h)(2)(ii)(A)(2) provides the treatment of F1's gross income in computing its adjusted net foreign base company income.

**Table 1 to paragraph (h)(2)(ii)(A)(2) of this section**

Gross income		Foreign base company income		
		Adjusted gross FBCI	Reductions	Adjusted net FBCI
<b>£60x covered distribution from F2</b>	US1's £30x assigned portion	£0 (\$959(b))		
	US2's £30x assigned portion	£0 (\$954(c)(6))		
<b>£40x covered gain on F3 stock</b>	US1's £20x assigned portion	£0 (\$961(c))	£0	£20x (£20x - £0)
	US2's £20x assigned portion	£20x		

(B) *Analysis.* Under paragraph (c) of this section, F1's subpart F income attributable to each covered item is separately allocated to US1 and US2. F1 has £0 of subpart F income attributable to the covered distribution and £20x of subpart F income attributable to the covered gain because in each case that is the portion of the covered item that is included in F1's adjusted net foreign base company income. See paragraph (c)(2)(i) of this section. The £20x of subpart F income attributable to the covered gain is allocated to each of US1 and US2 by multiplying the amount of such subpart F income by a fraction, the numerator of which is the portion of the covered gain that is both assigned to the United States shareholder under §1.951-2 and included in F1's adjusted gross foreign base company income (£0 in the case of US1, and £20x in the case of US2), and the denominator of which is the portion of the covered gain that is included in F1's adjusted gross foreign base company income (£20x). See paragraph (c)(2)(ii) of this section. Thus, US2 is allocated all £20x of the subpart F income attributable to the covered gain. Accordingly, for purposes of paragraph (b) of this section, US1 has a £0 pro rata share, and US2 has a £20x pro rata share, of F1's £20x of subpart F income. See paragraph (c)(1) of this section.

(C) *Alternative facts: expenses--(1) Facts.* The facts are the same as in paragraph (h)(2)(ii)(A) of this section, except as follows. Only £10x of US1's assigned portion of the covered gain is previously taxed earnings and profits (because there is only £10x of section 961(c) basis with respect to US1 available to be applied to US1's assigned portion). In addition, F1 has £5x of deductions, which are not foreign income taxes, that are definitely related to the covered gain. The deductions reduce F1's adjusted gross foreign base company income by £5x in computing net foreign base company income under §1.954-1(a)(4). Thus, F1 has £25x of subpart F income, all of which is attributable to the covered gain.

(2) *Analysis.* As summarized in Table 1 in this paragraph (h)(2)(ii)(C)(2), the £25x of subpart F income attributable to the covered gain is allocated to each of US1 and US2 by multiplying the amount of such subpart F income by a fraction, the numerator of which is the portion of the covered gain that is both assigned to the United States shareholder under §1.951-2 and included in F1's adjusted gross foreign base company income (£10x in the case of US1, and £20x in the case of US2), and the denominator of which is the portion of the covered gain that is included in F1's adjusted gross foreign base company income (£30x). See paragraph (c)(2)(ii) of this section.

Accordingly, for purposes of paragraph (b) of this section, US1 has a £8.3x pro rata share, and US2 has a £16.7x pro rata share, of F1's £25x of subpart F income.

**Table 1 to paragraph (h)(2)(ii)(C)(2) of this section**

FOREIGN BASE COMPANY INCOME ANALYSIS						
Gross income		Foreign base company income			Allocation of subpart F income attributable to the covered item under §1.951-1(c)(2)(ii)	
		Adjusted gross FBCI	Reductions	Adjusted net FBCI	US1	US2
£60x covered distribution from F2	US1's £30x assigned portion	£0 (\$959(b))				
	US2's £30x assigned portion	£0 (\$954(c)(6))				
£40x covered gain on F3 stock	US1's £20x assigned portion	£10x (\$961(c) for remaining £10x)	£5x	£25x (£30x – £5x)	£8.3x (£25x × £10x/£30x)	£16.7x (£25x × £20x/£30x)
	US2's £20x assigned portion	£20x				

(iii) *Example 2: Subpart F income attributable and not attributable to covered items--(A) Facts--(1) In general.* US1 and US2 each directly own 50% of the single class of outstanding stock of F1. F1 directly owns all the outstanding stock of each of F2 and F3. For F1's taxable year ending on December 31 of year 3, F1 has £500x of allocable earnings and profits for purposes of the hypothetical distribution described in paragraph (e) of this section. F1's gross income for the taxable year consists of a £60x covered distribution received from F2, £40x of covered gain recognized with respect to stock of F3, £295x of royalty income received from an unrelated person, and £125x of foreign oil and gas extraction income (as defined in section 907(c)(1)). US1 and US2 are assigned equal portions of each covered item under §1.951-2, and the entirety of US1's assigned portion of each covered item, but none of US2's assigned portion of either covered item, is previously taxed earnings and profits (because, in the case of the covered distribution, there are sufficient previously taxed earnings and profits with respect to US1 to be applied to US1's assigned portion and there are no previously taxed earnings and profits with respect to US2 to be applied to US2's assigned portion, and, in the case of the covered gain, there is sufficient section 961(c) basis with respect to US1 to be applied to US1's assigned portion and there is no section 961(c) basis with respect to US2 to be applied to US2's assigned portion). F1 has £20x of deductions for the taxable year, consisting of £15x of foreign withholding taxes imposed on the covered distribution and £5x of expenses, which are not foreign income taxes, that are definitely related to the covered gain. The £5x of expenses reduce F1's adjusted gross foreign base company income by £5x in computing net foreign base company income under §1.954-1(a)(4).

(2) *Subpart F income.* For F1's taxable year ending on December 31 of year 3, F1 has £310x of subpart F income consisting of foreign base company income (adjusted net foreign base company income as defined in §1.954-1(a)(5)). Table 1 in this paragraph (h)(2)(iii)(A)(2) provides the treatment of F1's items of gross income in computing its adjusted net foreign base company income.

**Table 1 to paragraph (h)(2)(iii)(A)(2) of this section**

**FOREIGN BASE COMPANY INCOME ANALYSIS**

Gross income		Foreign base company income		
		Adjusted gross FBCI	Reductions	Adjusted net FBCI
£60x covered distribution from F2	US1's £30x assigned portion	£0 (\$959(b))		
	US2's £30x assigned portion	£0 (\$954(c)(6))		
£40x covered gain on F3 stock	US1's £20x assigned portion	£0 (\$961(c))	£5x	£15x (£20x – £5x)
	US2's £20x assigned portion	£20x		
£295x royalty income		£295x	£0	£295x (£295x – £0)
£125x foreign oil and gas extraction income		£0		

(B) *Analysis--(1) In general.* Under paragraph (c) of this section, F1's subpart F income attributable to each covered item is separately allocated to US1 and US2, and then F1's remaining subpart F income is allocated to the United States shareholders. As described in paragraphs (h)(2)(iii)(B)(2) and (3) of this section and summarized in Table 1 in this paragraph (h)(2)(iii)(B)(1), US1 is allocated a total of £147.5x, and US2 is allocated a total of £162.5x, of subpart F income. Accordingly, for purposes of paragraph (b) of this section, US1 has a £147.5x pro rata share, and US2 has a £162.5x pro rata share, of F1's £310x of subpart F income. See paragraph (c)(1) of this section.

**Table 1 to paragraph (h)(2)(iii)(B)(1) of this section**

FOREIGN BASE COMPANY INCOME ANALYSIS						
Gross income		Foreign base company income			Allocation of subpart F income under §1.951-1(c)(2)(ii) and (iii)	
		Adjusted gross FBCI	Reductions	Adjusted net FBCI	US1	US2
£60x covered distribution from F2	US1's £30x assigned portion	£0 (\$959(b))				
	US2's £30x assigned portion	£0 (\$954(c)(6))				
£40x covered gain on F3 stock	US1's £20x assigned portion	£0 (\$961(c))	£5x	£15x (£20x – £5x)	£0 (£15x × £0/£20x)	£15x (£15x × £20x/£20x)
	US2's £20x assigned portion	£20x				
£295x royalty income		£295x	£0	£295x (£295x – £0)	£147.5x (£295x × £250x/£500x)	£147.5x (£295x × £250x/£500x)
£125x foreign oil and gas extraction income		£0				

(2) *Allocation of subpart F income attributable to covered items.* F1 has £0 of subpart F income attributable to the covered distribution and £15x of subpart F income attributable to the covered gain because in each case that is the portion of the covered item that is included in F1's adjusted net foreign base company income. See paragraph (c)(2)(i) of this section. The £15x of subpart F income attributable to the covered gain is allocated to each of US1 and US2 by multiplying the amount of such subpart F income by a fraction, the numerator of which is the portion of the covered gain that is both assigned to the United States shareholder under §1.951-2 and included in F1's adjusted

gross foreign base company income (£0 in the case of US1, and £20x in the case of US2), and the denominator of which is the portion of the covered gain that is included in F1's adjusted gross foreign base company income (£20x). See paragraph (c)(2)(ii) of this section. Thus, US2 is allocated all £15x of the subpart F income attributable to the covered gain.

(3) *Allocation of subpart F income not attributable to covered items.* F1 has £295x of subpart F income not attributable to covered items (£310x – £15x). This subpart F income is allocated to each of US1 and US2 by multiplying the amount of the subpart F income by a fraction, the numerator of which is portion of F1's £500x hypothetical distribution described in paragraph (e) of this section that would be distributed with respect to stock of F1 that the United States shareholder owns (£250x in the case of each of US1 and US2), and the denominator of which is the amount of the hypothetical distribution (£500x). See paragraph (c)(2)(iii) of this section. Thus, each of US1 and US2 is allocated £147.5x of the subpart F income not attributable to covered items.

(C) *Alternative facts: tested income--(1) Facts.* The facts are the same as in paragraph (h)(2)(iii)(A) of this section, except that F1's £125x item of foreign oil and gas extraction income is instead gross tested income. Because there are no allowable deductions properly allocable to the gross tested income, F1 thus has £125x of tested income.

(2) *Analysis.* The results are the same as in paragraph (h)(2)(iii)(B) of this section. In addition, each of US1 and US2 has a £62.5x pro rata share of F1's £125x of tested income, determined by multiplying the amount of the tested income by the fraction used in allocating F1's subpart F income not attributable to covered items to the United States shareholder (£250x/£500x, as described in paragraph (h)(2)(iii)(B)(3) of this section). See §1.951A-1(d)(2).

(i) *Applicability date.* This section applies to taxable years of foreign corporations that begin on or after [date of publication of final regulations in the **Federal Register**] or are early application years (as described in described in §1.959-12(d)) and to taxable years of persons for which such taxable years of those foreign corporations are relevant. See §1.951-1 as contained in 26 CFR part 1 revised as of April 1, 2024, for a version of this section applicable to prior taxable years.

**Par. 12.** Add section 1.951-2 to read as follows:

**§1.951-2 Foreign corporation-level assignment rules for covered items.**

(a) *Scope.* This section sets forth the rules for assigning a foreign corporation's covered items to covered shareholders. Under §§1.959-4 and 1.961-9, these assignments determine the extent to which shareholder-specific attributes (previously

taxed earnings and profits or section 961(c) basis) are applied to the covered items. Paragraph (b) of this section defines a covered item. Paragraph (c) of this section describes the rules for assigning covered items. Paragraph (d) of this section describes a fraction determining assignments under the general assignment rule. Paragraph (e) of this section adjusts assignments to account for general successor transactions. Paragraph (f) of this section provides a currency translation rule. Paragraph (g) of this section provides definitions and rules of general applicability for purposes of this section. Paragraph (h) of this section provides examples illustrating the application of this section. Paragraph (i) of this section provides the applicability date of this section.

(b) *Covered items.* A *covered item* is gross income of a foreign corporation that consists of either the portion of a covered distribution received by the foreign corporation (determined under §1.959-4) or a covered gain recognized by the foreign corporation (determined under §1.961-9). Covered shareholders that own stock of a foreign corporation during a taxable year of the foreign corporation in which the foreign corporation receives or recognizes a covered item are assigned portions of the covered item in accordance with the rules described in paragraph (c) of this section. See *also* paragraph (g) of this section, incorporating §1.959-1(b) for the definition of covered shareholder, §1.959-4(c) for the definition of covered distribution, and §1.961-9(c) for the definition of covered gain.

(c) *Rules for assigning a covered item--(1) Determine assignments based on stock ownership on the last relevant day.* First, assign a pro rata portion of the covered item to each covered shareholder that owns stock of the foreign corporation on the last relevant day of the foreign corporation's taxable year (defined in §1.959-1(b) as the last day of the taxable year on which the foreign corporation is a controlled foreign corporation), determined by multiplying the amount of the covered item by the fraction computed in accordance with paragraph (d) of this section. If there is no day during the

taxable year on which the foreign corporation is a controlled foreign corporation, then treat the last day of the taxable year as the last relevant day.

(2) *Adjust assignments for general successor transactions.* Second, if the foreign corporation is an acquired foreign corporation in one or more general successor transactions that occur during the foreign corporation's taxable year, then, for each such general successor transaction (starting with the earliest transaction), adjust covered shareholders' assigned portions of the covered item in accordance with paragraph (e) of this section. See also paragraph (g) of this section, incorporating §1.959-7(b) for the definitions of acquired foreign corporation and general successor transaction.

(d) *Fraction in determining assignments--(1) In general.* In determining a covered shareholder's assigned portion of a covered item of a foreign corporation under paragraph (c)(1) of this section, the fraction described in that paragraph is computed as follows. The numerator of the fraction is the amount that would be the covered shareholder's share of the hypothetical distribution described in §1.951-1(e) for the foreign corporation's taxable year if, for purposes of this paragraph (d), §1.951-1(e) were applied with the modifications described in paragraph (d)(2) of this section. The denominator of the fraction is the amount that would be the hypothetical distribution described in §1.951-1(e) for the foreign corporation's taxable year if, for purposes of this paragraph (d), §1.951-1(e) were applied with the modifications described in paragraph (d)(2) of this section.

(2) *Modifications--(i) Allocable earnings and profits.* For purposes of this paragraph (d), the foreign corporation's allocable earnings and profits (as defined in §1.951-1(e)(1)(ii)) are treated as the amount that is the greater of--

(A) The earnings and profits of the foreign corporation for the taxable year, determined under section 964 and not reduced by distributions during the taxable year; and



(B) The sum of all covered items of the foreign corporation for the taxable year.

(ii) *Controlled foreign corporation status.* For purposes of this paragraph (d), §1.951-1(e) applies without regard to whether the foreign corporation is a controlled foreign corporation. In addition, if there is no day during the taxable year on which the foreign corporation is a controlled foreign corporation, then the hypothetical distribution date (as defined in §1.951-1(e)(1)(i)) is treated as the last day of the taxable year.

(e) *Rules for general successor transactions--(1) In general.* In adjusting covered shareholders' assignments of a covered item for a general successor transaction under paragraph (c)(2) of this section, increase an assignment in accordance with paragraph (e)(2) of this section, and then decrease assignments in accordance with paragraphs (e)(3) and (4) of this section. Generally, under these rules (together with §§1.959-4 and 1.961-9), previously taxed earnings and profits or section 961(c) basis with respect to the transferor covered shareholder (if the general successor transaction occurs before the last relevant day) or successor covered shareholder (if the general successor transaction occurs on or after the last relevant day) are applied to a covered item to the same extent such previously taxed earnings and profits or section 961(c) basis would have been applied if the general successor transaction had not occurred.

(2) *Increase--(i) General successor transaction occurring before the last relevant day.* If the general successor transaction occurs before the last relevant day of the taxable year but after the covered item is received or recognized, then, subject to the limitation in paragraph (e)(2)(iii) of this section, increase the transferor covered shareholder's assignment of the covered item as follows. Increase the assignment by the additional portion of the covered item that would have been assigned to the transferor covered shareholder under paragraph (c)(1) of this section if the day on which the covered item is received or recognized were the last relevant day and the hypothetical distribution described in paragraph (d)(1) of this section were treated as

made immediately before the covered item is received or recognized.

(ii) *General successor transaction occurring on or after the last relevant day.* If the general successor transaction occurs on or after the last relevant day of the taxable year but before the covered item is received or recognized, then, subject to the limitation in paragraph (e)(2)(iii) of this section, increase the successor covered shareholder's assignment of the covered item as follows. Increase the assignment by the additional portion of the covered item that would have been assigned to the successor covered shareholder under paragraph (c)(1) of this section if the day on which the covered item is received or recognized were the last relevant day and the hypothetical distribution described in paragraph (d)(1) of this section were treated as made immediately before the covered item is received or recognized.

(iii) *Limitations.* The increase pursuant to paragraph (e)(2)(i) or (ii) of this section applies only to the extent it results in an additional portion of the covered item being previously taxed earnings and profits that are both with respect to the covered shareholder described in that paragraph and excluded from the foreign corporation's gross income under section 959(b) and §1.959-4 or section 961(c) and §1.961-9. Further, the increase cannot exceed the aggregate of each connected covered shareholder's assigned portion of the covered item under paragraph (c)(1) of this section.

(3) *Decreases for connected covered shareholders owning acquired stock.* For each connected covered shareholder that owns acquired stock of the foreign corporation on the last relevant day of the taxable year, decrease the connected covered shareholder's assignment (but not below zero) by the product of the increase pursuant to paragraph (e)(2) of this section and a fraction. The numerator of the fraction is the connected covered shareholder's assigned portion of the covered item under paragraph (c)(1) of this section, and the denominator of the fraction is the

aggregate of the assigned portion of the covered item under paragraph (c)(1) of this section of each connected covered shareholder described in the preceding sentence.

*(4) Decreases for connected covered shareholders not owning acquired stock.*

For each connected covered shareholder that does not own acquired stock of the foreign corporation on the last relevant day of the taxable year, decrease the connected covered shareholder's assignment by the product of the increase pursuant to paragraph (e)(2) of this section, reduced by the decreases pursuant to paragraph (e)(3) of this section, and a fraction. The numerator of the fraction is the connected covered shareholder's assigned portion of the covered item under paragraph (c)(1) of this section, and the denominator of the fraction is the aggregate of the assigned portion of the covered item under paragraph (c)(1) of this section of each connected covered shareholder described in the preceding sentence.

*(f) Currency rule.* For purposes of this section, if a covered item of a foreign corporation is denominated in a currency other than the foreign corporation's functional currency, then the covered item is translated into the foreign corporation's functional currency at the spot rate on the day on which the covered item is received or recognized.

*(g) Definitions and rules of general applicability.* The definitions in §§1.959-1(b) and 1.961-(b), and the rules of general applicability in §§1.959-1(c) and (d) and 1.961-1(c) and (d), apply for purposes of this section, with the following additions.

*Acquired stock.* The term *acquired stock* means, in a general successor transaction, stock of an acquired foreign corporation the ownership of which is acquired by the successor covered shareholder.

*Connected covered shareholder.* The term *connected covered shareholder* means, in a general successor transaction, a covered shareholder that owns acquired stock of an acquired foreign corporation on the last relevant day of the acquired foreign

corporation's taxable year in which the general successor transaction occurs, or any covered shareholder bearing a relationship described in section 267(b) (determined without regard to section 267(c)(3)) or 707(b) to a covered shareholder first described in this sentence.

*Covered item.* The term *covered item* has the meaning provided in paragraph (b) of this section.

(h) *Examples--(1) In general.* This paragraph (h) provides examples illustrating the application of this section.

(2) *Assumed facts.* For purposes of the examples in this paragraph (h), unless otherwise indicated, the following facts are assumed:

(i) US1 and US2 are unrelated domestic corporations that are covered shareholders. Neither US1 nor US2 is a member of a consolidated group (as defined in §1.1502-1(h)).

(ii) F1, F2, and F3 are foreign corporations, each of which is a controlled foreign corporation and uses the British pound (£) as its functional currency.

(iii) Each entity uses the calendar year as its taxable year, and no entity has a short taxable year.

(3) *Examples--(i) Example 1: General assignment rule and single class of stock--(A) Facts.* US1 and US2 each directly own 50% of the single class of outstanding stock of F1. F1 directly owns all the outstanding stock of each of F2 and F3. For F1's taxable year ending on December 31 of year 3, the last relevant day is December 31, and F1 has £500x of earnings and profits and two covered items. The covered items are a £60x covered distribution received from F2 and £40x of covered gain recognized with respect to stock of F3.

(B) *Analysis.* The portion of each covered item assigned to each of US1 and US2 is determined by multiplying the amount of the covered item by a fraction, the numerator of which is the portion of a £500x hypothetical distribution treated as made by F1 on the last relevant day that would be distributed with respect to stock of F1 that the covered shareholder owns (£250x in the case of each US1 and US2), and the denominator of which is the amount of the hypothetical distribution (£500x). See paragraphs (c)(1) and (d)(1) of this section; see *also* paragraph (d)(2) of this section (treating F1's hypothetical distribution as equal to the greater of £500x, F1's earnings and profits for the taxable year, and £100x, the sum of F1's covered items for the taxable year). Thus, US1 and US2 are each assigned £30x of the covered distribution

( $\text{£}60x \times \text{£}250x/\text{£}500x$ ) and  $\text{£}20x$  of the covered gain ( $\text{£}40x \times \text{£}250x/\text{£}500x$ ).

(C) *Alternative facts: common stock and preferred stock--(1) Facts.* The facts are the same as in paragraph (h)(3)(i)(A) of this section (*Example 1*), except as follows. The stock of F1 owned by US1 is an 8% nonparticipating, voting preferred share of stock with a par value of  $\text{£}1,000x$ , and the stock of F1 owned by US2 is common stock. There are no accrued but unpaid dividends with respect to the preferred stock.

(2) *Analysis.* The portion of each covered item assigned to each of US1 and US2 is determined by multiplying the amount of the covered item by a fraction, the numerator of which is the portion of a  $\text{£}500x$  hypothetical distribution treated as made by F1 on the last relevant day that would be distributed with respect to stock of F1 that the covered shareholder owns ( $\text{£}80x$  in the case of US1, computed as  $0.08 \times \text{£}1,000x$ , and  $\text{£}420x$  in the case of US2, computed as  $\text{£}500x - \text{£}80x$ ), and the denominator of which is the amount of the hypothetical distribution ( $\text{£}500x$ ). See paragraphs (c)(1) and (d) of this section. Thus, US1 is assigned  $\text{£}9.6x$  of the covered distribution ( $\text{£}60x \times \text{£}80x/\text{£}500x$ ) and  $\text{£}6.4x$  of the covered gain ( $\text{£}40x \times \text{£}80x/\text{£}500x$ ), and US2 is assigned  $\text{£}50.4x$  of the covered distribution ( $\text{£}60x \times \text{£}420x/\text{£}500x$ ) and  $\text{£}33.6x$  of the covered gain ( $\text{£}40x \times \text{£}420x/\text{£}500x$ ).

(ii) *Example 2: General successor transaction occurs before the last relevant day and after a covered distribution--(A) Facts.* US1 directly owns all the shares of the single class of outstanding stock of F1, and F1 directly owns all the outstanding stock of F2. On June 30 of year 3, US1 sells all the stock of F1 to US2 for money equal to the fair market value of the stock in a general successor transaction. For F1's taxable year ending on December 31 of year 3, the last relevant day is December 31, and F1 has  $\text{£}500x$  of earnings and profits and one covered item. The covered item is a  $\text{£}100x$  covered distribution received by F1 from F2 on March 31. Immediately before the covered distribution, F2 has  $\text{£}100x$  of previously taxed earnings and profits with respect to US1.

(B) *Analysis--(1) In general.* Without regard to paragraphs (c)(2) and (e) of this section (adjustments for general successor transactions), US2 would be assigned all  $\text{£}100x$  (and thus US1 would be assigned none) of the covered item because US2 owns all the stock of F1 on the last relevant day and therefore US2 would have a 100% share of a  $\text{£}500x$  hypothetical distribution treated as made by F1 on that day. See paragraphs (c)(1) and (d) of this section. However, because the sale is a general successor transaction occurring before the last relevant day but after F1 receives the covered item, the assignments to US1 (the transferor covered shareholder) and US2 (a connected covered shareholder by reason of owning acquired stock of F1 on the last relevant day) are adjusted. See paragraphs (c)(2) and (e)(1) of this section. The specific adjustments are described in paragraph (h)(3)(ii)(B)(2) of this section. As a result of these adjustments, the entirety of the covered item is a distribution to F1 of F2's previously taxed earnings and profits with respect to US1 under §1.959-4. Moreover, the previously taxed earnings and profits could be distributed by F1 to US1 before the sale and, to the extent not so distributed, are previously taxed earnings and profits of F1 that transfer from US1 to US2 in the sale under §1.959-7.

(2) *Adjustments.* US1's assigned portion of the covered item is increased by  $\text{£}100x$ , which is the additional portion of the covered item that would have been assigned to US1 under paragraph (c)(1) of this section if March 31 were the last relevant day (and, thus, F1's  $\text{£}500x$  hypothetical distribution were treated as made when

US1 owned all the stock of F1 and would therefore have a 100% share of the hypothetical distribution). See paragraph (e)(2)(i) of this section. In determining this increase, the first limitation in paragraph (e)(2)(iii) of this section does not apply because a £100x increase does not exceed the amount of F2's previously taxed earnings and profits with respect to US1 that could be applied to exclude such additional portion of the covered item from F1's gross income under section 959(b). In addition, the second limitation in paragraph (e)(2)(iii) of this section does not apply because a £100x increase does not exceed the amount of the covered item assigned to US2 under paragraph (c)(1) of this section. The £100x increase to US1's assigned portion of the covered item decreases US2's assigned portion of the covered item from £100x to £0. See paragraph (e)(3) of this section.

*(C) Alternative facts: limitation on increase and multiple connected covered shareholders--(1) Facts.* The facts are the same as in paragraph (h)(3)(ii)(A) of this section (*Example 2*), except as follows. Immediately before the £100x covered distribution on March 31, F2 has £90x (rather than £100x) of previously taxed earnings and profits with respect to US1. On September 30 of year 3, F1 issues shares of its single class of outstanding stock to US3, a corporate covered shareholder related to US2 within the meaning of section 267(b), with the result that US2 and US3 each own half of the stock of F1 on the last relevant day.

*(2) Analysis--(i) In general.* Without regard to paragraphs (c)(2) and (e) of this section (adjustments for general successor transactions), US2 and US3 would each be assigned £50x (and thus US1 would be assigned none) of the covered item because US2 and US3 each own half of the stock of F1 on the last relevant day and therefore would each have a 50% share of a £500x hypothetical distribution treated as made by F1 on that day. See paragraphs (c)(1) and (d) of this section. However, because the sale is a general successor transaction occurring before the last relevant day but after F1 receives the covered item, the assignments to US1 (the transferor covered shareholder), US2 (a connected covered shareholder by reason of owning acquired stock of F1 on the last relevant day), and US3 (a connected covered shareholder by reason of bearing a relationship described in section 267(b) to US2) are adjusted. See paragraphs (c)(2) and (e)(1) of this section. The specific adjustments are described in paragraph (h)(3)(ii)(C)(2)(ii) of this section. As a result of these adjustments, £90x of the covered item is a distribution to F1 of F2's previously taxed earnings and profits with respect to US1 under §1.959-4. Moreover, the previously taxed earnings and profits could be distributed by F1 to US1 before the sale and, to the extent not so distributed, are previously taxed earnings and profits of F1 that transfer from US1 to US2 in the sale under §1.959-7.

*(ii) Adjustments.* US1's assigned portion of the covered item is increased by £90x, which is the lesser of the additional portion of the covered item that would have been assigned to US1 if March 31 were the last relevant day (£100x) and the amount of F2's previously taxed earnings and profits with respect to US1 that could be applied to exclude such additional portion of the covered item from F1's gross income under section 959(b) (£90x). See paragraphs (e)(2)(i) and (iii) of this section. Because US2 owns acquired stock of F1 on the last relevant day, the £90x increase to US1's assigned portion of the covered item first decreases US2's assigned portion of the covered item, from £50x to £0. See paragraph (e)(3) of this section. Then, the remaining £40x increase to US1's assigned portion of the covered item decreases US3's assigned portion of the covered item, from £50x to £10x. See paragraph (e)(4) of this section.

(iii) *Example 3: General successor transaction occurs after the last relevant day--*

(A) *Facts.* US1 directly owns all 100 shares of the single class of outstanding stock of F1. F1 directly owns all the outstanding stock of F2. On March 31 of year 3, F1 issues 100 shares of its single class of outstanding stock to a nonresident alien individual and, consequently, F1 ceases to be a controlled foreign corporation. On June 30 of year 3, US1 sells its 100 shares of stock of F1 to US2 for money equal to the stock's fair market value in a general successor transaction. For F1's taxable year ending on December 31 of year 3, the last relevant day is March 31 and F1 has £500x of earnings and profits and one covered item. The covered item is a £100x covered distribution received by F1 from F2 on September 30. Immediately before the covered distribution, F2 has £50x of previously taxed earnings and profits with respect to US2 (all of which transferred from US1 to US2 in the Sale).

(B) *Analysis--(1) In general.* Without regard to paragraphs (c)(2) and (e) of this section (adjustments for general successor transactions), US2 would be assigned none of the covered item because US2 owns none of the stock of F1 on the last relevant day and therefore US2 would have a 0% share of a £500x hypothetical distribution treated as made by F1 on that day. See paragraphs (c)(1) and (d) of this section. However, because the sale is a general successor transaction occurring on or after the last relevant day but before F1 receives the covered item, the assignments to US2 (the successor covered shareholder) and US1 (a connected covered shareholder by reason of owning acquired stock of F1 on the last relevant day) are adjusted. See paragraphs (c)(2) and (e)(1) of this section. The specific adjustments are described in paragraph (h)(3)(iii)(B)(2) of this section. As a result of these adjustments, £50x of the covered item is a distribution to F1 of F2's previously taxed earnings and profits with respect to US2 under §1.959-4.

(2) *Adjustments.* US2's assigned portion of the covered item is increased by £50x, which is the additional portion of the covered item that would have been assigned to US2 under paragraph (c)(1) of this section if September 30 were the last relevant day (and, thus, F1's £500x hypothetical distribution were treated as made when US2 owned half of the stock of F1 and would therefore have a 50% share of the hypothetical distribution). See paragraph (e)(2)(ii) of this section. In determining this increase, the first limitation in paragraph (e)(2)(iii) of this section does not apply because a £50x increase does not exceed the amount of F2's previously taxed earnings and profits with respect to US2 that could be applied to exclude such additional portion of the covered item from F1's gross income under section 959(b). In addition, the second limitation in paragraph (e)(2)(iii) of this section does not apply because a £50x increase does not exceed the amount of the covered item assigned to US1 under paragraph (c)(1) of this section. The £50x increase to US2's assigned portion of the covered item decreases US1's assigned portion of the covered item by £50x. See paragraph (e)(3) of this section.

(i) *Applicability date.* This section applies to taxable years of foreign corporations that begin on or after [date of publication of final regulations in the **Federal Register**] or are early application years (as described in §1.959-12(d)) and to taxable years of persons for which such taxable years of those foreign corporations are relevant.

**Par. 13.** Section 1.951A-1 is amended by, for each paragraph listed in the following table, removing the language in the “Remove” column wherever it appears and adding in its place the language in the “Add” column:

<b>Paragraph</b>	<b>Remove</b>	<b>Add</b>
(d)(1)	§1.951-1(b) and (e)	§1.951-1(b) and (c)
(d)(1)	subpart F income	subpart F income not attributable to covered items
(d)(2)(i)	§1.951-1(b) and (e)	§1.951-1(b) and (c)
(d)(2)(i)	substituting “tested income” for “subpart F income” each place it appears, other than in §1.951-1(e)(1)(ii)(B) and the denominator of the fraction described in §1.951-1(b)(1)(ii)(A)	substituting “tested income” for “subpart F income” each place it appears in §1.951-1(b) other than in the denominator of the fraction described in §1.951-1(b)(1)(ii)(A), substituting “tested income of the foreign corporation” for “all subpart F income of the foreign corporation not attributable to covered items” in §1.951-1(c)(2)(iii), and substituting “such tested income” for “such subpart F income” in §1.951-1(c)(2)(iii)
(d)(3)(iii)	§1.951-1(e)(7)(vii)	§1.951-1(h)(1)(vii)
(d)(3)(iii)(A)(2)(i)	§1.951-1(e)(1)	§1.951-1(c)(2)(iii)
(d)(4)(i)	§1.951-1(b) and (e)	§1.951-1(b) and (c)
(d)(4)(i)(A)	substituted for “subpart F income” each place it appears	substituted for “subpart F income” each place it appears in §1.951-1(b) and (c), “tested loss of the foreign corporation” is substituted for “all subpart F income of the foreign corporation not attributable to covered items” in §1.951-1(c)(2)(iii), and “such tested loss” is substituted for “such subpart F income” in §1.951-1(c)(2)(iii)
(d)(4)(iv)	§1.951-1(e)(7)(viii)	§1.951-1(h)(1)(viii)

**Par. 14.** Section 1.951A-2 is amended by:

1. In paragraph (c)(1)(iv), removing the language “and”;
2. In paragraph (c)(1)(v), removing the period and adding the language “, and” in its place; and
3. Adding paragraph (c)(1)(vi).

The addition reads as follows:



## **§1.951A-2 Tested income and tested loss.**

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(vi) Previously taxed earnings and profits excluded from the corporation's gross income under section 959(b) and §1.959-4 or section 961(c) and §1.961-9.

\* \* \* \* \*

**Par. 15.** Section 1.951A-7 is amended by adding paragraph (f) to read as follows:

### **§1.951A-7 Applicability dates.**

\* \* \* \* \*

(f) *Pro rata share determinations and exclusions under sections 959(b) and 961(c).* Sections 1.951A-1(d) and 1.951A-2(c)(1)(vi) apply to taxable years of foreign corporations that begin on or after [date of publication of final regulations in the ***Federal Register***] or are early application years (as described in §1.959-12(d)) and to taxable years of persons for which such taxable years of those foreign corporations are relevant. See §1.951A-1(d) as contained in 26 CFR part 1 revised as of April 1, 2024, for a version of §1.951A-1(d) applicable to prior taxable years.

**Par. 16.** Section 1.952-1 is amended by adding paragraphs (c)(4), (c)(5), and (h) to read as follows:

### **§1.952-1 Subpart F income defined.**

\* \* \* \* \*

(c) \* \* \*

(4) *Coordination of earnings and profits limitation with sections 959(b) and 961(c)--(i) In general.* Distributions of previously taxed earnings and profits received by a controlled foreign corporation, and previously taxed earnings and profits resulting from

the application of a controlled foreign corporation's section 961(c) basis to gain recognized by the controlled foreign corporation, are not included in the controlled foreign corporation's earnings and profits for the taxable year for purposes of the limitation in section 952(c)(1)(A). See paragraph (h) of this section (regarding excluding previously taxed earnings and profits from a controlled foreign corporation's gross income for purposes of determining its subpart F income).

(ii) *Applicability date.* Paragraph (c)(4)(i) of this section applies to taxable years of foreign corporations that begin on or after [date of publication of final regulations in the ***Federal Register***] or are early application years (as described in §1.959-12(d)) and to taxable years of persons for which such taxable years of those foreign corporations are relevant.

(5) *Transition rule for deficits of a domestic partnership that was an inclusion shareholder with respect to a controlled foreign corporation--*(i) *In general.* For purposes of applying section 952(c)(1)(B) to any taxable year of a controlled foreign corporation, a United States shareholder that owns (within the meaning of section 958(a)) stock of the controlled foreign corporation by reason of an interest in a domestic partnership on the last day of the first taxable year of the controlled foreign corporation during which §1.958-1(d) applies to the domestic partnership (or, if earlier, the last day of such taxable year on which the foreign corporation is a controlled foreign corporation) (transition date) takes into account its assigned portion of any prior year deficit (determined under paragraph (c)(5)(ii) of this section) for any taxable year of the controlled foreign corporation ending before the application of §1.958-1(d) in determining the United States shareholder's pro rata share of a prior year deficit under section 952(c)(1)(B)(iv)(II), and the domestic partnership ceases to take into account such prior year deficit.

(ii) *Assigned portion of prior year deficit.* A United States shareholder's assigned

portion of a prior year deficit is determined on the transition date by multiplying a domestic partnership's pro rata share of the prior year deficit (determined under section 952(c)(1)(B)(iv)(II) as of the close of the taxable year in which the deficit arose) by a fraction, the numerator of which is the liquidation value of the United States shareholder's interest in the partnership and the denominator of which is the aggregate liquidation value of all partners' interests in the partnership. For purposes of this fraction, the liquidation value of a partner's interest in the partnership is the amount of cash the partner would receive with respect to the interest if, on the transition date, the partnership (and any partnership through which the partner indirectly owns an interest in the partnership) sold all of its property for an amount of cash equal to the fair market value of the property (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in §1.752-7), paid an unrelated third party to assume all of its §1.752-7 liabilities in a fully taxable transaction, and then the partnership (and any partnership through which the partner indirectly owns an interest in the partnership) liquidated.

(iii) *Applicability date.* This paragraph (c)(5) applies to taxable years of foreign corporations beginning on or after [date of publication of final regulations in the **Federal Register**], and to taxable years of United States shareholders in which or with which such taxable years of foreign corporation end. A United States shareholder may apply this paragraph (c)(5) to a taxable year of a foreign corporation that precedes the taxable years described in the preceding sentence if each of the following conditions is satisfied--

(A) *Consistent application condition.* This paragraph (c)(5) is applied in its entirety to the taxable year and all succeeding taxable years of the foreign corporation, to all taxable years of United States shareholders to which such a taxable year of the foreign corporation is relevant, and to all taxable years of related foreign corporations

that end on or after the later of the last day of the first taxable year of the foreign corporation to which this paragraph (c)(5) applies and the first day on which the foreign corporations are related. For purposes of the preceding sentence, foreign corporations are related if the foreign corporations bear a relationship to each other described in section 267(b).

(B) *Open period of limitations condition.* The period of limitations on assessment for each taxable year described in paragraph (c)(5)(iii)(A) of this section is open under section 6501.

(C) *Written consent condition.* Each United States shareholder described in paragraph (c)(5)(iii)(A) of this section provides to the foreign corporation a written statement in which the United States shareholder consents to apply the rules described in this paragraph (c)(5) to the taxable years of the United States shareholder described in paragraph (c)(5)(iii)(A) of this section and affirms that the period of limitations on assessment for each such taxable year is open under section 6501.

\* \* \* \* \*

(h) *Exclusions from gross income under sections 959(b) and 961(c).* See §§1.959-4 and 1.961-9 for rules excluding previously taxed earnings and profits from a controlled foreign corporation's gross income for purposes of determining its subpart F income.

**Par. 17.** Section 1.954-1 is amended by:

1. In paragraph (c)(1)(iii)(A), adding the language “or income from a covered item” immediately after the language “that is passive”; and
2. Adding paragraphs (c)(1)(iii)(C) and (h)(4).

The additions read as follows:

**§1.954-1 Foreign base company income.**

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(iii) \* \* \*

(C) *Covered items.* A single item of income is the portion of a covered item (as defined in §1.951-2(b)) that--

(1) Falls within a single category of foreign base company income described in paragraph (c)(1)(iii)(A)(1) or (2) of this section;

(2) Falls within a separate category (as defined in §1.904-5(a)(4)(v)); and

(3) In the case of any amount which constitutes passive foreign personal holding company income, falls within a single group of passive income under the grouping rules of §1.904-4(c)(3), (4), or (5).

\* \* \* \* \*

(h) \* \* \*

(4) *Paragraph (c)(1)(iii)(C) of this section.* Paragraph (c)(1)(iii)(C) of this section applies to taxable years of a foreign corporation that begin on or after [date of publication of final regulations in the ***Federal Register***] or are early application years (as described in §1.959-12(d)), and to taxable years of a United States shareholder of the foreign corporation in which or with which such taxable year of such foreign corporation ends.

**Par. 18.** Section 1.959-1 is revised to read as follows:

**§1.959-1 Overview, definitions, and rules of general applicability.**

(a) *Overview--(1) In general.* The section 959 regulations provide rules regarding previously taxed earnings and profits. This section sets forth definitions and rules of general applicability. Section 1.959-2 sets forth rules for shareholder-level and foreign corporation-level accounting of a foreign corporation's previously taxed earnings and profits. Section 1.959-3 provides the adjustments under section 959 to shareholder-

level accounts with respect to a foreign corporation. Section 1.959-4 provides rules for excluding previously taxed earnings and profits received in a distribution from gross income of a covered shareholder or controlled foreign corporation. Section 1.959-5 provides rules for excluding the portion of a section 956 amount that is allocated to previously taxed earnings and profits from gross income of a covered shareholder. Section 1.959-6 provides rules for allocating and apportioning current year taxes paid or accrued by a foreign corporation to its previously taxed earnings and profits. Section 1.959-7 provides rules for transferring previously taxed earnings and profits in a general successor transaction. Sections 1.959-8 through 1.959-9 are reserved. Section 1.959-10 provides examples illustrating the application of the section 959 regulations. Section 1.959-11 sets forth transition rules. Section 1.959-12 sets forth applicability dates. See §1.1502-59 for additional rules for a consolidated group.

(2) *Scope.* This section sets forth definitions and rules of general applicability for purposes of the section 959 regulations. Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules relating to S corporations. Paragraph (d) of this section provides an anti-avoidance rule.

(b) *Definitions.* The following definitions apply for purposes of the section 959 regulations.

*2019 notice provisions.* The term *2019 notice provisions* has the meaning provided in §1.959-12(c)(2).

*Acquired foreign corporation.* The term *acquired foreign corporation* has the meaning provided in §1.959-7(b).

*Adjusted applicable percentage.* The term *adjusted applicable percentage* has the meaning provided in §1.959-2(b)(2)(iii)(A).

*Annual PTEP account.* The term *annual PTEP account* means an account that is described in §1.959-2(b)(1) and tracks previously taxed earnings and profits.

*Character.* The term *character* means, with respect to previously taxed earnings and profits, the taxable year, section 904 category, PTEP group and, if applicable, PTEP subgroup to which the previously taxed earnings and profits relate, as well as, if applicable, the adjusted applicable percentage and section 965(c) deduction percentage with respect to the previously taxed earnings and profits.

*Controlled foreign corporation.* The term *controlled foreign corporation* has the meaning provided in section 957(a) (or, if applicable, section 957(b) or 953(c)(1)(B)).

*Corporate PTEP account.* The term *corporate PTEP account* has the meaning provided in §1.959-2(d)(1).

*Corporate PTEP tax pool.* The term *corporate PTEP tax pool* has the meaning provided in §1.959-2(d)(2).

*Covered distribution.* The term *covered distribution* has the meaning provided in §1.959-4(c).

*Covered gain.* The term *covered gain* has the meaning provided in §1.961-9(c).

*Covered shareholder.* The term *covered shareholder* means a United States person (as described in section 7701(a)(30)), other than a domestic partnership.

*Creditable PTEP tax group.* The term *creditable PTEP tax group* has the meaning provided in §1.959-2(b)(4)(ii).

*Current year taxes.* The term *current year taxes* has the meaning provided in §1.960-1(b)(4) except that “foreign corporation” is substituted for “controlled foreign corporation” and “the foreign corporation’s taxable year” is substituted for “current taxable year”.

*Deemed covered shareholder.* The term *deemed covered shareholder* has the meaning provided in §1.959-7(g).

*Dollar basis pool.* The term *dollar basis pool* means an account that is described in §1.959-2(b)(1) and that tracks the basis in U.S. dollars of previously taxed earnings

and profits.

*Domestic partnership.* The term *domestic partnership* has the meaning provided in section 7701(a)(2) and (4). See paragraph (c) of this section, providing that an S corporation is treated in the same manner as a domestic partnership.

*Early application corporation.* The term *early application corporation* has the meaning provided in §1.959-12(d)(1).

*Early application years.* The term *early application years* has the meaning provided in §1.959-12(d)(1).

*Foreign income taxes.* The term *foreign income taxes* has the meaning provided in §1.901-2(a).

*General successor PTEP.* The term *general successor PTEP* has the meaning provided in §1.959-7(c)(1).

*General successor transaction.* The term *general successor transaction* has the meaning provided in §1.959-7(b).

*GILTI inclusion amount.* The term *GILTI inclusion amount* has the meaning provided in §1.951A-1(c)(1) (or §1.1502-51(b) in the case of a member of a consolidated group, as defined in §1.1502-1(h)).

*Last relevant day.* The term *last relevant day* means the last day of a taxable year of a foreign corporation on which the foreign corporation is a controlled foreign corporation.

*Multi-year dollar basis account.* The term *multi-year dollar basis account* has the meaning provided in §1.959-11(b)(2)(ii)(B).

*Multi-year PTEP account.* The term *multi-year PTEP account* has the meaning provided in §1.959-11(b)(2)(ii)(A).

*Own.* The term *own* (or *ownership* or *owned*), when used with respect to stock of a foreign corporation, means to own the stock within the meaning of section 958(a) and



§1.958-1(a) (thus determined by treating a domestic partnership in the same manner as a foreign partnership pursuant to §1.958-1(d)). When used with respect to interests in a partnership, *own* (or *ownership* or *owned*) means to own the interests within the meaning of the preceding sentence, determined by treating the interests as stock of a foreign corporation.

*Previously taxed earnings and profits.* The term *previously taxed earnings and profits* means earnings and profits of a foreign corporation that are described in section 959(c)(1) or (2). See §1.959-2(b) and (d) for covered shareholder-level and foreign corporation-level accounting of previously taxed earnings and profits.

*Prior-law PTEP groups.* The term *prior-law PTEP groups* has the meaning provided in §1.959-11(c)(2)(iii).

*Prior-law PTEP group taxes.* The term *prior-law PTEP group taxes* has the meaning provided in §1.959-11(c)(2)(iii).

*PTEP group.* The term *PTEP group* means any of the groups listed in §1.959-2(b)(2)(i).

*PTEP realization event.* The term *PTEP realization event* has the meaning provided in §1.959-6(b).

*PTEP subgroup.* The term *PTEP subgroup* means any of the groups listed in §1.959-2(b)(2)(ii).

*PTEP tax pool.* The term *PTEP tax pool* means an account that is described in §1.959-2(b)(1) and that tracks the U.S. dollar amount of foreign income taxes associated with previously taxed earnings and profits.

*Relevant taxable year.* The term *relevant taxable year* has the meaning provided in §1.959-3(b).

*S corporation.* The term *S corporation* has the meaning provided in section 1361(a)(1). See paragraph (c) of this section, providing that an S corporation is treated

in the same manner as a domestic partnership.

*Same priority PTEP.* The term *same priority PTEP* has the meaning provided in §1.959-4(e)(5).

*Section 904 category.* The term *section 904 category* has the meaning provided in §1.960-1(b).

*Section 956 amount.* The term *section 956 amount* has the meaning provided in §1.959-5(c).

*Section 959 regulations.* The term *section 959 regulations* means the regulations in this part issued under section 959.

*Section 965(c) deduction percentage.* The term *section 965(c) deduction percentage* has the meaning provided in §1.959-2(b)(2)(iii)(B).

*Spot rate.* The term *spot rate* has the meaning provided in §1.988-1(d).

*Substituted basis property.* The term *substituted basis property* has the meaning provided in section 7701(a)(42).

*Successor covered shareholder.* The term *successor covered shareholder* has the meaning provided in §1.959-7(b).

*Subpart F income.* The term *subpart F income* has the meaning provided in section 952 and §1.952-1.

*Taxable year.* The term *taxable year* has the meaning provided in section 7701(a)(23), determined by treating a person (as described in section 7701(a)(1)) other than an individual that does not otherwise have a taxable year as computing taxable income on the basis of the calendar year.

*Tested income.* The term *tested income* has the meaning provided in section 951A(c)(2) and §1.951A-2(b)(1).

*Tested loss.* The term *tested loss* has the meaning provided in section 951A(c)(2) and §1.951A-2(b)(2).

*Transferor covered shareholder.* The term *transferor covered shareholder* has the meaning provided in §1.959-7(b).

*United States shareholder.* The term *United States shareholder* has the meaning provided in section 951(b) (or, if applicable, section 953(c)(1)(A)).

(c) *Treatment of an S corporation--(1) In general.* Except as provided in paragraph (c)(2) of this section, for purposes of the section 959 regulations, an S corporation is treated in the same manner as a domestic partnership, a reference to a domestic partnership includes an S corporation, and shareholders of an S corporation are treated as partners of such partnership. See section 1373(a). As applicable, the treatment of an S corporation and its shareholders under the preceding sentence is determined by replacing any partnership-specific provision with the equivalent provision for S corporations (for example, a reference to a partner's distributive share of a partnership's income refers to a shareholder's pro rata share of an S corporation's income).

(2) *Treatment as a covered shareholder for taxable years for which elective entity treatment applies for §1.958-1(d)(1) purposes.* See §1.959-11(d) for a rule treating an S corporation as a covered shareholder for any taxable year of the S corporation for which §1.958-1(d)(1) does not apply and §1.959-11(e) for a transition rule converting S corporation-level accounts (for example, annual PTEP accounts) to accounts of covered shareholders owning interests in the S corporation once the S corporation is no longer treated as a covered shareholder.

(d) *Anti-avoidance rule.* If a transaction, series of transactions, plan, or arrangement is engaged in with a principal purpose of avoiding the purposes of section 959 and the section 959 regulations, then appropriate adjustments are made, which may include adjustments to disregard the transaction, series of transactions, plan, or arrangement.

**Par. 19.** Section 1.959-2 is revised to read as follows:

**§1.959-2 Accounting of previously taxed earnings and profits.**

(a) *Scope.* This section sets forth rules for shareholder-level and foreign corporation-level accounting of a foreign corporation's previously taxed earnings and profits. Paragraph (b) of this section provides the shareholder-level accounting rules. Paragraph (c) of this section provides rules relating to combined pool elections for certain covered shareholder-level accounts. Paragraph (d) of this section provides the foreign corporation-level accounting rules.

(b) *Shareholder-level accounting--(1) In general.* A covered shareholder that owns stock of a foreign corporation must establish and maintain *annual PTEP accounts*, *dollar basis pools*, and *PTEP tax pools* with respect to the foreign corporation in accordance with this paragraph (b) and the adjustments prescribed in §1.959-3. The annual PTEP accounts track the foreign corporation's previously taxed earnings and profits with respect to the covered shareholder, the dollar basis pools track the basis in U.S. dollars of the previously taxed earnings and profits, and the PTEP tax pools track the U.S. dollar amount of any foreign income taxes associated with the previously taxed earnings and profits. See also §1.1502-59(c)(2), treating members of a consolidated group as a single covered shareholder for purposes of section 959.

(2) *Annual PTEP accounts--(i) In general.* Each annual PTEP account must relate to a single taxable year of the foreign corporation and a single section 904 category. In addition, previously taxed earnings and profits within each annual PTEP account must be maintained in the foreign corporation's functional currency and assigned to the PTEP groups identified in the following table.

**Table 1 to paragraph (b)(2)(i) of this section**

PTEP groups			
Section 959(c)(1) PTEP groups		Section 959(c)(2) PTEP groups	
Group	Description	Group	Description

<i>General section 959(c)(1) PTEP group</i>	Earnings and profits described in section 959(c)(1) and not described in another PTEP group	<i>Section 951(a)(1)(A) PTEP group</i>	Earnings and profits described in section 959(c)(2) and not described in another PTEP group
<i>Reclassified section 951A PTEP group</i>	Earnings and profits described in section 959(c)(1) and initially assigned to the section 951A PTEP group	<i>Section 951A PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 951A
<i>Reclassified section 245A(d) PTEP group</i>	Earnings and profits described in section 959(c)(1) and initially assigned to the section 245A(d) PTEP group	<i>Section 245A(d) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of an income inclusion to which section 245A(d) applies
<i>Reclassified section 965(a) PTEP group</i>	Earnings and profits described in section 959(c)(1) and initially assigned to the section 965(a) PTEP group	<i>Section 965(a) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 965(a)
<i>Reclassified section 965(b) PTEP group</i>	Earnings and profits described in section 959(c)(1) and initially assigned to the section 965(b) PTEP group	<i>Section 965(b) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 965(b)

(ii) *Subgroups--(A) In general.* To the extent required under §1.959-3(c), previously taxed earnings and profits assigned to a PTEP group within an annual PTEP account must be further assigned to the *taxable section 962 PTEP subgroup* or *taxable section 1411 subgroup*. These subgroups track previously taxed earnings and profits that will be includible in gross income under section 962(d) or includible in net investment income under section 1411(c) when distributed to the covered shareholder, as applicable.

(B) *Coordination rule.* A subgroup described in paragraph (b)(2)(ii)(A) of this section is not treated as a separate PTEP group for purposes of establishing and maintaining dollar basis pools and PTEP tax pools.

(iii) *Percentages with respect to section 965 previously taxed earnings and profits--(A) Adjusted applicable percentage.* An *adjusted applicable percentage* must be established and maintained with respect to all previously taxed earnings and profits assigned to the reclassified section 965(a) PTEP group, reclassified section 965(b) PTEP group, section 965(a) PTEP group, and section 965(b) PTEP group and relating to a single section 904 category (therefore without regard to the taxable years to which the previously taxed earnings and profits relate). The adjusted applicable percentage

tracks the percentage of a credit or deduction for foreign income taxes associated with previously taxed earnings and profits that is disallowed under §1.965-5. See §1.959-11(c)(3) for the initial determination of the adjusted applicable percentage and §1.959-3(c)(3) for adjustments.

(B) *Section 965(c) deduction percentage.* A section 965(c) deduction percentage must be established and maintained with respect to all previously taxed earnings and profits assigned to the reclassified section 965(a) PTEP group and section 965(a) PTEP group and relating to a single section 904 category (therefore without regard to the taxable years to which the previously taxed earnings and profits relate). The section 965(c) deduction percentage tracks the percentage of foreign currency gain or loss with respect to previously taxed earnings and profits that is not recognized under §1.986(c)-1. See §1.959-11(c)(4) for the initial determination of the section 965(c) deduction percentage and §1.959-3(c)(3) for adjustments.

(iv) *Deemed taxable years.* If previously taxed earnings and profits are distributed to an upper-tier foreign corporation or result from the application of section 961(c) basis to gain recognized by an upper-tier corporation, and the previously taxed earnings and profits relate to a taxable year of a lower-tier foreign corporation that includes one or more days on which the upper-tier foreign corporation did not exist, then, solely for purposes of the establishment and maintenance of annual PTEP accounts, the upper-tier corporation is treated as having the taxable year or taxable years it would have had if it were to have existed on those days, determined based on the manner in which it computes its taxable income for its initial taxable year.

(3) *Dollar basis pools.* Each dollar basis pool must relate to previously taxed earnings and profits assigned to a single PTEP group within a single annual PTEP account or, if a combined pool election applies to the covered shareholder, previously taxed earnings and profits assigned to a single PTEP group and relating to a single

section 904 category (therefore without regard to the taxable years to which the previously taxed earnings and profits relate). Basis within each dollar basis pool must be maintained in U.S. dollars.

(4) *PTEP tax pools*--(i) *In general.* Each PTEP tax pool must relate to previously taxed earnings and profits assigned to a single PTEP group within a single annual PTEP account or, if a combined pool election applies to the covered shareholder, previously taxed earnings and profits assigned to a single PTEP group and relating to a single section 904 category (therefore without regard to the taxable years to which the previously taxed earnings and profits relate). Foreign income taxes within each PTEP tax pool must be maintained in U.S. dollars.

(ii) *Creditable PTEP tax group.* To the extent required under §1.959-3(e), foreign income taxes within each PTEP tax pool must be assigned to the *creditable PTEP tax group*. This group tracks foreign income taxes that are eligible to be deemed paid under section 960(b).

(c) *Combined pool elections*--(1) *In general.* For purposes of paragraph (c) of this section, a combined pool election is made for a taxable year of a covered shareholder and, once made, remains in effect until revoked. The combined pool election applies with respect to each foreign corporation in which the covered shareholder owns stock, beginning as of the first day of the first taxable year of the foreign corporation that ends with or within the taxable year of the covered shareholder for which the combined pool election is made or, if later, the first day in which the covered shareholder owns stock of the foreign corporation.

(2) *Revocation.* A combined pool election may only be revoked with the consent of the Commissioner (and in the time and manner specified by the Commissioner), and such consent will be granted only in rare and unusual circumstances.

(3) *Time and manner of making election*--(i) *In general.* Except as otherwise

provided by a form, instruction, publication, or other guidance, a covered shareholder makes a combined pool election by, for a transaction related to a timely filed (including extensions) original Federal income tax return of the covered shareholder, computing the dollar basis of, or foreign income taxes associated with, previously taxed earnings and profits consistent with a combined pool election.

(ii) *Sixty-month limitation on a subsequent election.* A covered shareholder is not permitted to make a combined pool election for any taxable year beginning less than 60 months after the last day that a previous combined pool election applied to the covered shareholder (or a predecessor).

(4) *Converting to combined pools.* As of the beginning of the first day that a covered shareholder's combined pool election applies with respect to a foreign corporation, each of the covered shareholder's dollar basis pools or PTEP tax pools with respect to the foreign corporation (a *combined pool*) is equal to the sum of all of the dollar basis pools or PTEP tax pools, as applicable, that, immediately before the combined pool election applies, related to the same PTEP group and section 904 category to which the combined pool relates.

(d) *Foreign corporation-level accounting--(1) Corporate PTEP accounts.* *Corporate PTEP accounts* must be established and maintained with respect to a foreign corporation. Each corporate PTEP account must relate to a single covered shareholder, and previously taxed earnings and profits within a corporate PTEP account must be assigned to section 904 categories and the PTEP groups identified in the table to paragraph (b)(2)(i) of this section. A corporate PTEP account for a covered shareholder is equal to the aggregate of all previously taxed earnings and profits that are within such covered shareholder's annual PTEP accounts with respect to the foreign corporation. Thus, as a covered shareholder's annual PTEP accounts with respect to the foreign corporation are adjusted under §1.959-3, the foreign corporation's corporate



PTEP account for the covered shareholder and the foreign corporation's earnings and profits described in section 959(c)(1) or (c)(2) are also adjusted.

*(2) Corporate PTEP tax pools.* *Corporate PTEP tax pools* must be established and maintained by a foreign corporation. Each corporate PTEP tax pool must relate to a single covered shareholder, and foreign income taxes within a corporate PTEP tax pool must be assigned to section 904 categories and the PTEP groups identified in the table to paragraph (b)(2)(i) of this section. A corporate PTEP tax pool relating to a covered shareholder is equal to the aggregate of all foreign income taxes that are within that covered shareholder's PTEP tax pools with respect to the foreign corporation. Thus, as a covered shareholder's PTEP tax pools with respect to the foreign corporation are adjusted under §1.959-3, the foreign corporation's corporate PTEP tax pool relating to the covered shareholder is also adjusted. Foreign income taxes within a corporate PTEP tax pool that are eligible to be deemed paid under section 960(b) are assigned to the creditable PTEP tax group within the covered shareholder's PTEP tax pools.

*(3) Earnings and profits determined independently of previously taxed earnings and profits.* A foreign corporation's earnings and profits are determined independently of the foreign corporation's previously taxed earnings and profits. Thus, for example, the extent to which a distribution is made out of a foreign corporation's earnings and profits is determined independently of the foreign corporation's corporate PTEP accounts. See section 316. Similarly, a foreign corporation's earnings and profits may be less than the foreign corporation's previously taxed earnings and profits (with the result that the foreign corporation has a deficit in earnings and profits described in section 959(c)(3)).

**Par. 20.** Section 1.959-3 is revised to read as follows:

**§1.959-3 Adjustments to shareholder-level accounts.**

*(a) Scope.* This section provides the adjustments under section 959 to

shareholder-level accounts with respect to a foreign corporation. Paragraph (b) of this section provides the general rule, pursuant to which shareholder-level accounts (annual PTEP accounts, dollar basis pools, and PTEP tax pools) are adjusted with respect to a foreign corporation to reflect income inclusions relating to, and transactions occurring within, the foreign corporation's taxable year. Paragraph (c) of this section describes adjustments to annual PTEP accounts. Paragraph (d) of this section describes adjustments to dollar basis pools. Paragraph (e) of this section describes adjustments to PTEP tax pools. Paragraph (f) of this section provides timing rules for when adjustments are treated as made. Paragraph (g) of this section provides an ordering rule for the application of this section to tiered foreign corporations. See *also* §1.959-2(d)(1) and (2), providing that as shareholder-level accounts are adjusted with respect to a foreign corporation under this section, the foreign corporation-level accounts are consequently also adjusted.

(b) *In general.* To reflect income inclusions and transactions related to a taxable year of a foreign corporation (such taxable year for which this section is being applied, the *relevant taxable year*), a covered shareholder's annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to the foreign corporation must be adjusted in accordance with the rules in this section.

(c) *Adjustments to annual PTEP accounts--(1) In general--(i) Increases for amounts included in gross income under section 951(a)(1)(A).* If the foreign corporation is a controlled foreign corporation and the covered shareholder includes in gross income its pro rata share of the corporation's subpart F income for the relevant taxable year under section 951(a)(1)(A) (including by reason of section 245A(e)(2) or 964(e)(4), but not including an amount described in section 959(e)), then, for each annual PTEP account that relates to the relevant taxable year and a section 904 category to which a portion of the inclusion is assigned (determined at the level of the covered shareholder,

thus after the application of §1.904-4(c)), add an amount of previously taxed earnings and profits equal to such portion to the annual PTEP account. Assign such previously taxed earnings and profits to the section 951(a)(1)(A) PTEP group, except assign previously taxed earnings and profits to the section 245A(d) PTEP group to the extent section 245A(d) applies to the inclusion giving rise to the previously taxed earnings and profits (see sections 245A(e)(3) and 964(e)(4)). If applicable, further assign previously taxed earnings and profits to a PTEP subgroup in accordance with paragraph (c)(2) of this section.

(ii) *Increases for amounts included in gross income under section 951A(a).* If the foreign corporation is a controlled foreign corporation and the covered shareholder includes in gross income the portion of its GILTI inclusion amount that is treated as with respect to the corporation for the relevant taxable year under section 951A(a) and (f)(2), then, for each annual PTEP account that relates to the relevant taxable year and a section 904 category to which a portion of the inclusion is assigned (determined at the level of the covered shareholder, thus after the application of §1.904-4(c)), add an amount of previously taxed earnings and profits equal to such portion to the annual PTEP account. Assign such previously taxed earnings and profits to the section 951A PTEP group. If applicable, further assign previously taxed earnings and profits to a PTEP subgroup in accordance with paragraph (c)(2) of this section.

(iii) *Increases for receipt of distributed previously taxed earnings and profits.* If, during the relevant taxable year, previously taxed earnings and profits with respect to the covered shareholder are distributed to the foreign corporation in a covered distribution (determined under §1.959-4), then add such distributed previously taxed earnings and profits to the annual PTEP accounts in accordance with paragraph (c)(3) of this section.

(iv) *Increases for previously taxed earnings and profits resulting from section*

*961(c) basis.* If, during the relevant taxable year, previously taxed earnings and profits with respect to the covered shareholder result from the application of positive section 961(c) basis to covered gain recognized by the foreign corporation (determined under §1.961-9), then add such resulting previously taxed earnings and profits to the annual PTEP accounts in accordance with paragraph (c)(3) of this section.

(v) *Decreases for current year taxes.* If previously taxed earnings and profits are added to a PTEP group within an annual PTEP account pursuant to paragraph (c)(1)(iii) or (iv) of this section, then reduce the previously taxed earnings and profits in that PTEP group by the amount of the current year taxes allocated and apportioned under §1.959-6 to the corresponding PTEP group of the foreign corporation. The corresponding PTEP group of the foreign corporation is the PTEP group of the foreign corporation that is of the same type as the increased PTEP group and that is within a corporate PTEP account of the foreign corporation that is with respect to the covered shareholder. If the PTEP group of that type in multiple annual PTEP accounts increases pursuant to paragraph (c)(1)(iii) or (iv) of this section, apportion the amount of the current year taxes allocated and apportioned under §1.959-6 to the corresponding PTEP group of the foreign corporation among those increased PTEP groups under the principles of §1.861-20.

(vi) *Decreases for distributed previously taxed earnings and profits.* If, during the relevant taxable year, the foreign corporation distributes previously taxed earnings and profits with respect to the covered shareholder in a covered distribution (determined under §1.959-4), then remove such distributed previously taxed earnings and profits from the annual PTEP accounts.

(vii) *Increases for amounts included in gross income as a dividend under section 1248(a) or (f).* If, during the relevant taxable year, gain recognized by the covered shareholder is included in gross income as a dividend under section 1248(a) or (f) by

reason of earnings and profits of the foreign corporation, then, for each annual PTEP account that relates to the relevant taxable year and a section 904 category to which a portion of the inclusion is assigned (determined at the level of the covered shareholder, thus after the application of §1.904-4(c)), add an amount of previously taxed earnings and profits equal to such portion to the annual PTEP account (see section 959(e)). Assign such previously taxed earnings and profits to the section 951(a)(1)(A) PTEP group, except assign previously taxed earnings and profits to the section 245A(d) PTEP group to the extent section 245A(d) applies to the inclusion giving rise to the previously taxed earnings and profits (including by reason of section 245A(e)(3)). If applicable, further assign previously taxed earnings and profits to a PTEP subgroup in accordance with paragraph (c)(2) of this section.

(viii) *Decreases with respect to transferor covered shareholder for transferred previously taxed earnings and profits.* If, during the relevant taxable year, previously taxed earnings and profits of the foreign corporation transfer from the covered shareholder in a general successor transaction (determined under §1.959-7), then remove such transferred previously taxed earnings and profits from the annual PTEP accounts.

(ix) *Increases with respect to successor covered shareholder for transferred previously taxed earnings and profits.* If, during the relevant taxable year, previously taxed earnings and profits of the foreign corporation transfer to the covered shareholder in a general successor transaction (determined under §1.959-7), then add such transferred previously taxed earnings and profits to the annual PTEP accounts in accordance with paragraph (c)(3) of this section.

(x) *Reassignments for previously taxed earnings and profits to which a section 956 amount is allocated.* If the foreign corporation is a controlled foreign corporation and a portion of the covered shareholder's section 956 amount with respect to the

corporation for the relevant taxable year is allocated to previously taxed earnings and profits (determined under §1.959-5), then reassign such previously taxed earnings and profits from a section 959(c)(2) PTEP group to the section 959(c)(1) PTEP group in the same row in the table in §1.959-2(b)(2)(i). If applicable, further assign previously taxed earnings and profits to the PTEP subgroup to which they relate. See paragraph (c)(4) of this section in the case of certain acquisitions of stock to which a section 956 amount of another shareholder is attributable.

*(xi) Increases for amounts included in gross income under section 951(a)(1)(B).*

If the foreign corporation is a controlled foreign corporation and the covered shareholder includes in gross income a portion of its section 956 amount with respect to the corporation for the relevant taxable year under section 951(a)(1)(B), then, for each annual PTEP account that relates to the relevant taxable year and a section 904 category to which a portion of the inclusion is assigned (determined at the level of the covered shareholder, thus after the application of §1.904-4(c)), add an amount of previously taxed earnings and profits equal to such portion to the annual PTEP account. Assign such previously taxed earnings and profits to the general section 959(c)(1) PTEP group. If applicable, further assign previously taxed earnings and profits to a PTEP subgroup in accordance with paragraph (c)(2) of this section. See paragraph (c)(4) of this section in the case of certain acquisitions of stock to which a section 956 amount of another shareholder is attributable.

*(2) Assignment to PTEP subgroups--(i) Taxable section 962 PTEP subgroup.* If the covered shareholder is an individual and an election under §1.962-2 applies to the covered shareholder's income inclusions under section 951(a) or 951A(a) for the relevant taxable year, then further assign a portion of previously taxed earnings and profits added pursuant to paragraph (c)(1)(i), (ii), or (xi) of this section (section 951(a) or 951A(a) inclusions) to the taxable section 962 PTEP subgroup. The portion of

previously taxed earnings and profits assigned to the taxable section 962 PTEP subgroup is equal to the excess of the previously taxed earnings and profits over the income tax paid under this chapter on the income inclusions giving rise to the previously taxed earnings and profits (determined by translating such tax into the foreign corporation's functional currency at the exchange rate at which the income inclusion is translated into U.S. dollars under section 989(b)).

(ii) *Taxable section 1411 PTEP subgroup.* If the covered shareholder is an individual, estate, or trust, then further assign previously taxed earnings and profits added pursuant to paragraph (c)(1)(i), (ii), (vii), and (xi) of this section (section 951(a), 951A(a), or 1248(a) or (f) inclusions) to the taxable section 1411 PTEP subgroup to the extent the income inclusion giving rise to the previously taxed earnings and profits is not taken into account in determining net investment income under §1.1411-4(a)(1)(i).

(3) *Preserving the character of previously taxed earnings and profits--(i) In general.* Add previously taxed earnings and profits that are described in paragraph (c)(1)(iii), (iv), or (ix) of this section (previously taxed earnings and profits received in a distribution, resulting from section 961(c) basis, or transferred to the covered shareholder) and that relate to a single section 904 category and single taxable year to the annual PTEP account that relates to such section 904 category and such taxable year or a taxable year (including a deemed taxable year) that ends with, or closest to, the last day of such taxable year, as applicable. Assign the previously taxed earnings and profits to the PTEP group, and if applicable PTEP subgroup, to which they relate. See §1.959-4, 1.959-7, or 1.961-9 for rules determining the character of previously taxed earnings and profits received, transferred, or resulting from section 961(c) basis, respectively.

(ii) *Recalculate percentages with respect to section 965 previously taxed earnings and profits--(A) In general.* If applicable in adding previously taxed earnings

and profits described in paragraph (c)(1)(iii), (iv), or (ix) of this section (previously taxed earnings and profits received in a distribution, resulting from section 961(c) basis, or transferred to the covered shareholder) to annual PTEP accounts relating to the same section 904 category, recalculate an adjusted applicable percentage or section 965(c) deduction percentage with respect to relevant previously taxed earnings and profits within such annual PTEP accounts so that the percentage is a weighted average of--

(1) The adjusted applicable percentage or section 965(c) deduction percentage with respect to relevant previously taxed earnings and profits within the annual PTEP accounts immediately before the addition; and

(2) The adjusted applicable percentage or section 965(c) deduction percentage with respect to relevant previously taxed earnings and profits added to the annual PTEP accounts.

(B) *Determining the weighted average.* The weighted average is determined as the sum of the product of each percentage described in paragraph (c)(3)(ii)(A)(1) or (2) of this section and the amount of previously taxed earnings and profits described in that paragraph, divided by the sum of the amounts of previously taxed earnings and profits described in those paragraphs.

(4) *Certain acquisitions of stock to which a section 956 amount is attributable.* If the covered shareholder acquires ownership of stock of the foreign corporation during the relevant taxable year but on or after the last relevant day of the relevant taxable year (for example, in a general successor transaction), and a portion of a section 956 amount of a United States shareholder is attributable to such stock, then treat such portion of the section 956 amount and any inclusion thereof in gross income of the United States shareholder as being of the covered shareholder for purposes of paragraphs (c)(1)(x) and (xi) of this section.

(5) *Currency rule.* All adjustments to annual PTEP accounts are made in the



functional currency of the foreign corporation, determined, as applicable, by translating an inclusion described in paragraph (c)(1)(ii) of this section into functional currency at the average exchange rate for the relevant taxable year (see §1.951A-5(b)(3)) and by translating previously taxed earnings and profits described in paragraph (c)(1)(iii) of this section into functional currency at the spot rate on the day of the distribution (see section 989(b)). See also §1.961-9 (determining previously taxed earnings and profits described in paragraph (c)(1)(iv) of this section in functional currency), and §1.959-6 (determining current year taxes described in paragraph (c)(1)(v) of this section in functional currency).

*(d) Adjustments to dollar basis pools--(1) In general--(i) Increases for U.S. dollar amount of income inclusions under sections 951(a), 951A(a), and 1248(a) or (f).* For each addition pursuant to paragraph (c)(1)(i), (ii), (vii), or (xi) of this section of previously taxed earnings and profits relating to a single dollar basis pool, add an amount of basis equal to the income inclusion under section 951(a), 951A(a), or 1248(a) or (f) giving rise to such previously taxed earnings and profits to the dollar basis pool.

*(ii) Increases for dollar basis of received or resulting previously taxed earnings and profits.* For each addition pursuant to paragraph (c)(1)(iii) or (iv) of this section of previously taxed earnings and profits relating to a single dollar basis pool, add the dollar basis of such previously taxed earnings and profits (determined under §1.959-4 or 1.961-9, as applicable) to the dollar basis pool.

*(iii) Decreases for current year taxes.* For each reduction pursuant to paragraph (c)(1)(v) of this section to previously taxed earnings and profits relating to a single dollar basis pool, reduce the basis in the dollar basis pool by the amount of the current year taxes giving rise to the reduction.

*(iv) Decreases for dollar basis of distributed or transferred previously taxed earnings and profits.* For each removal pursuant to paragraph (c)(1)(vi) or (viii) of this

section of previously taxed earnings and profits relating to a single dollar basis pool, remove the dollar basis of such previously taxed earnings and profits (determined under §1.959-4 or 1.959-7, as applicable) from the dollar basis pool.

(v) *Increases for dollar basis of transferred previously taxed earnings and profits, adjusted for foreign currency gain or loss.* For each addition pursuant to paragraph (c)(1)(ix) of this section of previously taxed earnings and profits relating to a single dollar basis pool, add the dollar basis of such previously taxed earnings and profits (determined under §1.959-7 and adjusted in accordance with the next sentence) to the dollar basis pool. In applying the preceding sentence, increase (or decrease) the dollar basis of transferred previously taxed earnings and profits by foreign currency gain (or foreign currency loss) that the transferor covered shareholder recognizes with respect to the previously taxed earnings and profits. In addition, determine such foreign currency gain or loss without regard to §1.986-1(c)(3)(i) and (ii) (limitations for previously taxed earnings and profits resulting from section 965) and by treating the deemed covered shareholder in the same manner as a covered shareholder.

(vi) *Adjustments for dollar basis of previously taxed earnings and profits to which a section 956 amount is allocated.* For each reassignment pursuant to paragraph (c)(1)(x) of this section of previously taxed earnings and profits relating to a single dollar basis pool, remove the dollar basis of such previously taxed earnings and profits (determined under §1.959-5) from the dollar basis pool relating to the section 959(c)(2) PTEP group from which the previously taxed earnings and profits are reassigned and add such basis to the dollar basis pool relating to the section 959(c)(1) PTEP group to which the previously taxed earnings and profits are reassigned.

(2) *Currency rule.* All adjustments to dollar basis pools are made in U.S. dollars, determined, as applicable, by translating inclusions described in paragraph (d)(1)(i) of this section into U.S. dollars in accordance with section 989(b) and current year taxes

described in paragraph (d)(1)(iii) of this section into U.S. dollars in accordance with section 986(a) and §1.986(a)-1.

*(e) Adjustments to PTEP tax pools--(1) In general--(i) Increases for foreign income taxes associated with previously taxed earnings and profits received.* For each addition pursuant to paragraph (c)(1)(iii) of this section of previously taxed earnings and profits relating to a single PTEP tax pool, add the foreign income taxes that are associated with such previously taxed earnings and profits (determined under §1.959-4(g)) to the PTEP tax pool. Assign such associated foreign income taxes to the creditable PTEP tax group only to the extent the foreign corporation is deemed to pay the taxes under section 960(b)(2) and §1.960-3(c). See paragraph (e)(1)(ii) of this section for increases to PTEP tax pools for current year taxes paid or accrued by the foreign corporation on the receipt of the previously taxed earnings and profits.

*(ii) Increases for current year taxes.* For each reduction pursuant to paragraph (c)(1)(v) of this section to previously taxed earnings and profits relating to a single PTEP tax pool, add to the PTEP tax pool the current year taxes giving rise to the reduction. Assign such current year taxes to the creditable PTEP tax group only if the foreign corporation is a controlled foreign corporation when the taxes are paid or accrued and a credit for the taxes is not disallowed or suspended at the level of the controlled foreign corporation (*see, for example*, section 245A(e)(3) and §1.245A(d)-1(a)(2) and sections 901(k)(1), (l), and (m), 909, and 6038(c)(1)(B)).

*(iii) Decreases for foreign income taxes associated with distributed or transferred previously taxed earnings and profits.* For each removal pursuant to paragraph (c)(1)(vi) or (viii) of this section of previously taxed earnings and profits relating to a single PTEP tax pool, remove the foreign income taxes that are associated with such previously taxed earnings and profits (determined under §1.959-4 or 1.959-7, as applicable) from the PTEP tax pool.

(iv) *Increases for foreign income taxes associated with transferred previously taxed earnings and profits.* For each addition pursuant to paragraph (c)(1)(ix) of this section of previously taxed earnings and profits relating to a single PTEP tax pool, add the foreign income taxes that are associated with such previously taxed earnings and profits (determined under §1.959-7) to the PTEP tax pool. Assign such associated foreign income taxes to the creditable PTEP tax group only to the extent the taxes related to the creditable PTEP tax group immediately before the general successor transaction.

(v) *Adjustments for foreign income taxes associated with previously taxed earnings and profits to which a section 956 amount is allocated.* For each reassignment pursuant to paragraph (c)(1)(x) of this section of previously taxed earnings and profits relating to a single PTEP tax pool, remove the foreign income taxes that are associated with such previously taxed earnings and profits (determined under §1.959-5) from the PTEP tax pool relating to the section 959(c)(2) PTEP group from which the previously taxed earnings and profits are reassigned and add such foreign income taxes to the PTEP tax pool relating to the section 959(c)(1) PTEP group to which the previously taxed earnings and profits are reassigned. Assign such associated foreign income taxes to the creditable PTEP tax group only to the extent the taxes relate to the creditable PTEP tax group immediately before the reassignment.

(2) *Currency rule.* All adjustments to PTEP tax pools are made in U.S. dollars, determined, as applicable, by translating current year taxes described in paragraph (e)(1)(ii) of this section into U.S. dollars in accordance with section 986(a) and §1.986(a)-1.

(f) *Timing of adjustments--(1) Annual PTEP accounts.* An adjustment to an annual PTEP account is treated as made in accordance with the timing rules in the following table. In the case of adjustments described in paragraphs (c)(1)(iii) through

(xi) of this section that are treated as made at the same time, such adjustments are treated as made at that time in sequence (starting with the adjustment in the earliest paragraph).

**Table 1 to paragraph (f)(1) of this section**

**Timing of annual PTEP account adjustments**

<b>Adjustment described in this section</b>	<b>Description</b>	<b>When adjustment is treated as made</b>
Paragraph (c)(1)(i)	Increases for amounts included in gross income under section 951(a)(1)(A)	Beginning of the first day of the relevant taxable year
Paragraph (c)(1)(ii)	Increases for amounts included in gross income under section 951A(a)	
Paragraph (c)(1)(iii)	Increases for receipt of distributed previously taxed earnings and profits	
Paragraph (c)(1)(iv)	Increases for previously taxed earnings and profits resulting from section 961(c) basis	
Paragraph (c)(1)(v)	Decreases for current year taxes	
Paragraph (c)(1)(vi)	Decreases for distributed previously taxed earnings and profits	Concurrently with the covered distribution
Paragraph (c)(1)(vii)	Increases for amounts included in gross income as a dividend under section 1248	Concurrently with the sale or exchange
Paragraph (c)(1)(viii)	Decreases for transferred previously taxed earnings and profits	Concurrently with the general successor transaction
Paragraph (c)(1)(ix)	Increases for transferred previously taxed earnings and profits	
Paragraph (c)(1)(x)	Reassignments for previously taxed earnings and profits to which a section 956 amount is allocated	End of the last day of the relevant taxable year
Paragraph (c)(1)(xi)	Increases for amounts included in gross income under section 951(a)(1)(B)	

(2) *Dollar basis pools.* An adjustment to a dollar basis pool is treated as made concurrently with the related adjustment described in paragraph (c) of this section.

(3) *PTEP tax pools.* An adjustment to a PTEP tax pool is treated as made concurrently with the related adjustment described in paragraph (c) of this section.

(g) *Bottom-up application to tiered foreign corporations.* For purposes of applying this section to tiered foreign corporations, this section is applied first to the

foreign corporation at the lowest tier, then to the foreign corporation at the next lowest tier, and so on.

**Par. 21.** Section 1.959-4 is revised to read as follows:

**§1.959-4 Exclusion from gross income of previously taxed earnings and profits received in a distribution.**

(a) *Scope.* This section provides the rules for distributions of previously taxed earnings and profits under section 959. Paragraph (b) of this section excludes previously taxed earnings and profits received by a covered shareholder or controlled foreign corporation in a distribution from gross income. Paragraph (c) of this section defines a covered distribution. Paragraph (d) of this section describes rules for analyzing a covered distribution, including rules for determining the extent to which a covered distribution is a distribution of previously taxed earnings and profits. Paragraph (e) of this section provides rules for allocating covered distributions to earnings and profits. Paragraph (f) of this section provides a dollar basis rule. Paragraph (g) of this section provides an associated foreign income taxes rule. See §1.959-10(c)(1) and (2) (*Examples 1 and 2*) for examples illustrating the application of this section. See also §§1.367(b)-2(j)(2)(ii) and 1.367(b)-3(g)(1) for deemed distributions of previously taxed earnings and profits under other provisions of the Code.

(b) *Exclusion from gross income--(1) Distribution by a foreign corporation to a covered shareholder.* Previously taxed earnings and profits that are distributed to a covered shareholder, other than previously taxed earnings and profits relating to the taxable section 962 PTEP subgroup, are excluded from the covered shareholder's gross income.

(2) *Distribution by a controlled foreign corporation to another controlled foreign corporation--(i) In general.* Previously taxed earnings and profits that are distributed by a controlled foreign corporation to another controlled foreign corporation are excluded from the recipient controlled foreign corporation's gross income, solely for purposes of

determining the recipient controlled foreign corporation's subpart F income and tested income or tested loss, and provided that the covered shareholder to which the previously taxed earnings and profits relate is a United States shareholder in both controlled foreign corporations.

(ii) *Treatment of a specified foreign corporation as a controlled foreign corporation.* A specified foreign corporation (as defined in §1.965-1(f)(45)(i)(B)) that is not otherwise a controlled foreign corporation is treated as a controlled foreign corporation for purposes of applying paragraph (b)(2)(i) of this section to previously taxed earnings and profits resulting from the application of section 965 that are distributed by the specified foreign corporation.

(3) *Additional consequences.* Upon a distribution of previously taxed earnings and profits, see paragraph (d)(5) of this section for adjustments to previously taxed earnings and profits, §1.961-4 for basis adjustments, §1.986(c)-1 for recognition of foreign currency gain or loss if the distribution is to a covered shareholder, and §1.960-3 for deemed paid foreign income taxes if the distribution is to a United States shareholder that is a corporation or to a controlled foreign corporation. See *also* section 962(d) (previously taxed earnings and profits distributed to a covered shareholder and relating to the taxable section 962 PTEP subgroup are included in gross income); §1.1411-10(c)(1)(i)(A)(1) (previously taxed earnings and profits distributed to a covered shareholder and relating to the taxable section 1411 subgroup are included in net investment income).

(c) *Covered distribution--(1) In general.* A covered distribution is a distribution of property made by a foreign corporation to its shareholders with respect to its stock, to the extent that the distribution is a dividend (as defined in section 316), determined without regard to section 959(d), and not including an amount treated as a dividend by reason of section 78, 367(b), 964(e)(1), or 1248. In a covered distribution, previously

taxed earnings and profits are distributed in accordance with the rules described in paragraph (d) of this section.

(2) [Reserved]

(3) *Treatment of a partner's distributive share of a covered distribution.* For purposes of the section 959 regulations, if a portion of a covered distribution is made or is treated as made under this paragraph (c)(3) to a partnership, a partner's distributive share of such portion is treated as a portion of the covered distribution made to the partner.

(d) *Rules for analyzing a covered distribution--*(1) *Determine each covered shareholder's share of the covered distribution.* First, determine each covered shareholder's share of the covered distribution, computed as the sum of--

(i) Any portion of the covered distribution that is made to the covered shareholder, and

(ii) Any portions of the covered distribution that are made to upper-tier foreign corporations and assigned to the covered shareholder under §1.951-2.

(2) *Determine distributed previously taxed earnings and profits.* Second, determine the extent to which each covered shareholder's share of the covered distribution is a distribution of previously taxed earnings and profits in accordance with paragraph (e) of this section.

(3) *Determine dollar basis and associated foreign income taxes.* Third, determine the dollar basis of, and foreign income taxes associated with, distributed previously taxed earnings and profits in accordance with paragraphs (f) and (g) of this section.

(4) *Treat distributed previously taxed earnings and profits as distributed pro rata with respect to shares of stock of the foreign corporation.* Fourth, treat a pro rata portion of all previously taxed earnings and profits distributed in each covered



shareholder's share of the covered distribution as distributed with respect to each share of stock of the foreign corporation owned by the covered shareholder, determined by multiplying all such previously taxed earnings and profits by a fraction. The numerator of the fraction is the sum of any portion of the covered distribution that is made with respect to the share of stock to the covered shareholder and any portions of the covered distribution that are made with respect to the share of stock to upper-tier foreign corporations and assigned to the covered shareholder under §1.951-2. The denominator of the fraction is the amount of the covered shareholder's share of the covered distribution.

*(5) Adjust previously taxed earnings and profits and make related account adjustments.* Fifth, decrease the distributing foreign corporation's previously taxed earnings and profits, and if applicable increase a recipient foreign corporation's previously taxed earnings and profits, to reflect the covered distribution and make the related adjustments described in §1.959-3 to each covered shareholder's accounts.

*(e) Allocation of distributions--(1) In general.* A covered shareholder's share of a covered distribution (determined under paragraph (d)(1) of this section) is first allocated to previously taxed earnings and profits of the foreign corporation that are with respect to the covered shareholder immediately before the covered distribution (as reflected in the covered shareholder's annual PTEP accounts with respect to the foreign corporation), to the extent thereof and in accordance with paragraphs (e)(2) through (5) of this section. Any remaining portion of such share is allocated to the foreign corporation's earnings and profits described in section 959(c)(3).

*(2) Priority rules--(i) Section 959(c)(1) rule.* Allocate the covered shareholder's share of the covered distribution first to previously taxed earnings and profits assigned to a section 959(c)(1) PTEP group and then to previously taxed earnings and profits assigned to a section 959(c)(2) PTEP group.

(ii) *Rules within section 959(c)(1) PTEP groups.* In allocating the covered shareholder's share of the covered distribution to previously taxed earnings and profits assigned to section 959(c)(1) PTEP groups, allocate first to previously taxed earnings and profits assigned to the reclassified section 965(a) PTEP group, then to previously taxed earnings and profits assigned to the reclassified section 965(b) PTEP group, and finally to previously taxed earnings and profits assigned to the remaining section 959(c)(1) PTEP groups.

(iii) *Rules within section 959(c)(2) PTEP groups.* In allocating the covered shareholder's share of the covered distribution to previously taxed earnings and profits assigned to section 959(c)(2) PTEP groups, allocate first to previously taxed earnings and profits assigned to the section 965(a) PTEP group, then to previously taxed earnings and profits assigned to the section 965(b) PTEP group, and finally to previously taxed earnings and profits assigned to the remaining section 959(c)(2) PTEP groups.

(3) *Last-in, first-out rule.* In allocating the covered shareholder's share of the covered distribution to previously taxed earnings and profits assigned to a single PTEP group or PTEP groups with the same priority (for example, the section 951(a)(1)(A) PTEP group, section 951A PTEP group, and section 245A(d) PTEP group), allocate first to previously taxed earnings and profits that relate to the most recent taxable year, then to previously taxed earnings and profits that relate to the next most recent taxable year, and so on.

(4) *Section 962 ordering rule.* In allocating the covered shareholder's share of the covered distribution to previously taxed earnings and profits that are assigned to a single PTEP group or PTEP groups with the same priority and that relate to the same taxable year, allocate first to previously taxed earnings and profits that are not assigned to the taxable section 962 PTEP subgroup, and then to previously taxed earnings and

profits that are assigned to such subgroup.

(5) *Pro rata rule.* In allocating the covered shareholder's share of the covered distribution to previously taxed earnings and profits that are assigned to a single PTEP group or PTEP groups with the same priority and that relate to the same taxable year and have the same classification for section 962 purposes (*same priority PTEP*), allocate to a pro rata portion of same priority PTEP, determined by multiplying all same priority PTEP by a fraction, the numerator of which is the amount to be allocated to same priority PTEP, and the denominator of which is the amount of same priority PTEP.

(f) *Dollar basis rule.* The dollar basis of previously taxed earnings and profits distributed in a covered shareholder's share of a covered distribution (determined under paragraph (d)(2) of this section) is computed separately with respect to previously taxed earnings and profits relating to a single dollar basis pool, and in each case is equal to a pro rata portion of the dollar basis pool immediately before the covered distribution. The pro rata portion is determined by multiplying all basis in the dollar basis pool by a fraction, the numerator of which is previously taxed earnings and profits distributed in the covered shareholder's share of the covered distribution and relating to the dollar basis pool, and the denominator of which is all previously taxed earnings and profits relating to the dollar basis pool.

(g) *Associated foreign income taxes rule.* The foreign income taxes that are associated with previously taxed earnings and profits distributed in a covered shareholder's share of a covered distribution (determined under paragraph (d)(2) of this section) are computed separately with respect to previously taxed earnings and profits relating to a single PTEP tax pool, and in each case are equal to a pro rata portion of the PTEP tax pool immediately before the covered distribution. The pro rata portion is determined by multiplying all foreign income taxes in the PTEP tax pool by a fraction, the numerator of which is previously taxed earnings and profits distributed in the

covered shareholder's share of the covered distribution and relating to the PTEP tax pool, and the denominator of which is all previously taxed earnings and profits relating to the PTEP tax pool. Thus, associated foreign income taxes are sourced pro rata from foreign income taxes assigned to the creditable PTEP tax group in the PTEP tax pool and other foreign income taxes in the PTEP tax pool.

**Par. 22.** Sections 1.959-5 through 1.959-12 are added to read as follows:

Sec.

\* \* \* \* \*

1.959-5 Exclusion of a section 956 amount from gross income to the extent allocated to previously taxed earnings and profits.

1.959-6 Allocating and apportioning current year taxes to previously taxed earnings and profits of a foreign corporation.

1.959-7 General successor transactions.

1.959-8 and 1.959-9 [Reserved]

1.959-10 Examples.

1.959-11 Transition rules.

1.959-12 Applicability dates.

\* \* \* \* \*

**§1.959-5 Exclusion of a section 956 amount from gross income to the extent allocated to previously taxed earnings and profits.**

(a) *Scope.* This section provides rules for previously taxed earnings and profits to which a section 956 amount is allocated. Paragraph (b) of this section defines a section 956 amount. Paragraph (c) of this section describes rules for analyzing a section 956 amount, including rules for determining the extent to which a section 956 amount is excluded from gross income under section 959(a)(2). Paragraph (d) of this section provides rules for allocating a section 956 amount to previously taxed earnings and profits. Paragraph (e) of this section provides a dollar basis rule. Paragraph (f) of this section provides an associated foreign income taxes rule. See §1.959-10(c)(4) (*Example 4*) for an example illustrating the application of this section.

(b) *Section 956 amount.* A *section 956 amount* is the amount determined under section 956 and §1.956-1 with respect to a covered shareholder and a controlled foreign

corporation. A section 956 amount is excluded from gross income in accordance with the rules described in paragraph (c) of this section.

*(c) Rules for analyzing a section 956 amount--(1) Determine the portion of the section 956 amount excluded from gross income under section 959(a)(2).* First, the portion of the section 956 amount that it is allocated to section 959(c)(2) previously taxed earnings and profits, which is determined in accordance with paragraph (d) of this section, is excluded from the covered shareholder's gross income.

*(2) Determine dollar basis and associated foreign income taxes.* Second, determine the dollar basis of, and foreign income taxes associated with, previously taxed earnings and profits to which the section 956 amount is allocated in accordance with paragraphs (e) and (f) of this section.

*(3) Adjust previously taxed earnings and profits and make related account adjustments.* Third, reassign the controlled foreign corporation's previously taxed earnings and profits to which the section 956 amount is allocated from section 959(c)(2) PTEP groups to section 959(c)(1) PTEP groups, and if applicable increase the controlled foreign corporation's previously taxed earnings and profits assigned to the general section 959(c)(1) PTEP group by reason of section 951(a)(1)(B), to reflect the section 956 amount and make the related adjustments described in §1.959-3.

*(d) Allocation of section 956 amounts--(1) In general.* A covered shareholder's section 956 amount is first allocated to previously taxed earnings and profits of the controlled foreign corporation that are with respect to the covered shareholder and assigned to section 959(c)(2) PTEP groups (determined as described in paragraph (d)(2) of this section)), to the extent thereof and in accordance with the principles of §1.959-4(e)(2)(iii) through (5). Any remaining portion of the section 956 amount is allocated to the controlled foreign corporation's earnings and profits described in section 959(c)(3).

(2) *Determination of previously taxed earnings and profits.* In applying paragraph (d)(1) of this section, previously taxed earnings and profits are determined on the last relevant day of the controlled foreign corporation's taxable year to which the section 956 amount relates, but are reduced to the extent distributed during the taxable year, and are determined without regard to any transfer of previously taxed earnings and profits from the covered shareholder on (or after) the last relevant day of the taxable year.

(e) *Dollar basis rule.* The dollar basis of previously taxed earnings and profits to which a covered shareholder's section 956 amount is allocated (determined under paragraph (d)(1) of this section) is computed separately with respect to previously taxed earnings and profits relating to a single dollar basis pool, and in each case is equal to a pro rata portion of the dollar basis pool determined in the same manner as previously taxed earnings and profits are determined in paragraph (d)(2) of this section. The pro rata portion is determined by multiplying all basis in the dollar basis pool by a fraction, the numerator of which is previously taxed earnings and profits to which the section 956 amount is allocated and relating to the dollar basis pool, and the denominator of the which is all previously taxed earnings and profits relating to the dollar basis pool.

(f) *Associated foreign income taxes rule.* The foreign income taxes that are associated with previously taxed earnings and profits to which a covered shareholder's section 956 amount is allocated (determined under paragraph (d)(1) of this section) are computed separately with respect to previously taxed earnings and profits relating to a single PTEP tax pool, and in each case are equal to a pro rata portion of the PTEP tax pool determined in the same manner as previously taxed earnings and profits are determined in paragraph (d)(2) of this section. The pro rata portion is determined by multiplying all foreign income taxes in the PTEP tax pool by a fraction, the numerator of which is previously taxed earnings and profits to which the section 956 amount is allocated and relating to the PTEP tax pool, and the denominator of which is all

previously taxed earnings and profits relating to the PTEP tax pool. Thus, associated foreign income taxes are sourced pro rata from foreign income taxes assigned to the creditable PTEP tax group in the PTEP tax pool and other foreign income taxes in the PTEP tax pool.

**§1.959-6 Allocating and apportioning current year taxes to previously taxed earnings and profits of a foreign corporation.**

(a) *Scope.* This section provides rules for allocating and apportioning current year taxes for purposes of sections 959 and 960(b). Paragraph (b) of this section provides the general rule for determining which foreign income taxes paid or accrued by a foreign corporation may be allocated and apportioned to previously taxed earnings and profits. Paragraph (c) of this section provides rules for the application of §1.861-20 to allocate and apportion current year taxes among corporate PTEP accounts. Paragraph (d) of this section provides additional rules regarding the allocation and apportionment of deductions to previously taxed earnings and profits and a currency translation rule. See §1.959-10(c)(3) (*Example 3*) for an example illustrating the application of this section.

(b) *In general.* Current year taxes that a foreign corporation pays or accrues during its taxable year by reason of a PTEP realization event that occurs during the same taxable year are allocated and apportioned to the statutory groupings (as generally described in §1.861-8(a)(4)) of previously taxed earnings and profits of the foreign corporation and to the residual grouping in accordance with the rules of paragraph (c) of this section. For purposes of this section, the statutory groupings are the corporate PTEP accounts of the foreign corporation described in §1.959-2(d)(1). A *PTEP realization event* is an increase to the previously taxed earnings and profits of a foreign corporation by reason of its receipt of a covered distribution (as determined under §1.959-4) or the application of section 961(c) basis of the foreign corporation to covered gain (as determined under §1.961-9) during the taxable year, as determined

under §1.959-2(d)(1). Current year taxes that are paid or accrued with respect to a PTEP realization event that occurs in a different taxable year may not be allocated and apportioned to the corporate PTEP accounts of a foreign corporation. See §1.960-1(d)(3)(ii)(B) for rules regarding the assignment of foreign gross income to the statutory and residual groupings of income of a controlled foreign corporation when the controlled foreign corporation pays or accrues current year taxes with respect to a PTEP realization event that occurs in a different taxable year.

*(c) Rules for allocating and apportioning current year taxes to previously taxed earnings and profits.* Allocate and apportion current year taxes that a foreign corporation pays or accrues during its taxable year by reason of a PTEP realization event that occurs during the same taxable year (translated, if applicable, into the foreign corporation's functional currency as described in paragraph (d)(3) of this section) to its statutory groupings of previously taxed earnings and profits and to the residual grouping in accordance with the rules of §1.861-20. For this purpose, foreign gross income that a foreign corporation includes under foreign law by reason of a distribution that it receives, or by reason of its disposition of stock, is assigned to its statutory groupings of previously taxed earnings and profits by treating previously taxed earnings and profits arising from the distribution or disposition as included in the U.S. dividend amount or the U.S. capital gain amount, respectively, for purposes of applying §1.861-20(d)(1). For the definitions of U.S. dividend amount and U.S. capital gain amount, see §1.861-20(b).

*(d) Additional rules--(1) No deductions other than deductions for current year taxes paid or accrued with respect to a PTEP realization event that occurs in the same taxable year are allocated or apportioned to the statutory groupings of previously taxed earnings and profits of a foreign corporation.* No deductions of a foreign corporation, other than deductions for current year taxes that the foreign corporation pays or accrues during its taxable year with respect to a PTEP realization event that occurs in the same



taxable year, may be allocated or apportioned under section 861 to the statutory groupings of previously taxed earnings and profits of the foreign corporation.

(2) *Currency rule.* For purposes of this section, if current year taxes that a foreign corporation pays or accrues are denominated in a currency other than the foreign corporation's functional currency, then the current year taxes are translated into the foreign corporation's functional currency at the spot rate on the day on which the current year taxes are paid or accrued. See section 986(a) and §1.986(a)-1 for rules translating current year taxes into U.S. dollars.

### **§1.959-7 General successor transactions.**

(a) *Scope.* This section identifies certain transactions in which a foreign corporation's previously taxed earnings and profits with respect to a covered shareholder transfer to (and thus become previously taxed earnings and profits with respect to) another covered shareholder under section 959 (defined as general successor transactions) and provides rules for determining the previously taxed earnings and profits that transfer. Paragraph (b) of this section provides definitions. Paragraph (c) of this section describes rules for analyzing a general successor transaction, including rules for determining previously taxed earnings and profits that transfer in the general successor transaction. Paragraph (d) of this section describes a fraction determining the pro rata portion of certain previously taxed earnings and profits that transfer. Paragraph (e) of this section provides a dollar basis rule. Paragraph (f) of this section provides an associated foreign income taxes rule. Paragraph (g) of this section provides rules regarding the deemed covered shareholder. See §1.959-10(c)(5) (*Example 5*) for an example illustrating the application of this section. See *also* §§1.959-8 and 1.959-9, regarding the extent to which previously taxed earnings and profits transfer under section 959 in a transaction other than a general successor transaction.

(b) *General successor transaction*--(1) *In general.* A general successor transaction is any transaction in which a covered shareholder (the *successor covered shareholder*) acquires ownership of stock of one or more foreign corporations (each, an *acquired foreign corporation*) that, immediately before the transaction, is owned by another covered shareholder (the *transferor covered shareholder*), determined without regard to any portion of an acquisition of ownership of stock that results from a transaction described in paragraph (b)(2) of this section. In a general successor transaction, previously taxed earnings and profits of each acquired foreign corporation transfer from the transferor covered shareholder to the successor covered shareholder (and thus become with respect to the successor covered shareholder) in accordance with the rules described in paragraph (c) of this section.

(2) *Certain transactions.* A transaction is described in this paragraph (b)(2) if the transaction is--

- (i) An issuance of stock or a partnership interest,
- (ii) A redemption of stock (within the meaning of section 317(b)) or a liquidating distribution in redemption of a partnership interest, or
- (iii) 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.

(3) *Additional consequences.* Upon a general successor transaction, see §1.961-5 for basis adjustments and §1.986(c)-1 for recognition of foreign currency gain or loss by the transferor covered shareholder.

(c) *Rules for analyzing a general successor transaction*--(1) *Determine general successor PTEP*--(i) *In general.* First, determine *general successor PTEP*, which for each acquired foreign corporation is computed by multiplying all previously taxed earnings and profits of the acquired foreign corporation that are with respect to the

transferor covered shareholder immediately before the general successor transaction by the fraction computed in accordance with paragraph (d) of this section.

(ii) *Previously taxed earnings and profits not eligible to transfer if the general successor transaction is before the last relevant day.* In applying paragraph (c)(1)(i) of this section, if the general successor transaction is before the last relevant day of the acquired foreign corporation's taxable year that includes the general successor transaction, then do not take into account (and thus do not transfer to the successor covered shareholder) any previously taxed earnings and profits that result from an income inclusion of the transferor covered shareholder under section 951(a)(1)(A) or 951A(a) for such taxable year (as accounted for in adjusting annual PTEP accounts pursuant to §1.959-3(c)(1)(i) and (ii)). For example, if the successor covered shareholder acquires less than all of the transferor covered shareholder's stock of the acquired foreign corporation, and the transferor covered shareholder continues to own the retained stock on the last relevant day, then any previously taxed earnings and profits resulting from the transferor covered shareholder's income inclusions under section 951(a)(1)(A) and 951A for the acquired foreign corporation's taxable year do not transfer in the general successor transaction.

(2) *Determine section 959(e) successor PTEP.* Second, determine *section 959(e) successor PTEP*, which for each acquired foreign corporation is all the previously taxed earnings and profits of the acquired foreign corporation that, under section 959(e), result from the application of section 1248 to gain recognized by the transferor covered shareholder in the general successor transaction (as accounted for in adjusting annual PTEP accounts pursuant to §1.959-3(c)(1)(vii)).

(3) *Determine dollar basis and associated foreign income taxes.* Third, determine the dollar basis of, and foreign income taxes associated with, general successor PTEP and section 959(e) successor PTEP in accordance with paragraph (e)

of this section.

(4) *Transfer previously taxed earnings and profits and make related account adjustments.* Fourth, transfer general successor PTEP and section 959(e) successor PTEP from the transferor covered shareholder to the successor covered shareholder and make the related adjustments described in §1.959-3.

(d) *Fraction in determining general successor PTEP--(1) In general.* In determining general successor PTEP of an acquired foreign corporation, the fraction described in paragraph (c)(1)(i) of this section is computed as follows. The numerator of the fraction is the portion of the acquired foreign corporation's hypothetical distribution described in paragraph (d)(2) of this section that, under the principles of §1.951-1(e)(2) through (6), would be distributed with respect to the stock of the acquired foreign corporation the ownership of which is acquired by the successor covered shareholder in the general successor transaction. The denominator of the fraction is the amount of such hypothetical distribution. However, if the denominator of the fraction would be zero, then the fraction is considered to be zero.

(2) *Hypothetical distribution.* The hypothetical distribution described in this paragraph (d)(2) is a hypothetical distribution treated as made by the acquired foreign corporation with respect to stock of the acquired foreign corporation, immediately before the general successor transaction and in an amount equal to the acquired foreign corporation's previously taxed earnings and profits with respect to the transferor covered shareholder (determined as described in paragraph (c)(1) of this section). In the hypothetical distribution, stock of the acquired foreign corporation is taken into account only to the extent owned by the transferor covered shareholder immediately before the general successor transaction, and the earnings and profits of the acquired foreign corporation are treated as equal to the amount of the hypothetical distribution.

(e) *Dollar basis rule--(1) General successor PTEP.* The dollar basis of previously

taxed earnings and profits composing general successor PTEP (determined under paragraph (c)(1) of this section) is computed separately with respect to previously taxed earnings and profits relating to a single dollar basis pool, and in each case is equal to a pro rata portion of the dollar basis pool immediately before the general successor transaction. The pro rata portion is determined by multiplying all basis in the dollar basis pool by a fraction, the numerator of which is previously taxed earnings and profits composing general successor PTEP and relating to the dollar basis pool, and the denominator of which is all previously taxed earnings and profits relating to the dollar basis pool.

(2) *Section 959(e) successor PTEP.* The dollar basis of previously taxed earnings and profits composing section 959(e) successor PTEP (determined under paragraph (c)(2) of this section) is equal to the U.S. dollar amount of the income inclusion giving rise to the previously taxed earnings and profits (as accounted for in increasing dollar basis pools pursuant to §1.959-3(d)(1)(i)).

(f) *Associated foreign income taxes rule--(1) General successor PTEP.* The foreign income taxes that are associated with previously taxed earnings and profits composing general successor PTEP (determined under paragraph (c)(1) of this section) are computed separately with respect to previously taxed earnings and profits relating to a single PTEP tax pool, and in each case are equal to a pro rata portion of the PTEP tax pool immediately before the general successor transaction. The pro rata portion is determined by multiplying all foreign income taxes in the PTEP tax pool by a fraction, the numerator of which is previously taxed earnings and profits composing general successor PTEP and relating to the PTEP tax pool, and the denominator of which is all previously taxed earnings and profits relating to the PTEP tax pool. Thus, associated foreign income taxes are sourced pro rata from foreign income taxes assigned to the creditable PTEP tax group in the PTEP tax pool and other foreign income taxes in the

PTEP tax pool.

(2) *Section 959(e) successor PTEP.* The foreign income taxes associated with previously taxed earnings and profits composing section 959(e) successor PTEP (determined under paragraph (c)(2) of this section) are zero.

(g) *Deemed covered shareholder--(1) In general.* The *deemed covered shareholder* is a hypothetical person that is treated as owning all the stock of any foreign corporation that is not owned by a covered shareholder. For purposes of transferring previously taxed earnings and profits under section 959, the deemed covered shareholder is treated in the same manner as a covered shareholder and a reference to a covered shareholder includes the deemed covered shareholder. Thus, for example, if a covered shareholder sells stock of a foreign corporation to a nonresident alien individual, then the sale is a general successor transaction and previously taxed earnings and profits of the foreign corporation transfer from the seller covered shareholder to the deemed covered shareholder under this section. Moreover, if the individual subsequently sells stock of the foreign corporation to a covered shareholder, then previously taxed earnings and profits of the foreign corporation (adjusted consistent with §1.959-3, including to reflect distributions from the foreign corporation to the individual) transfer from the deemed covered shareholder to the buyer covered shareholder under this section.

(2) *Determining previously taxed earnings and profits that transfer from the deemed covered shareholder.* In a transaction in which previously taxed earnings and profits of a foreign corporation transfer from the deemed covered shareholder to a covered shareholder, the covered shareholder must use a reasonable method in determining the amount and character of the transferred previously taxed earnings and profits and in determining the foreign income taxes associated with the transferred previously taxed earnings and profits. Such method must take into account adjustments

to previously taxed earnings and profits with respect to the deemed covered shareholder that would have been made under §1.959-3 if the previously taxed earnings and profits were respect to a covered shareholder.

### **§§1.959-8 and 1.959-9 [Reserved]**

### **§1.959-10 Examples.**

(a) *In general.* This section provides examples that illustrate the application of §§1.959-1 through 1.959-9.

(b) *Assumed facts.* For purposes of the examples in this section, unless otherwise indicated, the following facts are assumed:

(1) US1 and US2 are unrelated domestic corporations that are covered shareholders, each of which uses the U.S. dollar as its functional currency and has a combined pool election in effect under §1.959-2(c). Neither US1 nor US2 is a member of a consolidated group (as defined in §1.1502-1(h)).

(2) F1 and F2 are foreign corporations, each of which is a controlled foreign corporation and uses the British pound (£) as its functional currency.

(3) PRS is a partnership.

(4) Each entity uses the calendar year as its taxable year, and no entity has a short taxable year.

(5) Tables depicting annual PTEP accounts, dollar basis pools, or PTEP tax pools do not depict accounts or PTEP groups with a balance of zero.

(c) *Examples--*(1) *Example 1: Exclusion from gross income of previously taxed earnings and profits distributed in a covered distribution--*(i) *Facts.* US1 directly owns all 100 shares of the single class of outstanding stock of F1. In year 3, F1 makes a £300x distribution of money with respect to its stock (£3x with respect to each share), and the entirety of this £300x is a covered distribution (a dividend as defined in section 316, determined without regard to section 959(d)). Immediately before the covered distribution, F1 has £180x of previously taxed earnings and profits with respect to US1, none of which is assigned to the taxable section 962 PTEP group. This example only analyzes the extent to which previously taxed earnings and profits are distributed and excluded from gross income under section 959. See paragraph (c)(2) of this section (*Example 2*) for an illustration of composition, dollar basis, and associated foreign income taxes of distributed previously taxed earnings and profits, along with foreign

currency gain or loss under section 986(c) and deemed paid taxes under section 960(b). See *also* §1.961-4 (basis reductions and gain recognition for distributions of previously taxed earnings and profits).

(ii) *Analysis*. For purposes of analyzing the covered distribution, US1's share of the covered distribution is the entire £300x because that amount of the covered distribution is made to US1. See §1.959-4(d)(1). Such share is allocated first to F1's previously taxed earnings and profits that are with respect to US1 immediately before the covered distribution (£180x) and then to F1's earnings and profits described in section 959(c)(3) and, therefore, is a distribution of £180x of previously taxed earnings and profits and £120x of earnings and profits described in section 959(c)(3). See §1.959-4(d)(2) and (e)(1). These previously taxed earnings and profits are treated as distributed pro rata with respect to the stock of F1 on which US1's share of the covered distribution is made. See §1.959-4(d)(4). Accordingly, £1.8x of previously taxed earnings and profits is treated as distributed with respect to each share of F1 stock, computed by multiplying the £180x distributed previously taxed earnings and profits by a fraction, the numerator of which is the portion of US1's share of the covered distribution that is made with respect to the share of F1 stock (£3x), and the denominator of which is the amount of US1's share of the covered distribution (£300x). See *id.* US1 excludes the £180x of previously taxed earnings and profits distributed to it from its gross income. See §1.959-4(b)(1); see *also* §1.312-8(c) (US1's receipt of previously taxed earnings and profits does not increase its earnings and profits).

(iii) *Alternative facts: split-ownership--(A) Facts*. The facts are the same as in paragraph (c)(1)(i) of this section (*Example 1*), except as follows. US1 owns all the outstanding stock of F2, and US1 directly owns 80%, and F2 directly owns 20%, of the stock of F1. Thus, US1 receives a £240x portion, and F2 receives a £60x portion, of the £300x covered distribution made by F1. Under §1.951-2, US1 is assigned the entirety of the £60x portion of the covered distribution received by F2.

(B) *Analysis*. For purposes of analyzing the covered distribution, US1's share of the covered distribution is the entire £300x, the sum of the portion of the covered distribution that is made to US1 (£240x) and the portion of the covered distribution that is made to F2 and assigned to US1 under §1.951-2 (£60x). See §1.959-4(d)(1). As is the case in paragraph (c)(1)(ii) of this section, such share is treated as a distribution of £1.8x of previously taxed earnings and profits with respect to each share of F1 stock (and F1's previously taxed earnings and profits with respect to US1 are reduced by the £180x of distributed previously taxed earnings and profits). Accordingly, US1 is treated as receiving £144x of previously taxed earnings and profits (£1.8x × 80 shares of F1 stock directly owned by US1) and F2 is treated as receiving £36x of previously taxed earnings and profits (£1.8x × 20 shares of F1 stock directly owned by F2). US1 excludes the £144x of previously taxed earnings and profits distributed to it from its gross income. See §1.959-4(b)(1). F2 excludes the £36x of previously taxed earnings distributed to it from its gross income, solely for purposes of determining its subpart F income and tested income or tested loss. See §1.959-4(b)(2)(i).

(iv) *Alternative facts: partnership-structure--(A) Facts*. The facts are the same as in paragraph (c)(1)(i) of this section (*Example 1*), except as follows. PRS directly owns all the stock of F1. US1 and US2, in the aggregate, directly own all the interests in PRS, and PRS's partnership agreement provides that US1 has a 60% share, and US2 has a 40% share, of any of PRS's items of income, gain, deduction, or loss. The covered distribution made by F1 is equal to £500x (£5x with respect to each share) and



thus gives rise to £500x of dividend income to PRS, of which US1 has a £300x distributive share (£500x × 60%) and US2 has a £200x distributive share (£500x × 40%). Immediately before the covered distribution, F1 has no previously taxed earnings and profits with respect to US2.

(B) *Analysis--(1) US1's share of the covered distribution.* US1 is treated as receiving £300x of the covered distribution, equal to its distributive share of the covered distribution. See §1.959-4(c)(3). Therefore, for purposes of analyzing the covered distribution, US1's share of the covered distribution is £300x (the amount of the covered distribution treated as made to US1). See §1.959-4(d)(1). For such share, the results are the same as in paragraph (c)(1)(ii) of this section.

(2) *US2's share of the covered distribution.* US2 is treated as receiving £200x of the covered distribution, equal to its distributive share of the covered distribution. See §1.959-4(c)(3). Therefore, for purposes of analyzing the covered distribution, US2's share of the covered distribution is £200x (the amount of the covered distribution treated as made to US2). See §1.959-4(d)(1). The entirety of such share is a distribution of earnings and profits described in section 959(c)(3) because F1 has no previously taxed earnings and profits with respect to US2. See §1.959-4(d)(2) and (e)(1). US2 excludes none of its £200x distributive share of the covered distribution from its gross income under section 959 because none of the covered distribution received by US2 is previously taxed earnings and profits.

(2) *Example 2: Composition, dollar basis, and associated foreign income taxes of distributed previously taxed earnings and profits--(i) Facts.* US1 directly owns all 100 shares of the single class of outstanding stock of F1. In year 8, F1 makes a £225x distribution of money with respect to its stock (£2.25x with respect to each share), and the entirety of this £225x is a covered distribution. On the day of the covered distribution, the spot rate is \$1:£0.4. Tables 1 through 3 in this paragraph (c)(2)(i) provide F1's previously taxed earnings and profits with respect to US1, determined immediately before the covered distribution and thus reflecting adjustments pursuant to §1.959-3 for US1's income inclusions under sections 951(a)(1)(A) and 951A (£80x and £70x, respectively) for F1's taxable year ending on December 31 of year 8. Some of the previously taxed earnings and profits are previously taxed earnings and profits that were distributed to F1 by other foreign corporations in earlier years. The adjusted applicable percentage with respect to previously taxed earnings and profits that resulted from section 965(a) or (b) and relate to the general category is 60%, and the section 965(c) deduction percentage with respect to previously taxed earnings and profits that resulted from 965(a) and relate to the general category is 60%.

**Table 1 to paragraph (c)(2)(i) of this section**

**US1'S ANNUAL PTEP ACCOUNTS WITH RESPECT TO F1**

	§904 Category						Total
Taxable Year	General Category			Passive Category	§951A Category		
	§965(a) PTEP group	§965(b) PTEP group	§951(a)(1)(A) PTEP group	§951(a)(1)(A) PTEP group	Reclassified §951A PTEP group	§951A PTEP group	
Year 8			£50x	£30x		£70x	£150x
Year 3					£65x	£10x	£75x
Year 1	£20x	£20x		£20x			£60x

**Table 2 to paragraph (c)(2)(i) of this section**

**US1'S DOLLAR BASIS POOLS WITH RESPECT TO F1 (COMBINED POOL ELECTION)**

§904 Category					
General Category			Passive Category	§951A Category	
<i>§965(a) PTEP group</i>	<i>§965(b) PTEP group</i>	<i>§951(a)(1)(A) PTEP group</i>	<i>§951(a)(1)(A) PTEP group</i>	<i>Reclassified §951A PTEP group</i>	<i>§951A PTEP group</i>
\$40x	\$40x	\$125x	\$115x	\$188.5x	\$204x

**Table 3 to paragraph (c)(2)(i) of this section**

**US1'S PTEP TAX POOLS WITH RESPECT TO F1 (COMBINED POOL ELECTION)**

	§904 Category					
	General Category			Passive Category	§951A Category	
	<i>§965(a) PTEP group</i>	<i>§965(b) PTEP group</i>	<i>§951(a)(1)(A) PTEP group</i>	<i>§951(a)(1)(A) PTEP group</i>	<i>Reclassified §951A PTEP group</i>	<i>§951A PTEP group</i>
<i>Creditable PTEP tax group</i>	\$10x	\$10x		\$6x	\$26x	\$4x
<i>Other taxes</i>				\$4x		

(ii) *Analysis--(A) Distributed previously taxed earnings and profits.* The entirety of US1's share of the covered distribution (£225x) is allocated to F1's previously taxed earnings and profits that are with respect to US1 immediately before the covered distribution because such previously taxed earnings and profits (£285x, computed as £150x + £75x + £60x, as set forth in table 1 in paragraph (c)(2)(i) of this section), are at least equal to such share. See §1.959-4(d)(2) and (e)(1). Specifically, US1's share of the covered distribution is allocated first to the £65x of previously taxed earnings and profits assigned to the reclassified section 951A PTEP group, second to the £20x of previously taxed earnings and profits assigned to the section 965(a) PTEP group, and third to the £20x of previously taxed earnings and profits assigned to the section 965(b) PTEP group. See §1.959-4(e)(2). The remaining portion of US1's share of the covered distribution (£120x, computed as £225x – £65x – £20x – £20x) is allocated pro rata to previously taxed earnings and profits that relate to year 8 and, therefore, is allocated to £40x of previously taxed earnings and profits assigned to the section 951(a)(1)(A) PTEP group and relating to year 8 and the general category (computed as £50x × £120x/£150x), £24x of previously taxed earnings and profits assigned to the section 951(a)(1)(A) PTEP group and relating to year 8 and the passive category (computed as £30x × £120x/£150x), and £56x of previously taxed earnings and profits assigned to the section 951A PTEP group and relating to year 8 and the section 951A category (computed as £70x × £120x/£150x). See §1.959-4(e)(3) and (e)(5). US1 excludes the £225x of previously taxed earnings and profits distributed to it from its gross income. See §1.959-4(b)(1); *see also* §1.961-4 (basis reductions and gain recognition for distributions of previously taxed earnings and profits).

(B) *Dollar basis and foreign currency gain or loss.* The dollar basis of previously taxed earnings and profits distributed in US1's share of the covered distribution (described in paragraph (c)(2)(ii)(A) of this section) is computed separately with respect to previously taxed earnings and profits relating to a single dollar basis pool, and in

each case is equal to a pro rata portion of the dollar basis pool immediately before the covered distribution (determined by multiplying all basis in the dollar basis pool by a fraction, the numerator of which is previously taxed earnings and profits distributed in the US1's share of the covered distribution and relating to the dollar basis pool, and the denominator of which is all previously taxed earnings and profits relating to the dollar basis pool). See §1.959-4(f). Under §1.986(c)-1, US1 recognizes foreign currency gain or loss with respect to previously taxed earnings and profits distributed to it, determined by translating the previously taxed earnings and profits into U.S. dollars using the spot rate on the day of the covered distribution and then subtracting from that U.S. dollar amount the dollar basis of the previously taxed earnings and profits. US1 does not recognize 60% (the section 965(c) deduction percentage) of the foreign currency gain or loss with respect to the previously taxed earnings and profits relating to the section 965(a) PTEP group. Table 1 in this paragraph (c)(2)(ii)(B) provides computations for dollar basis and foreign currency gain or loss with respect to each group of distributed previously taxed earnings and profits. Thus, US1 recognizes a total of \$8.8x of foreign currency gain and \$28.8x of foreign currency loss.

**Table 1 to paragraph (c)(2)(ii)(B) of this section**

**DOLLAR BASIS AND FOREIGN CURRENCY (FX) GAIN OR LOSS OF DISTRIBUTED PTEP**

		§904 Category					
Taxable Year		General Category			Passive Category	§951A Category	
		§965(a) PTEP group	§965(b) PTEP group	§951(a)(1)(A) PTEP group	§951(a)(1)(A) PTEP group	Reclassified §951A PTEP group	§951A PTEP group
Year 8	Distributed PTEP			£40x	£24x		£56x
	Dollar basis			\$100x (\$125x × £40x/£50x)	\$55.2x (\$115x × £24x/£50x)		\$142.8x (\$204x × £56x/£80x)
	FX gain or loss			\$0 (£40x × \$1/£0.4 – \$100x)	\$4.8x gain (£24x × \$1/£0.4 – \$55.2x)		\$2.8x loss (£56x × \$1/£0.4 – \$142.8x)
Year 3	Distributed PTEP					£65x	
	Dollar basis					\$188.5x (\$188.5x × £65x/£65x)	
	FX gain or loss					\$26x loss (£65x × \$1/£0.4 – \$188.5x)	
Year 1	Distributed PTEP	£20x	£20x				
	Dollar basis	\$40x (\$40x × £20x/£20x)	\$40x (\$40x × £20x/£20x)				
	FX gain or loss	\$4x gain ((£20x × \$1/£0.4 – \$40x) × (100% – 60%))	Not applicable				

(C) *Associated foreign income taxes.* The foreign income taxes that are associated with previously taxed earnings and profits distributed in US1's share of the covered distribution (described in paragraph (c)(2)(ii)(A) of this section) are computed separately with respect to previously taxed earnings and profits relating to a single PTEP tax pool, and in each case are equal to a pro rata portion of the PTEP tax pool immediately before the covered distribution (determined by multiplying all foreign

income taxes in the PTEP tax pool by a fraction, the numerator of which is previously taxed earnings and profits distributed in US1's share of the covered distribution and relating to the PTEP tax pool, and the denominator of which is all previously taxed earnings and profits relating to the PTEP tax pool). See §1.959-4(g). Table 1 in this paragraph (c)(2)(ii)(C) provides these computations (and refers to associated foreign income taxes sourced from the creditable PTEP tax group as "creditable taxes" and associated foreign income taxes not sourced from the creditable PTEP tax group as "other taxes").

**Table 1 to paragraph (c)(2)(ii)(C) of this section**

**ASSOCIATED FOREIGN INCOME TAXES OF DISTRIBUTED PTEP**

		§904 Category					
Taxable Year		General Category			Passive Category	§951A Category	
		§965(a) PTEP group	§965(b) PTEP group	§951(a)(1)(A) PTEP group	§951(a)(1)(A) PTEP group	Reclassified §951A PTEP group	§951A PTEP group
Year 8	Distributed PTEP			£40x	£24x		£56x
	Creditable taxes			\$0	\$2.9x (\$6x × £24x/£50x)		\$2.8x (\$4x × £56x/£80x)
	Other taxes				\$1.9x (\$4x × £24x/£50x)		
Year 3	Distributed PTEP					£65x	
	Creditable taxes					\$26x (\$26x × £65x/£65x)	
	Other taxes						
Year 1	Distributed PTEP	£20x	£20x				
	Creditable taxes	\$10x (\$10x × £20x/£20x)	\$10x (\$10x × £20x/£20x)				
	Other taxes						

(D) *Deemed paid taxes.* Under section 960(b), because F1 is a controlled foreign corporation in which US1 is a United States shareholder, US1 is deemed to pay the foreign income taxes properly attributable to previously taxed earnings and profits distributed to it, which are the foreign income taxes that are both associated with the previously taxed earnings and profits and sourced from the creditable PTEP tax group. See §1.960-3(b). Thus, US1 is deemed to pay \$51.7x of foreign income taxes (\$2.9x + \$2.8x + \$26x + \$10x + \$10x). Under §1.965-5(c), US1 is disallowed a credit for 60% (the adjusted applicable percentage) of the foreign income taxes deemed paid with respect to the previously taxed earnings and profits relating to the section 965(a) PTEP group or section 965(b) PTEP group, with the result that in each case US1 is disallowed a credit for \$6x of the foreign income taxes deemed paid with respect to each of those groups of previously taxed earnings and profits (\$10x × 60%).

(E) *Account adjustments.* To reflect the covered distribution, the distributed previously taxed earnings and profits, the dollar basis of the distributed previously taxed earnings and profits, and the foreign income taxes associated with the distributed

previously taxed earnings and profits are removed from US1's annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to F1. See §1.959-3(c)(1)(vi), (d)(1)(iv), and (e)(1)(iii). These adjustments are treated as made concurrently with the covered distribution. See §1.959-3(f). In addition, the distributed previously taxed earnings and profits, and the foreign income taxes associated with distributed previously taxed earnings and profits, are removed from F1's corporate PTEP accounts and corporate PTEP tax pools for US1, and these adjustments are also treated as made concurrently with the covered distribution. See §1.959-2(d).

(iii) *Alternative facts: distribution of built-in loss property--(A) Facts.* The facts are the same as in paragraph (c)(2)(i) of this section (*Example 2*), except that, in the covered distribution (which continues to be £225x), F1 distributes property other than money. At the time of the covered distribution, the fair market value of the property is £225x and F1's adjusted basis of the property is £250x. Thus, the covered distribution decreases F1's earnings and profits by £250x. See sections 301(b)(1) and 312(a)(3).

(B) *Analysis.* The results are the same as in paragraph (c)(2)(ii) of this section and thus the covered distribution decreases F1's previously taxed earnings and profits by £225x. The remainder of the £250x decrease to F1's earnings and profits under section 312(a)(3) is accounted for by decreasing (including below zero, if applicable) F1's earnings and profits described in section 959(c)(3) by £25x.

(iv) *Alternative facts: distribution to a foreign corporation--(A) Facts.* The facts are the same as in paragraph (c)(2)(i) of this section (*Example 2*), except as follows. US1 directly owns all the stock of F2, and F2 directly owns all 100 shares of the single class of stock of F1. Thus, F2 receives the entirety of the £225x covered distribution made by F1. Under §1.951-2, US1 is assigned the entirety of the £225x covered distribution received by F2.

(B) *Analysis.* The results are the same as described in paragraph (c)(2)(ii) of this section, except that F2 excludes the £225x of distributed previously taxed earnings and profits from its gross income in accordance with §1.959-4(b)(2), US1 does not recognize foreign currency gain or loss with respect to the distributed previously taxed earnings and profits in accordance with §1.986(c)-1(c), and F2 is deemed to pay the \$51.7x of foreign income taxes that are both associated with the distributed previously taxed earnings and profits and sourced from the creditable PTEP tax group in accordance with §1.960-3(c). In addition, the distributed previously taxed earnings and profits (£225x), the dollar basis of the distributed previously taxed earnings and profits (\$566.5x), and the foreign income taxes associated with the distributed previously taxed earnings and profits (\$51.7x + \$1.9x = \$53.6x) are added to US1's annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to F2. See §1.959-3(c)(1)(iii), (d)(1)(ii), and (e)(1)(i). Only the \$51.7x portion of the associated foreign income taxes that F2 is deemed to pay are assigned to the creditable PTEP tax group within US1's PTEP tax pools with respect to F2. See §1.959-3(e)(1)(i). These adjustments are treated as made at the beginning of F2's taxable year ending on December 31 of year 8. See §1.959-3(f). In addition, the distributed previously taxed earnings and profits, and the foreign income taxes associated with the distributed previously taxed earnings and profits, are added to F2's corporate PTEP accounts and corporate PTEP tax pools for US1, and these adjustments are also treated as made at the beginning of F2's taxable year ending on December 31 of year 8. See §1.959-2(d).

(3) *Example 3: Current year taxes imposed on a covered distribution--(i) Facts.*

US1 directly owns 60%, and US2 directly owns 40%, of the single class of outstanding stock of F2. F2 owns all the outstanding stock of F1. In year 3, F1 makes a £500x covered distribution to F2. Foreign withholding taxes of £75x (£500x × 15%) are paid on the covered distribution. F2 takes foreign income taxes into account when paid, the withholding taxes meet the definition of current year taxes for F2's taxable year ending on December 31 of year 3, and, other than pursuant to section 245A(d), no credits for taxes are disallowed or suspended at the level of F2. On the day of the covered distribution, the spot rate is \$1:£0.5. Under §1.959-4, the entirety of US1's £300x share of the covered distribution (£500x × 60%) is a distribution of F1's previously taxed earnings and profits with respect to US1, and none of US2's £200x share of the covered distribution (£500x × 40%) is a distribution of previously taxed earnings and profits. The distributed previously taxed earnings and profits consist of £120x of previously taxed earnings and profits assigned to the section 951(a)(1)(A) PTEP group and relating to year 2 and the passive category (*Character A PTEP*), £80x of previously taxed earnings and profits assigned to the section 245A(d) PTEP group and relating to year 2 and the passive category (*Character B PTEP*), £70x of previously taxed earnings and profits assigned to the section 951(a)(1)(A) PTEP group and relating to year 1 and the general category (*Character C PTEP*), and £30x of previously taxed earnings and profits assigned to the section 951(a)(1)(A) PTEP group and relating to year 1 and the passive category (*Character D PTEP*), as summarized in table 1 in this paragraph (c)(3)(i). This example only analyzes the allocation and apportionment of the current year taxes and related adjustments to previously taxed earnings and profits accounts. *See also* §1.959-4 (exclusion from gross income of previously taxed earnings and profits received in a distribution); §1.986(c)-1(c) (no foreign currency gain or loss recognized in distributions of previously taxed earnings and profits to a foreign corporation); §1.961-4 (basis reductions and gain recognition for distributions of previously taxed earnings and profits).

**Table 1 to paragraph (c)(3)(i) of this section**

DISTRIBUTED PTEP			
Taxable Year	§904 Category		
	General Category	Passive Category	
	§951(a)(1)(A) PTEP group	§951(a)(1)(A) PTEP group	§245A(d) PTEP group
Year 2		£120x (Character A)	£80x (Character B)
Year 1	£70x (Character C)	£30x (Character D)	

(ii) *Analysis--(A) In general.* As a result of the covered distribution, which is a PTEP realization event, F2 has £300x of previously taxed earnings and profits with respect to US1 and £0 of previously taxed earnings and profits with respect to US2. The foreign gross income that F2 includes by reason of its receipt of the covered distribution is assigned to the statutory groupings, which are described in §1.959-2(d)(1), and residual grouping by treating the previously taxed earnings and profits arising from such distribution as included in the U.S. dividend amount for purposes of §1.861-20(d)(1). *See* §1.959-6(c). The relevant statutory groupings are F2's corporate PTEP accounts that were increased by reason of its receipt of a covered distribution which was previously taxed earnings and profits with respect to US1 and the remaining portion of the covered distribution is assigned to the residual income grouping. *See id.* The £75x of current year taxes imposed on the covered distribution is allocated and

apportioned to the previously taxed earnings and profits (US1's share of the covered distribution) and the residual income grouping (US2's share of the covered distribution) pro rata, with the result that £45x ( $£75x \times £300x/£500x$ ) is allocated and apportioned to previously taxed earnings and profits arising from the covered distribution and the remaining £30 ( $£75x \times £200x/£500x$ ) is assigned to the residual income grouping. See *id.*

**(B) Allocation and apportionment of current year taxes among PTEP groups.**

The £45x of current year taxes allocated and apportioned to the previously taxed earnings and profits arising from the PTEP realization event with respect to US1 is further allocated and apportioned among the section 904 categories and PTEP groups within each corporate PTEP account that is increased by reason of F2's PTEP realization event. See §1.959-6(b) and (c). Accordingly, £18x of current year taxes is allocated and apportioned to Character A PTEP ( $£45x \times £120x/£300x$ ), £12x of current year taxes is allocated and apportioned to Character B PTEP ( $£45x \times £80x/£300x$ ), £10.5x of current year taxes is allocated and apportioned to Character C PTEP ( $£45x \times £70x/£300x$ ), and £4.5x of current year taxes is allocated and apportioned to Character D PTEP ( $£45x \times £30x/£300x$ ), each within F2's corporate PTEP account with respect to US1.

**(C) Account adjustments--(1) Shareholder-level accounts.** After the current year taxes are allocated and apportioned to the corporate PTEP accounts of F2 with respect to US1, the previously taxed earnings and profits in US1's PTEP groups within its annual PTEP accounts are reduced to reflect the current year taxes allocated and apportioned to the corresponding PTEP groups of F2. See §1.959-3(c)(1)(v). These adjustments are treated as made at the beginning of F2's taxable year ending on December 31 of year 3. See §1.959-3(f). Concurrently with this reduction, US1's dollar basis pools with respect to F2 are reduced by \$90x, the U.S. dollar amount of the reduction that reflects the current year taxes allocated and apportioned to the distributed previously taxed earnings and profits ( $£45x \times \$1/£0.5$ ), and \$90x of current year taxes is added to US1's PTEP tax pools with respect to F2. See §1.959-3(d)(1)(iii) and (d)(2), (e)(1)(ii) and (e)(2); see *also* section 986(a) and §1.986(a)-1 (translation of foreign income taxes into U.S. dollars). Tables 1 through 3 in this paragraph (c)(3)(ii)(C) summarize the adjustments to US1's accounts to reflect the current year taxes.

**Table 1 to paragraph (c)(3)(ii)(C)(1) of this section**

**US1'S ANNUAL PTEP ACCOUNTS WITH RESPECT TO F2 –  
ADJUSTMENTS FOR CURRENT YEAR TAXES**

Taxable Year	§904 Category		
	General Category	Passive Category	
	§951(a)(1)(A) PTEP group	§951(a)(1)(A) PTEP group	§245A(d) PTEP group
Year 2		£18x reduction	£12x reduction
Year 1	£10.5x reduction	£4.5x reduction	

**Table 2 to paragraph (c)(3)(ii)(C)(1) of this section**

**US1'S DOLLAR BASIS POOLS WITH RESPECT TO F2 (COMBINED POOL ELECTION) –  
ADJUSTMENTS FOR CURRENT YEAR TAXES**

§904 Category		
General Category	Passive Category	
§951(a)(1)(A) PTEP group	§951(a)(1)(A) PTEP group	§245A(d) PTEP group
\$21x reduction (£10.5x × \$1/£0.5)	\$45x reduction ((£18x + £4.5x) × \$1/£0.5)	\$24x reduction (£12x × \$1/£0.5)

**Table 3 to paragraph (c)(3)(ii)(C)(1) of this section**

**US1'S PTEP TAX POOLS WITH RESPECT TO F2 (COMBINED POOL ELECTION) –  
ADJUSTMENTS FOR CURRENT YEAR TAXES**

	§904 Category		
	General Category	Passive Category	
	§951(a)(1)(A) PTEP group	§951(a)(1)(A) PTEP group	§245A(d) PTEP group
Creditable PTEP tax group	\$21x increase (£10.5x × \$1/£0.5)	\$45x increase ((£18x + £4.5x) × \$1/£0.5)	
Other taxes			\$24x increase (£12x × \$1/£0.5)

(2) *Corporate-level accounts.* Concurrently with the adjustments described in paragraph (c)(3)(ii)(C)(1) of this section, the previously taxed earnings and profits in F2's corporate PTEP accounts for US1 are reduced by £45x and the foreign income taxes in F2's corporate PTEP tax pools for US1 are increased by \$90x. See §1.959-2(d).

(4) *Example 4: Section 956 amount--(i) Facts.* Individual A, a citizen of the United States, owns all the outstanding stock of F1 and does not make an election to apply the provisions of section 962 for any taxable year. For F1's taxable year ending on December 31 of year 3, the last relevant day is December 31 and Individual A's section 956 amount (amount determined under section 956 and §1.956-1) is £200x. At the beginning of the last relevant day, F1 has £125x of previously taxed earnings and profits with respect to Individual A, all of which relate to F1's taxable year ending on December 31 of year 1 and are assigned to section 959(c)(2) PTEP groups. On the last relevant day, F1 makes a £75x covered distribution to Individual A, the entirety of which is allocated to (and thus is a distribution of) F1's previously taxed earnings and profits with respect to Individual A under §1.959-4. This example only analyzes the extent to which the section 956 amount is allocated to previously taxed earnings and profits and excluded from gross income under section 959, along with related adjustments to annual PTEP accounts. See also §1.959-3(d) and (e) (related adjustments to dollar basis pools and PTEP tax pools).

(ii) *Analysis--(A) Allocation to previously taxed earnings and profits.* Individual A's section 956 amount is first allocated to F1's previously taxed earnings and profits that are with respect to Individual A and assigned to section 959(c)(2) PTEP groups on the last relevant day, but reduced to reflect the covered distribution (£50x, computed as £125x – £75x). See §1.959-5(c)(1) and (d). The £50x portion of the section 956 amount allocated to previously taxed earnings and profits is excluded from Individual A's gross income. See §1.959-5(c)(1). Under section 951(a)(1)(B), Individual A includes the remaining £150x of the section 956 amount (translated into U.S. dollars in accordance with section 989(b)) in its gross income.



(B) *Annual PTEP account adjustments.* To reflect the section 956 amount, the £50x of previously taxed earnings and profits to which the section 956 amount is allocated are reassigned from section 959(c)(2) PTEP groups to section 959(c)(1) PTEP groups within Individual A's annual PTEP accounts relating to F1's taxable year ending on December 31 of year 1, and then £150x of previously taxed earnings and profits are added to Individual A's annual PTEP accounts relating to F1's taxable year ending on December 31 of year 3, where they are assigned to the general section 959(c)(1) PTEP group. See §1.959-3(c)(1)(x) and (xi). These adjustments are treated as made at the end of the last day of F1's taxable year ending on December 31 of year 3. See §1.959-3(f)(1).

(5) *Example 5: General successor transaction--(i) Facts.* US1 directly owns all 100 shares of the single class of outstanding stock of F1. On June 30 of year 3, US1 sells 40 shares of stock of F1 to US2 for money equal to the fair market value of the shares. Section 304 does not apply to the sale. Immediately before the sale, F1 has £180x of previously taxed earnings and profits with respect to US1, none of which resulted from an income inclusion of US1 for F1's taxable year ending on December 31 of year 3 under section 951(a)(1)(A) or 951A(a) because F1 has no subpart F income or tested income for such taxable year. As a result of gain that US1 recognizes on the sale and includes in gross income as a dividend under section 1248(a) by reason of F1's earnings and profits described in section 959(c)(3), F1's previously taxed earnings and profits with respect to US1 are increased by £20x under section 959(e) and §1.959-3(c)(1)(vii), concurrently with the sale. This example only discusses the extent to which previously taxed earnings and profits transfer under section 959. See *also* §1.959-3 (related adjustments to annual PTEP accounts, dollar basis pools, and PTEP tax pools); §1.986(c)-1 (recognition of foreign currency gain or loss with respect to transferred previously taxed earnings and profits).

(ii) *Analysis--(A) In general.* The sale is a general successor transaction in which F1 is an acquired foreign corporation, US1 is the transferor covered shareholder, and US2 is the successor covered shareholder. See §1.959-7(b)(1). As described in paragraphs (c)(5)(ii)(B) and (C) of this section, there is £72x of general successor PTEP and £20x of section 959(e) successor PTEP. Such previously taxed earnings and profits transfer from US1 to US2, concurrently with the general successor transaction. See §1.959-3(f)(1).

(B) *General successor PTEP.* General successor PTEP is a pro rata portion of F1's previously taxed earnings and profits that are with respect to US1 immediately before the general successor transaction (£180x), determined by multiplying all such previously taxed earnings and profits by 40%, which is the percentage of a £180x hypothetical distribution treated as made by F1 immediately before the general successor transaction that would be distributed with respect to stock of F1 that US2 acquires in the general successor transaction. See §1.959-7(c)(1)(i) and (d). Thus, there is £72x of general successor PTEP, sourced pro rata from each PTEP group within each of US1's annual PTEP accounts with respect to F1. See *also* §1.959-7(e)(1) and (f)(1) (rules for determining the dollar basis and associated foreign income taxes of general successor PTEP).

(C) *Section 959(e) successor PTEP.* Section 959(e) successor PTEP is all £20x of F1's previously taxed earnings and profits with respect to US1 that, under section 959(e), result from the application of section 1248 to gain recognized by US1 in the general successor transaction. See §1.959-7(c)(2); see *also* §1.959-7(e)(2) and (f)(2)

(providing the dollar basis of section 959(e) successor PTEP, and providing that the foreign income taxes associated with section 959(e) successor PTEP is zero).

(iii) *Alternative facts: previously taxed earnings and profits not eligible to transfer--(A) Facts.* The facts are the same as in paragraph (c)(5)(i) of this section (*Example 5*), except as follows. F1 has £10x of subpart F income for its taxable year ending on December 31 of year 3 and thus US1 includes £6x ( $£10x \times 60\%$  of stock of F1 retained by US1) in its gross income for such taxable year under section 951(a)(1)(A). Consequently, F1 has an additional £6x of previously taxed earnings and profits with respect to US1 immediately before the sale.

(B) *Analysis.* The results are the same as described in paragraph (c)(5)(ii) of this section. None of the additional £6x of previously taxed earnings and profits transfer to US2 because the general successor transaction is before December 31 of year 3, the last relevant day of F1's taxable year that includes the general successor transaction. See §1.959-7(c)(1)(ii).

(iv) *Alternative facts: deemed covered shareholder--(A) Facts.* The facts are the same as in paragraph (c)(5)(i) of this section (*Example 5*), except that the purchaser of the shares of stock of F1 is a nonresident alien individual (Individual B).

(B) *Analysis.* The results are the same as described in paragraph (c)(5)(ii) of this section, applied by substituting *the deemed covered shareholder* (who is a hypothetical person treated as owning all the stock of F1 owned by Individual B) for US2. See §1.959-7(g). Thus, if a covered shareholder subsequently acquires a portion of Individual B's stock of F1, then a portion of F1's previously taxed earnings and profits with respect to the deemed covered shareholder (adjusted consistent with §1.959-3, including to reflect any distributions from F1 to Individual B) transfer from the deemed covered shareholder to the acquiror covered shareholder.

## **§1.959-11 Transition rules.**

(a) *Scope.* This section sets forth transition rules for the section 959 regulations. Paragraph (b) of this section addresses the establishment of annual PTEP accounts, dollar basis pools, and corporate PTEP accounts and provides for adjustments to reflect the transition tax under section 965. Paragraph (c) of this section addresses the establishment of PTEP tax pools, corporate PTEP tax pools, adjusted applicable percentages, and section 965(c) deduction percentages. Paragraph (d) of this section treats a domestic partnership (including an S corporation) as a covered shareholder for periods in which §1.958-1(d)(1) does not apply. Paragraph (e) converts accounts of a domestic partnership (including an S corporation) to accounts of covered shareholders owning interests in the domestic partnership when both §1.958-1(d)(1) and the section

959 regulations apply.

*(b) Establishing annual PTEP accounts, dollar basis pools, and corporate PTEP accounts and adjustments for section 965 transition tax--(1) In general.* When applying the 2019 notice provisions pursuant to §1.959-12(c) (interim application of 2019 notice provisions), or the section 959 regulations (other than §§1.959-8 and 1.959-9) pursuant to §1.959-12(d) (optional early application), to a taxable year of a foreign corporation, annual PTEP accounts, dollar basis pools, and corporate PTEP accounts are established and adjusted in accordance with the rules described in paragraphs (b)(2) and (3) of this section.

*(2) Establishment of accounts--(i) In general.* As of the beginning of the first taxable year of the foreign corporation to which the 2019 notice provisions apply, or, if earlier, the first taxable year of the foreign corporation to which the section 959 regulations (other than §§1.959-8 and 1.959-9) apply, a reasonable method (consistently applied) must be used to establish annual PTEP accounts, dollar basis pools, and corporate PTEP accounts reflecting the foreign corporation's previously taxed earnings and profits, including to reflect adjustments to previously taxed earnings and profits that would have been made if the principles of §§1.959-2 through 1.959-5 and 1.959-7 were to have previously applied. Establishing accounts in accordance with the preceding sentence includes conforming any of a covered shareholder's existing previously taxed earnings and profits accounts with respect to the foreign corporation, or dollar basis accounts with respect to the previously taxed earnings and profits, to the requirements of §1.959-2. In addition, a covered shareholder is treated as consistently applying a reasonable method only if the covered shareholder and any covered shareholders with which the covered shareholder joins in filing a Federal income tax return apply that method with respect to all foreign corporations in which the covered shareholders own stock.

(ii) *Multi-year accounts--(A) Previously taxed earnings and profits.* To the extent a covered shareholder has an account reflecting previously taxed earnings and profits of the foreign corporation that relate to two or more taxable years and are described in the next sentence (*multi-year PTEP account*), a reasonable method to conforming the multi-year PTEP account to the requirements of §1.959-2 includes treating such previously taxed earnings and profits as assigned to the general section 959(c)(1) PTEP group or the section 951(a)(1)(A) PTEP group (as applicable) within an annual PTEP account that relates to the last taxable year of the foreign corporation ending on or before December 31, 2017, and the section 904 category to which the multi-year PTEP account relates. Previously taxed earnings and profits are described in this sentence to the extent they are described in section 959(c)(1)(A) by reason of section 951(a)(1)(B) and not by reason of section 959(a)(2); described in section 959(c)(1)(B), including by reason of section 959(a)(3) (before its repeal); or described in section 959(c)(2) by reason of section 951(a)(1)(A) and without regard to section 965(a), 965(b)(4)(A), 951A(f)(2), 245A(e)(2), 959(e), or 964(e)(4).

(B) *Dollar basis.* To the extent a covered shareholder has an account reflecting the dollar basis of previously taxed earnings and profits of the foreign corporation that relate to two or more taxable years (*multi-year dollar basis account*), a reasonable method for conforming the multi-year dollar basis account to the requirements of §1.959-2 includes treating previously taxed earnings and profits to which the multi-year dollar basis account relates as having a dollar basis equal to a pro rata portion of the multi-year dollar basis account, and placing that dollar basis into the related dollar basis pool. The pro rata portion is determined by multiplying the multi-year dollar basis account by a fraction, the numerator of which is previously taxed earnings and profits to which the multi-year dollar basis account relates, and the denominator of which is all previously taxed earnings and profits to which the multi-year dollar basis account

relates.

*(3) Adjustments for section 965 transition tax--(i) Increases for amounts included in gross income under section 951(a)(1)(A) by reason of section 965(a).* When adding previously taxed earnings and profits to annual PTEP accounts to reflect an amount a covered shareholder includes in gross income under section 951(a)(1)(A) with respect to the foreign corporation by reason of section 965(a), assign such previously taxed earnings and profits to the section 965(a) PTEP group (rather than the section 951(a)(1)(A) PTEP group).

*(ii) Increases for section 965(b) reductions.* For purposes of adjusting annual PTEP accounts and dollar basis pools, treat an amount that a covered shareholder would have included in gross income under section 951(a)(1)(A) with respect to the foreign corporation but for section 965(b) and §1.965-1(b)(2) or 1.965-8(b), as applicable, as included in the covered shareholder's gross income under section 951(a)(1)(A) with respect to the foreign corporation, and assign previously taxed earnings and profits resulting from such treatment to the section 965(b) PTEP group (rather than the section 951(a)(1)(A) PTEP group).

*(c) Establishing PTEP tax pools, corporate PTEP tax pools, adjusted applicable percentages, and section 965(c) deduction percentages--(1) In general.* As of the beginning of the first taxable year of a foreign corporation to which the section 959 regulations (other than §§1.959-8 and 1.959-9) apply pursuant to §1.959-12(b) (general applicability date) or, if applicable, §1.959-12(d) (optional early application), PTEP tax pools, corporate PTEP tax pools, adjusted applicable percentages, and section 965(c) deduction percentages reflecting the foreign corporation's previously taxed earnings and profits must be established in accordance with the rules described in paragraphs (c)(2) through (4) of this section.

*(2) PTEP tax pools and corporate PTEP tax pools.* PTEP tax pools and

corporate PTEP tax pools are established by adding a pro rata portion of the foreign corporation's prior-law PTEP group taxes with respect to a prior-law PTEP group (defined in this paragraph (c)(2)) to each PTEP tax pool with respect to the foreign corporation, determined by multiplying such prior-law PTEP group taxes by a fraction. The numerator of the fraction is the balance of the prior-law PTEP group that is previously taxed earnings and profits relating to the PTEP tax pool, and the denominator of the fraction is the balance of the prior-law PTEP group. For purposes of this paragraph (c)(2), *prior-law PTEP group taxes* and *prior-law PTEP groups* mean PTEP group taxes and PTEP groups, respectively, as defined in §1.960-3 as contained in 26 CFR part 1 revised as of April 1, 2024.

(3) *Adjusted applicable percentage.* An adjusted applicable percentage is established with respect to all of the foreign corporation's previously taxed earnings and profits assigned to the reclassified section 965(a) PTEP group, reclassified section 965(b) PTEP group, section 965(a) PTEP group, and section 965(b) PTEP group within a covered shareholder's annual PTEP accounts relating to the same section 904 category by calculating a weighted average of the applicable percentages (as defined in §1.965-5(d)) with respect to the previously taxed earnings and profits. The weighted average is determined as the sum of the product of each such applicable percentage and the amount of previously taxed earnings and profits to which the applicable percentage relates, divided by the sum of the amount of previously taxed earnings and profits described in the preceding sentence. For purposes of this paragraph (c)(3), applicable percentages and previously taxed earnings and profits are determined as of the beginning of the taxable year.

(4) *Section 965(c) deduction percentage.* A section 965(c) deduction percentage is established with respect to all of the foreign corporation's previously taxed earnings and profits assigned to the reclassified section 965(a) PTEP group and section 965(a)

PTEP group within a covered shareholder's annual PTEP accounts relating to the same section 904 category by calculating a weighted average of the percentages for which foreign currency gain or loss recognized under section 986(c) with respect to distributions of the previously taxed earnings and profits would be reduced under §1.986(c)-1 as contained in 26 CFR part 1 revised as of April 1, 2024. The weighted average is determined as the sum of the product of each such percentage and the amount of previously taxed earnings and profits to which the percentage relates, divided by the sum of the amount of previously taxed earnings and profits described in the preceding sentence. For purposes of this paragraph (c)(4), percentages for which foreign currency gain or loss would be reduced under §1.986(c)-1 and previously taxed earnings and profits are determined as of the beginning of the taxable year.

*(d) Treatment of domestic partnerships (including S corporations) before application of §1.958-1(d)(1).* For purposes of the section 959 regulations, a domestic partnership (including an S corporation) is treated as a covered shareholder for any taxable year of the domestic partnership to which §1.958-1(d)(1) does not apply. If a domestic partnership is treated as a covered shareholder, then rules regarding distributions of previously taxed earnings and profits apply to the domestic partnership in its capacity as a covered shareholder before those rules apply to covered shareholders that own interests in the domestic partnership. In such a case, for example, a covered distribution made to the domestic partnership is first a distribution of the distributing foreign corporation's previously taxed earnings and profits with respect to the partnership and then, to the extent remaining, a distribution of the distributing foreign corporation's previously taxed earnings and profits with respect to covered shareholders owning interests in the partnership.

*(e) Converting domestic partnership-level (including S corporation-level) accounts to partner-level accounts after the application of §1.958-1(d)(1)--(1) In general.*

As of the beginning of the first taxable year of a domestic partnership (including an S corporation) to which both §1.958-1(d)(1) and the section 959 regulations (other than §§1.959-8 and 1.959-9) apply (pursuant to §1.959-12(c) (general applicability date) or (d) (optional early application)), the domestic partnership's accounts described in §1.959-2 with respect to a foreign corporation are converted to accounts of covered shareholders owning interests in the partnership in accordance with the rules described in paragraphs (e)(2) through (4) of this section.

*(2) Rules for converting accounts--(i) Allocate previously taxed earnings and profits to each covered shareholder--(A) In general.* First, allocate a pro rata portion of the foreign corporation's previously taxed earnings and profits with respect to the domestic partnership to each covered shareholder owning an interest in the partnership at the beginning of the taxable year, determined by multiplying all the foreign corporation's previously taxed earnings and profits with respect to the partnership by a fraction. The numerator of the fraction is the liquidation value of the covered shareholder's interest in the partnership, and the denominator of the fraction is the aggregate liquidation value of all partners' interests in the partnership (determined in each case under paragraph (e)(2)(i)(B) of this section).

*(B) Liquidation value.* For purposes of this paragraph (e)(2)(i), the liquidation value of a partner's interest in the partnership is the amount of cash the partner would receive with respect to the interest if, at the beginning of the taxable year, the partnership (and any partnership through which the partner indirectly owns an interest in the partnership) sold all of its property for an amount of cash equal to the fair market value of the property (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in §1.752-7), paid an unrelated third party to assume all of its §1.752-7 liabilities in a fully taxable transaction, and then the partnership (and any partnership through which the partner indirectly owns an interest in the partnership)



liquidated. Moreover, any change to a partnership agreement made with a principal purpose of altering the allocation of previously taxed earnings and profits under this paragraph (e)(2)(i) is disregarded.

(ii) *Compute dollar basis and associated foreign income taxes.* Second, treat the dollar basis of, or foreign income taxes associated with, previously taxed earnings and profits allocated to each covered shareholder as the same as what would be the dollar basis of, or foreign income taxes associated with, the previously taxed earnings and profits under §1.959-4 if the previously taxed earnings and profits were distributed at the beginning of the taxable year.

(iii) *Eliminate the domestic partnership's accounts and increase covered shareholders' accounts.* Third, eliminate the domestic partnership's annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to the foreign corporation. Concurrently with such eliminations, increase each covered shareholder's annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to the foreign corporation to reflect the foreign corporation's previously taxed earnings and profits that are allocated to the covered shareholder or the dollar basis of, or foreign income taxes associated with, the previously taxed earnings and profits, as applicable.

(3) *Coordination with section 986(c).* No foreign currency gain or loss is recognized with respect to previously taxed earnings and profits under section 986(c) as a result of previously taxed earnings and profits ceasing to be with respect to the domestic partnership pursuant to this paragraph (e) (notwithstanding §1.986(c)-1).

(4) *Coordination with deemed covered shareholder rules.* The portion, if any, of the foreign corporation's previously taxed earnings and profits with respect to the domestic partnership that does not give rise to an increase to a covered shareholder's annual PTEP accounts with respect to the foreign corporation under paragraph (e)(1) of this section becomes previously taxed earnings and profits of the foreign corporation

with respect to the deemed covered shareholder for purposes of subsequently transferring the previously taxed earnings and profits under section 959. See §1.959-7(g) for rules regarding the deemed covered shareholder.

**§1.959-12 Applicability dates.**

(a) *Scope.* This section sets forth applicability dates for the section 959 regulations. Paragraph (b) of this section provides the general applicability dates. Paragraph (c) of this section provides interim application for certain provisions. Paragraph (d) of this section allows early application.

(b) *In general.* Sections 1.959-1 through 1.959-7 and 1.959-10 and 1.959-11 apply to taxable years of foreign corporations beginning on or after [date of publication of final regulations in the ***Federal Register***] and to taxable years of persons for which such taxable years of those foreign corporations are relevant.

(c) *Interim application of 2019 notice provisions--(1) In general.* For taxable years of United States shareholders (and successors in interest) ending after December 14, 2018, and to which §§1.959-1 through 1.959-7 and 1.959-10 and 1.959-11 do not apply pursuant to paragraph (b) or (d) of this section, and taxable years of foreign corporations ending with or within such taxable years, the 2019 notice provisions (defined in paragraph (c)(2) of this section) and §1.959-11 apply.

(2) *2019 notice provisions.* The *2019 notice provisions* means §§1.959-1(c) (treatment of an S corporation), 1.959-2 (accounting of previously taxed earnings and profits), 1.959-3 (adjustments to shareholder-level accounts and, consequently, foreign corporation-level accounts), 1.959-4(e) and 1.959-5(d) (allocation of distributions and section 956 amounts), and the relevant definitions in §1.959-1(b), along with treating previously taxed earnings and profits as distributed under section 959 only to the extent that the distribution is a dividend (as defined in section 316), determined without regard to section 959(d). For purposes of applying the 2019 notice provisions, the PTEP

groups listed in the following table may be used in lieu of the PTEP groups listed in §1.959-2, the portions of §§1.959-2 and 1.959-3 relating to PTEP tax pools, corporate PTEP tax pools, adjusted applicable percentages, and section 965(c) deduction percentages do not apply, and the portions of §§1.959-3 through 1.959-5 and 1.959-7 relating to the timing of adjustments and determinations do not apply.

**Table 1 to paragraph (c)(2) of this section**

**2019 notice PTEP groups**

<b>Section 959(c)(1) PTEP groups</b>		<b>Section 959(c)(2) PTEP groups</b>	
<b>Group</b>	<b>Description</b>	<b>Group</b>	<b>Description</b>
<i>Reclassified section 965(a) PTEP group</i>	Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 965(a)	<i>Section 965(a) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 965(a)
<i>Reclassified section 965(b) PTEP group</i>	Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 965(b)(4)(A)	<i>Section 965(b) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 965(b)(4)(A)
<i>Section 951(a)(1)(B) PTEP group</i>	Earnings and profits described in section 959(c)(1)(A) by reason of section 951(a)(1)(B) and not by reason of section 959(a)(2)		
<i>Reclassified section 951A PTEP group</i>	Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 951A(f)(2)	<i>Section 951A PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 951A(f)(2)
<i>Reclassified section 245A(e)(2) PTEP group</i>	Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 245A(e)(2)	<i>Section 245A(e)(2) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 245A(e)(2)
<i>Reclassified section 959(e) PTEP group</i>	Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 959(e)	<i>Section 959(e) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 959(e)
<i>Reclassified section 964(e)(4) PTEP group</i>	Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 964(e)(4)	<i>Section 964(e) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 964(e)(4)
<i>Reclassified section 951(a)(1)(A) PTEP group</i>	Earnings and profits described in section 959(c)(1)(A) that were initially described in section 959(c)(2) by reason of section 951(a)(1)(A) and not described in another PTEP group	<i>Section 951(a)(1)(A) PTEP group</i>	Earnings and profits described in section 959(c)(2) by reason of section 951(a)(1)(A) and not described in another PTEP group

<i>Section 956A PTEP group</i>	Earnings and profits described in section 959(c)(1)(B), including by reason of section 959(a)(3) (before its repeal)		
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(d) *Early application--(1) In general.* Sections 1.959-1 through 1.959-7 and 1.959-10 and 1.959-11 may be applied to a taxable year of a foreign corporation not described in paragraph (b) of this section, and then must be applied to all succeeding taxable years of the foreign corporation not described in paragraph (b) of this section, if the conditions described in paragraphs (d)(2) through (4) of this section are satisfied. The foreign corporation described in the preceding sentence is the *early application corporation* and any taxable years to which the early application corporation applies §§1.959-1 through 1.959-7, 1.959-10, and 1.959-11 pursuant to the preceding sentence are the *early application years*.

(2) *Consistent application condition--(i) In general.* The provisions described in paragraph (d)(2)(ii) of this section are applied in their entirety to the early application years and all taxable years of covered shareholders for which the early application years are relevant. In addition, §§1.959-1 through 1.959-7, 1.959-10, and 1.959-11 are applied in their entirety pursuant to paragraph (d) of this section to all taxable years that both are of foreign corporations that are related to the early application corporation and end on or after the later of the last day of the first early application year and the first day on which the foreign corporations are related to the early application corporation. For purposes of the preceding sentence, foreign corporations are related if the foreign corporations bear a relationship to each other described in section 267(b).

(ii) *Provisions.* The provisions described in this paragraph (d)(2)(ii) are §§1.163(j)-7(g)(2)(ii), 1.245A(d)-1(d), 1.312-6(f), 1.312-8(c), 1.861-20, 1.904-6(e), 1.905-3, 1.905-4(c)(6), 1.951-1, 1.951-2, 1.951A-1(d), 1.951A-2(c)(1)(vi), 1.952-1(c)(4), 1.954-1(c)(1)(iii)(C), 1.959-1 through 1.959-7, 1.959-10, 1.959-11, 1.960-1, 1.960-3, 1.961-1 through 1.961-5, 1.961-8 through 1.961-13, 1.965-5(d)(5), 1.986(a)-1, 1.986(c)-

1, and 1.1502-59.

(3) *Open period of limitations condition.* The period of limitations on assessment for each taxable year described in paragraph (d)(2) of this section is open under section 6501.

(4) *Written consent condition.* Each covered shareholder described in paragraph (d)(2) of this section provides to the early application corporation a written statement in which the covered shareholder consents to apply the rules described in paragraph (d)(2) of this section to the taxable years of the covered shareholder described in paragraph (d)(2) of this section and affirms that the period of limitations on assessment for each such taxable year is open under section 6501.

**Par. 23.** Section 1.960-1 is amended by:

1. Revising paragraph (a)(1);
2. Revising paragraphs (b)(1) and (b)(3);
3. Removing paragraph (b)(12);
4. Redesignating paragraphs (b)(13) through (b)(16) as paragraphs (b)(12) through (b)(15), respectively;
5. Revising newly redesignated paragraph (b)(15);
6. Redesignating paragraph (b)(17) as paragraph (b)(16), and revising newly redesignated paragraph (b)(16);
7. Adding a new paragraph (b)(17);
8. Removing paragraphs (b)(18) through (b)(21);
9. Redesignating paragraphs (b)(22) through (b)(24) as paragraphs (b)(18) through (b)(20), respectively;
10. Removing paragraph (b)(25);
11. Redesignating paragraphs (b)(26) and (b)(27) as paragraphs (b)(21) and (b)(22), respectively, and revising newly redesignated paragraphs (b)(21) and

- (b)(22);
12. Removing paragraph (b)(28);
  13. Redesignating paragraphs (b)(29) through (b)(38) as paragraphs (b)(23) through (b)(32), respectively;
  14. Revising paragraphs (c)(1)(i) through (iii);
  15. In paragraph (c)(1)(iv), removing the language “§1.960-3(b)” and adding the language “§1.960-3” in its place;
  16. Removing paragraph (c)(1)(v);
  17. Redesignating paragraphs (c)(1)(vi) and (vii) as paragraphs (c)(1)(v) and (c)(1)(vi), respectively;
  18. Revising newly redesignated paragraphs (c)(1)(v) and (vi);
  19. Revising paragraph (c)(2);
  20. Revising paragraph (d)(1);
  21. Revising paragraphs (d)(2)(i) and (d)(2)(ii)(A) and (D);
  22. Revising the heading of paragraph (d)(3) and the introductory text of paragraph (d)(3)(i);
  23. Revising the last sentence of paragraph (d)(3)(i)(A) and the last two sentences of paragraph (d)(3)(ii)(A);
  24. Revising paragraph (d)(3)(ii)(B); and
  25. Revising paragraphs (e) and (f).

The additions and revisions read as follows:

**§1.960-1 Overview, definitions, and computational rules for determining foreign income taxes deemed paid under section 960(a), (b), and (d).**

(a) *Overview--(1) Scope of §§1.960-1 through 1.960-3.* This section and §1.960-2 provide rules for attributing foreign income taxes paid or accrued by a controlled foreign corporation to its income that a corporate United States shareholder of the controlled foreign corporation takes into account in determining its subpart F inclusion or

GILTI inclusion amount. This section provides definitions, identifies the statutory and residual groupings for purposes of section 960(a) and (d), and sets forth computational rules for determining the amount of income and taxes assigned to each grouping. Section 1.960-2 provides rules for computing the amount of foreign income taxes deemed paid by a corporate United States shareholder of a controlled foreign corporation under section 960(a) and (d). Section 1.960-3 provides rules for determining the foreign income taxes that are deemed paid by a corporate United States shareholder in a controlled foreign corporation, or by a controlled foreign corporation that is a shareholder in another controlled foreign corporation, under section 960(b). This section, §1.960-2, and §1.960-3 provide the exclusive rules for determining the foreign income taxes deemed paid by a domestic corporation or controlled foreign corporation under section 960. Only foreign income taxes paid or accrued by a controlled foreign corporation that are properly attributable under these rules to an item of income that a corporate United States shareholder of the controlled foreign corporation includes as a subpart F inclusion or GILTI inclusion amount may be deemed paid by the domestic corporation under section 960(a) or (d). Only foreign income taxes that are properly attributable under §1.960-3 to previously taxed earnings and profits that are distributed by a controlled foreign corporation may be deemed paid by a domestic corporation or a controlled foreign corporation under section 960(b). This section, §1.960-2, and §1.960-3 also apply for purposes of any provision that treats a taxpayer as a domestic corporation that is deemed to pay foreign income taxes or treats a foreign corporation as a controlled foreign corporation for purposes of section 960. See, for example, sections 962(a)(2) and 1293(f).

\* \* \* \* \*

(b) \* \* \*

(1) *Annual PTEP account.* The term *annual PTEP account* has the meaning

provided in §1.959-1(b).

\* \* \* \* \*

(3) *Current taxable year.* The term *current taxable year* means the U.S. taxable year of a controlled foreign corporation which ends with or within the U.S. taxable year of a United States shareholder of the controlled foreign corporation.

\* \* \* \* \*

(15) *Previously taxed earnings and profits.* The term previously taxed earnings and profits has the meaning provided in §1.959-1(b).

(16) *PTEP group.* The term *PTEP group* has the meaning provided in §1.959-1(b).

(17) *PTEP realization event.* The term *PTEP realization event* has the meaning provided in §1.959-1(b).

\* \* \* \* \*

(21) *Specified section 959(a) distribution.* The term *specified section 959(a) distribution* means a distribution of previously taxed earnings and profits, as determined under §1.959-4, that a domestic corporation that is a United States shareholder in a controlled foreign corporation receives (or is treated as receiving pursuant to §1.959-4(c)(3)) from the controlled foreign corporation and that is excluded from the income of the recipient domestic corporation under §1.959-4(b)(1).

(22) *Section 959(b) distribution.* The term *section 959(b) distribution* means a distribution of previously taxed earnings and profits, as determined under §1.959-4, that a controlled foreign corporation receives from another controlled foreign corporation and that is excluded from the income of the recipient controlled foreign corporation for purposes of determining the recipient controlled foreign corporation's subpart F income and tested income or tested loss under §1.959-4(b)(2).

\* \* \* \* \*



(c) \* \* \*

(1) \* \* \*

(i) First, items of gross income of a controlled foreign corporation for the current taxable year are assigned to section 904 categories and included in income groups within those section 904 categories under the rules in paragraph (d)(2) of this section. See section 959 and the regulations thereunder for rules regarding the receipt of a section 959(b) distribution by a controlled foreign corporation.

(ii) Second, deductions (other than for current year taxes) of a controlled foreign corporation for the current taxable year are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category. See paragraph (d)(3)(i) of this section. Additionally, the functional currency amounts of current year taxes are allocated and apportioned to reduce gross income in the section 904 categories and the income groups within a section 904 category. See paragraph (d)(3)(ii) of this section. For rules regarding the allocation and apportionment of foreign income taxes paid or accrued by a foreign corporation to previously taxed earnings and profits, see §1.959-6.

(iii) Third, for purposes of computing foreign income taxes deemed paid under section 960(a) and (d), eligible current year taxes that were allocated and apportioned to income groups in the section 904 categories are translated into U.S. dollars in accordance with section 986(a) and §1.986(a)-1.

\* \* \* \* \*

(v) Fifth, paragraphs (c)(1)(i) through (iv) of this section are repeated for each next higher-tier controlled foreign corporation in the chain.

(vi) Sixth, with respect to the highest-tier controlled foreign corporation in a chain that is owned directly (or indirectly through one or more partnerships) by the domestic corporation, foreign income taxes that are deemed paid under section 960(b)(1) in

connection with the receipt of a specified section 959(a) distribution by the domestic corporation are computed under the rules of §1.960-3.

(2) *Current taxable year items.* For a current taxable year, the items of income and deductions (including for taxes), and the U.S. dollar amounts of current year taxes, that are included in the computations described in this section are the items that a controlled foreign corporation accrues and takes into account during the current taxable year. An item of income with respect to a current taxable year does not include an amount included as subpart F income of a controlled foreign corporation by reason of the recharacterization of a recapture account established in a prior U.S. taxable year (and the corresponding earnings and profits) of the controlled foreign corporation under section 952(c)(2) and §1.952-1(f).

\* \* \* \* \*

(d) \* \* \*

(1) *Scope.* This paragraph (d) provides rules for assigning gross income (including gains) of a controlled foreign corporation for the current taxable year to a section 904 category and income group within a section 904 category, and for allocating and apportioning deductions (including losses and current year taxes) and the U.S. dollar amount of eligible current year taxes of the controlled foreign corporation for the current taxable year among the section 904 categories and income groups within a section 904 category. See §1.959-6 for rules for allocating and apportioning foreign income taxes paid or accrued by a foreign corporation to previously taxed earnings and profits.

(2) \* \* \*

(i) *Assigning items of gross income to section 904 categories.* Items of gross income of a controlled foreign corporation for the current taxable year are first assigned to a section 904 category of the controlled foreign corporation under §§1.904-4 and

1.904-5. Income of a controlled foreign corporation cannot be assigned to the section 951A category. See §1.904-4(g). *But see* §1.959-2(b)(2)(i) for rules relating to the assignment of previously taxed earnings and profits to PTEP groups within an annual PTEP account, which may assign previously taxed earnings and profits to the section 951A PTEP group.

(ii) \* \* \*

(A) *In general.* Gross income within a section 904 category is assigned to a subpart F income group, tested income group, or residual income group under the rules of this paragraph (d)(2)(ii). See §1.959-2(d) for rules regarding the accounting of previously taxed earnings and profits by a foreign corporation.

\* \* \* \* \*

(D) *Residual income group.* The term *residual income group* means the income group within a section 904 category that is not in a subpart F income group or tested income group. For purposes of this paragraph (d)(2)(ii)(D), treat items of gross income that give rise to previously taxed earnings and profits described in §1.959-6(b) as gross income in a residual income group. See paragraph (d)(3)(ii)(B) of this section for rules regarding the assignment of foreign gross income to the statutory and residual groupings of income of a controlled foreign corporation when the controlled foreign corporation pays or accrues current year taxes with respect to a PTEP realization event that occurs in a different taxable year.

\* \* \* \* \*

(3) *Allocation and apportionment of deductions among section 904 categories and income groups within a section 904 category--*(i) *In general.* Gross income of a controlled foreign corporation in each income group within each section 904 category is reduced by deductions (including losses and current year taxes) of the controlled foreign corporation for the current taxable year under the rules in this paragraph

(d)(3)(i). For purposes of this paragraph (d)(3), allocate and apportion current year taxes arising by reason of a PTEP realization event that occurs in the same taxable year to the residual income group within a section 904 category under §1.959-6(c). For additional rules regarding the allocation and apportionment of deductions (including foreign income taxes) paid or accrued by a foreign corporation to previously taxed earnings and profits, see §1.959-6.

(A) \* \* \* See paragraph (d)(3)(ii) of this section for special rules for allocating and apportioning current year taxes to section 904 categories and income groups.

\* \* \* \* \*

(ii) \* \* \*

(A) \* \* \* For special rules regarding current year taxes paid or accrued with respect to a PTEP realization event that occurs in a different taxable year, see paragraph (d)(3)(ii)(B) of this section. For purposes of determining foreign income taxes deemed paid under section 960(a) and (d) and §1.960-2, the U.S. dollar amount of eligible current year taxes is assigned to the section 904 categories and income groups to which the eligible current year taxes are allocated and apportioned.

(B) *Current year taxes that a controlled foreign corporation pays or accrues that relate to a PTEP realization event that occurs in a different U.S. taxable year.* If a current year tax is allocated and apportioned by reference to foreign gross income that includes previously taxed earnings and profits with respect to a PTEP realization event that occurs in a different taxable year, the foreign gross income is assigned to the subpart F income group, tested income group, or residual income group to which the income that gave rise to the previously taxed earnings and profits would be assigned if that income were recognized by that controlled foreign corporation under Federal income tax principles in the current taxable year. For example, a net basis tax paid or accrued with respect to a section 959(b) distribution that occurred in the preceding

taxable year would be assigned to a section 904 category and to a subpart F income group, tested income group, or residual income group by reference to the income that gave rise to the previously taxed earnings and profits.

(e) *Current year taxes related to a residual income group are not deemed paid.*

Current year taxes paid or accrued by a controlled foreign corporation that are allocated and apportioned under paragraph (d)(3)(ii) of this section to a residual income group cannot be deemed paid under section 960 for any taxable year, except to the extent such taxes are allocated and apportioned to previously taxed earnings and profits under §1.959-6 and deemed paid by a domestic corporation under §1.960-3.

(f) *Example.* The following example illustrates the application of this section and §1.960-3.

(1) *Facts--(i) CFC1 and CFC2.* CFC1, a controlled foreign corporation, conducts business in Country X. CFC1 uses the “u” as its functional currency. At all relevant times, 1u=\$1. CFC1 owns all the stock of CFC2, a controlled foreign corporation. All the stock of CFC1 and CFC2 is owned (within the meaning of section 958(a)) by corporate United States shareholders that use the calendar year as their U.S. taxable year. CFC1 and CFC2 both use the calendar year as their U.S. and foreign taxable years.

(ii) *Income of CFC1 and CFC2.* In Year 3, CFC1 earns 2,000,000u of gross income that is foreign base company sales income, and 1,000,000u of interest income from unrelated persons, for both U.S. and Country X tax law purposes. Under Country X tax law, CFC1’s interest income is exempt from tax. In Year 3, CFC1 also receives a section 959(b) distribution from CFC2 of 4,000,000u of previously taxed earnings and profits, in the general category and relating to a single PTEP group and taxable year. There are no foreign income taxes associated with the previously taxed earnings and profits distributed by CFC2 at the level of CFC2 under §1.959-4. The section 959(b) distribution is treated as a dividend taxable to CFC1 under Country X tax law. In Year 3, CFC2 earns no gross income and receives no distributions.

(iii) *Deductions of CFC1 and CFC2 other than taxes.* For both U.S. and Country X tax purposes, in Year 3, CFC1 incurs 1,500,000u of deductible expenses other than current year taxes that are allocable to all gross income. For U.S. tax purposes, under §§1.861-8 through 1.861-14T, 1,000,000u of the deductions are apportioned to CFC1’s foreign base company sales income and 500,000u of the deductions are apportioned to CFC1’s interest income. Under Country X tax law, 1,000,000u of deductions are apportioned to the 4,000,000u treated as a dividend, and 500,000u of deductions are apportioned to the 2,000,000u of foreign base company sales income. Under Country X tax law, no deductions are apportioned to the interest income. Under Country X tax law, CFC1 pays eligible current year taxes of 900,000u on a base of 4,500,000u (7,000,000u gross income – 1,000,000u exemption and 1,500,000u deductions) consisting of

3,000,000u (4,000,000u – 1,000,000u) of previously taxed earnings and profits, 1,000,000u of interest income (exempt from tax under Country X law), and 1,500,000u (2,000,000u – 500,000u) of foreign base company sales income. In Year 3, CFC2 has no expenses (including current year taxes).

(2) *Analysis*--(i) *CFC2*. Under paragraph (c)(1) of this section, the computational rules of paragraph (c)(1) of this section are applied beginning with CFC2. However, CFC2 has no gross income or expenses in Year 3. Accordingly, the computational rules in paragraphs (c)(1)(i) through (iv) of this section are not relevant with respect to CFC2. Under paragraph (c)(1)(v) of this section, the rules in paragraph (c)(1)(i) through (iv) of this section are then applied to CFC1.

(ii) *CFC1*--(A) *Step 1*. Under paragraph (c)(1)(i) of this section, CFC1's items of gross income for the current taxable year are assigned to section 904 categories and included in income groups within those section 904 categories. Under paragraph (d)(2)(i) of this section and §1.904-4, the interest income is passive category income and the foreign base company sales income is general category income. Under paragraph (d)(2)(ii) of this section, the 1,000,000u of interest income is assigned to a subpart F income group (the "FPHCI income group") within the passive category because it is foreign personal holding company income described in §1.954-1(c)(1)(iii)(A)(1)(i) that falls within a single group of income under §1.904-4(c)(3)(iii) for passive income that is subject to no withholding tax or other foreign tax. The 2,000,000u of foreign base company sales income is assigned to a subpart F income group within the general category (the "FBCSI income group"), because it is foreign base company income described in §1.954-1(c)(1)(iii)(A)(2)(i). Under paragraph (d)(2) of this section, the 4,000,000u of previously taxed earnings and profits is treated as a U.S. dividend amount (as defined in §1.861-20(b)(21)) and is assigned to the residual income group within the general category for purposes of applying section 960(a) and (d) and §§1.960-1 and 1.960-2.

(B) *Step 2*--(1) *Allocation and apportionment of deductions other than taxes*. Under paragraph (c)(1)(ii) of this section, CFC1's deductions for the current taxable year are allocated and apportioned among the section 904 categories and income groups within a section 904 category that were increased as provided in paragraph (c)(1)(i) of this section. Under paragraph (d)(3)(i) of this section and §§1.861-8 through 1.861-14T, 1,000,000u of deductions are allocated and apportioned to the FBCSI income group within the general category, and 500,000u of deductions are allocated and apportioned to the FPHCI income group within the passive category. Therefore, CFC1 has 1,000,000u (2,000,000u – 1,000,000u) of pre-tax income attributable to the FBCSI income group within the general category and 500,000u (1,000,000u – 500,000u) of pre-tax income attributable to the FPHCI income group within the passive category. For U.S. tax purposes, no deductions other than eligible current year taxes are allocated and apportioned to the 4,000,000u of previously taxed earnings and profits in CFC1's residual income group within the general category because no deductions of CFC1 other than deductions for current year taxes are allocated and apportioned to previously taxed earnings and profits under section 861. See paragraph (d)(3)(i) of this section and §1.959-6(d)(1).

(2) *Allocation and apportionment of current year taxes*. Under paragraph (c)(1)(ii) of this section, CFC1's current year taxes are allocated and apportioned among the section 904 categories and income groups within a section 904 category that were increased as provided in paragraph (c)(1)(i) of this section. Under paragraphs (d)(3)(i)

and (ii) of this section, for purposes of allocating and apportioning taxes to reduce the income in a section 904 category or an income group, §1.861-20 (as modified by §1.904-6(c)) is applied to determine the amount of foreign taxable income, computed under Country X tax law but characterized under Federal income tax law, in each section 904 category and income group that is included in the Country X tax base. For Country X tax purposes, 1,000,000u of deductions are allocated and apportioned to CFC1's 4,000,000u of previously taxed earnings and profits, which is assigned to the residual income grouping within the general category, 500,000u of deductions are allocated and apportioned to the FBCSI income group within the general category, and no deductions are allocated and apportioned to the FPHCI income group in the passive category. Therefore, for Country X tax purposes, CFC1 has 3,000,000u of foreign taxable income assigned to the residual income group within the general category, 1,500,000u of foreign taxable income assigned to the FBCSI income group within the general category, and no taxable income assigned to the FPHCI income group within the passive category. Under paragraphs (d)(3)(i) and (ii) of this section and §1.959-6, 600,000u ( $3,000,000u / 4,500,000u \times 900,000u$ ) of the 900,000u eligible current year taxes paid by CFC1 are related to the residual income group within the general category, and 300,000u ( $1,500,000u / 4,500,000u \times 900,000u$ ) are related to the FBCSI income group within the general category. No current year taxes are allocated or apportioned to the FPHCI income group within the passive category because the interest expense is exempt from Country X tax. See §1.959-6 for rules allocating and apportioning the 600,000u of current year taxes among the corporate PTEP accounts, section 904 categories, and PTEP groups. Thus, for U.S. tax purposes, CFC1 has 3,400,000u of previously taxed earnings and profits ( $4,000,000u - 600,000u$ ) in the residual income group within the general category (see §§1.959-2 and 1.959-3 for rules relating to accounting for previously taxed earnings and profits), 500,000u of income in the FPHCI income group within the passive category, and 700,000u of income ( $1,000,000u - 300,000u$ ) in the FBCSI income group within the general category.

(C) *Step 3.* Under paragraph (c)(1)(iii) of this section, for purposes of computing foreign income taxes deemed paid under section 960(a), CFC1 has \$300,000 of current year taxes in the FBCSI income group within the general category. Under paragraph (e) of this section, the United States shareholders of CFC1 cannot claim a credit with respect to the \$600,000 of taxes on CFC1's income in the residual income group under section 960, except to the extent the taxes are allocated and apportioned to previously taxed earnings and profits under §1.959-6 and deemed paid by a domestic corporation under section 960(b) and §1.960-3.

(D) *Step 4.* Under paragraph (c)(1)(iv) of this section, the United States shareholders of CFC1 compute current year taxes deemed paid under section 960(a) and (d) and the rules of §1.960-2. None of the Country X tax is allocated to CFC1's FPHCI income group. Therefore, there are no current year taxes deemed paid by CFC1's United States shareholders with respect to their passive category subpart F inclusions. Country X tax equal to \$300,000 is allocated and apportioned to CFC1's FBCSI income group. Therefore, \$300,000 of the current year taxes are deemed paid by CFC1's United States shareholders with respect to their general category subpart F inclusions. See §1.960-2(b)(5) and (c)(7) for examples of the application of section 960(a) and (d) and the rules in §1.960-2. The remaining \$600,000 of Country X tax is allocated and apportioned to the residual income group within the general category with respect to the previously taxed earnings and profits and will generally be allocated and apportioned to previously taxed earnings and profits under the rules in §1.959-6.

(E) *Step 5.* Paragraph (c)(1)(v) of this section does not apply because CFC1 is the highest-tier controlled foreign corporation in the chain.

(F) *Step 6.* Paragraph (c)(1)(vi) of this section does not apply because CFC1 did not make a specified section 959(a) distribution.

**Par. 24.** Section 1.960-3 is revised to read as follows:

**§1.960-3 Foreign income taxes deemed paid under section 960(b).**

(a) *Scope.* This section provides rules for determining foreign income taxes that are deemed paid under section 960(b) with respect to the receipt of distributions of previously taxed earnings and profits. Paragraph (b) of this section describes the foreign income taxes that a domestic corporation is deemed to pay with respect to its receipt of a specified section 959(a) distribution. Paragraph (c) of this section describes the foreign income taxes that a controlled foreign corporation is deemed to pay with respect to its receipt of a section 959(b) distribution. For rules regarding the maintenance and adjustment by a foreign corporation of corporate PTEP accounts and corporate PTEP tax pools with respect to each of its covered shareholders, see §1.959-2(d). For rules regarding the maintenance and adjustment by a covered shareholder of annual PTEP accounts and PTEP tax pools with respect to a foreign corporation in which it owns stock, see §§1.959-2(b) and 1.959-3(c) and (e).

(b) *Foreign income taxes deemed paid under section 960(b)(1)–(1) In general.* A domestic corporation that is a United States shareholder of a controlled foreign corporation is deemed to have paid the foreign income taxes that are properly attributable to a specified section 959(a) distribution that it receives from the controlled foreign corporation and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year. A credit for foreign income taxes deemed paid under this section may be subject to disallowance under other provisions of the Code or regulations in this title that apply at the level of the United States shareholder.



(2) *Properly attributable.* The foreign income taxes that are properly attributable to a specified section 959(a) distribution are the foreign income taxes that are removed under §§1.959-2(d)(2) and 1.959-3(e)(1)(iii) from each creditable PTEP tax group (as defined in §1.959-2(b)(4)(ii)) by reason of the specified section 959(a) distribution.

(c) *Foreign income taxes deemed paid under section 960(b)(2)--(1) In general.* A controlled foreign corporation is deemed to have paid the foreign income taxes that are properly attributable to a section 959(b) distribution that it receives from another controlled foreign corporation and that have not been deemed to have been paid by a domestic corporation under section 960 for the current taxable year or any prior taxable year.

(2) *Properly attributable.* The foreign income taxes that are properly attributable to a section 959(b) distribution received by a controlled foreign corporation are the foreign income taxes that are removed under §§1.959-2(d)(2) and 1.959-3(e)(1)(iii) from each creditable PTEP tax group (as defined in §1.959-1(b)) by reason of the section 959(b) distribution.

**Par. 25.** Section 1.960-7 is amended by:

1. In the first sentence of paragraph (a), removing the language “paragraph (b)” and adding the language “paragraphs (b) and (c)” in its place; and
2. Adding a new paragraph (c).

The addition reads as follows:

**§1.960-7 Applicability dates.**

\* \* \* \* \*

(c) Sections 1.960-1 and 1.960-3 apply to taxable years of a foreign corporation that begin on or after [date of publication of final regulations in the ***Federal Register***] or are early application years (as described in §1.959-12(d)), and to taxable years of a domestic corporation that is a United States shareholder of the foreign corporation in

which or with which such taxable years of such foreign corporation end. See §§1.960-1 and 1.960-3 as contained in 26 CFR part 1 revised as of April 1, 2024, for a version of these sections applicable to prior taxable years.

**Par. 26.** Section 1.961-1 is revised to read as follows:

**§1.961-1 Overview, definitions, and rules of general applicability.**

(a) *Overview--(1) In general.* The section 961 regulations provide rules for basis adjustments related to previously taxed earnings and profits. Section 1.961-1 sets forth definitions and rules of general applicability. Section 1.961-2 describes the types of property units and types of basis for purposes of applying section 961. Section 1.961-3 provides basis increases for income inclusions. Section 1.961-4 provides reductions to basis and gain recognition for distributions of previously taxed earnings and profits. Section 1.961-5 provides basis adjustments for foreign currency gain or loss and for general successor transactions. Sections 1.961-6 and 1.961-7 are reserved. Section 1.961-8 describes the consequences of positive derived basis. Section 1.961-9 describes the consequences of positive section 961(c) basis. Section 1.961-10 describes the consequences of negative derived basis and negative section 961(c) basis. Section 1.961-11 provides for the inclusion by United States shareholders in a controlled foreign corporation of the controlled foreign corporation's income arising under section 961(c). Section 1.961-12 provides examples illustrating the application of the section 961 regulations. Section 1.961-13 sets forth transition rules. Section 1.961-14 sets forth applicability dates. See §1.1502-59 for additional rules for a consolidated group.

(2) *Scope.* This section sets forth definitions and rules of general applicability for purposes of the section 961 regulations. Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules relating to S corporations. Paragraph (d) of this section provides an anti-avoidance rule.

(b) *Definitions.* The definitions in §1.959-1(b) apply for purposes of the section 961 regulations, with the following additions.

*Acquired partnership.* The term *acquired partnership* has the meaning provided in §1.961-5(c)(1).

*Common basis.* The term *common basis* means a partnership's adjusted basis of an item of property, excluding any basis that is solely with respect to a specific partner (for example, a section 743(b) basis adjustment or derived basis).

*Covered gain.* The term *covered gain* has the meaning provided in §1.961-9(c)(1).

*Derived basis.* The term *derived basis* means basis described in §1.961-2(d)(2).

*Derivative ownership unit.* The term *derivative ownership unit* has the meaning provided in §1.961-2(d)(1).

*Lookback PTEP.* The term *lookback PTEP* has the meaning provided in §1.961-9(f)(3)(ii).

*Lower-tier partnership interest.* The term *lower-tier partnership interest* has the meaning provided in §1.961-8(d).

*Midyear transaction.* The term *midyear transaction* has the meaning provided in §1.961-3(c)(2).

*Mirrored PTEP.* The term *mirrored PTEP* has the meaning provided in §1.961-9(f)(2)(ii).

*Negative derived basis.* The term *negative derived basis* means the amount by which derived basis with respect to a covered shareholder of a derivative ownership unit is less than zero.

*Negative section 961(c) basis.* The term *negative section 961(c) basis* means the amount by which section 961(c) basis with respect to a covered shareholder of a section 961(c) ownership unit is less than zero.

*Net foreign currency gain.* The term *net foreign currency gain* has the meaning provided in §1.961-5(b)(2).

*Net foreign currency loss.* The term *net foreign currency loss* has the meaning provided in §1.961-5(b)(2).

*Nonrecognition transaction.* The term *nonrecognition transaction* has the meaning provided in section 7701(a)(45).

*Positive derived basis.* The term *positive derived basis* means the amount by which derived basis with respect to a covered shareholder of a derivative ownership unit is greater than zero.

*Positive section 961(c) basis.* The term *positive section 961(c) basis* means the amount by which section 961(c) basis with respect to a covered shareholder of a section 961(c) ownership unit is greater than zero.

*Property unit.* The term *property unit* has the meaning provided in §1.961-2(b).

*Relevant taxable year.* The term *relevant taxable year* has the meaning provided in §1.961-3(b).

*Section 951(a)(1)(A) inclusion amount.* The term *section 951(a)(1)(A) inclusion amount* has the meaning provided in §1.961-3(c)(1)(ii).

*Section 951(a)(1)(B) inclusion amount.* The term *section 951(a)(1)(B) inclusion amount* has the meaning provided in §1.961-3(c)(1)(iii).

*Section 961 regulations.* The term *section 961 regulations* means the regulations in this part issued under section 961.

*Section 961(a) ownership unit.* The term *section 961(a) ownership unit* has the meaning provided in §1.961-2(c).

*Section 961(c) basis.* The term *section 961(c) basis* means basis described in §1.961-2(e)(2).

*Section 961(c) income.* The term *section 961(c) income* has the meaning

provided in §1.961-11(b).

*Section 961(c) ownership unit.* The term *section 961(c) ownership unit* has the meaning provided in §1.961-2(e)(1).

*Section 961(c) PTEP.* The term *section 961(c) PTEP* has the meaning provided in §1.961-9(f)(1).

*Transferred units.* The term *transferred units* has the meaning provided in §1.961-8(b)(1) or §1.961-9(c)(1), as applicable.

*Transferring partnership.* The term *transferring partnership* has the meaning provided in §1.961-8(b)(1).

*Upper-tier partnership.* The term *upper-tier partnership* has the meaning provided in §1.961-8(d).

(c) *Treatment of an S corporation--(1) In general.* Except as provided in paragraph (c)(2) of this section, for purposes of the section 961 regulations, an S corporation is treated in the same manner as a domestic partnership, a reference to a domestic partnership includes an S corporation, and shareholders of an S corporation are treated as partners of such partnership. See section 1373(a). As applicable, the treatment of an S corporation and its shareholders under the preceding sentence is determined by replacing any partnership-specific provision with the equivalent provision for S corporations (for example, a reference to an adjustment under section 705 to a partner's basis in its partnership interest refers to the adjustment under section 1367 to a shareholder's basis in its stock of an S corporation).

(2) *Treatment as a covered shareholder for taxable years for which elective entity treatment applies for §1.958-1(d)(1) purposes.* See §1.961-13(c) for a rule treating an S corporation as a covered shareholder for any taxable year of the S corporation for which §1.958-1(d)(1) does not apply and §1.961-13(d) for a transition rule converting basis with respect to an S corporation to basis with respect to covered shareholders owning

interests in the S corporation once the S corporation is no longer treated as a covered shareholder.

(d) *Anti-avoidance rule.* If a transaction, series of transactions, plan, or arrangement is engaged in with a principal purpose of avoiding the purposes of section 961 and the section 961 regulations, then appropriate adjustments are made, which may include adjustments to disregard the transaction, series of transactions, plan, or arrangement.

**Par. 27.** Section 1.961-2 is revised to read as follows:

**§1.961-2 Types of property units and basis.**

(a) *Scope.* This section describes the types of property units and types of basis for purposes of applying section 961. Paragraph (b) of this section defines a property unit and provides the general rule for basis of a property unit. Paragraphs (c) through (e) of this section provide definitions and rules for section 961(a) ownership units, derivative ownership units, and section 961(c) ownership units, respectively. See §§1.961-3 through 1.961-11 for basis adjustments and the effects of basis and §1.961-12(c)(1) (*Example 1*) for an example illustrating the application of this section.

(b) *Property unit.* A *property unit* is a section 961(a) ownership unit, derivative ownership unit, or section 961(c) ownership unit, as applicable (defined in paragraphs (c) through (e) of this section). Basis in a property unit must be established and maintained in U.S. dollars in accordance with this section and the adjustments prescribed in the section 961 regulations.

(c) *Section 961(a) ownership unit.* A *section 961(a) ownership unit* is a share of stock of a foreign corporation directly owned by a covered shareholder, or an interest in a partnership directly owned by a covered shareholder and through which the covered shareholder owns stock of a foreign corporation. A covered shareholder is provided adjusted basis in a section 961(a) ownership unit.

(d) *Derivative ownership unit--(1) In general.* A *derivative ownership unit* is a share of stock of a foreign corporation directly owned by a partnership and owned (indirectly) by one or more covered shareholders through only one or more partnerships, or 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. A partnership is provided derived basis in a derivative ownership unit in accordance with paragraph (d)(2) of this section.

(2) *Derived basis.* *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 unit through only one or more partnerships. Derived basis with respect to a covered shareholder may be a positive or negative amount and is treated as an attribute of the partnership that directly owns the derivative ownership unit.

(e) *Section 961(c) ownership unit--(1) In general.* A *section 961(c) ownership unit* is a share of stock of a foreign corporation directly owned by a controlled foreign corporation and owned (indirectly) by one or more covered shareholders. A controlled foreign corporation is provided section 961(c) basis in a section 961(c) ownership unit in accordance with paragraph (e)(2) of this section.

(2) *Section 961(c) basis.* *Section 961(c) basis* is basis of a section 961(c) ownership unit that must be established and maintained separately with respect to each covered shareholder that owns the section 961(c) ownership unit. Section 961(c) basis with respect to a covered shareholder may be a positive or negative amount and is treated as an attribute of the controlled foreign corporation that directly owns the section 961(c) ownership unit. Section 961(c) basis applies only for the purposes prescribed in the section 961 regulations and, therefore, for example does not affect the amount of the controlled foreign corporation's gross income or the amount of its earnings and

profits.

**Par. 28.** Sections 1.961-3 through 1.961-14 are added to read as follows:

Sec.

\* \* \* \* \*

1.961-3 Basis increases for certain income inclusions.

1.961-4 Basis reductions and gain recognition for distributions.

1.961-5 Basis adjustments for foreign currency gain or loss and for general successor transactions.

1.961-6 and 1.961-7 [Reserved]

1.961-8 Application of positive derived basis to covered shareholders' distributive shares of gain or loss.

1.961-9 Exclusion from gross income of previously taxed earnings and profits resulting from positive section 961(c) basis.

1.961-10 Gain recognition for negative basis.

1.961-11. Amounts included in gross income of United States shareholders.

1.961-12 Examples.

1.961-13 Transition rules.

1.961-14 Applicability dates.

\* \* \* \* \*

### **§1.961-3 Basis increases for certain income inclusions.**

(a) *Scope.* This section provides the increases to basis under section 961 for inclusions under sections 951(a) and 951A(a) and §1.961-11. Paragraph (b) of this section provides the general rule, pursuant to which, to reflect a covered shareholder's income inclusions for a controlled foreign corporation's taxable year, basis of certain property units (shares of stock of the controlled foreign corporation directly owned by the covered shareholder, property through which the covered shareholder owns (indirectly) stock of the controlled foreign corporation, and shares of stock of the controlled foreign corporation owned (indirectly) by the covered shareholder), is increased. Paragraph (c) of this section describes the specific rules for increasing basis pursuant to paragraph (b) of this section. Paragraph (d) of this section determines certain basis increases based on distributions of previously taxed earnings and profits by the controlled foreign corporation during the taxable year. Paragraph (e) of this section determines certain basis increases based on a hypothetical distribution, to the



extent paragraph (d) of this section does not increase basis. Paragraph (f) of this section provides limitations on basis increases in certain cases. See §1.961-12(c)(2) (*Example 2*) for an example illustrating the application of this section.

(b) *In general.* To reflect a covered shareholder's income inclusions for a taxable year of a controlled foreign corporation (such taxable year for which this section is being applied, the *relevant taxable year*), basis of property units that are shares of stock of the controlled foreign corporation owned by the covered shareholder, and basis of any property units through which the covered shareholder owns stock of the controlled foreign corporation, is in each case increased in accordance with the rules described in paragraph (c) of this section. Generally, under those rules, basis increases begin at the level of stock of the controlled foreign corporation and then tier through property units through which the covered shareholder owns such stock, with at each level basis increases allocated among property units based on how previously taxed earnings and profits resulting from the income inclusions are, or likely will be, distributed on the property units (thus, the allocations may differ from the extent to which the income inclusions are attributable to the property units). Solely for purposes of this section, a reference to the basis of a property unit means adjusted basis in the case of a section 961(a) ownership unit, derived basis with respect to the covered shareholder in the case of a derivative ownership unit, or section 961(c) basis with respect to the covered shareholder in the case of a section 961(c) ownership unit.

(c) *Rules for increasing basis--*(1) *Determine amount of income inclusions giving rise to increases to basis--*(i) *In general.* First, determine the amount of the covered shareholder's income inclusions with respect to the controlled foreign corporation for the relevant taxable year that give rise to increases to basis under section 961, computed as the sum of the section 951(a)(1)(A) inclusion amount and section 951(a)(1)(B) inclusion amount (defined in paragraphs (c)(1)(ii) and (iii) of this section).

(ii) *Section 951(a)(1)(A) inclusion amount.* The *section 951(a)(1)(A) inclusion amount* is the sum of any amount (in U.S. dollars) that the covered shareholder includes in gross income with respect to the controlled foreign corporation for the relevant taxable year under section 951(a)(1)(A) or 951A(a) or §1.961-11.

(iii) *Section 951(a)(1)(B) inclusion amount.* The *section 951(a)(1)(B) inclusion amount* is the amount (in U.S. dollars) that the covered shareholder includes in gross income with respect to the controlled foreign corporation for the relevant taxable year under section 951(a)(1)(B).

(2) *Determine if any midyear transactions occur.* Second, determine if any midyear transactions (which affect the timing of certain basis adjustments under paragraphs (d) and (e) of this section) occur within the relevant taxable year. A *midyear transaction* is any sale, exchange, or other disposition (including an issuance or redemption) occurring before the last relevant day of the relevant taxable year and involving one or more items of property that, immediately before or after the sale, exchange, or other disposition are stock of the controlled foreign corporation owned by the covered shareholder or property through which the covered shareholder owns stock of the controlled foreign corporation.

(3) *Apply actual distribution rule.* Third, if, before the last relevant day of the relevant taxable year, the controlled foreign corporation distributes previously taxed earnings and profits with respect to the covered shareholder in a covered distribution (determined under §1.959-4), then increase basis for a portion of the section 951(a)(1)(A) inclusion amount in accordance with paragraph (d) of this section.

(4) *Apply hypothetical distribution rule.* Fourth, increase basis for any remaining portion of the section 951(a)(1)(A) inclusion amount and the section 951(a)(1)(B) inclusion amount in accordance with paragraph (e) of this section.

(d) *Actual distribution rule--(1) In general.* For each distribution described in

paragraph (c)(3) of this section (starting with the earliest distribution), increase basis of property units that are shares of stock of the controlled foreign corporation and, if applicable, property units through which the covered shareholder owns such shares, in accordance with paragraphs (d)(2) and (3) of this section. Treat each such increase to basis as made at the beginning of the first day of the relevant taxable year, unless the distribution is made after any midyear transactions, in which case treat each such increase as made immediately after the midyear transaction that most recently precedes the distribution.

*(2) Increases to basis of shares of stock of the controlled foreign corporation.*

Increase the basis of each property unit that is a share of stock of the controlled foreign corporation that the covered shareholder owns on the last relevant day of the relevant taxable year by the amount of the adjustment required under §1.961-4 (basis reductions and gain recognition for distributions) to such basis by reason of the distribution, subject to the following limitation. Do not increase the basis of the share by an amount greater than the product of the section 951(a)(1)(A) inclusion amount, reduced by all increases to basis under this paragraph (d)(2) by reason of earlier distributions, and a fraction, the numerator of which is the portion of the distribution that is made with respect to the share, and the denominator of which is the amount of the distribution.

*(3) Increases to basis of property units through which the covered shareholder owns stock of the controlled foreign corporation.* If, when the distribution is made, the covered shareholder owns stock of the controlled foreign corporation through one or more property units, then increase the basis of each such property unit by the portion of the hypothetical distribution described in paragraph (e)(2) of this section (modified as described in the next sentence) that would be distributed with respect to the property unit in accordance with paragraph (e)(3) of this section, subject to the limitations in paragraph (f) of this section. For purposes of this paragraph (d)(3), the hypothetical

distribution is treated as made when the distribution of previously taxed earnings and profits is made, the amount of the hypothetical distribution is equal to the increase to basis under paragraph (d)(2) of this section by reason of the distribution of previously taxed earnings and profits, and, at the level of the controlled foreign corporation, the hypothetical distribution is made in the same manner as the distribution of previously taxed earnings and profits.

(e) *Hypothetical distribution rule*--(1) *In general.* Increase the basis of each property unit that the covered shareholder owns on the last relevant day of the relevant taxable year by the portion of the hypothetical distribution described in paragraph (e)(2) of this section that would be distributed with respect to the property unit in accordance with paragraph (e)(3) of this section, subject to the limitations in paragraph (f) of this section. Except as provided in paragraph (e)(4) of this section, treat a portion of each such increase to basis as made at the end of the last day of the relevant taxable year, determined by multiplying the amount of the increase to basis by a fraction, the numerator of which is the section 951(a)(1)(B) inclusion amount, and the denominator of which is the amount of the hypothetical distribution. Treat the remaining portion of each such increase to basis as made at the beginning of the first day of the relevant taxable year on which the covered shareholder owns the property unit, unless there are any midyear transactions, in which case treat each such remaining portion as made immediately after the last midyear transaction occurring during the relevant taxable year.

(2) *Hypothetical distribution.* The hypothetical distribution described in this paragraph (e)(2) is a hypothetical distribution treated as made by the controlled foreign corporation, through all property (if any) through which the covered shareholder owns stock of the controlled foreign corporation, to the covered shareholder on the last relevant day of the relevant taxable year. The amount of the hypothetical distribution is

equal to the section 951(a)(1)(A) inclusion amount, reduced by any increases to basis under paragraph (d)(2) of this section, plus the section 951(a)(1)(B) inclusion amount. In the hypothetical distribution, stock of the controlled foreign corporation and other property is taken into account only to the extent owned by the covered shareholder on the last relevant day, and the earnings and profits of the controlled foreign corporation and any foreign corporations through which the hypothetical distribution is treated as made are in each case treated as equal to the amount of the hypothetical distribution.

(3) *Distribution rights.* The portion of the hypothetical distribution that would be distributed with respect to a property unit is determined under the principles of §1.951-1(e)(2) through (6). However, an earlier distribution affects property units' distribution rights for purposes of the hypothetical distribution to the extent such earlier distribution results in the section 951(a)(1)(A) inclusion amount increasing basis under paragraph (d) of this section.

(4) *Certain increase to basis for section 951(a)(1)(B) inclusion amount.* If basis of a property unit is increased pursuant to the second sentence of paragraph (e)(1) of this section, and at the end of the last day of the relevant taxable year the covered shareholder either does not own the property unit or owns the property unit in a manner different than how the covered shareholder owns the property unit at the time of the hypothetical distribution described in paragraph (e)(2) of this section, then treat such increase to basis as made immediately before the transaction in which the covered shareholder ceases to own the property unit in the same manner as it owns the property unit at the time of such hypothetical distribution. In addition, treat such increase to basis as made after the determination of any amount that must be included in gross income as a dividend (for example, under section 1248 or §1.367(b)-4) as a result of such transaction.

(f) *Limitations--(1) Section 961(c) ownership units that are not stock of a*

*controlled foreign corporation.* Section 961(c) basis of a section 961(c) ownership unit is increased only if the section 961(c) ownership unit is a share of stock of a controlled foreign corporation.

(2) *Taxable section 962 previously taxed earnings and profits.* The portion of an income inclusion that gives rise to previously taxed earnings and profits relating to the taxable section 962 PTEP subgroup does not increase adjusted basis of a section 961(a) ownership unit or derived basis of a derivative ownership unit.

(3) *Derivative ownership units that are partially owned by foreign corporations.* If a derivative ownership unit is owned (indirectly) by one or more foreign corporations, then an increase to derived basis of the derivative ownership unit resulting from a hypothetical distribution described in paragraph (d)(3) or (e)(2) of this section 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.

#### **§1.961-4 Basis reductions and gain recognition for distributions.**

(a) *Scope.* This section sets forth the rules for reducing basis and recognizing gain under section 961 for distributions of previously taxed earnings and profits. Paragraph (b) of this section describes adjustments to section 961(a) ownership units in the case of distributions of previously taxed earnings and profits to a covered shareholder. Paragraph (c) of this section describes adjustments to derivative ownership units in the case of distributions of previously taxed earnings and profits through one or more partnerships to one or more covered shareholders. Paragraph (d) of this section describes adjustments to section 961(c) ownership units in the case of distributions of previously taxed earnings and profits to a controlled foreign corporation. Paragraph (e) of this section provides timing rules for when adjustments are treated as made. Paragraph (f) of this section provides rules regarding the treatment of gain

recognized under this section. See §1.961-12(c)(3) (*Example 3*) for an example illustrating the application of this section.

(b) *Adjustments to section 961(a) ownership units--(1) In general.* If a covered shareholder receives previously taxed earnings and profits that are excluded from its gross income under section 959(a) and §1.959-4, then the resulting adjustments under section 961 to the covered shareholder's adjusted basis of section 961(a) ownership units are determined in accordance with the rules described in paragraph (b)(2) of this section.

(2) *Rules for adjusting basis--(i) Determine amounts of adjustments.* First, determine the amount of the adjustment to the covered shareholder's adjusted basis of each section 961(a) ownership unit, which is equal to the dollar basis of, and foreign income taxes associated with, previously taxed earnings and profits that are received with respect to such section 961(a) ownership unit (determined under §1.959-4), but only including foreign income taxes for which the covered shareholder is allowed a credit under section 901.

(ii) *Reduce basis.* Second, reduce the covered shareholder's adjusted basis of each section 961(a) ownership unit by the amount of the adjustment to such adjusted basis (determined under paragraph (b)(2)(i) of this section), but not below zero.

(iii) *Recognize gain.* Third, to the extent that the amount of an adjustment to the covered shareholder's adjusted basis of a section 961(a) ownership unit (determined under paragraph (b)(2)(i) of this section) exceeds such adjusted basis, treat the covered shareholder as recognizing gain with respect to such section 961(a) ownership unit in accordance with paragraph (f) of this section.

(c) *Adjustments to derivative ownership units--(1) In general.* If, through a partnership, one or more covered shareholders receive previously taxed earnings and profits that are excluded from the covered shareholders' gross income under section

959(a) and §1.959-4, then the resulting adjustments under section 961 to the partnership's derived basis of derivative ownership units are determined in accordance with the rules described in paragraph (c)(2) of this section. In the case of tiered partnerships, each tiered partnership's derived basis of derivative ownership units is adjusted as described in paragraph (c)(2) of this section, starting with the partnership at the lowest tier.

*(2) Rules for adjusting basis--(i) Determine amounts of adjustments.* First, determine the amount of the adjustment to the partnership's derived basis with respect to each covered shareholder of each derivative ownership unit, which is equal to the dollar basis of, and foreign income taxes associated with, previously taxed earnings and profits that are both with respect to such covered shareholder and received with respect to such derivative ownership unit (determined under §1.959-4).

*(ii) Reduce positive derived basis.* Second, reduce the partnership's derived basis with respect to each covered shareholder of each derivative ownership unit by the amount of the adjustment to such derived basis (determined under paragraph (c)(2)(i) of this section), but not below zero.

*(iii) Reduce positive section 743(b) basis (if applicable) and increase negative derived basis.* Third, to the extent that the amount of an adjustment to the partnership's derived basis with respect to a covered shareholder of a derivative ownership unit (determined under paragraph (c)(2)(i) of this section) exceeds the related reduction to positive derived basis (determined under paragraph (c)(2)(ii) of this section), reduce the covered shareholder's positive section 743(b) basis adjustment of such derivative ownership unit (if applicable), but not below zero, and then, if applicable, reduce such derived basis below zero, but only to the extent permitted under paragraph (c)(3) of this section.

*(iv) Recognize and allocate gain.* Fourth, to the extent that the amount of an



adjustment to the partnership's derived basis with respect to a covered shareholder of a derivative ownership unit (determined under paragraph (c)(2)(i) of this section) exceeds the aggregate of the related reductions to derived basis (determined under paragraphs (c)(2)(ii) and (iii) of this section) and positive section 743(b) basis (determined under paragraph (c)(2)(iii) of this section), treat the partnership as recognizing gain with respect to such derivative ownership unit in accordance with paragraph (f) of this section, and allocate the gain solely to the covered shareholder.

(3) *Limitation on reducing derived basis--*(i) *In general.* An adjustment to a partnership's derived basis with respect to a covered shareholder of a derivative ownership unit can reduce (or further reduce) such derived basis below zero only to the extent of the amount of common basis of such derivative ownership unit available with respect to the covered shareholder (determined under paragraph (c)(3)(ii) of this section), less, if applicable, the covered shareholder's negative section 743(b) basis adjustment of the derivative ownership unit (expressed as a positive amount).

(ii) *Determining common basis available with respect to the covered shareholder.* In applying paragraph (c)(3)(i) of this section, the amount of common basis of the derivative ownership unit available with respect to the covered shareholder is equal to the product of the following amounts--

(A) The partnership's common basis of the derivative ownership unit (translated, if applicable, into U.S. dollars at the spot rate on the day on which the adjustment described in paragraph (c)(3)(i) of this section would be treated as reducing basis), reduced by all negative derived basis of the derivative ownership unit (determined immediately before the adjustment described in paragraph (c)(3)(i) of this section would be treated as made); and

(B) A fraction, the numerator of which is the amount by which the adjustment described in paragraph (c)(3)(i) of this section would reduce derived basis with respect

to the covered shareholder below zero if derived basis could be reduced without limitation, and the denominator of which is the sum of the amounts by which the adjustment described in paragraph (c)(3)(i) of this section and any concurrent adjustments to derived basis with respect to other covered shareholders would reduce derived basis of the derivative ownership unit below zero if derived basis could be reduced without limitation.

(d) *Adjustments to section 961(c) ownership units--(1) In general.* If a controlled foreign corporation receives previously taxed earnings and profits that are excluded from its gross income under section 959(b) and §1.959-4, then the resulting adjustments under section 961 to the controlled foreign corporation's section 961(c) basis of section 961(c) ownership units are determined in accordance with the rules described in paragraph (d)(2) of this section.

(2) *Rules for adjusting basis--(i) Determine amounts of adjustments.* First, determine the amount of the adjustment to the controlled foreign corporation's section 961(c) basis with respect to each covered shareholder of each section 961(c) ownership unit, which is equal to the dollar basis of, and foreign income taxes associated with, previously taxed earnings and profits that are both with respect to such covered shareholder and received with respect to such section 961(c) ownership unit (determined under §1.959-4).

(ii) *Reduce basis.* Second, reduce the controlled foreign corporation's section 961(c) basis with respect to each covered shareholder of each section 961(c) ownership unit by the amount of the adjustment to such section 961(c) basis, including below zero, but only to the extent permitted under paragraph (d)(3) of this section.

(iii) *Recognize and assign gain.* Third, to the extent that the amount of an adjustment to the controlled foreign corporation's section 961(c) basis with respect to a covered shareholder of a section 961(c) ownership unit (determined under paragraph

(d)(2)(i) of this section) exceeds the related reduction to section 961(c) basis (determined under paragraph (d)(2)(ii) of this section), treat the controlled foreign corporation as recognizing gain with respect to such section 961(c) ownership unit in accordance with paragraph (f) of this section, and assign the gain solely to the covered shareholder.

(3) *Limitation on reducing section 961(c) basis--(i) In general.* An adjustment to a controlled foreign corporation's section 961(c) basis with respect to a covered shareholder of a section 961(c) ownership unit can reduce (or further reduce) such section 961(c) basis below zero only to the extent of the amount of adjusted basis of such section 961(c) ownership unit available with respect to the covered shareholder (determined under paragraph (d)(3)(ii) of this section).

(ii) *Determining adjusted basis available with respect to the covered shareholder.* In applying paragraph (d)(3)(i) of this section, the amount of adjusted basis of the section 961(c) ownership unit available with respect to the covered shareholder is equal to the product of the following amounts--

(A) The controlled foreign corporation's adjusted basis of the section 961(c) ownership unit (translated, if applicable, into U.S. dollars at the spot rate on the day on which the adjustment described in paragraph (d)(3)(i) of this section would be treated as reducing basis), reduced by all negative section 961(c) basis of the section 961(c) ownership unit (determined immediately before the adjustment described in paragraph (d)(3)(i) of this section would be treated as made); and

(B) A fraction, the numerator of which is the amount by which the adjustment described in paragraph (d)(3)(i) of this section would reduce section 961(c) basis with respect to the covered shareholder below zero if section 961(c) basis could be reduced without limitation, and the denominator of which is the sum of the amounts by which the adjustment described in paragraph (d)(3)(i) of this section and any concurrent

adjustments to section 961(c) basis with respect to other covered shareholders would reduce section 961(c) basis of the section 961(c) ownership unit below zero if section 961(c) basis could be reduced below zero without limitation.

(e) *Timing of basis reductions--*(1) *Basis of stock.* A reduction to basis of stock of a foreign corporation under paragraph (b), (c), or (d) of this section is treated as made concurrently with the distribution giving rise to the basis reduction (and before any other adjustment to basis by reason of the distribution, for example, under section 301(c)(2)).

(2) *Basis of partnership interests.* A reduction to basis of an interest in a partnership under paragraph (b) or (c) of this section 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.

(f) *Treatment of gain--*(1) *In general.* Gain treated as recognized with respect to a section 961(a) ownership unit, derivative ownership unit, or section 961(c) ownership unit under paragraph (b), (c), or (d) of this section is treated as gain from a sale or exchange of such ownership unit occurring concurrent with when the adjustment described in that paragraph would be treated as reducing basis.

(2) *Gain recognized by a partnership.* Gain treated as recognized by a partnership under paragraph (c) of this section constitutes an item of gain solely with respect to the covered shareholder to which it is allocated and 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 gain is treated as the covered shareholder's distributive share of gain of the partnership (derived through each partnership through which the covered shareholder owns the partnership recognizing the gain, if applicable) and is taken into account in adjusting basis under section 705.

(3) *Gain recognized by a controlled foreign corporation.* Gain treated as recognized by a controlled foreign corporation under paragraph (d) of this section is

gain recognized pursuant to section 961(c). Such gain applies only for purposes of determining amounts included in gross income of United States shareholders of the controlled foreign corporation under §1.961-11 and, therefore, for example does not affect the controlled foreign corporation's items of gross income for purposes of section 952 or 951A or its earnings and profits.

(4) *Translation rule.* If applicable, gain treated as recognized by a partnership or controlled foreign corporation under paragraph (c) or (d) of this section is translated into functional currency at the spot rate on the day on which the gain is treated as recognized.

**§1.961-5 Basis adjustments for foreign currency gain or loss and for general successor transactions.**

(a) *Scope.* This section sets forth the rules for adjusting basis under section 961 for foreign currency gain or loss recognized with respect to previously taxed earnings and profits under section 986(c) and for general successor transactions. Paragraph (b) of this section provides the adjustments for foreign currency gain or loss. Paragraph (c) of this section provides the adjustments for general successor transactions. Paragraph (d) of this section coordinates with section 743(b).

(b) *Adjustments for foreign currency gain or loss--(1) In general.* If a covered shareholder recognizes foreign currency gain or loss with respect to a foreign corporation's previously taxed earnings and profits under §1.986(c)-1 in a transaction other than a distribution of the previously taxed earnings and profits, then basis of property units that are shares of stock of the foreign corporation owned by the covered shareholder, and basis of any property units through which the covered shareholder owns stock of the foreign corporation, is in each case adjusted in accordance with the rules described in paragraphs (b)(2) through (4) of this section. Generally, under those rules, basis adjustments begin at the level of stock of the foreign corporation and then tier through property units through which the covered shareholder owns such stock, with

at each level basis adjustments allocated among property units based on proportionate shares of foreign currency gain or loss. Solely for purposes of this paragraph (b), a reference to the basis of a property unit means adjusted basis in the case of a section 961(a) ownership unit, derived basis with respect to the covered shareholder in the case of a derivative ownership unit, or section 961(c) basis with respect to the covered shareholder in the case of a section 961(c) ownership unit.

(2) *Determine net foreign currency gain or loss.* First, determine the amount of foreign currency gain or loss that gives rise to adjustments to basis, computed by comparing the sum of all foreign currency gain and the sum of all foreign currency loss that the covered shareholder recognizes with respect to the foreign corporation's previously taxed earnings and profits in the transaction under §1.986(c)-1(b), without regard to §1.986(c)-1(b)(3)(i) and (ii) (limitations for previously taxed earnings and profits resulting from section 965). The excess of the sum of foreign currency gain over the sum of foreign currency loss is *net foreign currency gain*, and the excess of the sum of foreign currency loss over the sum of foreign currency gain is *net foreign currency loss*.

(3) *Determine each property unit's share of net foreign currency gain or loss--(i) In general.* Second, determine each property unit's share of net foreign currency gain or net foreign currency loss by multiplying the net foreign currency gain or net foreign currency loss, as applicable, by a fraction (which is based on a hypothetical distribution by the foreign corporation of previously taxed earnings and profits with respect to which the covered shareholder recognizes, or would recognize, foreign currency gain or loss in the transaction). The numerator of the fraction is the portion of the hypothetical distribution described in paragraph (b)(3)(ii) of this section that, under the principles of §1.951-1(e)(2) through (6), would be distributed with respect to the property unit, and the denominator of the fraction is the amount of such hypothetical distribution.

(ii) *Hypothetical distribution.* The hypothetical distribution described in this paragraph (b)(3)(ii) is a hypothetical distribution treated as made by the foreign corporation, through all property (if any) through which the covered shareholder owns stock of the foreign corporation, to the covered shareholder immediately before the transaction. The amount of the hypothetical distribution is equal to all previously taxed earnings and profits of the foreign corporation with respect to which the covered shareholder recognizes (or, but for §1.986(c)-1(b)(3)(i) and (ii), would recognize) any foreign currency gain or loss in the transaction. In the hypothetical distribution, stock of the foreign corporation is taken into account only to the extent owned by the covered shareholder immediately before but not immediately after the transaction, and other property is taken into account only to the extent owned by the covered shareholder immediately before the transaction. The earnings and profits of the foreign corporation and any foreign corporations through which the hypothetical distribution is treated as made are in each case treated as equal to the amount of the hypothetical distribution.

(4) *Adjust basis--*(i) *In general.* Third, adjust the basis of each property unit in accordance with paragraph (b)(4)(ii) or (iii) of this section, as applicable, starting with property units at the lowest tier and subject to the limitation in paragraph (b)(4)(iv) of this section. Treat each such adjustment to basis as made immediately before the transaction (and therefore take the adjustments into account in determining the Federal income tax consequences of the transaction).

(ii) *Basis increases for net foreign currency gain.* In the case of net foreign currency gain, increase the basis of each property unit by the property unit's share of the net foreign currency gain (determined under paragraph (b)(3) of this section).

(iii) *Basis reductions and gain recognition for net foreign currency loss.* In the case of net foreign currency loss, reduce the basis of each property unit by the property unit's share of net foreign currency loss (determined under paragraph (b)(3) of this

section) or recognize gain in accordance with the principles of §1.961-4 (applied by treating such share of net foreign currency loss as the amount of the adjustment to basis described in §1.961-4(b)(2)(i), (c)(2)(i), or (d)(2)(i), as applicable).

(iv) *Limitation for section 961(c) ownership units.* Section 961(c) basis of a section 961(c) ownership unit is adjusted only if the section 961(c) ownership unit is a share of stock of a controlled foreign corporation. A specified foreign corporation (as defined in §1.965-1(f)(45)(i)(B)) that is not otherwise a controlled foreign corporation is treated as a controlled foreign corporation for purposes of applying this paragraph (b)(4) to foreign currency gain or loss with respect to previously taxed earnings and profits resulting from the application of section 965(a).

(c) *Successor basis--(1) In general.* In a general successor transaction, derived basis of each partnership in which the successor covered shareholder acquires ownership of a partnership interest (each an *acquired partnership*), and section 961(c) basis of each acquired foreign corporation, transfers from the transferor covered shareholder to the successor covered shareholder (and thus becomes derived basis or section 961(c) basis with respect to the successor covered shareholder) in accordance with the rules described in paragraph (c)(2) this section. Solely for purposes of this paragraph (c), a reference to the basis of a property unit means derived basis with respect to the transferor covered shareholder in the case of a derivative ownership unit, or section 961(c) basis with respect to the transferor covered shareholder in the case of a section 961(c) ownership unit.

(2) *Rules for transferring basis--(i) Allocate basis before adjustment for foreign currency gain or loss.* First, for each property unit directly owned by an acquired partnership or acquired foreign corporation, allocate to the successor covered shareholder a pro rata portion of the basis of the property unit immediately before the adjustments pursuant to paragraph (b) of this section by reason of the general



successor transaction, determined by multiplying such basis by a fraction. The numerator of the fraction is the value of the interest in the acquired partnership or stock of the acquired corporation, as applicable, ownership of which is acquired by the successor covered shareholder in the general successor transaction. The denominator of the fraction is the total value of all the interests of the acquired partnership or all the stock of the acquired foreign corporation, as applicable, that the transferor covered shareholder owns immediately before the general successor transaction.

(ii) *Adjust allocations for foreign currency gain or loss.* Second, adjust the allocation of basis of each property unit as follows. Increase the allocation to the successor covered shareholder by the amount of the increase to basis of the property unit pursuant to paragraph (b) of this section by reason of the general successor transaction. Decrease the allocation to the successor covered shareholder by the amount of the reduction to basis of the property unit pursuant to paragraph (b) of this section by reason of the general successor transaction.

(iii) *Transfer of successor basis.* Third, transfer basis from the transferor covered shareholder to the successor covered shareholder by reducing basis with respect to the transferor covered shareholder, and increasing basis with respect to the successor covered shareholder, of each property unit by the amount of basis of the property unit allocated to the successor covered shareholder under paragraphs (c)(2)(i) and (ii) of this section (if such amount is positive) or, if such amount is negative, by increasing basis with respect to the transferor covered shareholder and reducing basis with respect to the successor covered shareholder by such amount, expressed as a positive number. Treat each such transfer of basis as made concurrently with the general successor transaction.

(3) *Deemed covered shareholder--(i) In general.* For purposes of transferring basis under this paragraph (c), the deemed covered shareholder is treated in the same

manner as a covered shareholder and a reference to a covered shareholder includes the deemed covered shareholder. Thus, for example, if a covered shareholder sells an interest in a partnership that directly owns stock of a foreign corporation to a nonresident alien individual in a general successor transaction, then derived basis of the partnership transfers from the seller covered shareholder to the deemed covered shareholder under this paragraph (c). Moreover, if the individual subsequently sells the partnership interest to a covered shareholder, then derived basis of the partnership (adjusted consistent with the section 961 regulations, including to reflect distributions from the foreign corporation to the individual) transfers from the deemed covered shareholder to the buyer covered shareholder under this paragraph (c).

(ii) *Treatment as controlled foreign corporation stock.* Solely for purposes of determining section 961(c) basis that transfers to or from the deemed covered shareholder under this paragraph (c), any foreign corporation in which the deemed covered shareholder is treated as owning stock is treated as a controlled foreign corporation (to the extent the foreign corporation is not otherwise a controlled foreign corporation). Thus, for example, if a covered shareholder sells stock of an upper-tier foreign corporation that directly owns stock of a lower-tier foreign corporation to a nonresident alien individual in a general successor transaction, the upper-tier foreign corporation's shares of stock in the lower-tier foreign corporation remain section 961(c) ownership units and section 961(c) basis of the upper-tier foreign corporation transfers from the seller covered shareholder to the deemed covered shareholder under this paragraph (c) even if the upper-tier foreign corporation ceases to be a controlled foreign corporation as a result of the sale. Consequently, if the individual subsequently sells the stock of the upper-tier foreign corporation to a covered shareholder and, as a result, the upper-tier foreign corporation becomes a controlled foreign corporation, then section 961(c) basis of the upper-tier foreign corporation (adjusted consistent with the section

961 regulations, including to reflect distributions from the lower-tier foreign corporation to the upper-tier foreign corporation) transfers from the deemed covered shareholder to the buyer covered shareholder under this paragraph (c).

(iii) *Determining basis that transfers from the deemed covered shareholder.* In a transaction in which basis of a derivative ownership unit or section 961(c) ownership unit transfers from the deemed covered shareholder to a covered shareholder, the covered shareholder must use a reasonable method in determining the amount of transferred basis. Such method must take into account adjustments to basis with respect to the deemed covered shareholder that would have been made under the section 961 regulations if the basis were with respect to a covered shareholder during the time that it was with respect to the deemed covered shareholder.

(d) *Coordination of successor derived basis with section 743(b).* For purposes of a basis adjustment under section 743(b) with respect to a derivative ownership unit directly owned by an acquired partnership, the amount of any basis adjustment with respect to the successor covered shareholder to the acquired partnership's assets is calculated under §1.743-1(d) and allocated under §1.755-1(b) by including any derived basis in the basis of the derivative ownership unit that is transferred to the successor covered shareholder under paragraph (c)(2) of this section for purposes of gain and loss calculations and basis allocations under those provisions.

#### **§§1.961-6 and 1.961-7 [Reserved]**

#### **§1.961-8 Application of positive derived basis to covered shareholders' distributive shares of gain or loss.**

(a) *Scope.* This section describes the consequences of a partnership's positive derived basis. Paragraph (b) of this section applies 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. Paragraph (c) of this section describes related basis adjustments to certain partnership interests directly

owned by a covered shareholder. Paragraph (d) of this section describes related basis adjustments to certain lower-tier partnership interests directly owned by an upper-tier partnership. See §1.961-12(c)(4) (*Example 4*) for an example illustrating the application of this section.

*(b) Sale, exchange, or other disposition of derivative ownership units with positive derived basis--*(1) *In general.* In a sale, exchange, or other disposition by a partnership (*transferring partnership*) of one or more derivative ownership units (*transferred units*), each partner's distributive share of gain or loss recognized by the transferring partnership on the sale, exchange, or other disposition is first determined without regard to derived basis (taking into a partner's section 743(b) basis adjustment). Then, positive derived basis is applied to each covered shareholder's distributive share of such gain or loss in accordance with paragraph (b)(2) of this section. Such application of positive derived basis to a covered shareholder's distributive share is treated as an application of positive derived basis by the transferring partnership, unless the covered shareholder owns the transferred units through multiple partnerships, in which case only partnerships in which the covered shareholder directly owns an interest are treated as applying the positive derived basis.

*(2) Application of positive derived basis--*(i) *In general.* 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, subject to the limitations in paragraphs (b)(2)(ii) and (iii) of this section, as applicable.

*(ii) Limitation in nonrecognition transactions.* In a nonrecognition transaction, the amount of positive derived basis that is taken into account in applying paragraph (b)(2)(i) of this section with respect to the covered shareholder is limited to the excess of

the amount of positive derived basis that would be taken into account by the covered shareholder but for this paragraph (b)(2)(ii) over the covered shareholder's share of the gain realized but not recognized by the transferring partnership with respect to the transferred units. 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).

(iii) *Limitation on loss.* Positive derived basis can create or increase a distributive share of loss only if loss is, or would be if there were a loss, recognized by the transferring partnership on the sale, exchange, or other disposition of the transferred units and a current deduction in respect of the loss is, or would be, allowable.

(iv) *Translation rule.* If applicable, positive derived basis is translated into functional currency at the spot rate on the day on which the sale, exchange, or other disposition occurs.

(c) *Basis adjustment to top-tier partnership interest.* In the case of a partnership interest that is directly owned by a covered shareholder and through which the covered shareholder owns the transferred units described in paragraph (b) of this section, adjusted basis of such interest is adjusted under section 705 after taking into account the partnership's application of positive derived basis to the covered shareholder's distributive share of gain or loss with respect to the transferred units (determined under paragraph (b)(2) of this section).

(d) *Basis adjustments to lower-tier partnership interests.* In the case of a partnership interest (*lower-tier partnership interest*) that is directly owned by another

partnership (*upper-tier partnership*) and through which a covered shareholder owns the transferred units described in paragraph (b) of this section, the upper-tier partnership's basis in such lower-tier partnership interest is adjusted as described in this paragraph (d). Common basis in the lower-tier partnership interest is adjusted under section 705 without regard to the application of positive derived basis to the covered shareholder's distributive share of gain or loss with respect to the transferred units (determined under paragraph (b)(2) of this section). Concurrently with and taking into account the adjustment under section 705, derived basis with respect to the covered shareholder of the lower-tier partnership interest is reduced by the amount of positive derived basis applied to the covered shareholder's distributive share of gain or loss with respect to the transferred units (determined under paragraph (b)(2) of this section) or gain is recognized in accordance with the principles of §1.961-4 (applied by treating such amount of applied positive derived basis as the amount of the adjustment to basis described in §1.961-4(c)(2)(i)). If there is more than one lower-tier partnership, adjustments to derived basis under this paragraph (d) are made starting with the partnership at the lowest tier.

**§1.961-9 Exclusion from gross income of previously taxed earnings and profits resulting from positive section 961(c) basis.**

(a) *Scope.* This section describes the consequences of positive section 961(c) basis. Paragraph (b) of this section excludes from gross income previously taxed earnings and profits resulting from the application of section 961(c) basis to covered gain. Paragraph (c) of this section defines covered gain. Paragraph (d) of this section describes rules for analyzing covered gain. Paragraph (e) of this section provides rules for applying positive section 961(c) basis to covered gain. Paragraph (f) of this section provides rules characterizing covered gain as previously taxed earnings and profits. Paragraph (g) of this section provides a dollar basis rule. Paragraph (h) of this section provides a rule allocating previously taxed earnings and profits to shares of stock. See

§1.961-12(c)(5) (*Example 5*) for an example illustrating the application of this section.

(b) *Exclusion from gross income of previously taxed earnings and profits resulting from section 961(c) basis.* Previously taxed earnings and profits that result from the application of a controlled foreign corporation's section 961(c) basis to covered gain are excluded from the controlled foreign corporation's gross income, solely for purposes of determining the controlled foreign corporation's subpart F income and tested income or tested loss, and provided that the covered shareholder to which the previously taxed earnings and profits relate is a United States shareholder in the controlled foreign corporation.

(c) *Covered gain--(1) In general.* Covered gain is all gain recognized by a controlled foreign corporation on a sale, exchange, or other disposition of one or more section 961(c) ownership units that are shares of stock of a single corporation (*transferred units*), determined without regard to loss recognized on any transferred unit and without regard to section 961(c) basis. Covered gain includes amounts treated as gain from a sale, exchange, or other disposition (for example, under section 301(c)(3)), other than gain recognized pursuant to section 961(c) (for example, for distributions of previously taxed earnings and profits in excess of basis under §1.961-4(d)). Section 961(c) basis is applied to covered gain, and previously taxed earnings and profits result from such application of section 961(c) basis, in accordance with the rules described in paragraph (d) of this section.

(2) *Coordination with dividend recharacterization provisions.* Section 964(e)(1) (or any provision of the Code or regulations in this title that would treat covered gain as a dividend in whole or in part) does not apply to the portion of covered gain to which section 961(c) basis is applied and that, consequently, is previously taxed earnings and profits.

(d) *Rules for analyzing covered gain--(1) Determine each covered shareholder's*

*share of the covered gain.* First, determine each covered shareholder's share of the covered gain, computed as the portion of the covered gain that is assigned to the covered shareholder under §1.951-2.

(2) *Apply section 961(c) basis.* Second, apply the controlled foreign corporation's positive section 961(c) basis to each covered shareholder's share of the covered gain in accordance with paragraph (e) of this section.

(3) *Characterize covered gain as previously taxed earnings and profits.* Third, characterize the portion of each covered shareholder's share of the covered gain to which section 961(c) basis is applied as previously taxed earnings and profits of the controlled foreign corporation in accordance with paragraph (f) of this section. Such characterization does not reduce previously taxed earnings and profits of the foreign corporation in which shares of stock are transferred units or any foreign corporation in which stock is owned through the transferred units.

(4) *Determine dollar basis.* Fourth, determine the dollar basis of previously taxed earnings and profits resulting from section 961(c) basis in accordance with paragraph (g) of this section.

(5) *Treat resulting previously taxed earnings and profits as recognized with respect to particular transferred units.* Fifth, treat previously taxed earnings and profits resulting from section 961(c) basis as recognized with respect to particular transferred units by allocating such previously taxed earnings and profits in accordance with paragraph (h) of this section. Such allocation is taken into account, for example, in applying section 964(e)(1) (taking into account paragraph (c)(2) of this section) to gain recognized with respect to a particular transferred unit.

(6) *Adjust previously taxed earnings and profits and make related account adjustments.* Sixth, increase the controlled foreign corporation's previously taxed earnings and profits to reflect previously taxed earnings and profits resulting from



section 961(c) basis and make the related adjustments described in §1.959-3 to each covered shareholder's accounts.

(e) *Application of positive section 961(c) basis--(1) In general.* In a sale, exchange, or other disposition in which a controlled foreign corporation recognizes covered gain, the controlled foreign corporation's positive section 961(c) basis with respect to a covered shareholder of the transferred units is applied to such covered shareholder's share of the covered gain (determined under paragraph (d)(1) of this section), to the extent thereof and subject to the limitation in paragraph (e)(2) of this section.

(2) *Limitation in nonrecognition transactions.* In a nonrecognition transaction, the amount of positive section 961(c) basis that is taken into account in applying paragraph (e)(1) of this section with respect to the covered shareholder is limited to the excess of the amount of positive section 961(c) basis that would be taken into account by the covered shareholder but for this paragraph (e)(2) over the covered shareholder's share of the gain realized but not recognized by the controlled foreign corporation with respect to the transferred units. The covered shareholder's share of such realized-but-not-recognized gain is determined by multiplying the amount of that gain of the controlled foreign corporation by a fraction, the numerator of which is the covered shareholder's share of covered gain with respect to the transferred units (determined under paragraph (d)(1) of this section), and the denominator of which is the amount of covered gain with respect to the transferred units (determined under paragraph (c)(1) of this section).

(3) *Translation rule.* If applicable, positive section 961(c) basis is translated into functional currency of the controlled foreign corporation at the spot rate on the day on which the sale, exchange, or other disposition occurs.

(4) *Unused positive section 961(c) basis.* See §1.961-11(c)(2) and (e) for rules applying positive section 961(c) basis in excess of covered gain to gain recognized

pursuant to section 961(c).

(f) *Characterization of covered gain as previously taxed earnings and profits*--(1)

*In general.* The portion of a covered shareholder's share of covered gain to which section 961(c) basis is applied (determined under paragraph (d)(2) of this section) is characterized as previously taxed earnings and profits with respect to the covered shareholder (*section 961(c) PTEP*) in accordance with the rules described in paragraphs (f)(2) through (4) of this section.

(2) *Mirroring rule*--(i) *In general.* The portion of section 961(c) PTEP that does not exceed the amount of mirrored PTEP (defined in paragraph (f)(2)(ii) of this section) has the same character as a pro rata portion of mirrored PTEP. The pro rata portion is determined by multiplying mirrored PTEP by a fraction, the numerator of which is the portion of section 961(c) PTEP described in the preceding sentence and the denominator of which is the amount of mirrored PTEP.

(ii) *Mirrored PTEP.* For purposes of this paragraph (f)(2), mirrored PTEP is--

(A) All previously taxed earnings and profits that transfer from the covered shareholder under §1.959-7 in the sale, exchange, or other disposition in which the covered gain is recognized (or that would so transfer if the transferred units were sold in a general successor transaction); and

(B) All previously taxed earnings and profits that would exist if foreign income taxes associated with previously taxed earnings and profits described in paragraph (f)(2)(ii)(A) of this section (determined under §1.959-7 and, if applicable, translated into the functional currency of the foreign corporation to which the previously taxed earnings and profits would relate at the spot rate on the day on which the sale, exchange, or other disposition occurs) were treated as an additional amount of such previously taxed earnings and profits.

(iii) *Currency rule.* For purposes of this paragraph (f)(2), if any previously taxed

earnings and profits described in paragraph (f)(2)(ii) of this section are denominated in a currency other than the functional currency of the controlled foreign corporation recognizing the covered gain, then such previously taxed earnings and profits are translated into such controlled foreign corporation's functional currency at the spot rate on the day on which the covered gain is recognized.

(3) *Lookback rule*--(i) *In general*. The portion of section 961(c) PTEP that is not characterized under paragraph (f)(2) of this section, if any, and that does not exceed the amount of lookback PTEP (defined in paragraph (f)(3)(ii) of this section) has the same character as a pro rata portion of lookback PTEP. The pro rata portion is determined by multiplying lookback PTEP by a fraction, the numerator of which is the portion of section 961(c) PTEP described in the preceding sentence and the denominator of which is the amount of lookback PTEP.

(ii) *Lookback PTEP*. For purposes of this paragraph (f)(3), lookback PTEP is all previously taxed earnings and profits that both--

(A) Resulted from an income inclusion under section 951(a) or 951A(a) of the covered shareholder attributable to the transferred units (including stock owned through the transferred units); and

(B) Were related to a taxable year of a foreign corporation ending during the 36-month period that ends on the day on which the covered gain is recognized.

(iii) *Currency rule*. For purposes of this paragraph (f)(3), if any previously taxed earnings and profits described in paragraph (f)(3)(ii) of this section are denominated in a currency other than the functional currency of the controlled foreign corporation recognizing the covered gain, then such previously taxed earnings and profits are translated into such controlled foreign corporation's functional currency by translating the U.S. dollar amount of the income inclusion giving rise to the previously taxed earnings and profits at the spot rate on the day on which the covered gain is

recognized.

(4) *Section 245A(d) PTEP rule.* The portion of section 961(c) PTEP that is not characterized under paragraphs (f)(2) and (3) of this section, if any, is characterized as relating to the section 245A(d) PTEP group, the taxable year of the controlled foreign corporation in which the covered gain is recognized, and the general category income under section 904(d)(1)(D).

(g) *Dollar basis rule.* The dollar basis of previously taxed earnings and profits with respect to a covered shareholder that result from section 961(c) basis (determined under paragraph (d)(3) of this section) is equal to the U.S. dollar amount of the section 961(c) basis giving rise to such previously taxed earnings and profits.

(h) *Allocation of previously taxed earnings and profits--(1) In general.* Previously taxed earnings and profits with respect to a covered shareholder that result from section 961(c) basis (determined under paragraph (d)(3) of this section) are allocated to transferred units in accordance with the rules of paragraph (h)(2) of this section.

(2) *Rules--(i) Stacking rule.* First, allocate to each transferred unit an amount of previously taxed earnings and profits equal to the lesser of the amount of positive section 961(c) basis with respect to the covered shareholder of the transferred unit (to the extent taken into account in applying paragraph (e)(1) of this section) and the portion of the covered shareholder's share of the covered gain that is recognized with respect to the transferred unit.

(ii) *Pro rata rule.* Second, allocate to each transferred unit a pro rata portion of any amount of previously taxed earnings and profits not allocated under paragraph (h)(2)(i) of this section, determined by multiplying such amount by a fraction. The numerator of the fraction is the portion of the covered shareholder's share of the covered gain that is recognized with respect to the transferred unit, less the amount of previously taxed earnings and profits allocated to the transferred unit under paragraph

(h)(2)(i) of this section. The denominator of the fraction is the amount of previously taxed earnings and profits not allocated under paragraph (h)(2)(i) of this section.

**§1.961-10 Gain recognition for negative basis.**

(a) *Scope.* This section describes the consequences of negative derived basis and negative section 961(c) basis. Paragraph (b) of this section sets forth a rule requiring gain recognition for negative derived basis. Paragraph (c) of this section sets forth a rule requiring gain recognition for negative section 961(c) basis. See §1.961-12(c)(6) and (7) (*Examples 6 and 7*) for examples illustrating the application of this section.

(b) *Gain recognition for negative derived basis--(1) In general.* If a partnership has negative derived basis of a derivative ownership unit, then, in any transaction involving the derivative ownership unit (for example, a sale, exchange, or distribution under section 301(c)(2)), the partnership is treated as recognizing gain with respect to the derivative ownership unit in accordance with the rules described in paragraphs (b)(2) through (5) of this section.

(2) *Amount of gain--(i) In general.* 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 negative derived basis of the derivative ownership unit. 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.

(ii) *Special rule if derivative ownership unit ceases to be a derivative ownership unit.* If the derivative ownership unit is not a derivative ownership unit immediately after

the transaction (including, for example, because the derivative ownership unit is redeemed, or becomes directly owned by a foreign corporation or covered shareholder, in the transaction), then, notwithstanding paragraph (b)(2)(i) of this section, the amount of the gain recognized is equal to the sum of all negative derived basis of the derivative ownership unit.

(iii) *Translation rule.* If applicable, negative derived basis is translated into functional currency at the spot rate on the day on which the transaction involving the derivative ownership unit occurs.

(3) *Allocation of gain.* 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 the fraction is the negative derived basis with respect to the covered shareholder of the derivative ownership unit, and the denominator of the fraction is the sum of all negative derived basis of the derivative ownership unit.

(4) *Treatment of gain.* The gain is treated in the same manner as gain recognized under §1.961-4(c) for distributions of previously taxed earnings and profits in excess of basis (and thus the rules in §1.961-4(f) apply to the gain), except that the gain is recognized concurrently with, but separate from, the transaction.

(5) *Negative derived basis eliminated to the extent it gives rise to gain.* Negative derived basis is eliminated to the extent it increases the amount of gain recognized under this paragraph (b), concurrent with the transaction.

(c) *Gain recognition for negative section 961(c) basis--(1) In general.* If a controlled foreign corporation has negative section 961(c) basis of a section 961(c) ownership unit, then, in any transaction involving the section 961(c) ownership unit (for example, a sale, exchange, or distribution under section 301(c)(2)), the controlled foreign corporation is treated as recognizing gain with respect to the section 961(c) ownership unit in accordance with the rules described in paragraphs (c)(2) through (5)

of this section.

(2) *Amount of gain--(i) In general.* 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 controlled foreign corporation would have recognized in the transaction if, immediately before the transaction, the controlled foreign corporation's adjusted basis of the section 961(c) ownership unit were reduced by all negative section 961(c) basis of the section 961(c) ownership unit. Thus, for example, in a sale of the section 961(c) ownership unit, the amount of the gain recognized is generally equal to the sum of all negative section 961(c) basis of the section 961(c) ownership unit and, in a nonrecognition transaction, the amount of the gain recognized may be less than the sum of all negative section 961(c) basis of the section 961(c) ownership unit.

(ii) *Special rule if section 961(c) ownership unit ceases to be a section 961(c) ownership unit.* If the section 961(c) ownership unit is not a section 961(c) ownership unit immediately after the transaction (including, for example, because the section 961(c) ownership unit is redeemed, or becomes directly owned by a covered shareholder, in the transaction), then, notwithstanding paragraph (c)(2)(i) of this section, the amount of the gain recognized is equal to the sum of all negative section 961(c) basis of the section 961(c) ownership unit.

(iii) *Translation rule.* If applicable, negative section 961(c) basis is translated into functional currency of the controlled foreign corporation at the spot rate on the day on which the transaction involving the section 961(c) ownership unit occurs.

(3) *Assignment of gain.* A pro rata portion of the gain is assigned to each covered shareholder, determined by multiplying the amount of such gain by a fraction. The numerator of the fraction is the negative section 961(c) basis with respect to the covered shareholder of the section 961(c) ownership unit, and the denominator of the fraction is the sum of all negative section 961(c) basis of the section 961(c) ownership

unit.

(4) *Treatment of gain.* The gain is treated in the same manner as gain recognized under §1.961-4(d) for distributions of previously taxed earnings and profits in excess of basis (and thus the rules in §1.961-4(f) apply to the gain), except that the gain is recognized concurrently with, but separate from, the transaction. Thus, the gain is recognized pursuant to section 961(c) and therefore applies only for purposes of determining amounts included in gross income of United States shareholders of the controlled foreign corporation under §1.961-11.

(5) *Negative section 961(c) basis eliminated to the extent it gives rise to gain.* Negative section 961(c) basis is eliminated to the extent it increases the amount of gain recognized under this paragraph (c), concurrent with the transaction.

**§1.961-11 Amounts included in gross income of United States shareholders.**

(a) *Scope.* This section sets forth rules regarding amounts that United States shareholders of a controlled foreign corporation must include in gross income under section 961(c) to account for gain recognized by the controlled foreign corporation pursuant to section 961(c) (for distributions of previously taxed earnings and profits in excess of basis under §1.961-4(d), for foreign currency loss in excess of basis under §1.961-5(b), or for negative section 961(c) basis under §1.961-10(c)). Paragraph (b) of this section provides the general rule. Paragraph (c) of this section allocates gain recognized pursuant to section 961(c) to a United States shareholder. Paragraph (d) of this section adjusts allocations of gain to reflect transfers of stock of the controlled foreign corporation. Paragraph (e) of this section determines loss recognized under section 961(c) with respect to a United States shareholder. See §1.961-12(c)(8) (*Example 8*) for an example illustrating the application of this section. See also §1.961-3, regarding basis increases for an inclusion under this section.

(b) *In general.* If a United States shareholder owns stock of a controlled foreign



corporation on the last relevant day of a taxable year of the controlled foreign corporation, and the controlled foreign corporation recognizes gain pursuant to section 961(c) within that taxable year (all such gain, *section 961(c) income*), then the United States shareholder includes in gross income the amount of section 961(c) income that is allocated to the United States shareholder (determined under paragraph (c) of this section). The inclusion is for the United States shareholder's taxable year in which or with which the controlled foreign corporation's taxable year ends and is treated in the same manner as an amount included in gross income under section 951(a)(1)(A) solely for purposes of increasing basis under §1.961-3 and translation into U.S. dollars under 989(b).

(c) *Allocation of section 961(c) income.* For purposes of paragraph (b) of this section, the amount of the controlled foreign corporation's section 961(c) income that is allocated to a United States shareholder is the excess (if any) of--

(1) The sum of any portions of section 961(c) income that are assigned to the United States shareholder under §1.961-4, 1.961-5, or 1.961-10, adjusted, if applicable, in accordance with paragraph (d) of this section as a result of transfers of stock of the controlled foreign corporation; over

(2) The amount of loss that the controlled foreign corporation is treated as recognizing under section 961(c) with respect to the United shareholder in accordance with paragraph (e) of this section.

(d) *Rules for transfers of stock of the controlled foreign corporation--*(1) *General successor transactions--*(i) *General successor transaction occurring before the last relevant day.* For purposes of paragraph (c)(1) of this section, if the controlled foreign corporation is an acquired foreign corporation in a general successor transaction that occurs before the last relevant day of the controlled foreign corporation's taxable year, then treat a pro rata portion of section 961(c) income that is both recognized before the

general successor transaction and assigned to the transferor covered shareholder under §1.961-4, 1.961-5, or 1.961-10 as instead assigned to the successor covered shareholder, determined by multiplying such section 961(c) income by the fraction described in §1.961-5(c)(2)(i) for determining the controlled foreign corporation's section 961(c) basis that transfers in the general successor transaction.

(ii) *General successor transaction occurring on or after the last relevant day.* For purposes of paragraph (c)(1) of this section, if the controlled foreign corporation is an acquired foreign corporation in a general successor transaction that occurs on or after the last relevant day of the controlled foreign corporation's taxable year, then treat a pro rata portion of section 961(c) income that is both recognized after the general successor transaction and assigned to the successor covered shareholder under §1.961-4, 1.961-5, or 1.961-10 as instead assigned to the transferor covered shareholder, determined by multiplying such section 961(c) income by the fraction described in §1.961-5(c)(2)(i) for determining the controlled foreign corporation's section 961(c) basis that transfers in the general successor transaction.

(2) *Other transfers.* The principles of paragraph (d)(1) of this section apply to transactions, other than general successor transactions, in which the controlled foreign corporation's 961(c) basis transfers to another covered shareholder.

(e) *Determining loss under section 961(c)--(1) In general.* For purposes of paragraph (c)(2) of this section, the amount of loss that the controlled foreign corporation is treated as recognizing under section 961(c) with respect to the United States shareholder is, subject to the limitations in paragraph (e)(2) of this section, equal to the sum of the controlled foreign corporation's positive section 961(c) basis with respect to the United States shareholder of section 961(c) ownership units that are sold, exchanged, or otherwise disposed of by the controlled foreign corporation within the controlled foreign corporation's taxable year, reduced by the amount of such positive

section 961(c) basis that is applied to covered gain under §1.961-9.

(2) *Limitations--(i) In general.* Positive section 961(c) basis of section 961(c) ownership units increases the amount of loss that the controlled foreign corporation is treated as recognizing under section 961(c) only if loss is, or would be if there were a loss, recognized by the controlled foreign corporation on the sale, exchange, or other disposition of the section 961(c) ownership units and a current deduction in respect of the loss is, or would be, allowable.

(ii) *Loss recognized only to the extent of certain gain.* Positive section 961(c) basis of section 961(c) ownership units that are shares of stock of a single foreign corporation increases the amount of loss that the controlled foreign corporation is treated as recognizing under section 961(c) only to the extent of the portion of the amount described in paragraph (c)(1) of this section that is recognized with respect to stock of such foreign corporation.

(3) *Translation rule.* If applicable, positive section 961(c) basis of section 961(c) ownership units is translated into the controlled foreign corporation's functional currency at the spot rate on the day of the sale, exchange, or other disposition of the section 961(c) ownership units.

### **§1.961-12 Examples.**

(a) *In general.* This section provides examples that illustrate the application of §§1.961-1 through 1.961-11.

(b) *Assumed facts.* For purposes of the examples in this section, unless otherwise indicated, the following facts are assumed for U.S. tax purposes:

(1) US1 and US2 are unrelated domestic corporations that are covered shareholders, each of which uses the U.S. dollar as its functional currency and chooses to claim a credit for foreign income taxes pursuant to section 901. Neither US1 nor US2 is a member of a consolidated group (as defined in §1.1502-1(h)).

(2) F1, F2, and F3 are foreign corporations, each of which is a controlled foreign corporation and uses the British pound (£) as its functional currency.

(3) PRS1 and PRS2 are partnerships.

(4) Each entity uses the calendar year as its taxable year, and no entity has a short taxable year.

(5) There are no adjustments under section 743(b) to the basis of any partnership property.

(c) *Examples--(1) Example 1: Types of property units and basis--(i) Facts.* US1 directly owns 60, and US2 directly owns 40, of the 100 shares of the single class of outstanding stock of F1. F1 directly owns all 50 shares of the single class of outstanding stock of F2. This example only analyzes the types of basis provided under section 961 in the items of property.

(ii) *Analysis.* Each of the 60 shares of stock of F1 directly owned by US1 and the 40 shares of stock of F1 directly owned by US2 is a section 961(a) ownership unit in which the covered shareholder (US1 or US2) is provided adjusted basis. See §1.961-2(c). In addition, each of the 50 shares of stock of F2 directly owned by F1, a controlled foreign corporation, is a section 961(c) ownership unit in which F1 is provided section 961(c) basis. See §1.961-2(e)(1). F1's section 961(c) basis in each section 961(c) ownership unit is maintained separately with respect to each of US1 and US2. See §1.961-2(e)(2). Further, each of the section 961(a) ownership units and section 961(c) ownership units is a property unit, and adjusted basis or section 961(c) basis in the property unit, as applicable, is maintained in U.S. dollars. See §1.961-2(b).

(iii) *Alternative facts: partnership structure--(A) Facts.* The facts are the same as paragraph (c)(1)(i) of this section (*Example 1*), except that US1 and US2, in the aggregate, directly own all the interests in PRS1, and PRS1 directly owns all 100 of the shares of stock of F1.

(B) *Analysis.* The interest in PRS1 directly owned by each of US1 and US2 is a section 961(a) ownership unit in which the covered shareholder (US1 or US2) is provided adjusted basis. See §1.961-2(c). In addition, each of the 100 shares of stock of F1 directly owned by PRS1 is a derivative ownership unit in which PRS1 is provided derived basis. See §1.961-2(d)(1). PRS1's derived basis in each derivative ownership unit is established and maintained separately with respect to each of US1 and US2. See §1.961-2(d)(2). Further, as is the case in paragraph (c)(1)(ii) of this section, each of the 50 shares of stock of F2 directly owned by F1, a controlled foreign corporation, is a section 961(c) ownership unit in which F1 is provided section 961(c) basis, and that basis is maintained separately with respect to each of US1 and US2. Moreover, each of the section 961(a) ownership units, derivative ownership units, and section 961(c) ownership units is a property unit, and adjusted basis, derived basis, or section 961(c) basis in the property unit, as applicable, is maintained in U.S. dollars. See §1.961-2(b).

(2) *Example 2: Basis increases for income inclusions--(i) Facts.* US1 directly owns all 100 shares of the single class of outstanding stock of F1, and F1 directly owns

all 50 shares of the single class of outstanding stock of F2. Thus, the shares of stock of F1 directly owned by US1 are section 961(a) ownership units, and the shares of stock of F2 directly owned by F1 are section 961(c) ownership units. For F2's taxable year ending on December 31 of year 3, the last relevant day is December 31 and US1 includes \$80x in gross income under section 951(a)(1)(A) (its pro rata share of F2's subpart F income, translated into U.S. dollars in accordance with section 989(b)) and \$120x in gross income under section 951A(a) (the portion of its GILTI inclusion amount that is treated as with respect to F2 for the taxable year under section 951A(f)(2)). F2 does not make any covered distributions, and therefore does not distribute any previously taxed earnings and profits, during the taxable year. This example only analyzes basis increases for the income inclusions. See *also* §1.312-6(f) (income inclusions increase US1's earnings and profits); §1.959-3 (adjustments to previously taxed earnings and profits accounts).

(ii) *Analysis--(A) In general.* To reflect US1's income inclusions for F2's taxable year ending on December 31 of year 3, basis of shares of stock of F2, and basis of shares of stock of F1 (property units through which US1 owns stock of F2), is in each case increased in accordance with §1.961-3. See §1.961-3(b). In the case of stock of F2, F1's section 961(c) basis with respect to US1 is increased because shares of stock of F2 are section 961(c) ownership units and F2 is a controlled foreign corporation, as required by §1.961-3(f)(1). In the case of stock of F1, US1's adjusted basis is increased because shares of stock of F1 are section 961(a) ownership units. Paragraph (c)(2)(ii)(B) of this section provides the specific increases to basis.

(B) *Increases to basis of each property unit.* The amount of US1's income inclusions with respect to F2 that give rise to increases to basis under section 961 is \$200x (\$80x + \$120x). See §1.961-3(c)(1). In determining the specific increases to basis, the actual distribution rule in §1.961-3(d) does not apply because F2 does not distribute any previously taxed earnings and profits before the last relevant day. See §1.961-3(c)(3). Thus, the hypothetical distribution rule in §1.961-3(e) determines the entirety of the increases to basis for the income inclusions. See §1.961-3(c)(4). Under the hypothetical distribution rule, the basis of each share of stock of F2 is increased by \$4x (\$200x ÷ 50 shares), and the basis of each share of stock of F1 is increased by \$2x (\$200x ÷ 100 shares), which in each case is equal to the portion of a \$200x hypothetical distribution treated as made by F2 through all tiers to US1 on the last relevant day that would be distributed with respect to the property unit. See §1.961-3(e). These increases to basis are treated as made at the beginning of F2's taxable year 3 because there are no midyear transactions and the entirety of the \$200x of income inclusions is under section 951(a)(1)(A) or 951A(a). See §1.961-3(c)(2) and (e)(1). Accordingly, at the beginning of F2's taxable year 3, F1 increases its section 961(c) basis with respect to US1 of each share of stock of F2 by \$4x, and US1 increases its adjusted basis of each share of stock of F1 by \$2x.

(iii) *Alternative facts: midyear transaction and actual distribution rule--(A) Facts.* The facts are the same as in paragraph (c)(2)(i) of this section, except as follows. On January 1 of year 3, US1 directly owns all the stock of F2. On March 31 of year 3, F2 distributes previously taxed earnings and profits to US1 (pro rata with respect to the shares of stock of F2) and, consequently, US1 is required under §1.961-4 (basis reductions and gain recognition for distributions) to adjust its adjusted basis of each share of stock of F2 by \$3x (the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are distributed on the share). On June 30 of year 3, F1 is formed and US1 immediately contributes all its stock of F2 to

F1 in exchange for 100 shares of stock of F1. Thus, before the contribution, shares of stock of F2 are section 961(a) ownership units and, beginning as of the contribution, all the shares of stock of F1 are section 961(a) ownership units and all the shares of stock of F2 are section 961(c) ownership units.

(B) *Analysis--(1) In general.* To reflect US1's income inclusions for F2's taxable year ending on December 31 of year 3, basis of shares of stock of F2, and basis of shares of stock of F1 (property units through which US1 owns stock of F2), is in each case increased in accordance with §1.961-3. See §1.961-3(b). In the case of stock of F2, because shares of the stock are section 961(a) ownership units before the contribution and section 961(c) ownership units after the contribution, the type of basis that is increased depends on the timing of adjustments. Specifically, in the case of stock of F2 and an increase to basis that is treated as made before the contribution, the basis that is increased is US1's adjusted basis because shares of stock of F2 are section 961(a) ownership units before the contribution. In the case of stock of F2 and an increase to basis that is treated as made after the contribution, the basis that is increased is F1's section 961(c) basis with respect to US1 because shares of stock of F2 are section 961(c) ownership units after the contribution and F2 is a controlled foreign corporation, as required by §1.961-3(f)(1). In the case of stock of F1, US1's adjusted basis is increased because shares of stock of F1 are section 961(a) ownership units. Paragraph (c)(2)(iii)(B)(2) of this section provides the specific increases to basis.

(2) *Increases to basis of each property unit.* The amount of US1's income inclusions with respect to F2 that give rise to increases to basis under section 961 is \$200x (\$80x + \$120x). See §1.961-3(c)(1). In determining the specific increases to basis for the income inclusions, the actual distribution rule in §1.961-3(d) applies because F2's distribution of previously taxed earnings and profits is made before the last relevant day. See §1.961-3(c)(3). Under the actual distribution rule, basis of each share of stock of F2 is increased by \$3x, which is equal to the adjustment required under §1.961-4 to the basis of such share by reason of the distribution, and thus basis of stock of F2 increases by \$150x in total (\$3x × 50 shares). See §1.961-3(d)(2). These increases to basis are treated as made at the beginning of F2's taxable year because the distribution is made before the contribution of all the stock of F2 to F1, the sole midyear transaction occurring within the taxable year. See §1.961-3(c)(2) and (d)(1). Then, the hypothetical distribution rule in §1.961-3(e) determines increases to basis for the remaining \$50x of income inclusions (\$200x of income inclusions – \$150x of basis increases to stock of F2 under the actual distribution rule). See §1.961-3(c)(4). Under the hypothetical distribution rule, the basis of each share of stock of F2, and the basis of each share of stock of F1, is increased by the portion of a \$50x hypothetical distribution treated as made by F2 through all tiers to US1 on the last relevant day that would be distributed with respect to the property unit. See §1.961-3(e). These increases to basis are treated as made immediately after the contribution (the sole midyear transaction occurring within F2's taxable year). See §1.961-3(e)(1). Table 1 in this paragraph (c)(2)(iii)(B)(2) provides the increases to basis.

**Table 1 to paragraph (c)(2)(iii)(B)(2) of this section**

BASIS INCREASES TO REFLECT US1'S INCOME INCLUSIONS WITH RESPECT TO F2		
	Basis increases	
	January 1 of year 3	June 30 of year 3

US1's adjusted basis of stock of F1 (100 shares)			\$0.5x increase for each share (\$50x hypothetical distribution ÷ 100 shares)
Stock of F2 (50 shares)	US1's adjusted basis (before contribution)	\$3x increase for each share (actual distribution rule)	
	F1's section 961(c) basis with respect to US1 (as of contribution)		\$1x increase for each share (\$50x hypothetical distribution ÷ 50 shares)

(iv) *Alternative facts: partnership structure and section 951(a)(1)(B) inclusion--(A) Facts.* The facts are the same as in paragraph (c)(2)(i) of this section (*Example 2*), except as follows. US1 is a citizen of the United States (rather than a domestic corporation), referred to as Individual A for purposes of the rest of this paragraph (c)(2)(iv), and does not make an election to apply the provisions of section 962 for any taxable year. PRS1 directly owns all the stock of F1, and Individual A owns 60%, and a nonresident alien individual owns 40%, of the interests in PRS1. Thus, the interest in PRS1 directly owned by Individual A is a section 961(a) ownership unit, the shares of stock of F1 directly owned by PRS1 are derivative ownership units, and the shares of stock of F2 directly owned by F1 are section 961(c) ownership units. In addition, for F2's taxable year ending on December 31 of year 3, Individual A includes \$80x in gross income under section 951(a)(1)(A) (its pro rata share of F2's subpart F income, translated into U.S. dollars in accordance with section 989(b)), \$120x in gross income under section 951A(a) (the portion of its GILTI inclusion amount that is treated as with respect to F2 for the taxable year under section 951A(f)(2)), and \$50x in gross income under section 951(a)(1)(B) (the portion of its section 956 amount that is not allocated to previously taxed earnings and profits, translated into U.S. dollars in accordance with section 989(b)).

(B) *Analysis--(1) In general.* To reflect Individual A's income inclusions for F2's taxable year ending on December 31 of year 3, basis of shares of stock of F2, and basis of shares of stock of F1 and basis of Individual A's interest in PRS1 (property units through which Individual A owns stock of F2), is in each case increased in accordance with §1.961-3. See §1.961-3(b). In the case of stock of F2, the basis that is increased is F1's section 961(c) basis with respect to Individual A because shares of stock of F2 are section 961(c) ownership units and F2 is a controlled foreign corporation, as required by §1.961-3(f)(1). In the case of stock of F1, PRS1's derived basis with respect to Individual A is increased because shares of stock of F1 are derivative ownership units. In the case of Individual A's interest in PRS1, Individual A's adjusted basis is increased because its interest in PRS1 is a section 961(a) ownership unit. Paragraph (c)(2)(iv)(B) of this section provides the specific increases to basis.

(2) *Increases to basis of each property unit.* The amount of Individual A's income inclusions with respect to F2 that give rise to increases to basis under section 961 is \$250x (\$80x + \$120x + \$50x). See §1.961-3(c)(1). The hypothetical distribution rule in §1.961-3(e) determines the entirety of the increases to basis for the income inclusions. See §1.961-3(c)(3) and (4). Under the hypothetical distribution rule, the basis of each property unit is increased by the portion of a \$250x hypothetical distribution treated as made by F2 through all tiers to Individual A on the last relevant day that would be distributed with respect to the property unit (determined by regarding stock of F2 and other property only to the extent owned by Individual A on the last relevant day). See §1.961-3(e). In addition, because 20% of the \$250x of income inclusions is under section 951(a)(1)(B) (\$50x/\$250x), 20% of each increase to basis is treated as made at

the end of the last day of F2's taxable year (which is when the previously taxed earnings and profits resulting from the income inclusion under section 951(a)(1)(B) are added to previously taxed earnings and profits accounts), with the remaining 80% treated as made at the beginning of the taxable year (which is when the previously taxed earnings and profits resulting from the income inclusions under sections 951(a)(1)(A) and 951A(a) are added to previously taxed earnings and profits accounts). See §1.961-3(e)(1). Table 1 in this paragraph (c)(2)(iii)(B)(2) provides the increases to basis.

**Table 1 to paragraph (c)(2)(iv)(B)(2) of this section**

**BASIS INCREASES TO REFLECT INDIVIDUAL A'S INCOME INCLUSIONS WITH RESPECT TO F2**

	Basis increases	
	January 1 of year 3	December 31 of year 3
Individual A's adjusted basis of its interest in PRS1	\$200x increase (\$250x × 80%)	\$50x increase (\$250x × 20%)
PRS1's derived basis with respect to Individual A of stock of F1 (100 shares)	\$2x increase for each share (\$250x ÷ 100 shares × 80%)	\$0.5 increase for each share (\$250x ÷ 100 shares × 20%)
F1's section 961(c) basis with respect to Individual A of stock of F2 (50 shares)	\$4x increase for each share (\$250x ÷ 50 shares × 80%)	\$1x increase for each share (\$250x ÷ 50 shares × 20%)

(3) *Example 3: Basis reductions and gain recognition for distributions--(i) Facts.* US1 and US2, in the aggregate, directly own all the shares of the single class of outstanding stock of F1. In year 3, F1 makes a covered distribution (pro rata with respect to the shares of stock of F1). Under §1.959-4, the entirety of the portion of the covered distribution received by each of US1 and US2 is previously taxed earnings and profits excluded from the covered shareholder's (US1's or US2's) gross income. In addition, the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are distributed on each share of stock of F1 owned by US1 is \$6x, and the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are distributed on each share of stock of F1 owned by US2 is \$4x. Immediately before the covered distribution, US1's adjusted basis of each of its shares of stock of F1 is \$4.5x, and US2's adjusted basis of each of its shares of stock of F1 is \$3x. Each of US1 and US2 is deemed to pay the entirety of the associated foreign income taxes of the previously taxed earnings and profits distributed to it under section 960(b) (because all such taxes are sourced from the creditable PTEP tax group and the covered shareholder is a United States shareholder of F1) and is allowed a credit under section 901 for the entirety of such taxes. This example only analyzes adjustments to basis of US1's and US2's shares of stock of F1 (section 961(a) ownership units) under section 961. See *also* §1.959-3 (adjustments to previously taxed earnings and profits accounts).

(ii) *Analysis--(A) In general.* Under §1.961-4(b), each of US1 and US2 reduces its adjusted basis of, and if applicable recognizes gain with respect to, each share of stock of F1 on which it receives previously taxed earnings and profits. The specific adjustments are provided in paragraphs (c)(3)(ii)(B) through (D) of this section and summarized in table 1 in this paragraph (c)(3)(ii)(A).

**Table 1 to paragraph (c)(3)(ii)(A) of this section**

**BASIS ADJUSTMENTS RESULTING FROM F1'S DISTRIBUTION OF PTEP**



	Basis immediately before the covered distribution	Adjustments to basis under §1.961-4(b)	
US1's adjusted basis of its shares of stock of F1	\$4.5x for each share	\$6x adjustment for each share	\$4.5x reduction to basis (to \$0)
			\$1.5x gain recognized
US2's adjusted basis of its shares of stock of F1	\$3x for each share	\$4x adjustment for each share	\$3x reduction to basis (to \$0)
			\$1x gain recognized

(B) *US1's receipt of previously taxed earnings and profits.* As a result of US1's receipt of previously taxed earnings and profits, the amount of the adjustment to US1's adjusted basis of each of its shares of stock of F1 is \$6x, the dollar basis and associated foreign income taxes of the previously taxed earnings and profits received on the share. See §1.961-4(b)(2)(i). Consequently, US1 reduces its adjusted basis of each of its shares of stock of F1 (\$4.5x) to \$0 and then is treated as recognizing \$1.5x of gain with respect to the share (computed as the excess of the \$6x adjustment to basis over the \$4.5x reduction to basis). See §1.961-4(b)(2)(ii) and (iii).

(C) *US2's receipt of previously taxed earnings and profits.* As a result of US2's receipt of previously taxed earnings and profits, the amount of the adjustment to US2's adjusted basis of each of its shares of stock of F1 is \$4x, the dollar basis and associated foreign income taxes of the previously taxed earnings and profits received on the share. See §1.961-4(b)(2)(i). Consequently, US2 reduces its adjusted basis of each of its shares of stock of F1 (\$3x) to \$0 and then is treated as recognizing \$1x of gain with respect to the share (computed as the excess of the \$4x adjustment to basis over the \$3x reduction to basis). See §1.961-4(b)(2)(ii) and (iii).

(D) *Timing of adjustments.* The reductions to adjusted basis described in paragraphs (c)(3)(ii)(B) and (C) of this section are treated as made, and the gains described in those paragraphs are treated as recognized, concurrently with the covered distribution. See §1.961-4(e)(1) and (f)(1).

(iii) *Alternative facts: previously taxed earnings and profits received through a partnership--(A) Facts.* The facts are the same as in paragraph (c)(3)(i) of this section (*Example 3*), except as follows. PRS1 directly owns all the shares of the single class of outstanding stock of F1, and US1 and US2, in the aggregate, directly own all the interests in PRS1. Under §1.959-4, the entirety of the portion of the covered distribution treated as received by each of US1 and US2 through PRS1 is previously taxed earnings and profits excluded from the covered shareholder's (US1's or US2's) gross income. In addition, the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are both with respect to US1 and distributed on each share of stock of F1 is \$6x, and the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are both with respect to US2 and distributed on each share of stock of F1 is \$4x. Immediately before the covered distribution, for each share of stock of F1, PRS1's common basis is \$2.5x, its derived basis with respect to US1 is \$3x, and its derived basis with respect to US2 is \$2x. This paragraph (c)(3)(iii) analyzes adjustments to basis of PRS1's shares of stock of F1 (derivative ownership units) under section 961. See also §1.961-4(b) (related adjustments to basis of US1's and US2's interests in PRS1).

(B) *Analysis--(1) In general.* Under §1.961-4(c), PRS1 reduces its derived basis of, and if applicable recognizes gain with respect to, each share of stock of F1 on which US1 or US2 receives previously taxed earnings and profits through PRS1. The specific adjustments are provided in paragraphs (c)(3)(iii)(B)(2) through (5) of this section and summarized in table 1 in this paragraph (c)(3)(iii)(B)(1).

**Table 1 to paragraph (c)(3)(iii)(B)(1) of this section**

<b>BASIS ADJUSTMENTS RESULTING FROM F1'S DISTRIBUTION OF PTEP</b>			
	<b>PRS1 derived basis immediately before the covered distribution</b>	<b>Adjustments to PRS1 derived basis under §1.961-4(c)</b>	
PRS1's derived basis with respect to US1 of its shares of stock of F1	\$3x for each share	\$6x adjustment for each share	\$4.5x reduction to basis (to negative \$1.5x)
			\$1.5x gain recognized
PRS1's derived basis with respect to US2 of its shares of stock of F1	\$2x for each share	\$4x adjustment for each share	\$3x reduction to basis (to negative \$1x)
			\$1x gain recognized

(2) *US1's receipt of previously taxed earnings and profits through PRS1.* As a result of US1's receipt of previously taxed earnings and profits through PRS1, the amount of the adjustment to PRS1's derived basis with respect to US1 of each of PRS1's shares of stock of F1 is \$6x, the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are both with respect to US1 and received on the share. See §1.961-4(c)(2)(i). Consequently, PRS1 reduces its derived basis with respect to US1 of each of its shares of stock of F1 (\$3x) to \$0 and then reduces such derived basis below zero in accordance with the limitation in §1.961-4(c)(3), which permits a \$1.5x reduction below zero to the derived basis because \$1.5x of PRS1's common basis of the share is available with respect to US1 (as described in paragraph (c)(3)(iii)(B)(4) of this section). See §1.961-4(c)(2)(ii) and (iii), (c)(3)(i). Further, PRS1 is treated as recognizing \$1.5x of gain with respect to each of its shares of stock of F1 (computed as the excess of the \$6x adjustment to basis over the sum of the \$3x reduction to positive derived basis and the \$1.5x reduction of derived basis below zero), and this gain is allocated solely to US1. See §1.961-4(c)(2)(iv); see also §1.961-4(f)(2) (taking the gain into account in adjusting US1's basis in its interest in PRS1 under section 705).

(3) *US2's receipt of previously taxed earnings and profits through PRS1.* As a result of US2's receipt of previously taxed earnings and profits through PRS1, the amount of the adjustment to PRS1's derived basis with respect to US2 of each of PRS1's shares of stock of F1 is \$4x, the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are both with respect to US2 and received on the share. See §1.961-4(c)(2)(i). Consequently, PRS1 reduces its derived basis with respect to US2 of each of its shares of stock of F1 (\$2x) to \$0 and then reduces such derived basis below zero in accordance with the limitation in §1.961-4(c)(3), which permits a \$1x reduction below zero to the derived basis because \$1x of PRS1's common basis of the share is available with respect to US2 (as described in paragraph (c)(3)(iii)(B)(4) of this section). See §1.961-4(c)(2)(ii) and (iii) and (c)(3)(i). Further, PRS1 is treated as recognizing \$1x of gain with respect to each of its shares of

stock of F1 (computed as the excess of the \$4x adjustment to basis over the sum of the \$2x reduction to positive derived basis and the \$1x reduction of derived basis below zero), and this gain is allocated solely to US2. See §1.961-4(c)(2)(iv); see also §1.961-4(f)(2) (taking the gain into account in adjusting US2's basis in its interest in PRS1 under section 705).

(4) *Available common basis.* For each of PRS1's shares of stock of F1, the amount of common basis of the share that is available with respect to each of US1 and US2 is determined by multiplying \$2.5x (the common basis of the share, reduced by all negative derived basis of the share existing immediately before the distribution being analyzed, of which there is none) by a fraction. See §1.961-4(c)(3)(ii). The numerator of the fraction is the amount by which PRS1's derived basis with respect to the covered shareholder of the share would be reduced below zero if derived basis could be reduced without limitation and, accordingly, is \$3x in the case of the derived basis with respect to US1 (computed as the excess of the \$6x adjustment to basis over the \$3x reduction to positive derived basis) and is \$2x in the case of derived basis with respect to US2 (computed as the excess of the \$4x adjustment to basis over the \$2x reduction to positive derived basis). The denominator of the fraction is the sum of the amounts by which any of PRS1's derived basis of the share would be reduced below zero if derived basis could be reduced without limitation (\$5x, computed as the \$3x with respect to US1 plus the \$2x with respect to US2). Therefore, for each of PRS1's shares of stock of F1, there is \$1.5x of common basis available with respect to US1 ( $\$2.5x \times \$3x/\$5x$ ) and \$1x of common basis available with respect to US2 ( $\$2.5x \times \$2x/\$5x$ ), and this common basis permits a \$1.5x and \$1x reduction below zero to derived basis with respect to US1 and US2, respectively (as described in paragraphs (c)(3)(iii)(B)(2) and (3) of this section). See also §1.961-10(b) (gain resulting from negative derived basis is allocated to covered shareholders in proportion to relative negative derived basis).

(5) *Timing of adjustments.* The reductions to derived basis described in paragraphs (c)(3)(iii)(B)(2) and (3) of this section are treated as made, and the gains described in those paragraphs are treated as recognized, concurrently with the covered distribution. See §1.961-4(e)(1) and (f)(1).

(iv) *Alternative facts: previously taxed earnings and profits received by a controlled foreign corporation--(A) Facts.* The facts are the same as in paragraph (c)(3)(i) of this section (*Example 3*), except as follows. US1 and US2, in the aggregate, directly own all the outstanding stock of F2 and are United States shareholders of F2. F2 directly owns all the shares of the single class of outstanding stock of F1. Under §1.959-4, the entirety of each of US1's and US2's share of F1's covered distribution is previously taxed earnings and profits excluded from F2's gross income for purposes of determining its subpart F income and tested income or tested loss. In addition, the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are both with respect to US1 and distributed on each share of stock of F1 is \$6x, and the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are both with respect to US2 and distributed on each share of stock of F1 is \$4x. Immediately before the covered distribution, for each share of stock of F1, F2's adjusted basis is £1.25x, its section 961(c) basis with respect to US1 is \$3x, and its section 961(c) basis with respect to US2 is \$2x. On the day of the covered distribution, the spot rate is \$1:£0.5. This paragraph (c)(3)(iv) analyzes adjustments to basis of F2's shares of stock of F1 (section 961(c) ownership units) under section 961.

(B) *Analysis--(1) In general.* Under §1.961-4(d), F2 reduces its section 961(c) basis of, and if applicable recognizes gain with respect to, each share of stock of F1 on which it receives previously taxed earnings and profits. The specific adjustments are provided in paragraphs (c)(3)(iv)(B)(2) through (5) of this section and summarized in table 1 in this paragraph (c)(3)(iv)(B)(1).

**Table 1 to paragraph (c)(3)(iv)(B)(1) of this section**

<b>BASIS ADJUSTMENTS RESULTING FROM F1'S DISTRIBUTION OF PTEP</b>			
	<b>F2 section 961(c) basis immediately before the covered distribution</b>	<b>Adjustments to F2 section 961(c) basis under §1.961-4(d)</b>	
F2's section 961(c) basis with respect to US1 of its shares of stock of F1	\$3x for each share	\$6x adjustment for each share	\$4.5x reduction to basis (to negative \$1.5x)
			\$1.5x gain recognized
F2's section 961(c) basis with respect to US2 of its shares of stock of F1	\$2x for each share	\$4x adjustment for each share	\$3x reduction to basis (to negative \$1x)
			\$1x gain recognized

(2) *F2's receipt of previously taxed earnings and profits with respect to US1.* As a result of F2's receipt of previously taxed earnings and profits with respect to US1, the amount of the adjustment to F2's section 961(c) basis with respect to US1 of each of F2's shares of stock of F1 is \$6x, the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are both with respect to US1 and received on the share. See §1.961-4(d)(2)(i). Consequently, F2 reduces its section 961(c) basis with respect to US1 of each of its shares of stock of F1 (\$3x) to \$0 and then reduces such section 961(c) basis below zero in accordance with the limitation in §1.961-4(d)(3), which permits a \$1.5x reduction below zero to the section 961(c) basis because \$1.5x of F2's adjusted basis of the share is available with respect to US1 (as described in paragraph (c)(3)(iv)(B)(4) of this section). See §1.961-4(d)(2)(ii) and (d)(3)(i). Further, F2 is treated as recognizing £0.75x of gain with respect to each of its shares of stock of F1 (computed as the excess of the \$6x adjustment to basis over the sum of the \$3x reduction to positive section 961(c) basis and the \$1.5x reduction of section 961(c) basis below zero (\$1.5x excess), with such excess of \$1.5x translated into British pounds at \$1:£0.5), and this gain is assigned solely to US1. See §1.961-4(d)(2)(iii) and (f)(4). Moreover, the gain applies only for purposes of determining amounts included in gross income of US1 and US2 (the United States shareholders of F2) under §1.961-11. See §1.961-4(f)(3).

(3) *F2's receipt of previously taxed earnings and profits with respect to US2.* As a result of F2's receipt of previously taxed earnings and profits with respect to US2, the amount of the adjustment to F2's section 961(c) basis with respect to US2 of each of F2's shares of stock of F1 is \$4x, the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are both with respect to US2 and received on the share. See §1.961-4(d)(2)(i). Consequently, F2 reduces its section 961(c) basis with respect to US2 of each of its shares of stock of F1 (\$2x) to \$0 and then reduces such section 961(c) basis below zero in accordance with the limitation in §1.961-4(d)(3), which permits a \$1x reduction below zero to the section 961(c) basis because \$1x of F2's adjusted basis of the share is available with respect to US2 (as described in paragraph (c)(3)(iv)(B)(4) of this section). See §1.961-4(d)(2)(ii) and

(d)(3)(i). Further, F2 is treated as recognizing £0.5x of gain with respect to each of its shares of stock of F1 (computed as the excess of the \$4x adjustment to basis over the sum of the \$2x reduction to positive section 961(c) basis and the \$1x reduction of section 961(c) basis below zero (\$1x excess), with such excess of \$1x translated into British pounds at \$1:£0.5), and this gain is assigned solely to US2. See §1.961-4(d)(2)(iii) and (f)(4). Moreover, the gain applies only for purposes of determining amounts included in gross income of US1 and US2 (the United States shareholders of F2) under §1.961-11. See §1.961-4(f)(3).

(4) *Available adjusted basis.* For each of F2's shares of stock of F1, the amount of adjusted basis of the share that is available with respect to each of US1 and US2 is determined by multiplying \$2.5x (the £1.25x of adjusted basis of the share translated into U.S. dollars at \$1:£0.5, reduced by all negative derived basis of the share existing immediately before the distribution being analyzed, of which there is none) by a fraction. See §1.961-4(d)(3)(ii). The numerator of the fraction is the amount by which F2's section 961(c) basis with respect to the covered shareholder of the share would be reduced below zero if section 961(c) basis could be reduced without limitation and, accordingly, is \$3x in the case of the section 961(c) basis with respect to US1 (computed as the excess of the \$6x adjustment to basis over the \$3x reduction to positive section 961(c) basis) and is \$2x in the case of section 961(c) basis with respect to US2 (computed as the excess of the \$4x adjustment to basis over the \$2x reduction to positive section 961(c) basis). The denominator of the fraction is the sum of the amounts by which any of F2's section 961(c) basis of the share would be reduced below zero if section 961(c) basis could be reduced without limitation (\$5x, computed as the \$3x with respect to US1 plus the \$2x with respect to US2). Therefore, for each of F2's shares of stock of F1, there is \$1.5x of adjusted basis available with respect to US1 ( $\$2.5x \times \$3x/\$5x$ ) and \$1x of adjusted basis available with respect to US2 ( $\$2.5x \times \$2x/\$5x$ ), and this adjusted basis permits a \$1.5x and \$1x reduction below zero to section 961(c) basis with respect to US1 and US2, respectively (as described in paragraphs (c)(3)(iv)(B)(2) and (3) of this section). See also §1.961-10(c) (gain resulting from negative section 961(c) basis is allocated to covered shareholders in proportion to relative negative section 961(c) basis).

(5) *Timing of adjustments.* The reductions to section 961(c) basis described in paragraphs (c)(3)(iv)(B)(2) and (3) of this section are treated as made, and the gains described in those paragraphs are treated as recognized, concurrently with the covered distribution. See §1.961-4(e)(1) and (f)(1).

(4) *Example 4: Use of positive derived basis--(i) Facts.* US1 and a nonresident alien individual, in the aggregate, directly own all the interests in PRS1. PRS1 directly owns all the shares of the single class of outstanding stock of F1 (derivative ownership units). In year 3, PRS1 sells all the stock of F1 for money equal to the stock's fair market value. Section 304 does not apply to the sale. US1's distributive share of gain recognized by PRS1 on the sale is \$60x, determined without regard to derived basis. Immediately before the sale (and taking into account any adjustments under §1.961-5(b) resulting from the sale), PRS1's positive derived basis with respect to US1 of the shares of stock of F1 is \$50x in total. In addition, PRS1 has no negative derived basis in any of the shares. This example only analyzes the application of positive derived basis to US1's distributive share of gain on the sale. See also §1.959-3 (adjustments to previously taxed earnings and profits accounts); §1.959-7 (transfer of previously taxed earnings and profits in general successor transactions); §1.986(c)-1 (foreign currency gain or loss recognized in general successor transactions).

(ii) *Analysis.* PRS1 is treated as applying its \$50x of positive derived basis with respect to US1 of the stock of F1 to US1's \$60x distributive share of gain on the sale. See §1.961-8(b). As result, US1's distributive share of gain on the sale is adjusted by \$50x, to a \$10x distributive share of gain. See *also* §1.961-8(c) (for purposes of adjusting US1's adjusted basis of its interest in PRS1 under section 705, US1's distributive share on the sale is \$10x of gain).

(iii) *Alternative facts: positive derived basis creates a distributive share of loss--*  
(A) *Facts.* The facts are the same as in paragraph (c)(4)(i) of this section, except that PRS1's positive derived basis with respect to US1 of the shares of stock of F1 is \$75x in total. In addition, if there were a loss in PRS1's stock of F1, PRS1 would recognize all such loss in the sale and a current deduction in respect of the loss would be allowable.

(B) *Analysis.* PRS1 is treated as applying its \$75x of positive derived basis with respect to US1 of the stock of F1 to US1's \$60x distributive share of gain on the sale. See §1.961-8(b). As result, US1's distributive share of the gain on the sale is adjusted by \$75x, to a \$15x distributive share of loss. See *also* §1.961-8(c) (for purposes of adjusting US1's adjusted basis of its interest in PRS1 under section 705, US1's distributive share on the sale is \$15x of loss).

(iv) *Alternative facts: tiered partnerships--*(A) *Facts.* The facts are the same as in paragraph (c)(4)(i) of this section (*Example 4*), except as follows. US1 and a nonresident alien individual, in the aggregate, directly own all the interests in PRS2. PRS2 and a nonresident alien individual, in the aggregate, directly own all the interests in PRS1. US1's distributive share of gain recognized by PRS1 on the sale (through its interest in PRS2) is \$55x, determined without regard to derived basis.

(B) *Analysis.* PRS2 is treated as applying PRS1's \$50x of positive derived basis with respect to US1 of the stock of F1 to US1's \$55x distributive share of gain on the sale. See §1.961-8(b). As result, US1's distributive share of gain on the sale is adjusted by \$50x, to a \$5x distributive share of gain. See *also* §1.961-8(c) (for purposes of adjusting US1's adjusted basis of its interest in PRS2 under section 705, US1's distributive share on the sale is \$5x of gain); §1.961-8(d) (for purposes of adjusting PRS2's common basis of its interest in PRS1 under section 705, PRS2's distributive share of gain is determined without regard to the application of positive derived basis; concurrently with the adjustment under section 705, reducing PRS2's derived basis with respect to US1 of the interest in PRS1 by \$50x, the amount of positive derived basis applied to US1's distributive share of gain).

(5) *Example 5: Use of positive section 961(c) basis--*(i) *Facts.* US1 and a nonresident alien individual, in the aggregate, directly own all the shares of the single class of outstanding stock of F1. F1 directly owns all the shares of the single class of outstanding stock of F2 (section 961(c) ownership units). In year 3, F1 sells all the stock of F2 for money equal to the stock's fair market value. Section 304 does not apply to the sale. F1 recognizes £100x of gain on the sale, determined without regard to loss recognized on any share and without regard to section 961(c) basis. This £100x is covered gain and US1 is assigned a £60x portion of the covered gain under §1.951-2. Immediately before the sale (and taking into account any adjustments under §1.961-5(b) resulting from the sale), F1's positive section 961(c) basis with respect to US1 of the shares of stock of F2 is £50x in total (as translated from U.S. dollars into British pounds at the spot rate on the day of the sale). In addition, F1 has no negative section

961(c) basis in any of the shares. Table 1 in this paragraph (c)(5)(i) provides the previously taxed earnings and profits of F2 that transfer from US1 in the sale to a successor covered shareholder under §1.959-7 (total of £44x), along with the foreign income taxes that are associated with such previously taxed earnings and profits (total of £6x, as translated from U.S. dollars into British pounds at the spot rate on the day of the sale for purposes of §1.961-9(f)(2)). This example only analyzes the extent to which previously taxed earnings and profits result from the application of F1's section 961(c) basis and are excluded from F1's gross income under section 961(c). See *also* §1.959-3 (adjustments to previously taxed earnings and profits accounts); §1.986(c)-1 (foreign currency gain or loss recognized in general successor transactions).

**Table 1 to paragraph (c)(5)(i) of this section**

**F2 PTEP TRANSFERRING FROM US1 & ASSOCIATED FOREIGN INCOME TAXES**

Taxable Year		§904 Category			
		General Category		Passive Category	§951A Category
		§951(a)(1)(A) PTEP group	§245A(d) PTEP group	§951(a)(1)(A) PTEP group	§951A PTEP group
Year 2	Transferred PTEP				£10x
	Taxes				
Year 1	Transferred PTEP	£7.2x	£4x	£4.8x	£18x
	Taxes	£1.8x	£1x	£1.2x	£2x

(ii) *Analysis--(A) In general.* For purposes of analyzing the covered gain, US1's share of the covered gain is £60x because that amount of the covered gain is assigned to US1 under §1.951-2. See §1.961-9(d)(1). All £50x of F1's positive section 961(c) basis with respect to US1 of the stock of F2 is applied to such share. See §1.961-9(d)(2) and (e)(1). As a result, £50x of the covered gain is previously taxed earnings and profits of F1 with respect to US1, characterized as described in paragraph (c)(5)(ii)(B) of this section. See §1.961-9(d)(3) and (f)(1). F1 excludes the £50x of previously taxed earnings resulting from section 961(c) basis from its gross income, solely for purposes of determining its subpart F income and tested income or tested loss. See §1.961-9(b).

(B) *Character of previously taxed earnings and profits resulting from section 961(c) basis.* The mirroring rule in §1.961-9(f)(2) determines the specific character of all £50x of F1's previously taxed earnings and profits resulting from section 961(c) basis because the amount of such previously taxed earnings and profits does not exceed the amount of mirrored PTEP, of which there is £50x. See §1.961-9(f)(2)(i). The mirrored PTEP is the previously taxed earnings and profits described in table 1 to paragraph (c)(5)(i) of this section, determined by treating foreign income taxes associated with transferred previously taxed earnings and profits as additional previously taxed earnings and profits (£44x + £6x). See §1.961-9(f)(2)(ii). Under the mirroring rule, the £50x of previously taxed earnings and profits resulting from section 961(c) basis have the same character as the £50x of mirrored PTEP, as summarized in table 1 in this paragraph (c)(5)(ii)(B). See §1.961-9(f)(2)(i); see *also* §1.961-9(g) and (h) (dollar basis rule and rule for allocating previously taxed earnings and profits to specific shares of stock).

**Table 1 to paragraph (c)(5)(ii)(B) of this section**

### F1 PTEP RESULTING FROM §961(C) BASIS

Taxable Year	§904 Category			
	General Category		Passive Category	§951A Category
	§951(a)(1)(A) PTEP group	§245A(d) PTEP group	§951(a)(1)(A) PTEP group	§951A PTEP group
Year 2				£10x (£10x + £0)
Year 1	£9x (£7.2x + £1.8x)	£5x (£4x + £1x)	£6x (£4.8x + £1.2x)	£20x (£18x + £2x)

(iii) *Alternative facts: unused section 961(c) basis--(A) Facts.* The facts are the same as in paragraph (c)(5)(i) of this section (*Example 5*), except that the amount of F1's covered gain is £70x (instead of £100x) and US1 is assigned a £42x (instead of £60x) portion of the covered gain under §1.951-2.

(B) *Analysis.* For purposes of analyzing the covered gain, US1's share of the covered gain is £42x, and £42x of F1's £50x of positive section 961(c) basis with respect to US1 of the stock of F2 is applied to such share. See §1.961-9(d)(1) and (2), (e)(1). As a result, £42x of the covered gain is previously taxed earnings and profits of F1 with respect to US1, with the same character as a pro rata portion of the previously taxed earnings and profits set forth in table 1 to paragraph (c)(5)(ii)(B) of this section, determined by multiplying all such previously taxed earnings and profits by 84% (computed as \$42x of previously taxed earnings and profits resulting from section 961(c) basis divided by £50x of mirrored PTEP). See §1.961-9(d)(3), (f)(1) and (2). Moreover, the £8x of F1's positive section 961(c) basis that is not applied to the covered gain is taken into account only for purposes of determining amounts included in gross income of United States shareholders of F1 under §1.961-11.

(6) *Example 6: Gain recognition for negative derived basis--(i) Facts.* US1 and US2, in the aggregate, directly own all the interests in PRS1. PRS1 directly owns all the shares of the single class of stock of F1 (derivative ownership units). In year 3, PRS1 sells all the stock of F1 for money equal to the stock's fair market value. Section 304 does not apply to the sale, and the shares of stock of F1 remain derivative ownership units immediately after the sale (because the buyer is a partnership the interests in which are owned by one or more covered shareholders). PRS1 recognizes \$2x of loss with respect to each share of stock of F1, determined without regard to derived basis and allocated to US1 and US2 in accordance with section 704. Immediately before the sale (and taking into account any adjustments under §1.961-5(b) resulting from the sale), for each share of stock of F1, PRS1's derived basis with respect to US1 is negative \$1.5x and its derived basis with respect to US2 is negative \$1x. This example only analyzes the consequences of negative derived basis in the sale. See *also* §1.959-3 (adjustments to previously taxed earnings and profits accounts); §1.959-7 (transfer of previously taxed earnings and profits in general successor transactions); §1.986(c)-1 (foreign currency gain or loss recognized in general successor transactions).

(ii) *Analysis.* As a result of negative derived basis, PRS1 is treated as recognizing gain with respect to each share of stock of F1. See §1.961-10(b)(1). For each share of stock of F1, the amount of such gain is \$2.5x, which is the lesser amount



of loss (\$2x, expressed as a positive amount), plus the additional amount of gain (\$0.5x), that PRS1 would have recognized with respect to the share if PRS1's common basis of the share were reduced by \$2.5x (the sum of all PRS1's negative derived basis of the share), and thus all negative derived basis gives rise to gain. See §1.961-10(b)(2)(i); *compare* paragraph (c)(6)(iii) of this section (scenario where less than all negative derived basis gives rise to gain). A pro rata portion of the \$2.5x of gain treated as recognized with respect to each share of stock of F1 is allocated to US1 and US2 by multiplying the amount of such gain by a fraction, the numerator of which is PRS1's negative derived basis with respect to the covered shareholder of the share (\$1.5x in the case of US1, and \$1x in the case of US2), and the denominator of which is the sum of all PRS1's negative derived basis of the share (\$2.5x). See §1.961-10(b)(3). Thus, in addition to the allocation in accordance with section 704 of the \$2x of loss that PRS1 recognizes with respect to each share of stock of F1, US1 is allocated \$1.5x, and US2 is allocated \$1x, of the \$2.5x of gain treated as recognized by PRS1 with respect to each share of stock of F1. See §1.961-10(b)(4); *see also* §1.961-4(f)(2) (gain allocated to US1 or US2 is taken into account in adjusting US1's or US2's basis in its interest in PRS1 under section 705).

(iii) *Alternative facts: section 301(c)(2) distribution--(A) Facts.* The facts are the same as in paragraph (c)(6)(i) of this section (*Example 6*), except as follows. PRS1 does not sell any stock of F1. In year 3, F1 makes a distribution that is \$10x with respect to each share of its stock. None of the distribution is a covered distribution because F1 has no accumulated or current year earnings and profits in year 3. Immediately before the distribution, for each share of stock of F1, PRS1's common basis is \$12x, its derived basis with respect to US1 is negative \$1.5x, and its derived basis with respect to US2 is negative \$1x. Thus, section 301(c)(2) applies to the entirety of the \$10x that is distributed with respect to each share of stock of F1. This example only analyzes the consequences of negative derived basis in the distribution.

(B) *Analysis.* PRS1 determines the amount of gain it is treated as recognizing as a result of negative derived basis by calculating the additional amount of gain that it would have recognized with respect to each share of stock of F1 under section 301(c)(3) if its common basis of the share were reduced by \$2.5x (the sum of all PRS1's negative derived basis of the share). See §1.961-10(b)(2)(i). Specifically, if PRS1's common basis of each share were reduced by \$2.5x, the common basis would be \$9.5x (\$12x – \$2.5x), such that the distribution of \$10x on the share would result in \$9.5x being treated as a return of basis under section 301(c)(2) and \$0.5x being treated as gain recognized under section 301(c)(3). Thus, PRS1 is treated as recognizing \$0.5x of gain with respect to each share as a result of the \$2.5x of negative derived basis of the share, and PRS1 retains the remaining \$2x of negative derived basis of the share (which, under these facts, is equal to the portion of the common basis of the share that is not reduced by the distribution under section 301(c)(2) (\$12x – \$10x, or \$2x)). A pro rata portion of the \$0.5x of gain treated as recognized with respect to each share of stock of F1 is allocated to US1 and US2 by multiplying the amount of such gain by a fraction, the numerator of which is PRS1's negative derived basis with respect to the covered shareholder of the share (\$1.5x in the case of US1, and \$1x in the case of US2), and the denominator of which is the sum of all PRS1's negative derived basis of the share (\$2.5x). See §1.961-10(b)(3). Thus, US1 is allocated \$0.3x, and US2 is allocated \$0.2x, of the \$0.5x of gain treated as recognized by PRS1 with respect to each share of stock of F1. See §1.961-10(b)(4); *see also* §1.961-4(f)(2) (gain allocated to US1 or US2 is taken into account in adjusting US1's or US2's basis in its interest in PRS1 under section 705). Immediately after the distribution, for each share of stock of

F1, PRS1's derived basis with respect to US1 is negative \$1.2x (negative \$1.5x + \$0.3x) and its derived basis with respect to US2 is negative \$0.8x (negative \$1x + \$0.2x). See §1.961-10(b)(5).

(7) *Example 7: Gain recognition for negative section 961(c) basis--*(i) *Facts.* US1 and US2, in the aggregate, directly own all the shares of the single class of stock of F1 and are United States shareholders of F1. F1 directly owns all the shares of the single class of stock of F2 (section 961(c) ownership units). In year 3, F1 sells all the stock of F2 for money equal to the stock's fair market value. Section 304 does not apply to the sale, and the shares of stock of F2 remain section 961(c) ownership units immediately after the sale (because the buyer is a controlled foreign corporation). F1 recognizes £2x of loss with respect to each share of stock of F2, determined without regard to section 961(c) basis. Immediately before the sale (and taking into account any adjustments under §1.961-5(b) resulting from the sale), for each share of stock of F2, F1's section 961(c) basis with respect to US1 is negative £1.5x and its section 961(c) basis with respect to US2 is negative £1x (as translated from U.S. dollars into British pounds at the spot rate on the day of the sale). This example only analyzes the consequences of negative section 961(c) basis in the sale. See *also* §1.959-3 (adjustments to previously taxed earnings and profits accounts); §1.959-7 (transfer of previously taxed earnings and profits in general successor transactions); §1.986(c)-1 (foreign currency gain or loss recognized in general successor transactions).

(ii) *Analysis.* As a result of negative section 961(c) basis, F1 is treated as recognizing gain with respect to each share of stock of F2. See §1.961-10(c)(1). For each share of stock of F2, the amount of such gain is £2.5x, which is the lesser amount of loss (£2x, expressed as a positive amount), plus the additional amount of gain (£0.5x), that F1 would have recognized with respect to the share if F1's adjusted basis of the share were reduced by £2.5x (the sum of all F1's negative section 961(c) basis of the share), and thus all negative section 961(c) basis gives rise to gain. See §1.961-10(c)(2)(i); *compare* paragraph (c)(7)(iii) of this section (scenario where less than all negative section 961(c) basis gives rise to gain). A pro rata portion of the £2.5x of gain treated as recognized with respect to each share of stock of F2 is assigned to US1 and US2 by multiplying the amount of such gain by a fraction, the numerator of which is F1's negative section 961(c) basis with respect to the covered shareholder of the share (£1.5x in the case of US1, and £1x in the case of US2), and the denominator of which is the sum of all F1's negative section 961(c) basis of the share (£2.5x). See §1.961-10(c)(3). Thus, US1 is assigned £1.5x, and US2 is assigned £1x, of the £2.5x of gain treated as recognized by F1 with respect to each share of stock of F2. Moreover, the gain applies only for purposes of determining amounts included in gross income of US1 and US2 (the United States shareholders of F1) under §1.961-11. See §1.961-10(c)(4); *see also* §§1.961-4(f)(3) (the gain does not affect F1's items of gross income for purposes of section 952 or 951A or its earnings and profits).

(iii) *Alternative facts: section 351 exchange with boot--*(A) *Facts.* The facts are the same as in paragraph (c)(7)(i) of this section (*Example 7*), except as follows. Instead of the sale, F1 contributes property, including all its stock of F2, to F3, a controlled foreign corporation, in exchange for stock of F3 and money equal, in the aggregate, to the fair market value of the contributed property. Other unrelated persons also contribute property to F3 in exchange for stock of F3 as part of the same transaction. Section 351(b) applies to F1's exchange, but sections 304 and 362(e) do not, and no income inclusions are required under §1.367(b)-4. The shares of stock of F2 remain section 961(c) ownership units immediately after the contribution (because

F3 is a controlled foreign corporation). In the exchange, for each share of stock of F2, F1 receives stock of F3 and £10x of money but recognizes no gain because F1's adjusted basis of the share is £2x greater than the fair market value of the share. Immediately before the exchange (and taking into account any adjustments under §1.961-5(b) resulting from the exchange), for each share of stock of F2, F1's section 961(c) basis with respect to US1 is negative £1.5x and its section 961(c) basis with respect to US2 is negative £1x (as translated from U.S. dollars into British pounds at the spot rate on the day of the exchange). This example only analyzes the consequences of negative section 961(c) basis in the exchange.

(B) *Analysis.* F1 determines the amount of gain it is treated as recognizing as a result of negative section 961(c) basis by calculating the additional amount of gain that it would have recognized with respect to each share of stock of F2 under section 351(b) if its adjusted basis of the share were reduced by £2.5x (the sum of all F1's negative section 961(c) basis of the share). See §1.961-10(c)(2)(i). Specifically, a £2.5x reduction to F1's adjusted basis of each share would convert a £2x loss on the share into a £0.5x gain, which would then be recognized pursuant to section 351(b) in the exchange. Thus, F1 is treated as recognizing £0.5x of gain with respect to each share as a result of the £2.5x of negative section 961(c) basis of the share, and the remaining £2x of negative section 961(c) basis of the share is retained (which, under these facts, is equal to the loss in the share that is not recognized in the exchange (£2x, the excess of the adjusted basis of the share over the fair market value of the share)). A pro rata portion of the £0.5x of gain treated as recognized with respect to each share of stock of F2 is assigned to US1 and US2 by multiplying the amount of such gain by a fraction, the numerator of which is F1's negative section 961(c) basis with respect to the covered shareholder of the share (£1.5x in the case of US1, and £1x in the case of US2), and the denominator of which is the sum of all F1's negative section 961(c) basis of the share (£2.5x). See §1.961-10(c)(3). Thus, US1 is assigned £0.3x, and US2 is assigned £0.2x, of the £0.5x of gain treated as recognized by F1 with respect to each share of stock of F2. Moreover, the gain applies only for purposes of determining amounts included in gross income of US1 and US2 (the United States shareholders of F1) under §1.961-11. See §1.961-10(c)(4); see also §§1.961-4(f)(3) (the gain does not affect F1's items of gross income for purposes of section 952 or 951A or its earnings and profits). Immediately after the exchange, for each share of stock of F2, the functional currency amount of F3's section 961(c) basis with respect to US1 is negative £1.2x (negative £1.5x + £0.3x) and its section 961(c) basis with respect to US2 is negative £0.8x (negative £1x + £0.2x). See §1.961-10(c)(5).

(8) *Example 8: Amounts included in gross income of United States shareholders-*  
(i) *Facts.* US1 and US2, in the aggregate, directly own all the shares of the single class of stock of F1 and are United States shareholders of F1. F1 directly owns all the shares of the single class of stock of each of F2 and F3 (section 961(c) ownership units). For F1's taxable year ending on December 31 of year 3, F1 recognizes £50x of section 961(c) income. The section 961(c) income consists of £10x of gain recognized as a result of F1's receipt of previously taxed earnings and profits from F2 and £40x of gain recognized as a result of F1's sale of stock of F3 with negative section 961(c) basis. US1 and US2 are assigned equal portions of the £10x gain under §1.961-4(d) (basis reductions and gain recognition for distributions) and US2 is assigned all the £40x gain under §1.961-10(c) (gain recognition for negative basis). F1 has no positive section 961(c) basis in any of the sold shares of stock of F3. This example only analyzes the allocation of F1's section 961(c) income and resulting inclusions in gross income of United States shareholders under section 961(c).

(ii) *Analysis.* Under §1.961-11, F1's £50x of section 961(c) income is allocated to each of US1 and US2 by adding up the amounts of the section 961(c) income that are assigned to each United States shareholder. See §1.961-11(c). No additional computations are required because F1 does not recognize any loss under section 961(c) and there are no transfers of stock of F1. See *id.* Thus, US1 is allocated £5x (£5x of gain with respect to stock of F2 plus £0 of gain with respect to stock of F3), and US2 is allocated £45x (£5x of gain with respect to stock of F2 plus £40x of gain with respect to stock of F3), of the section 961(c) income. Accordingly, US1 includes £5x in its gross income and US2 includes £45x in its gross income, in each case for the United States shareholder's (US1's or US2's) taxable year ending on December 31 of year 3 and translated into U.S. dollars in accordance with section 989(b). See §1.961-11(b). Under §1.961-3, each of US1's and US2's income inclusion increases its adjusted basis of its stock of F1 by the U.S. dollar amount of the inclusion.

(iii) *Alternative facts: loss under section 961(c)--(A) Facts.* The facts are the same as in paragraph (c)(8)(i) of this section (*Example 8*), except as follows. F1 is treated as recognizing £7x of loss under section 961(c) with respect to US2 because F1 has positive section 961(c) basis with respect to US2 in some of the sold shares of stock of F3 and, under §1.961-9, all but £7x of such positive section 961(c) basis is applied to US2's share of covered gain recognized by F1 on the sale of stock of F3.

(B) *Analysis.* Under §1.961-11, F1's £50x of section 961(c) income is allocated to each of US1 and US2 by first adding up the amounts of the section 961(c) income that are assigned to the United States shareholder (£5x in the case of US1, and £45x in the case of US2) and then reducing (but not below zero) such sum by the amount of loss F1 is treated as recognizing under section 961(c) with respect to the United States shareholder (£0 in the case of US1, and £7x in the case of US2). See §1.961-11(c). Thus, US1 is allocated £5x (£5x – £0), and US2 is allocated £38x (£45x – £7x), of the section 961(c) income. Accordingly, US1 includes £5x in its gross income and US2 includes £38x in its gross income, in each case for the United States shareholder's (US1's or US2's) taxable year ending on December 31 of year 3 and translated into U.S. dollars in accordance with section 989(b). See §1.961-11(b). Under §1.961-3, each of US1's and US2's income inclusion increases its adjusted basis of its stock of F1 by the U.S. dollar amount of the inclusion.

### **§1.961-13 Transition rules.**

(a) *Scope.* This section sets forth transition rules for the section 961 regulations.

Paragraph (b) of this section addresses the establishment of derived basis of a partnership and section 961(c) basis of a controlled foreign corporation. Paragraph (c) of this section treats a domestic partnership (including an S corporation) as a covered shareholder for periods in which §1.958-1(d)(1) does not apply. Paragraph (d) of this section converts basis with respect to a domestic partnership (including an S corporation) to basis with respect to covered shareholders owning interests in the

domestic partnership when both §1.958-1(d)(1) and the section 961 regulations first apply.

*(b) Establishing derived basis of a partnership and section 961(c) basis of a controlled foreign corporation--(1) In general.* As of the beginning of the first taxable year of a foreign corporation to which the section 961 regulations (other than §§1.961-6 and 1.961-7) apply pursuant to §1.961-14(b), a partnership's derived basis of derivative ownership units, and a controlled foreign corporation's section 961(c) basis of section 961(c) ownership units, that are shares of stock of the foreign corporation or property through one or more covered shareholders own stock of the foreign corporation must be established in accordance with the rules described in paragraphs (b)(2) through (5) of this section.

*(2) Derived basis--(i) In general.* The partnership's derived basis of each derivative ownership unit is established by increasing derived basis with respect to each covered shareholder by the U.S. dollar amount of derived basis with respect to the covered shareholder that would exist at the beginning of the taxable year (and therefore would not have been decreased in a distribution or general successor transaction, for example) if the principles of §§1.961-2 through 1.961-5, 1.961-8, and 1.961-10 were to have previously applied, determined using a reasonable method (consistently applied to each foreign corporation whose stock is owned by the partnership and with respect to each covered shareholder that owns an interest in the partnership). In the case of a domestic partnership, the increase described in the preceding sentence is determined without regard to an income inclusion of the domestic partnership or any lower-tier domestic partnership (for example, an income inclusion of the domestic partnership under section 951(a)(1)(A) that occurs in a period before §1.958-1(d) applies to the domestic partnership).

*(3) Section 961(c) basis.* The controlled foreign corporation's section 961(c)

basis of each section 961(c) ownership unit is established by increasing section 961(c) basis with respect to each covered shareholder by the U.S. dollar amount of section 961(c) basis with respect to the covered shareholder that would exist at the beginning of the taxable year (and therefore would not have been decreased in a distribution or general successor transaction, for example) if the principles of §§1.961-2 through 1.961-5, 1.961-9, 1.961-10, and 1.961-11 were to have previously applied, determined using a reasonable method (consistently applied to each foreign corporation whose stock is owned by the controlled foreign corporation and with respect to each covered shareholder that owns stock in the controlled foreign corporation).

*(4) Treatment of a specified foreign corporation as a controlled foreign corporation.* A specified foreign corporation (as defined in §1.965-1(f)(45)(i)(B)) that is not otherwise a controlled foreign corporation is treated as a controlled foreign corporation for purposes of the application of the principles of §1.961-3 to an income inclusion under section 951(a)(1)(A) by reason of section 965(a).

*(5) Anti-duplication rule.* Derived basis or section 961(c) basis is increased under this paragraph (b) to reflect an income inclusion under section 951(a)(1)(A) or 951A(a) only to the extent such an increase would not duplicate basis (including basis previously used) at the level of the partnership or the controlled foreign corporation, as applicable, to reflect the income inclusion (for example, in the case of a foreign partnership, basis previously provided under §1.965-2(h)(5)(ii)).

*(c) Treatment of domestic partnerships (including S corporations) before application of §1.958-1(d)(1).* For purposes of the section 961 regulations, a domestic partnership (including an S corporation) is treated as a covered shareholder for any taxable year of the domestic partnership to which §1.958-1(d)(1) does not apply. If a domestic partnership is treated as a covered shareholder, then rules regarding derived basis (of a partnership that is owned by the domestic partnership) or section 961(c)

basis (of a controlled foreign corporation that is owned by the domestic partnership) apply to the domestic partnership in its capacity as a covered shareholder before those rules apply to a covered shareholder that owns interests in the domestic partnership. In such a case, for example, covered gain recognized by a controlled foreign corporation and assigned to the domestic partnership is first previously taxed earnings and profits by reason of the controlled foreign corporation's positive section 961(c) basis with respect to the domestic partnership and then, to the extent remaining, previously taxed earnings and profits by reason of positive section 961(c) basis with respect to covered shareholders owning interests in the domestic partnership.

*(d) Converting basis with respect to domestic partnerships (including S corporations) to basis with respect to partners (or shareholders) after the application of §1.958-1(d)(1)--(1) In general.* As of the beginning of the first taxable year of a domestic partnership (including an S corporation) to which both §1.958-1(d)(1) and the section 961 regulations (other than §§1.961-6 and 1.961-7) apply (pursuant to §1.961-14(b)), the rules described in paragraphs (d)(2) through (4) of this section apply to convert--

(i) A lower-tier partnership's derived basis with respect to the domestic partnership of derivative ownership units (if such derived basis was earlier established pursuant to paragraphs (b)(2) and (c) of this section) to derived basis with respect to covered shareholders owning interests in the domestic partnership; and

(ii) A controlled foreign corporation's section 961(c) basis with respect to the domestic partnership of section 961(c) ownership units (if such section 961(c) basis was earlier established pursuant to paragraphs (b)(3) and (c) of this section) to section 961(c) basis with respect to covered shareholders owning interests in the domestic partnership.

*(2) Rules for converting derived basis with respect to a domestic partnership--(i)*

*Allocate derived basis to each covered shareholder.* First, allocate a pro rata portion of the lower-tier partnership's derived basis with respect to the domestic partnership of each derivative ownership unit to each covered shareholder owning an interest in the domestic partnership at the beginning of the taxable year, determined by multiplying the derived basis with respect to the domestic partnership by the fraction described in §1.959-11(e)(2)(i)(A) for the covered shareholder and the domestic partnership.

(ii) *Transfer derived basis.* Second, transfer to each covered shareholder the portion of the lower-tier partnership's derived basis with respect to the domestic partnership of each derivative ownership unit that is allocated to the covered shareholder under paragraph (d)(2)(i) of this section.

(3) *Rules for converting section 961(c) basis with respect to a domestic partnership--*(i) *Allocate section 961(c) basis to each covered shareholder.* First, allocate a pro rata portion of the controlled foreign corporation's section 961(c) basis with respect to the domestic partnership of each section 961(c) ownership unit to each covered shareholder owning an interest in the domestic partnership at the beginning of the taxable year, determined by multiplying the section 961(c) basis with respect to the domestic partnership by the fraction described in §1.959-11(e)(2)(i)(A) for the covered shareholder and the domestic partnership.

(ii) *Transfer section 961(c) basis.* Second, transfer to each covered shareholder the portion of the controlled foreign corporation's section 961(c) basis with respect to the domestic partnership of each section 961(c) ownership unit that is allocated to the covered shareholder under paragraph (d)(3)(i) of this section.

(4) *Coordination with deemed covered shareholder rules.* The portion, if any, of the lower-tier partnership's derived basis with respect to the domestic partnership, or the controlled foreign corporation's section 961(c) basis with respect to the domestic partnership, that does not increase derived basis or section 961(c) basis with respect to



a covered shareholder becomes with respect to the deemed covered shareholder for purposes of subsequently transferring the basis under §1.961-5(c).

**§1.961-14 Applicability dates.**

(a) *Scope.* This section sets forth applicability dates for the section 961 regulations. Paragraph (b) of this section provides the applicability dates.

(b) *Applicability dates.* Sections 1.961-1 through 1.961-5 and 1.961-8 through 1.961-13 apply to taxable years of foreign corporations that begin on or after [date of publication of final regulations in the ***Federal Register***] or are early application years (as described in §1.959-12(d)) and to taxable years of persons for which such taxable years of those foreign corporations are relevant.

**Par. 29.** Section 1.962-1 is amended by:

1. Removing the last sentence in paragraph (a)(3); and
2. Adding paragraph (a)(4).

The addition reads as follows:

**§1.962-1 Limitation of tax for individuals on amounts included in gross income under section 951(a).**

(a) \* \* \*

(4) See section 959 and the regulations in this part issued under section 959 for rules regarding previously taxed earnings and profits, including previously taxed earnings and profits assigned to the taxable section 962 PTEP subgroup (as defined in §1.959-2(b)(2)(ii)(A)).

\* \* \* \* \*

**§1.962-3 [Removed].**

**Par. 30.** Section 1.962-3 is removed.

**Par. 31.** Section 1.965-5 is amended by:

1. In the introductory text of paragraph (d)(1), removing the language “and (d)(3)” and adding the language “through (d)(5)” in its place; and

2. Adding paragraph (d)(5).

The addition reads as follows:

**§1.965-5 Allowance of credit or deduction for foreign income taxes.**

\* \* \* \* \*

(d) \* \* \*

(5) *Adjusted applicable percentage for certain taxable years.* For taxable years to which §§1.959-1 through 1.959-7 and 1.959-10 and 1.959-11 apply (see §1.959-12), the term applicable percentage means “adjusted applicable percentage” as defined in §1.959-2(b)(2)(iii)(A), except for purposes of §1.959-11(c)(3) (initial determination of the adjusted applicable percentage).

**Par. 32.** Section 1.965-9 is amended by adding paragraph (d) to read as follows:

**§1.965-9 Applicability Dates.**

\* \* \* \* \*

(d) *Applicability date for adjusted applicable percentage.* Section 1.965-5(d)(5) applies to taxable years of foreign corporations that begin on or after [date of publication of final regulations in the ***Federal Register***] or are early application years (as described in §1.959-12(d)) and to taxable years of persons for which such taxable years of those foreign corporations are relevant.

**§1.985-5 [Amended]**

**Par. 33.** Section 1.985-5 is amended by removing the language “(e)(2),” from the last sentence in paragraph (a) and removing and reserving paragraph (e)(2).

**§1.986(a)-1 [Amended]**

**Par. 34.** Section 1.986(a)-1 is amended by:

1. In paragraph (c), removing the language “PTEP group taxes (as defined in § 1.960-3(d)(1))” from the first sentence and adding the language “the corporate PTEP tax pool (as defined in §1.959-1(b)) or any covered shareholder’s

PTEP tax pool (as defined in §1.959-1(b))” in its place.

2. In paragraph (e)(1) removing the language “PTEP group taxes” and adding the language “a PTEP tax pool” in its place.
3. In paragraph (e)(2) removing the language “PTEP group taxes (as defined in § 1.960-3(d)(1))” in the first sentence and adding the language “the corporate PTEP tax pool (as defined in §1.959-1(b)) or any covered shareholder’s PTEP tax pool (as defined in §1.959-1(b))” in its place, and removing the language “PTEP group taxes” in the second sentence and adding the language “a PTEP tax pool” in its place.
4. In paragraph (e)(3) removing the language “PTEP group taxes” in the last sentence and adding the language “a PTEP tax pool” in its place.

**Par. 35.** Section 1.986(c)-1 is revised to read as follows:

**§1.986(c)-1 Foreign currency gain or loss with respect to previously taxed earnings and profits.**

(a) *Scope.* This section provides rules for the recognition of foreign currency gain or loss with respect to previously taxed earnings and profits (as described in section 959) under section 986(c). Paragraph (b) of this section provides rules for distributions of previously taxed earnings and profits to a covered shareholder and certain transactions that transfer or eliminate previously taxed earnings and profits. Paragraph (c) of this section provides a rule for distributions of previously taxed earnings and profits to a foreign corporation. Paragraph (d) of this section provides definitions. Paragraph (e) of this section provides the applicability date of this section. See §1.961-5 for related basis adjustments in certain cases and §1.959-10(c)(2) (*Example 2*) for an example illustrating the application of this section. See *also* §1.367(b)-2(j)(2) for the interaction of certain nonrecognition transactions and section 986(c).

(b) *Recognition of foreign currency gain or loss--(1) In general.* If, in any

transaction, previously taxed earnings and profits with respect to a covered shareholder are distributed to the covered shareholder or cease to be with respect to the covered shareholder (for example, because the previously taxed earnings and profits transfer from the covered shareholder in a general successor transaction or are eliminated by reason of an election under section 338(g)), then the covered shareholder recognizes foreign currency gain or loss with respect to such previously taxed earnings and profits in accordance with the rules described in paragraphs (b)(2) through (4) of this section, subject to the exception in paragraph (b)(5) of this section for transfers of previously taxed earnings and profits other than in a general successor transaction.

(2) *Determining foreign currency gain or loss.* Foreign currency gain or loss is determined by comparing the U.S. dollar amount of the previously taxed earnings and profits described in paragraph (b)(1) of this section on the day on which the transaction occurs to the dollar basis of the previously taxed earnings and profits. If the U.S. dollar amount exceeds the dollar basis, the excess is foreign currency gain. If the dollar basis exceeds the U.S. dollar amount, the excess is foreign currency loss. If applicable, the U.S. dollar amount is determined by translating the previously taxed earnings and profits into U.S. dollars at the spot rate on the day on which the transaction occurs. See §§1.959-4 and 1.959-7 for determining dollar basis in distributions and general successor transactions, respectively.

(3) *Limitations--(i) Section 965(a) previously taxed earnings and profits.* In the case of previously taxed earnings and profits that are described in paragraph (b)(1) of this section and relate to the reclassified section 965(a) PTEP group or section 965(a) PTEP group, only a portion of foreign currency gain or loss with respect to the previously taxed earnings and profits is recognized, determined by multiplying the amount of the foreign currency gain or loss by the excess of 100 percent over the section 965(c) deduction percentage with respect to the previously taxed earnings and

profits.

(ii) *Section 965(b) previously taxed earnings and profits.* No foreign currency gain or loss is recognized with respect to previously taxed earnings and profits that are described in paragraph (b)(1) of this section and relate to the reclassified section 965(b) PTEP group or section 965(b) PTEP group.

(iii) *Taxable section 962 earnings and profits.* No foreign currency gain or loss is recognized with respect to previously taxed earnings and profits that are described in paragraph (b)(1) of this section and relate to the taxable section 962 PTEP subgroup.

(4) *Treatment of foreign currency gain or loss.* Foreign currency gain or loss described in paragraph (b)(1) of this section is recognized concurrently with the transaction and is treated as ordinary income or loss from the same source, and relating to the same section 904 category, as the income inclusion to which the previously taxed earnings and profits are attributable.

(5) *Exception for transfer of previously taxed earnings and profits other than in a general successor transaction.* Except as provided in §1.367(b)-2(j)(2)(i), no foreign currency gain or loss is recognized with respect to previously taxed earnings and profits when the previously taxed earnings and profits transfer to another covered shareholder in a transaction other than a general successor transaction.

(c) *Distributions of previously taxed earnings and profits to a foreign corporation.* No foreign currency gain or loss is recognized with respect to previously taxed earnings and profits when the previously taxed earnings and profits are distributed to a foreign corporation.

(d) *Definitions.* The definitions in §1.959-1(b) apply for purposes of this section.

(e) *Applicability date.* This section applies to taxable years of foreign corporations that begin on or after [date of publication of final regulations in the **Federal Register**] or are early application years (as described in §1.959-12(d)) and to taxable

years of persons for which such taxable years of those foreign corporations are relevant. See §1.986(c)-1 as contained in 26 CFR part 1 revised as of April 1, 2024, for a version of this section applicable to prior taxable years.

**Par. 36.** Section 1.1411-10 is amended by adding a sentence at the end of paragraph (c)(1)(i)(A)(1) to read as follows:

**§1.1411-10 Controlled foreign corporations and passive foreign investment companies.**

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(i) \* \* \*

(A) \* \* \*

(1) \* \* \* See section 959 and the regulations in this part issued under section 959 for rules regarding previously taxed earnings and profits, including previously taxed earnings and profits assigned to the taxable section 1411 PTEP subgroup (as defined in §1.959-2(b)(2)(ii)(A)).

\* \* \* \* \*

**Par. 37.** Section 1.1502-59 is added to read as follows:

**§1.1502-59 Previously taxed earnings and profits and related basis adjustments.**

(a) *Overview and scope.* This section addresses the consequences to consolidated groups of previously taxed earnings and profits of foreign corporations, including under section 959 (regarding exclusions from gross income of distributions of previously taxed earnings and profits of foreign corporations) and section 961 (regarding basis adjustments to the stock of foreign corporations and other property). Paragraph (b) of this section provides definitions. Paragraph (c) of this section provides rules to treat a consolidated group as a single covered shareholder for purposes of the rules relating to previously taxed earnings and profits. Paragraph (d) of this section

addresses the application of section 961 to consolidated groups. Paragraph (e) of this section addresses members that join or leave a consolidated group. Paragraph (f) of this section contains examples. Paragraph (g) of this section provides the applicability date of this section.

(b) *Definitions.* The definitions and rules of general applicability in §§1.959-1 and 1.961-1 apply for purposes of this section, with the following additions:

(1) *Departing transaction.* The term *departing transaction* has the meaning provided in paragraph (e)(3) of this section.

(2) *Group derived basis.* The term *group derived basis* has the meaning provided in paragraph (d)(2)(ii) of this section.

(3) *Group section 961(c) basis.* The term *group section 961(c) basis* has the meaning provided in paragraph (d)(2)(ii) of this section.

(4) *Joining transaction.* The term *joining transaction* has the meaning provided in paragraph (e)(2) of this section.

(5) *Member shareholder.* The term *member shareholder* means a member that owns stock of a foreign corporation.

(6) *Section 959 rules.* The term *section 959 rules* means section 959 and the section 959 regulations.

(7) *Section 961 rules.* The term *section 961 rules* means section 961 and the section 961 regulations.

(c) *Single covered shareholder treatment under section 959--(1) Overview.* This paragraph (c) addresses the application of the section 959 rules to a consolidated group. Paragraph (c)(2) of this section provides the general rule that treats the group as a single covered shareholder. Paragraphs (c)(3) through (5) of this section describe the application of this general rule: paragraph (c)(3) of this section addresses the maintenance of group PTEP accounts; paragraph (c)(4) of this section provides for the

allocation of PTEP among members; and paragraph (c)(5) of this section addresses intercompany transfers of foreign corporation stock. Where other provisions of the Code or regulations reference the section 959 rules (for example, sections 960(b) and 986(c)), the treatment described in this paragraph (c) applies for purposes of the application of those provisions.

(2) *In general.* For purposes of applying the section 959 rules, members of a consolidated group are treated as a single covered shareholder. However, each member computes and takes into account its own items with respect to the stock of foreign corporations (including items allocated by a partnership, or assigned from a controlled foreign corporation, to the member). For example, if a member receives a distribution from a foreign corporation, that member takes into account the tax consequences of the distribution.

(3) *PTEP accounting.* For purposes of applying §§1.959-2 (regarding accounting of previously taxed earnings and profits) and 1.959-3 (regarding adjustments to shareholder-level accounts relating to previously taxed earnings and profits)--

(i) A consolidated group establishes and maintains a single set of annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to a foreign corporation whose stock is owned by one or more members (for example, a consolidated group has a single combined pool election under §1.959-2(c)); and

(ii) A foreign corporation establishes and maintains a single corporate PTEP account and corporate PTEP tax pool with respect to a consolidated group.

(4) *Allocation of group accounts--(i) In general.* When necessary (for example, to determine a member shareholder's section 956 amount or foreign currency gain or loss under section 986(c)), the relevant amount of the consolidated group's accounts described in paragraph (c)(3) of this section is allocated among the member shareholders. The relevant amount is the amount that the single covered shareholder



would access if all members of a consolidated group were treated as a single covered shareholder. The allocation is made in proportion to each member shareholder's share of the item at issue relative to the total amount of the item for all member shareholders.

(ii) *Application to covered distributions--(A) Overview.* The allocation rule in paragraph (c)(4)(i) of this section applies if one or more member shareholders receive, or are assigned under §1.951-2, a portion of a covered distribution (each, a *member's portion*), then each member shareholder is allocated a portion of the group's accounts described in paragraph (c)(3) of this section to determine the extent to which the member's portion is previously taxed earnings and profits under §1.959-4.

(B) *The relevant amount of the covered distribution.* For purposes of allocating the group accounts, the relevant amount is the amount of the total portion of the covered distribution received by or assigned to all member shareholders (*group's portion*) that would be previously taxed earnings and profits to a single covered shareholder. This amount is determined under §1.959-4 based on the consolidated group's accounts described in paragraph (c)(3) of this section.

(C) *Member shareholder's PTEP amount for covered distribution.* The extent to which the member's portion is previously taxed earnings and profits under §1.959-4 is determined by multiplying the amount determined under paragraph (c)(4)(ii)(B) of this section by a fraction. The numerator of the fraction is the member's portion, and the denominator is the group's portion.

(5) *Intercompany transfers.* Because a group maintains a single set of accounts under paragraph (c)(3) of this section (that is, member shareholders do not have their own accounts), an intercompany transfer (within the meaning of §1.1502-13(b)(1)) of the stock of a foreign corporation is not a general successor transaction as defined in §1.959-7(b).

(d) *Basis under section 961--(1) Overview.* This paragraph (d) addresses the

application of the section 961 rules to consolidated groups. Paragraph (d)(2) of this section contains the general rule providing for single- or separate-entity treatment of the group with respect to different types of property units. Paragraphs (d)(3) and (4) of this section, respectively, address basis increases and reductions under section 961. Paragraph (d)(5) of this section addresses the use of the group's basis to determine gain or loss on a property unit.

(2) *Treatment of property units--*(i) *Section 961(a) ownership units.* Because member shareholders directly own section 961(a) ownership units, adjustments to these ownership units under the section 961 rules are made separately to member shareholders' actual ownership interests.

(ii) *Derivative ownership units and section 961(c) ownership units.* Members of a consolidated group are treated as a single covered shareholder for purposes of accounting for the basis of derivative ownership units and section 961(c) ownership units. Therefore, a partnership has a single derived basis with respect to a consolidated group in a derivative ownership unit (*group derived basis*), and a controlled foreign corporation has a single section 961(c) basis with respect to a consolidated group in a section 961(c) ownership unit (*group section 961(c) basis*).

(3) *Basis increases for income inclusions and gains--*(i) *In general.* Adjustments under §§1.961-3 (for inclusions under sections 951(a), 951A(a), and 961) and 1.961-5(b) (relating to foreign currency gain) are determined based on each member shareholder's respective income inclusions under sections 951(a) and 951A(a), foreign currency gain under section 986(c), or income inclusions under §1.961-11. To the extent the adjustment is to a section 961(a) ownership unit, the adjustments are made separately to each member shareholder's section 961(a) ownership unit. In contrast, to the extent the adjustment is to a derivative ownership unit or a section 961(c) ownership unit, the adjustment is made to the group derived basis or the group section 961(c)

basis.

(ii) *Example.* A member (M1) directly owns all the stock of a foreign corporation (CFC1), which directly owns all the preferred stock in another foreign corporation (CFC3). Another member (M2) owns all the stock of a foreign corporation (CFC2), which owns all the common stock of CFC3. M1 and M2 have section 951(a) inclusions resulting from CFC3's subpart F income. M1's basis in its CFC1 stock, which is determined separately with respect to M1, and the group section 961(c) basis in CFC1's preferred stock in CFC3, are both adjusted based on M1's inclusion. Similarly, M2's basis in its CFC2 stock, which is determined separately with respect to M2, and the group section 961(c) basis in CFC2's common stock in CFC3, are both adjusted based on M2's inclusion.

(4) *Basis reductions--(i) Reductions to basis of section 961(a) ownership units.* Reductions to the basis of section 961(a) ownership units under §§1.961-4 (for distributions of previously taxed earnings and profits) and 1.961-5(b) (relating to foreign currency loss) are determined on a separate-entity basis. See paragraph (d)(2)(i) of this section.

(ii) *Reductions to derived basis or section 961(c) basis.* This paragraph (d)(4)(ii) coordinates the application of the section 961 rules to determine how to reduce group derived basis and group section 961(c) basis under §§1.961-4 and 1.961-5.

(A) *Step 1: Proportionate allocation of derived basis and section 961(c) basis.* When the section 961 rules apply to reduce derived basis or section 961(c) basis, the group derived basis and group section 961(c) basis is allocated to the member shareholders. The allocation is made in proportion to each member shareholder's share of the item at issue relative to the total for all member shareholders (for example, in proportion to a member shareholder's PTEP amount for a covered distribution, as described in paragraph (c)(4)(ii)(C) of this section).

(B) *Step 2: Separate entity basis reduction.* The member shareholders separately apply the section 961 rules to make the necessary basis reductions, taking into account the amount of group derived basis and group section 961(c) basis allocated to that member in paragraph (d)(4)(ii)(A) of this section (step 1) (for example, see §1.961-4(d) for adjustments to section 961(c) ownership units for distributions of previously taxed earnings and profits to a controlled foreign corporation owned by member shareholders). To the extent the basis reduction exceeds the relevant basis in the ownership unit with respect to the member shareholder, the partnership or controlled foreign corporation recognizes gain (for example, see §1.961-4(f)), which is allocated or assigned to the member shareholder.

(C) *Step 3: Recombination of derived basis and section 961(c) basis.* After applying the rules in paragraphs (d)(4)(ii)(A) and (B) of this section, to the extent there is any remaining positive derived basis or positive section 961(c) basis, or any resulting negative derived basis or negative section 961(c) basis, those bases are combined to produce the group derived basis or group section 961(c) basis for the relevant ownership unit.

(5) *Use of group derived basis and group section 961(c) basis to determine gain or loss--*(i) *Section 1.961-8(b)(1) gain or loss.* This paragraph (d)(5)(i) applies when a member shareholder is allocated a distributive share of gain or loss as described in §1.961-8(b)(1). For purposes of applying positive derived basis under §1.961-8(b)(2), the member shareholder is allocated a portion of the relevant group derived basis in proportion to the member shareholder's ownership interest in the foreign corporation described in §1.961-8(b)(1) relative to the aggregate of all ownership interests in the foreign corporation of all member shareholders. The relevant group derived basis is the amount of derived basis the single covered shareholder would access if all members of the consolidated group were treated as a single covered shareholder.

(ii) *Section 1.961-9(c) covered gain.* This paragraph (d)(5)(ii) applies when a member shareholder is assigned a share of covered gain under §1.951-2. For purposes of applying positive section 961(c) basis under §1.961-9(e), the member shareholder is allocated a portion of the relevant group section 961(c) basis in proportion to the member shareholder's share of covered gain relative to the total for all member shareholders. The relevant group section 961(c) basis is the amount of section 961(c) basis the single covered shareholder would access if all members of a consolidated group were treated as a single covered shareholder.

(e) *Consequences of joining or leaving a consolidated group--(1) In general.* For purposes of applying the section 959 rules and the section 961 rules, a transaction in which a member shareholder joins or leaves a consolidated group is treated in the same manner as an acquisition or disposition of the stock of a foreign corporation owned by the member at the time the member joins or leaves the consolidated group, as applicable. Paragraphs (e)(2) and (3) of this section coordinate the application of §§1.959-7 (general successor transaction rules) and 1.961-5 (successor basis rules) to transactions in which a member shareholder joins or leaves a consolidated group, respectively. Paragraph (e)(4) of this section coordinates the application of section 986(c) to such transactions. The rules of this paragraph (e) apply only to transactions treated as acquisitions or dispositions of stock of the member shareholder (for example, if a member shareholder is sold to an unrelated party and an election under section 338(h)(10) is made, paragraph (e)(3) of this section does not apply).

(2) *Joining transactions--(i) In general.* A transaction (*joining transaction*) in which a corporation (*joining member*) becomes a member of a consolidated group is treated in the same manner as a general successor transaction. In the joining transaction, the transferor covered shareholder is the joining member, the successor covered shareholder is the consolidated group, and the consolidated group is treated as

acquiring ownership of all the stock of foreign corporations owned by the joining member. Thus, for example, any previously taxed earnings and profits in the joining member's annual PTEP accounts with respect to a foreign corporation are added to the consolidated group's annual PTEP accounts with respect to the foreign corporation. Similarly, a controlled foreign corporation's section 961(c) basis with respect to the joining member in a section 961(c) ownership unit is added to the controlled foreign corporation's section 961(c) basis with respect to the consolidated group in that unit, and a partnership's derived basis with respect to the joining member in a derivative ownership unit is added to the partnership's derived basis with respect to the consolidated group in that unit.

(ii) *Combined pool election.* The consolidated group's combined pool election status pursuant to §1.959-2(c) controls after a joining transaction.

(3) *Departing transactions--(i) In general.* A transaction (*departing transaction*) in which a member shareholder (*departing member*) ceases to be a member of a consolidated group is treated in the same manner as a general successor transaction. In the departing transaction, the transferor covered shareholder is the consolidated group, the successor covered shareholder is the departing member, and the departing member is treated as acquiring ownership of all the stock of foreign corporations owned by the departing member at the time of the departing transaction. Thus, for example, any previously taxed earnings and profits in the consolidated group's annual PTEP accounts with respect to the foreign corporation are allocated between the consolidated group and the departing member shareholder. Similarly, a controlled foreign corporation's section 961(c) basis in a section 961(c) ownership unit with respect to the consolidated group is allocated between the consolidated group and the departing member, and a partnership's derived basis in a derivative ownership unit with respect to the consolidated group is allocated between the consolidated group and the departing

member.

(ii) *Combined pool election.* The departing member retains the consolidated group's combined pool election status under §1.959-2(c). However, if the departing member joins a new consolidated group, paragraph (e)(2)(ii) of this section applies to the new consolidated group.

(4) *Coordination with section 986(c).* Joining transactions and departing transactions do not result in recognition of foreign currency gain or loss under section 986(c) (notwithstanding §1.986(c)-1). Thus, for example, the dollar basis of previously taxed earnings and profits in a joining member's annual PTEP accounts carries over when adding the previously taxed earnings and profits to the consolidated group's annual PTEP accounts pursuant to paragraph (e)(2)(i) of this section.

(f) *Examples--(1) In general.* This paragraph (f) provides examples illustrating the application of this section. These examples do not discuss every consequence of the transactions under related provisions of the Code and regulations.

(2) *Assumed facts.* For purposes of the examples in this paragraph (f), unless otherwise indicated, the following facts are assumed:

(i) USP, USS1, and USS2 are domestic corporations, each of which uses the U.S. dollar as its functional currency. USP is the common parent of the P consolidated group (P group), USS1 and USS2 are members of the P group, and all the stock of USS1 and USS2 is owned by USP.

(ii) F1 and F2 are controlled foreign corporations, each of which uses the British pound (£) as its functional currency.

(iii) PRS1 is a partnership.

(iv) Each entity uses the calendar year as its taxable year, and no entity has a short taxable year.

(v) There are no adjustments under section 743(b) to the basis of any partnership

property.

(3) *Example 1: Exclusion from gross income of distributed previously taxed earnings and profits*--(i) *Facts*. Each of USS1 and USS2 directly owns 50 of the 100 shares of the single class of outstanding stock of F1. In year 3, F1 makes a £300x distribution of money with respect to its stock (£3x with respect to each share), and the entirety of this £300x is a covered distribution (a dividend as defined in section 316, determined without regard to section 959(d)). Immediately before the covered distribution, F1 has £180x of previously taxed earnings and profits with respect to the P group, none of which is assigned to the taxable section 962 PTEP group.

(ii) *Analysis*. For purposes of analyzing the covered distribution under §1.959-4, the P group is treated as a single covered shareholder. See paragraph (c)(2) of this section. The P group's share of the covered distribution is the entire £300x because the entire covered distribution is made to members of the P group (£150x to USS1 plus £150x to USS2). See §1.959-4(d)(1). The £300x are allocated first to F1's previously taxed earnings and profits that are with respect to the P group immediately before the covered distribution (£180x), and then to F1's earnings and profits described in section 959(c)(3). Therefore, the £300x consist of £180x of previously taxed earnings and profits and £120x of earnings and profits described in section 959(c)(3). See §1.959-4(d)(2) and (e)(1). These previously taxed earnings and profits are treated as distributed pro rata with respect to the F1 stock on which the P group's share of the covered distribution is made. See §1.959-4(d)(4) and paragraph (c)(4)(ii) of this section. Accordingly, £1.8x of previously taxed earnings and profits is treated as distributed with respect to each share of F1 stock. See *id.* USS1 and USS2 each excludes the £90x ( $(£150x \div £300x) \times £180x$ ) of previously taxed earnings and profits distributed to it from its gross income. See §1.959-4(b)(1) and paragraph (c)(4)(ii) of this section. Moreover, the distributions of previously taxed earnings and profits to USS1 and USS2 do not result in any investment adjustments under §1.1502-32 (see §1.1502-32(b)(5)(ii), *Example 9*) or adjustments to earnings and profits (see §§ 1.312-8(c) and 1.1502-33). Because this analysis depends only on F1's PTEP with respect to the P group, these results do not depend on whether USS1 or USS2 owned F1 stock or had income inclusions with respect to F1 during the taxable years to which the distributed previously taxed earnings and profits relate.

(4) *Example 2: Basis increases for income inclusions*--(i) *Facts*. F1 has two classes of stock outstanding. USS1 directly owns all 100 shares of F1 common stock, and USS2 directly owns all 100 shares of F1 preferred stock. F1 directly owns all 50 shares of the single class of outstanding stock of F2. The shares of F1 stock directly owned by USS1 or USS2 are section 961(a) ownership units, and the shares of F2 stock directly owned by F1 are section 961(c) ownership units. For year 3, USS1 includes \$60x and USS2 includes \$40x in gross income under section 951(a)(1)(A) with respect to F2 (their pro rata shares of F2's subpart F income, translated into U.S. dollars in accordance with section 989(b)). F2 does not make any covered distributions, and therefore does not distribute any previously taxed earnings and profits, during the taxable year.

(ii) *Analysis*--(A) *In general*. To reflect USS1's and USS2's income inclusions for year 3, the basis of the F2 stock and F1 stock is increased in accordance with §1.961-3. See §1.961-3(b). F1's section 961(c) basis in the F2 stock with respect to the P group is increased based on the total inclusions of the P group, because members of a consolidated group are treated as a single covered shareholder for purposes of



accounting for basis of section 961(c) ownership units, and because all of the P group's inclusions arise with respect to this F2 stock. See paragraphs (d)(2)(ii) and (d)(3)(i) of this section. USS1's adjusted basis in the F1 common stock and USS2's adjusted basis in the F1 preferred stock are increased based on each member's separate inclusion, because adjustments to section 961(a) ownership units are made separately to member shareholders' actual ownership interests. See paragraphs (d)(2)(i) and (d)(3)(i) of this section.

(B) *Increases to basis of each property unit.* The amount of the P group's income inclusions with respect to F2 that give rise to increases to basis under section 961 is \$100x (\$60x + \$40x). See §1.961-3(c)(1) and paragraph (d)(3) of this section. Under §1.961-3(e), the section 961(c) basis with respect to the P group of each share of F2 stock is increased by \$2x ( $\$100x \div 50$  shares). The basis of each share of F1 common stock owned by USS1 is increased by \$0.60x ( $\$60x \div 100$  shares) and the basis of each share of F1 preferred stock owned by USS2 is increased by \$0.40x ( $\$40x \div 100$  shares). These increases to basis are treated as made at the beginning of F2's taxable year. See §1.961-3(c)(2) and (e)(1). These adjustments to the basis of the section 961(a) ownership units may be different from the adjustments that would be made under §1.961-3(e) if they were all held by a single owner.

(C) *Section 1502 basis and E&P adjustments.* USP increases its basis in its USS1 stock by \$60x and in its USS2 stock by \$40x, reflecting each member's inclusion in income under section 951(a)(1)(A). See §1.1502-32(b)(2)(i). Because the income inclusions increase USS1's and USS2's earnings and profits (see §1.312-6(f)), USP's earnings and profits are increased under §1.1502-33(b)(1).

(5) *Example 3: Basis reductions and gain recognition for distributions from upper-tier foreign corporation--*(i) *Facts.* USS1 and USS2 directly own all the shares of the single class of outstanding stock of F1, with USS1 owning 60 shares and USS2 owning 40 shares. In year 3, F1 makes a pro rata covered distribution to USS1 and USS2. Under §1.959-4, the entirety of the covered distribution is previously taxed earnings and profits with respect to the P group and excluded from the members' gross income. In addition, the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are distributed on each share of F1 stock is \$6x. Immediately before the covered distribution, USS1's adjusted basis in each share of its F1 stock is \$8x, and USS2's adjusted basis in each share of its F1 stock is \$5x. Each of USS1 and USS2 is deemed to pay the entirety of the associated foreign income taxes of the previously taxed earnings and profits distributed to it under section 960(b) (because all such taxes are sourced from the creditable PTEP tax group and the member is a United States shareholder of F1) and is allowed a credit under section 901 for the entirety of such taxes.

(ii) *Analysis.* Under §1.961-4(b), each of USS1 and USS2 separately reduces its adjusted basis in each share of F1 stock on which it receives previously taxed earnings and profits and, if applicable, recognizes gain with respect to those shares. See paragraph (d)(4)(i) of this section. The adjustment to each share of F1 stock is \$6x, the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits received by the member on the share. See §1.961-4(b)(2)(i). The basis of each of USS1's shares of F1 stock is reduced to \$2x (\$8x original basis – \$6x adjustment). See §1.961-4(b)(2)(ii). The basis of each of USS2's shares of F1 stock is reduced to \$0x, and USS2 recognizes \$1x of gain per share (\$5x original basis – \$6x adjustment). See §1.961-4(b)(2)(ii) and (iii). These adjustments are treated as made

concurrently with the covered distribution. See §1.961-4(e)(1) and (f)(1).

(6) *Example 4: Basis reductions and gain recognition for distributions from lower-tier foreign corporation*--(i) *Facts*. USS1 and USS2 directly own all the shares of the single class of outstanding stock of F1, with USS1 owning 60 shares and USS2 owning 40 shares. F1 directly owns all the shares of the single class of outstanding stock of F2. In year 3, F2 makes a covered distribution to F1. Under §1.959-4, the entirety of the covered distribution is previously taxed earnings and profits that are with respect to the P group and excluded from F1's gross income for purposes of determining its subpart F income and its tested income or tested loss. In addition, the sum of the dollar basis and associated foreign income taxes of the previously taxed earnings and profits that are distributed on each share of F2 stock is \$6x. Immediately before the covered distribution, F1's adjusted basis in each share of F2 stock is £1.50x, and its section 961(c) basis with respect to the P group in each share is \$5x. On the day of the covered distribution, the spot rate is \$1:£0.5.

(ii) *Analysis*. Under §1.961-4(d), F1 reduces its section 961(c) basis in each share of F2 stock on which it receives previously taxed earnings and profits. If applicable, F1 recognizes gain with respect to those shares. These adjustments are made separately with respect to USS1 and USS2. See paragraph (d)(4)(ii) of this section. First, under paragraph (d)(4)(ii)(A) of this section, for each share of F2 stock, F1's section 961(c) basis with respect to the P group is allocated proportionately to USS1 (\$3x, or 60%) and USS2 (\$2x, or 40%). Next, under paragraph (d)(4)(ii)(B) of this section, the basis reductions are made separately for each of USS1 and USS2. For each share of F2 stock, USS1's portion of F1's section 961(c) basis (\$3x) is reduced by USS1's share of the dollar basis and associated foreign income taxes ( $\$3.60x = 60\% \times \$6x$ ). See §1.961-4(d)(2). Because the reduction exceeds the positive section 961(c) basis, it must be tested against the limitation in §1.961-4(d)(3). The amount of F1's adjusted basis in each share that is available with respect to USS1 is £0.90x ( $60\% \times £1.50x$ ), which is equal to \$1.80x. Because \$1.80x is greater than \$0.60x, USS1's portion of F1's section 961(c) basis is reduced to negative \$0.60x ( $\$3x - \$3.60x$ ), and no gain is recognized under §1.961-4(d)(2)(iii). Similarly, USS2's share of F1's section 961(c) basis in each share of F2 stock (\$2x) is reduced by its share of the dollar basis and associated foreign income taxes ( $\$2.40x = 40\% \times \$6x$ ). The amount of F1's adjusted basis in each share that is available with respect to USS2 is £0.60x ( $40\% \times £1.50x$ ), which is equal to \$1.20x. Therefore, USS2's portion of F1's section 961(c) basis is reduced to negative \$0.40x ( $\$2x - \$2.40x$ ), and no gain is recognized under §1.961-4(d)(2)(iii). Finally, under paragraph (d)(4)(ii)(C) of this section, the separately computed section 961(c) bases are recombined. As a result, F1's section 961(c) basis with respect to the P group in each share of F2 stock is negative \$1x (negative \$0.60x + negative \$0.40x = negative \$1x). The reductions to section 961(c) basis are treated as made concurrently with the covered distribution. See §1.961-4(e)(1) and (f)(1).

(iii) *Alternative facts: distribution in excess of basis*. The facts are the same as in paragraph (f)(6)(i) of this section (*Example 4*), except that the sum of the dollar basis and associated foreign income taxes per share of F2 stock is \$9x instead of \$6x. The application of paragraph (d)(4)(ii)(A) of this section is the same as in paragraph (f)(6)(ii) of this section. When applying paragraph (d)(4)(ii)(B) of this section, the basis reductions per share are \$5.40x ( $60\% \times \$9x$ ) for USS1 and \$3.60x ( $40\% \times \$9x$ ) for USS2. Because the reductions again exceed the positive section 961(c) basis, they must be tested against the limitation in §1.961-4(d)(3). The amounts of F1's adjusted basis in each share that are available with respect to each member are the same as in

paragraph (f)(6)(ii) of this section. For USS1, because the \$1.80x limitation is less than \$2.40x (\$3x section 961(c) basis – \$5.40x adjustment), USS1's portion of F1's section 961(c) basis per share is reduced to negative \$1.80x, and \$0.60x (\$2.40x – \$1.80x) of gain per share is recognized under §1.961-4(d)(2)(iii), with this gain assigned solely to USS1. Similarly, for USS2, the \$1.20x limitation is less than \$1.60x (\$2x section 961(c) basis – \$3.60x adjustment). Therefore, USS2's portion of F1's section 961(c) basis per share is reduced to negative \$1.20x, and \$0.40x (\$1.60x – \$1.20x) of gain per share is recognized under §1.961-4(d)(2)(iii), with this gain assigned solely to USS2. The basis of USS1 and USS2's F1 stock is increased under §1.961-3 to reflect the gains recognized by F1 and included in the member's gross income pursuant to §1.961-11. Finally, under paragraph (d)(4)(ii)(C) of this section, the separately computed section 961(c) bases are recombined. As a result, F1's section 961(c) basis with respect to the P group in each share of F2 stock is negative \$3x (negative \$1.80x + negative \$1.20x = negative \$3x).

(7) *Example 5: Use of positive derived basis--(i) Facts.* USS1, USS2, and a nonresident alien individual, in the aggregate, directly own all the interests in PRS1, with USS1 and USS2 owning equal interests in PRS1. PRS1 directly owns all the shares of the single class of outstanding stock of F1 (derivative ownership units). In year 3, PRS1 sells all the F1 stock to an unrelated party for money. The distributive share of the gain recognized by PRS1 is \$30x to each of USS1 and USS2, determined without regard to derived basis. Immediately before the sale (and taking into account any adjustments under §1.961-5(b) resulting from the sale), PRS1's positive derived basis with respect to the P group in the F1 stock is \$50x in total. In addition, PRS1 has no negative derived basis with respect to the P group in any of the shares.

(ii) *Analysis.* In applying PRS1's positive derived basis with respect to the P group in the F1 stock, a pro rata portion of such derived basis is taken into account with respect to each member. See paragraph (d)(5)(i) of this section. Thus, because USS1 and USS2 own equal interests in PRS1, \$25x (or 50%) of the derived basis is taken into account with respect to each of USS1 and USS2. Accordingly, for each of USS1 and USS2, PRS1 is treated as applying \$25x of derived basis to the member's \$30x distributive share of gain on the sale. See §1.961-8(b). As result, each member's distributive share of gain on the sale is adjusted by \$25x, to a \$5x distributive share of gain. See also §1.961-8(c) (for purposes of adjusting each member's adjusted basis in its PRS1 interest under section 705, the member's distributive share of gain on the sale is \$5x).

(8) *Example 6: Use of positive section 961(c) basis--(i) Facts.* USS1, USS2, and a nonresident alien individual, in the aggregate, directly own all the shares of the single class of outstanding stock of F1. USS1 and USS2 own an equal number of shares of F1. F1 directly owns all the shares of the single class of outstanding stock of F2 (section 961(c) ownership units). In year 3, F1 sells all the F2 stock to an unrelated party for money. F1 recognizes £100x of gain on the sale, determined without regard to loss recognized on any share and without regard to section 961(c) basis. This £100x is covered gain, and each of USS1 and USS2 is assigned a £30x portion of the covered gain under §1.951-2. Immediately before the sale (and taking into account any adjustments under §1.961-5(b) resulting from the sale), F1's positive section 961(c) basis in the F2 stock with respect to the P group is £50x (as translated from U.S. dollars into British pounds at the spot rate on the day of the sale). In addition, F1 has no negative section 961(c) basis with respect to the P group in any of the shares.

(ii) *Analysis.* In applying F1's positive section 961(c) basis with respect to the P group of the F2 stock, a pro rata portion of such section 961(c) basis is taken into account with respect to each member. See paragraph (d)(5)(ii) of this section. Thus, because USS1 and USS2 own equal interests in F1, £25x (£30x ÷ £60x, or 50%) of the section 961(c) basis is taken into account with respect to each of USS1 and USS2. All £25x of the section 961(c) basis taken into account with respect to each of USS1 and USS2 is applied to the member's £30x share of the covered gain. See §1.961-9(d)(2) and (e)(1). As a result, a total of £50x of the covered gain is previously taxed earnings and profits of F1 with respect to the P group, characterized in accordance with §1.961-9(f)(2) through (4). See §1.961-9(d)(3), (f)(1) and paragraph (c)(1) of this section. F1 excludes the £50x of previously taxed earnings resulting from section 961(c) basis from its gross income, solely for purposes of determining its subpart F income and tested income or tested loss. See §1.961-9(b).

(g) *Applicability date.* This section applies to a taxable year of a consolidated group for which a taxable year of a foreign corporation is relevant if such taxable year of the foreign corporation begins on or after [date of publication of final regulations in the ***Federal Register***] or is an early application year (as described in §1.959-12(d)).

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[FR Doc. 2024-27227 Filed: 11/29/2024 8:45 am; Publication Date: 12/2/2024]