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March 3, 2025

Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Proposed Rules Regarding Previously Taxed Earnings and Profits and Related Basis Adjustments (NPRM REG–105479-18)

Dear Mr. Blessing:

The Alliance for Competitive Taxation ("ACT") is a coalition of leading American companies from a wide range of industries that supports a globally competitive corporate tax system.

Attached are ACT's comments on proposed regulations regarding previously taxed earnings and profits and related basis adjustments, as requested by NPRM REG–105479-18 (the "Proposed Regulations"). We appreciate your consideration of these comments. ACT members welcome the opportunity to discuss these comments further with your staff.

Yours sincerely,

Alliance for Competitive Taxation

cc: William M. Paul, Principal Deputy Chief Counsel, Internal Revenue Service

ALLIANCE FOR COMPETITIVE TAXATION COMMENTS ON PROPOSED RULES REGARDING PREVIOUSLY TAXED EARNINGS AND PROFITS AND RELATED BASIS ADJUSTMENTS (NPRM REG–105479-18)

Introduction

On December 2, 2024, Treasury and the Internal Revenue Service ("IRS") issued Proposed Regulations which provided important and substantial guidance related to previously taxed earnings and profits ("PTEP"). PTEP has increased in significance after the enactment of the mandatory repatriation tax in section 965 and the tax on global intangible low-taxed income ("GILTI") in section 951A as part of the 2017 Tax Cuts and Jobs Act ("TCJA"), causing much more income of a controlled foreign corporation ("CFC") to result in PTEP. The Proposed Regulations: (1) address the timing of increases and decreases to PTEP under section 959 and stock basis under section 961, (2) implement Notice 2019-01 by providing general rules for tracking PTEP and the ordering of PTEP distributions, and (3) provide additional guidance under sections 951, 960, and 1502. In the preamble to the Proposed Regulations (the "Preamble"), Treasury and the IRS encouraged comments on this new set of Proposed Regulations. Below are comments by the Alliance for Competitive Taxation ("ACT") on this guidance.

ACT commends Treasury and the IRS for their dedication in providing long-awaited rules for PTEP. ACT remains committed to assisting in the development of these rules. ACT believes certain approaches adopted by Treasury and the IRS with respect to the interaction between sections 959 and 961 are unnecessarily complex to achieve Congress's intent to avoid double taxation of earnings repatriated to the United States. As explained in further detail below, ACT believes certain rules (*e.g.*, tracking and maintenance of PTEP accounts and basis, transition rules, section 961(c) basis, and the proposed share-by-share basis approach) would: (1) add unnecessary complexity and increase the compliance burden for taxpayers; (2) in some cases, go beyond the statutory authority provided with respect to sections 959 and 961; and (3) appear contrary to the policy and purpose of section 959 and section 961 to prevent the double taxation of PTEP.

The complexity resulting from these Proposed Regulations, plus other post-TCJA regulatory regimes,[1] all of which affect the repatriation and redeployment of active business profits, should be better harmonized with the principles set forth by Congress.

In 1962, upon enacting sections 959 and 961, Congress made clear that a U.S. shareholder should first receive tax free amounts equal to his/her prior inclusions (*i.e.*, "at the earliest possible point"[2]):

> Under subsection (c), earnings and profits attributable to amounts once taxed (described in paragraphs (1) and (2)) are to be considered to be distributed until they are exhausted (first from the current year and next from past years). Subsequent distributions, after the earnings and profits described in paragraphs (1) and (2) have been received by a shareholder, are taxable as dividends to the extent of the remaining earnings and profits.[3]

In 2005, Congress enacted section 954(c)(6) to increase the ability of U.S. multinational corporations to redeploy their active business earnings (*i.e.*, CFC earnings subject to U.S. tax deferral) without an additional tax burden in appropriate circumstances. The House Report stated:

> Most countries allow their companies to redeploy active foreign earnings with no additional tax burden. The Committee believes that this provision will make U.S. companies and U.S. workers

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[1] *See, e.g.,* Treas. Reg. §§ 1.861-20 and 1.245A(d)-1 (addressing foreign tax credits); Treas. Reg. §§ 1.245-5 through -11 and 1.245A(e)-1 (dealing with TCJA's section 245A participation regime).

[2] 71 Fed. Reg. 51155 (Aug. 29, 2006) ("[S]ection 959 affects the relevant gross income exclusion at the earliest possible point.").

[3] H.R. Rep. No. 87-1447 (1962).

> more competitive with respect to such countries. By allowing U.S. companies to reinvest their active foreign earnings where they are most needed without incurring the immediate additional tax that companies based in many other countries never incur, the Committee believes that the provision will enable U.S. companies to make more sales overseas, and thus produce more goods in the United States.[4]

In 2017, Congress made a major shift when it enacted section 245A, curtailing the "lockout effect" of imposing U.S. tax on the repatriation of foreign earnings. The House Report stated:

> The Committee believes that a territorial system with appropriate anti-base erosion safeguards, combined with a lower corporate tax rate, will make American workers and companies competitive again, and also will remove tax-driven incentives to keep funds offshore.[5]

While some of the foregoing principles and Code sections are outside of sections 959 and 961, they attempt to achieve Congress's desire to alleviate double taxation at the earliest point in time and to permit U.S. businesses the flexibility to redeploy their capital as their businesses demand. Accordingly, ACT does not believe it is appropriate that the proposed PTEP rules impose a lockout effect that was intended to be eliminated with the enactment of the TCJA.

With the enactment of section 961(c) in 1997, Congress sought to reduce a U.S. shareholder's section 951 inclusion (to mitigate double taxation) for unrepatriated lower-tier CFC PTEP. Nothing in the statute or the Congressional record suggests, however, that Congress intended to modify the computation of a CFC's subpart F income, and an example in the legislative history to section 961(c) strongly suggests that Congress intended not to alter the computation of subpart F income. Thus, ACT's comments begin by addressing this threshold issue. Our other comments flow in part from the decision in the Proposed Regulations to apply section 961(c) at the CFC level rather than the shareholder level, which leads to the introduction of new concepts such as "negative section 961(c) basis."

While this letter provides specific comments intended to ensure that the PTEP regime aligns more closely with Congressional intent (discussed above and described more fully below), we respectfully recommend that Treasury and the IRS consider more significant simplifications to the PTEP regime than the specific suggestions we have described herein. As we discuss further below, the burden imposed upon taxpayers and the IRS by the Proposed Regulations is wholly disproportionate for a set of rules that deals exclusively with income that has already been subject to U.S. tax. Indeed, the complexity of these rules and the burden imposed by them will inevitably frustrate the intent of Congress (expressed clearly in 1962 and in subsequent enactments) to facilitate the efficient repatriation of PTEP and to minimize double taxation. We would welcome the opportunity to engage with Treasury and the IRS (and potentially Congress) on developing a significantly simplified regime.

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[4] H.R. Rep. No. 109-304 (2005), at 45.

[5] H.R. Rep. No. 115-409 (2017), at 370.

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I. Certain rules under the Proposed Regulations go beyond the statutory framework of sections 959 and 961.

A. Negative Section 961(c) Basis and Gain Arising from Section 959(b) Distributions

The Proposed Regulations' approach to section 961(c) is a departure from the way many taxpayers have interpreted the statutory language. Because the operative language provides that section 961(c) applies, "only for the purposes of determining the amount included under section 951 in the gross income of such United States shareholder," many have treated section 961(c) basis as a U.S. shareholder attribute. This approach, when combined with the language of section 959(b), which states that a distribution of PTEP is excluded from a CFC's gross income for purposes of section 951(a), means that a distribution of PTEP from one CFC to another could not give rise to section 961(b)(2) gain. The Proposed Regulations take a different approach and treat section 961(c) basis as a CFC attribute. The Preamble describes Treasury's apparent reasoning, which was primarily to address issues arising in fact patterns involving multiple covered shareholders. While a CFC level approach may address certain issues, ACT believes that such an approach is in conflict with the statutory language and legislative history. Accordingly, we recommend that the final regulations treat section 961(c) basis as a U.S. shareholder attribute, consistent with the statutory text, and that covered shareholder allocation issues be addressed through other means that are more consistent with the foundational principles of section 961(c).

1. Purpose of section 961(c) and tax on section 959(b) distributions

To prevent double taxation, in the event that the stock of a CFC is transferred before such CFC distributes all or a portion of its PTEP to a U.S. shareholder, section 961(a) provides that the basis of a U.S. shareholder's stock in a CFC and the basis of property by reason of which such shareholder is considered under section 958(a)(2) as owning stock of a CFC ("applicable property") are generally increased by the amount included in such shareholder's gross income under section 951(a) with respect to such stock or with respect to such property. Conversely, section 961(b)(1) requires the U.S. shareholder to reduce the basis in the CFC stock or the applicable property by the amount of PTEP distributions received and excluded from gross income under section 959(a). Section 961(b)(2) then requires the U.S. shareholder to recognize gain from the sale or exchange of property to the extent the PTEP distribution exceeds the U.S. shareholder's basis in the CFC stock.

Section 961(c), which was added to the Code 35 years later, provides that under regulations prescribed by the Secretary, if a U.S. shareholder is treated under section 958(a)(2) as owning stock in a CFC which is owned by another CFC, then adjustments similar to the adjustments provided by sections 961(a) and (b) shall be made to the basis of such stock and the basis of stock in any other CFC by reason of which the U.S. shareholder is treated as owning such lower-tier CFC stock under section 958(a)(2); however, these basis adjustments are made only for purposes of determining the amount included in such U.S. shareholder's gross income under section 951.

Under the Proposed Regulations, when a U.S. shareholder owns a CFC which in turn owns a lower-tier CFC, the first-tier CFC has a "section 961(c) ownership unit" with respect to each share of the lower-tier CFC.[6] When a CFC is determined to have section 961(c) basis in a section 961(c) ownership unit, the Proposed Regulations require that such CFC maintain any section 961(c) basis (which can be positive or

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[6] The concept of a "section 961(c) ownership unit" has not been explicitly addressed by Congress, so there is uncertainty whether it is an appropriate interpretation of the statutory text. While section 961 and its related provisions provide a framework for basis adjustments in certain foreign corporation ownership structures, there is no direct statutory or legislative history reference to the specific notion of an ownership unit under section 961(c). As discussed further below, in debating the subpart F provisions in the 1962 Act, Senator Jack Miller of Iowa highlighted the inadequacy of section 961 to prevent potential double taxation on earnings previously taxed under subpart F. Senator Miller's acknowledgment of these limitations underscores the need to approach the concept of a section 961(c) ownership unit with caution.

negative) with respect to the lower-tier CFC separately for each covered shareholder, notwithstanding that section 961(c) basis is generally treated under the Proposed Regulations as a CFC-level attribute. The Proposed Regulations apply the section 961(c) basis upon a sale, exchange, or other disposition of the lower-tier CFC (or section 961(c) ownership unit). If a CFC receives a distribution of PTEP, its section 961(c) basis for each covered shareholder of a section 961(c) ownership unit is generally decreased by an amount equal to the dollar basis and associated foreign income taxes of the PTEP attributed to a covered shareholder and received with respect to the section 961(c) ownership unit. If the required reduction exceeds the section 961(c) basis of the section 961(c) ownership unit, the basis may be reduced below zero, but only to the extent of the amount of adjusted basis available for the covered shareholder in that ownership unit. The Proposed Regulations further provide that to the extent there is any remaining portion of the distribution of PTEP in excess of adjusted basis, the CFC is treated as recognizing gain with respect to the section 961(c) ownership unit, and such gain is assigned to the covered shareholder.

The subpart F provisions, including section 961, were originally enacted into law as part of the Revenue Act of 1962 (the "1962 Act").[7] In debating the subpart F provisions in the 1962 Act, Senator Jack Miller of Iowa highlighted the inadequacy of section 961 to prevent potential double taxation on earnings previously taxed under subpart F. Specifically as it related to PTEP in lower-tier CFCs, Senator Miller argued that "[section 961 did] not go far enough" [8] by positing the following fact pattern:

> X, a U.S. citizen, owns all the stock of P, a Panama corporation, which owns all the stock of S, a Swiss corporation. S has subpart F income charged to X under section 951. Under section 961(a) the basis of ·the P stock is increased, but not the basis of the S stock in the hands of P. A sale of S stock by P would thus increase the earnings and profits of P and the increase could form the base for further taxes (for example under sec. 956) imposed upon X, essentially stemming from the same income already taxed.[9]

Senator Miller concluded "that the basis of the S stock in the hands of P should also be increased under these circumstances"; however, Senator Miller's suggestion was not ultimately adopted as part of the 1962 Act. Instead, some 35 years passed before Congress addressed the issue of potential double taxation arising as a result of the existence of PTEP in lower-tier CFCs, through the addition of section 961(c). Congress added section 961(c) under the Taxpayer Relief Act of 1997 (the "1997 Act").[10] Section 961(c) states in relevant part:

> Under regulations prescribed by the Secretary, if a United States shareholder is treated under section 958(a)(2) as owning stock in a controlled foreign corporation which is owned by another controlled foreign corporation, then adjustments similar to the adjustments provided by subsections (a) and (b) shall be made to—

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7 Revenue Act of 1962 (P.L. 87-834), 87th Cong., 2nd Sess. (1962).

8 108 Cong Rec 18235 (Aug 30, 1962).

9 *Id.*

10 Pub. L. No. 105-34, sec. 1112(b), 111 Stat. at 969. Section 961(c) was amended to read as it does now by the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, §409(b), 119 Stat. at 2635–36, a change that the Joint Committee on Taxation Staff labeled a technical correction to "clarif[y] that the basis adjustments of Code section 961(c) apply not only with respect to the stock of the controlled foreign corporation that earns the subpart F income that gives rise to the basis adjustments, but also with respect to the stock of the higher-tiered controlled foreign corporation in the same chain of ownership," Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 4440, The 'Gulf Opportunity Zone Act of 2005' as Passed by the House of Representatives and the Senate* (JCX-88-05), at 34 (Dec. 16, 2005). Prior to the Gulf Opportunity Zone Act of 2005 (Gulf Act), section 961(c) protected taxpayers from duplicative subpart F income if the CFC, which was the direct-owner of a lower-tier CFC that reported the subpart F income, sold the lower-tier CFC stock. Section 961(c) basis increases (prior to this amendment in 2005) did not ratchet-up the chain where there were more than two CFCs in the same chain of ownership. The Gulf Act modified section 961(c) so that subpart F inclusions of lower-tier CFCs in the same chain of ownership do not give rise to duplicative subpart F inclusions if stock of a higher-tier CFC is sold at a gain.

(1) the basis of such stock, and

(2) the basis of stock in any other controlled foreign corporation by reason of which the United States shareholder is considered under section 958(a)(2) as owning the stock described in paragraph (1),

but only for the purposes of determining the amount included under section 951 in the gross income of such United States shareholder.

The legislative history suggests that the purpose of section 961(c) is to prevent double taxation of PTEP in the event a CFC disposes of stock in a lower-tier CFC prior to the distribution by such lower-tier CFC of its PTEP, acknowledging that "[if] subpart F income of a lower-tier CFC is included in the gross income of a U.S. 10-percent shareholder, no provision of present law allows adjustment of the basis of the upper-tier CFC's stock in the lower-tier CFC."[11] In describing the purpose of section 961(c), the 1997 House Report states:

> Under [section 961(c)], when a lower-tier CFC earns subpart F income, and stock in that corporation is later disposed of by an upper-tier CFC, the resulting income inclusion of the U.S. 10-percent shareholders, under regulations, is to be adjusted to account for previous inclusions, in a manner similar to the adjustments provided to the basis of stock in a first-tier CFC. Thus, just as the basis of a U.S. 10-percent shareholder in a first-tier CFC rises when subpart F income is earned and falls when previously taxed income is distributed, so as *to avoid double taxation of the income on a later disposition of the stock* of that company, the subpart F income from gain on the disposition of a lower-tier CFC generally is reduced by income inclusions of earnings that were not subsequently distributed by the lower-tier CFC.[12]

The House Report provides an example, illustrating Congress's desire to apply similar section 961 adjustments to the U.S. shareholder's subpart F inclusion (*i.e.*, no adjustments are made at the CFC level)[13]:

> For example, assume that a U.S. person is the owner of all of the stock of a first-tier CFC which, in turn, is the sole shareholder of a second-tier CFC. In year 1, the second-tier CFC earns $100 of subpart F income which is included in the U.S. person's gross income for that year. In year 2, the first-tier CFC disposes of the second-tier CFC's stock and recognizes $300 of income with respect to the disposition. *All of that income constitutes subpart F foreign personal holding company income*. Under [section 961(c)], the Secretary is granted regulatory authority to *reduce the U.S. person's year 2 subpart F inclusion by $100* — the amount of year 1 subpart F income of the second-tier CFC that was included, in that year, in the U.S. person's gross income. Such an adjustment, *in effect*, allows for a step-up in the basis of the stock of the second-tier CFC to the extent of its subpart F income previously included in the U.S. person's gross income.[14]

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[11] H. Rep. 105-148, at 528–530 (1997).

[12] *Id.* at 450 (emphasis added); *see also* S. Rep. No. 105-33, at 160–61 (1997) (providing an identical explanation of section 961(c)); H.R. Conf. Rep. No. 105-220, at 510–11 (1997) (same).

[13] Former House Ways & Means Chairman Brady's draft Tax Technical and Clerical Corrections Act (the Technical Corrections Act) would have expanded the existing scope of section 961(c) by providing that the same section 961(a) and section 961(b) adjustments that are made to the basis of first-tier CFC stock are made to the basis of lower-tier CFC stock for all purposes of the Code. *See* Tax Technical and Clerical Corrections Act Discussion Draft 64–65 (Jan. 2, 2019). *See also* Joint Committee on Taxation*, Technical Explanation of the House Ways and Means Committee Chairman's Discussion Draft of the 'Tax Technical and Clerical Corrections Act"* (JCX-1-19) (Jan. 2, 2019).

[14] *Id.* (emphasis added).

Thus, the legislative history of section 961(c) explains the following:

1. Subpart F income at the seller CFC level with respect to the sale of lower-tier CFCs does not take into account section 961(c) adjustments;
2. The section 961(c) adjustment operates as a reduction to the U.S. shareholder's section 951(a) inclusion (does not adjust the amount of subpart F income at the CFC level); and
3. The adjustments required by section 961(c) are (i) for the purpose of preventing double taxation that could otherwise occur when a lower-tier CFC is sold (*i.e.*, section 961(c) was meant to be a taxpayer-favorable provision, and nothing in the legislative history suggests that it was meant to be a gain-triggering provision) and (ii) similar, but not identical, to basis adjustments provided for in section 961(a) and section 961(b).

Section 961(c), as currently enacted, does not contemplate the concept of negative section 961(c) basis, nor does it contemplate potential gain recognition (see above) upon a distribution of PTEP by a lower-tier CFC to an upper-tier CFC where the amount of the PTEP distribution exceeds the upper-tier CFC's basis in the stock of the lower-tier CFC, as provided in the Proposed Regulations.[15] The language of section 961(c) provides that "adjustments similar to the adjustments provided by subsections (a) and (b) shall be made" only for the purposes of determining the amount of existing income at the CFC level included under section 951 in the gross income of the U.S. shareholder. The adjustments made under sections 961(a) and 961(b) include (1) an increase to the basis of CFC stock (and property through which such stock is owned) by the amount included in a U.S. shareholder's gross income under section 951(a) with respect to such stock or property and (2) a basis reduction to the stock or other property with respect to which the U.S. shareholder receives a PTEP distribution excluded from gross income under section 959.

Section 961(b)(2) further provides that a U.S. shareholder shall recognize gain from the sale or exchange of property to the extent a PTEP distribution excluded from gross income under section 959(a) exceeds the basis of the stock or other property with respect to which the distribution is received. However, section 961(b)(2) is not "an adjustment provided by [section 961(b)]." Rather, it is a separate gain recognition provision and thus is not within the scope of section 961(c). The legislative history of section 961(c) makes clear that section 961(c) adjustments (unlike section 961(a) and section 961(b) adjustments) operate to reduce a section 951(a) inclusion amount of a U.S. shareholder with respect to certain existing subpart F income of a CFC. The adjustments under section 961(c) are with respect to existing subpart F income at the CFC level; they do not *create* subpart F income. Indeed, if Congress thought that section 961(b)(2) gain could be triggered where there was insufficient section 961(c) basis to support a CFC-to-CFC PTEP distribution (assuming these basis adjustments are made at the CFC-level), this would mean PTEP created prior to the 1997 Act would cause section 961(b)(2) gain whenever such PTEP is distributed between CFCs.

The view that there cannot be section 961(b)(2) gain at the CFC level, in general, produces outcomes that are more consistent with legislative intent of avoiding double taxation and allowing U.S. persons to receive the full benefit of their PTEP at the earliest possible time.

The approach taken in the Proposed Regulations to require potential section 961(b)(2) gain recognition on CFC-to-CFC PTEP distributions particularly has a negative impact on taxpayers who still have section 965(b) PTEP in lower-tier CFCs (*i.e.*, amounts of a U.S. shareholder's inclusions under section 965(a) that were reduced by deficits under section 965(b) that were treated as amounts included in the shareholder's gross income under section 951(a) for purposes of section 959, but not for purposes of

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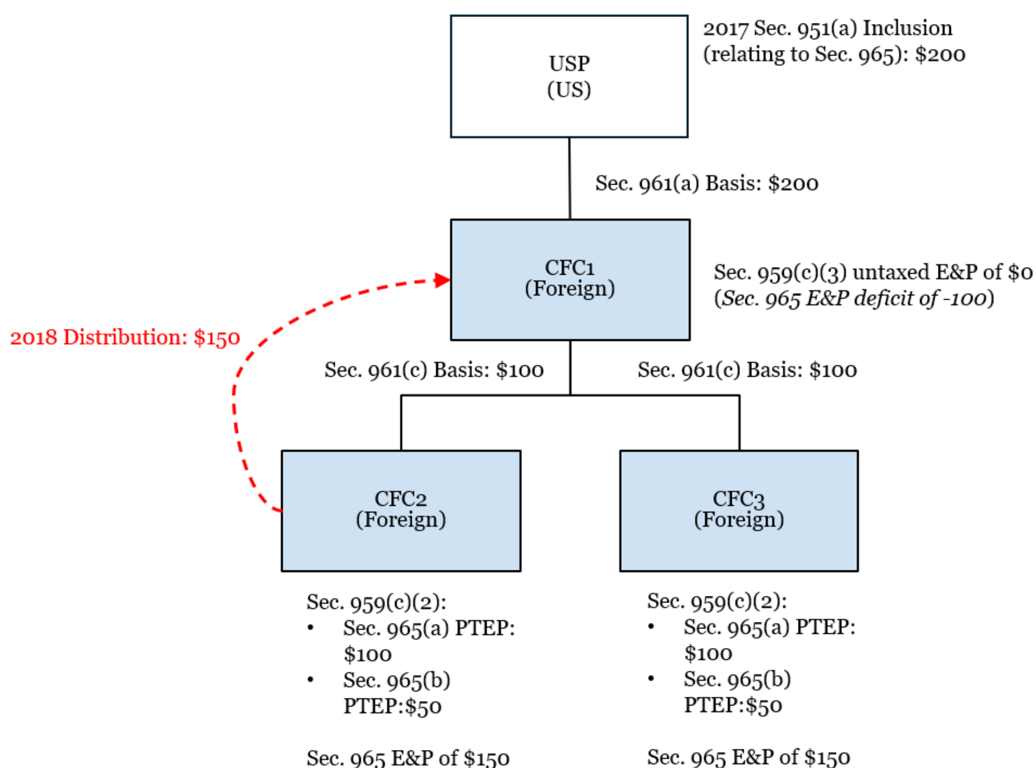
[15] *See Loper Bright Enters. v. Raimondo*, 144 S. Ct. 2244 (2024) (providing that when "the best reading of the statute is that it delegates discretionary authority to an agency, the role of the reviewing court under the APA is, as always, to independently interpret the statute and effectuate the will of Congress subject to constitutional limits" and the reviewing court fulfills such role by "'fix[ing] the boundaries of [the] delegated authority'") (quoting H. Monaghan, *Marbury* and the Administrative State, 83 Colum. L. Rev. 1, 27 (1983)).

section 961).[16] Absent an election under Treas. Reg. § 1.965-2(f)(2) to reallocate basis from the stock of a deficit CFC, such taxpayers have no basis attributable to section 965(b) PTEP. Accordingly, under the Proposed Regulations, such taxpayers would potentially be taxed at 21% on section 965(b) PTEP distributions from one CFC to another CFC on earnings that were used to offset their section 965 inclusion, which was taxed at a rate of 15.5% or 8%.

Consider a simple example where a domestic corporation (USP) wholly owns a CFC (CFC1), which in turn wholly owns two other CFCs (CFC2 and CFC3). Assume all entities have calendar taxable year-ends and U.S. dollar functional currencies. All CFCs were owned by USP since their formation, and USP has zero tax basis in each of the CFC's stock (before any application of section 961). In 2017, CFC2 and CFC3 each had E&P subject to section 965(a) of $150 (for a total of $300), and CFC1 had an E&P deficit for purposes of section 965(b) of $100 that resulted in USP having a section 951(a) inclusion by reason of section 965 of $200. USP's basis in CFC1 was increased by $200 under section 961(a) (i.e., equal to the amount of the section 965(a) PTEP at CFC2 and CFC3). However, there is no section 961(a) basis increase with respect to section 965(b) PTEP.

On January 1, 2018, CFC1 had no section 959(c)(1) or section 959(c)(2) PTEP and had section 959(c)(3) untaxed E&P equal to zero; CFC2 and CFC3 each had $150 of section 959(c)(2) PTEP, $100 of which was section 965(a) PTEP and $50 of which was section 965(b) PTEP. In 2018, none of the CFCs had any additional earnings (or deficits in E&P). During 2018, CFC2 distributed all its $150 of PTEP to CFC1.



If section 961(c) applied to PTEP distributions between CFCs and section 961(b)(2) were applicable at the CFC level, then CFC1 would have to (i) increase its section 961(c) "basis" in CFC2 by $100 (the

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[16] Section 965(b)(4)(A). *See also* Treas. Reg. § 1.965-2(d).

section 951(a) inclusion with respect to CFC2), (ii) decrease its basis in CFC2 by the $100 (PTEP distribution to the extent of basis), and (iii) recognize gain of $50 under section 961(b)(2) for PTEP distributions in excess of basis. The $50 of section 961(b)(2) gain is expected to be section 954(c)(1)(B) foreign personal holding company income (because section 961(b)(2) gain is treated as the gain from the sale or exchange of property) and thus triggers a section 951(a) inclusion of $50 by USP with respect to CFC1 in 2018.

This example illustrates two problems: 1) the timing of USP's recognition of section 961(b)(2) gain on the section 965(b) PTEP is accelerated to a time before USP receives the distribution, and 2) section 965 taxed offshore earnings at a preferential rate and that benefit is lost when earnings that were offset by a deficit for purposes of transition tax are subsequently taxed at the full corporate tax rate. This is not the result intended by the drafters of section 959 and section 961. In this particular fact pattern, USP should have the ability to repatriate up to $200 of PTEP tax-free before being subject to section 961(b)(2) gain. This result also contravenes the policy of allowing foreign earnings to move between foreign subsidiaries (*e.g.*, section 954(c)(6) look-thru for dividends and section 951A exclusion of related-party dividends from tested income) without being subject to U.S. tax. It is irrational that the offshore movement of PTEP could cause additional U.S. tax whereas a similar distribution of "taxable" dividends (*i.e.*, untaxed earnings) does not, particularly when section 959 requires distributions to be sourced first out of PTEP (to the extent thereof).

If Treasury and the IRS decide to retain the current rules in the Proposed Regulations that treat section 961(c) basis as a CFC attribute, ACT requests that Treasury and the IRS clarify that section 964(e) applies to any section 961(b)(2) gain required to be recognized by a CFC by reason of a PTEP distribution. Section 964(e)(1) provides that if a CFC sells or exchanges stock in any other foreign corporation, any gain recognized on such sale or exchange is included in the gross income of the selling CFC as a dividend, to the same extent as it would have been included under section 1248(a) if the selling CFC were a U.S. person.[17] Section 964(e)(3) further provides that "[f]or purposes of [section 964(e)], a [CFC] shall be treated as having sold or exchanged any stock if, under any provisions of this subtitle, such [CFC] is treated as having gain from the sale or exchange of such stock."[18]

The Proposed Regulations provide that if a CFC recognizes gain with respect to a section 961(c) ownership unit as a result of a PTEP distribution, such CFC is treated as "recognizing gain with respect to such section 961(c) ownership unit in accordance with [Prop. Reg. § 1.961-4(f)]."[19] Prop. Reg. § 1.961-4(f)(1) provides that gain recognized with respect to a section 961(c) ownership unit is "treated as gain from a sale or exchange of such ownership unit." Since the Proposed Regulations provide that a section 961(c) ownership unit is "a share of stock of a foreign corporation directly owned by a [CFC],"[20] this suggests that section 961(b)(2) gain required to be recognized by a CFC as a result of a PTEP distribution is treated as gain from the sale or exchange of the distributing CFC stock. Accordingly, ACT requests that Treasury and the IRS clarify that section 964(e) applies to such gain, such that a portion of the gain may be recharacterized as a dividend to the extent of the distributing CFC's section 1248 E&P attributable to the distributing CFC's stock.

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17 Section 1248(a) generally provides, in relevant part, that to the extent a U.S. person sells or exchanges stock in a foreign corporation and owns or is considered as owning 10 percent or more of the voting power of such foreign corporation, then the gain recognized on the sale or exchange of such stock is included in the gross income of such person as a dividend, to the extent of the E&P of the foreign corporation.

18 Section 964(e)(3).

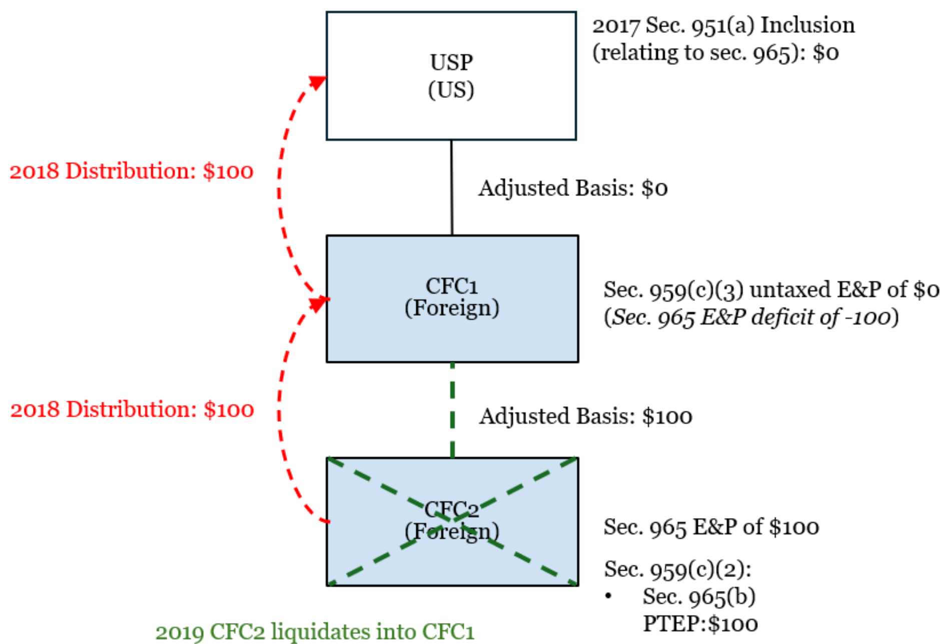
19 Prop. Reg. § 1.961-4(d)(2)(iii).

20 Prop. Reg. § 1.961-2(e)(1).

2. Negative section 961(c) basis and double taxation

The negative section 961(c) basis rules in Prop. Reg. § 1.961-4 and -10 may result in double taxation for distributions of PTEP which caused negative section 961(c) basis with respect to a section 961(c) ownership unit. To illustrate this result, consider the following fact pattern:

> A domestic corporation (USP) wholly owns a CFC (CFC1), which in turn wholly owns another CFC (CFC2). Assume again that all entities have calendar taxable year-ends and U.S. dollar functional currencies. CFC1 has been owned by USP since its formation, and USP has zero tax basis in the stock of CFC1. CFC2 has been owned by CFC1 since its formation, and CFC1 has $100 of adjusted basis in the stock of CFC2 (before any application of section 961).
>
> In 2017, CFC2 had E&P subject to section 965(a) of $100, and CFC1 had an E&P deficit for purposes of section 965(b) of $100 that resulted in USP having a section 951(a) inclusion by reason of section 965 of $0. On January 1, 2018, CFC1 had no section 959(c)(1) or section 959(c)(2) PTEP and had section 959(c)(3) untaxed E&P equal to zero; CFC2 had $100 of section 959(c)(2) PTEP, which was section 965(b) PTEP.
>
> In 2018, neither of the CFCs had any additional earnings (or deficits in E&P). During 2018, CFC2 distributed all its $100 of PTEP to CFC1, and CFC1 in turn distributed the $100 of PTEP to USP. In 2019, CFC2 liquidates into CFC1 in a transaction subject to section 332.



Because there is no section 961(a) or 961(c) basis increase with respect to the section 965(b) PTEP of CFC2, USP's section 961(a) basis in CFC1 and CFC1's section 961(c) basis in CFC2 is zero. Under the Proposed Regulations, CFC1 must decrease its section 961(c) basis in CFC2 by $100 (*i.e.*, to the extent of its adjusted basis in the CFC 2 stock) as a result of the 2018 distribution from CFC2 to CFC1, resulting in a section 961(c) basis of negative $100. Moreover, upon CFC1's distribution of the PTEP to USP, USP would recognize gain of $100 under section 961(b)(2) (*i.e.*, the PTEP distribution in excess of its basis in CFC1).

Upon the section 332 liquidation of CFC2, the Proposed Regulations would then require CFC1 to recognize gain to the extent of its negative $100 of section 961(c) basis because the section 961(c) ownership unit with respect to CFC2 ceases to be a section 961(c) ownership unit immediately after the liquidation.[21] Accordingly, gain would be recognized twice on the same underlying earnings and profits: once on the PTEP distribution from CFC1 to USP and then again on the subsequent liquidation of CFC2.

The same double taxation result can also occur if CFC1 were to sell the stock of CFC2. There is no rule in the Proposed Regulations that allows a taxpayer to offset negative section 961(c) basis when a covered shareholder recognizes section 961(b)(2) gain on the same PTEP by reason of a section 959(a) distribution. If Treasury and the IRS decide to retain the current rules in the Proposed Regulations on negative section 961(c) basis, ACT believes that the regulations should provide a rule to coordinate negative section 961(c) basis and section 961(b)(2) gain. Failing to provide such a rule is inconsistent with the Congressional intent of preventing double taxation. Requiring gain recognition on earnings that were already taxed when repatriated frustrates the policy of sections 959 and 961 to allow PTEP to be distributed to a section 958(a) U.S. shareholder without double taxation.[22]

B. Inability to use positive section 961(c) basis in excess of covered gain to offset other covered gain or to create a loss that reduces subpart F or tested income

In the event Treasury and the IRS do not adopt the recommendation discussed in Part I.A above with respect to adjustments to section 961(c) basis, ACT recommends revising the Proposed Regulations to provide that when an upper-tier CFC incurs a loss from the sale of a lower-tier CFC due to an adjustment under section 961(c), such loss is taken into account in computing the subpart F inclusions of the upper tier CFC, including by offsetting gains to determine the amount of foreign personal holding company income under section 954(c)(1)(B) that should be included by such U.S. shareholder.

Under the Proposed Regulations, when a CFC sells or transfers one or more section 961(c) ownership units, it first determines the aggregate gain (*i.e.*, "covered gain") without considering section 961(c) basis or any recognized loss with respect to any transferred unit. The covered gain is then generally assigned to covered shareholders pursuant to Prop. Reg. § 1.951-2, following the same rules used for assigning covered distributions. Each covered shareholder's share of the covered gain is reduced by the CFC's positive section 961(c) basis with respect to such covered shareholder, and such portion is characterized as PTEP, which is excluded from the CFC's gross income for purposes of determining such CFC's subpart F or tested income.[23]

The Preamble to the Proposed Regulations explains that an aggregate approach allows positive section 961(c) basis from one transferred unit to offset gain recognized from another, even if the first unit is sold at a loss. This method replicates the effect of netting gains and losses across similar property types when determining a CFC's subpart F income and aligns with the general principles of section 954(c)(1)(B), which treats excess gains over losses on certain property sales as foreign personal holding company income. However, the Proposed Regulations do not allow excess positive section 961(c) basis beyond the covered shareholder's share of covered gain to offset other types of income or create a loss reducing

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[21] Prop. Reg. § 1.961-10(c)(2)(ii). If a section 961(c) ownership unit ceases to be a section 961(c) immediately after a transaction, the Proposed Regulations require immediate gain recognition equal to the sum of all negative section 961(c) basis of the section 961(c) ownership unit. There are no exceptions to this rule, even for certain nonrecognition transactions. Thus, gain recognition is required in the event of a section 332 liquidation of a lower-tier CFC, despite the fact that the adjusted basis in the stock of the lower-tier CFC is not taken into account in such transaction. There is no clear policy reason to require gain recognition with respect to the negative section 961(c) basis as a result of a section 332 liquidation.

[22] Interestingly, if CFC1 had no adjusted basis in the stock of CFC2 at the time of CFC2's PTEP distribution to CFC1, USP would have recognized gain once under the Proposed Regulations (at the time of the section 959(b) distribution), CFC1 would not have had negative section 961(c) basis in CFC2, and there would have been no gain recognition resulting from the liquidation of CFC2 (same result with a sale).

[23] *See* Prop. Reg. § 1.961-9(b), (d)(3).

subpart F or tested income. The application of section 961(c) basis is strictly limited to reducing section 951 inclusions from transactions involving the same foreign corporation's stock (*i.e.*, section 961(c) basis can only be applied to gain recognized under section 961(c) if such gain relates to the same foreign corporation's stock).[24]

As discussed above, the language of section 961(c) provides that the adjustments under such section are made "only for purposes of determining the amount included under section 951 in the gross income of such United States shareholder…". The scope of section 961(c) is clear and applies expansively for all purposes of determining inclusions under section 951(a). When a U.S. shareholder computes its inclusions under sections 951(a) and 951A(a) with respect to an upper-tier CFC, the U.S. shareholder must make adjustments under section 961(c) with respect to the basis of any lower-tier CFC stock owned by the upper-tier CFC but solely for purposes of determining the U.S. shareholder's section 951(a) inclusions. There is no evidence that Congress intended the enactment of section 961(c) to modify section 954(c)(1)(B) or otherwise limit the netting of gains and losses for purposes of determining the CFC's subpart F income.[25]

If the effect of the adjustment under section 961(c) would be such that the selling CFC would incur a loss (rather than a gain without such adjustment) with respect to a disposition of a CFC, then such loss should be taken into account in determining the U.S. shareholder's inclusions with respect to the selling CFC, including by offsetting gains recognized by such selling CFC to the extent allowable under section 954(c)(1)(B) and the corresponding regulations. This would give effect to the economic position of the selling CFC and its U.S. shareholders.

For example,

> USP is a domestic corporation and a U.S. shareholder that owns, within the meaning of section 958(a)(1), 100 percent of the issued and outstanding stock of CFC1, a CFC. CFC1, in turn, owns 100 percent of the issued and outstanding stock of each of CFC2 and CFC3. CFC2 and CFC3 are each CFCs and USP is considered to own, under section 958(a)(2) through its interest in CFC1, the stock of CFC2 and CFC3. Without taking into account any adjustments under section 961(c), CFC1's basis in the stock of CFC2 is $10x, and CFC1's basis in the stock of CFC3 is $15x.
>
> In Year 1, CFC2 generates $40x of foreign personal holding company income that is included in USP's gross income under section 951(a). Neither CFC1 nor CFC3 earn any income in Year 1.

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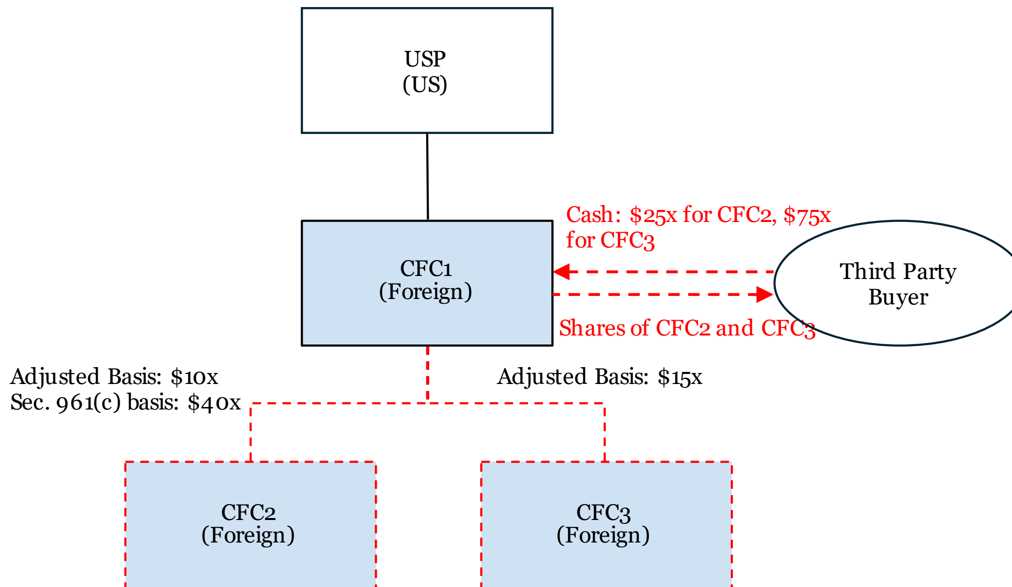
[24] *See* Prop. Reg. § 1.961-9(e)(1), which refers to Prop. Reg. § 1.961-9(d)(1) that then refers to Prop. Reg. § 1.951-2.

[25] Although withdrawn, the interaction (or the lack thereof) between section 961(c) and 954(c)(1)(B) was recognized by Treasury and the IRS in the 2006 Proposed Regulations:

> Section 961(c) is only applicable for purposes of determining the amount included under section 951 in gross income of a United States shareholder. Consequently, the IRS and Treasury Department have so limited the application of Prop. Reg. § 1.961-3. In the event of a sale of a lower-tier CFC by an upper-tier CFC for which the rules of section 961(c) are implicated in determining the gain on the sale, the basis created in the lower-tier CFC stock for purposes of applying section 951 would not apply, for example, to determine the earnings and profits of the upper-tier CFC. However, the IRS and Treasury Department are concerned about the potential double taxation that may result in the event of the later distribution of these earnings and profits to a United States person.

71 Fed. Reg. 51155, 51161

In Year 2, CFC1 sells its interests in each of CFC2 and CFC3 to a third party for $25x and $75x, respectively.



Accordingly, absent any adjustments under section 961(c), CFC1 would realize $15x ($25x-$10x) of gain with respect to the disposition of the stock of CFC2 and $60x ($75x-$15x) of gain with respect to the disposition of the stock of FC3, with the aggregate of such items constituting foreign personal holding company income under section 954(c)(1)(B). However, USP included $40x in its income with respect to its interest in CFC2 in Year 1 and has section 961(c) basis equal to that amount with respect to CFC2. Accordingly, to recognize the economic effect of the loss realized by CFC2, the $40x of section 961(c) basis should be taken into account when determining USP's inclusions under section 951(a) with respect to CFC1. Accordingly, and solely for such purpose, CFC1's item of foreign personal holding company income under section 954(c)(1)(B) should be $35x, representing the net gains in excess of losses from the disposition of property (*i.e.*, the gain of $60x from the disposition of CFC3 stock less the loss of $25x with respect to the CFC2 stock).

As previously discussed, Congress enacted section 961(c) to avoid double taxation that would result in fact patterns where a U.S. shareholder had an inclusion with respect to a lower-tier CFC and the stock of the lower-tier CFC was subsequently sold. Absent an adjustment for the full section 961(c) basis (in the example above, $40), the U.S. shareholder would, in effect, recognize the same income twice – first, with respect to the section 951(a) inclusion with respect to the FC2 stock and second, by failing to take into account the economic loss generated with respect to the FC2 stock in the computation of foreign personal holding company income under section 954(c)(1)(B) and the regulations, which provides for recognition of gains over losses. This result is contrary to the purpose for which Congress enacted section 961(c) because it fails to prevent double taxation of subpart F income (and later GILTI) upon the disposition by one CFC of another CFC's stock.

Accordingly, ACT recommends that the Proposed Regulations be revised to provide that where, for purposes of determining a U.S. shareholder's inclusions, an upper-tier CFC recognizes a loss from the disposition of a lower-tier CFC by reason of an adjustment under section 961(c), such loss is taken into account in computing the inclusions of the U.S. shareholder with respect to the upper-tier CFC, including by offsetting gains with losses in determining the amount of foreign personal holding company income under section 954(c)(1)(B) that should be included by such U.S. shareholder.

II. The Proposed Regulations introduce certain rules that appear contrary to the policy of sections 959 and 961 to prevent the double taxation of PTEP.

As stated in the Preamble to the Proposed Regulations, section 959 and 961 are intended to operate in tandem to "prevent double taxation of PTEP." Section 959 is intended to prevent double taxation by excluding PTEP from the gross income of U.S. persons and CFCs. Section 961, which provides 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), prevents undistributed PTEP of a foreign corporation from giving rise to gain or a subpart F 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.

A. Inability to use basis in another section 961(a) ownership unit.

While adjustments to annual PTEP accounts pursuant to section 959(a) are made generally for all stock owned by a covered shareholder, under the Proposed Regulations, basis adjustments are specific to a share of stock or other item of property through which a covered shareholder owns a share of stock (*i.e.*, share-by-share basis tracing). Under such an approach, basis may not always align with the related PTEP when such PTEP is later distributed, resulting in potential gain under section 961(b)(2) that would result in double taxation. Moreover, the Proposed Regulations specifically provide that excess basis in a section 961(a) ownership unit cannot be used to reduce gain under section 961(b)(2) on another section 961(a) ownership unit to the same covered shareholder upon a distribution of PTEP. The inability to use basis in another section 961(a) ownership unit frustrates the policy of sections 959 and 961 for PTEP to be distributed to a section 958(a) U.S. shareholder without double taxation.[26]

> For example, consider a fact pattern where a domestic corporation (USP) owns 100% of the issued and outstanding stock of a controlled foreign corporation (CFC1). In Year 1, CFC1 earns $100x of subpart F income, giving rise to $100x of PTEP. In Year 2, USP makes a contribution to CFC1 of stock in another CFC (CFC2) in which USP has zero basis in exchange for additional shares in CFC1 (the "Additional Shares") that qualifies as a tax-free contribution of property under section 351.[27] In Year 3, CFC1 makes a pro rata distribution of $100, and, therefore, a portion of such PTEP distribution is made with respect to the Additional Shares.

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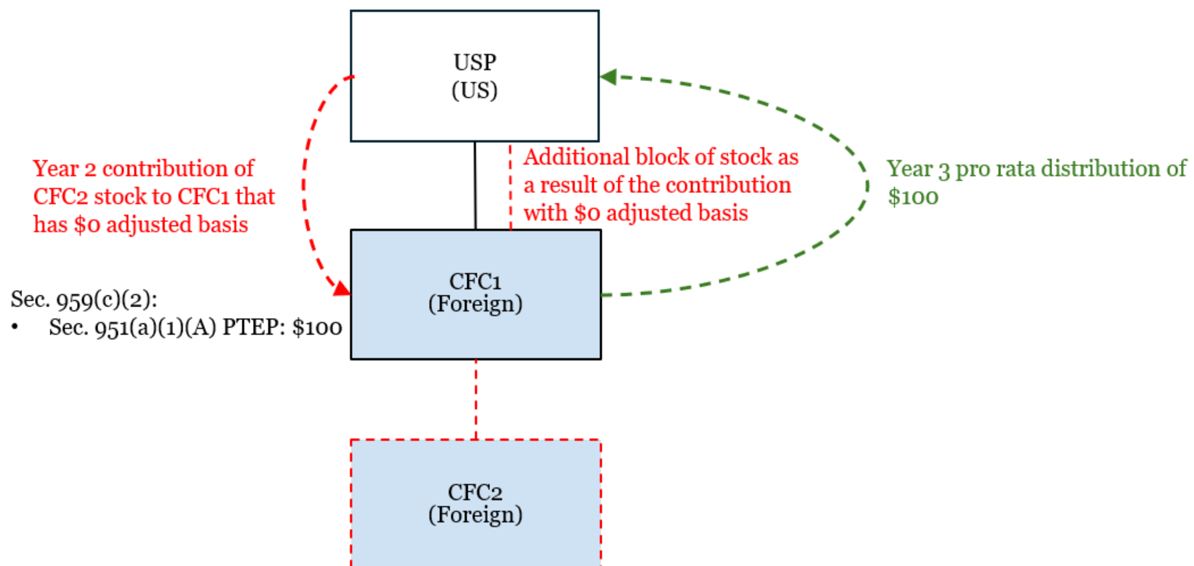
[26] *See* H.R. Rep. No. 87-1447 (1962) ("Under [section 959](c), earnings and profits attributable to amounts once taxed . . . are to be considered to be distributed until they are exhausted (first from the current year and next from past years)"); *see also* 71 Fed. Reg. 51155 (Aug. 29, 2006) ("[S]ection 959 affects the relevant gross income exclusion at the earliest possible point.").

[27] For completeness, we note USP would need to enter into a gain recognition agreement as defined in Treas. Reg. § 1.367(a)-8 to prevent any gain from being recognized under section 367(a) on the outbound transfer of stock.

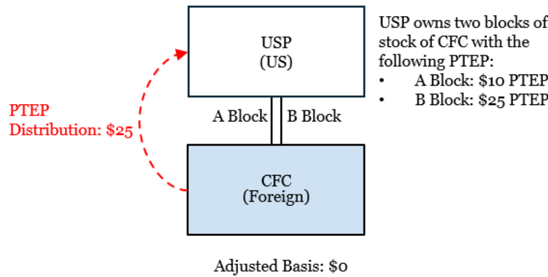


Although PTEP is distributed with respect to the Additional Shares, under the Proposed Regulations, USP would recognize section 961(b)(2) gain in connection with the PTEP distributed with respect to the Additional Shares because USP would not be allowed to use its basis in another section 961(a) ownership unit (*i.e.*, basis in its non-Additional Shares) to reduce gain under section 961(b)(2). Such a result under the Proposed Regulations is inappropriate and counter to the policy of sections 959 and 961 to prevent the double taxation of PTEP. Further, it can create built-in losses in the shares with the original inclusion and section 961(a) basis adjustment.

The 2006 Proposed Regulations acknowledged the need to prevent double taxation by reason of section 961(b)(2) and included a rule that facilitated the sharing of PTEP (known at the time as PTI) among different blocks of stock held by the same covered shareholder. Under the 2006 Proposed Regulations, PTI accounts (and corresponding basis) were assigned to blocks of stock for which the inclusion was attributable. The basis sharing rule (in Prop. Reg. § 1.959-3(f)) was designed to address situations where a distribution of earnings and profits exceeded the PTI account for one or more blocks of stock. In such cases, the PTI accounts for the shareholder's other blocks of stock were reduced on a pro rata basis, thereby increasing the PTI account that would have been exceeded. While the rule applied to PTI accounts instead of explicitly to basis, the rule effectively prevented the recognition of gain under section 961(b)(2) on the distribution of PTI where there was corresponding basis on the other shares. Further, when PTI was shared among members of a consolidated group, a member that utilized PTI from another member treated the increase in its PTI account as the receipt of tax-exempt income. Conversely, a member whose PTI was utilized treated the reduction in its PTI account as a noncapital nondeductible expense for the purpose of making the investment adjustments required by Treas. Reg. § 1.1502-32. The rationale for allowing PTI sharing among blocks of stock was to ensure that shareholders could fully utilize their PTI without incurring additional tax, thereby aligning with the legislative intent of avoiding double taxation and allowing shareholders to benefit from their PTI at the earliest possible time. The government expressed concerns about these rules leading to inappropriate basis shifting and had requested comments in the preamble of the regulations.

See below examples illustrating the differences between the Proposed Regulations and the 2006 Proposed Regulations:

Proposed Regulation

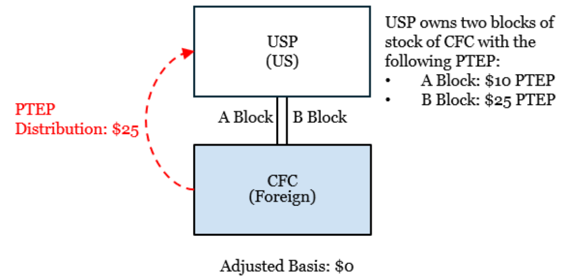


Block	Original PTEP	Decrease	Sec. 961(b)(2) Gain	Remaining PTEP
A	$10	($12.5)	$2.5	$0
B	$25	($12.5)	$0	$12.5

The covered distribution of $25 is treated as 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 (i.e., Block A and Block B) of the CFC owned by USP. See Prop. Reg. § 1.959-4(d)(4).

As the adjustment to Block A exceeds its PTEP amount, a section 961(b)(2) gain is expected to result. Further, Block B may give rise to a non-economic loss.

2006 Proposed Regulation



Block	Original PTEP	Decrease	Ending PTEP
A	$10	($10)	$0
B	$25	($15)	$10

The former 2006 proposed regulations provided a special rule when a shareholder has more than one PTI/PTEP account with respect to stock in a foreign corporation, and, during the tax year, the CFC distributes E&P in an amount that exceeds one or more PTI/PTEP accounts, the shareholder may reduce other PTI/PTEP accounts pro rata and increase the PTI/PTEP account by the amount of the excess. See Former Prop. Reg. § 1.959-3(f)(1).

Accordingly, since the adjustment to Block A stock exceeds the PTEP balance, the excess reduces the other PTEP account that USP holds with respect to its Block B stock in CFC. As there is a sufficient amount of PTEP, no Section 961(b)(2) adjustment is expected to occur, nor is a noneconomic loss expected to arise with respect to Block B.

Basis sharing or shifting to prevent double taxation can be achieved while still addressing the government's concerns of creating non-economic losses or other inappropriate basis shifting. As discussed below, other areas of the Code and regulations, such as rules on the taxation of S Corporations and the consolidated return regulations,[28] can serve as a framework for a similar PTEP rule.

1. Consolidated Return Regulations - Treas. Reg. § 1.1502-32

The investment adjustment rules in Treas. Reg. § 1.1502-32, for example, provide a framework for adjusting the basis of a subsidiary's (S's) stock owned by another member (M) of a consolidated group. These rules are designed to prevent duplicative adjustments and inappropriate gain recognition, ensuring that the basis adjustments reflect the actual economic interests and priorities of the shareholders.

This goal is generally accomplished through the use of positive or negative adjustments to the basis of the S stock owned by M to reflect the increase or decrease in value of S resulting from income or loss (and certain other items) that have been taken into account by the consolidated group. These adjustments are

[28] The investment adjustment rules in Treas. Reg. § 1.1502-32 provide a framework for adjusting the basis of a subsidiary's stock owned by another member of a consolidated group. The rules are designed to prevent duplicative adjustments and inappropriate gain recognition, ensuring that the basis adjustments reflect the actual economic interests and priorities of the shareholders.

made at the close of each consolidated return year and as of any other time that is necessary to determine a tax liability, such as when S stock is sold during the taxable year. If negative adjustments exceed M's basis in S stock, the resulting negative amount is an Excess Loss Account (ELA), which functions as a negative basis account.[29] Subject to certain exceptions, if M is treated as disposing of a share of S stock, M takes into account an ELA in the share as income or gain from the disposition.[30]

Distributions from S to M generally result in reductions to M's stock basis in S under the investment adjustment rules and are not included in the gross income of M. For example, no amount is included in M's gross income under section 301(c)(3) from a distribution in excess of the basis of the stock of S that results in an ELA.[31]

Adjustments to stock basis that are allocable to a class of common stock are generally allocated equally to each share within the class. However, Treas. Reg. § 1.1502-32 contains special rules that allocate basis adjustments in a non-*pro rata* manner that is intended to reduce or eliminate ELAs, effectively shifting basis adjustments between shares of stock held by a member to help avoid negative basis in any share of stock. If a member has an ELA in a share of a class of common stock at the time that a positive adjustment is to be allocated, the positive adjustment allocable to the member with respect to the class is allocated first to equalize and then eliminate that member's ELAs. Only after the elimination of ELAs is any remaining positive basis adjustment allocated equally among the member's shares in that class. Similarly, the portion of any negative basis adjustment allocable to the member with respect to the class is allocated to the member's shares with positive bases, eliminating all positive basis in the shares of the class before creating or increasing any ELAs. After positive basis is eliminated, any remaining portion of the negative adjustment is allocated to equalize the member's ELAs in the shares of that class to the greatest extent possible.[32]

2. Taxation of S Corporations - Treas. Reg. § 1.1367-1

Another example that may serve as a framework is the basis recovery model taken in Treas. Reg. § 1.1367-1 for shareholders of S corporations.[33] Under such model, the basis of a shareholder's share of S corporation stock is decreased by such shareholder's pro rata portion of a distribution on a per share, per day basis. However, if the amount of the distribution attributable to a particular share exceeds the shareholder's basis in that share, the remaining basis of all other shares of stock owned by such shareholder in the S corporation can be reduced (not below zero) to prevent inappropriate taxation on the distribution.[34] See an illustrative example below of the aggregate basis recovery model for S corporations.

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29 Treas. Reg. § 1.1502-32(a)(3)(ii).

30 Treas. Reg. § 1.1502-19(b).

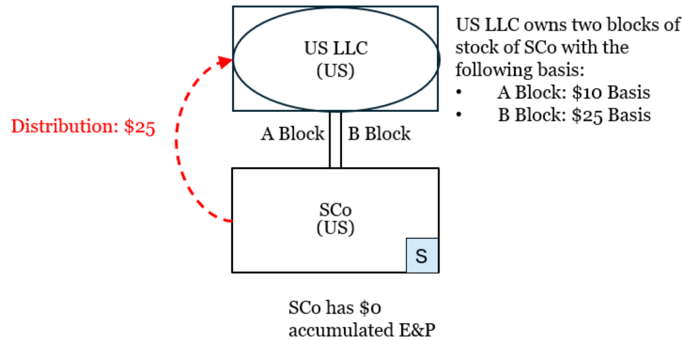
31 Treas. Reg. § 1.1502-13(f)(2)(ii).

32 *See, generally*, Treas. Reg. § 1.1502-32(c)(2).

33 We understand that the IRS may already be contemplating whether the aggregate basis recovery model similar to S corporations would be appropriate in this context. *See Tax Notes Federal*, Jan. 20, 2025, p. 609 ("in finalizing the proposed regulations, we are considering an aggregate basis recovery model similar to the S corporation context.") (quoting Shane McCarrick, IRS Office of Associate Chief Counsel (International)).

34 *See* Treas. Reg. § 1.1367-1(c)(3). Under Subchapter S of the Code, the income of an S corporation is generally not taxed at the entity level. Rather, the corporation's income and loss items are passed through to the S corporation's shareholders. Because the income of an S corporation is taxed currently to its shareholders, even if such income is not currently distributed, adjustments are made with respect to each shareholder of the S corporation to prevent the double taxation of earnings upon a later distribution. The basis recovery model for an S corporation in Treas. Reg. § 1.1367-1(c)(3), known as the "spillover rule," implements Congressional intent of a single level of taxation for taxpayers by permitting shareholder(s) of an S corporation to utilize the aggregate of his or her basis in all

S Corporation



Block	Original Basis	Decrease	Adjusted Basis
A	$10	($10)	$0
B	$25	($12.5 + $2.5)	$10

The basis of US LLC's block of stock is reduced by US LLC's pro rata portion of the distribution of $25 (i.e., $12.5 each for the two blocks of stock) on a per share, per day basis. As the pro rata portion with respect to Block A exceeds USP's basis in such block, the remaining basis of all other blocks (here, Block B) owned by US LLC is reduced (not below zero) to prevent an inappropriate taxation on distribution. See Treas. Reg. § 1.1367-1(c)(3).

Similar to the basis recovery approaches taken in Treas. Reg. § 1.1367-1 and Treas. Reg. § 1.1502-32, ACT requests that Treasury and the IRS amend the Proposed Regulations to allow a covered shareholder to reduce basis in a separate section 961(a) ownership unit to the extent necessary to prevent gain that would otherwise be recognized under section 961(b)(2). In the event Treasury and the IRS do not adopt the recommendation discussed in Part I.A above with respect to adjustments to section 961(c) basis, ACT further requests that such amendment to the Proposed Regulations be expanded to provide that if a CFC receives a distribution of PTEP with respect to a section 961(c) ownership unit, such CFC may reduce its section 961(c) basis in a separate section 961(c) ownership unit with respect to the same shareholder to prevent gain that would otherwise be recognized under section 961(c).

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shares of stock in such S corporation in order to determine taxability of distributions. *See* T.D. 8508, 59 Fed. Reg. 12 (Jan. 3, 1994).

Conceptually, the PTEP model is similar to the S corporation model, both of which provide a mechanism to allow income which has already been subject to U.S. taxation under a deemed inclusion regime to be distributed tax-free, preventing double taxation. Under the Proposed Regulations, each member of a consolidated group must track its PTEP and basis separately, leading to potential taxable gain recognition even when the group as a whole has sufficient basis. If basis shifting were allowed within a consolidated group, it would more closely align with the S corporation approach, preventing unintended double taxation and better reflecting the Congressional intent of sections 959 and 961.

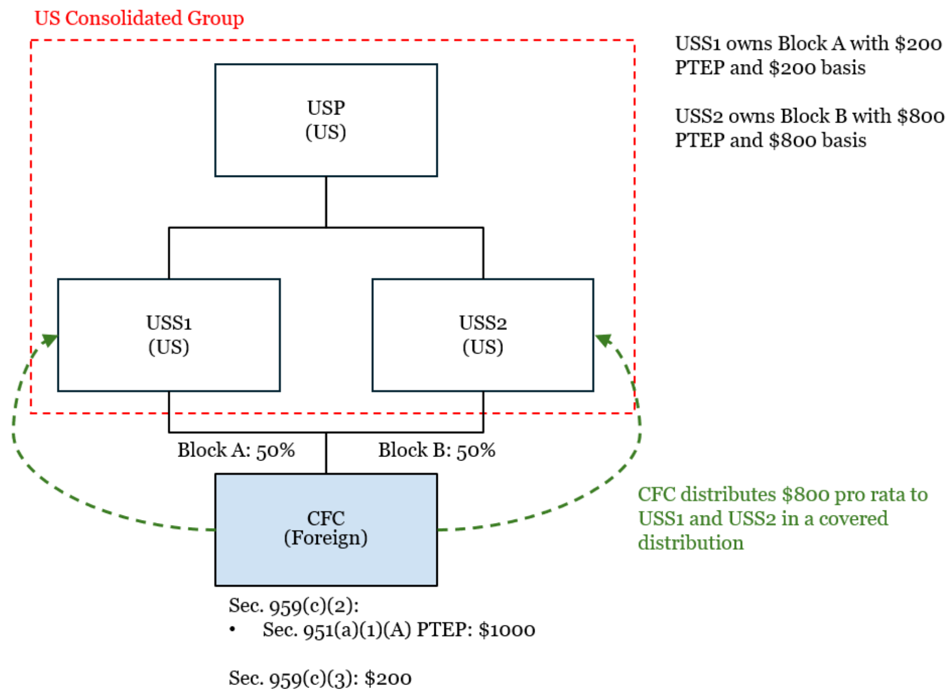
ACT believes a basis recovery approach similar to Treas. Reg. § 1.1367-1 and Treas. Reg. § 1.1502-32 would not lead to inappropriate results. The Preamble to the Proposed Regulations provided an example of what Treasury and the IRS consider to be an inappropriate result that could arise from pure basis shifting. In such example, 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. The foreign corporation subsequently distributes PTEP, in part with respect to the newly issued share of stock. The Preamble concludes that it would be inappropriate to shift section 961(a) basis from the original shares to the newly-issued share as such basis shifting could produce a noneconomic loss in the newly issued share. However, under either of the basis recovery approaches discussed above, there would be no creation of a noneconomic loss in the newly issued share, as basis would not shift to the newly issued share. Rather, basis in a separate section 961(a) unit (*i.e.*, basis in the original shares), would be reduced to the extent necessary to prevent gain under section 961(b)(2).

B. Inability to shift basis among consolidated group members.

Under the Proposed Regulations, members of a consolidated group are treated as a single covered shareholder for purposes of section 959, meaning that they would maintain a single set of annual PTEP accounts, dollar basis pools, and PTEP tax pools for each foreign corporation owned by one or more members. While this aggregated approach simplifies certain aspects of PTEP tracking, the Proposed Regulations also maintain separate entity treatment for basis adjustments under section 961. As a result, individual consolidated group members continue to track their own basis in their directly held stock or property units separately, which can lead to inappropriate gain recognition if a member receives a PTEP distribution but has insufficient basis in the property.

The approach taken in the Proposed Regulations introduces a structural inconsistency that undermines the policy goals of sections 959 and 961, which were designed to prevent double taxation on earnings that have already been included in income under Subpart F or GILTI. For example,

> USP owns USS1 and USS2. USP, USS1, and USS2 file a U.S. consolidated group tax return. USS1 and USS2 each own 50 percent of CFC. CFC has $1,000 of PTEP and $200 of section 959(c)(3) earnings and profits. USS1 owns Block A with $200 PTEP account and $200 basis while USS2 owns Block B with $800 PTEP account and $800 basis. CFC distributes $800 pro-rata to USS1 and USS2 in a covered distribution.



> Under the Proposed Regulations, the U.S. consolidated group is treated as a single covered shareholder, but each member takes its own items into account pursuant to Prop. Reg. § 1.1502-59(c)(2). The U.S. consolidated group has a single set of annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to CFC. USS1 and USS2 would each exclude from gross income the entire $400 PTEP distribution. USS1 would reduce its basis in Block A by $400 and recognize $200 of gain under section 961(b)(2) for the $400 PTEP distribution, and USS2 would reduce its basis in Block B by $400 for the $400 PTEP distribution in which no gain is recognized as USS2 has sufficient basis for the distribution.

Under the Proposed Regulations, USS1 would recognize gain as a result of the PTEP distribution while USS2 would not, even though the consolidated group as a whole has sufficient basis in CFC. This double taxation contradicts the policy of sections 959 and 961, which are meant to allow tax-free repatriation of PTEP. While this result causes built in loss in the Block B stock, taxpayers may never realize or be able to recognize the loss. The Proposed Regulations provide no mechanism to shift section 961(a) basis within the consolidated group, even though all earnings were already included in the group's taxable income. This effectively undermines the tax policy objectives of the TCJA to eliminate the "lockout" of earnings abroad.

Considering the policy intention cited above, we respectfully submit that the Proposed Regulations should be revised to allow limited basis shifting in the section 961(a) basis context among consolidated group members. This would prevent double taxation of PTEP distributed among consolidated group members. Allowing basis sharing in this context would be consistent with the approach taken under the withdrawn 2006 Proposed Regulations and better align with the policy of sections 959 and 961 to allow for the tax-free repatriation of PTEP.

C. Section 78 gross up on taxes paid with respect to section 959(b) distributions.

Section 78 was amended as part of the TCJA to include section 960(b) credits explicitly. As amended, section 78 provides:

> If a domestic corporation chooses to have the benefits of subpart A of part III of subchapter N (relating to foreign tax credit) for any taxable year, an amount equal to the taxes deemed to be paid by such corporation under subsections (a) , (b) , and (d) of section 960 (determined without regard to the phrase "80 percent of" in subsection (d)(1) thereof) for such taxable year shall be treated for purposes of this title (other than sections 245 and 245A) as a dividend received by such domestic corporation from the foreign corporation.

When a portion of a distribution from a CFC is excluded from the gross income of a domestic corporation under section 959(a), section 960(b)(1) provides that the domestic corporation is deemed to pay foreign taxes attributable to such portion so long as it has not otherwise been deemed paid in another year. Section 960(b)(2) provides a similar rule for distributions received by a CFC and excluded from gross income under section 959(b).

Under the Proposed Regulations, for a distribution to be considered a distribution of PTEP under section 959, the distribution must first qualify as a "covered distribution," generally defined as any distribution made by a foreign corporation to the extent the distribution qualifies as a dividend under section 316.[35] Because section 78 treats taxes deemed paid as a dividend for purposes of the Code (besides sections 245 and 245A), a section 78 gross-up could qualify as a covered distribution and therefore could be treated as a distribution of PTEP, excluded from the gross income of the domestic corporation receiving the distribution. However, the Proposed Regulations specifically exclude amounts treated as dividends by reason of section 78. This exclusion creates double taxation of PTEP when foreign tax is imposed on PTEP and the taxpayer elects to credit those taxes under section 960(b).

Under the framework of the Proposed Regulations, a PTEP distribution with associated foreign taxes results in both a reduction of basis under section 961(b) for the portion of the distribution that qualifies as a covered distribution and a deemed dividend under section 78 for the portion of the distribution attributable to the foreign taxes.[36] This means that a single PTEP distribution is effectively treated as both a taxable event and a reduction of an attribute (basis) for the taxpayer. This treatment is inconsistent with the fundamental purpose of sections 959 and 961, which aim to prevent double taxation of earnings that have already been included in the U.S. shareholder's gross income under subpart F or GILTI.

For example, USP, a domestic corporation, owns 100% of CFC1, and CFC1 owns 100% of CFC2. In Year 1, CFC2 earns $100 of subpart F income, which is included in the income of USP resulting in USP having a $100 PTEP account with respect to CFC2. The following year, CFC2 distributes the $100 of PTEP to CFC1, and such distribution is subject to a foreign withholding tax of 20%, imposed by CFC2's country of incorporation. These taxes are tracked in a PTEP tax pool with respect to USP, and the PTEP account is reduced by the amount of the taxes imposed ($100 - $20 = $80). CFC1 then distributes the remaining $80 of PTEP to USP.

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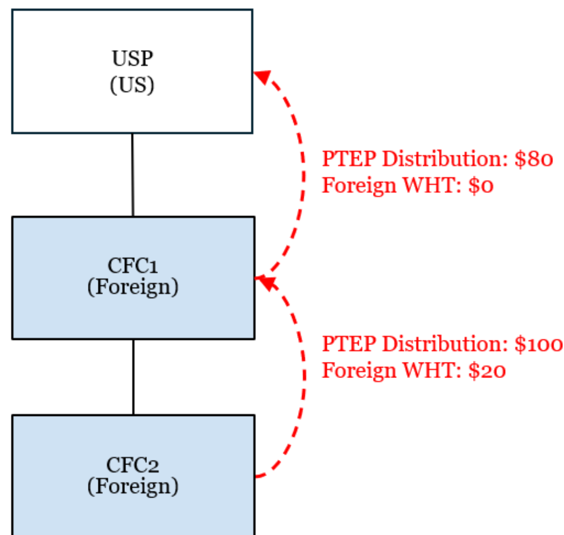
[35] Prop. Reg. § 1.959-4(c) provides that a "covered distribution is a distribution of property made by a foreign corporation to its shareholders with respect to its stock, to the extent that the distribution is a dividend (as defined in section 316), determined without regard to section 959(d), and **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 [Prop. Reg. § 1.959-4(d)]." (emphasis added)

[36] *See* Prop. Reg. § 1.961-4(b) and section 78.



When USP receives the PTEP distribution, it may claim a foreign tax credit ("FTC") under section 960(b)(1) for the withholding taxes paid to CFC2's taxing authority. However, section 78 requires USP to include in income (as a dividend) the amount of taxes deemed to be paid under section 960(b). If the amount included under section 78 (the "section 78 gross-up") cannot be characterized as a PTEP distribution (as defined in section 959(a)), the result is double taxation of USP on a portion of CFC2's income. Consequently:

- $100 of CFC2's subpart F income is included by USP in Year 1 and taxed at 21% = $21 of tax
- $80 of PTEP is received by USP in the subsequent year and is excluded from gross income under section 959(a)
- $20 of income (attributable to the section 78 gross up of the section 960(b) deemed paid credits) is included by USP in the year it receives the PTEP distribution and is taxed at 21% = $4.2 of additional tax

The result is that $120 of income is subject to U.S. tax even though CFC2 only earned $100.

The legislative history of section 78, dating back to its enactment in the Revenue Act of 1962,[37] provides important context for evaluating whether Treasury's approach in the Proposed Regulations aligns with Congressional intent. Congress enacted section 78 to address a perceived disparity in the treatment of foreign earnings when U.S. corporations elected to claim an FTC under section 960. Before 1962, U.S. corporations that claimed FTCs did not have to increase (or "gross-up") their taxable income to reflect the foreign taxes paid on the underlying foreign earnings. As a result, foreign-source income was taxed at a lower effective rate compared to domestic earnings. To eliminate this tax advantage, Congress required that any foreign taxes deemed paid under section 960 be included in the U.S. corporation's taxable income as a deemed dividend under section 78.

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37 Pub. L. No. 87-834, 76 Stat. 960.

The Senate Finance Committee Report on the Revenue Act of 1962 makes clear that the purpose of section 78 was purely computational, designed to ensure that the U.S. corporate tax base accurately reflected pre-tax foreign earnings, rather than imposing tax on an already taxed item of income.[38]

This legislative history demonstrates that Congress did not intend for section 78 to result in a separate economic tax burden on U.S. taxpayers. Instead, it was an adjustment to ensure parity between foreign and domestic earnings. Treasury's exclusion of section 78 deemed dividends from covered distributions under the Proposed Regulations contradicts this historical intent by transforming a computational adjustment into an additional taxable event.

The section 78 gross-up related to section 960(b) credits represents the reduction to E&P that a CFC incurred because of local country tax on income (the PTEP distribution for U.S. tax purposes) that had been previously included by the U.S. shareholder. An additional section 78 gross-up on section 960(b) taxes ought not be included in gross income because the underlying earnings that it represents were PTEP. To align with Congressional intent and prevent double taxation, we respectfully submit that Treasury should revise the Proposed Regulations to ensure that section 78 gross-up amounts attributable to section 960(b) deemed paid taxes are included in the definition of a covered distribution under section 959.

In the example above, if the recommendation were adopted, USP would not reduce its PTEP account when the CFC's country of incorporation imposed the withholding taxes. Instead, when CFC1 distributes the $80 to USP, USP would treat the section 78 gross-up amount attributable to the section 960(b) credits as a PTEP distribution under section 959(a). The result would be a reduction in USP's PTEP account with respect to CFC1 of $100. In total, USP would be taxed on $100 of CFC2 earnings, as opposed to $120 and would have $20 of FTC that could be claimed subject to section 904 limitations.

D. Lack of guidance with respect to section 304(b)(6) and additional requested guidance.

The Proposed Regulations fail to provide important guidance under section 304(b)(6) regarding the application of sections 959 and 961 in the context of a section 304(a) transaction in which the acquiring corporation or the issuing corporation is a foreign corporation. While ACT believes that section 304(b)(6) is self-executing, IRS and Treasury clarification of this point would be appropriate to eliminate any remaining uncertainty. If section 304(b)(6) is not self-executing, a section 304(a) transaction in which the acquiring corporation or the issuing corporation is a foreign corporation with PTEP would result in inappropriate double taxation.

Congress enacted section 304(b)(6) as part of the IRS Restructuring and Reform Act of 1998 (the "1998 Act"),[39] which provides that in the case of an acquisition described in section 304(a) "the Secretary shall prescribe such regulations as are appropriate in order to eliminate a multiple inclusion of any item in income by reason of this subpart and to provide appropriate basis adjustments (including modifications to the application of sections 959 and 961)." Thus, section 304(b)(6) directs Treasury to promulgate regulations to (1) prevent multiple inclusions of income (*i.e.*, under section 959) and (2) make appropriate basis adjustments to reflect the movement of PTEP (*i.e.*, under section 961).

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[38] In *Champion Int'l Corp. v. Commissioner*, the Tax Court explained that section 78 merely treats the U.S. corporation as if it had received a distribution out of the foreign corporation's pre-tax profits and then paid the foreign income tax itself. See, *Champion Int'l Corp. v. Commissioner*, 81 T.C. 424, 427 (1983). Similarly, in H.H. Robertson Co. v. Commissioner (unpublished), the court noted that the section 78 gross-up ensures that the full profits of the foreign corporation are accounted included for U.S. tax purposes but does not impose an additional tax liability. See, *H.H. Robertson Co. v. Commissioner*, 59 T.C. 53, 77 n.13 (1972), aff'd, 500 F.2d 1399 (3d Cir. 1974)

[39] Pub. L. No. 105-206, 112 Stat. 685.

The 1998 Act added section 304(b)(6) as a technical correction to section 304(b)(5) to remove the cross-reference to section 1248(d) under former section 304(b)(5)(B).[40] The need for section 304(b)(6) was illustrated in two letters submitted at the time to the staff of the Joint Committee on Taxation, which highlighted certain issues with former section 304(b)(5)(B), including those that arose from cross-chain section 304 transactions.[41]

In enacting section 304(b)(6), Congress intended regulations be promulgated to (i) allow PTEP to be distributed across different section 958(a) U.S. shareholder ownership chains in a tax-free manner in a section 304 transaction, and (ii) to make adjustments to the basis of stock held by the corporation treated as receiving the distribution or by the corporation that had the prior inclusion with respect to the PTEP be made. If taxpayers were not allowed to make adjustments under section 959 and 961, a deemed distribution in a section 304 transaction might not be characterized as PTEP, thus causing earnings that are PTEP with respect to the acquiring entity to not be treated as PTEP to the seller and/or its covered shareholder. Further, if taxpayers are not allowed to shift basis to the shares of stock of a seller CFC, a subsequent distribution could result in section 961(b)(2) gain and thus double taxation.

ACT respectfully requests that Treasury and the IRS issue guidance under section 304(b)(6) confirming that section 304(b)(6) is self-executing and that taxpayers are permitted to make appropriate basis adjustments. Absent further guidance, characterizing a deemed distribution as PTEP in a section 304(a)(1) transaction without a corresponding basis shift will separate PTEP from the associated section 961(a) basis in ways that may inhibit the ability of the taxpayer to repatriate the PTEP without recognizing gain under section 961(b)(2). We understand the government's concern with basis shifting that can cause built-in loss in the stock of a seller CFC, however we believe this can be addressed with a principle-based rule for determining what constitutes an appropriate basis adjustment.

In addition to the requested guidance under section 304(b)(6) discussed above, we acknowledge that future guidance will address certain issues not addressed in the Proposed Regulations. For example, issues involving successor in interest transactions that are not described in general successor transactions, structures where CFCs are partners in a partnership, and the application of sections 959 and 961 to partnerships. ACT recommends that Treasury and the IRS include, as part of the final regulations, proposed guidance on these matters.

III. The Proposed Regulations add unnecessary complexity, increase the compliance burden for taxpayers as well as the IRS, and can result in undesirable outcomes.

A. Tracking and Maintenance of PTEP Accounts and Basis: Requiring taxpayers to track items at both the U.S. shareholder and CFC level adds complexity, risk, and costs.

ACT appreciates the efforts of Treasury and the IRS to develop and issue much needed rules for PTEP and related basis adjustments. However, members of ACT are concerned about the complexity introduced by

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40 *See* JCX-18-98 (Mar. 26, 1998) ("The proposal would eliminate the cross-reference to section 1248(d) for purposes of determining the [E&P] to be taken into account under section 304(b)(5). Instead, under the proposal, the direction to the Secretary to issue regulations would specifically include regulations to prevent the multiple inclusion of an item of income and to provide appropriate basis adjustments. The 1997 Act amendments to section 304, including the modifications under the proposal, are not intended to change the foreign tax credit results reached in Rev. Rul. 92-86 and 91-5.").

41 D. Kevin Dolan, Letter to Barbara M. Angus, Business Tax Counsel for the Joint Committee on Taxation (Mar. 9, 1998), *reprinted in* Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2002, Section 394 Transactions, 548 PLI/Tax 77, 85 (2002). A second letter was submitted on March 27, 1998, shortly after the release of the Chairman's Mark. *See id.* Another practitioner also criticized the treatment of PTEP in section 304 transactions under the 1997 Act in an article published prior to the March 1998 Chairman's Mark. *See* Sparagna, *The Taxpayer Relief Act of 1997 Significantly Alters the U.S. Tax Treatment of Cross-Border Related Party Sales of Stock*, Tax Mgmt. Memo. Vol. 38, Spec. Ed. 11, S-314 (Nov. 24, 1997).

the proposed regulations and how this will affect their compliance function and ability to repatriate efficiently or otherwise deploy cash throughout their structures.

1. Impact on compliance

The Proposed Regulations introduce a complex framework for managing PTEP through the establishment of 10 distinct PTEP accounts, dollar basis pools, and foreign tax credit pools. Each PTEP account is specific to a tax year and section 904 category, maintained in the foreign corporation's functional currency, and generally assigned among the 10 PTEP groups. Further, these accounts must be maintained at the U.S. shareholder and foreign entity level. We understand that this intricate system is designed to accurately track amounts under provisions such as sections 959, 986(c), and 960(b), but the sheer number of attributes to track puts significant administrative burdens on taxpayers and increases the risk of unintentional mistakes and non-compliance. This burden will not be felt by taxpayers alone; IRS exams will become substantially more complicated, further exacerbating inefficiencies within the broader tax administration system. Audits will inevitably become more protracted and contentious, and the IRS's limited resources will be stretched as examiners grapple with the same complexities.

2. Impact on repatriation and cash deployment

One of the TCJA's key objectives, as previewed by the U.S. Senate Committee on Finance in July 2017 and widely publicized at the time of enactment, was ending the lockout effect and encouraging the repatriation of cash, activities, and intellectual property back into the United States.[42] CFOs and CEOs, well aware of this key objective, expect that cash may be easily and efficiently repatriated to the United States or otherwise deployed throughout their corporate structure. The Proposed Regulations, through their complexity as well as rules that can easily cause double taxation (*i.e.*, by not allowing basis sharing, which is discussed in detail above) will impose administrative and economic hurdles that will frustrate TCJA policy. U.S. companies will not repatriate cash if there are uncertainties about attributes or risk of double or excessive taxation.

ACT respectfully requests that Treasury and the IRS revisit the Proposed Regulations with a focus on practical approaches for the taxpayer that align with legislative intent. A recalibrated regulatory regime should uphold the core policy of the TCJA, promote repatriation and investment in the United States, and avoid excessively detailed compliance requirements that introduce unnecessary complexity. ACT believes that the regulations could significantly reduce the number of attributes taxpayers are required to track and embrace a simplified regime that furthers the core goals of the TCJA and reduces compliance costs for taxpayers, while maintaining the integrity of sections 959 and 961.

Alternatively, Treasury should consider withdrawing the Proposed Regulations and engaging with Congress to develop an appropriately tailored legislative approach to refining sections 959 and 961 in a manner that ensures reasonable compliance expectations for affected taxpayers. ACT believes that such an approach could produce a statutory and regulatory framework that supports the broader aims of U.S. economic policy—fostering investment, ensuring a competitive tax environment, and minimizing compliance burdens.

B. Conforming Accounts under the Transition Rules.

Once finalized, taxpayers must apply the transition rules in Prop. Reg. § 1.959-11 to conform their current accounts and basis to the rules in the regulations. Additional transition rules in Prop. Reg. § 1.961-13 require taxpayers to reconstruct their section 961(c) and derived basis. Except for the rules implementing the provisions of Notice 2019-01 or in cases of early adoption, the Proposed Regulations are generally applicable to tax years of foreign corporations starting on or after the date that final regulations are issued. The transition rules require a reasonable method to establish annual PTEP accounts, dollar basis pools, corporate PTEP accounts, and section 961(c) and derived basis. These rules ensure that existing

[42] *See also* H.R. Rep. No. 115-409 at 370 (2017).

accounts and basis conform to the new requirements in the regulations and that adjustments are made for the transition tax under section 965 (*i.e.*, Prop. Reg. § 1.959-11(b)).

The members of ACT appreciate the principle-based approach to constructing accounts and basis that allows taxpayers to use a reasonable method. However, we request that the final regulations clarify that a "reasonable method" is not limited to methods that would require taxpayers to make account or basis adjustments that would effectively necessitate a retroactive application of the Proposed Regulations. Negative section 961(c) basis and negative derived basis are new concepts introduced by the Proposed Regulations, which did not exist prior to the issuance of these rules, and ACT does not believe it would be appropriate for regulations to require the application of these concepts on a retroactive basis.

ACT representatives express our appreciation to Treasury for the solicitation and consideration of comments on the Proposed Regulations. We would welcome the opportunity to discuss these matters with you at your convenience.