Proposed PTEP regulations

KPMG analysis and observations

December 19, 2024

kpmg.com/us

Contents

The U.S. Treasury Department and IRS (collectively, "**Treasury**") on November 29, 2024, released proposed regulations (REG-105479-18) ("**2024 Proposed Regulations**") regarding previously taxed earnings and profits ("**PTEP**") of foreign corporations and related basis adjustments. The 2024 Proposed Regulations were published in the Federal Register on December 2, 2024, almost six years after Treasury issued Notice 2019-01, 2019-02 I.R.B. 275 ("**2019 Notice**"), which announced Treasury's intention to withdraw PTEP proposed regulations released in 2006 (71 FR 51155) ("**2006 Proposed Regulations**") and issue proposed regulations under sections 959 and 961 that would take into account various statutory changes, such as those introduced by the enactment of Pub. L. No. 115-97 (enacted December 22, 2017, and often referred to as the "**Tax Cuts and Jobs Act**" or "**TCJA**").

Background

The term PTEP refers to earnings and profits (**E&P**) of a foreign corporation described in section 959(c)(1) and (2); that is, E&P of the foreign corporation that are attributable to amounts which are, or have been, included in the gross income of a 10% U.S. Shareholder ("**U.S. Shareholder**"), most commonly under sections 951(a) and 951A(a). Sections 959 and 961, the primary statutory provisions governing the treatment of PTEP, are designed to work together to avoid double taxation of PTEP. To that end, section 959 provides rules regarding the exclusion from gross income of distributions of PTEP. Section 961, in turn, provides rules for adjusting basis in controlled foreign corporation ("**CFC**") stock to reflect the accrual of PTEP (increase) and distribution of PTEP (decrease), including by requiring gain to be recognized to the extent PTEP distributed exceeds basis.

Overview

The 2024 Proposed Regulations represent Treasury's most recent effort to provide long-awaited guidance addressing certain fundamental aspects of the PTEP system. The urgent need for more comprehensive guidance under sections 959 and 961 was exacerbated in large part due to the proliferation of PTEP following the enactment of the TCJA, which introduced section 965, a one-time mandatory transition tax on the untaxed foreign earnings of certain foreign corporations, and section 951A, the global intangible low-taxed income ("**GILTI**") regime, as well as the complex interaction of the PTEP system with other statutory provisions.

Treasury first issued regulations under sections 959 and 961 in 1965 (TD 6795), with modest amendments in 1974 (TD 7334), 1978 (TD 7545), and 1983 (TD 7893). Since 1983, no further updates have been adopted to reflect subsequent statutory changes, such as the addition of section 961(c) in 1997 and, importantly, statutory provisions introduced or amended by the TCJA.

More than four decades after issuing the initial regulations, Treasury issued the 2006 Proposed Regulations relating to the exclusion from gross income of PTEP under section 959 and related basis adjustments under section 961 (71 FR 51155); correcting amendments to the 2006 Proposed Regulations were also issued in 2006 (71 FR 71116). The 2006 Proposed Regulations were intended to provide more complete guidance with respect to a number of issues that were not specifically addressed in the existing regulations, as well as to resolve some of the complexities raised regarding the application of sections 959 and 961. The 2006 Proposed Regulations were never finalized, however.

Thereafter, in 2018, Treasury issued the 2019 Notice. The 2019 Notice announced Treasury's intent to withdraw the 2006 Proposed Regulations and issue a new notice of proposed rulemaking providing more fulsome rules under sections 959 and 961 that would also take into account various changes made by the TCJA. The 2019 Notice described general rules for the accounting and treatment of PTEP, requested comments on certain topics, and permitted taxpayer reliance until Treasury released proposed regulations. *See TaxNewsFlash* Notice 2019-01: Future regulations, foreign corporations with previously taxed earnings and profits (text of notice) In 2022, Treasury formally withdrew the 2006 Proposed Regulations (87 FR

63981), citing concerns that taxpayers were misusing the proposed rules to obtain "inappropriate basis adjustments in certain stock acquisitions to which section 304(a)(1) applies."

As indicated in the 2019 Notice, the 2024 Proposed Regulations are intended to address many of the core issues regarding the treatment of PTEP under section 959 and basis adjustments under section 961, particularly following the enactment of the TCJA. Although the TJCA did not substantively modify the principal statutory provisions governing the treatment of PTEP and basis adjustments, the existing PTEP and basis adjustment rules needed to be revised for a number of reasons, including to reflect the additional types of PTEP created under the TCJA, such as PTEP arising from inclusions under sections 951A and 965.

Similarly, Issues regarding the interaction of the existing PTEP rules with other statutory provisions, including those that were left largely untouched by the TCJA, such as section 986(c), needed to be resolved. In this regard, PTEP distributions may require recognition of foreign currency gain or loss under section 986(c)(1). Notice 88-71, 1988-2 C.B. 374 ("**1988 Notice**"), which was issued after the enactment of section 986(c) in the Tax Reform Act of 1986, Pub. L. No. 99-514, provided guidance regarding foreign currency gain or loss with respect to PTEP and announced an intent to issue regulations consistent with the guidance. The 2024 Proposed Regulations address some of these issues related to determining foreign currency gain or loss with respect to distributions of PTEP.

The 2024 Proposed Regulations also include PTEP guidance relating to foreign tax credits ("**FTCs**") and, in particular, with respect to foreign income taxes that are eligible to be deemed paid under section 960(b).

Furthermore, the existing final regulations do not address the application of sections 959 and 961 with respect to a consolidated group or its members; nor do they address unique PTEP issues raised by statutory provisions that affect certain non-corporate taxpayers, such as sections 962 and 1411. Although the 2006 Proposed Regulations would have provided such guidance with respect to consolidated groups, as mentioned above, Treasury never adopted the 2006 Proposed Regulations. The 2024 Proposed Regulations would thus provide helpful guidance regarding the application of sections 959 and 961 to these provisions.

Following the enactment of section 951A in the TCJA, Treasury published regulations (TD 9866, 84 FR 29288) that generally treat a domestic partnership as an aggregate of its partners for purposes of determining a partner's inclusion under section 951A ("**GILTI inclusion**"), effectively placing partners in domestic partnerships on par with partners in foreign partnerships for purposes of applying the GILTI regime and associated rules. In 2022, Treasury published final regulations that extended the aggregate treatment of domestic partnerships to inclusions of subpart F income under section 951(a)(1)(A) ("**subpart F inclusions**") and inclusions of section 956 amounts under section 951(a)(1)(B) ("**section 956 inclusions**") (TD 9960, 87 FR 3648), for tax years of foreign corporations beginning on or after January 25, 2022 (though taxpayers could choose to apply this aggregate treatment for tax years of foreign corporations beginning after December 31, 2017, subject to certain consistency requirements). As a result of these changes, guidance on the application of sections 959 and 961 to domestic partnerships and their partners has also been needed. The 2024 Proposed Regulations would address some of these issues regarding the operation of sections 959 and 961, particularly in the context of a partnership that holds stock of a foreign corporation with PTEP.

Notwithstanding the length and complexity of the proposed regulation package, many open issues concerning the operation of the PTEP system were left unaddressed. To answer these outstanding questions, Treasury intends to provide additional rules to address other PTEP-related issues not covered in the 2024 Proposed Regulations. For example, Treasury has indicated that future guidance is anticipated to address PTEP issues that involve nonrecognition transactions, redemptions, section 964(e) transactions (dealing with sales by a CFC of the stock of a lower-tier foreign corporation), and partnerships with CFC partners. In addition, Treasury has indicated in Notice 2024-16, 2024-5 I.R.B. 622 ("**2024 Notice**") that it intends to issue proposed regulations that address the treatment of basis under section 961(c) in connection with certain inbound nonrecognition transactions in future regulations.

The 2024 Proposed Regulations reflect the introduction of a new and complex set of rules that would significantly affect the operation of the PTEP system, necessitating a detailed and thoughtful analysis by taxpayers. Furthermore, taxpayers—particularly those that have made or received, or intend to make or receive, distributions of PTEP—should carefully evaluate the impact of the 2024 Proposed Regulations, and, as part of their review, determine the impact of the various applicability dates and transition rules, including the potential benefits, if any, of making the election to retroactively apply the 2024 Proposed Regulations. Taxpayers should also assess the future application of these rules to determine whether it would be beneficial for them to submit comment letters.

This report (the "**Report**") summarizes a number of key aspects of the 2024 Proposed Regulations and provides certain KPMG observations.

Applicability dates and transition rules

Applicability dates

The 2024 Proposed Regulations would generally apply prospectively to tax years of foreign corporations beginning on or after the date the 2024 Proposed Regulations are finalized and to tax years of persons for which such tax years of foreign corporations are relevant (the "**General Applicability Date**").

Notwithstanding the General Applicability Date, certain provisions relating to rules described in the 2019 Notice would apply retroactively to tax years of U.S. Shareholders ending after December 14, 2018, and tax years of foreign corporations ending with or within those tax years (the "**2019 Notice Years**"). These provisions include, for example, rules in Prop. Treas. Reg. § 1.959-1(c), relating to the treatment of S corporations; Prop. Treas. Reg. § 1.959-2, relating to PTEP accounting; Prop. Treas. Reg. § 1.959-3, relating to adjustments to shareholder level accounts and, consequently, foreign-corporation level accounts; Prop. Treas. Reg. § 1.959-4(e) and Prop. Treas. Reg. § 1.959-5(d), relating to the allocation of distributions and section 956 amounts; and, finally, the relevant definitions in Prop. Treas. Reg. § 1.959-1(b) (collectively, the "**2019 Notice Provisions**"). The 2019 Notice Provisions do not include, however, proposed rules related to PTEP tax pools, corporate PTEP tax pools, adjusted applicable percentages, and section 965(c) deduction percentages outlined in Prop. Treas. Reg. § 1.959-2 and -3; nor do the 2019 Notice Provisions apply to the portions of the proposed rules concerning the timing of adjustments and determinations under Prop. Treas. Reg. § 1.959-3 through -5, as well as Prop. Treas. Reg. § 1.959-7.

Additionally, the 2024 Proposed Regulations would provide an early application option. Under this option, taxpayers may choose to apply the 2024 Proposed Regulations, as finalized, to tax years of foreign corporations beginning before the General Applicability Date, subject to certain conditions. Importantly, taxpayers that choose this option must apply the 2024 Proposed Regulations in their entirety to an early application year and each succeeding year, and each covered shareholder (a new term introduced by the 2024 Proposed Regulations that is described in greater detail below), and any related foreign corporations, with relatedness determined under section 267(b), must likewise consistently apply the 2024 Proposed Regulations. Each covered shareholder must also provide written consent to the foreign corporation as a condition to making the election to apply the early application option. Finally, the early application option is only available to relevant years for which the statute of limitations for assessment and collection under section 6501 is otherwise open.

KPMG observation

The early application option should not be confused with reliance. The preamble to the 2024 Proposed Regulations (the "**preamble**") does not contain an express statement that taxpayers may rely on the 2024 Proposed Regulations before finalization. As a result, it appears that taxpayers may not currently rely on the 2024 Proposed Regulations, which is consistent with internal Treasury procedures. *See* Chief Counsel Directives Manual 32.1.1.2.2, Notice of Proposed Rulemaking ("Taxpayers generally may not rely on proposed regulations for planning purposes, except if there are no applicable final or temporary regulations in force and there is an express statement in the preamble to the proposed regulations that taxpayers may rely on them currently."). Thus, it appears that taxpayers must wait until the 2024 Proposed Regulations are finalized before adopting the early application option, at which time presumably taxpayers should have the information needed to make a determination as to whether to make the election.

The 2024 Proposed Regulations also produce some uncertainty regarding taxpayer reliance on the 2019 Notice and the 2019 Notice Provisions within the 2024 Proposed Regulations. First, the 2019 Notice stated that taxpayers may rely on the 2019 Notice "[b]efore the issuance of forthcoming regulations" and defined "forthcoming regulations" as future proposed regulations. Thus, issuance of the 2024 Proposed Regulations arguably forecloses any continued reliance on the 2019 Notice. Second, the preamble contains no express reliance language and, while the 2024 Proposed Regulations would apply the 2019 Notice Provisions retroactively, proposed regulations do not have full force and legal effect unless and until they are adopted as final regulations. However, at a public event subsequent to the issuance of the 2024 Proposed Regulations, an IRS official stated that IRS and Treasury's intent is to allow taxpayers to rely on the 2019 Notice Provisions contained in the 2024 Proposed Regulations. Ideally, the government will provide additional clarity on this point through either a Notice or a technical correction to the NPRM preamble language.

KPMG observation

If the covered shareholder is a partner in a partnership, the partnership must coordinate with the covered shareholder partner to obtain the written notice required to utilize the early application option with respect to its CFCs. This coordination may be challenging for partnerships that have multiple covered shareholder partners, changes in covered shareholder partners, or that are in tiered partnership structures. The 2024 Proposed Regulations do not explicitly permit a partnership to make an early application election on behalf of its covered shareholders. This is noteworthy because, in the context of the GILTI high-tax exclusion election, a domestic partnership acting as a controlling domestic shareholder can make or revoke the election.

Transition rules—in general

The 2024 Proposed Regulations also provide certain transition rules, which are intended to facilitate application of the 2024 Proposed Regulations. In general, the transition rules address: (1) conforming accounts under section 959; (2) establishing "derived basis" and section 961(c) basis under section 961; and (3) application of such transition rules with respect to domestic partnerships. The transition rules generally allow for the application of a reasonable method (consistently applied) with respect to establishing annual PTEP accounts, dollar basis pools, corporate PTEP accounts, derived basis, and section 961(c) basis. More detailed transition rules apply with respect to establishing PTEP tax pools, corporate PTEP tax pools, and, specifically, with respect to section 965 PTEP, adjusted applicable percentages, and section 965(c) deduction percentages.

KPMG observation

The transition rules generally would impose a significant compliance burden on many taxpayers, because, under these rules, a host of complex adjustments to the books and records of affected taxpayers would be required to establish and conform historical PTEP accounts, as well as to establish basis and related adjustments. Specifically, the 2024 Proposed Regulations include various transition rules that require a retrospective review of all transactions affecting PTEP and basis in prior years, which encompass CFC inclusions, distributions, foreign currency gains and losses, and other relevant events. This historical analysis is necessary to establish the initial amounts for the annual PTEP accounts, dollar basis pools, corporate PTEP, and derived basis. In certain circumstances, taxpayers may lack the required information to reconstruct their books and records necessary to determine PTEP and basis, for example, due to historical acquisitions or divestures. Further, even though the transition rules would not impose any gain recognition, there does not appear to be any explicit limitation on the look-back period, posing additional compliance hurdles. The transition rules present a valuable opportunity for taxpayers to provide comments suggesting simplifications.

Transition rules for partnerships (and S corporations)

As generally described above, before regulations in 2022 adopted an aggregate treatment, domestic partnerships that were U.S. Shareholders were treated as an entity for purposes of determining their subpart F and section 956 inclusions. Thus, under the existing regulations, domestic partnerships have PTEP accounts for their prior subpart F and section 956 inclusions (although not with respect to GILTI inclusions, because aggregate treatment regulations applied back to the implementation of the TCJA). The 2024 Proposed Regulations provide rules to transition PTEP accounts and the associated pools and section 961 basis to account for the aggregate treatment of domestic partnerships. With regard to a domestic partnership's existing annual PTEP accounts, dollar basis pools, and PTEP tax pools, the 2024 Proposed Regulations would convert such accounts to accounts held by partners in the partnerships that are covered shareholders that own an interest in the partnership at the beginning of the tax year. Similarly, the transition rules convert a domestic partnership's section 961(a) basis to derived basis with respect to the covered shareholder partner and a lower-tier CFC's section 961(c) basis is reassigned from the domestic partnership to the covered shareholder partner. The allocations generally would be based on each partner's share of proceeds in a hypothetical liquidation for fair market value at the beginning of the tax year.

In general, under the qualified deficit rule in section 952(c), a U.S. Shareholder may reduce its subpart F inclusion with respect to a CFC based on certain prior year E&P deficits of the CFC. After application of the aggregate approach described above, a domestic partnership can no longer benefit from a qualified deficit because it no longer has any subpart F inclusions to reduce. The extent to which the partners of a domestic partnership are able to use the partnership's qualified deficits is unclear under current law. The 2024 Proposed Regulations would provide a special transition rule that would transfer the qualified deficits of a domestic partnership to its partners to ensure that prior E&P deficits of the partnership's CFC are properly accounted for when a domestic partnership transitions from being treated as an entity to an aggregate of its partners. Under the 2024 Proposed Regulations, a domestic partnership's qualified deficits generally would be considered qualified deficits of its partners that are U.S. Shareholders. Further, under the 2024 Proposed Regulations, a U.S. Shareholder that owns CFC stock through a domestic partnership on the last day of the CFC's first tax year where aggregate treatment applies to the partnership ("**transition date**") would be able to use its "assigned portion" of the partnership's pre-existing qualified deficit. The "**assigned portion**" would be determined using the shareholder's liquidation rights in the partnership as of the transition date. The proposed transition rule aims to ensure that the shift to aggregate treatment for domestic partnerships would not inadvertently eliminate the benefit of prior qualified deficits for partners of the partnership that are U.S. Shareholders.

KPMG observation

Although the use of liquidation value to allocate PTEP among partners is intended to represent a more simplified approach, it may not accurately reflect the economics of the partnership arrangement, particularly when special allocations are tied to specific assets, such as tracking interests, where the partners' interest in the partnership have changed materially (*e.g.*, due to disproportionate contributions or distributions) since the period after the subpart F income was included by the partnership, or other circumstances where prior allocations of CFC inclusions to partners differ significantly from the liquidation value used for PTEP allocations under the transition rule. For instance, if a partnership agreement dictates that distributions related to specific pools of assets are allocated differently among partners, application of the overall liquidation value may result in an allocation that deviates from the partners' economic entitlement in each asset. Taxpayers that find these deviations to be significant might consider advocating to be allowed, on an optional basis, to use a more accurate, more computationally intensive mechanism for allocating PTEP, such as based on the historic allocation of subpart F income. Treasury permitted similar optionality for transition rules in its post-TCJA regulations under section 163(j), by permitting taxpayers to allocate historic disallowed interest expense between excepted or non-excepted trades or businesses through either a complex method based on the historic years in which the interest expense was paid or accrued or a simplified method by treating the interest expense as paid or accrued in 2018. The allocation of a domestic partnership's qualified deficits raises similar concerns as the allocation of PTEP, though this issue is less pervasive.

Partnerships may not always know the specific identity of their direct or indirect partners that are U.S. Shareholders with respect to a CFC owned by the partnership. Notably, the 2024 Proposed Regulations do not require that a partner disclose to the partnership its status as a U.S. Shareholder or the amounts of any CFC inclusions with respect to partnership-owned CFCs. This information gap may prevent a partnership from reasonably determining its opening balances for basis adjustments, as required by the transition rules.

The application of the transition rule will vary among partnerships based on the first year to which both the aggregate approach and the final regulations apply to the partnership. The aggregate approach with respect to subpart F and section 956 inclusions was mandatory for tax years of foreign corporations beginning on or after January 25, 2022, but partnerships had the option of applying the rules to tax years beginning after December 31, 2017, subject to certain consistency requirements. Moreover, as discussed above, although the 2024 Proposed Regulations generally would apply to tax years of foreign corporations beginning on or after the date the final regulations are published, they would provide for elective retroactive application after finalization if certain conditions are satisfied. A partnership that chooses to apply the rules retroactively should ensure that it has the appropriate information to apply the transition rules to the relevant earlier tax year.

Finally, for purposes of subpart F (sections 951 through 956), including GILTI, S corporations and their shareholders are treated as partnerships and partners, respectively. Thus, for purposes of the discussion in this Report, unless otherwise indicated, references to partnerships and their partners generally include references to S corporations and their shareholders.

Section 959: PTEP

Overview

As generally described above, a U.S. Shareholder (other than a domestic partnership) of a CFC that owns stock in a foreign corporation on the last day of the year on which it is a CFC includes in income a subpart F inclusion, a GILTI inclusion, and a section 956 inclusion (collectively, "**CFC inclusions**"), if any. In addition, as added by TCJA, a U.S. Shareholder of a specified foreign corporations ("**SFC**") included in income as a subpart F inclusion an amount determined under section 965 (a "**section 965 inclusion**"), with respect to which a deduction was allowed. Special FTC and foreign currency exchange rules applied with respect to 965 inclusions. An SFC is a CFC and any foreign corporation that had at least one corporate U.S. Shareholder. Unlike current law regarding subpart F inclusions, domestic partnerships had section 965 inclusions.

Each of the CFC inclusions give rise to PTEP; a section 956 inclusion creates PTEP described in section 959(c)(1) ("**section 959(c)(1) PTEP**"), whereas a subpart F inclusion and a GILTI inclusion create PTEP described in section 959(c)(2) ("**section 959(c)(2) PTEP**"). Section 965 resulted in two types of section 959(c)(2) PTEP (collectively, "**section 965 PTEP**")—E&P taken into account in a section 965 inclusion ("**section 965(a) PTEP**") and E&P of an SFC that did not give rise to a section 965 inclusion because such E&P was offset by the E&P deficit of another SFC (such untaxed E&P, "**section 965(b) PTEP**"). Special FTC and foreign currency exchange rules also apply with respect to section 965 PTEP, and domestic partnerships potentially have section 965 PTEP.

The 2024 Proposed Regulations would replace the existing section 959 Treasury Regulations and would provide detailed guidance on excluding PTEP distributions from income, including PTEP distributed through chains of CFCs, which would require detailed rules to track and adjust a U.S. Shareholder's PTEP account and to determine a successor in interest's PTEP. As described below, some of the proposed rules build upon the current regulations or rules described in the 2019 Notice or the 2006 Proposed Regulations, while other proposed rules are entirely new.

PTEP accounting

The 2024 Proposed Regulations would require PTEP to be tracked both at the level of a covered shareholder and the foreign corporation. A "**covered shareholder**" is any U.S. person, other than a domestic partnership, that owns stock in a foreign corporation. As discussed throughout this report, the tracking and accounting of PTEP is necessary to apply the foreign currency and FTC rules to PTEP distributions.

KPMG observation

The term "covered shareholder" is used throughout the 2024 Proposed Regulations. The term is not limited to U.S. persons that are U.S. Shareholders because section 959 can apply to PTEP distributed to a U.S. person that is not a U.S. Shareholder, including because that person was a U.S. shareholder at the time of the CFC inclusion but ceased to be a U.S. Shareholder as of the distribution or acquired an interest in a foreign corporation from a U.S. Shareholder and thus is treated as a PTEP successor (the successor rules are discussed below). The term does not encompass domestic partnerships because, as discussed above, domestic partnerships are treated as an aggregate of their partners for CFC inclusion purposes.

The use of the term "foreign corporation" rather than CFC would allow the 2024 Proposed Regulations to apply to distributions from SFCs with respect to which a U.S. Shareholder had a section 965 inclusion as well as foreign corporations that were once CFCs but, at the time of a PTEP distribution, are no longer CFCs.

KPMG observation

The 2024 Proposed Regulations would require PTEP to be maintained on a covered shareholder basis. This is a change from the 2006 Proposed Regulations, which would have required a covered shareholder to maintain PTEP on a share-by-share (or block-by-block) basis.

Shareholder-level accounts

Each covered shareholder would be required to establish and maintain (1) annual PTEP accounts, (2) dollar basis pools, and (3) PTEP tax pools (collectively, "**Shareholder-Level Accounts**"). Within each PTEP tax pool, covered shareholders would be required to maintain a "**creditable PTEP tax group**" comprised of taxes that are eligible to be deemed paid under section 960(b).

Annual PTEP Accounts. Covered shareholders would be required to maintain an annual PTEP account for each foreign corporation, which would correspond to a single tax year and a specific section 904 category.

The PTEP within the accounts would be maintained in the foreign corporation's functional currency and assigned to one of 10 PTEP groups. Of the 10 PTEP groups, five relate to section 959(c)(1) PTEP and five relate to section 959(c)(2) PTEP. The PTEP groups generally correspond to underlying statutory rules that create the PTEP, certain of which are aggregated into a single group.

The 2024 Proposed Regulations also would require, if applicable, the establishment and tracking of two PTEP subgroups relevant to the taxation of individual covered shareholders within certain PTEP groups: a section 962 PTEP subgroup and section 1411 PTEP subgroup. The section 962 PTEP subgroup would track PTEP that is taxable when distributed to a covered shareholder due to the shareholder's section 962 election and the section 1411 subgroup would track PTEP that is included in a covered shareholder's net investment income when distributed for purposes of the section 1411 net investment income tax. The 10 PTEP groups and two subgroups are described in Appendix A to this Report.

The 2024 Proposed Regulations also would allow taxpayers the option to continue to maintain their PTEP in the sixteen PTEP groups described in the 2019 Notice for the 2019 Notice Years.

KPMG observation

The 10 PTEP groups in the 2024 Proposed Regulations are consistent with the 10 PTEP groups in Treas. Reg. § 1.960-3(c)(2), which combine certain of the sixteen PTEP groups described in the 2019 Notice. The reduction in the 2024 Proposed Regulations from the sixteen PTEP groups in the 2019 Notice to the 10 PTEP groups in the FTC regulations was expected. U.S. Shareholders currently are required to report information about the 10 PTEP groups, on a section 904 category basis, on Schedules J and P to Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations ("**Form 5471**"), although the schedules do not track the proposed subgroups. In general, the new subgroups would not impact corporate covered shareholders, which cannot make section 962 elections and are not subject to section 1411. However, under current regulations, a corporation can succeed to the section 962 PTEP with respect to an electing individual U.S. shareholder.

Although the maintenance of separate section 962 PTEP and section 1411 PTEP groups is not currently required, as a practical matter, taxpayers that make 962 elections currently need to separately track the taxable portion of their section 962 PTEP in order to apply the section 962 rules and taxpayers subject to section 1411 that own CFCs for which an election under Treas. Reg. § 1.1411-10(g) is not in effect need to track PTEP in order to apply the section 1411 rules. Thus, it is likely that many impacted shareholders are already tracking the two PTEP subgroups in their internal records.

Dollar Basis Pools and Tax Pools. The 2024 Proposed Regulations would generally require covered shareholders to maintain a separate dollar basis pool for each PTEP group within a single annual PTEP account that relates to a single section 904 category in order to calculate foreign currency gain or loss upon the distribution of PTEP. The dollar basis in each annual PTEP account would not change as PTEP is distributed through tiers in order to preserve the amount of foreign currency gain or loss until recognized.

Also, the 2024 Proposed Regulations would require a covered shareholder to maintain separate PTEP tax pools to track the U.S. dollar amount of foreign income taxes that correspond to the separate PTEP groups within each annual PTEP account. Those pools are further divided between taxes that are eligible to be deemed paid under section 960(b) (*e.g.,* taxes that were paid or accrued when the foreign corporation was a CFC and that are not subject to loss or suspension at the CFC level) and other taxes.

A covered shareholder can make an election to combine its existing separate-annual dollar basis pools and PTEP tax pools across years for each PTEP group and section 904 category within such group (the "**combined pool election**"). Upon making a combined pool election, the covered shareholder would combine its existing separate-annual dollar basis pools and PTEP tax pools for each PTEP group and section 904 category for a foreign corporation into a single combined dollar basis pool and a single combined PTEP tax pool for such PTEP group and section 904 category for the foreign corporation that reflects the sum of all related annual pools before the election, and thereafter would not have to track either pool on an annual basis. A combined pool election would apply to all of the covered shareholder's foreign corporations, and remain in effect unless revoked, which would require the Commissioner's consent, granted only in exceptional cases.

KPMG observation

The combined pool election only applies to the dollar basis and PTEP tax pools. As such, taxpayers would still need to maintain annual PTEP accounts for each PTEP group. Whether a covered shareholder would benefit from such an election will depend on the specific attributes of the shareholder and its PTEP accounts (*e.g.*, the election could be detrimental if the shareholder's newer PTEP annual layers have greater basis and more taxes than the older PTEP annual layers).

A section 965(c) deduction percentage would need to be maintained for each section 965(a) PTEP group on a separate category basis that would apply for all annual accounts in order to haircut the foreign exchange gain or loss recognized upon distributions of section 965(a) PTEP.

An adjusted applicable percentage would also need to be maintained for each section 965(a) PTEP group and section 965(b) PTEP group in order to haircut the associated deduction or credit for foreign income taxes attributable to a section 965 PTEP group.

Foreign corporation accounts

In addition to the covered shareholder accounts discussed above, the 2024 Proposed Regulations would require tracking of two accounts at the foreign corporation level (the "**Foreign Corporation Accounts**") for each covered shareholder: the foreign corporate PTEP account and the foreign corporate PTEP tax pool. The foreign corporate PTEP account would track, for a foreign corporation, each covered shareholder's PTEP within the 10 PTEP groups and two subgroups on a section 904 category basis. Likewise, the foreign corporate PTEP tax pool would track, for a foreign corporation, each covered shareholder's foreign income taxes for each PTEP group and subgroup on a section 904 category basis. The Foreign Corporation Accounts are similar to the Shareholder-Level Accounts in that they are maintained on the basis of the PTEP groups and subgroups and on a section 904 category basis, but unlike the Shareholder-Level Accounts, they are not maintained on an annual basis.

KPMG observation

The 2024 Proposed Regulations would require PTEP to be maintained on a covered shareholder basis. This is a change from the 2006 Proposed Regulations, which would have required a covered shareholder to maintain PTEP on a share-by-share (or block-by-block) basis.

The preamble states that Treasury is studying whether a Foreign Corporation Account for covered shareholders also should be required for section 959(c)(3) E&P, which generally would require a foreign corporation to calculate its untaxed E&P separately with respect to each covered shareholder.

KPMG observation

As a practical matter, tracking section 959(c)(3) E&P for covered shareholders is a logical extension of the 2024 Proposed Regulations, and more detailed tracking of E&P could help serve the purposes of section 959. For example, the tracking may prove helpful when a corporation distributes built-in loss property, resulting in deficit E&P for multiple covered shareholders (*see, e.g.*, Prop. Treas. Reg.

§ 1.959-10(c)(2)(iii) Example 2, alternative facts, examining the impact of the distribution of built-in loss property by a foreign corporation with only one covered shareholder). Nonetheless, the 2024 Proposed Regulations already would impose extensive record-keeping requirements on taxpayers. Thus, the benefits of tracking 959(c)(3) E&P, such as preventing double taxation when a foreign corporation has multiple covered shareholders, would need to be weighed against the additional administrative burden of tracking section 959(c)(3) E&P that presumably would be imposed on all covered shareholders.

Consistent with the 2019 Notice and Revenue Ruling 86-131, 1986-2 C.B. 135, the 2024 Proposed Regulations would clarify that a CFC's E&P is determined independently of PTEP, but that the aggregate amounts of a CFC's PTEP and section 959(c)(3) E&P must equal its total E&P.

KPMG observation

Because a CFC's E&P is determined independently of PTEP, a distribution from a CFC with PTEP could nonetheless result in a return of basis under section 301(c)(2) if the distribution exceeds the CFC's total E&P. Moreover, under the 2024 Proposed Regulations, because the aggregate amounts of PTEP and section 959(c)(3) E&P must equal total E&P, an increase to the PTEP of a CFC within a tax year without a commensurate increase to its E&P can create or increase a deficit in section 959(c)(3) E&P.

Adjustments to PTEP accounts

In general, the 2024 Proposed Regulations set forth rules that adjust annual PTEP accounts, dollar basis pools, and PTEP tax pools (and make assignments from the PTEP tax pools to the related creditable PTEP tax groups) to reflect CFC inclusions, distributions, and certain transactions that occur during the tax year of the foreign corporation. The 2024 Proposed Regulations would make eleven adjustments and include rules on the amount and timing of each adjustment. The adjustments would occur either at the beginning or end of the foreign corporation's tax year or during the tax year, in the case of certain transactions. Priority rules would determine the timing of an adjustment when multiple adjustments are otherwise required at the same time (*e.g.*, at the beginning of the year or end of the year). PTEP that is distributed or reclassified in a subsequent year would retain its initial annual year, PTEP group (and subgroup, if applicable), and section 904 limitation category classification. Adjustments to Shareholder-Level Accounts would take a bottom-up approach, occurring successively from the lowest-tier foreign corporation to the highest-tier foreign corporation, and adjustments to the annual PTEP accounts would be made in the functional currency of each foreign corporation when a covered shareholder owns a foreign corporation through tiers of foreign corporations. Adjustments to Foreign Corporation Accounts would be made at the same time as adjustments to Shareholder-Level Accounts. Adjustments required in respect of PTEP tax pools and foreign currency gain or loss are described in the related sections of this Report.

The adjustments to annual PTEP accounts and their timing are in Appendix B of this Report.

KPMG observation

In general, the eleven adjustments to the Shareholder Level Accounts in the 2024 Proposed Regulations would be an expansion of the adjustments proposed in the 2006 Proposed Regulations. Specifically, the 2024 Proposed Regulations would include the adjustments in the 2006 Proposed Regulations for subpart F inclusions, amounts included in income as a dividend under section 1248(a) or (f), distributions of PTEP, transfers of PTEP, reclassifications of PTEP from section 959(c)(2) to section 959(c)(1) in connection with section 956, and section 956 inclusions. The 2024 Proposed Regulations would add adjustments for GILTI inclusions and adjustments related to section 961(c) basis. Notably, 2024 Proposed Regulations do not include an adjustment for redemptions, for example under section 304. However, the preamble states that future guidance is expected be issued with respect to section 304.

The timing rules in the 2024 Proposed Regulations are more varied than those in the 2006 Proposed Regulations, which would have made all PTEP adjustments at the end of the year.

Similarly, when a foreign corporation succeeds to all or a portion of an annual PTEP account of a covered shareholder in connection with an acquisition of such covered shareholder's interest in a foreign corporation that qualifies as a general successor transaction (discussed in more detail below), a pro rata portion of the U.S. dollar amount of the corresponding U.S. dollar basis pool and PTEP tax pool maintained by the covered shareholder with respect to the transferred PTEP group would be decreased, and the U.S. dollar basis pool and PTEP tax pool maintained by the new covered shareholder would be established at these same amounts, with the U.S. dollar basis pool increased by any section 986(c) foreign currency gain or loss recognized by the transferring covered shareholder.

Distributions of PTEP

The 2024 Proposed Regulations would provide guidance for a covered shareholder to exclude PTEP from gross income as well as guidance to prevent double taxation when PTEP is distributed through a chain of CFCs, generally treating an SFC as a CFC with respect to distributions of section 965 PTEP. As a starting point, the proposed rules would apply to a "**covered distribution**," which would be defined as a dividend as determined under section 316 (determined without regard to section 959(d) and would not include amounts treated as a dividend under sections 78, 367(b), 964(e)(1), or 1248. Thus, consistent with the 2019 Notice, a CFC would be able to distribute PTEP only to the extent that the CFC has either current or accumulated E&P under section 316.

The 2024 Proposed Regulations would follow the long-standing statutory rule of treating distributions as first distributed from section 959(c)(1) PTEP, followed by section 959(c)(2) PTEP, and then section 959(c)(3) E&P. Additionally, the 2024 Proposed Regulations generally would maintain the long-standing annual layer and last-in first out ("**LIFO**") approach, which generally treats the most recent annual layer of PTEP as distributed first. When less than the entire annual layer of PTEP is distributed and there are multiple PTEP groups in the annual layer, the proposed rules would treat the distribution as being made pro rata from each PTEP group in the annual layer. As an exception to the general LIFO approach, the proposed rules would require section 965(a) PTEP to be distributed first, followed by 965(b) PTEP before applying the general LIFO approach when determining distributions from section 959(c)(1) PTEP and, separately, section 959(c)(2) PTEP. The 2024 Proposed Regulations also would provide that non-taxable section 962 PTEP within a group and annual layer is distributed prior to taxable section 962 PTEP in the same group and annual layer. These general ordering rules for analyzing PTEP distributions largely follows the rules described in the 2019 Notice.

KPMG observation

It is unclear whether taxpayers are permitted to rely on these ordering rules before the finalization of the 2024 Proposed Regulations. As discussed above in the Applicability Date part of this Report, the 2019 Notice permitted taxpayers to rely on its provisions, including the ordering rules, but only until the publication of proposed regulations. In contrast, while the 2024 Proposed Regulations would retroactively apply these ordering rules to the 2019 Notice Years, the 2024 Proposed Regulations contain no reliance language.

Framework for analyzing CFC distributions

The 2024 Proposed Regulations would implement the general statutory rules that exclude PTEP distributions (other than taxable section 962 PTEP) from a covered shareholder's gross income and that prevent double taxation when PTEP is distributed through a chain of CFCs. The proposed rules would introduce a new framework for analyzing distributions received by a CFC from a lower-tier CFC, in part to address concerns with split-ownership structures.

Under the proposed framework, a covered shareholder first would determine its share of a covered distribution (*i.e.*, a dividend) received by the upper-tier CFC under new rules that would "assign" the distribution to its shareholders. These new rules also would apply for purposes of assigning "covered gain" of the upper-tier CFC to its shareholders. The proposed rules for covered gain are discussed below in the Section 961 part of this Report. In general, covered distributions received by a CFC and covered gain recognized by a CFC (collectively, "**covered items**") generally would be assigned to a shareholder pro rata based on the stock of the CFC owned on the last day of the CFC's tax year on which it was a CFC ("**last relevant day**"), subject to special rules when there are certain mid-year changes in ownership discussed below. Under the general rules, the amount of a covered item assigned to a shareholder generally would be determined under the hypothetical distribution rules for determining pro rata share for subpart F inclusion purposes but based on a hypothetical distribution on the last relevant date of the greater of the CFC's current year E&P or the aggregate of all of the CFC's covered items. Then, the extent to which the amount assigned to each shareholder is a PTEP distribution would be determined based on the shareholder's PTEP account for the lower-tier CFC. Finally, the covered item would be excluded from the CFC's gross subpart F income and tested income to the extent of the aggregate of the shareholders' PTEP.

Any amount of the covered item in excess of the shareholders' PTEP would be treated as a distribution of the lower-tier CFC's section 959(c)(3) E&P and would be analyzed under the general rules for determining subpart F income and tested income. To the extent the amount is foreign base company income ("**FBCI**"), it would be treated as a newly-created "item" for purposes of computing the upper-tier CFC's FBCI. The 2024 Proposed Regulations then would provide new pro rata share rules to determine each covered shareholder's pro rata share of the CFC's FBCI attributable to covered items, which would apply on a covered item by covered item basis. Under the pro rata share rules for covered items, each U.S. Shareholder would include in income its proportionate share of the covered item included in the CFC's FBCI based on its share of the covered item assigned to it under the new assignment rules and included in FBCI.

As noted above, the 2024 Proposed Regulations would provide additional rules for determining the amount of a covered item assigned to a shareholder when there are certain mid-year changes in ownership of the CFC. These rules would apply to general successor transactions, which are defined and discussed in more detail below in the Transfer of PTEP to Successor Shareholders part of this Report.

KPMG observation

The general rules for determining FBCI apply after a covered item is included in a CFC's income. For example, a covered distribution that is included in a CFC's gross income under the assignment rule may be excluded from the CFC's foreign personal holding company income under the look-through rule in section 954(c)(6). This is illustrated in example 2 in Prop. Treas. Reg. § 1.951-1(h)(2)(iii).

A U.S. Shareholder that has PTEP at least equal to the amount of a covered item assigned to it would not have a subpart F inclusion for the covered item because its pro rata share of the item would be zero under the proposed pro rata share rules for covered items.

The framework for CFC distributions that would be adopted in the 2024 Proposed Regulations to address split-ownership structures represents a departure from the approach taken by the IRS Revenue Ruling 82-16 ("**1982 Revenue Ruling**"). In the 1982 Revenue Ruling, a U.S. Shareholder ("**US 1**") owned 70% of a top-tier CFC, and an unrelated foreign person owned the remaining 30%. The top-tier CFC wholly owned a lower-tier CFC. The lower-tier CFC earned $100 of subpart F income, which resulted in a $70 subpart F inclusion and $70 of PTEP for US 1. The lower-tier CFC distributed $200 of E&P to the upper-tier CFC, which generally would be included in the CFC's subpart F income. The issue was whether $100 or $70 would be excluded from the upper-tier CFC's subpart F income for purposes of determining US 1's subpart F inclusion. The 1982 Revenue Ruling concluded that $100—the amount of E&P that gave rise to the $70 of PTEP – was excluded from the upper-tier CFC's subpart F income (*i.e.*, the "grossed-up" amount). As a result, the upper-tier CFC had only $100 of subpart F income for purposes of determining US 1's subpart F inclusion, which resulted in a subpart F inclusion of $70.

According to the preamble, Treasury believes that the framework of the 2024 Proposed Regulations better ensures that the benefits of PTEP inure solely to the relevant shareholder than the gross-up approach of the 1982 Revenue Ruling. Although the 2024 Proposed Regulations create a new framework, the amount of the US 1's subpart F inclusion under the facts of the 1982 Revenue Ruling generally would not change under the proposed rules. Specifically, under the 2024 Proposed Regulations, assuming that upper-tier CFC had a single class of stock and current year E&P of $200, US 1 would be assigned $140 of the $200 covered distribution (70% x $200) from the upper-tier CFC to the lower-tier CFC. Of the $140 assigned to US1, $70 would be treated as a PTEP distribution. Thus, upper-tier CFC would exclude $70 from its subpart F income, which would result in subpart F income of $130. US 1's pro rata share of upper-tier CFC's $130 of subpart F income would be determined under the new pro rata share rules for covered items $130 x ($70/130), or $70. Thus, US 1 would have a $70 subpart F inclusion under the 2024 Proposed Regulations.

The 2024 Proposed Regulations do not withdraw the 1982 Revenue Ruling. Therefore, taxpayers may continue to apply the gross-up mechanism in the ruling pending the finalization of the 2024 Proposed Regulations.

Additional rules for PTEP distributions received by a CFC or covered shareholder

The 2024 Proposed Regulations would provide that a distribution of PTEP from a lower-tier CFC to an upper-tier CFC that is excluded from the upper-tier CFC's subpart F income under the framework discussed above also would be excluded from the CFC's tested income or tested loss with respect to a U.S. Shareholder of both CFCs, even though the PTEP is otherwise included in the upper-tier CFC's gross income. Additionally, the 2024 Proposed Regulations also would provide that the PTEP distribution would not increase the E&P of the upper-tier CFC for purposes of applying the rule that limits a U.S. Shareholder's subpart F inclusion based in part on a CFC's current year E&P even though the distribution generally increases the upper-tier CFC's E&P.

KPMG observation

The proposed rule that excludes a PTEP distribution received by an upper-tier CFC from a lower-tier CFC from the upper-tier CFC's tested income would be a welcome clarification. Though in most cases a PTEP distribution would also be excluded from tested income under the statutory rule that excludes dividends from related persons, the rule in the 2024 Proposed Regulations would exclude all PTEP distributions received by a CFC from another CFC from tested income, including PTEP distributions from unrelated CFCs, a fact pattern that is more prevalent since the repeal of section 958(b)(4).

Similarly, the proposed rule that a PTEP distribution does not increase the recipient's CFC E&P for purposes of applying the subpart F E&P limitation is a sensible application of the limitation rule to tiered CFCs. For example, under the proposed rule, if a U.S. Shareholder wholly owned tiered CFCs that each had $100 of subpart F income and the upper-tier CFC also had a $100 foreign oil and gas extraction ("**FOGEI**") loss, the U.S. Shareholder would have only a $100 subpart F inclusion regardless of whether the lower-tier CFC distributed the $100 of PTEP, consistent with the $100 subpart F inclusion that also would occur if the lower-tier CFC had the FOGEI loss. The U.S. Shareholder consistently having a $100 subpart F inclusion when the two CFCs each earned $100 of subpart F income and one CFC earned a $100 FOGEI loss is a reasonable result. The proposed rule is described as a clarification in the preamble.

The 2024 Proposed Regulations would also clarify that a PTEP distribution received by a domestic corporation would not increase the E&P of the covered shareholder. Finally, the 2024 Proposed Regulation would provide that PTEP received by, or resulting from the application of 961(c) basis to covered gain recognized by, a foreign corporation would not give rise to tentative taxable income in calculating the foreign corporation's section 163(j) limitation.

KPMG observation

As the preamble explains, these rules are necessary to avoid double counting. Specifically, there should be no increase to the E&P of a domestic corporation on the receipt of a PTEP distribution because the CFC inclusion that gave rise to the PTEP would have already increased the corporation's E&P. Similarly, a PTEP distribution received by a CFC should not increase the recipient CFC's adjusted taxable income for purposes of section 163(j) because the income that gave rise such income would have already increased adjusted taxable income of the distributing CFC.

Treatment of PTEP distributions for partnerships

Under the 2024 Proposed Regulations, when a partnership receives a covered distribution from a CFC, a partner's distributive share of the distribution would be treated as if it were received directly by the partner in accordance with their distributive share. For a covered shareholder of 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.

Transfer of PTEP to successor shareholders

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

The 2024 Proposed Regulations would provide new rules for determining the extent to which PTEP transfers when shares of a CFC are transferred, which would replace the existing successor PTEP regulations. As under the current regulations, the successor PTEP rules generally would apply to any relevant U.S. person that acquires shares of a foreign corporation, without regard to whether the U.S. person is a U.S. Shareholder or the corporation is a CFC, although (unlike the current regulations) the proposed regulations would exclude U.S. partnerships from the successor PTEP rules.

The 2024 Proposed Regulations would apply to a shareholder that directly or indirectly acquires a foreign corporation in a "**general successor transaction**," which is defined as a transfer of ownership of a CFC directly or indirectly owned by a covered shareholder to another covered shareholder. Although the successor rules would apply to most transactions involving a change of ownership of foreign corporate shares directly or indirectly owned by a covered shareholder, they would not apply with respect to shares of a foreign corporation acquired by a U.S. person in any of the following transactions: (1) the issuance of stocks or partnership interests; (2) redemptions of stock or liquidating distributions in redemption of a partnership interest; and (3) any transfer of stock of a foreign corporation, or any property through which the corporation is owned, if the acquiring U.S. person has a substituted basis in the property (*i.e.,* the transfer is pursuant to a nonrecognition transaction).

In general, under the 2024 Proposed Regulations, some or all of the transferor's PTEP would transfer to the acquirer along with any PTEP created as a result of the application of section 1248 to the disposition. In general, the proposed rules would determine the extent to which PTEP transfers when less than all of a transferor's shares are transferred based on a hypothetical distribution of the transferor's PTEP immediately before the relevant transaction, other than PTEP created by reason of any current-year inclusions of the transferor with respect to shares that it retains. Additionally, the proposed rules generally would apply a pro rata approach for determining the dollar basis and associated foreign income taxes of PTEP that transfers to an acquiror.

The 2024 Proposed Regulations also would address situations in which a U.S. person acquires the shares of the foreign corporation from a person other than a U.S. Shareholder, including when there is intervening ownership of the shares by a foreign person. For purposes of the application of the general successor transaction rules, a foreign person is treated in the same manner as a covered shareholder (a "**deemed covered shareholder**") and when a covered shareholder sells CFC stock to a foreign person, the foreign person is a deemed covered shareholder that succeeds to the PTEP of the seller. Therefore, if the foreign person subsequently sells the CFC stock to a covered shareholder, the purchaser succeeds to the remaining PTEP with respect to the seller. The proposed rules would require the acquiring U.S. person to use a reasonable method to determine the amount of PTEP that would transfer from the seller, taking into account the adjustments to PTEP accounts generally required under the 2024 Proposed Regulations that would have occurred during the period of intervening foreign ownership if the shares had been owned by a hypothetical U.S. Shareholder (*i.e.,* the amount of PTEP does not remain static during the intervening period of foreign ownership).

KPMG observation

The current regulations under section 959 do not explicitly address the application of the successor rules when a U.S. person indirectly acquires shares of a foreign corporation. The 2024 Proposed Regulations, however, would explicitly allow a U.S. person that indirectly acquires the stock of a foreign corporation to succeed to the PTEP. For example, the proposed successor rules could apply when a U.S. partnership that has at least one partner that has PTEP with respect to the partnership's CFC sells its interest to another U.S. partnership that has U.S. partners. In that case, the PTEP of the partner of the selling partnership would transfer to the U.S. partners of the acquiring partnership.

The current regulations have a degree of electivity because they apply only to the extent a successor shareholder submits a statement with its return containing the information required in the regulations. In contrast, an amount of PTEP calculated under the 2024 Proposed Regulations is not dependent on the submission of any form or statement and thus would transfer automatically to successor shareholders. The automatic transfer of PTEP may not be favorable for domestic corporate acquirers who might prefer to receive distributions of section 959(c)(3) E&P rather than PTEP because a dividend out of section 959(c)(3) E&P could be eligible for a deduction under section 245A and not require a basis reduction under section 961(b).

The proposed rules that would apply when there has been intervening foreign ownership may be a trap for unwary taxpayers. For example, taxpayers who acquire the stock of foreign corporations from foreign persons in a transaction for which a section 338(g) election is not made would have to determine whether the foreign corporation was once a CFC with respect to which one or more U.S. Shareholders had CFC inclusions and, if so, would need to access the financials of the foreign corporations in order to reconstruct its annual PTEP accounts. In recognizing the burden this may be to U.S. persons the 2024 Proposed Regulations helpfully provide that such U.S. persons may use any "reasonable method" to determine the transferred PTEP.

Certain transactions that are excluded from general successor transactions are economically similar to transactions that fall within the definition. For example, stock issuance or redemption, which would not transfer PTEP, can be similar to an over-the-top transaction, which would transfer PTEP. The significantly different PTEP consequences that would occur under the proposed rules would be another factor for taxpayers to consider when deciding on the form of a direct or indirect acquisition or disposition of CFC stock.

Section 956 and PTEP

A U.S. Shareholder can have a section 956 inclusion when its CFC owns U.S. property (as defined for section 956 purposes) during the year. In general, a U.S. Shareholder's section 956 inclusion with respect to a CFC is the CFC's section 956 amount reduced by the shareholder's section 959(c)(2) PTEP. Section 959(c)(2) PTEP that reduces a section 956 inclusion is reclassified into section 959(c)(1) PTEP.

A section 956 amount with respect to a CFC is the lesser of (1) the average amount of U.S. property held by the CFC on quarterly measuring dates reduced by section 959(c)(1) PTEP and (2) the CFC's current and accumulated E&P, reduced by distributions made during the tax year and section 959(c)(1) PTEP ("**applicable earnings**"). Under current regulations, a corporate U.S. Shareholder's section 956 amount for a CFC is reduced to the extent that the CFC's E&P that supports the inclusion would be eligible for a section 245A deduction if it were distributed to the shareholder (the "**section 245A reduction rule**"). PTEP does not reduce a CFC's 956 amount under the section 245A reduction rule. However, section 959(c)(1) PTEP reduces a section 956 amount through a reduction in the average amount of U.S. property owned and in applicable earnings, and section 959(c)(2) PTEP can reduce the resulting section 956 inclusion.

Because the calculation of a U.S. Shareholder's section 956 inclusion is dependent on PTEP, including PTEP from subpart F and GILTI inclusions, ordering rules are necessary to determine a section 956 inclusion. Specifically, for any particular year, a U.S. Shareholder first determines its subpart F and GILTI inclusions for the CFC, then accounts for CFC distributions, and finally determines its section 956 inclusion for the CFC. Thus, for example, the section 956 inclusion calculation takes into account any PTEP from the U.S. Shareholder's current year subpart F and GILTI inclusions, and PTEP and section 959(c)(3) E&P is determined after any current year distributions of E&P.

The 2024 Proposed Regulations would generally follow the statutory ordering rules and provide general coordination with section 956. For purposes of calculating a section 956 inclusion, the proposed rule would provide that PTEP is determined at the end of the year and is reduced for any current year PTEP distributions. The proposed rules also would provide that section 959(c)(2) PTEP that reduces a section 956 inclusion is reclassified to section 959(c)(1) PTEP at the end of the year.

KPMG observation

There is not a clear unified set of rules for calculating a section 956 inclusion, which requires understanding the interaction of sections 951(a)(1)(B), 956, and 959 to determine the amount of a section 956 inclusion and its impact on PTEP accounts. The 2024 Proposed Regulations would advance the coordination of the underlying statutory provisions, and helpfully provide a clear rule for reclassifying section 959(c)(2) PTEP to section 959(c)(1) PTEP when a U.S. Shareholder's section 956 inclusion is reduced by its section 959(c)(2) PTEP.

KPMG observation

As generally discussed above, because of the section 245A reduction rule, a corporate U.S. Shareholder may largely be indifferent to section 956. However, such shareholder may still need to take into account section 956 in determining its PTEP balances. Specifically, under the section 245A reduction rule, a corporate U.S. Shareholder's section 956 amount with respect to a CFC is reduced to the extent that a hypothetical distribution of the CFC's E&P would give rise to a section 245A DRD. However, to the extent that a hypothetical distribution would be out of section 959(c)(2) PTEP, such distribution would not be eligible for a section 245A DRD and thus the corporate U.S. shareholder would not be permitted to reduce its section 956 amount. While the resulting section 956 *inclusion* would be reduced by the section 959(c)(2) PTEP, such reduction results in the reclassification of the section 959(c)(2) PTEP to section 959(c)(1) PTEP, which could in turn impact when such PTEP is distributed under the ordering rules.

Section 961: Basis adjustments and gain recognition

Overview

As discussed above, section 961 provides rules regarding basis adjustments resulting from CFC inclusions and gain recognition resulting from the distribution of the PTEP attributable to such amounts. The preamble explains that the purpose of section 961 basis increases is to prevent double taxation (*e.g.*, by ensuring PTEP is not taxed again on a subsequent sale of CFC stock), while the purpose of section 961 basis decreases and gain recognition is to prevent double tax benefits that could result from section 961 basis increases (*e.g.*, by a CFC distributing PTEP tax-free to a U.S. Shareholder and the U.S. Shareholder using section 961 basis increases to reduce gain recognized from the sale of the stock with respect to which the PTEP was distributed).

Pursuant to the grants of regulatory authority in section 961, the 2024 Proposed Regulations would require the establishment and maintenance of basis for three types of "**property units**" to reflect PTEP associated with a covered shareholder: (1) section 961(a) ownership units, (2) derivative ownership units, and (3) section 961(c) ownership units. A section 961(a) ownership unit is a share of CFC stock 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 derivative ownership unit is a share of stock of a foreign corporation that is directly owned by a partnership and indirectly owned by a covered shareholder through only partnerships, or an interest in a partnership directly owned by another partnership and through which a covered shareholder owns stock of a foreign corporation through only partnerships. . A section 961(c) ownership unit is a share of a stock of a foreign corporation that is directly owned by a CFC and indirectly owned by a covered shareholder.

KPMG observation

The 2024 Proposed Regulations use a "share-by-share approach" for making section 961 basis adjustments to CFC stock. As regards section 961 basis decreases, this approach is different than the "basis-shifting approach" used in the 2006 Proposed Regulations, which permitted the basis to shift among blocks of stock in the same CFC to defer the recognition of gain from PTEP distributions. The preamble explains that this difference is intentional and designed to prevent the creation of noneconomic losses. The share-by-share approach is consistent with the section 961 statute and the subchapter C principles that do not permit basis shifting among blocks of stock when determining the USFIT consequences of non-redemptive corporate distributions. However, the share-by-share approach is arguably counter to sound PTEP policy because it can accelerate taxation of PTEP distributions.

As discussed above, PTEP accounting, unlike the section 961 basis adjustments, is not share-specific. The different approaches adopted for PTEP accounting and section 961 basis adjustments can, in certain circumstances, accelerate gain recognition (actual or noneconomic) when PTEP is distributed. For example, assume that as of January 1, Year 1, USP owns all the stock of CFC 1, consisting of 100 shares of common stock with an adjusted basis of $100 ("**Block 1**"). USP has $100 of PTEP related to CFC 1. In Year 2, CFC 1's value decreases to $20 and USP contributes $20 to CFC in exchange for an additional 100 shares ("**Block 2**"). USP has an adjusted basis of $20 in Block 2. In Year 3, CFC 1 distributes $50 to USP. Consistent with maintenance of PTEP accounts at the covered shareholder level, the distribution is treated as a pro rata PTEP distribution with respect to both Block 1 and Block 2, notwithstanding that Block 2 was not in existence at the time the income giving rise to the PTEP was generated. In contrast and as discussed above, the section 961 basis consequences and any resulting section 961 gain recognition are determined using the share-by-share approach. With respect to Block 1, USP would recognize no gain because it has sufficient adjusted basis in the stock to offset the $25 of PTEP that is allocable to Block 1. With respect to Block 2, USP would recognize $5 of gain because USP does not have sufficient adjusted basis in Block 2 to fully absorb the section 961 basis decrease for the $25 of PTEP allocable to Block 2, notwithstanding that USP’s aggregate stock basis in CFC1, $120, exceeds the total PTEP distributed by CFC1. Unlike the 2006 Proposed Regulations, the 2024 Proposed Regulations prohibit USP’s basis in Block 1 from shifting to Block 2 to prevent section 961 gain recognition.

KPMG observation

The definition of a “property unit” does not necessarily encompass every share of stock or interest in a section 958(a) ownership chain through which a covered shareholder indirectly owns a CFC. A share of CFC stock held by a non-CFC foreign corporation is not a property unit. Likewise, where an upper-tier CFC owns an interest in a partnership and that partnership owns stock of a lower-tier CFC, neither the interest in the intermediate partnership nor the stock of the lower-tier CFC is a property unit. Further, while a share of stock of a non-CFC foreign corporation held by a CFC is a section 961(c) ownership unit, no section 961(c) basis adjustments are made with respect to such property unit. Thus, under the 2024 Proposed Regulations, section 961 basis adjustments may not be made with respect to all stock or property included in the chain of ownership described in section 958(a) through which a U.S. Shareholder has a CFC inclusion. The preamble indicates, however, that Treasury is studying whether to, and to what extent, basis adjustments may or should be made in these situations.

Basis increases

Basis increase amount

Building on the statutory language in sections 961(a) and (c), the 2024 Proposed Regulations would generally require taxpayers to increase the basis of a property unit in a tax year by the amount of PTEP created in that year that could reasonably be expected to be distributed with respect to such unit (the “**hypothetical distribution**” and the “**hypothetical distribution rule**”). The 2024 Proposed Regulations would treat the hypothetical distribution as being made through each tier of ownership, so that corresponding basis increases would generally be made at each level in the ownership chain to section 961(a) ownership units (the resulting basis, “**adjusted basis**”), derivative ownership units (the resulting basis, “**derived basis**”), and shares of CFC stock that are section 961(c) ownership units (the resulting basis, “**section 961(c) basis**”), as applicable. The 2024 Proposed Regulations would provide that basis increases are performed in essentially the same manner for each type of property unit. Increases to the basis of section 961(a) ownership units are treated no differently than any other adjusted basis, whereas section 961(c) basis and derived basis have unique properties, as discussed in more detail below.

KPMG observation

As the preamble explains, the hypothetical distribution rule is intended to ensure that the section 961(a) basis increase in each property unit reasonably reflects the amount by which the basis is expected to decrease under section 961(b) upon a distribution of PTEP with respect to such unit. As such, the rule could increase the basis of a share of CFC stock in a manner that is inconsistent with the amount of a U.S. Shareholder’s CFC inclusion with respect to such share. The purpose of the hypothetical distribution rule to determine section 961 basis increases, and its inconsistency with the rules that allocate a CFC inclusion between shares, is illustrated in an example in the preamble. In the example, USP owns all the stock of CFC, consisting of common stock and one share of preferred stock with a $10 preference. CFC’s E&P for the year is $100, consisting of $90 of subpart F income and $10 of other income. USP has $90 CFC inclusion with respect to CFC for the tax year, $9 is allocated to the preferred share and $81 is allocated to the common stock. If the section 961 basis increase followed the income inclusion, USP would recognize $1 of gain under section 961(b)(2) on the preferred share if the $90 were actually distributed to USP because of the $10 preference (*i.e.*, because the section 961 basis increase for the preferred share would only be $9, but the amount of PTEP distributed on the preferred share would be $10). Thus, the 2024 Proposed Regulations attempt to prevent USP from recognizing non-economic gain in this situation by matching the section 961 basis increase with the amount of current year PTEP that would be distributed on each share of CFC stock. As a result, under the hypothetical distribution rule, USP increases its basis in its preferred stock by $10 and its basis in its common stock by $80.

KPMG observation

As illustrated above, the interaction of the share-by-share approach for basis adjustments and the shareholder-level approach for maintaining PTEP accounts can result in noneconomic gain in certain scenarios. In addition, the interaction of these approaches can cause the same economic arrangement to have different consequences. For instance, a U.S. Shareholder that holds its economic rights in a CFC through multiple classes of stock rather through a single class of stock could increase the probability of recognizing a noneconomic gain or loss on a disposition of stock, if the basis increase required under the 2024 Proposed Regulations with respect to such stock does not properly reflect the accretion in value of such stock by reason of the CFC inclusion.

The hypothetical distribution rule does not apply to the extent a CFC actually distributes current year PTEP prior to the last relevant day of its tax year. Instead, if a CFC makes an actual distribution of current year PTEP, the corresponding section 961 basis increase is generally equal to the amount of such PTEP (the “**actual distribution rule**”). Thus, the actual distribution rule prevents the section 961 basis decrease for a distribution of current year PTEP from exceeding the amount of the section 961 basis increase for such PTEP. The actual distribution rule applies in chronological order to multiple PTEP distributions made by a CFC during the same CFC tax year. If a U.S. Shareholder’s CFC inclusion amount with respect to a CFC exceeds the current year PTEP distributed by the CFC during the tax year, the section 961 basis increases for such excess are determined under the hypothetical distribution rule.

Section 961 basis increases under the hypothetical distribution rule generally “tier up” through property units through which a U.S. shareholder indirectly owns CFC stock based on how the related PTEP would be distributed through the ownership chain.

In the preamble, Treasury requests comments on the hypothetical distribution and actual distribution rules. In particular, Treasury welcomes comments on the tiering approach under the actual distribution rule and whether there are ways to improve the accuracy of tiering without adding complexity or compliance burdens.

Basis increase timing

Under the hypothetical distribution rule, the basis of a property unit would be increased as of the first day of a CFC's tax year for subpart F and GILTI inclusions and would be increased as of the last day of the CFC's tax year for section 956 inclusions. Under the actual distribution rule, the basis of a property unit would be increased as of the first day of a CFC's tax year for subpart F and GILTI inclusions in an amount generally equal to the amount of the PTEP distribution. This favorable timing rule is consistent with the approach outlined in Private Letter Ruling 202304008, in which a section 961(a) basis increase for a current year inclusion was taken into account for purposes of determining and the amount of gain recognized under section 961(b)(2) by reason of a mid-year distribution.

KPMG observation

Delaying the section 961 basis increase for a U.S. Shareholder's section 956 inclusion is necessary because, as discussed above, the amount of this inclusion is dependent on the E&P (including PTEP) remaining after distributions during the tax year and thus cannot be determined until year end.

The general timing rules discussed above would be modified to account for the occurrence of any transaction that changes the covered shareholder's ownership structure of the CFC during the tax year (a "**mid-year transaction**"). For example, if an actual distribution occurs before a mid-year transaction, the section 961 basis increase would occur on the first relevant day of the CFC's tax year. Conversely, if an actual distribution occurs after a mid-year transaction, the section 961 basis increase would occur immediately after such transaction. With respect to section 956 inclusions, in the event that a mid-year transaction changes how a covered shareholder holds a property unit (*e.g.*, a sale or exchange), the section 961 basis increase occurs immediately before the mid-year transaction, but after determining amounts to be included in gross income as a dividend as a result of the transaction (*e.g.*, under section 1248 or Treas. Reg. § 1.367(b)-4).

KPMG observation

The section 961 basis increases for mid-year transactions under the actual distribution rule would generally preserve the character of the basis (*i.e.*, adjusted basis, section 961(c) basis, or derived basis) as it is established at the time the distribution is made. For example, if a CFC makes an actual distribution with respect to shares owned directly by a U.S. Shareholder (*i.e.*, a section 961(a) ownership unit), and in the same tax year but following the actual distribution, the U.S. Shareholder contributes the section 961(a) ownership unit to another CFC so that the section 961(a) ownership unit becomes a section 961(c) ownership unit, the 2024 Proposed Regulations would increase the basis in the transferred stock for CFC inclusions while a section 961(a) ownership unit, thus ensuring that the resulting section 961(c) ownership unit's adjusted basis, not its section 961(c) basis, is adjusted to reflect the distribution.

Basis decreases

Overview

In furtherance of the policy objective of preventing double tax benefits, the 2024 Proposed Regulations would generally require taxpayers to reduce the basis in a property unit when PTEP is received with respect to that unit. To the extent there is insufficient basis in the property unit, the rules would generally require gain recognition to the extent the amount distributed exceeds such basis. The 2024 Proposed Regulations would provide unique rules with respect to each of three types of property units, as discussed below.

The 2024 Proposed Regulations would provide special rules for PTEP distributions to partnerships. When a partnership receives a PTEP distribution from a CFC, the distribution would generally be treated as dividend income to the partnership and allocated to its partners. If the distribution is a PTEP distribution to a covered shareholder partner, the partnership must reduce its derived basis with respect to such shareholder of each derivative ownership unit. The partnership's derived basis is generally reduced by the dollar basis and associated foreign income taxes of the PTEP. This basis reduction is coordinated with the corresponding increase to the covered shareholder partner's basis in its partnership interest for its distributive share of dividend income from the partnership under section 705. Specifically, a basis increase under section 705 for the distribution occurs simultaneously with the reduction to derived basis.

Section 961(a) ownership unit basis decreases

Generally, the 2024 Proposed Regulations would decrease, but not below zero, a covered shareholder’s adjusted basis of its section 961(a) ownership unit to the extent of the dollar basis of, and creditable foreign income taxes associated with, PTEP received with respect to such ownership unit. To the extent a PTEP distribution exceeds the adjusted basis of a section 961(a) ownership unit, the excess would give rise to gain under section 961(b)(2). Citing *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971), Treasury explains in the preamble that this approach to section 961(b)(2) is consistent with the approach under section 301(c)(3), pursuant to which basis on one share of stock cannot be used to reduce gain with respect to another share.

KPMG observation

As discussed in the preamble, Treasury determined that allowing basis shifting could lead to inappropriate results, is not required by the statute, and would depart from similar provisions, such as section 358, which provides for basis increases for capital contribution but does not shift basis for distributions of capital. To illustrate the inappropriate results from permitting basis shifting, the preamble contains the following example: USP owns CFC, which has PTEP. USP contributes cash to CFC in exchange for newly issued stock and CFC subsequently distributes the PTEP on all shares, including the newly issued shares. According to the preamble, if the section 961 basis were permitted to shift between the shares, the basis would be added to the shares that already have a fair market value basis, potentially resulting in a noneconomic loss in the stock.

Section 961(c) ownership unit basis decreases

Similar to the basis decreases required with respect to section 961(a) ownership units, the 2024 Proposed Regulations would provide that if a CFC receives a PTEP distribution from another CFC, the recipient CFC’s section 961(c) basis with respect to each covered shareholder for the distributing CFC is reduced by the dollar basis of, and the creditable foreign income taxes associated with, such PTEP. To the extent the decrease exceeds the recipient CFC’s section 961(c) basis with respect to a covered shareholder (*e.g.*, because the recipient CFC purchased stock of the distributing CFC and has no section 961(c) basis or the distributing CFC has section 965(b) PTEP), the section 961(c) basis is reduced below zero (*i.e.*, creating negative section 961(c) basis with respect to such covered shareholder), but only to the extent of the covered shareholder's allotment of the CFC's adjusted basis in the distributing CFC stock. Any remaining excess portion is treated as gain recognized by the recipient CFC from the sale or exchange of a section 961(c) ownership unit and is assigned to the covered shareholder. Importantly, the 2024 Proposed Regulations would provide that this gain is only for limited purposes and, therefore, does not affect the CFC's E&P or items of gross income for purposes of determining subpart F income or tested income.

KPMG observation

While not free from doubt, it appears that section 964(e) would not apply to gain recognized under the 2024 Proposed Regulations by reason of a PTEP distribution with respect to a section 961(c) ownership unit. Section 964(e) recharacterizes an upper-tier CFC's gain from the sale or exchange (including, in general, gain under section 301(c)(3)) of a lower-tier CFC's stock as a dividend, which dividend is included in the gross income of a U.S. shareholder as a subpart F inclusion which is made eligible for a section 245A DRD if certain conditions are satisfied. The 2024 Proposed Regulations do not explicitly provide for the inapplicability of section 964(e) (in contrast to the explicit provision in the proposed rules that covered gain to which section 961(c) applies is not subject to section 964(e)), and the proposed rules generally provide that gain recognized on a PTEP distribution with respect to any ownership unit "is treated as gain from a sale or exchange of such ownership unit." However, the 2024 Proposed Regulations prescribe a more specific rule for gain recognized from a PTEP distribution with respect to a section 961(c) ownership unit, providing that it does not affect the CFC's items of gross income for purposes of section 952 or section 951A or its E&P, and is only relevant for purposes of determining amounts included in a U.S. Shareholder's gross income under Prop. Treas. Reg. § 1.961-11, which in turn treats the amount of such gain allocated to the U.S. shareholder as a subpart F inclusion. The 2024 Proposed Regulations do not appear to contemplate that the resulting subpart F inclusion could be eligible for a section 245A DRD under section 964(e)(4).

KPMG observation

Historically, taxpayers have taken the position that no section 961(b)(2)-type gain may be recognized under section 961(c), on the basis that that provision prescribes only "adjustments" (*i.e.*, not gain) similar to section 961(a) and (b). However, the 2024 Proposed Regulations would provide that gain can be recognized under section 961(c) to the extent a distribution of PTEP exceeds section 961(c) basis and adjusted basis. The preamble explains that Treasury believes such gain recognition is necessary to "appropriately prevent the 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."

Derived basis unit basis decreases

The 2024 Proposed Regulations would also permit a PTEP distribution to reduce a partnership's derived basis in a derivative ownership unit with respect to a covered shareholder below zero (*i.e.*, create negative basis), but only to the extent of the amount of the partnership's adjusted basis in the derivative ownership unit, excluding any basis adjustment specific to any partner ("**common basis**"), that is "available" to such shareholder. To address concurrent adjustments with respect to multiple covered shareholders, the 2024 Proposed Regulations would provide rules for determining the common basis available with respect to each covered shareholder. The preamble explains that this approach is intended to defer the gain recognition without affecting the treatment or availability of the adjusted basis of a derivative ownership unit under any other provisions of the Code, such as section 704(c).

The utilization of positive derived basis in a derivative ownership unit before creating negative derived basis effectively defers gain recognition and aligns the timing of gain recognition with the realization of economic benefits associated with PTEP distributions. With regards to a covered shareholder, if the required section 961 basis decrease to a derivative ownership unit exceeds the aggregate of the reductions allowable to derived basis and positive section 743(b) basis with respect to the shareholder of a derivative ownership unit, the partnership recognizes gain from the sale or exchange of the derivative ownership unit. This gain is allocated solely to the covered shareholder and is considered in adjusting its basis in the partnership under section 705. The gain, however, does not have any effect on the partnership's computation or allocation of any other item under section 703 or 704 or on the covered shareholder's capital account.

Basis adjustments for foreign currency gain or loss

If foreign currency gain or loss is recognized under section 986(c) with respect to PTEP of a foreign corporation in any transaction other than a PTEP distribution (*e.g.*, in a general successor transaction), the basis in the shares of stock of the foreign corporation owned by the covered shareholder and the basis in any property units through which the covered shareholder owns the stock of the foreign corporation is adjusted by the amount of the net foreign currency gain or loss. This adjustment is an increase for foreign currency gain and a decrease for foreign currency loss.

At each level, foreign currency gain or loss recognized is allocated among property units based on their proportionate share of a PTEP distribution determined by a fraction. The fraction is based on a hypothetical distribution of all the foreign corporation's PTEP with respect to which the covered shareholder recognizes foreign currency gain or loss in the transaction. The fraction numerator is the portion of the hypothetical distribution that would be distributed with respect to the property unit under Prop. Treas. Reg. § 1.951-1(e)(2) through (6), and the fraction denominator is the amount of the hypothetical distribution.

These basis adjustments are taken into account immediately before the transaction. As a result, foreign currency gain or loss with respect to PTEP recognized by the covered shareholder under section 986(c) will not also increase or decrease any gain or loss recognized upon the disposition of the property units.

Basis adjustments for general successor transactions

Section 961(c) provides that a U.S. shareholder can inherit the section 961(c) basis from another U.S. shareholder through the acquisition of the latter shareholder's indirect interest in the stock of a foreign corporation. The 2024 Proposed Regulations would expand on this rule, by providing that, in a general successor transaction, a successor covered shareholder acquires a pro rata portion, determined based on the relative value of the partnership interests or CFC stock acquired, of the derived basis of an acquired partnership and the section 961(c) basis of an acquired foreign corporation. The amount of basis acquired by the successor covered shareholder is increased or decreased by the amount of foreign currency gain or loss recognized on the transaction. The successor covered shareholder is treated as acquiring such basis concurrently with the applicable general successor transaction.

In a general successor transaction where a partnership that owns a derivative ownership unit is acquired and has a section 754 election is in effect or a substantial built-in loss exists, the acquired partnership's assets receive a basis adjustment under section 743(b). The 2024 Proposed Regulations specify that the transferred derived basis is factored into the calculation and allocation of the overall section 743(b) basis adjustment. However, the 2024 Proposed Regulations do not address the interaction of derived basis with the rules concerning distributions, such as section 732 and 734, but request comments on how derived basis should interact with these sections.

In the case of a sale to a foreign person, the deemed covered shareholder rules that apply for purposes of section 959 (as discussed above) also apply for purposes of transferring basis for purposes of section 961. Therefore, if a covered shareholder sells CFC stock to a foreign person, the foreign person is a deemed covered shareholder that succeeds to section 961(c) basis with respect to the seller, and if the foreign person subsequently resells the CFC stock to a U.S. covered shareholder, the purchaser succeeds to the remaining section 961(c) basis with respect to the seller. Similar to the adjustments to PTEP accounts under the 2024 Proposed Regulations, the purchasing covered shareholder must use a reasonable method to make adjustments to the transferred basis it receives to take into account any adjustments to basis that would have been made under the proposed rules with respect to the deemed covered shareholder if the basis had been with respect to a covered shareholder.

Derived basis adjustments for distributive shares of gain or loss

The 2024 Proposed Regulations outline the process of applying positive derived basis to a covered shareholder's distributive share of gain or loss from the sale, exchange, or other disposition of derivative ownership units by a partnership. The partnership first determines each partner's distributive share of gain or loss, without regard to positive derived basis but taking into account any adjustments under section 743(b). The positive derived basis is then applied to adjust the covered shareholder's distributive share.

In the case where a covered shareholder holds its interest in a lower-tier partnership through an upper-tier partnership, the upper-tier partnership's distributive share of gain or loss with respect to property units transferred by, and the common basis of its interest in, the lower-tier partnership is determined without considering the positive derived basis adjustment. The derived basis of the upper-tier partnership in the lower-tier partnership interest is reduced, or gain is recognized, by the amount of positive derived basis that was applied to the covered shareholder's distributive share. This effectively replaces derived basis with common basis. Where a covered shareholder holds a direct interest in the upper-most tier partnership, its distributive share of gain or loss with respect to the transfer of a property unit by a lower-tier partnership and the basis of its interest in the upper-most tier partnership is adjusted for its positive derived basis.

The application of positive derived basis is subject to two key limitations. In nonrecognition transactions, the amount of positive derived basis that can be applied is capped. It is limited to the difference between the total positive derived basis and the covered shareholder's share of the gain that was realized but not recognized by the partnership. This limitation is similar to the "boot-within-gain" rule under sections 351(b) and 356(a)(1).

The second limitation precludes the use of positive derived basis to create or increase a loss for a covered shareholder unless the transferring partnership recognizes a loss on the disposition. Further, even when the partnership recognizes a loss, positive derived basis can only increase that loss if a current deduction for the loss is permissible. For example, positive derived basis cannot create a loss if the gain on the transferred units is recognized under section 301(c)(3).

Impact of section 961(c) basis and section 961(c) PTEP

The statute provides that section 961(c) basis only applies for purposes of determining the amount of a CFC’s subpart F income that is included in the gross income of a U.S. Shareholder. To implement this limited purpose, the 2024 Proposed Regulations would provide rules for how to treat gain that is, in effect, reduced by section 961(c) basis. In particular, the rules would exclude gain determined without regarding to section 961(c) (“**covered gain**”) from gross income for purposes of determining the CFC’s subpart F income and tested income or tested loss to the extent such covered gain is reduced by section 961(c) PTEP.

KPMG observation

The 2024 Proposed Regulations would treat section 961(c) basis as applying both for purposes of determining a U.S. Shareholder’s subpart F and tested income or loss. While the statute itself only explicitly applies for purposes of section 951 (*i.e.*, subpart F), the preamble explains that Treasury used the express delegation of authority in section 951A(f)(1)(B) to extend its application for GILTI purposes in an effort to prevent double taxation, consistent with the policy of section 961.

Further, the 2024 Proposed Regulations would treat the E&P from the covered gain as PTEP to the extent such gain is reduced by section 961(c) basis (“**section 961(c) PTEP**”). Subsequent distributions of section 961(c) PTEP would be excluded from an upper-tier CFC’s gross income for purposes of determining that CFC’s subpart F and tested income or tested loss, to the extent the PTEP relates to a covered shareholder that is a U.S. Shareholder of the CFC.

KPMG observation

In the preamble, Treasury suggests that section 961(c) PTEP, an innovation of the 2024 Proposed Regulations, is supported by a plain reading of the statute. In particular, section 959(a) refers to a foreign corporation’s E&P that is “attributable to amounts which are, or have been, included in gross income under section 951(a) [or 951A(a)].” Because section 961(c) basis reflects amounts included in gross income under section 951(a) or 951A(a), Treasury argues that “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).”

Regardless of whether section 961(c) PTEP is supported by the statute, as the preamble illustrates, it is intended to prevent both double non-taxation and double taxation. To illustrate the potential for double non-taxation, assume USP owns CFC1, which owns CFC2. CFC1 has an adjusted basis in its CFC2 stock of $0, but $100 of section 961(c) basis. CFC1 sells the CFC2 stock for $100, which results is $0 subpart F income and tested income because of CFC1’s $100 of section 961(c) basis), and $100 of E&P because CFC1’s section 961(c) basis does not apply for E&P purposes. If the $100 of E&P were characterized as section 959(c)(3) E&P, USP would not pay tax on a subsequent distribution of such E&P, assuming USP qualified for a section 245A DRD for the distribution. As a result, USP would receive a double benefit—once from the section 961 basis increase from the original CFC inclusion, and second time upon distribution of E&P without taxation or a stock basis reduction. The 2024 Proposed Regulations would solve this problem by treating the E&P generated in the sale of CFC2 as section 961(c) PTEP, a distribution of which by CFC1 would reduce the basis of USP’s CFC1 stock.

The 2024 Proposed Regulations generally provide a multi-step process for determining a covered shareholder’s gain resulting from the sale, exchange, or other disposition by a CFC of one or more section 961(c) ownership units. In general, the 2024 Proposed Regulations take an aggregate approach to applying positive section 961(c) basis, applying such basis to each covered shareholder’s share of gain arising from sales, exchanges, or disposals of section 961(c) ownership units. While this aggregate approach differs from the share-by-share approach under section 961 to adjusting basis, the preamble explains that it is intended to replicate the netting effect that occurs for subpart F purposes and provides a simpler and more direct way of achieving the same effect as a share-by-share approach that allows section 961(c) basis sharing among a covered shareholder’s shares of stock.

The 2024 Proposed Regulations would also provide guidance for determining the character and dollar basis of section 961(c) PTEP. Specifically, in an attempt to simplify the process and reduce administrative burdens for tracking PTEP, section 961(c) PTEP generally mirrors the character of the PTEP transferred and eliminated in the transaction.

Finally, to address overlap with certain dividend recharacterization provisions (*e.g.*, section 964(e)) that occur as a result of the creation of section 961(c) PTEP, the 2024 Proposed Regulations would provide certain rules coordinating the application of these rules.

Gain recognition in transactions involving property units with negative basis

Where a partnership or CFC owns property units with negative derived basis or negative section 961(c) basis and engages in certain transactions involving such property units, the 2024 Proposed Regulations would provide rules for recognizing gain with respect to such property units. These transactions, include dispositions by sale, exchange, or distribution of the property unit; distributions of the property under section 301(c)(2); contributions of the property unit to a corporation under section 351; or transactions where the property unit loses its status as a derivative ownership unit or section 961(c) ownership unit. In general, these gain recognition rules apply to two scenarios.

The rules provided by the 2024 Proposed Regulations may apply to cause gain recognition where a partnership's common basis or a CFC's adjusted basis of a property unit is relevant for determining gain or loss with respect to such property unit (*e.g.*, sale or exchange of the property unit). The gain recognized under the first set of rules would generally reflect income that would exist or counteract loss that would not exist if common basis or adjusted basis were reduced by the negative basis (*i.e.*, essentially replicating the result that would occur if the common basis or adjusted basis were reduced by negative basis).

The rules also apply to any transaction where a property unit loses its status as a derivative ownership unit or section 961(c) ownership unit and would treat the CFC is treated as recognizing gain as a result. In these transactions, the partnership or CFC would recognize gain to account for all negative basis, ensuring that the gain is not permanently deferred. Instead, such gain would be allocated to each covered shareholder based on their share of the negative section 961(c) basis or negative derived basis, preventing unwarranted benefits.

In each scenario, gain recognized is allocated pro rata to the covered shareholders based on their relative negative derived basis or negative section 961(c) basis. This allocation prevents a covered shareholder from disproportionately benefiting from the common basis or adjusted basis that led to the creation of the negative basis.

Inclusions in gross income for gain recognized under section 961

The 2024 Proposed Regulations would include rules for determining a U.S. Shareholder's allocable section 961(c) income, which generally (1) includes amounts a CFC recognizes under section 961(c) resulting from the receipt of distributions in excess of basis and (2) amounts recognized as a result of a trigger of negative section 961(c) basis, discussed above. The preamble explains that the rules for recognizing gain under section 961(c) were intended to treat section 961(c) basis in essentially the same manner as adjusted basis of directly held CFC stock, such that transactions involving a section 961(c) ownership unit would give rise to comparable U.S. tax consequences as transactions involving directly held CFC stock.

To prevent the imposition of double taxation, any amounts included in a U.S. Shareholder's gross income under these proposed rules would be treated as a subpart F inclusion and thus results in an increase to property units in the section 958(a) chain of ownership. However, because no additional E&P is created at the CFC level as a result of the section 961(c) income (*i.e.*, section 961(c) basis, including negative section 961(b) basis, does not apply for E&P purposes), the income inclusion would not increase the CFC's PTEP.

For purposes of calculating a U.S. Shareholder's income inclusions, gain recognized by a CFC would be offset at the U.S. Shareholder-level to account for adjustments for foreign currency loss in excess of basis and excess positive section 961(c) basis (*i.e.*, the extent to which positive section 961(c) basis exceeds amounts previously applied to offset covered gain). The preamble states that allowing excess positive section 961(c) basis to offset section 961(c) gain is intended to mirror the application of section 954(c)(1)(B). However, the extent of this permissive treatment is limited, as loss can only be recognized to the extent of gain, which is determined on a covered shareholder by covered shareholder basis.

Finally, the 2024 Proposed Regulations would provide specific rules for allocating a CFC's section 961(c) income in cases where the CFC stock is transferred during the tax year. These rules would address both transactions in which the CFC is an acquired foreign corporation in a general successor transaction and transactions in which the CFC's section 961(c) basis is transferred to another covered shareholder.

Foreign tax credits

Background

Pursuant to section 960(b)(1), when a U.S Shareholder of a CFC that is a domestic corporation receives a PTEP distribution from a first-tier CFC that originated from a lower-tier CFC, the domestic corporation is deemed to have paid the foreign income taxes paid or deemed paid by the first-tier CFC that are “properly attributable” to the PTEP and that have not already been deemed paid by the domestic corporation. The foreign income taxes that may be deemed paid by the U.S. Shareholder under section 960(b)(1) may include foreign income taxes paid or accrued by the first-tier CFC when it received the PTEP from a lower-tier CFC. Further, because such PTEP may have been distributed through multiple tiers of CFCs and foreign income taxes may have been paid or accrued by a lower-tier CFC on receipt of the PTEP, section 960(b)(2) provides that if an upper-tier CFC receives a distribution of PTEP from a lower-tier CFC, the upper-tier CFC is deemed to have paid the foreign income taxes of the lower-tier CFC that are “properly attributable” to such PTEP. Any foreign income taxes paid or accrued by a lower-tier CFC that were treated as deemed paid by the first-tier CFC upon receipt of the PTEP under section 960(b)(2) may also be deemed paid by the domestic corporation under section 960(b)(1) when the PTEP is distributed to the domestic corporation. (Taxes paid or accrued by the domestic corporation on receipt of the PTEP distribution are direct foreign tax credits of the domestic corporation and therefore do not need to be deemed paid under section 960(b).)

Therefore, each time a PTEP distribution is received by a CFC, two different regulations are relevant to the determination of foreign income taxes that may ultimately be deemed paid by the domestic corporation under section 960(b)(1) when it later receives the PTEP. First, current year foreign income taxes that are paid or accrued by the recipient CFC in the year in which it receives PTEP must be allocated and apportioned among such PTEP and the recipient’s other income under the rules for allocating and apportioning foreign income taxes contained in Treas. Reg. § 1.861-20. Second, it must be determined if the recipient CFC is deemed to have paid foreign income taxes that were paid or accrued by a lower-tier CFC if the lower-tier CFC had received the PTEP from another CFC under the “properly attributable” standard set out in Treas. Reg. § 1.960-3. The current year foreign income taxes paid or accrued by the recipient CFC that are allocated and apportioned to the PTEP groups within each PTEP account under Treas. Reg. § 1.861-20 and the foreign income taxes deemed paid by the recipient CFC on receipt of the PTEP under Treas. Reg. § 1.960-3 are combined and tracked in tax pools that correspond to each income group within a PTEP account so that when the PTEP is ultimately distributed to the domestic corporation, the foreign income taxes “properly attributable” to those particular PTEP under section 960(b)(1) and under Treas. Reg. § 1.960-3 may be readily determined.

The 2024 Proposed Regulations would introduce a number of changes as to how the foreign income taxes that are deemed paid under section 960(b) are determined. Specifically, these proposed regulations would: (1) require covered shareholder-specific tracking of PTEP tax pools; (2) substantially revise the mechanical rules for allocating and apportioning current year taxes and creditable PTEP group taxes (each defined below) paid or accrued by a PTEP recipient in the year it receives PTEP; and (3) confirm the calculation of the amount of foreign income taxes deemed paid in connection with a PTEP distribution when less than the full amount of the PTEP in the PTEP account and group is distributed in the current year.

The 2024 Proposed Regulations would also apply for any provision of the Code that treats a foreign corporation as a CFC for purposes of section 960 or an individual as a domestic corporation that is deemed to pay foreign income taxes.

Shareholder-specific tracking of foreign income taxes attributable to PTEP

The 2024 Proposed Regulations would propose rules requiring the tracking of foreign income taxes associated with PTEP in a shareholder-specific manner.

KPMG observation

Under existing regulations under section 960, the determination of the amount of foreign income taxes deemed paid requires the establishment and maintenance of foreign corporation-level accounts that track a foreign corporation's PTEP accounts and foreign income taxes associated with the PTEP. However, the 2024 Proposed Regulations would opt instead for an approach under which the foreign corporation's PTEP accounts (and the income groups within such accounts) must be maintained in a shareholder-specific manner. This new approach is intended to ensure that foreign income taxes imposed with respect to certain PTEP are only deemed paid by the covered shareholder with the underlying PTEP account.

To illustrate how taxes are tracked in a shareholder-specific manner, assume US1 and US2 each own 50% of CFC3. CFC3 wholly owns CFC1 and CFC2, brother-sister corporations. CFC1 and CFC2 each have $100 PTEP in the same PTEP group (and same annual account), but all of CFC1's PTEP is assigned to US1's shareholder-level account and all of CFC2's PTEP is assigned to US2's shareholder-level account. CFC1 and CFC2 each distribute $100 to CFC3, but only CFC1's distribution is subject to withholding tax. On these facts, the resulting PTEP tax pool at CFC3 is expected to be assigned entirely to US1.

Allocating and apportioning current year foreign income taxes to PTEP accounts

Pursuant to existing regulations under section 960, current year foreign income taxes may be allocated and apportioned to a PTEP account only if such taxes are paid or accrued in the same U.S. tax year in which the CFC receives the related PTEP distribution. In contrast, if the CFC receives the related PTEP distribution in a different U.S. tax year, current year foreign income taxes are allocated and apportioned to the subpart F or tested income group to which the distributed PTEP relate. Current year foreign income taxes are allocated and apportioned to a PTEP distribution under existing regulations by determining the portion of foreign gross income that is treated as a PTEP distribution in the current U.S. tax year and assigning such amount to the relevant PTEP group within an annual PTEP account maintained for each separate section 904 category. In determining the net amount of a PTEP distribution, no deductions of a CFC other that current year foreign income taxes are allocated and apportioned to a PTEP group for determining a CFC's net income in its income groups. *See* KPMG report: Analysis of final and proposed foreign tax credit regulations for an overview of how existing rules determine CFC taxes attributable to PTEP.

The 2024 Proposed Regulations would maintain the foregoing basic concepts but reorganize them in regulations under section 959 (rather than section 960) and substantially expand upon them to implement the proposed covered shareholder tracking of the foreign corporation's PTEP accounts. Under the 2024 Proposed Regulations, current year foreign income taxes ("**current year taxes**") would be allocated and apportioned to a PTEP account only if the foreign corporation pays or accrues such taxes with respect to a PTEP realization event that occurs in the same U.S. tax year. As a change from the existing regulations, a "**PTEP realization event**" would include both a PTEP distribution and 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.

Treas. Reg. § 1.861-20, as proposed to be modified for purposes of applying Prop. Treas. Reg. § 1.959-6 as the operative section, would treat the corporation's PTEP accounts and the relevant PTEP groups within such accounts, as maintained with respect to each covered shareholder, that are increased in the current U.S. tax year in connection with a PTEP distribution as U.S. dividend income and would treat the corporation's PTEP accounts maintained with respect to a covered shareholder that are increased in connection with section 961(c) basis as U.S. capital gain from the sale of stock.

Current year taxes would then be allocated and apportioned to such PTEP accounts and groups based on the amount of foreign gross income assigned to each under the ordering rules in Treas. Reg. § 1.861-20 that apply to distributions and gains from the sale of shares. If the current year taxes were paid in nonfunctional currency, such taxes would be translated into the CFC's functional currency at the spot rate on the date such taxes were paid or accrued. In determining foreign gross income, the 2024 Proposed Regulations would maintain the rule that no deductions of a CFC other than current year foreign income taxes are allocated and apportioned to a PTEP group for determining a CFC's net income in its income groups, but Treasury requested comments on other possible approaches. As a final step, once current year taxes have been allocated and apportioned to the PTEP accounts, the portion of such current year taxes that would be assigned to the "creditable PTEP tax group" must be determined as only the current year taxes assigned to the creditable PTEP tax group can be deemed paid under section 960(b). Current year taxes would be assigned to the "**creditable PTEP tax group**" only if the foreign corporation is a CFC when the taxes were paid or accrued and a credit for the taxes is not disallowed or suspended at the level of the CFC under provisions such as section 901(m) or 909. All current year taxes, including those that are not assigned to the creditable PTEP tax group, would result in adjustments to the shareholder-level and corporate level PTEP accounts, such as by reducing the corporation's PTEP account and the relevant dollar basis pools of the covered shareholders.

KPMG observation

While not new, the rule that foreign income taxes that accrue in a different U.S. tax year than the PTEP realization event can never be allocated and apportioned to a PTEP account can lead to "trapped taxes" when the recipient CFC has a different U.S. tax and foreign tax year-end. For example, assume CFC1 owns CFC2 and both have an 11/30 U.S. tax year and a 12/31 local tax year. If CFC2 earns $100 of subpart F income in its U.S. tax year ending 11/30/Y1 and distributes such amount to CFC1 before 11/30, such distribution will be a PTEP realization event in Y1, but the local country net income tax will not accrue until Y2. As a result, any foreign income taxes CFC1 pays on such income will be allocated and apportioned to a subpart F or tested income group that corresponds to the underlying PTEP earnings and will only be eligible to be deemed paid under section 960(a) or (d) if CFC1 has positive income in the corresponding income group in Y2. Similar fact patterns arise when CFC1 owns CFC2 through a DRE and tax is imposed on the disregarded payment of CFC2's PTEP from DRE to CFC1.

KPMG observation

Under the 2024 Proposed Regulations, current year taxes paid or accrued by a CFC on the sale of CFC stock would result in such taxes being allocated and apportioned to a PTEP account of a covered shareholder and may be deemed paid under section 960(b) to the extent gain recognized on the sale results in PTEP to a covered shareholder on account of section 961(c) basis. To the extent a taxpayer would have treated such gain as giving rise to untaxed E&P under current law, such taxes would have been ineligible for an FTC.

Pro rata portion of PTEP taxes treated as deemed paid

The 2024 Proposed Regulations would also clarify that when less than all of the PTEP in a PTEP group maintained with respect to covered shareholder is distributed, the amount of taxes in the relevant PTEP tax pool that would be associated with such distribution and treated as "deemed paid" under Treas. Reg. § 1.960-3(b) would equal the pro rata portion of the PTEP tax pool that corresponds to the amount of the PTEP group that was distributed as measured immediately before the distribution.

KPMG observation

Under existing regulations, Treas. Reg. § 1.960-3(b)(4) applies a pro rata approach in determining section 960(b) deemed paid taxes, while Treas. Reg. § 1.959-3(e), which was issued much earlier, generally provides that distributions from an upper-tier corporation will first be attributable to E&P received in a distribution from a lower-tier corporation for FTC purposes. For example, assume USP wholly owns CFC1, and CFC1 wholly owns CFC2. CFC1 and CFC2 each have $100 of PTEP in the same PTEP group (and same annual account), and CFC2 has $20 of taxes attributable to its PTEP under section 960(b)(2). CFC2 distributes $100 to CFC1, and CFC1 distributes $100 to USP. On these facts, existing Treas. Reg. § 1.959-3(e) suggests that USP is required to trace the $100 PTEP to the E&P that was initially distributed by CFC2, and thus arguably all $20 of section 960(b) taxes could be treated as deemed paid. On the other hand, Treas. Reg. § 1.960-3(b)(4), issued subsequently to Treas. Reg. § 1.959-3(e), appears to override this result and provides that $10 are deemed paid [$20 PTEP group taxes x ($100 distribution from PTEP group / $200 total PTEP group)]. The 2024 Proposed Regulations would confirm the pro rata approach applied by existing Treas. Reg. § 1.960-3(b)(4), and thus only $10 would be deemed paid on these facts. *See* Prop. Treas. Reg. §§ 1.959-4(g), 1.959-10(c), Example 2.

Application of Treas. Reg. § 1.965-5

For PTEP resulting from the application of section 965(a) or (b), an adjusted applicable percentage would be required to be maintained, which tracks the percentage of a credit or deduction for foreign income taxes associated with PTEP that is disallowed under Treas. Reg. § 1.965-5. While the adjusted applicable percentage would be required to be calculated separately with respect to each of the section 965(a) and section 965(b) PTEP groups that fall within a different section 904 category, a separate applicable percentage does not need to be calculated for each annual account therein.

The 2024 Proposed Regulations would not amend, revoke, or otherwise address Treas. Reg. § 1.965-5(c)(1)(ii) which was determined to be invalid in *FedEx Corp. & Subsidiaries v. United States*, No. 20-CV-2794, 2023 WL 2755311 (W.D. Tenn. Mar. 31, 2023).

KPMG observation

A U.S. corporation subject to a Section 965 inclusion on the accumulated undistributed earnings ("**section 965(a) earnings**") of its foreign subsidiaries under section 965(a) offset its section 965(a) earnings subject to inclusion by its pro rata share of E&P deficits (such offset, its "**E&P deficit offset**") of other foreign corporations that were allocated to it under section 965(b). The E&P deficit offset resulted in less than the full amount of the U.S. corporation's pro rata share of the foreign income taxes attributable to the foreign corporation's section 965(a) earnings being deemed paid by the U.S. corporation in connection with its section 965(a) inclusion since it included less than 100% of the section 965(a) earnings. In *FedEx*, a federal district court held that a U.S. corporation may treat foreign income taxes that were not previously deemed paid in connection with its section 965(a) inclusion due to the E&P deficit offset as deemed paid upon a distribution of related PTEP under the plain language of former section 960(a)(3), the pre-TCJA version of section 960(b). Because section 960(b) now requires that foreign income taxes be "properly attributable" to a PTEP distribution, the *FedEx* decision arguably may only have applicability to taxpayers who distributed section 965(b) PTEP prior to the effective date of the TCJA provision.

Foreign currency gains and losses

Background

In general, under section 986(c), distributions of PTEP result in foreign currency gain or loss to the extent of the difference in exchange rates between the time a U.S. Shareholder is deemed to receive a distribution (*e.g.*, on account of a subpart F inclusion) and the time the U.S. Shareholder actually receives a distribution of such amounts. Section 986(c)(1) provided Treasury authority to issue regulations with respect to the treatment of distributions of PTEP through tiers of foreign corporations. The 1988 Notice provided some guidance on tiered distributions, but questions remained as to how to determine the dollar basis in PTEP and treat distributions to foreign corporations with U.S. dollar functional currencies.

Timing and calculation of foreign currency gains and losses

Under the 2024 Proposed Regulations, foreign currency gain or loss would be recognized upon a distribution of PTEP to a covered shareholder or when PTEP ceases to be with respect to the covered shareholder (*e.g.*, the PTEP transfer in a general successor transaction (such as a sale of shares) or are eliminated in connection with a section 338(g) election). However, the 2024 Proposed Regulations would provide that foreign currency gain or loss is not recognized when PTEP transfers to another covered shareholder outside a general successor transaction except in connection with transactions listed in Treas. Reg. § 1.367(b)-2(j)(2)(i). As an example, the preamble provides that no foreign currency gain or loss would be recognized when a covered shareholder contributes shares to a domestic corporation that is not a member of its consolidated group in a section 351 transaction.

Foreign currency gain or loss is determined by comparing the U.S. dollar amount of the PTEP on the day the transaction occurs to the dollar basis of the distributed PTEP and is treated as ordinary income or loss with the same source and in the same section 904 category as the income inclusion from which the PTEP arose. When the foreign currency gain or loss would be recognized in a transaction other than a distribution (such as a sale transaction), a corresponding basis adjustment is made to avoid a duplicative amount of gain or loss being recognized in the shares.

The section 986(c) rules relating to section 965(a) PTEP would remain generally the same; the section 986(c) gain or loss recognized with respect to section 965(a) PTEP would be reduced by the same section 965(c) deduction percentage (without regard to the annual year), which is a weighted average initially calculated at transition, and recalculated as necessary, for all section 965(a) PTEP within a single section 904 category. No section 986(c) gain or loss would be recognized with respect to section 965(b) PTEP. Additionally, the 2024 Proposed Regulations would provide that no section 986(c) gain or loss is recognized with respect to section 962 PTEP.

Furthermore, the proposed regulations would clarify that no section 986(c) gain or loss would be recognized when PTEP is distributed to a foreign corporation. Therefore, no section 986(c) gain or loss would be recognized when a lower tier CFC with a non-USD functional currency makes a PTEP distribution to an upper-tier foreign corporation with a USD functional currency.

Shareholder-level account and foreign corporation account adjustments

To determine the dollar basis of the PTEP, the proposed regulations refer to the rules in Prop. Treas. Reg. §§ 1.959-4 and 1.959-7 for distributions of PTEP and general successor transactions, respectively. As discussed above, generally, dollar basis pools would be required to be maintained with respect to a covered shareholder within annual accounts (and assigned to section 904 categories and PTEP groups within such accounts) under the methodology provided in the transition rules, unless a combined pool election is made.

KPMG observation

Although not required in the current regulations, U.S. Shareholders generally maintain a U.S-dollar basis in their PTEP for CFCs that have a functional currency other than the U.S. dollar, for purposes of applying the foreign currency rules and for reporting their PTEP in U.S. dollars on Schedule P to Form 5471. It is expected that most U.S. Shareholders generally would be maintaining aggregate dollar basis pools for these CFCs already rather than tracking the basis on a year-by-year basis. The 1988 Notice provides guidance on dollar basis pools and the 2019 Notice stated that dollar basis pools were expected to be included in the proposed regulations. Moreover, the 2006 Proposed Regulations also included dollar basis pools.

A pro rata portion of the corresponding dollar basis pool maintained with respect to a PTEP group of a distributing foreign corporation would move to the recipient foreign corporation unchanged so as to preserve the underlying foreign currency gain or loss to be recognized under section 986(c). The associated increase to the annual recipient corporation's PTEP account (and group within such account) I resulting from the receipt of a PTEP distribution would be translated from the functional currency of the distributing foreign corporation into the functional currency of the recipient foreign corporation as necessary at the spot rate on the date of distribution.

For example, consider a scenario where a covered shareholder wholly owns a CFC with a GBP functional currency which wholly owns a CFC with a EUR functional currency. In year 1, EUR 100 from the EUR CFC is included as subpart F income at the covered shareholder level when the exchange rate is EUR 1 = USD 1. The EUR 100 is distributed to the GBP CFC in year 2 when the exchange rate is GBP 1 = EUR 2. As a result, the GBP CFC would have an annual corporate PTEP account of GBP 50 (EUR 100 multiplied by the exchange rate of 0.5) and the covered shareholder's corresponding dollar basis pool would be USD 100 (the basis from the time of inclusion).

KPMG observation

Because the dollar basis of PTEP remains unchanged as it is distributed through tiers of foreign corporations, the PTEP account of a foreign corporation with a USD functional currency may differ from the dollar basis of the PTEP in the case. It appears that Treasury anticipated this potential scenario as Prop. Treas. Reg. § 1.986(c)-1(b)(2) states that for purposes of determining section 986(c) gain or loss, the U.S. dollar amount of the PTEP is determined on the date of the transaction by translating it into USD using the spot rate on the date of the transaction "if applicable", indicating it may not always be necessary to translate the amount into USD.

Other foreign currency issues

The 2024 Proposed Regulations would remove Treas. Reg. § 1.985-5(e)(2) which stated that a U.S. Shareholder recognizes foreign currency gain or loss under section 986(c) when a CFC changes its functional currency to the dollar. Due to the comprehensive system for tracking the dollar basis of PTEP in the proposed rules and concerns that taxpayers could inappropriately accelerate foreign currency loss, Treasury no longer thinks this rule is needed.

Treasury is also considering whether a similar rule in Treas. Reg. § 1.985-7(c)(3) relating to the dollar approximate separate transaction method ("**DASTM**") should be modified.

Consolidated group rules

Overview

The 2024 Proposed Regulations provide rules under sections 959 and 961 for members of an affiliated group of corporations that elects to file a consolidated return for U.S. tax purposes.

PTEP and related basis adjustments

In general, the 2024 Proposed Regulations would treat members of a consolidated group as a single covered shareholder for purposes of section 959. As a result, a consolidated group would maintain a single set of annual PTEP accounts, dollar basis pools, and PTEP tax pools with respect to a foreign corporation, the stock of which is owned by one or more members of the consolidated group. These annual PTEP accounts are intended to enable the consolidated group to track the foreign corporation's PTEP with respect to the group.

In contrast, the 2024 Proposed Regulations would primarily adopt a separate-entity approach for purposes of determining related basis adjustments to the stock of a foreign corporation under section 961. In this regard, the 2024 Proposed Regulations would require a member to separately determine its basis in its directly held property units, as defined above, with the result that adjustments to the basis of section 961(a) ownership unit are generally computed using a separate-entity methodology.

KPMG observation

The single-entity approach for section 959 is consistent with other international provisions related to consolidated groups, such as the rules for determining the group's consolidated section 250 deduction attributable to GILTI or foreign derived intangible income (**"FDII"**). It is also consistent with recent regulations that treat a consolidated group as a single entity for purposes of applying section 951(a)(2)(B) to CFC-to-CFC PTEP distributions in the context of certain intercompany transfers of stock of a CFC. It is, however, inconsistent with the separate-entity approach that Treasury adopted for purposes of determining whether a member of a consolidated group qualified for a deemed paid credit under section 902, before its repeal in the TCJA.

In support of this single-entity approach, Treasury raised the concern that a consolidated group could alter the characterization of a distribution from a foreign corporation by adjusting the ownership within the consolidated group, effectively electing in or out of PTEP distributions by changing the ownership structure of the group's foreign corporations. By applying single-entity treatment, a consolidated group would, in theory, be agnostic as to the location of a foreign corporation in the group for purposes of determining whether distributions from the corporation to a member are made out of PTEP, as the location of the foreign corporation within the group would not change the group's characterization of a distribution by the foreign corporation. Further, the relevant amount of the consolidated group's accounts is allocated among the member shareholders in proportion to each member shareholder's share of the item (*e.g.*, for purposes of computing foreign currency gain or loss under section 986(c)).

However, in the context of basis adjustments under section 961, Treasury would adopt a separate-entity, or member-by-member, approach. This approach raises the specter of potential gain recognition under section 961(b)(2), for example, if the recipient of a PTEP distribution does not have sufficient section 961(a) basis to absorb the distribution. This approach also represents a sharp departure from the 2006 Proposed Regulations, which permitted basis shifting between members of a consolidated group. As noted in the preamble, Treasury rejected this approach in order to foreclose

> opportunities for basis shifting among members without a concomitant economic change to the members' relative investments in the foreign corporation.

Interests in lower-tier CFCs

The 2024 Proposed Regulations also provide rules under section 961 for interests in lower-tier CFCs, *i.e.,* derivative ownership units and section 961(c) ownership units. These rules would generally apply a single-entity approach, by treating a consolidated group as a single covered shareholder. However, the 2024 Proposed Regulations would also include special rules to prevent basis shifting among members with respect to these property units, which, under certain circumstances, may result in gain recognition if the derivative basis of a member is insufficient to absorb the distribution.

In this manner, 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. A reduction in derived basis for a partnership or section 961(c) basis for a CFC owned by group members, however, is initially computed separately for the separate group members and then recombined at the partnership/CFC-level to reach a single derived basis amount/section 961(c) basis amount for each share (or block) of lower-tier CFC stock held by the partnership or CFC.

Joining or leaving a group

The 2024 Proposed Regulations would also address the PTEP and section 961 basis consequences to members leaving or entering a consolidated group. In general, these rules would provide for single-entity treatment. For example, if a shareholder of a foreign corporation joins a consolidated group, solely for purposes of sections 959 and 961, the transaction is treated as if the group directly acquired the stock in the foreign corporation. Consequently, any PTEP in the joining member's annual PTEP accounts with respect to the foreign corporation are added to the consolidated group's annual PTEP accounts, and a CFC's section 961(c) basis with respect to the joining member in a section 961(c) ownership unit is added to the CFC's section 961(c) basis with respect to the consolidated group in that property unit.

If a shareholder of a corporation leaves a consolidated group, it is treated as if the group directly disposed of the stock in the foreign corporation. Accordingly, any PTEP in the consolidated group's annual PTEP accounts with respect to the foreign corporation is allocated between the consolidated group and the departing member shareholder. A CFC'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.

> **KPMG observation**
>
> Any changes to the consolidated group structure as a result of a member joining or leaving the group would need to be tracked in the PTEP accounts of the consolidated group and the foreign corporations owned by the consolidated group. These structural changes would likely impose additional administrative and compliance burdens and could place a greater premium on taxpayers obtaining access to the books and records of domestic corporate targets, and their CFCs, as part of the customary M&A due diligence process.

Requests for comments

The preamble requests comments on a number of unresolved questions and open issues by March 3, 2025, and, specifically, regarding the following topics, many of which are discussed in greater detail above:

- Adjustments to Shareholder-Level Accounts;
- Allocation and apportionment of deductions under section 861, particularly where some, but not all, of a distribution (or gain recognized) is attributable to PTEP;
- Successor transactions involving the acquisition of stock of a foreign corporation that results in a change of ownership of the stock;
- Treatment and scope of the rules related to deemed covered shareholders, specifically with respect to transfers of PTEP and derived basis or section 961(c) basis;
- Allocation of basis to and among property unit adjustments;
- Increases to basis under the actual distribution rule in Prop. Treas. Reg. § 1.961-3(d)(3);
- Limitations on negative derived basis and negative section 961(c) basis;
- Adjustments to basis for deemed dividends under sections 1248(c)(2) or 964(e)(1);
- Interaction of derived basis with rules regarding distributions by a partnership (*e.g.*, sections 732 and 734);
- Interaction of derived basis under the dividend recharacterization rules of section 1248;
- Application of section 1248 when stock of a foreign corporation is owned by or through a partnership;
- Application of section 959(b) and section 961(c) at the shareholder level;
- Allocation of tested items in cases where a covered item is excluded from subpart F income by reason of de minimis rule;
- Foreign currency gain or loss;
- Foreign trusts and estates;
- Passive foreign investment companies (**"PFICs"**); and
- Interaction with existing section 962 regulations.

Along with these specific requests for comment, Treasury has requested comments on all aspects of the 2024 Proposed Regulations, more generally.

KPMG observation

The detailed list of specific requests for comments, although extensive, is not exclusive, as Treasury has invited comments on all aspects of the 2024 Proposed Regulations. Furthermore, notwithstanding the complex nature of the issues raised by the 2024 Proposed Regulations, taxpayers will need to quickly analyze the potential impact of these proposed rules, not only in terms of the impact on their existing structures, distribution plans, and pending or potential M&A activity, for example, but also in light of the forthcoming March 3, 2025, comment deadline, should they choose to submit comments.

Appendix

Appendix A – PTEP Groups and Subgroups

Section 959(c)(1)		**Section 959(c)(2)**	
PTEP Group/ Subgroup	Description	PTEP Group/ Subgroup	Description
General section 959(c)(1) PTEP group	Section 959(c)(1) PTEP not described in another group	Section 951(a)(1)(A) PTEP group	Section 959(c)(2) PTEP not described in another group
• Section 962 Subgroup	Reclassed taxable portion of PTEP from a CFC inclusion for which a section 962 election was made	• Section 962 Subgroup	Taxable portion of PTEP from a CFC inclusion for which a section 962 election was made
• Section 1411 Subgroup	Reclassed PTEP from a CFC inclusion for which an election under Treas. Reg. §1.1411-10(g) is not in effect	• Section 1411 Subgroup	PTEP from a CFC inclusion for which an election under Treas. Reg. §1.1411-10(g) is not in effect
Reclassified section 951A PTEP group	Reclassified PTEP from a GILTI inclusion	Section 951A PTEP group	PTEP from a GILTI inclusion
• Section 962 Subgroup	Reclassed taxable portion of PTEP from a CFC inclusion for which a section 962 election was made	• Section 962 Subgroup	Taxable portion of PTEP from a CFC inclusion for which a section 962 election was made
• Section 1411 Subgroup	Reclassed PTEP from a CFC inclusion for which an election under Treas. Reg. §1.1411-10(g) is not in effect	• Section 1411 Subgroup	PTEP from a CFC inclusion for which an election under Treas. Reg. §1.1411-10(g) is not in effect
Reclassified section 245A(d) PTEP group	Reclassified PTEP for inclusions to which section 245A(d) apply	Section 245A(d) PTEP group	PTEP for inclusions to which section 245A(d) apply
Reclassified section 965(a) PTEP group	Reclassified section 965(a) PTEP	Section 965(a) PTEP group	PTEP from section 965(a) inclusions
Reclassified section 965(b) PTEP group	Reclassified section 965(b) PTEP	Section 965(b) PTEP group	PTEP arising from a foreign corporation having negative E&P

			under section 965(b)

Appendix B – Timing of Adjustment to Annual PTEP Accounts

Timing of Annual PTEP Account Adjustments	
Description of Adjustment	**Timing of Adjustment**
Increase for a subpart F inclusion	Beginning of the first day of the tax year
Increase for a GILTI inclusion	Beginning of the first day of the tax year
Increase for receiving PTEP from a lower-tier CFC	Beginning of the first day of the tax year
Increase for PTEP resulting from section 961(c) basis applied to gain (discussed above in Part Section 961: Basis Adjustments, above)	Beginning of the first day of the tax year
Decrease for current year foreign taxes allocated to PTEP as a result of a CFC receiving PTEP or applying section 961(c) basis to gain	Beginning of the first day of the tax year
Decrease for PTEP distributed by the CFC	Concurrently with the distribution
Increase for amounts included in income as a dividend under section 1248 as the result of a sale or exchange of a CFC	Concurrently with the sale or exchange of the CFC
Decrease for PTEP transferred in a general successor transaction	Concurrently with the general successor transaction
Increase for PTEP transferred in a general successor transaction	Concurrently with the general successor transaction
Reassign PTEP from section 959(c)(2) to 959(c)(1) in connection with determining a section 956 inclusion	End of the last day of the tax year
Increase for a section 956 inclusion	End of the last day of the tax year

Any adjustments that occur at the same time are sequentially taken into account in the order in the table.

Contact us

For more information, contact a KPMG tax professional in Washington National Tax:

Douglas Poms
T: +1 (202) 533-3073
E: dpoms@kpmg.com

Gary Scanlon
T: +1 (202) 533-4651
E: gscanlon@kpmg.com

David De Ruig
T: +1 (415) 963-5100
E: dderuig@kpmg.com

Jake Burgers
T: +1 (612) 305-5472
E: jburgers@kpmg.com

Kevin Brogan
T: +1 (202) 533-3425
E: kevinbrogan@kpmg.com

Kristen Gamboa
T: +1 (202) 533-4146
E: kgamboa@kpmg.com

Timothy Chan
T: +1 (949) 885-5730
E: timothyychan@kpmg.com

Beverly Katz
T: +1 (202) 533-3820
E: beverlykatz@kpmg.com

Stephen Massed
T: +1 (202) 533-4738
E: smassed@kpmg.com

Barbara Rasch
T: +1 (213) 533-3382
E: brasch@kpmg.com

Gloria LaBerge
T: +1 (713) 319-2000
E: glaberge@kpmg.com

Matthew Sorenson
T: +1 (612) 305-5219
E: matthewsorensen@kpmg.com

www.kpmg.com
kpmg.com/socialmedia