December 28, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC  20224

Re:  Comments on Proposed Regulations Under Sections 959 and 961

Dear Commissioner Koskinen:

Enclosed please find comments on the exclusion from gross income of previously taxed earnings and adjustment to basis of stock in controlled foreign corporations under sections 959 and 961 (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

CCs:  William Wilkins, Chief Counsel, Internal Revenue Service
      Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
      Steven Musher, Associate Chief Counsel (International), Internal Revenue Service
      Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
      Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON EXCLUSION FROM GROSS INCOME OF PREVIOUSLY TAXED EARNINGS AND ADJUSTMENT TO BASIS OF STOCK IN CFCS UNDER SECTIONS 959 AND 961

These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Jeffrey S. Korenblatt, with helpful contributions from John Bates of the Committee on Foreign Activities of U.S. Taxpayers ("FAUST"). The Comments were reviewed by Paul J. Crispino, Chair of FAUST, and Robert J. Peroni, Academic Vice-Chair of FAUST. The Comments were further reviewed by Joseph Calianno, on behalf of the Section's Committee on Government Submissions, by Alan I. Appel, the Section's Council Director for FAUST, and by Peter H. Blessing, the Section's Vice-Chair for Government Relations.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date: December 28, 2015
EXECUTIVE SUMMARY

Sections 959 and 961 generally provide rules to prevent double taxation of income that has already been taxed once under the subpart F anti-deferral regime (sections 951 to 965). The existing regulations under these sections were issued in 1965 and have since been amended several times. In 2006, the Internal Revenue Service (the “Service”) and the Department of Treasury (“Treasury”) issued proposed regulations under sections 959 and 961 (the “Proposed Regulations”). This comment letter discusses several discrete issues raised by the Proposed Regulations.

Sections 959 and 961 are intended to prevent a U.S. shareholder from being taxed a second time when earnings that gave rise to a deemed distribution under subpart F are distributed by a “controlled foreign corporation” within the meaning of section 957(a) (“CFC”) or when the U.S. shareholder sells its stock in the CFC. Section 959 reflect a policy of excluding “previously taxed earning and profits” or “previously taxed income” (“PTI”) from gross income of the U.S. shareholder at the earliest appropriate time.

When section 304(a)(1) applies to a sale of stock in one corporation to an affiliated corporation, the property received by the shareholder (e.g., the sales proceeds) is treated as received in a distribution in redemption of stock of the acquiring corporation. Under section 301(c)’s ordering rule, the distribution would be treated first as a dividend as provided under section 316, second as a reduction in the shareholder’s basis in the stock of the acquiring corporation, and third as gain from the deemed sale or exchange of such stock.

Section 304(b)(2) provides that for purposes of determining the amount of the deemed distribution treated as a dividend, the current and accumulated earnings and profits (“E&P”) of both the acquiring corporation and the issuing corporation are taken into account. Reference is made first to the acquiring corporation to the extent of its current and accumulated E&P (section 304(b)(2)(A)) and second to the issuing corporation to the extent of its current and accumulated E&P (section 304(b)(2)(B)). The E&P of the relevant corporation is reduced to the extent its E&P is taken into account under section 304(b)(2).

The Proposed Regulations build on several of the policies set forth in sections 959 and 961. They would require PTI accounts to be maintained both at the shareholder level and the CFC level, which accounts would be adjusted for subsequent transactions. As discussed below, the Proposed Regulations also implement and expand upon section 959(c)’s PTI-first policy, including through rules that permit the sharing of PTI on a block basis and on an affiliate basis. In particular, the cross-affiliate PTI sharing rule effectively would allow PTI from one member

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1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), and to the Regulations promulgated thereunder, unless otherwise indicated.
4 I.R.C. § 312(a).
of an affiliated group that files a consolidated federal income tax return to shield a distribution or section 956 amount with respect to another member.\textsuperscript{5}

While addressing section 304 transactions, the Proposed Regulations do not explicitly address the section 304(b)(2) distribution sourcing or ordering rule as it applies to PTI. Hence, it is unclear whether the Proposed Regulations intend that the “PTI-first” approach overrides the general ordering rule of section 304(b)(2).

Our principal suggestions regarding the following discrete issues raised by the Proposed Regulations may be summarized as follows:

(A) Comments regarding section 304 transactions:

(1) Final regulations should permit a selling shareholder in a section 304(a)(1) transaction to source distributions to the PTI accounts of other members of the shareholder’s section 304(c) control group.

(2) Final regulations should clarify whether the E&P and PTI ordering rules apply in a manner consistent with section 304(b)(2).

(3) Final regulations should permit certain shareholders to recover PTI in a section 304(a)(2) transaction.

(B) Comments on the effect of E&P deficits on PTI distributions:

(1) Final regulations should clarify the effect on a shareholder’s PTI account where a CFC with an accumulated deficit and no current E&P makes a distribution. We believe that in such a case, the non-PTI E&P deficit should not reduce the U.S. shareholder’s PTI account.

(2) Final regulations should clarify whether distributions from an upper-tier CFC not attributable to PTI in a lower-tier CFC reduce PTI basis in the stock of the upper-tier CFC. We believe that, in such a case, none of the U.S. shareholder’s basis relating to the lower-tier CFC’s PTI should be available to support distributions from the upper-tier CFC.

DETAILED DISCUSSION

I. Background

A. Subpart F Generally

A U.S. person generally is not subject to tax on earnings of a foreign subsidiary of which the person owns stock until the subsidiary distributes the earnings in the form of dividends. This concept is referred to as “deferral,” and there are several “anti-deferral” regimes in the Code, the most prominent of which is subpart F.

Under section 951(a)(1), a “United States shareholder” within the meaning of section 951(b) (a “U.S. shareholder”) with respect to a “controlled foreign corporation” within the meaning of section 957(a) (“CFC”) is required to include in its gross income its pro rata share of certain earnings of the CFC on a current basis (that is, in the U.S. shareholder’s taxable year in or with which the taxable year of the CFC ends). In general, a U.S. shareholder is required to take into account its share of both (1) certain types of passive and mobile income, hereinafter referred to as “subpart F income,” earned by the CFC and (2) certain earnings of the CFC invested in “United States property” (“U.S. property”). Subpart F income includes, among other categories of income, “foreign base company sales income,” “foreign base company services income,” and “foreign personal holding company income.”

Section 956 governs the amount a U.S. shareholder must take into account as a result of a CFC’s investment in U.S. property (the “section 956 amount”). Conceptually, section 956 provides a backstop for subpart F, permitting a CFC to use its income that is not subpart F income to acquire certain types of property with nexus to the United States only if the amounts are included ratably in the gross income of the CFC’s U.S. shareholders as if distributed. The theory underlying section 956 is that such investments can be the economic equivalent of a dividend distribution to the CFC’s U.S. shareholders and should be taxed in the same manner.

B. Sections 959 and 961

1. Section 959

The U.S. shareholder’s subpart F inclusion determined under section 951(a) is implemented through a deemed distribution mechanism. Sections 959 and 961, therefore, are

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6 I.R.C. §§ 952(a), 954(a).
7 The amount determined under section 956 equals the lesser of (i) the excess of the U.S. shareholder’s pro rata share of the average amounts of U.S. property held by the CFC as of the close of each quarter of its taxable year, over the amount of earnings and profits (“E&P”) described in section 959(c)(1)(A), or (ii) the shareholder’s pro rata share of the “applicable earnings” of the CFC. Section 951(a)(1). A CFC’s applicable earnings equal the sum of the accumulated E&P of the CFC described in section 316(a)(1) (but not taking into account an accumulated E&P deficit) and the CFC’s current-year E&P described in section 316(a)(2), but reduced by current-year distributions of E&P and E&P described in section 959(c)(1). The amount taken into account with respect to United States property generally is determined by reference to the CFC’s adjusted basis in the property. I.R.C. § 956(a)(1).
necessary to prevent the U.S. shareholder from being taxed a second time when the earnings that
gave rise to a deemed distribution under subpart F are actually distributed by the CFC or when
the U.S. shareholder sells its stock in the CFC.

The provisions of section 959 reflect a policy of excluding “previously taxed earnings
and profits” or “previously taxed income” (“PTI”) from gross income of the U.S. shareholder at
the earliest appropriate time. Consequently, section 959 provides a “PTI-first” distribution
ordering rule. Section 959(a)(1) generally excludes from a U.S. shareholder’s gross income any
distributions by a CFC of E&P that is attributable to amounts that are or have been included in
the U.S. shareholder’s gross income under section 951(a). Section 959(a)(2) provides an
analogous rule for section 956 amounts, excluding from a U.S. shareholder’s gross income
amounts that are or have been included in a U.S. shareholder’s gross income under section
951(a) and that would, but for the application of the provision, be again included as a section 956
amount under section 951(a)(1)(B).

Special rules are needed where a U.S. shareholder has a subpart F inclusion with respect
to a CFC in which the U.S. shareholder does not hold stock directly (a “lower-tier CFC”). The
subpart F inclusion effectively “hopskotches” any intermediate upper-tier CFCs in that the lower-
tier CFC is not explicitly treated as having distributed the E&P giving rise to the subpart F
inclusion through the chain of CFCs to the U.S. shareholder. In order to avoid double taxation
under subpart F upon a subsequent actual distribution of the PTI to an upper-tier CFC, section
959(b) provides intermediate-CFC-level exclusions for PTI. It generally provides that when PTI
is distributed through a chain of ownership described in section 958(a) (i.e., direct and indirect
ownership, but not constructive ownership as described in section 958(b)), it is not included in
the gross income of a distributee intermediate CFC for purposes of determining the subpart F
income of the distributee CFC. Without this rule, the distribution of the PTI could give rise to a
second inclusion to the extent the distribution constituted foreign personal holding company
income.

Section 959(c) establishes three categories of E&P of a CFC and provides ordering rules
for implementing the exclusions for distributions of PTI.

- PTI attributable to section 956 amounts that were included in the U.S. shareholder’s gross
  income under section 951(a)(1)(B) is described in section 959(c)(1) (“959(c)(1) PTI”).
- PTI attributable to amounts included in a U.S. shareholder’s gross income under section
  951(a)(1)(A) is described in section 959(c)(2) (“959(c)(2) PTI”).
- Other, non-PTI E&P is described in section 959(c)(3) (“959(c)(3) E&P”).

Section 959(c) implements the general PTI-first policy by providing that for purposes of
applying the operative exclusionary rules of section 959(a) and section 959(b), a distribution of
E&P by a CFC is allocated (i) first to 959(c)(1) PTI, (ii) second to 959(c)(2) PTI, and (iii) third

8 “Section 959 was enacted so that PTI is excluded from gross income and, thus, not taxed again when distributed
by the foreign corporation. Moreover, section 959 effects the relevant gross income exclusion at the earliest
9 Cf. I.R.C. § 960(c).
to 959(c)(3) E&P. Distributions of PTI generally are not treated as dividends, except that they reduce the E&P of the distributing CFC.  

Section 959(e) extends the PTI rules to constructive dividends taken into account under section 1248. It provides that any amount included in the gross income of any person as a dividend under section 1248(a) or (f) is treated as an amount taken into account under section 951(a)(1)(A), so that sections 959 and 961 apply by their terms. When applicable, section 1248(a) characterizes gain recognized from the sale or exchange of stock in a foreign corporation as a deemed dividend from such corporation, and section 1248(f) extends this treatment to certain nonrecognition transactions. Section 964(e) generally extends the recharacterization rules of section 1248 to sales or exchanges of foreign corporate stock by a CFC.

2. Section 961

Section 961 authorizes the Service and Treasury to issue corresponding basis adjustment rules necessary to prevent double taxation. To illustrate the function of section 961, suppose a U.S. shareholder had a subpart F inclusion with respect to a CFC, the CFC did not distribute the resulting PTI generated by the subpart F inclusion, and the U.S. shareholder subsequently sold its shares of stock in the CFC. If the U.S. shareholder did not increase its basis in its shares of the CFC’s stock in connection with the subpart F inclusion, it effectively could be taxed twice on the E&P giving rise to the inclusion. First, the U.S. shareholder would take into account the E&P through the subpart F inclusion and, second, it would take into account an amount realized on the sale that would be affected by the E&P. Presumably the fair market value of the stock would reflect the E&P, as it would not have been distributed. Thus, the U.S. shareholder would recognize more gain or less loss on the sale in the absence of appropriate basis adjustments.

Section 961(a) authorizes the Service and Treasury to provide regulations under which a U.S. shareholder increases its basis in stock of a CFC, or in property by reason of which it is considered to own such stock, by the amount it is required to include in gross income under section 951(a) with respect to such stock. Thus, at the time PTI is generated there is a parallel increase in the U.S. shareholder’s basis in the stock of the CFC.

Section 961(b) authorizes the Service and Treasury to provide regulations under which the U.S. shareholder decreases its basis in stock of the CFC, or in property by reason of which it is considered to own such stock, by the amount of any PTI distribution received by the U.S. shareholder with respect to such stock. Such a downward adjustment is needed so that the U.S. shareholder does not recognize a double benefit: first, an exclusion from gross income under section 959, and second, an effectively permanent increase in basis in the stock of the CFC under section 961(a).

Finally, section 961(c) addresses basis adjustments for a subpart F inclusion with respect to a lower-tier CFC. The provision authorizes the Service and Treasury to provide regulations under which basis adjustments similar to those in section 961(a) and section 961(b) are allowed for intermediate CFCs for purposes of determining the amount included in gross income of the

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10 I.R.C. § 959(d).
C. Section 304

1. Section 304, Generally

Section 304 recasts certain related-party stock transactions as stock redemptions subject to section 302. Sections 302 and 303 then apply to such deemed redemption, with the result that, in a “brother-sister” section 304 transaction, the transaction often gives rise to a deemed section 301 distribution.\textsuperscript{12}

Generally, the policy behind section 304 is to preclude a “bailout” of a corporation’s E&P in a transaction formally structured as a sale that would give rise to capital gain or loss but that is economically similar to a dividend distribution of the E&P. As an example illustrating the policy, assume a shareholder owns all of the stock of two corporations, Corporation A and Corporation B. But for the application of section 304, the shareholder could sell the stock of Corporation B to Corporation A for cash, utilize existing basis, and recognize capital gain or loss. Nonetheless, after the transaction, the shareholder would continue to own, albeit indirectly, all of the stock of Corporation B. Economically, the sale would be similar to a distribution of cash by Corporation A to the shareholder, all or part of which might have constituted a dividend under section 301.

Section 304(a)(1) applies to “brother-sister” section 304 transactions, and section 304(a)(2) applies to “parent-subsidiary” section 304 transactions. Transactions that would constitute both brother-sister and parent-subsidiary section 304 transactions are treated as constituting only parent-subsidiary section 304 transactions.\textsuperscript{13}

2. Brother-Sister Section 304 Transactions

Under section 304(a)(1), if (i) one or more persons are in control of each of two corporations and (ii) one corporation (the “acquiring corporation”) acquires the stock of the other corporation (the “target corporation”) from the controlling person or persons in exchange for money or other property, the transaction is recast as a redemption of stock. For these purposes, a person or persons control the acquiring and target corporation if they owns at least 50 percent of the voting power or value of all classes of stock of each of the corporations, and certain constructive ownership rules apply for these purposes.\textsuperscript{14}

If section 304(a)(1) applies, the money or other property received by the shareholder (the sale proceeds) is treated as received in a distribution in redemption of stock of the acquiring corporation. To the extent the deemed redemption is a distribution to which section 301 applies,\textsuperscript{11}

\textsuperscript{11} In accordance with section 961(c), the intermediate CFC’s basis adjustment is made “only for the purposes of determining the amount included under section 951” in the gross income of the U.S. shareholder.
\textsuperscript{12} I.R.C. § 302(d).
\textsuperscript{13} I.R.C. § 304(a)(1).
\textsuperscript{14} I.R.C. § 304(c).
(i) the shareholder is treated as transferring the stock of the target corporation to the acquiring corporation in exchange for stock in the acquiring corporation in a transaction to which section 351(a) applies (i.e., a contribution to the capital of the acquiring corporation eligible for nonrecognition treatment), and (ii) the acquiring corporation is treated as transferring the money or other property to the shareholder in redemption of the deemed issued stock.\(^{15}\)

Section 304(b)(2) provides that for purposes of determining the amount of the deemed distribution treated as a dividend, the current and accumulated E&P of both the acquiring corporation and the target corporation are taken into account. Reference is made first to the acquiring corporation to the extent of its current and accumulated E&P (section 304(b)(2)(A)) and second to the target corporation to the extent of its current and accumulated E&P (section 304(b)(2)(B)). The E&P of the relevant corporation is reduced to the extent its E&P is taken into account under section 304(b)(2).\(^{16}\)

The Service addressed the application of the indirect foreign tax credit rules of section 902 in the context of a section 304(a)(1) transaction involving a domestic corporation as the selling shareholder, a foreign target corporation, and a foreign acquiring corporation.\(^{17}\) The selling shareholder did not actually own any stock of the acquiring corporation, which was a first-tier foreign subsidiary of another domestic corporation, which owned all of the stock of the selling shareholder. Based on the legislative history behind section 304(b)(2), the ruling concluded that, despite the fact that the selling shareholder did not actually own any stock of the acquiring corporation, the selling shareholder would be considered to own 10 percent of the voting stock of the acquiring corporation for purposes of section 902, so that for such purposes it would be deemed to have paid foreign taxes in connection with the portion of the distribution sourced from the E&P of the acquiring corporation.\(^{18}\)

The Service subsequently addressed the application of U.S. “FDAP” withholding rules of sections 1441 and 1442 and U.S. income tax treaties in the context of section 304(a)(1)
transactions.19 Situation 1 of Revenue Ruling 92-85, involved a foreign corporation as the selling shareholder, a domestic acquiring corporation, and a foreign target corporation. The ruling respected the distribution sourcing rules of section 304(b)(2) for withholding and treaty purposes, concluding that (i) the portion of the deemed distribution sourced to the E&P of the domestic acquiring corporation was subject to U.S. withholding, (ii) the U.S. income tax treaty with the country in which the selling shareholder was organized was the relevant treaty for purposes of determining whether a reduced rate of withholding was applicable, and (iii) the portion of the deemed distribution sourced to the E&P of the foreign target corporation was not subject to U.S. withholding tax. In Situation 2 of the ruling, the Service applied a consistent approach to a section 304(a)(1) transaction involving a foreign corporation as the selling shareholder, a foreign acquiring corporation, and a domestic target corporation.

3. Parent-Subsidiary Section 304 Transactions

Under section 304(a)(2), if (i) a corporation (the “acquiring corporation”) acquires the stock of another corporation (the “parent corporation”) from a shareholder of the parent corporation in exchange for money or other property, and (ii) the parent corporation “controls” the acquiring corporation, the money or other property is treated as having been distributed in redemption of the stock of the parent corporation. For these purposes, the parent corporation controls the acquiring corporation if it owns stock of the acquiring corporation representing at least 50 percent of the voting power or value of all classes of stock, applying certain constructive ownership rules.20

If the deemed redemption constitutes a distribution under section 301, section 304(b)(2) applies for purposes of determining the amount of the deemed distribution treated as a dividend. The current and accumulated E&P of both the acquiring corporation and the parent corporation are taken into account, with reference first made to the E&P of the acquiring corporation and then to the E&P of the parent corporation.21

Prior to changes to section 304(b)(2) enacted in 1984, to determine the portion of the deemed distribution constituting a dividend, the property was treated as distributed first by the acquiring corporation to the parent corporation and second by the parent corporation to the selling shareholder. The Service initially took the position that this rule caused the parent corporation to recognize a constructive dividend from the acquiring corporation, under section 301.22 This position was rejected by several courts, which concluded that the rule was directed at increasing the E&P available for purposes of characterizing the deemed distribution by the parent corporation and did not cause the parent corporation to recognize a constructive dividend.23 The Service subsequently modified its position, following the holdings of these cases.24

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20 I.R.C. § 304(c).
21 I.R.C. § 304(b)(2)(A), (B).
23 See, e.g., Webb v. Commissioner, 67 T.C. 293 (1976), aff’d per curiam 572 F.2d 135 (5th Cir. 1978).
Section 304(b)(6) authorizes the Service and Treasury to issue regulations preventing multiple inclusions of an item of income and to provide appropriate basis adjustments in section 304 transactions in which either the acquiring corporation or target or parent corporation is a foreign corporation. The provision makes specific reference to sections 959 and 961, and the legislative history clarifies that the regulations are expected to provide exclusions for distributions of PTI of the acquiring corporation, the target or the parent corporation and appropriate basis adjustments.

II. Proposed Regulations

The Proposed Regulations would, if finalized, build on several of the policies delineated in the statutory provisions of section 959, section 961 and the existing final regulations.

A. PTI Accounts

The Proposed Regulations would require PTI accounts to be maintained at both the shareholder and CFC levels. The shareholder-level account is maintained on a share-by-share basis, although a shareholder can maintain a single PTI account for blocks of identical shares. The shareholder must identify the 959(c)(1) PTI and 959(c)(2) PTI attributable to the stock for each year of the CFC. The CFC, in comparison, must maintain aggregate 959(c)(1) PTI, 959(c)(2) PTI, and 959(c)(3) E&P accounts. The Proposed Regulations call for adjustments to such shareholder-level and CFC-level accounts for relevant transactions.

B. PTI-First Ordering Policy

The Proposed Regulations implement and expand upon section 959(c)’s PTI-first policy. In the case of a distribution of E&P, the amount the shareholder excludes from gross income is equal to the amount by which the shareholder’s PTI accounts are decreased, with the shareholder first reducing its 959(c)(1) PTI account (but not below zero) and then reducing its 959(c)(2) PTI account (again, but not below zero) to the extent of the distribution. The Proposed Regulations then expand upon the statutory PTI-first policy in two important ways, through what is referred to as “cross-block PTI sharing” and “cross-affiliate PTI sharing” rules.

The cross-block PTI sharing rule effectively allow a shareholder to utilize PTI attributable to one share or one block of shares that it directly owns to shield a distribution with respect to another share or block of shares that it directly owns to the extent the distribution would exceed the PTI attributable to the latter share or block (an “excess distribution amount”). The shareholder increases its PTI account with respect to the PTI-deficient shares and reduces its

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PTI accounts for its other stock on a pro rata basis.\textsuperscript{31} A similar rule is provided to allow cross-block sharing to shield section 956 amounts.\textsuperscript{32}

The cross-affiliate PTI sharing rule effectively allows a PTI account with respect to one member of an affiliated group that files a consolidated federal income tax return to shield a distribution or section 956 amount received by another member.\textsuperscript{33} The mechanisms of increasing and decreasing share-related PTI accounts under the cross-affiliate PTI sharing ruling are similar to those applicable in the case of the cross-block PTI sharing rule and described above.

C. Distributions, Basis, Deficit Rules, and Associated Rules

The Proposed Regulations contain a number of rules that, as discussed below, interact together in a way that may require further clarification when the regulations are made final. First, the Proposed Regulations provide that “any distribution excluded from gross income of a covered shareholder under section 959(a)(1) and section 1.959-1(c)(1) shall be treated, for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Code as a distribution which is not a dividend, except such a distribution shall immediately reduce earnings and profits.”\textsuperscript{34}

In a second deviation from the normal treatment accorded E&P, the Proposed Regulations provide that “If a foreign corporation has a deficit in earnings and profits, as determined under section 964(a) and section 1.964-1, for any taxable year, a covered shareholder’s previously taxed earnings and profits account with respect to its stock in such foreign corporation shall not be adjusted to take into account the deficit and the deficit shall be applied only to the non-previously taxed earnings and profits of the foreign corporation.”\textsuperscript{35} The Proposed Regulations provide the following example of this rule: DP, a United States shareholder, owns 100% of the only class of stock in FC, a CFC. Both DP and FC use the calendar year as their taxable year. FC uses the “u” as its functional currency. At the end of Year 1, FC has 50u of section 959(c)(2) earnings and profits and 400u of non-previously taxed earnings and profits. FC has a net deficit in earnings and profits of 500u for year 2. Explaining the consequences, the example provides that:

At the end of year 2, DP's section 959(c)(2) earnings and profits for year 1 remains at 50u, pursuant to paragraph (e)(5) of this paragraph, because a shareholder's previously taxed earnings and profits account is not adjusted to take into account the CFC's deficit in earnings and profits. Pursuant to paragraph (e)(4) of this section, at the end of year 2, FC's non-previously taxed earnings and

profits are reduced to (100u), and no adjustment is made to FC’s previously taxed earnings and profits, which remains at 50u.\(^{36}\)

With respect to basis adjustments under section 961, the Proposed Regulations generally provide for increases and reductions in the basis of foreign corporation stock or other property through which foreign corporation stock is owned that match the increases and reductions in the PTI account with respect to such stock under the section 959 proposed regulations. In this regard, the section 961 Proposed Regulations provide that “the adjusted basis of a covered shareholder’s stock in a foreign corporation or property (as defined in section 1.961-1(c)) by reason of the ownership of which such covered shareholder is considered under section 958(a) as owning stock in a foreign corporation shall be reduced under section 961(b) each time, and to the extent, that such covered shareholder’s dollar basis in a previously taxed earnings and profits account with respect to the stock in such foreign corporation is decreased pursuant to the steps outlined in section 1.959-3(e)(2).”\(^{37}\)

The section 959 Proposed Regulations, in turn, provide that a covered shareholder is to “Decrease the amount of the section 959(c)(1) earnings and profits in the account (but not below zero), and then the amount of section 959(c)(2) earnings and profits in the account (but not below zero) by the amount of earnings and profits distributed to the covered shareholder during the year with respect to such stock, [and] decrease the dollar basis in the account by the dollar amount attributable to the distributed earnings and profits…. ”\(^{38}\)

D. Section 304 Transactions

1. Treatment of Stock Redemptions, Generally

The Proposed Regulations clarify that the PTI consequences of a stock redemption transaction depends on whether the redemption constitutes an exchange of the stock or a distribution to which section 301 applies. This reflects a principle that the PTI consequences follow from the subchapter C characterization of a transaction. If the redemption is characterized as an exchange of the stock under section 302 or 303, the shareholder’s PTI account for the redeemed stock is eliminated.\(^{39}\)

If the redemption is characterized as a distribution to which section 301 applies, the PTI rules apply as they would with respect to any distribution to which section 301 applies.\(^{40}\) Any excess of the PTI account with respect to the redeemed shares over the amount chargeable to the E&P of the distributing corporation is reallocated among the shareholder’s other shares of stock consistently with, and in proportion to, the reallocation of the shareholder’s basis in the redeemed stock under the applicable section 302 regulations.\(^{41}\) Presumably these general rules


applicable to redemptions apply to deemed redemptions in section 304 transactions under the Proposed Regulations.

2. Cross-Affiliate PTI Sharing in Section 304(a)(1) Transactions

Consistent with the principle reflected in the cross-affiliate PTI sharing rule, the Proposed Regulations provide a taxpayer-favorable rule that treats a shareholder that is deemed to receive a distribution to which section 301 applies in a section 304(a)(1) transaction as having PTI accounts in each foreign corporation treated as distributing its E&P under section 304(b)(2), even if the person did not otherwise have a PTI account with respect to the corporations. Under certain circumstances, this rule allows for cross-affiliate PTI sharing of PTI where an affiliate is deemed to receive a distribution from a CFC in a brother-sister redemption but does not actually own stock, directly or indirectly, in the CFC. It is illustrated with an example:

DP, a domestic corporation, owns all of the stock in DS, a domestic corporation, and F1, a CFC. DP and DS are members of the same consolidated group. DS owns all of the stock in F2, a CFC. DP, DS, F1 and F2 all use the calendar year as their taxable year and F1 and F2 each use the U.S. dollar as its functional currency. During year 1, F1 purchases all the stock in F2 from DS for $80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of F2’s stock, DP has a previously taxed earnings and profits account consisting of $20x of section 959(c)(2) earnings and profits with respect to its stock in F1, and F1 has previously taxed earnings and profits consisting of $20x of section 959(c)(2) earnings and profits and non-previously taxed earnings and profits of $10x. At the end of year 1, before taking into account the purchase of F2’s stock, DS has a previously taxed earnings and profits account consisting of $50x of section 959(c)(2) earnings and profits and profits with respect to its stock in F2, and F2 has section 959(c)(2) earnings and profits of $50x and non-previously taxed earnings and profits of $0.

Under section 304(a)(1), DS is deemed to have transferred the F2 stock to F1 in exchange for F1 stock in a transaction to which section 351(a) applies, and F1 is treated as having redeemed, for $80x, the F1 stock deemed issued to DS. The payment of $80x is treated as a distribution of property to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend is made as if the distribution were made, first, by F1 to the extent of its earnings and profits ($30x), and then by F2 to the extent of its earnings and profits ($50x). Before taking into account the deemed distributions, DS had a previously taxed earnings and profits account consisting of $50x of section 959(c)(2) earnings and profits with respect to its stock in F2, and DP had had a previously taxed earnings and profits account consisting of $20x of section 959(c)(2) earnings and profits with respect to its stock in F1. Under [Prop. Reg. § 1.959-3(h)(4)(i)], DS has a previously taxed earnings and profits account with respect to

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the stock in F1. Under [the cross-affiliate PTI sharing rules], the section 959(c)(2) earnings and profits in DP’s previously taxed earnings and profits account with respect to the F1 stock are reduced from $20x to $0 and the section 959(c)(2) earnings and profits in DS’s previously taxed earnings and profits account with respect to the F1 stock are increased from $0 to $20x. The distribution by F1 causes the section 959(c)(2) earnings and profits in DS’s previously taxed earnings and profits account with respect to F1 stock to be reduced from $20x to $0, and causes F1’s section 959(c)(2) earnings and profits to be reduced from $20x to $0 and its non-previously taxed earnings and profits to be reduced from $10x to $0. The deemed distribution by F2 causes the section 959(c)(2) earnings and profits in DS’s previously taxed earnings and profits account with respect to F2 stock to be reduced from $50x to $0, and causes F2’s section 959(c)(2) earnings and profits to be reduced from $50x to $0. Of the distribution of $80x, $70x is excluded from DS’s gross income pursuant to §1.959-1(c)(1), and $10x is included in DS’s gross income as a dividend.

Prop. Reg. § 1.959-3(h)(4)(ii), Ex.

3. CFC-Level Exemption in Section 304(a)(1) Transactions

The Proposed Regulations also provide explicit guidance regarding the treatment of section 304(a)(1) transactions where the selling shareholder is a CFC, extending the CFC-level exclusion provided in section 959(b) to a section 301 distribution resulting from a section 304(a)(1) transaction, even if the selling CFC has neither direct nor indirect ownership in the acquiring CFC. Under Prop. Reg. § 1.959-2(b)(1), the selling CFC is deemed to receive the distribution through a chain of ownership described in section 958(a), so that section 959(b) applies by its terms. This rule is illustrated in the Proposed Regulations through an example of a section 304(a)(1) transaction involving a CFC selling shareholder and foreign acquiring and target corporations:

DP, a domestic corporation, owns all of the stock in two foreign corporations, FX and FY. FX owns all of the stock in foreign corporation FZ. DP, FX, FY, and FZ all use the calendar year as their taxable year and the U.S. dollar as their functional currency. During year 1, FY purchases all of the stock in FZ from FX for $80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of FZ’s stock, FY has section 959(c)(2) earnings and profits of $20x and non-previously taxed earnings and profits of $10x, and FZ has section 959(c)(2) earnings and profits of $50x and non-previously taxed earnings and profits of $0.

... 

Under section 304(a)(1), FX is deemed to have transferred the FZ stock to FY in exchange for FY stock in a transaction to which section 351 applies, and FY is treated as having redeemed, for $80x, the FY stock deemed issued to FX. The payment of $80x is treated as a distribution to which section 301 applies. Under
section 304(b)(2), the determination of the amount which is a dividend (and the source) is made as if the distribution were made, first, by FY to the extent of its earnings and profits, $30x, and then by FX to the extent of its earnings and profits, $50x. Under paragraph (c)(1) of this section, FX is deemed to receive the distributions from FY and FZ through a chain of ownership described in section 958(a). Under [Prop. Reg. § 1.959-2(a)], the amount of FY’s previously taxed earnings and profits, $20x, and the amount of FZ’s previously taxed earnings and profits, $50x, distributed to FX are excluded from the gross income of FX. Accordingly, only $10x is included in FX’s gross income.


4. E&P and PTI Ordering Rules

Although the Proposed Regulations do not explicitly discuss the section 304(b)(2) distribution sourcing or ordering rule as it applies to PTI, the examples appear to treat a distribution as coming first out of the E&P of the acquiring corporation and second out of the E&P of the target corporation, regardless of the extent to which the acquiring corporation has section 959(c)(3) E&P (“non-PTI E&P”) and the target corporation has PTI. Some commentators have suggested that it might be appropriate to adopt a PTI-first approach that would source a distribution out of the target corporation’s PTI before it is sourced out of the acquiring corporation’s section 959(c)(3) E&P.

III. Comments

We commend the Service and Treasury on the Proposed Regulations, which we believe represent a thoughtful and practical set of proposals that would resolve many issues long open under section 959 and 961 in a practical fashion. We believe, however, that the Proposed Regulations would benefit from the clarification of certain points regarding their application to transactions governed by section 304 generally. We also respectfully submit that the proposed rules governing the sharing of PTI among related shareholders within the context of section 304(a)(1) transactions may be too narrow and that they could be expanded in a manner that would be consistent both with the definition of “control” under section 304(c) and the PTI-first policy generally taken by the Proposed Regulations without increasing the possibility of inappropriate tax results. Additionally, we set forth below our responses to the request for comments regarding whether the PTI sharing rules should be made explicitly applicable to transactions described in section 304(a)(2). Finally, we suggest that some additional clarification may be required with respect to the interaction of the E&P deficit rules, the basis rules, and the general treatment of distributions.

43 Note that this reference appears to be a mistake; the reference should be to (b)(1).
A. Comments Regarding Section 304 Transactions

1. Final Regulations should permit a selling shareholder in a section 304(a)(1) transaction to source distributions to the PTI accounts of other members of the shareholder’s section 304(c) control group.

As a general matter, we commend the Service and Treasury on the cross-block PTI sharing and cross-affiliate PTI sharing rules. In particular, we recognize that the cross-affiliate sharing rules in Prop. Reg. § 1.959-3(g), described in section II.B. above, generally provide an administrable set of rules and a reasonable limitation on the sharing of PTI accounts among related parties. However, we respectfully submit that constraining the sharing of PTI within the context of section 304(a)(1) transactions to those cases in which the covered shareholder is a member of a consolidated group may be too narrow and, in fact, appears inconsistent with the policy and general rules of section 304. We suggest, instead, that the final version of Prop. Reg. § 1.959-3(h)(4)(i) be expanded to include a “Section 304(c) Control Group PTI sharing rule” that would be in parallel with and adapt the cross-affiliate PTI sharing rules of Prop. Reg. § 1.959-3(g).

The Proposed Regulations generally represent a sensible approach to the sharing of PTI among co-investor U.S. shareholders in CFCs.44 Presumably, the Service and Treasury believe that limiting PTI sharing to members of a consolidated group furthers the policy of allowing the recovery of PTI first while preventing tax avoidance. We believe, however, that such a narrow rule may be inconsistent with the deemed redemption fiction arising under the broader definition of “control” under section 304(c) and that rules modeled on the cross-affiliate PTI sharing rules can be applied to the section 304(c) control group without raising tax-avoidance concerns.45

As a preliminary matter, section 304(a) mandates that, where a section 304(c) control group exists, what is in form a sale must be recast as in substance a redemption. This result is predicated upon the conclusion that, where section 304(c) control exists, sufficient economic and ownership integration is present to require a selling shareholder to be treated as continuing to retain an interest in the issuing corporation and, in many instances, to recognize a deemed section 301(c)(1) distribution. Indeed, where section 304(c) control exists, the selling shareholder is deemed to have access, pursuant to section 304(b)(2), to E&P in an acquiring corporation in which, in fact, the seller has no direct stock ownership. Further, as discussed above, the Service and Treasury have concluded that the relationships identified under section 304(c) are significant enough to support allowing the selling shareholders to access foreign taxes in acquiring corporations in which they own no (or insufficient) direct stock ownership.46

Given the fact that section 304(c) control is deemed a sufficient reason for forcing deemed dividend treatment and accessing both E&P and foreign taxes even in the absence of

45 We recognize that permitting the shifting of basis within a consolidated group, or within a section 304(c) control group, may lead to inappropriate results when combined with the proper basis adjustment provisions of Reg. § 1.302-2(c). These results, however, appear to be attributable primarily to the proper basis adjustment provisions of Reg. § 1.302-2(c), and not to the recovery of PTI, such that anti-abuse concerns should be addressed in connection with the proper basis adjustment rules and not the sharing of PTI rules.
actual stock ownership, we believe it should also be deemed a sufficient reason to allow access to PTI of the acquiring or issuing (target) entity in a section 304(a)(1) transaction without further ownership restrictions. Indeed, the absence of such a rule is difficult to reconcile with section 304(b)(2), which already requires a selling shareholder to reference (and, therefore, recognize section 301(c)(1) dividend income with respect to) non-PTI E&P attributable to another shareholder’s stock ownership.

We suggest that introduction of a rule allowing for sharing of PTI among members of the same section 304(c) control group could be accomplished by building upon the architecture of the cross-affiliate PTI sharing rules proposed in Prop. Reg. § 1.959-3(g) and incorporating the rules in an expanded version of Prop. Reg. § 1.959-3(h)(4)(i) (described in section II.D.2. above). We further believe that the final version of Prop. Reg. § 1.959-2(b)(1) (described in section II.D.3. above) should contain a similar express rule. We note that it appears that, in effect, the example under Prop. Reg. § 1.959-2(b)(2) already contemplates allowing the selling entity, FX, to avoid realizing subpart F income pursuant to section 959(b) by accessing PTI associated with one block of stock owned by DP in FY, although in the example the same U.S. shareholder owns directly or indirectly both the acquiring company and the issuer. It is not clear, therefore, whether this result would occur if both the selling and the acquiring entities were not owned by the same U.S. shareholder (or, for that matter, members of the same consolidated group). We believe that it should, and that this should be spelled out in the text of the final regulations.

2. Final Regulations should clarify whether the E&P and PTI ordering rules apply in a manner consistent with section 304(b)(2).

As discussed in section II.D.4. above, the Proposed Regulations do not explicitly address the section 304(b)(2) distribution sourcing or ordering rule as it applies to PTI. The example contained in Prop. Reg. § 1.959-2(b)(2) seems fairly clear that section 304(b)(2) is to be followed without modification and that a distribution is to be treated as coming first out of the E&P of the acquiring corporation and second out of the E&P of the target corporation, regardless of the extent to which the acquiring corporation has section 959(c)(3) E&P (i.e., non-PTI E&P) and the target corporation has PTI. However, given the amounts assumed, the result would be no different if PTI of the issuing corporation were accessed before the section 959(c)(3) account of the acquiring corporation. Further, a second example is less clear. Indeed, it is this latter example that has led some commentators to believe, and to recommend that the Service and Treasury confirm in final regulations, that PTI of both the acquiring and the issuing corporations, if any, are accessed before the section 959(c)(3) account of the acquiring corporation.

47 The example contained in Prop. Reg. § 1.959-3(h)(4)(ii) (described in section II.D.2. above), which on this question is essentially identical to the example under Prop. Reg. § 1.959-2(b)(2) (described in section II.D.3. above), is ambiguous as to the ordering rule of PTI in the context of section 304(b)(2).

48 See, e.g., Letter from KPMG to Commissioner Everson et al., Re: Comments on Proposed Treasury Regulations Relating to Exclusion from Gross Income of Previously Taxed Earnings and Profits under Section 959 of the Internal Revenue Code (Code) and Related Basis Adjustments under Section 961 of the Code (REG-121509-00) (Mar. 27, 2007) (recommending that the example be amended to clarify that PTI of both the acquiring and issuing corporations, if any, are accessed before the section 959(c)(3) account of the acquiring corporation), Doc 2007-11826, 2007 TNT 95-10.
As in the case of other interactions between section 959 and general corporate tax law requirements, there is a question of whether the Proposed Regulations intend to provide for a “PTI-first” approach, rather than for conformity with the general ordering rule of section 304(b)(2). Practitioners, including the members of the Committee, have different views on the proper resolution of this issue. Our majority view is that the Proposed Regulations do not intend to provide for a PTI-first approach, rather than for conformity with the general ordering rule of section 304(b)(2). Further, we believe that such a PTI-first approach may actually lead to accelerated taxation of taxpayers in certain circumstances and, accordingly, should not be adopted in any final regulations.

To illustrate the issues, consider the following alternative scenarios. The basic facts are these: USP, a U.S. corporation, owns 100% of both FS and FA. Each of FS and FA is a CFC with respect to which USP is a U.S. shareholder. FS owns 100% of a third CFC with respect to which USP is a U.S. shareholder, CFC Issuer (“CFCI”). The fair market value of CFCI is $10x. USP has $10x of basis in FS, and FS has $10x of basis in CFCI, in each case pursuant to section 961. CFCI has section 959(c)(2) earnings and profits of $10x, no non-previously taxed earnings and profits, and $10x of cash. USP has $10x of basis in FA (arising under Code provisions other than section 961), which has no section 959(c)(2) earnings and profits, non-PTI E&P of $10x, and $20x cash. So, collectively, CFCI and FA have $30x of cash they could repatriate (in both taxable and non-taxable distributions).

**Scenario One.** In what we refer to as Scenario One, we assume that no section 304 transactions occurs, and instead, the parties simply distribute all $30x of cash. We would expect the following results to arise:

1.A. CFCI distributes its $10x of cash up the chain to USP with corresponding PTI and basis reductions under sections 959 and 961 to $0 in each case and without the incidence of any additional U.S. taxation.

1.B. FA distributes $10x cash to USP. This should constitute a section 301(c)(1) distribution and, accordingly, be taxed as a dividend in the hands of USP.

1.C. FA distributes the final $10x cash to USP. This should constitute a section 301(c)(2) distribution, reducing USP’s basis in FA from $10x to $0, and incurring no additional U.S. taxation.

Final Result: $30x of cash has been distributed, with additional tax imposed upon $10x of such distributions and no basis remaining.

**Scenario Two.** In Scenario Two, we assume that FS sells CFCI to FA in what is treated as a section 304 transaction, that the normal section 304(b)(2) rules apply without regard to recovering PTI from CFCI in advance of non-previously taxed earnings and profits of FA, and that the parties again distribute all $30x of cash back to USP.

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49 See section III.B., *infra*, for a discussion of another instance of this issue.

50 FS’s $10x basis in CFCI is solely for purposes of determining the amount includible in a United States shareholder’s gross income under section 951. I.R.C. § 961(c).
2.A. FA uses $10x of its cash to purchase CFCI. This is treated as a section 301(c)(1) distribution to FS that, in accordance with section 304(b)(2), is sourced out of FA’s $10x of non-previously taxed earnings and profits, notwithstanding the fact that CFCI has $10x of section 959(c)(2) earnings and profits. We further assume that corresponding basis adjustments should be made so that USP’s basis in FA is increased to $20x and its basis in FS is reduced to zero, and FA’s basis in CFCI, for purposes of determining the amount includible in USP’s gross income under section 951(a), is $10x, in each case reflecting the $10x of PTI that remains in CFCI. Also, FS distributes the sale proceeds back to USP. This is treated as a section 301(c)(1) distribution that is sourced out of FS’s $10x of non-previously taxed earnings and profits (attributable to the deemed distribution of FA’s $10x of non-previously taxed earnings and profits triggered by the sale of CFCI).

2.B. CFCI distributes its $10x of cash to FA, which in turn distributes the same $10x to USP. As this amount is sourced entirely to CFCI’s $10x of section 959(c)(2) earnings and profits, it should be excluded from FA’s income under section 959(b) and USP’s income under section 959(a). Corresponding downward basis adjustments should be made under section 961, leaving USP’s basis in FA at $10 and FA’s basis in CFCI at $0.

2.C. FA distributes its final $10x of cash to USP. Under section 301(c)(2), this distribution should result in a corresponding reduction in USP’s basis in FA to $0 and no additional tax to USP.

Final Result: $30x of cash has been distributed, with additional tax imposed upon $10x of such distributions and no basis remaining.

Scenario Three. In the final scenario, we assume that FS sells CFCI to FA in what is treated as a section 304 transaction, but that the normal section 304(b)(2) rules are altered to enable a PTI-first approach so that CFCI’s PTI is recovered in advance of FA’s non-PTI E&P. The parties again distribute all $30x of cash back to USP.

3.A. FA uses $10x of its cash to purchase CFCI. This is treated as a section 301(c)(1) distribution that, in accordance with the PTI-first approach, is sourced out of CFCI’s $10x of section 959(c)(2) E&P, notwithstanding FA’s $10x of non-PTI E&P. We further assume that the deemed distribution of CFCI’s PTI to FS should result in a corresponding reduction of $10x to CFCI’s PTI account and a concomitant reduction to the tax basis in CFCI, resulting in each being reduced to $0.\footnote{I.R.C. § 304(b)(2)(B) (following distribution of acquiring corporation’s E&P, distribution treated as dividend to the extent of issuing corporation’s E&P). The characterization and source of a distribution from either the acquiring corporation or the issuing corporation is treated as if the corporation had made the distribution directly to the selling shareholder, and its E&P is accordingly reduced to reflect such distribution. See H.R. Conf. Rept. No. 861, 98th Cong., 2d Sess. at 1223 (June 23, 1984). The tax basis in CFCI is reduced for purposes of determining the amount includible in a United States shareholder’s gross income under section 951. Prop. Reg. §§ 1.961-3(a), -4(a)(2), Ex. (2), 71 Fed. Reg. 51,177-178 (2006). While the tax basis in the CFCI shares is reduced to reflect the distribution of CFCI’s PTI, CFCI retains its $10x of cash. Thus, a future disposition of the CFCI shares, or CFCI’s distribution of the $10x, would result in realized gain to FA. The intersection of section 304 and sections 959 and 961 appears to mandate this result, although we question the propriety of the result because of the acceleration of tax discussed in scenario 3: current taxation to USP from...
FA's basis in CFCl ($0). Also, FS distributes the sale proceeds back to USP, reducing USP’s basis in FS shares to $0.

3.B. CFCl distributes its $10x of cash to FA. With no E&P (whether PTI or otherwise) remaining in CFCl and no basis attributable to its shares, this distributions should result in section 301(c)(3) gain at the level of FA, giving rise to a gross income inclusion for USP under sections 951 and 954. Under section 959, a corresponding PTI account of $10x should be created at the level of FA and USP's basis in FA should increase by $10x under section 961. FA thereafter distributes this $10x of PTI to USP without additional tax and USP's basis in FA is correspondingly reduced and therefore returns to $10x.

3.C. FA distributes its final $10x of cash to USP. Because FA has retained its $10x of non-PTI E&P throughout the prior steps, this distribution is a treated as a taxable section 301(c)(1) distribution to USP. USP retains a basis of $10x in FA.

Final Result: $30x of cash has been distributed, with additional tax imposed upon $20x of such distributions, and USP has $10x basis in its FA shares.

Note that in Scenario Three, unlike the prior two scenarios, USP continues to retain a basis of $10x in FA. Presumably, this means that USP’s subsequent taxable disposition of FA could result in a loss of at least $10x in USP’s hands. In this respect, Scenario Three may result in a temporary acceleration of taxation, rather than a permanent difference. Nonetheless, we do not believe that even this acceleration is an appropriate result. The policy underlying section 959 is to allow recovery of PTI at the earliest possible date because it furthers the overall policy of ameliorating double taxation of a U.S. shareholder who has already incurred a section 951(a) inclusion. Our majority view is that pursuing a PTI-first policy in this context so as to alter what would otherwise be the clear statutory rule under section 304(b)(2) makes little sense where the result is actually an acceleration of taxation. Accordingly, we suggest that the final regulations clearly provide that the E&P and PTI ordering rules are to be applied in a manner consistent with section 304(b)(2).

52 Some members of the Committee have a different view. They believe that the policies underlying the PTI-first policy should override the usually applicable rules under section 304(b)(2).

53 Section 304(a)(2) is briefly described in section I.C.3. above.

3. Final Regulations Should Permit Certain Shareholders to Recover PTI in a Section 304(a)(2) Transaction.

In the Preamble to the Proposed Regulations, the Service and Treasury requested comments regarding whether the PTI sharing rules should be made explicitly applicable to transactions described in section 304(a)(2). We believe that this request raises the larger question of whether the final regulations under sections 959 and 961 as a whole, including the PTI sharing rules, should apply to transactions described in section 304(a)(2). The Proposed Regulations provide no direct reference to section 304(a)(2), even though they specifically...
provide rules for transactions described in section 304(a)(1). We suggest that the final regulations under sections 959 and 961 should apply to parent-subsidiary section 304 transactions, but only under the circumstances described below. Within that context, we further suggest that there is a role for the PTI sharing rules.

As a policy matter, we see no reason why a selling shareholder in a section 304(a)(2) transaction should not be entitled to benefit from PTI in appropriate circumstances. The challenge, we believe, is assuring that inappropriate results do not occur. For example, assume Shareholder A, a U.S. person, owns 70% of U.S. parent, which owns 100% of CFC acquiring subsidiary in which U.S. parent, but not Shareholder A, has a PTI account. Assuming a 304(a)(2) transaction that is treated as a section 301(c)(1) distribution sourced from CFC acquiring subsidiary, it would not be appropriate to allow Shareholder A to receive any PTI: it had no direct PTI account itself, never paid U.S. tax on those earnings and should not benefit from U.S. parent’s account because U.S. parent could not have distributed the PTI that it had received from CFC acquiring subsidiary to Shareholder A without Shareholder A incurring additional U.S. tax consequences. In contrast, if the parent corporation were foreign, such that Shareholder A did have a PTI account, consistent with sections 951(a) and 958(a)(2), in the CFC acquiring subsidiary, then allowing access to such PTI in a section 304(a)(2) transaction is reasonable and should be permitted. PTI should also be available in the event that parent is a U.S. entity, but Shareholder A otherwise is a covered shareholder with respect to CFC acquiring subsidiary and had a PTI account with respect to such CFC (in such case, the cross-block PTI sharing rules should apply). Finally, if Shareholder A were a member of a consolidated group with U.S. parent or with another covered shareholder, it again seems appropriate to allow Shareholder A to benefit from the PTI accounts of other members of the consolidated group under the cross-affiliate PTI sharing rules.

Given these considerations, we believe that the definition of “covered shareholder” contained in the proposed regulations can be effectively utilized to assure that PTI is not inappropriately accessed in section 304(a)(2) transactions. However, to accomplish the extension of the overall section 959 and section 961 rules to section 304(a)(2) transactions, the final regulations should contain an explicit reference to such transactions. In this regard, we also believe that a selling shareholder who is a “successor in interest” with respect to either an issuing parent or an acquiring subsidiary should be entitled to access PTI in such entities in appropriate circumstances, as discussed above. To achieve this result within the section 304(a)(2) context, a clarification may be required. A section 304(a)(2) selling shareholder need not hold any particular threshold of interest (i.e., there is no requirement that the seller in a section 304(a)(2) transaction be included within a section 304(c) control group). For similar reasons, we believe that a successor in interest also need not meet any ownership threshold, e.g., 10%, with respect to a given CFC. We believe that this latter point is explicitly illustrated under the current regulations, but less clear under the Proposed Regulations, although reasonably clear from the preamble to the Proposed Regulations. We recommend that the final regulations contain a clear statement to this effect, although we acknowledge that circumstances where a less-than-10%
shareholder sells an interest in an issuing parent and still incurs a section 301(c)(1) distribution pursuant to section 304(a)(2) may be exceedingly rare.

B. Comments on the Effect of E&P Deficits on PTI Distributions

We believe that the Service and Treasury should consider providing additional clarification regarding (1) the effect on a shareholder’s PTI account where a CFC with an accumulated deficit and no current E&P makes a distribution, and (2) whether, in the event that a distribution not covered by section 316 does not reduce PTI, basis created by PTI should, nonetheless, be adjusted.55

Two examples illustrate the clarifications sought. In the first example, assume that a U.S. shareholder owns 100% of CFC1. In a prior year, CFC1 generated $50x of section 959(c)(2) E&P, resulting in a commensurate PTI account and a section 961 basis adjustment, and that U.S. shareholder’s basis is $100x ($50x of section 961 basis and $50x of other basis). In a subsequent year, but prior to the current year, CFC1 generated an E&P deficit of $100x, resulting in an accumulated E&P deficit of $50x. In the current year, when no further E&P is generated, CFC1 makes a distribution of $60x.

Example two has similar facts, except that CFC1 is the 100% owner of CFC2 and it is CFC2 that generated $50x of section 959(c)(2) E&P, along with commensurate basis and PTI account adjustments, in a prior year. CFC1, again, has previously generated an E&P deficit of $100x and, in the current year, makes a distribution of $60x. Importantly, however, CFC2 has not distributed any of its PTI to CFC1.

In the first example, does any of the $60x distributed represent a reduction of the U.S. shareholder’s PTI account under Prop. Reg. § 1.959-3(e)(2)? On the one hand, this section requires a distribution of “E&P,” but CFC1 has only an accumulated deficit at the time of the distribution. Prop. Reg. § 1.959-3(e)(5) and the associated regulatory example suggest that CFC1’s subsequent E&P deficit does not reduce U.S. shareholder’s PTI account. Accordingly, $50x of the $60x distribution would appear to consist of PTI, not resulting in a taxable inclusion for the U.S. shareholder, while the remaining $10x appears to constitute a section 301(c)(2) return of basis.

If this interpretation were not correct (i.e., if a distribution from a PTI account is not possible if an overall deficit exists), one of two possible alternatives would result: either the

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55 Additional issues arise in respect of the interaction of sections 312, 316 and 959. For example, if a corporation having PTI and non-PTI E&P distributes built-in loss property that exceeds the amount of the non-PTI E&P, is any portion of the PTI reduced by the amount of the basis in excess of the non-PTI E&P? Rev. Rul. 86-131, 1986-2 C.B. 135, provides that PTI is reduced by the fair market value of the distributed property and the excess of the basis in the depreciated property over the fair market value of the property reduces only the non-PTI E&P. It does not discuss, however, what happens in the event that there is insufficient non-PTI E&P to absorb the excess basis. Does that excess basis reduce the non-PTI E&P below zero or is any of the PTI reduced? A second issue is whether current year PTI is allocated among current year distributions in accordance with section 316 or whether the PTI first approach overrides section 316 in this regard. While neither of these issues is addressed in this comment letter, guidance addressing both would be helpful and we would be happy to provide a separate comment letter in respect of these issues upon request.
entire $100x of basis (including basis created under section 961) is available for reduction and the $60x distribution constitutes solely a return of basis, or only the $50x of non-section 961 basis would be available in which case U.S. shareholder should realize $10x of section 301(c)(2) gain, while still retaining a PTI account and associated section 961 basis of $50x to support a later distribution or minimized gain upon a disposition of CFC1 stock.\textsuperscript{56}

Clarification also is needed in respect of example two. When CFC1 makes its distribution of $60x, none of the distribution relates to CFC2’s PTI, and accordingly, the argument that all $100x of U.S. shareholder’s basis in CFC1 should be available to support the distribution as section 301(c)(2) return of basis appears harder to justify. We note that failure to allow access to all basis in CFC1 to support the distribution would run counter to the PTI-first policy articulated throughout the Proposed Regulations. On the other hand, however, such an exception to the general policy could be warranted on the basis of administrative clarity as it would be consistent with the treatment of dividend distributions under section 316. Also, to allow a reduction of section 961 basis in such a case would either (1) allow PTI to effectively “spring” from CFC2 to CFC1 in the absence of an actual distribution, or (2) lead to a de-linking of the section 959 PTI account and the section 961 basis\textsuperscript{57} in a manner that could overly complicate an already administratively difficult area.\textsuperscript{58}

We recognize that practitioners have different views on the proper resolution of these issues. Of primary importance is the priority given to the PTI-first policy over the general corporate law requirement that dividend distributions can be made only from positive E&P (current or accumulated). Some Committee members favor consistency with the general corporate tax law requirements of sections 312 and 316 and, therefore, would support the recommendation that PTI cannot be distributed in the absence of positive E&P. Other Committee members believe that the policy underlying the PTI-first approach creates an exception to general corporate tax law requirements and would support the recommendation that PTI can be distributed in the absence of positive E&P. Overall, we believe that a subsequent E&P deficit in non-PTI within a CFC having PTI should not reduce the U.S. shareholder’s PTI account. Accordingly, in example one, $50x of the $60x distribution should consist of PTI and the remaining $10x should be a section 301(c)(2) return of basis. We also believe that none of the U.S. shareholder’s basis relating to CFC2’s PTI in example two should be available to support CFC1’s distribution of $60x, for the reasons mentioned above.

\textsuperscript{56} In this latter case, section 961 basis being available for reduction would follow from the fact that the PTI account associated with that basis would not be available for reduction.

\textsuperscript{57} It should be noted that PTI and its associated basis can be “decoupled” under current law. For example, under the PTI successor rule, while a successor may have access to PTI, it does not have access to the predecessor’s basis associated with that PTI.

\textsuperscript{58} In addition to the broader issues, discussed above, we suggest that the Service and Treasury clarify whether CFC2’s 50x of PTI in example two is unaffected if it is subsequently distributed to CFC1, which maintains a current and accumulated E&P deficit. We believe that the plain language of the Proposed Regulation supports the position that the PTI amount should remain unreduced notwithstanding CFC1’s overall deficit. Given that the deficit and the PTI arise in the hands of different CFCs prior to the PTI distribution, however, there is some ambiguity that we believe the Service and Treasury should remove in final regulations.