You May Be Right (I May Be Crazy):
A Study of Attributes Post-Tax Reform

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Withdrawal of Proposed Basis Regulations
Law before 2009 Proposed Regulations

► **Basis Identification.**

► On 23 January 2006, IRS and Treasury issued final Reg. §1.358-2 (the 2006 Regulations), which generally requires tracing in all reorganizations and §351 exchanges that also qualify as §354 exchanges. See Reg. §1.358-2(a)(2).


► Tracing does not apply to §§351/354/356 overlap transactions if, “in connection with the exchange—the shareholder … exchanges property for stock … in an exchange to which neither section 354 nor section 356 applies [or] … in a transaction for which an election to apply section 362(e)(2)(C) is in effect; or … liabilities of the shareholder … are assumed.” See Reg. §1.358-2(a)(2)(viii).

► **Basis Recovery.**

► The 2006 Regulations included a basis recovery rule for reorganization exchanges and §355 exchanges in which “boot” is received. Reg. §1.356-1 provides that a taxpayer may designate which shares are exchanged for “boot”.

► The 2006 Regulations also included rules that provide taxpayers the ability to designate which shares are exchanged for stock, securities, or “boot”. See Reg. §1.358-2.

► No current regulations address basis recovery for §§301, 302 and 304 transactions.
Basis Identification:

Extended tracing to:

- transfers of stock in all §351 transactions, including to transactions that are currently non-overlap §351 transactions, except where liabilities of the shareholder are assumed (see Prior Prop. Reg. §§1.358-2(f)(2), (g), and 1.1016-2(e)). See also Reg. §1.358-2(a)(2)(viii)(B) (providing that tracing will not apply where election under §362(e)(2)(C) is made).

- capital contributions to which §118 applies and stockless §351 transactions by treating the transaction as resulting in a deemed issuance and recapitalization of shares in the same manner as for “stockless” reorganizations (see Prior Prop. Reg. §§1.1016-2(e) and 1.358-2(g)(3)).

Basis Recovery (for dividend equivalent transactions):

- §301. The portion of a distribution that is not a dividend is applied pro rata, on a share-by-share basis, to reduce the adjusted basis of each share of stock held by the shareholder within the class of stock upon which the distribution is made. Prior Prop. Reg. §1.301-2(a); see also Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971).

- §302(d). Treated as a pro rata distribution on all shares in the redeemed class followed by a deemed recapitalization of all shares in the redeemed class, including the redeemed shares, into the number of shares held by the holder after redemption. Prior Prop. Reg. §1.302-5(a)(1)-(2). Where all of the shareholder’s shares in a class were redeemed in a dividend equivalent redemption, any unrecovered basis became a deferred loss. Prior Prop. Reg. §1.302-5(a)(3).

- §304. The transferor would be treated as receiving only shares of acquiring common stock in the deemed §351 transaction. Prior Prop. Reg. §1.304-2(a)(3).

- Reorganizations. Taxpayers may not specify the terms of the exchange within a class of stock and “boot” is received pro rata on each share in the class of stock. Prior Prop. Reg. §§1.354-1(d)(1), 1.356-1(b); 1.358-2(b)(4).
Withdrawal of Proposed Regulations

On March 28, 2019, the government withdrew the 2009 Proposed Regulations. The notice of withdrawal states:

“The chief concern raised by commenters was that the approach taken in the 2009 Proposed Regulations represented an unwarranted departure from current law as a result of which minor changes to an overall business transaction could cause meaningful changes to the tax consequences, thereby elevating the form of the transaction over its substance.”

Isn’t this concern -- that minor changes to an overall business transaction could cause meaningful changes to the tax consequences -- also present, it not more so, in many cases under current law and what in part prompted the issuance of the 2009 Proposed Regulations?
“After thoroughly considering the comments received, the Treasury Department and the IRS have determined that it is unlikely that the approach of the 2009 Proposed Regulations can be implemented in comprehensive final regulations without significant modifications.”

Was implementing at least a portion of the 2009 Proposed Regulations considered?

Cf. NYSBA Tax Section, Report on Proposed Regulations Regarding Allocation of Consideration and Allocation and Recovery of Basis in Transactions involving Corporate Stock or Securities (Report No. 1316, Feb, 6, 2015), pages 127-128 (noting that addressing all aspects of the 2009 Proposed Regulations might be a daunting proposition in the near term and suggesting that consideration be given to at least addressing certain matters, such as dividend-equivalent redemptions of shares of a corporation having only one class of shares outstanding or dividend equivalent brother-sister §304 transactions where both the issuing and acquiring corporation have a single class of shares outstanding.)
Where do we go from here?

Implications of withdrawal

- Basis identification/determination implications for:
  - §351 stock transactions (non-reorg overlap) and capital contributions
  - Reorganizations

- Basis recovery implications for:
  - §301 distributions
  - §302(d) redemptions
  - §304 transactions
  - Reorganizations
  - §355 transactions

- Will taxpayer certainty decrease? Will taxpayer electivity increase?
**Statement: §301 distributions**

“The Treasury Department and the IRS continue to believe that under current law, the results of a section 301 distribution should derive from the consideration received by a shareholder in respect of each share of stock, notwithstanding designations otherwise. See *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971).”

- §301(c)(1) provides: “That portion of the distribution which is a dividend (as defined in §316) shall be included in gross income.”

- §301(c)(2) provides: “That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.”
  - What is meant by “the stock” --- i.e., aggregate basis of all shares of stock or share-by-share approach?

- §301(c)(3)(A) provides: “[T]hat portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.”
Basis Recovery in Ordinary Distributions

- X owns 100% of USS
- USS has $25 of E&P
- X has 3 shares of USS stock (each with a FMV of $100)
  - Share 1 has a basis of $60
  - Share 2 has a basis of $30
  - Share 3 has a basis of $0

- USS distributes $100 to X

See Johnson v. United States, 435 F.2d 1257 (4th Cir. 1971); Prior Prop. Reg. §1.301-2(a); but cf. §1.1367-1(c)(3); Rev. Rul. 84-53.

**Consequences to X under Johnson case:**
- The entire $100 is distributed pro rata to each share.
- The first $25 is a dividend; for the remaining $75:

<table>
<thead>
<tr>
<th>Share</th>
<th>FMV</th>
<th>Basis</th>
<th>Allocation</th>
<th>$301(c)(2)</th>
<th>$301(c)(3)</th>
<th>Ending Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share 1</td>
<td>100</td>
<td>60</td>
<td>25</td>
<td>25</td>
<td>-</td>
<td>35</td>
</tr>
<tr>
<td>Share 2</td>
<td>100</td>
<td>30</td>
<td>25</td>
<td>25</td>
<td>-</td>
<td>5</td>
</tr>
<tr>
<td>Share 3</td>
<td>100</td>
<td>-</td>
<td>25</td>
<td>-</td>
<td>25</td>
<td>-</td>
</tr>
<tr>
<td>TOTAL</td>
<td>300</td>
<td>90</td>
<td>75</td>
<td>50</td>
<td>25</td>
<td>40</td>
</tr>
</tbody>
</table>
“The Treasury Department and the IRS are continuing to study the issues addressed in the 2009 Proposed Regulations, with a particular focus on issues surrounding sections 301(c)(2) and 304, and §1.302-2(c) of the Income Tax Regulations.”
Basis recovery in §302(d) redemption

- X owns 100% of USS
- USS has $25 of E&P
- X has 3 shares of USS stock (each with a FMV of $100)
  - Share 1 has a basis of $60
  - Share 2 has a basis of $30
  - Share 3 has a basis of $0
- USS redeems Share 1 for $100

**Consequences to X:**
- The redemption is dividend equivalent under §302(d); X has a $25 dividend under §301(c)(1).
- What are the consequences of the remaining $75 of the distribution?
Current Law of Basis Recovery in Dividend Equivalent Redemptions

At least three possible alternatives


► **All shares approach**: The amount distributed in redemption is deemed distributed pro rata over both the redeemed and non-redeemed shares, and any basis not recovered on the redeemed shares is then allocated to the non-redeemed shares (but only after application of §301(c)(2) and (3)) (see Prior Prop. Reg. §§1.302-5, 1.304-2(a)(4) and -2(c), Ex. 2; see also Reg. §1.367(a)-9T(e), Ex. (reducing basis in both redeemed and non-redeemed shares))

► Same income/gain results as ordinary distribution example on Slide 5 (i.e., $25 of §301(c)(3) gain)

► **Redeemed shares approach**: Basis recovery under §301(c)(2) is limited to the basis in the shares redeemed. In effect, this approach would view the distribution under §301 as occurring with respect to only the redeemed shares (Cf. Announcement 2006-30; Preamble, T.D. 9250 (2006); Preamble, REG-127740-04 (2005); Prop. Reg. §1.304-2(c), Ex. 2)

► X recovers the $60 of basis associated with Share 1 (§301(c)(2)), and recognizes gain of $15 (§301(c)(3))

► **Non-redeemed shares approach**: The basis attributable to the shares actually redeemed is first allocated proportionally to, and blended with, the basis in the non-redeemed shares, and the amount distributed in redemption is then treated as a §301 distribution proportionately with respect to the non-redeemed shares (Cf. 1984 legislative history to §1059; Cox v. Comm’r, 78 T.C. 1021 (1982)).

<table>
<thead>
<tr>
<th>Share</th>
<th>FMV</th>
<th>Basis Adjustment</th>
<th>Adjusted Basis</th>
<th>Allocation</th>
<th>§301(c)(2)</th>
<th>§301(c)(3)</th>
<th>Ending Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Share 1</td>
<td>100</td>
<td>60</td>
<td>(60)</td>
<td>37.50</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Share 2</td>
<td>100</td>
<td>30</td>
<td>30</td>
<td>37.50</td>
<td>37.50</td>
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<td>22.50</td>
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<tr>
<td>Share 3</td>
<td>100</td>
<td>-</td>
<td>30</td>
<td>37.50</td>
<td>30</td>
<td>7.50</td>
<td>-</td>
</tr>
<tr>
<td>TOTAL</td>
<td>300</td>
<td>90</td>
<td>75</td>
<td>67.50</td>
<td>7.50</td>
<td>22.50</td>
<td></td>
</tr>
</tbody>
</table>
Basis Recovery in §304 Transactions

If a brother-sister §304 transaction is dividend equivalent, then:

“[T]he transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which §351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.” §304(a)(1).

Many uncertainties exist regarding how basis is recovered and what happens to unrecovered basis

See e.g., Reg. §§1.302-2(c), 1.367(a)-9T; Rev. Rul. 71-563; Notice 2012-15; PLR 201330004
Basis Recovery in §304 Transactions

USP’s Target stock

<table>
<thead>
<tr>
<th>Block</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Block 1</td>
<td>$10</td>
<td>$50</td>
</tr>
<tr>
<td>Block 2</td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>Total</td>
<td>$60</td>
<td>$100</td>
</tr>
</tbody>
</table>

USP’s Acquiring stock

<table>
<thead>
<tr>
<th>Block</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Block 1</td>
<td>$100</td>
<td>$100</td>
</tr>
</tbody>
</table>

► USP owns 100% of Target and Acquiring; USP, Target, and Acquiring are not members of a consolidated group.

► Target and Acquiring have E&P of $0

► USP has 2 blocks of Target stock (each with a $50 value):
  ▶ Block 1 has a basis of $10
  ▶ Block 2 has a basis of $50

► USP sells Target to Acquiring for $100
Basis Recovery in §304 Transactions

**USP’s Acquiring stock (hypothetical shares)**

<table>
<thead>
<tr>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>$60</td>
<td>$100</td>
</tr>
</tbody>
</table>

*Should the hypothetical shares mirror the blocks in USP’s Target shares?

**Consequences to USP**

- Deemed §351(a) transfer of Target stock to Acquiring for hypothetical shares of Acquiring stock
- Acquiring redeems hypothetical shares for $100
- USP recognizes $0 dividend (no combined Acquiring and Target E&P)

**How does USP treat $100 distribution (basis recovery and/or gain)?**

- Are the hypothetical shares a new class of stock? *See Prior Prop. Reg. §1.304-2(a)(3).*
- Does USP take a “blended basis” in its hypothetical shares of Acquiring stock?
- Can USP recover basis in its old and cold shares of Acquiring stock?
Statement: basis shifts

► “The Treasury Department and the IRS also continue to believe that, under current law, with respect to redemptions governed by section 302(d), any unrecovered basis in the redeemed stock of a shareholder may be shifted to other stock only if such an adjustment is a proper adjustment within the meaning of §1.302-2(c).”

► “Not all shifts of a redeemed shareholder’s unrecovered basis result in proper adjustments, and certain basis adjustments can lead to inappropriate results. See, e.g., Notice 2001-45, 2001-33 I.R.B. 129”
Unrecovered Basis

► Reg. § 1.302-2(c) provides that, in the case of a redemption of stock which is treated as a distribution of a dividend “proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed.”

► Ex. (2) provides as follows:

**Facts:**
► In Year 0, H purchased all of the stock of Corp. X for $100 cash.
► In Year 1, H gave one-half of the stock to W, the stock having a value in excess of $50.
► In Year 6, all of the stock held by H is redeemed for $150 in a dividend equivalent redemption.

**Conclusion:**
► Immediately after the transaction, W holds the remaining stock of Corp. X with a basis of $100.

**Note:** For a similar basis shifting result in a consolidated return context, see PLR 9815050 (Jan. 9, 1998) and PLR 200810015 (Dec. 4, 2007)
Option 1: USS3 redeems 9 shares of USS1’s USS3 common stock for $90 in a dividend equivalent redemption.

- USS1 recognizes dividend under §302(d), proceeds are excluded from gross income, and basis is reduced by $90 under Reg. § 1.1502-32(b)(2)(iv).
- What happens to USS1’s $90 unrecovered basis in the 9 shares of commons stock redeemed?

Option 2: USS3 redeems 10 shares of USS1’s USS3 common stock for $100 in a dividend equivalent redemption.

- USS1 recognizes dividend under §302(d), proceeds are excluded from gross income, and basis is reduced by $90 under Reg. § 1.1502-32(b)(2)(iv).
- What happens to USS1’s $100 unrecovered basis in the 10 shares of commons stock redeemed?

What if USP also owns USS3 common stock?

See PLR 9815050 (Jan. 9, 1998) and PLR 200810015 (Dec. 4, 2007)
Redemption of Class

- X owns 100% of USS
- USS has > $1000 of E&P
- USS has common and preferred stock outstanding
  - 100 Shares Common Stock
    - Value = $1000
    - Basis = $300
  - 100 Shares Preferred Stock
    - Value = $1000
    - Basis = $1000
- USS redeems all Preferred Stock for $1000

Consequences to X under 2009 Proposed Regulations:
Where the shareholder holds no additional shares of the redeemed class, the basis becomes a deferred loss, to be taken into account on disposition of common stock. Prior Prop. Reg §1.302-5(a)(3); Cf. Rev. Rul. 66-37.
Redemption of < All of Class

- X owns 100% of USS
- USS has > $1000 of E&P
- USS has common and preferred stock outstanding
  - 100 Shares Common Stock
    - Value = $1000
    - Basis = $300
  - 100 Shares Preferred Stock
    - Value = $1000
    - Basis = $1000
- USS redeems 99 shares of Preferred Stock for $990

Consequences to X under 2009 Proposed Regulations:
Deemed recapitalization concentrates the pre-redemption basis of the preferred stock in the retained share. Prior Prop. Reg. §1.302-5(a)(2). Remaining share could be sold at a loss.

Is this basis shift “proper” after withdrawal of the 2009 Proposed Regulations?
Other impacts of withdrawal?

► Note IRS CCN CC-2003-014: If there are no final or temporary regulations currently in force addressing a particular matter, but there are proposed regulations on point, Chief Counsel attorneys should look to the proposed regulations to determine the office's position on the issue.

► Implications for transactions covered by the 2009 Proposed Regulations?
  ► No longer any guidance on what type of shares deemed issued in §304.
  ► Impact on government prior statements that redeemed shares only approach was better view? See Announcement 2006-30.
    ► BEAT implications for inbound §302(d) redemptions?

► Any other signaling should one read into the withdrawal or wording thereof?
Adjustments to Attributes under the TCJA
The Tax Cuts and Jobs Act ("TCJA") fundamentally altered the E&P and stock basis landscape in several important respects:

- Taxation of previously untaxed offshore E&P ("toll charge"); conversion of pre-TCJA offshore E&P into §959(c)(2) E&P ("PTI"); corresponding (but in some cases insufficient) elective stock basis adjustments for future distributions; offsetting of e&p and e&p deficits across related “specified foreign corporations” ("SFCs") by reducing/eliminating e&p deficit and converting e&p to PTI without basis bump.

- Taxation of a significant portion of CFC income through the global intangible low taxed income ("GILTI") rules; corresponding and complicated basis adjustments rules to account for netting of income and losses across CFCs; treatment of “offset tested income” as 100% dividends received deduction ("DRD") eligible income.

- 100% DRD for offshore §959(c)(3) E&P ("Untaxed E&P") (which often may be largely QBAI deemed returns or offset tested income; but note “purchased E&P”).
  - Untaxed E&P may also include income eligible for GILTI high tax exception?
  - Related basis adjustment rules to prevent losses in certain instances (§961(d)).
  - New relevance for §1059 (basis reduction and possible gain recognition for “extraordinary” dividends).
GILTI E&P and basis adjustments

- A US shareholder’s GILTI inclusion amount is treated as subpart F income for certain purposes, including §959 (PTI) and §961 (basis adjustments). Prop. Reg. §1.951A-6(b)(1).
  - For these purposes, any GILTI inclusion amount of a US shareholder is allocated among such US shareholder’s tested income CFCs in proportion to the tested income of each. Prop. Reg. §1.951A-6(b)(2).
  - No amount is allocated to tested loss CFCs.
- The E&P of a tested loss CFC is increased by an amount equal to such CFCs tested loss in an inclusion year for §952(c)(1)(A) purposes (i.e., the E&P constraint on Subpart F inclusions). Prop. Reg. §1.951A-6(d).
- Tested losses of CFCs available to offset tested income of CFCs held by single US Shareholder (or multiple US Shareholders that are members of a consolidated group)
- Deferred basis reduction for net used tested losses:
  - Immediately before the disposition of specified stock, the adjusted basis in such stock is reduced by the net used tested loss amount with respect to the CFC attributable to such stock. Prop. Reg. §1.951A-6(e).
  - Per preamble: Basis reduction intended to prevent a second and duplicative benefit of the loss—either through the recognition of a loss or the reduction of gain—if the stock of the tested loss CFC is disposed of. See Charles Ilfeld Co. v. Hernandez, 292 U.S. 62 (1934).
GILTI basis adjustments

Tested loss offset

**Facts:**
- USP owns 100% of CFC1 and CFC2.
- USP’s basis in CFC1 and CFC2 is $0 and $20, respectively (prior to GILTI).
- In year 1, CFC1 has $100 of tested income.
- In year 1, CFC2 has a $20 tested loss.

**E&P and basis consequences:**
- USP has a $80 inclusion under §951A.
  - USP’s net CFC tested income is the excess of CFC1’s $100 tested income over CFC2’s $20 tested loss (Cf. next slide).
- USP’s basis in CFC1 is increased by $80 under §961.
- $80 of CFC1’s E&P is treated as PTI under §959. The remaining $20 is treated as untaxed, non-PTI E&P.
- USP’s basis in CFC2 is reduced by $20 immediately prior to the disposition of CFC2 under Prop. Reg. §1.951A-6(e)(1).
- CFC2’s E&P is increased by $20 (i.e., the deficit is reduced to $0) for purposes of §952(c)(1)(A) under Prop. Reg. §1.951A-6(d).
GILTI basis adjustments
Tested loss offset (cont’d)

Facts:
► Same as prior slide except USP has only $12 of basis in its CFC2 stock.

E&P and basis consequences:
► USP has a $80 inclusion under §951A.
  ► USP’s net CFC tested income is the excess of CFC1’s $100 tested income over CFC2’s $20 tested loss.
  
  ► USP’s basis in CFC1 is increased by $80 under §961.
  
  ► $80 of CFC1’s E&P is treated as PTI under §959. The remaining $20 is treated as untaxed, non-PTI E&P.
  
  ► USP’s basis in CFC2 is reduced by $12 to $0 and USP recognizes $8 of gain immediately prior to the disposition of CFC2 under Prop. Reg. §1.951A-6(e)(1).
  
  ► CFC2’s E&P is increased by $20 (i.e., the deficit is reduced to $0) for purposes of §952(c)(1)(A) under Prop. Reg. §1.951A-6(d).
<table>
<thead>
<tr>
<th>Possible E&amp;P and basis shifting paradigms</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Proposed/Final 965 Regs</strong></td>
</tr>
<tr>
<td>► E&amp;P (and E&amp;P deficit) synthetically largely eliminated from system to extent of shifted losses (E&amp;P deficits)</td>
</tr>
<tr>
<td>► E&amp;P continues as PTI, however; which raises interesting questions regarding interactions with other provisions such as 301, 1248, etc. [some interactions resolved]</td>
</tr>
<tr>
<td><strong>Proposed GILTI Regs</strong></td>
</tr>
<tr>
<td>► E&amp;P offset by E&amp;P deficits continues in system as “exempt” E&amp;P; deficits in E&amp;P that offset E&amp;P eliminated for purposes of 952(c)(1)(A) only</td>
</tr>
<tr>
<td><strong>Possible Single CFC Paradigm (NYSBATS Primary Proposal)</strong></td>
</tr>
<tr>
<td>► Eliminate E&amp;P from the system</td>
</tr>
<tr>
<td><strong>E&amp;P</strong></td>
</tr>
<tr>
<td>► No basis eliminated from system</td>
</tr>
<tr>
<td>► Basis shifting electively permitted, with gain recognition toll charge if shifted loss (E&amp;P deficit) greater than basis in loss CFC, subject to election to stop basis shift when basis in loss CFC hits zero</td>
</tr>
<tr>
<td><strong>Basis</strong></td>
</tr>
<tr>
<td>► Basis eliminated, with gain recognition if shifted loss greater than basis; impact deferred until disposition of loss CFC stock</td>
</tr>
<tr>
<td>► Mandatory current basis shift proportional to shifted loss (E&amp;P deficit) but no gain recognition</td>
</tr>
<tr>
<td><strong>Comments</strong> (red = maybe taxpayer unfavorable; green = maybe taxpayer favorable)</td>
</tr>
<tr>
<td>► May result in greater or earlier income/gain recognition on income CFC stock (via distributions on, or sales of, the income CFC stock) compared to a single CFC paradigm</td>
</tr>
<tr>
<td>► May permit greater loss recognition (via disposition of shares of loss CFC) than possible in a single CFC paradigm</td>
</tr>
<tr>
<td>► Closer to pure single CFC approach but some discontinuities would continue due to architecture of the Code (e.g., no QBAI for tested loss CFCs) and actual existence of two juridical entities</td>
</tr>
<tr>
<td>► Query regulatory authority to implement</td>
</tr>
<tr>
<td>► May permit exemption of income/gain with respect to income CFC stock (to extent of shifted losses) compared to a single CFC paradigm</td>
</tr>
<tr>
<td>► May result in less loss/greater gain recognition (via disposition of loss CFC shares) than would result in a single CFC paradigm</td>
</tr>
</tbody>
</table>
GILTI consolidated basis adjustments

► Under the proposed GILTI regulations, the investment adjustments prescribed by Reg. §1.1502-32 are modified to reflect the GILTI inclusions of members of a consolidated group.

► **Negative Adjustments:** S’s noncapital, nondeductible expense includes its amount of used tested loss amount with respect to a CFC. Prop. Reg. §1.1502-32(b)(3)(iii)(C).

► **Positive Adjustments:**
  ► S’s tax-exempt income includes the aggregate of S’s offset tested income amounts with respect to a CFC, but only to the extent this amount does not exceed S’s aggregate used tested losses. Prop. Reg. §1.1502-32(b)(3)(ii)(E).
  ► S is also treated as having tax exempt income immediately prior to a recognition transaction in which another member of S’s consolidated group recognizes income, gain, deduction, or loss with respect to a share of S stock. Prop. Reg. §1.1502-32(b)(ii)(F) (the “F adjustment”).

► **Nonrecognition Transactions:** With respect to nonrecognition transactions between members of a consolidated group, if stock of a CFC that has a net used tested loss amount is directly transferred, the adjusted basis of the nonrecognition property received is immediately reduced by the amount of the net used tested loss amount. Prop. Reg. §1.1502-51(c)(5).

► **Status Report:** What is the government’s current thinking regarding GILTI-related basis adjustments?
The TCJA added new §245A (and related provisions) which generally provides a 100% DRD for foreign source dividends from 10% owned specified foreign corporations.

- Note the foreign corporation does not need to be a CFC.
- DRD extended to stock gain recharacterized as a dividend (see §§1248(j) and 964(e)(4)).

Loss limitation provisions added to prevent dividend stripping – see, e.g., §§961(d), 964(e)(4)(B)

In addition, §1059 was amended to include §245A in determining the taxable portion of a dividend.

- §1059 requires basis reduction and possibly gain recognition for “extraordinary dividends”, including per se extraordinary dividends, non prorata redemptions, §304 transactions, and partial liquidations.
- As a result, a seldom applicable provision may now apply to a large category of common internal transactions
§1059

- §1059: Where a shareholder claims a DRD for an “extraordinary dividend”, §1059 generally requires a shareholder to (i) reduce stock basis by the amount of the DRD and (ii) recognize gain to the extent the DRD exceeds that basis.

- TCJA amended §1059(b)(2) such that §1059 now applies to DRD under §245A.

- Under §1059(e), dividend equivalent §304 transactions are generally per se “extraordinary dividends”.
  - In addition, non-pro rata redemptions (including non-pro rata §356 boot dividends) are per se “extraordinary dividends”.

- §1059 is likely to apply to a significantly wider array of transactions due to §245A DRD.
Facts:
► USP transfers the stock of CFC2 to CFC1 in exchange for $100.

Considerations:
► General Mechanics:
  ► Under §304(a)(1), transaction is treated as if (i) USP contributed CFC2 stock to CFC1 in exchange for CFC1 stock in an exchange under §351 and (ii) CFC1 redeemed the deemed issued stock for $100.
  ► The deemed redemption is treated as a taxable dividend under §302(d) and 301(c)(1).
► Pre-TCJA:
  ► Taxable dividend sourced first to extent of CFC1’s E&P and then to the extent of CFC2’s E&P.
► Post-TCJA:
  ► Same sourcing rules
  ► Dividend-equivalent redemption is eligible for §245A DRD.
  ► If §245A DRD allowed, §1059 will require USP to reduce its basis in the stock of CFC1 that is redeemed (or, in the event of insufficient basis, recognize gain). See §1059(e).
► Consider impact on formally separate distributions and contributions (i.e., North/South); integration may now result in different tax consequences as compared to pre-TCJA.
Basis Recovery – TCJA Implications
Recovery of §961(b) Basis

**Facts:**
- US Parent has $100 basis in its CFC1 stock and $0 basis in its CFC2 stock.
- CFC1 has $0 PTI and CFC2 has $100 PTI.
- In Year 1, CFC2 merges into CFC1.
- In Year 2, CFC1 makes a distribution of $50 of PTI to US Parent.

**Consequences:**
- How should US Parent reduce its basis in CFC1 under §961 to account for the distribution?
  - Reg. §1.961-2(b) provides that the reduction is made with respect to “each share of such stock”
  - §961(b)(2) requires gain recognition “to the extent that an amount excluded from gross income under section 959(a) exceeds the adjusted basis of the stock or other property with respect to which it is received.”
  - Proposed PTI regulations note that legislative intent is to avoid “double taxation and [allow] United States persons to receive the full benefit of their PTI at the earliest possible time.”
- Different result depending on whether stock was issued in the reorganization?
- Does origin of basis matter? See Reg. §1.961-2(d), Example 1(b).
- What if CFC1 had started out with $100 of PTI and $100 of basis?
Under §961(d), if a domestic corporation receives a dividend from a specified 10-percent owned foreign corporation (as defined in §245A) in any taxable year, then solely for purposes of determining loss on any disposition of stock of the foreign corporation in that year or in any subsequent year, the domestic corporation’s basis in the foreign sub stock will be reduced (but not below zero) by the amount of any deduction allowable to the domestic corporation under §245A with respect to that stock (except to the extent that basis was already reduced under §1059).
Application of §961(d)

**Facts:**
- Foreign Sub pays a $30 dividend to US Parent to which §245A applies (and §1059 does not).
- Foreign Sub’s value is reduced from $100 to $70, but US Parent’s basis in Foreign Sub remains $80.
- US Parent sells the stock of Foreign Sub to Buyer for $70

**Consequences:**
- §961(d) applies solely for purposes of determining loss on any disposition of stock. Consequently, US Parent does not recognize a loss.
- Pre-sale dividend still has the result of eliminating $20 gain on the sale of stock.
- Correct policy result? Compare to result of a sale without a pre-sale dividend under §1248.
Application of §961(d) with Blocks of Stock

Facts:
- Same as previous except, US Parent also owns FS2 stock with a value of $10 and basis of $0.
- Following the distribution from Foreign Sub but prior to the sale of Foreign Sub, FS2 merges into Foreign Sub in exchange for stock of Foreign Sub.
- In an unrelated transaction, US Parent sells Foreign Sub to buyer for $80.

Consequences:
- What results under §961(d)?
  - In the aggregate, there hasn’t been a loss on the disposition of stock.
  - However, if the stock of Foreign Sub and FS2 had been sold individually, §961(d) would have applied.
  - What if US Parent contributed all of Foreign Sub’s stock to capital except for one share, or recapitalized into one share?
So Much PTI
Facts:

► USS1 and USS2 each own 50% of CFC
► CFC has $250 of PTI and $100 of Untaxed E&P
► USS1 owns Block 1 with a $50 PTI account; USS2 owns Block 2 with $200 PTI account
► CFC distributes $200 pro rata to USS1 and USS2

Consequences under 2006 Proposed PTI Regs:

► $50 of USS2’s PTI account is allocated to USS1; thus, the full amount can be excluded. See Prop. Reg. §1.959-3(g)(4), Ex. 1
► Corresponding basis adjustments must be made under Prop. Reg. §§1.961-1(b), 1.961-2(a), 1.1502-32(b)(3)(ii)(D), and 1.1502-32(b)(3)(iii)(B).
► Post-TCJA, absent PTI sharing, distribution to USS1 would generally be eligible for §245A DRD. Is complexity of PTI sharing system still warranted? Potential for inappropriate basis shifting?
► Note that proposed regs also permit single US shareholder to share PTI among different blocks. Cf. Reg. §1.965-2(h)(4) (specified basis adjustments under §965 regulations made share by share).
E&P allocation to Controlled

- D transfers $10 of its assets (10% by FMV) to C in a “D” reorganization and then distributes the C stock in a §355 distribution
- D’s E&P is generally allocated based upon FMV (Reg. §1.312-10) (e.g., 10% x $60 = $6)
  - What would be a proper case for not doing so?
  - What considerations are relevant if the E&P is PTI vs. Untaxed E&P?
    - Relevant that Untaxed E&P eligible for §245A allows tax-free repat post TCJA?
    - Relevant if Untaxed E&P arises because of shareholder-level attributes (e.g., QBAI)?
PTI and Boot Dividends

**Facts:**
- CFC Target transfers all of its assets and liabilities to CFC Acquiring in an all-cash “D” reorganization. Parent recognizes $50 of gain under §356.

**Considerations:**
- Should PTI be available for purposes of boot dividend?
  - Because §356(a)(2) boot dividend is gain limited, §961 basis associated with PTI reduces boot dividend.
  - If sourced from PTI, boot dividend is excluded from USP’s income under §959(a).
  - PTI-available approach: $50 boot dividend is out of PTI E&P and is excluded from USP’s income under §959(a).
  - Boot dividend is generally treated as “dividend” for all purposes of the Code. See, e.g., Rev. Rul. 74-387.
  - Service has issued PLRs approving PTI-available approach. See PLR 8952048; PLR 9117053; PLR 9118004; PLR 9327010, corrected by PLR 9349008.
  - PTI-unavailable approach: $50 boot dividend is out of non-PTI E&P and is included in income.
    - Compare language of §356(a)(2) vs. §959(d); treated as a “dividend”?
    - In preamble to final all cash D regulations (T.D. 9475), Government requested comments on “whether and how, under §959 an exchanging shareholder should be able to access” PTI before any non-PTI of either corporation.
    - Compare §1248(d)(1), which excludes PTI E&P for purposes of determining amount of gain recharacterized as a dividend.
The Link Between Basis and E&P
Interaction of Basis and E&P

► There is often a parallel relationship between E&P and tax basis

► Tax basis in assets = E&P + invested capital

► This relationship can fall out of balance in many circumstances, such as:
  ► Reorganizations involving boot
  ► Triangular reorganizations
  ► Taxable stock purchases followed by §332 liquidations of Target
  ► Stock sales subject to §304
  ► §302(d) redemptions

► Query whether E&P adjustments should (or can) be made to preserve a “balanced” tax basis relationship

► Neither the current basis regulations nor the withdrawn 2009 proposed regulations considered E&P consequences

► In a world in which [almost all] earnings of a CFC are either taxed currently with an upward outside stock basis adjustment or generally tax exempt when distributed, how should one think about the interrelationship between inside and outside basis?
Anti-loss importation regulations under §362(e)(1) and §334(b)(1)(B)

FS1 liquidates into USP under §332.

**Considerations:**

What is USP’s basis in the FS2 stock? What is USP’s “all E&P” inclusion?

- USP’s basis in FS2 is reduced to $10 under §334(b)(1)(B)
- Should USP’s “all E&P” amount of $90 in FS1 be reduced by the $90’s of basis “lost” in the stock of FS2? Under the final regulations: No. See T.D. 9759.
  - See Reg. §1.334-1(b)(3)(iii)(C)(3) (“No effect on earnings and profits. Any determination of basis under this paragraph (b)(3) does not reduce or otherwise affect the calculation of the all earnings and profits amount provided in § 1.367(b)-2(d.”). See also Reg. §1.362-3(b)(4)(iii)
  - Preamble: “First, there is no indication in section 334(b) or 362(e), or their legislative history, that the basis reduction should be reduced or otherwise affected by an inclusion of the all earnings and profits amount. Second, such a reduction may be contrary to the policies underlying these provisions...Finally, determining the extent to which the built-in loss relates to the all earnings and profits amount would involve undue complexity.”
  - Cf. Proposed GILTI regulations. More complex than basis adjustment regime for used tested loss?
§367(b) and Domestication Transaction

**Facts:**
- USP owns CFC1 which owns CFC2.
  - CFC1 holds assets (including the CFC2 stock) with a FMV of $100 and basis of $60; CFC1 has $20 of Untaxed E&P.
  - CFC2 holds assets with a FMV of $60 and basis of $0; CFC2 has $40 of Untaxed E&P.
  - CFC1 domesticates and becomes USS in an inbound “F” reorganization.

**Considerations:**
- USP would include $20 into income as a deemed dividend of CFC1’s “all E&P amount”. See §367(b); Reg. §1.367(b)-3
- USP may have to include $40 into income as a deemed dividend of CFC2’s E&P under Notice 2016-73 (treating CFC1’s “excess asset basis” of $60 as ‘funded’ by CFC2’s E&P in certain instances), which is deemed to be paid from CFC2 to CFC1 and then from CFC1 to USP.
- Presumably, these deemed dividends would be eligible for a 100% DRD under §245A (assuming requirements otherwise satisfied).
Policy Considerations under §367(b)

► §367(b) income inclusion “prevents the conversion of a deferral of tax into a forgiveness of tax and generally ensures that the section 381 carryover basis reflects an after-tax amount. However, the all earnings and profits amount inclusion does not consider tax attributes that accrue during a non-U.S. person's holding period.” See TD 8862.

► “The definition of the all earnings and profits amount, in particular its limitation with respect to the earnings and profits of subsidiaries, is premised on an assumption that the basis in the assets of the foreign acquired corporation reflects solely the earnings and profits of the foreign acquired corporation, the liabilities of the foreign acquired corporation, the liabilities of the foreign acquired corporation, and capital acquired from a shareholder.” See Notice 2016-73

► The TCJA established a participation exemption system for the taxation of certain foreign income. See §245A.

► In light of §245A, what is the continued role and relevance of existing §367(b) regulations?

► See, e.g., Proposed §956 Regulations – “The Treasury Department and the IRS have determined that as a result of the enactment of the participation exemption system, the current broad application of section 956 to corporate U.S. shareholders would be inconsistent with the purposes of section 956 and the scope of transactions it is intended to address.”