U.S. Shareholder Basis in Foreign Corporations Post-Tax Reform

American Bar Association
Section of Taxation
2019 Midyear Tax Meeting

Continuing Importance of Basis In CFCs

• A U.S. Shareholder’s Basis in a CFC determines both the amount of gain and its character with respect to a distribution or the sale of a CFC.

• If basis and PTI (now PTEP) accounts do not align, income can end up being taxed twice.

• Basis adjustments in respect of PTEP are required through chains of corporations to accurately reflect taxable income and loss.

• 245A and, correspondingly, 964(e)(4) & 1248(j) mean that basis is now all about PTEP.
CFC Basis Basics

• Both before and after tax reform, the U.S. imposes U.S. income tax on certain earnings of a controlled foreign corporation even when they are not distributed as a dividend to the US shareholder. (951 & 951A)

• Because tax is imposed currently, as opposed to when a dividend occurs, adjustments must be made to basis of stock in the CFC. (959 & 961)

• The Basis of Stock in a CFC is generally increased:
  • By the amount of Subpart F income included in the US shareholder’s income
  • By 956 inclusions (except to extent 956 inclusion is reclassified 959(c)(2) PTI)
  • By the GILTI inclusion (post tax-reform)

• The Basis of Stock in a CFC is generally decreased
  • By the amount of distributions by that CFC from its PTEP
  • By the amount of distributions by that CFC to the extent it has no E&P (return of basis)
  • By the amount of distributions of PTEP by lower-tier CFCs up and through a CFC
985 & 986(c) Basics

- CFCs have a functional currency, which is generally the currency in which the majority of their business is transacted. 985
- When a CFC earns income that is subject to current taxation in the U.S., that amount is translated into USD. 986(a)
- However, the CFC maintains the PTI/PTEP account in its functional currency.
- When the PTI/PTEP is distributed to the US shareholder, f/x gain or loss is recognized based on the difference in the USD value of the funds actually received and the USD basis in the PTI. 986(c)
- Thus, although PTI/PTEP is generally reflected in the basis of stock of a CFC, the taxpayer must then make a second calculation when the funds are repatriated to the United States.
PTI/PTEP had numerous areas in which the law and regulations were unclear.

In 2006, the IRS issued proposed regulations clarifying a number of open questions regarding PTI/PTEP.

Those regulations, which were never finalized, provided, inter alia:
- That each US Shareholder had a PTI account with respect to each share in a CFC
- That a CFC had a PTI account
- That PTI could be, in certain circumstances, shared amongst members of a consolidated group and/or between blocks of shares held by the same US shareholder
245A Participation Exemption

• General rule allows US shareholders 100% deduction for foreign-source portion of dividends from specified 10% owned foreign corporations.

• No foreign tax credits or deductions available for taxes paid or accrued with respect to dividends that qualify for the 100% deduction under Section 245A.

• Sections 1248(j) and 964(e)(4) effectively permit deemed dividends upon CFC stock sales to be eligible for a 100% deduction under Section 245A.
245A(e) Hybrid Dividends

- Denies the 100% deduction for dividends received by US shareholders from CFCs.
- Tiered CFC dividends are treated as Subpart F income of US shareholders.
245A Participation Exemption – Basis Reductions

• Under Section 1059, basis in stock of a specified 10% owned foreign corporation is reduced by the “untaxed portion” of any “extraordinary dividend,” which “untaxed portion” can include the deduction granted under 245A.
  • Limited Application:
    • US shareholder held the stock for two years or less before the announcement date of the “extraordinary dividend.”
    • “Extraordinary dividend” is a dividend that equals or exceeds 10% of the shareholder’s stock tax basis (or, by election, the fair market value of the stock).
  • Excess of reduction over basis is treated as gain from sale of the stock.

• For purposes of determining loss on a sale or exchange of the stock of a specified 10% owned foreign corporation, if a US shareholder’s basis in such stock has not been reduced under Section 1059, Section 961(d) reduces basis (not below 0) by the deduction granted under Section 245A.
  • In effect, this disallows losses on dispositions to the extent of distributions eligible for the Section 245A deduction, but does not apply if stock basis was reduced under Section 1059.
965 Transition Tax

• General Rule:
  • Treats as Subpart F income the accumulated post-1986 deferred foreign income of a “deferred foreign income corporation” (or “DFIC”) for the last tax year that ends before January 1, 2018 (greater of the amount at November 2, 2018 or December 31, 2018).

• Section 965(b) Reduction for E&P Deficits:
  • Section 965(a) inclusions are reduced by a US Shareholder’s aggregate foreign E&P deficit from E&P deficit foreign corporations.

• Applicable Currency:
  • Section 965 inclusions are tracked in US dollars (note, however, that PTEP must be tracked in functional currency ).
965 PTEP Rules

- Section 959(c)(2) E&P is increased by the Section 965(a) inclusion amounts of a US Shareholder.

- Section 959(c)(3) E&P is decreased (or a deficit is increased) by the Section 965(a) inclusion amounts of a US Shareholder.

- Proposed Regulations also treat the Section 965(b) reduction in Section 965(a) inclusions in similar fashion (increase in Section 959(c)(2) E&P; and corresponding decrease (or increase to deficit) in Section 959(c)(3) E&P).
  - Note, however, that Section 965(b) reductions increase the Section 959(c)(3) E&P of the corresponding E&P deficit foreign corporations that generated the reductions. This should generally cause a netting of the deficit within the Section 959(c)(3) E&P of the E&P deficit foreign corporation. (See Prop. Reg. 1.965-2(j) Examples 5 and 6).
965 Basis Rules

• General Rule:
  • A US Shareholder increases its basis in a DFIC by its Section 965(a) inclusion with respect to the DFIC.

• Section 965(b) Reductions:
  • General rule does not allow any adjustment to basis for Section 965(b) reductions to Section 965(a) inclusions.
  • Elective basis adjustments: increase the US Shareholder’s basis in a DFIC by an amount equal to the Section 965(b) reduction and decrease the US Shareholder’s basis in the respective E&P deficit foreign corporations by proportionate amounts. Prop. Reg. 1.965-2(f)(2).

• Gain-Reduction Rule:
  • Reduces gain that would otherwise be recognized under Section 961(b)(2) (when a distribution excluded from income as PTEP under Section 959 reduces basis below zero) for distributions during inclusion year attributable to Section 965(a) inclusions, and also for Section 965(b) reductions when a taxpayer has made an election to adjust basis for Section 965(b) reductions under Prop. Reg. 1.965-2(f)(2).
  • Gain reduction amount is equal to the Section 965(a) previously taxed E&P (and the Section 965(b) previously taxed E&P, if the taxpayer has elected to make basis adjustments for Section 965(b) reductions under Prop. Reg. 1.965-2(f)(2)).
  • Basis in the DFIC must be decreased by the amount of the gain reduction.

• Basis Limitation Rule:
  • Any net basis reduction under the election under Prop. Reg. 1.965-2(f)(2) or the gain-reduction rule in excess of the US Shareholder’s basis in the stock is treated as gain from a sale of such stock.
  • The net effect of the gain reduction rule and the basis limitation rule can nevertheless result in gain that otherwise would have been recognized under Section 961(b)(2).

• Section 962 Elections:
  • Guidance on basis adjustments for Section 962 elections in this context are reserved.
Notice 2019-1
Notice 2019-01

• 2006 Proposed Regulations will be withdrawn in favor of new proposed regulations under Sections 959 and 961 to reflect changes under the TCJA.

• Acknowledgement of additional amounts that may generate Section 959(c)(2) PTEP from Subpart F inclusions under Section 951(a)(1)(A):
  • Amounts treated as hybrid dividends under Section 245A(e)(2) (only payments between CFCs);
  • GILTI;
  • Amounts treated as a dividend under Section 1248 for sales by US Shareholders of CFCs or under Section 964(e)(4) for dispositions of lower-tier CFCs;
  • Section 965(a) inclusions and Section 965(b) reductions in amounts that otherwise would result in Section 965(a) inclusions.
PTEP Groups

- Annual PTEP accounts must be maintained, segregated into 16 PTEP groups in each §904 category (Section 951A, Passive, General, and Treaty Resourced Categories)
- After PTEP is assigned to PTEP group within annual PTEP account, it is maintained in annual PTEP account corresponding to year it originated, including as it is distributed up chain of CFCs or is reclassified
- Maintenance of 16 PTEP groups is necessary for most precise application of §960(b), §986(c), §956, and §904

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PTEP Groups, Cont’d

• PTEP groupings depend on whether E&P was earned within particular group or reclassified from (c)(2) PTI to (c)(1) PTI by reason of §959(a)(2)

• 7 categories likely will not apply to most taxpayers (green), and priority rule for §965 PTEP could enable 4 categories to be eliminated (blue), leaving 5 categories to be maintained (red)

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Distribution of PTEP

- Distribution is treated as distribution of PTEP only to extent
distribution otherwise would have been dividend under §316
  - §316(a) – “Dividend” means any distribution by corporation out of (1) E&P
  accumulated after February 28, 1913, or (2) E&P for current year determined
  without diminution for distributions during current year and without regard
to E&P at time distribution was made
  - §301(c) – Distribution is treated as dividend (§301(c)(1)), then return of basis
  (§301(c)(2)), and finally gain from sale or exchange of stock (§301(c)(3))
- If CFC has no current year E&P or accumulated E&P, distribution will
be return of basis under §301(c)(2) or gain from sale or exchange of
stock under §301(c)(3), even if shareholder has annual PTEP accounts
Distribution of PTEP, Cont’d

• Aggregate (c)(1) PTEP, (c)(2) PTEP, and (c)(3) E&P must equal amount of §964/§312 E&P of foreign corporation

• Current year E&P first are classified as (c)(3) E&P and then are reclassified as (c)(1) PTEP or (c)(2) PTEP, which can create or increase deficit in (c)(3) E&P

• (c)(3) E&P is reduced by entire amount of PTEP created, which can create or increase deficit in (c)(3) E&P, such as if §951A inclusion exceeds current year E&P

• Current year E&P deficit reduces only (c)(3) E&P
Distribution of PTEP, Cont’d

- On 1/1/19, FC has accumulated E&P of $50, all of which is (c)(3) E&P
- During 2019, FC has $25 of current-year E&P and makes no distributions
- During 2019, USP has a GILTI inclusion of $100 allocated to FC

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- Adjustments to §959(c) amounts
  - First, FC increases its (c)(3) E&P by $25, its current-year E&P
  - Second, FC increases its (c)(2) PTEP and decreases its (c)(3) E&P by $100, the GILTI inclusion allocated to FC

- The sum of FC’s §959(c) amounts ($100 minus $25) equals FC’s §312 E&P
Ordering Rules

• Distribution of PTEP sourced:
  • First to (c)(1) PTEP groups,
  • Second to (c)(2) PTEP groups, and
  • Third to (c)(3) E&P

• Within this §959(c) ordering, distribution of PTEP generally sourced under LIFO approach (i.e., out of most recent annual PTEP account first)

• Section 965 PTEP priority rules
  • Special “priority rule” for Section 965(a) PTEP and then Section 965(b) PTEP overrides general LIFO approach
  • Similar Section 965 PTEP priority rule applies to reclassification of (c)(2) PTEP as (c)(1) PTEP under §959(a)(2)

• If CFC has PTEP in PTEP group in more than one §904 category, distribution is sourced pro rata out of PTEP in each §904 category
Ordering Rules, Cont’d

• Specific ordering rules – Distributions sourced from (c)(1) PTEP (blue), then (c)(2) PTEP (red), and finally (c)(3) E&P (green) in following order:
  • First, from Reclassified Section 965(a) PTEP
  • Second, from Reclassified Section 965(b) PTEP
  • Third, under LIFO approach on pro rata basis from the remaining (c)(1) PTEP groups
  • Fourth, from Section 965(a) PTEP
  • Fifth, from Section 965(b) PTEP
  • Sixth, under LIFO approach on pro rata basis from remaining (c)(2) PTEP groups
  • Seventh, from (c)(3) E&P
Section 965 Priority Rules

• Appear intended to reduce administrative burden, but could have significant favorable or unfavorable foreign tax credit and FX consequences
  • Prop. §1.965-5(b) would apply §965(g) “haircut” to foreign taxes paid by US shareholder on distributions of Section 965(a) PTEP and Section 965(b) PTEP
  • Prop. §1.965-5(c) would apply haircut to foreign taxes deemed paid by US shareholder under §960(b) (or former §960(a)(3)) on distributions of Section 965(a) PTEP and Section 965(b) PTEP
  • Such deemed paid foreign taxes will be predominantly allocated to General Category
  • Prop. §1.986(c)-1(b) would proportionately reduce FX gain/loss recognized on distributions of Section 965(a) PTEP
  • Prop. §1.986(c)-1(c) would provide that zero FX gain/loss is recognized on distributions of Section 965(b) PTEP
Transition Rules

Under transition rules, prior to tax year to which proposed regulations are effective, following groups of PTEP must be tracked:

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If taxpayer previously maintained multi-year pools of Section 951(a)(1)(B) PTEP, Section 956A PTEP, and Section 951(a)(1)(A) PTEP, each pool treated as an annual PTEP account with average USD basis for last tax year before proposed regulations are effective.
Other Rules

• §961 – Distribution of PTEP reduces US shareholder’s (or successor’s) basis in stock of CFC under §961(b)(1) regardless of how basis is created
• §986(c)
  • USD basis tracked separately each annual PTEP account and possibly for each PTEP group within an annual PTEP account
  • If taxpayer previously maintained aggregate USD basis pools for (c)(1) PTEP and (c)(2) PTEP or both, taxpayer may assign average dollar basis to PTEP in each annual PTEP account other than Section 965 PTEP groups
Comments Requested

• Comments were requested regarding:
  • Extent to which §961(c) basis should be treated as basis for determining tested income
  • Extent to which gain or loss (including currency) should be recognized on distributions of PTEP
  • Potential election for multi-year Section 951A PTEP Group and not apply §250(a)(2) to extent such provision would otherwise be relevant in calculating FX gain/loss on distribution of Section 951A PTEP
  • Application of §§959 and 961 to domestic and foreign partnerships
  • Other comments, including with respect to the 2006 proposed regulations
Section 961 Basis Issues

- Section 961(b)(2) provides that a distribution out of PTEP that reduces basis below 0 results in gain, and is determined as of the date of the distribution.
  - Reg. 1.961-2(a)(1): basis decrease occurs as of the time the person receives the excluded amount.

- However, the increase in basis under Section 961(a) from the inclusion that created the PTEP occurs at the end of the year.
  - Reg. 1.961-1(a)(1): basis increase occurs as of the last day of the taxable year.
  - Prop. Reg. 1.961-1(a) (2006): basis increase occurs each time PTEP is increased (also on the last day of the taxable year).

- The Section 965 Gain-Reduction Rule seems to confirm this ordering because it provides a solution solely for Section 965 PTEP. Why not use this opportunity to revise the Section 961 Regulations to apply a similar rule for all flavors of PTEP?
Section 961 Basis Issues

• Example (Based on 1.965-2(j), Example 4):
  • USP’s taxable year ends December 31.
  • CFC’s taxable year ends November 30.
  • USP’s adjusted basis in CFC is $0.
  • CFC has a Section 956(a) inclusion of $100, taken into account on USP’s taxable year ending December 31, 2018, because CFC’s inclusion year ends on November 30, 2018.
  • CFC distributes $100 to USP on January 1, 2018

• Analysis:
  • CFC has $100 Section 965(a) PTEP (Section 959(c)(2)) for 2018
  • CFC distribution is attributable to Section 965(a) PTEP and would result in Section 961(b)(2) gain, but for the gain-reduction rule.
  • On November 30, 2018, USP’s basis in CFC is increased by $100 for the Section 965(a) inclusion amount but then decreased by $100 for the gain prevented by the gain-reduction rule.
Section 961 Basis Issues

• What about Subpart F inclusions other than from Section 965?
• Example (same facts, except in 2018 CFC has a non-Section 965, Subpart F inclusion):
  • USP’s taxable year ends December 31.
  • CFC’s taxable year ends November 30.
  • USP’s adjusted basis in CFC is $0.
  • CFC has a Section 951(a)(1)(A) inclusion (not from Section 965) of $100, taken into account on USP’s taxable year ending December 31, 2018.
  • CFC distributes $100 to USP on January 1, 2018
• Analysis:
  • CFC has $100 Section 951(a)(1)(A) PTEP (Section 959(c)(2)) for 2018
  • Under Section 961(b)(2), as of January 1, 2018, the date of the distribution, $100 gain apparently is recognized because the basis increase for the Section 951(a)(1)(A) PTEP does not occur until November 30, 2018.
  • Same issue could arise after Section 965 PTEP groups are eliminated under the priority rule in Notice 2019-01.
• Could a fix be made in the Section 961 regulations that would apply to all such interim distributions, not just those attributable to Section 965 inclusions?
Open Issues Regarding PTEP
PTEP Sharing

• Cross-block sharing
  • Under current law, PTEP might relate to specific shares of CFC stock, and apportionment of subpart F/GILTI inclusions to shares might not correspond with subsequent distributions
  • These possible mismatches might result in double taxation, although this risk is mitigated by §245A
  • 2006 proposed regulations would have allowed a US shareholder to use PTEP from one block of stock to exclude distributions with respect to other blocks that it held in same CFC on the last day of CFC’s tax year

• Consolidated group sharing
  • If multiple members of a consolidated group own stock of a CFC, subpart F/GILTI inclusions and distributions or sales of the stock might result in double taxation to consolidated group
  • In PLR 9802018, IRS ruled that CFC owned by a member of a consolidated group could only exclude a distribution of PTEP of a lower-tier CFC to extent it was attributable to amounts included in the income of that particular US shareholder, not other members of consolidated group
  • 2006 proposed regulations would have allowed member to share PTEP from shares of stock that another member of its consolidated group held in CFC, provided that the stock was owned on last day of CFC’s tax year
Application of §961(c) for GILTI Regime

- CFC1 has $20 FPHCI from sale. Does CFC1 recognize any tested income?
- §961(c) – Applies “only for the purposes of determining the amount included under section 951”
- §951A(f)(1)(A) – “Except as provided in subparagraph (B), any global intangible low-taxed income included in gross income under subsection (a) shall be treated in the same manner as an amount included under section 951(a)(1)(A) for purposes of applying” §959 and §961
- §951A(f)(1)(B) – “The Secretary shall provide rules for the application of subparagraph (A) to other provisions of this title in any case in which the determination of subpart F income is required to be made at the level of the controlled foreign corporation”
- §951A(c)(2)(A) – Tested income excludes “any gross income taken into account in determining the subpart F income of such corporation”
Application of §961(b)(2) to CFC-to-CFC Distributions of PTEP

- Under §961(c) and §961(b)(1) CFC1 would reduce its basis to $0. Does CFC1 recognize gain under §961(c) and §961(b)(2)?
- §961(c) – Requires “adjustments” to basis similar to those in §961(a) and §961(b)
- §961(b)(2) – “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, the amount shall be treated as gain from the sale or exchange of property”
Application of §961 to Partnerships

- Does USP increase its outside basis in its partnership interest, and does the partnership increase its inside basis in the stock of CFC for the $50 of PTEP?
- Domestic partnership
  - Domestic partnership is a US shareholder, so it increases its inside basis in CFC stock under §961(a)
  - USP increases its outside basis in its partnership interest for its distributive share of domestic partnership’s subpart F inclusion under §705
- Foreign partnership
  - Foreign partnership is not a US shareholder
  - USP increases its outside basis in its partnership interest under §961(a)
  - Does foreign partnership increase its inside basis in CFC stock ($961(a) applies to the US shareholder and §961(c) applies to an upper-tier CFC)?
Treatment of §965(b) PTEP for §1248 Purposes

- In determining §1248(c) E&P of CFC, is Section 965(b) PTEP taken into account?
- §1248(d)(1) – Excludes “earnings and profits of the foreign corporation attributable to any amount previously included in the gross income of such person under section 951”
- §965(b)(4)(A) – “For purposes of applying section 959 in any taxable year beginning with the taxable year described in subsection (a), with respect to any United States shareholder of a deferred foreign income corporation, an amount equal to such shareholder's reduction under paragraph (1) which is allocated to such deferred foreign income corporation under this subsection shall be treated as an amount which was included in the gross income of such United States shareholder under section 951(a)”
PTEP in §304 Transactions/§356 Deemed Dividends

- §304(a)(1) transaction
  - §304(b)(2) – Sources deemed dividend first to E&P of CFC2 and second to E&P of CFC1
  - §304(b)(6) – Requires Treasury to “prescribe such regulations as are appropriate in order to eliminate a multiple inclusion of any item in income by reason of this subpart and to provide appropriate basis adjustments (including modifications to the application of sections 959 and 961)”
  - 2006 proposed regulations would have applied generally applicable PTEP rules to constructive dividend

- §356(a)(2) deemed dividend
  - §356(a)(2) – “If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913”
  - §959(d) – “Any distribution excluded from gross income under subsection (a) shall be treated, for purposes of this chapter, as a distribution which is not a dividend”
  - If §356(a)(2) deemed dividend is treated as distribution of PTI, is basis in stock of CFC reduced under §961(b)(1), potentially increasing amount of gain, deemed dividend, and distribution of PTEP, creating circularity?
PTEP in §304: Complex Example--Background

- USP owns USS and CFC 1.
- USS owns CFC 2. Therefore, CFC 1 and CFC 2 have different US shareholders.
- CFC 1 has $100 USD of 959(c)(2) PTEP and $50 USD of 961 basis associated with the PTI.
- USP has $130 USD of basis in the stock of CFC 1 ($50 of which is attributable to the PTI).
- CFC 1 has no 959(c)(1) PTI and a 959(c)(3) deficit post tax reform of $50 because it was a DFIC but other CFCs of its consolidated group members had losses. (Which generated $50 of 959(c)(2) PTI having no basis.)
- CFC 2 has $400 of 959(c)(2) PTI and $400 of basis with respect to the PTI.
- USS has $600 of basis in CFC 2 ($400 of which is attributable to the PTI).
- CFC 2 has no 959(c)(1) PTI and $200 of 959(c)(3).
PTEP in §304: Complex Example—Transaction

- USP sells 30% of CFC 1 to CFC 2 for $70.
- Where does PTEP go? Where does basis go?
- For the purposes of this example, assume that all PTEP in the 959(c)(2) bucket is 965(a) and 965(b) PTEP.

<table>
<thead>
<tr>
<th>Bucket</th>
<th>Amount</th>
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<tbody>
<tr>
<td>959(c)(1)</td>
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</tr>
<tr>
<td>959(c)(2)</td>
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<tr>
<td>959(c)(3)</td>
<td>$-50</td>
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<tr>
<td>959(c)(1)</td>
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<tr>
<td>959(c)(2)</td>
<td>$400</td>
</tr>
<tr>
<td>959(c)(3)</td>
<td>$200</td>
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</tbody>
</table>
PTEP in §304: Complex Example—Deemed Transaction

- USP is deemed to make a contribution under 351 to CFC 2 of the CFC 1 stock in exchange for CFC 2 stock (the deemed 351).
- CFC 2 is deemed to redeem the newly-issued stock of USP in exchange for $70.
- The redemption is tested under 302, and is treated as a distribution under 301.
- The distribution first comes from the E&P of the acquiring corporation – CFC 2 per 304(b)(2).
- So, the entire $70 would come from the 959(c)(2) PTEP of CFC 2.
- What’s the basis of USP’s 351 stock in CFC 2?
- What happens to non-PTEP basis in USP’s 351 stock that is redeemed?
- If non-PTEP basis jumps back to CFC 1 stock retained by USP (e.g. Rev. Rul. 71-563), does PTEP and associated PTEP basis jump back to USP stock of CFC 1?
- Is USP a Successor in Interest to the PTEP of USS, even if stock is newly issued?
- How do we calculate gain or loss when CFC 1 liquidates? We have a 331 liquidation, with potentially a meaningful loss for USP and a meaningless loss for CFC 2.
- What if CFC 1 has the Indonesian Rupiah as its functional currency and CFC 2 has the USD as its functional currency? What if CFC 2 had the Euro as its functional currency?
- Does Rev. Rul. 92-86 provide an answer?