The Challenges Associated with Accumulating and Distributing Previously Taxed Earnings & Profits

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I. Introduction

In the post-tax reform world, taxpayers and their advisors must deal with a new reality. That is, almost all foreign corporations are now controlled foreign corporations (CFCs) and virtually all CFCs were recently subject to the Code Sec. 965 transition tax, resulting in these CFCs being flush with *earnings and profits* (E&P) that have been recharacterized as previously taxed earnings and profits (PTEP). Furthermore, virtually all CFCs annually generate Subpart F income or, more likely, Global Intangible Low-Taxed Income (also known as GILTI), which also becomes recharacterized as PTEP. Sounds simple enough. However, not all PTEP is treated equally. PTEP must be allocated into one of four separate Code Sec. 904(d) categories, known as baskets, depending on how the PTEP was generated. Furthermore, PTEP is subject to a certain set of ordering rules that clarify how distributions of such PTEP are treated to the recipient.

This all matters because of one significant purpose—the calculation of available foreign tax credits that would reduce on a dollar-for-dollar basis the amount of U.S. income tax owed, and the creditability of foreign taxes allocable to each Code Sec. 904(d) basket is subject to the Code Sec. 904(a) limitation with respect to the specific basket. For example, any foreign taxes paid or accrued on GILTI income are allocated to the GILTI basket. If a U.S. shareholder is in an excess credit position with respect to its GILTI basket and excess limitation position with respect to its general basket, any excess foreign taxes that have been allocated to the GILTI basket generally cannot be reallocated to the general basket. Thus, the excess foreign tax credits attributable to a GILTI inclusion would effectively become useless because GILTI foreign tax credits cannot be carried to future or previous tax years. To confuse matters more, distributions of PTEP may be subject to an additional tax in the CFC's country of residence. Such taxes often come in the form of a withholding tax imposed by the local country on distributions of earnings. Withholding taxes on a distribution of income have to be allocated to a specific Code Sec. 904(d) basket subject to the Code Sec. 904(a) limitation to determine the creditability of such taxes. Even worse, local country withholding taxes applied on a distribution of transition tax generated PTEP are subject to a significant reduction, often called a tax credit haircut. Finally, these rules are further modified when an individual or trust that owns a CFC makes a *so-called* Code Sec. 962 election.

II. The Law

A. Code Sec. 959—Basketing and Ordering Rules for PTEP Distributions

Where the E&P of a CFC consists in whole or in part of PTEP, special rules under Code Sec. 959 apply in determining the ordering and taxation of distributions of such PTEP. Amounts included in the gross income of a U.S. shareholder as Subpart F or GILTI are not included in gross income again when such amounts are distributed to that U.S. shareholder, directly or indirectly through a chain of ownership. A PTEP distribution is generally sourced in the following order: (1) PTEP attributable to investments in U.S. property under Code Sec. 959(c)(1); (2) PTEP attributable to Subpart F income under Code Sec. 959(c)(2); and (3) general current and accumulated E&P under Code Sec. 959(c)(3). For Code Sec. 959 purposes, and subject to recent PTEP guidance discussed below, a distribution is generally attributed to E&P according to the "last in first out" method (LIFO) based on the year income was earned. For example, a distribution is treated as if it were first made out of a CFC's current year E&P, and then the CFC's prior year accumulated E&P.

On November 28, 2018, the Department of Treasury (Treasury) and the Internal Revenue Service (Service) released proposed regulations related to the determination of the foreign tax credit (the Proposed FTC Regulations). In addition, Notice 2019-01 announced Treasury and the Service's intention to withdraw prior proposed regulations under Code Sec. 959 and issue new proposed regulations under Code Secs. 959 and 961. The new proposed regulations described in Notice 2019-01 include rules related to the maintenance of PTEP in annual accounts and within specified groups and the ordering of PTEP upon distribution and reclassification. Thus, the proposed regulations would vary the ordering of PTEP attributable to a distribution and require the maintenance of a system to track the various forms of PTEP.

Under the Proposed FTC Regulations, CFCs are required to establish an annual account for PTEP (annual PTEP account) for each of the Code Sec. 904 baskets. Within each account, a CFC must assign PTEP to one of 10 different PTEP groups in each of the relevant Code Sec. 904 basket (PTEP Groups) based on the U.S. shareholder's underlying income inclusion, while also accounting for any PTEP reclassification as a result of Code Sec. 956 inclusions. Notice 2019-01 adds an additional six PTEP Groups to the 10 PTEP Groups described in the Proposed FTC Regulations. Thus, within each basket, PTEP is allocated to up to 16 groups determined on an annual basis. Among these 16 groups, eight of them are for PTEP attributable to Code Sec. 956 inclusions (including PTEP that are reclassified from Code Sec. 959(c)(2) to Code Sec. 959(c)(1)) described under Code Sec. 959(c)(1), and one of them is for PTEP attributable to the old Code Sec. 951(a)(1)(C) inclusions that are not relevant for most CFCs. Therefore, if the CFC does not have PTEP attributable to investment in U.S. property under Code Sec. 959(c)(1), it will have at most seven PTEP Groups under Code Sec. 959(c)(2).

The Proposed FTC Regulations do not address the ordering of PTEP distributions. Instead, the preamble to the Proposed FTC Regulations notes that the Service and Treasury anticipate that ordering will be addressed in forthcoming regulations under Code Sec. 959. Notice 2019-01 describes regulations that Treasury intends to propose that involve PTEP ordering upon distribution. Generally, and subject to a special priority rule for PTEP arising from Code Sec. 965(a) and (b) (the Special Priority Rule), the notice applies a LIFO approach to the sourcing of distributions from annual PTEP accounts. Thus, subject to the Special Priority Rule, Code Sec. 959(c)(1) PTEP in the most recent annual PTEP account is treated as distributed first, followed by the second most recent annual PTEP account, and continued through each annual PTEP account under Code Sec. 959(c)(1) until each account is exhausted. The same approach will then apply to Code Sec. 959(c)(2) PTEP. Finally, the remaining amount of any distributions is sourced from Code Sec. 959(c)(3), to the extent thereof.

The Special Priority Rule provides an exception from the general LIFO approach described above for Code Sec. 965(a) and (b) PTEP under either Code Sec. 959(c)(1) or Code Sec. 959(c)(2). Starting with Code Sec. 959(c)(1) PTEP, distributions are sourced first from reclassified Code Sec. 965(a) PTEP and then from reclassified Code Sec. 965(b) PTEP. Once these two PTEP Groups are exhausted for Code Sec. 959(c)(1), the remaining annual PTEP accounts related to Code Sec. 959(c)(1) are sourced *pro rata* under the LIFO approach until the Code Sec. 959(c)(1) groups are exhausted. After exhausting Code

Sec. 959(c)(1) PTEP, distributions are then sourced from Code Sec. 959(c)(2) PTEP. Similarly, applying the Special Priority Rule, distributions are first sourced from Code Sec. 965(a) PTEP and then from Code Sec. 965(b) PTEP. After exhausting Code Sec. 965(a) and (b) PTEP, distributions are then sourced *pro rata* from the remaining Code Sec. 959(c)(2) PTEP groups under the LIFO approach until such groups are exhausted. Finally, the remaining amount of any distributions is sourced from Code Sec. 959(c)(3) E&P, as applicable.

The framework described in Notice 2019-01 is admittedly complex. For simplicity and for purposes of illustrating the ordering framework, assume that U.S. Corp, a U.S. corporation, owns 100 percent of the interests in CFC1, a controlled foreign corporation. At the end of Year 2, CFC1 distributes $100 to U.S. Corp, and CFC1 has $150 of E&P that consists entirely of PTEP. CFC1 did not have Code Sec. 956 income inclusions and thus does not have PTEP described in Code Sec. 959(c)(1). For all years, the PTEP of CFC1 in each PTEP group and Code Sec. 959(c)(3) E&P are described in a single Code Sec. 904 basket. The $150 of PTEP consists of the following PTEP types and amounts: (1) $70 of Code Sec. 965(a) PTEP; (2) $20 of Code Sec. 951A PTEP attributable to GILTI inclusion in Year 2; (3) $30 of Code Sec. 951A PTEP attributable to GILTI inclusion in Year 1; and (4) $30 of Code Sec. 951(a)(1)(A) PTEP attributable to Subpart F inclusion in Year 1.

Under the framework, the Special Priority Rule applies before the LIFO approach. Accordingly, $70 of the distribution will be sourced from Code Sec. 965(a) PTEP. After the Special Priority Rule, under the LIFO approach, $20 of the distribution will be sourced from the Code Sec. 951A PTEP attributable to GILTI inclusion in Year 2. The remaining $10 of the distribution will be sourced from both (i) the Code Sec. 951A PTEP attributable to the Year 1 GILTI inclusion and (ii) the Subpart F PTEP attributable to the Year 1 inclusion proportionately, *i.e.*, $5 is from the Year 1 Code Sec. 951A PTEP, and another $5 is from the Year 1 Subpart F PTEP.

B. Code Sec. 960—Deemed Paid Credits on Distributions of PTEP[1]

For any distributions of PTEP, the ordering rule determines the type of PTEP that is distributed. Such determination is particularly important for purposes of determining the creditability of any foreign taxes (such as withholding taxes) that are imposed by the CFC's country on the PTEP distributions.

Prior to the 2017 Tax Act, former Code Secs. 902 and 960(a)(1) permitted a corporate U.S. shareholder to claim a credit for foreign taxes paid by a CFC when the related income was either distributed to the shareholder as a dividend or included in the shareholder's income as a Subpart F inclusion. In both scenarios, the amount of deemed paid foreign taxes was based on multi-year "pools" of earnings and taxes, with the shareholder generally deemed to have paid the same proportion of the CFC's post-1986 foreign income taxes as the amount of the dividend or subpart F inclusion bore to such CFC's post-1986 undistributed earnings. Former Code Sec. 960(a)(3) generally applied the rules of former Code Sec. 902 in allowing the corporate U.S. shareholder to claim a deemed paid credit for foreign income taxes paid by a CFC on a distribution of PTEP.

The 2017 Tax Act repealed Code Sec. 902, modified Code Secs. 904 and 960, and changed the system for determining the deemed paid credit from multi-year pooling to a "properly attributable" standard. The 2017 Tax Act added two new categories of income (GILTI inclusions and foreign branch income) to Code Sec. 904(d), thereby doubling the number of Code Sec. 904(d) categories from two (general and passive categories) to four. The new law entirely repealed the Code Sec. 902 "pooling" mechanism for imputing foreign taxes paid by a CFC to its U.S. shareholders upon a dividend or Subpart F inclusion. Instead, deemed paid credits are now governed solely by Code Sec. 960, which applies a "properly attributable" standard. Specifically, under new Code Secs. 960(a) and (d), a corporate U.S. shareholder can claim a deemed paid credit for foreign income taxes that are properly attributable to current year Subpart F income and GILTI inclusions, respectively. In addition, under new Code Sec. 960(b), a shareholder is generally deemed to have paid foreign income taxes that are properly attributable to distributions of PTEP received from a first-tier CFC (in the case of a corporate U.S. shareholder) or from a lower-tier CFC (in the case of an upper-tier CFC shareholder) (in both cases, PTEP group taxes).

C. Foreign Tax Credit Haircut on Foreign Taxes Incurred on PTEP Distributions

Code Sec. 960(b) provides the deemed paid credits for a CFC's foreign taxes that the U.S. shareholder has not been previously deemed paid and that are properly attributable to a PTEP distribution under either Code Sec. 959(a) or Code Sec. 959(b). As noted, the Proposed FTC Regulations under Code Sec. 960 assign the PTEP at the CFC level to a specific PTEP Group based on the underlying inclusion, such as Subpart F or GILTI.

For distributions of Subpart F PTEP (specifically Code Sec. 965(a) or 965(b) PTEP), the final regulations under Code Sec. 965 adopt the same approach as in the proposed regulations and require a "haircut" of any foreign taxes that are properly attributable to a distribution of Code Sec. 965(a) or 965(b) PTEP. These taxes are generally withholding taxes or local taxes imposed by the CFC's country of residence. The amount of the haircut is equal to the applicable percentage as provided in Code Sec. 965(g) and generally reduces the tax credits by between 55 percent and 77 percent of the foreign taxes paid.

In contrast, for distributions of GILTI PTEP, the Proposed FTC Regulations do not apply any haircut on foreign taxes paid or deemed paid upon distributions of GILTI PTEP. Code Sec. 960(d) allows a deemed paid credit for only an 80 percent of the foreign taxes properly attributable to GILTI inclusions. In compliance with the statutory 20-percent haircut for taxes attributable to GILTI inclusions, the Proposed FTC Regulations make clear that any foreign taxes allocated to the tested income group at the CFC level are subject to the 20-percent haircut. However, the Proposed FTC Regulations do not require the same haircut for any foreign taxes assigned to the GILTI PTEP group. As a consequence, any foreign taxes paid or accrued on distributions of GILTI PTEP may be deemed paid by the U.S. shareholders without any haircut.

Interestingly, the "Bluebook" issued by the Joint Committee of Taxation on December 20, 2018, stated that a technical correction may be necessary to reflect the intent that a 20-percent haircut applies to foreign taxes triggered by distributions of GIILTI PTEP and the foreign taxes not creditable are not deductible under Code Sec. 901. The House Ways and Means Committee Chairman Brady's discussion draft for technical corrections to the tax reform legislation, released on January 2, 2019, also included a provision allowing a deemed paid credit for only 80 percent of the foreign income taxes paid or accrued with respect to distributions of GILTI PTEP.

D. Code Sec. 960(c)—Fixing Foreign Tax Credit Timing Mismatches

Code Sec. 960(c) provides a timing mismatch fix for distributions of PTEP under Code Sec. 959 that are made in a year subsequent to a Code Sec. 951(a) Subpart F inclusion. Specifically, a distribution of PTEP is not treated as an income inclusion to the recipient in the year in which the PTEP distribution occurs. If a local country imposes a withholding tax on such a distribution, Code Sec. 904(a) could deny credit for such tax because a PTEP distribution is not gross income, and with no foreign source gross income, the Code Sec. 904(a) foreign tax credit limitation (calculated based on the proportion of foreign source income bears to worldwide income) is necessarily zero. Code Sec. 960(c) provides relief to this scenario by increasing the Code Sec. 904(a) limitation upwards in appropriate circumstances. Code Sec. 960(c) applies whether the taxpayer is a corporation or an individual.

On its face, this adjustment appeared to apply only to distributions of Code Sec. 951(a) (*i.e.*, Subpart F) generated PTEP and not to distributions of GILTI PTEP. Thankfully, the Treasury recently released favorable guidance in Proposed Reg. §1.960-4(a)(1) and Proposed Reg. §1.960-5, which, among other things, would increase a U.S. shareholder's foreign tax credit limitation under Code Secs. 904 and 960(c) when GILTI earnings are distributed in a later year, thus allowing, in appropriate circumstances, a foreign tax credit for withholding taxes paid on distributions of GILTI PTEP.

E. Code Sec. 961—PTEP Basis Adjustment Issues

The PTEP regime also requires upward and downward basis adjustments in CFC stock for gross income inclusions at the U.S. shareholder level attributable to such CFC. One of the main purposes of the basis adjustments required by the PTEP regime is to prevent the same earnings of a CFC from being taxed more than once so that, for instance, a U.S. shareholder is not taxed on undistributed PTEP when it sells the stock of a CFC.

When a U.S. shareholder has a Subpart F or GILTI gross income inclusion from a CFC that it owns directly or indirectly, Code Sec. 961(a) generally requires a U.S. shareholder to increase its basis in the stock of such CFC by the total amount of such gross income inclusion (*i.e.*, the amount of the PTEP). Code Sec. 961(b), on the other hand, generally requires a U.S. shareholder to reduce its basis in the stock of a CFC when it receives a distribution of PTEP as part of a Code Sec. 301 distribution. The basis reduction is not limited to stock basis created by the PTEP regime, but also includes, for example, acquisition basis under Code Sec. 1012 or Code Sec. 358 basis created as part of a Code Sec. 351 exchange. Moreover, to the extent a U.S. shareholder receives a distribution of PTEP in excess of its basis in the stock of such CFC, Code Sec. 961(b)(2) requires the U.S. shareholder to recognize gain equal to such excess amount.[2]

In the event a U.S. shareholder owns multiple CFCs through a tiered chain of ownership, the PTEP regime basis adjustment rules generally provide that all adjustments occur in the CFC stock owned directly by the U.S. shareholder.[3] For example, assume that a U.S. shareholder owns all of the stock of CFC1, which in turn owns all of the stock of CFC2. Assume further that the U.S. shareholder purchased all of the stock of CFC1 in Year 1 for $100x, and that in Year 2, CFC1 and CFC2 earned $25x and $50x of Subpart F income, respectively. Thus, to reflect its Code Sec. 951(a) gross income inclusion from CFC1 and CFC2 for Year 2, the U.S. shareholder would increase its basis in the CFC1 stock to $175x. If in Year 3 CFC2 distributes $40x to CFC1, which in turn distributes $40x to the U.S. shareholder, the U.S. shareholder would decrease its basis in its CFC1 stock to $135x. The distribution of $40x from CFC2 to CFC1 does not impact the U.S. shareholder's basis in its CFC1 stock.

1. Current Code Sec. 961 Issues. In Notice 2019-1, the Treasury and the Service announced their intent to issue regulations providing for the annual basketing of PTEP and the ordering of PTEP distributions. Much to the disappointment of many taxpayers, the Notice is virtually silent with respect to Code Sec. 961 basis adjustments—except for one significant point. That is, section 3.01 of the Notice specifically provides that forthcoming regulations will confirm that distributions from *any PTEP group* will reduce the U.S. shareholder's stock basis under Code Sec. 961(b)(1) without regard to how that basis was originally created, including if the basis was created under Code Sec. 961(a) due to an inclusion unrelated to the PTEP group being distributed.

This rule will help, for example, U.S. shareholders that either miss the deadline or choose not to make a basis election under the Code Sec. 965 regulations to increase stock basis in any CFC for any Code Sec. 965(b) PTEP attributable to such CFC. Thus, the U.S. shareholder may use other PTEP basis (*e.g.,* GILTI PTEP basis) to offset the distribution of Code Sec. 965(b) PTEP rather than have to recognize gain under Code Sec. 961(b)(2) due to having no Code Sec. 961(a) basis attributable to the distributed Code Sec. 965(b) PTEP.

Notice 2019-1 left unresolved the potential for recognizing gain[4] on the distribution of PTEP during the year it is earned due to potential timing differences between the required upward and downward stock basis adjustments. For example, assume that a calendar-year U.S. shareholder year forms a CFC with a $25x investment and during the CFC's first taxable year the U.S. shareholder will have a GILTI inclusion of $40x with respect to the newly formed CFC. Assume further that the CFC distributes $30x to the U.S. shareholder during its first taxable year.

The existing Code Sec. 961 regulations (which have not been updated since 1965) provide that upward stock basis adjustments occur on the last day of the CFC's taxable year and that downward stock basis adjustments occur when a U.S. shareholder receives a distribution of PTEP. Thus, in the example above, one view is that the U.S. shareholder might be required to recognize $5x of gain under Code Sec. 961(b)(2) upon the distribution of $30x resulting in double taxation of the same $5x.

We believe the better view is that the U.S. shareholder should be able to access its Code Sec. 961(a) stock basis from the current year GILTI inclusion so that it does not recognize any taxable gain under Code Sec. 961(b)(2), and we expect Treasury and the Service to issue guidance consistent with this view.[5] However, until further guidance is released, taxpayers who do not have an urgent need for cash may decide to wait until the following taxable year to make a distribution of PTEP to avoid the potential for Code Sec. 961(b)(2) gain. Alternatively, taxpayers who need instant access to foreign cash may consider other planning opportunities to work around basis adjustment issues such as having the CFC with insufficient basis make a loan to its U.S. shareholder rather than a Code Sec. 301 distribution. Corporate U.S. shareholders may benefit from the recently released proposed Code Sec. 956 regulations which generally do not tax the CFC's earnings attributable to CFC loans under Code Sec. 245A principles or, due to the PTEP ordering rules, would be treated as a distribution of current year PTEP. Nonetheless, other U.S. tax issues—for both corporate and non-corporate U.S. shareholders—would need to be considered (*e.g.*, the possibility of U.S. withholding tax on interest payments to the CFC).

In brief, the PTEP regime basis adjustment rules go hand-in-hand with the Code Sec. 959 PTEP rules. While the upward and downward adjustment mechanics are relatively straightforward, unresolved issues exist that create an unexpected potential for taxable gain. Thus, the Code Sec. 961 rules should not be overlooked when planning a distribution of PTEP.

F. Code Sec. 962 Election for U.S. Individual or Trust Shareholders of CFCs

Code Sec. 962 provides that a U.S. shareholder may elect to have the tax imposed on GILTI and Subpart

F income inclusions be an amount equal to the tax that would be imposed under Code Sec. 11 (*i.e.*, 21 percent corporate tax) as if the amounts were received by a domestic corporation.[6] That is, a Code Sec. 962 election allows an individual to be subject to tax on Subpart F and GILTI inclusions as if such individual were a domestic corporation. If such election is made, the amounts of GILTI and Subpart F income included in the individual's gross income are also treated as if the amounts were received by a domestic corporation for purposes of applying Code Sec. 960. A Code Sec. 962 election applies only with respect to the E&P of the CFC that is considered Subpart F income or GILTI. As a result of making a Code Sec. 962 election, a second layer of tax results when the CFC actually distributes the foreign earnings that have already been included in gross income under Code Sec. 951(a) (and are thus PTEP under Code Sec. 959).

That is, almost all foreign corporations are now controlled foreign corporations (CFCs) and virtually all CFCs were recently subject to the Code Sec. 965 transition tax, resulting in these CFCs being flush with earnings and profits (E&P) that have been recharacterized as previously taxed earnings and profits (PTEP).

The treasury regulations under Code Sec. 962 provide a unique set of ordering rules with respect to distributions of PTEP and current year earnings, which modify the traditional Code Sec. 959 rules. When a CFC makes an actual distribution of E&P, the regulations distinguish between E&P earned during a tax year in which the individual U.S. shareholder has made an election under Code Sec. 962 (962 E&P) and other, non-section 962 E&P (Non-962 E&P). Code Sec. 962 E&P is further classified between (i) "Excludable 962 E&P," which represents an amount of 962 E&P equal to the amount of U.S. federal corporate tax paid on 962 E&P, and (ii) "Taxable 962 E&P," which is the excess of 962 E&P over Excludable 962 E&P.

Generally, a distribution of E&P that the U.S. shareholder has already included in his or her income is tax-free to the U.S. shareholder. However, when a CFC distributes 962 E&P, the portion of the earnings that comprises Taxable 962 E&P is subject to a second layer shareholder level tax. If no Code Sec. 962 election had been made, then the distribution of all of the PTEP would have been tax-free to the recipient shareholder. Thus, the Code Sec. 962 election results in the imposition of an additional layer of tax on the 962 E&P that is considered Taxable 962 E&P. This second layer of tax is consistent with treating the U.S. individual shareholder in the same manner as if he or she invested in the CFC through a domestic corporation.

The Code Sec. 962 regulations adopt the general Code Sec. 959 ordering rules with respect to a CFC's distribution of E&P, but modify them by providing a priority between 962 E&P and non-962 E&P. First, distributions of E&P that is PTEP under Code Sec. 959(c)(1) (*i.e.*, Code Sec. 956 inclusions) are distributed first, E&P that is PTEP under Code Sec. 959(c)(2) (*e.g.*, Code Secs. 951(a) or 951A(a) inclusions) is distributed second, and all other E&P under Code Sec. 959(c)(3) (*i.e.*, E&P relating to the net deemed tangible return amount, high-taxed excepted Subpart F income) is distributed last. This is the case irrespective of the year in which the E&P is earned. Second, when distributions of E&P that is PTEP under Code Sec. 959(c)(1) (*e.g.*, Code Sec. 956 inclusions) are made, distributions of E&P come first from Non-962 E&P. The distributions of E&P that is PTEP under Code Sec. 959(c)(1) then comprise Excludable 962 E&P, and finally Taxable 962 E&P. The same ordering rule applies to distributions of E&P that is PTEP under Code Sec. 959(c)(2) (*e.g.*, Code Secs. 951(a) or 951A(a) inclusions). That is, distributions of E&P that is PTEP under Code Sec. 959(c)(2) come first from Non-962 E&P, then Excludable 962 E&P, and finally Taxable 962 E&P. Finally, within each subset of PTEP (*e.g.*, Code Secs. 959(c)(1) and 959(c)(2)), the ordering rule is LIFO, meaning that E&P from the current year is distributed first, then the E&P from the prior year, and then E&P from all other prior years in descending order.

To illustrate the above ordering rules, assume that an individual U.S. shareholder wholly owns FC, which is a CFC. CFC has never made distributions to the U.S. shareholder. The U.S. shareholder makes a Code Sec. 962 election for year 2018, but not for year 2017. In year 2017, FC's total earnings for 2017 were $200. The U.S. shareholder had a Code Sec. 951(a)(1)(B) inclusion of $100 (attributable to Code Sec. 956 income inclusion), which became PTEP under Code Sec. 959(c)(1).

The U.S. shareholder had a Code Sec. 951(a)(1)(A) inclusion of $100 (attributable to Code Sec. 965 income inclusion), which became PTEP under Code Sec. 959(c)(2). The U.S. shareholder paid full tax on these inclusions, with the result that when the E&P is distributed it should not be subject to a second layer of tax.

In year 2018, FC's total earnings were $80. The U.S. shareholder had a Code Sec. 951A(a) inclusion of $50, which becomes PTEP under Code Sec. 959(c)(2). The U.S. shareholder pays U.S. federal corporate tax of $5 on such inclusion. At this point, for 2018, the Excludable 962 E&P is $5 and the Taxable 962 E&P is $45. The remaining $30 of FC's earnings ($80 less $50) represented the net deemed tangible return amount, which was not currently taxable to the U.S. shareholder. This amount falls within Code Sec. 959(c)(3).

On January 1, 2019, FC distributes $180 to the U.S. shareholder. Under the Code Sec. 962 PTEP ordering rules, the first $100 of the distribution is considered to come out of Code Sec. 959(c)(1) PTEP, which represents the non-962 E&P comprised of the Code Sec. 951(a)(1)(B) inclusion of $100 in 2017 (relating to Code Sec. 956). The next $5 of the distribution is considered to come out of Code Sec. 959(c)(2) PTEP, which is first from 962 E&P comprised of the Excludable 962 E&P from 2018 (attributable to the Code Sec. 951A(a) amount of $50 subject to U.S. federal corporate tax). The next $45 of the distribution is also considered to come out of Code Sec. 959(c)(2) PTEP, but is from the 962 E&P comprised of the Taxable 962 E&P from 2018 (attributable to the Code Sec. 951A(a) amount not subject to U.S. federal corporate tax). This $45 of E&P distributed is subject to a second layer shareholder tax. The next $30 of the distribution is considered to come out of the Code Sec. 959(c)(2) PTEP, but from non-962 E&P from 2017 (attributable to the Code Sec. 951(a) amount of $100 resulting from Code Sec. 965 applying). This example illustrates an unfortunate result, which is that E&P that was subject to the Code Sec. 965 transition tax and not subject to further tax is distributed *after* current year E&P attributable to Code Sec. 951A(a) inclusions (GILTI), which may require a second layer of tax when distributed (relating to Taxable 962 E&P).

ENDNOTES

[1] See Enrica Ma and Bradford LaBonte, "*Proposed Foreign Tax Credit Regulations Clarify Taxpayers' Ability to Claim Deemed Paid Credits*," available at: *https://www.mwe.com/insights/proposed-foreign-tax-credits-clarify-paid-credits/*, Dec. 27, 2018.

[2] For non-corporate U.S. shareholders who have made an election under Code Sec. 962 for the taxable year, the basis adjustment rules under the PTEP regime are slightly modified and focus on the amount of tax paid by the non-corporate U.S. shareholder rather than the total amount of the gross income inclusion.

[3] Basis adjustments in the stock of lower-tier CFCs for PTEP are addressed by Code Sec. 961(c), which directs the Treasury and the Service to issue regulations providing for such adjustments. However, to date, no final regulations have been issued and the proper application of any lower-tier CFC stock basis adjustments remains unresolved although, under current law, there is a strong position that Code Sec. 959(b) should prevent recognition of gain for distributions of PTEP between CFCs in the same tiered ownership chain. This article focuses exclusively on the Code Sec. 961(a) and (b) basis adjustments and does not address potential implications under the principles of Code Sec. 961(c).

[4] Such gain would be recognized under Code Sec. 961(b)(2).

[5] The gain reduction rule in the Code Sec. 965 regulations is instructive as to the position the Treasury and the Service should likely adopt. Under that rule, a U.S. shareholder did not recognize gain under Code Sec. 961(b)(2) for distributions of Code Sec. 965 PTEP made during the transition tax inclusion year that were in excess of the U.S. shareholder's current year PTEP stock basis in the distributing foreign corporation.

[6] S. Rept. No.1881, 1962-3 CB at 798 ("The purpose of this provision [Section 962] is to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be no heavier than they would have been had they invested in an American corporation doing business abroad.").