

Treasury and IRS Release Long-Awaited Proposed Regulations on Previously Taxed Earnings and Profits

Tax Alert

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On the day after Thanksgiving, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) released [proposed regulations](#) addressing previously taxed earnings and profits (PTEP) and related basis adjustments. In the spirit of abundance, the extensive guidance provides detailed technical rules for tracking PTEP and related attributes, adjusting basis to account for PTEP, handling PTEP in the context of a consolidated group, recognizing foreign currency gain or loss on distributions of PTEP, and computing PTEP foreign tax pools. Although the notice of proposed rulemaking clocks in at more than 110,000 words, this tranche of guidance does not address nonrecognition transactions, redemptions, section 304 transactions, transactions to which section 964(e) applies, or structures in which controlled foreign corporations (CFCs) are partners in a partnership. The proposed rules request taxpayer comments on at least 19 specific issues. All comments, and any requests for a hearing, are due by March 3, 2025.

In general, the proposed regulations prescribe a prospective applicability date. With limited exceptions, the proposed regulations would apply to tax years of foreign corporations that begin on or after the date the rules are finalized, and the tax years of any persons for which the tax years of those foreign corporations are relevant. When finalized, the portion of the proposed section 959 regulations that implement certain rules previously announced in [Notice 2019-01](#) would apply retroactively to tax years of U.S. shareholders (and any successors) ending after December 14, 2018, as well as tax years of foreign corporations that end with or within those tax years. Once finalized, taxpayers would be permitted to apply the proposed regulations in their entirety to earlier tax years, if certain stringent conditions were satisfied. The notice of proposed rulemaking does not invite taxpayers to rely on the proposed regulations before they are finalized.

The proposed regulations under section 959 prescribe a detailed regime for tracking PTEP with respect to "covered shareholders" at the shareholder level and foreign corporation level, along with "dollar basis pools" necessary to compute foreign currency gain or loss on distributions of PTEP, and "PTEP tax pools" necessary to calculate the foreign tax credit (FTC) under section 960(b). To reduce complexity, the proposed regulations would allow covered shareholders to elect to combine dollar basis pools and PTEP tax pools across years, with specific rules ensuring consistent application and restricting a taxpayer's ability to revoke the election. Depending on the transaction, shareholder-level accounts would be adjusted at the beginning of the year, at the time of a transaction, or at the end of the year, with a stated goal of "ensur[ing] that PTEP generated or received during the taxable year is available for distribution as of the start of the taxable year." Together, the proposed regulations under sections 959 and 961 would eliminate the potential concern with mid-year distributions of PTEP that precipitated [the release of a taxpayer-favorable advice memorandum in March 2023 \(AM 2023-002\)](#). Adjustments would apply successively from the lowest-tier foreign corporation to the highest-tier.

In drafting the rules governing the composition of "covered distributions," Treasury and the IRS rejected significant taxpayer comments to Notice 2019-01. In particular, the proposed regulations retain a priority rule that treats section 965 PTEP as distributed before certain other types of PTEP – including, in certain cases, current year PTEP. This sequencing arguably conflicts with the plain language of section 959(c) and may adversely affect a taxpayer's FTC. The proposed regulations also retain the position announced in Notice 2019-01 that PTEP is only treated as distributed when a distribution constitutes a dividend under section 316, determined without regard to section 959(d). Under this rule, when a foreign corporation has a deficit in untaxed earnings and profits that exceeds its PTEP, the PTEP would remain trapped and a distribution would constitute a return of capital under section 301(c)(2) or trigger gain under section 301(c)(3).

Under section 959(b), PTEP distributed by a CFC to another CFC is excluded from the recipient CFC's gross income when

computing subpart F income. The proposed regulations confirm that this relief extends to the computation of tested income or loss for purposes of global intangible low-taxed income (GILTI). The proposed regulations would provide special relief for section 965 PTEP distributed from a specified foreign corporation that is not otherwise a CFC. For distributions received by CFCs with split-ownership, the proposed regulations would overturn the longstanding approach of the IRS. Specifically, the proposed regulations would eliminate the "gross-up" mechanism articulated in Revenue Ruling 82-16, in order to ensure that the section 959(b) exclusion only benefits the specific U.S. shareholder to which the distributed PTEP relates. Given the existence of the look-through and same-country exceptions to subpart F, and the related party dividend exception to GILTI, this proposed change may have limited practical impact.

The proposed regulations under section 961 prescribe extensive rules for increasing basis to reflect income inclusions under section 951 and reducing basis (and recognizing gain) to reflect distributions of PTEP. In general, the time at which the proposed rules provide for adjustments to basis matches the time at which annual PTEP accounts are adjusted. In contrast to the annual PTEP accounts prescribed for section 959, each basis adjustment is specific to a share of stock or other item of property. If a PTEP distribution requires a downward adjustment that exceeds the covered shareholder's adjusted basis in a specific share of foreign corporation stock, the covered shareholder recognizes gain under section 961(b)(2). This result holds, even if the covered shareholder owns additional shares of stock of the foreign corporation with positive adjusted basis. In a departure from the [2006 proposed regulations \(which were withdrawn in 2022\)](#), basis attributable to section 961 would not shift between shares when PTEP is distributed with respect to other shares. The revised approach is intended to prevent technical interpretations of section 961 that Treasury and the IRS view as permitting "basis shifting" that leads to "large uneconomic losses." In its zeal to shut down "inappropriate results" from certain brother-sister stock acquisitions under section 304, the proposed regulations may risk triggering non-economic gain (and double taxation) for anodyne, ordinary course transactions. Further study will be required to fully understand the risks of the proposed system.

The proposed regulations establish special "derived basis" rules for stock of a foreign corporation directly owned by a partnership and indirectly owned by a covered shareholder. In addition, the proposed regulations articulate complex rules for the limited purpose basis afforded by section 961(c), which applies to property directly owned by a CFC and indirectly owned by a covered shareholder. Under the proposed rules, a partnership's derived basis or a CFC's section 961(c) basis may be reduced below zero, subject to a limitation, which may result in negative basis instead of triggering immediate gain recognition. Both sets of rules tread upon untouched ground and will likely attract significant comments from stakeholders.

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