Recent IRS Ruling on a Mid-Year PTEP Distribution

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This note discusses a recent Internal Revenue Service ("IRS") private letter ruling addressing a distribution of previously taxed earnings and profits ("PTEP"). The ruling in effect provides that the recipient of a PTEP distribution can access a basis increase under Code Sec. 961(a) for the current year at the time of a distribution (rather than at the end of the year) for purposes of determining gain under Code Sec. 961(b)(2).

Background on Basis Adjustments for PTEP

Code Secs. 961(a) and (b) provide rules for adjusting the basis of a U.S. shareholder's stock in a first-tier controlled foreign corporation ("CFC"). Under Code Sec. 961(a), a U.S. shareholder's basis in stock of a first-tier CFC is increased by amounts included in the U.S. shareholder's gross income as an inclusion under subpart F[1] or global intangible low-taxed income ("GILTI")[2] with respect to such stock (including from CFCs owned by the first-tier CFC).[3] These basis adjustments are intended to prevent double taxation of a CFC's earnings when the stock of the CFC is sold before the CFC has distributed all of its PTEP.

To ensure that the Code Sec. 961(a) basis increase serves its purpose of preventing double taxation of earnings that give rise to inclusions under subpart F or GILTI, under Code Sec. 961(b)(1), a U.S. shareholder's basis in stock of a first-tier CFC is reduced by any amounts of PTEP received from the first-tier CFC that are excluded from the shareholder's gross income under Code Sec. 959(a).[4] Where the amount of PTEP distributed to the U.S. shareholder from a first-tier CFC exceeds the available basis in the CFC, the excess is treated as gain from the sale or exchange of property under Code Sec. 961(b)(2).[5]

For purposes similar to (but more limited than) those underlying Code Secs. 961(a) and (b), Code Sec. 961(c) contemplates basis adjustments to stock in lower-tier CFCs. Code Sec. 961(c) provides for upward basis adjustments to the stock of lower-tier CFCs when they generate PTEP and downward basis adjustments when they distribute such PTEP to an upper-tier

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CFC. The Code Sec. 961(c) basis adjustments apply "only for the purposes of determining the amount included under Code Sec. 951 in the gross income of [the CFC's] United States shareholder." The statute provides that the adjustments contemplated therein shall be made "[u]nder regulations prescribed by the Secretary." Final or temporary regulations have yet to be issued.

If a taxpayer had reported gain under Code Sec. 961(b)(2) as a result of a mid-year PTEP distribution, the taxpayer should consider revisiting that reporting position.

As a result of Code Sec. 965 and GILTI, both enacted as part of the Tax Cuts and Jobs Act of 2017, multinational groups have enormous amounts of PTEP in CFCs. In contrast, pre-Tax Cuts and Jobs Act, most foreign income was not subject to current inclusion and thus multinational groups had relatively small amounts of PTEP in CFCs.

Regulations addressing PTEP and PTEP basis were issued in 1965 and do not address many common issues for taxpayers. The regulations also do not address statutory amendments such as the addition of Code Sec. 304(b)(6). In 2006, the Service and Treasury had published proposed regulations under Code Secs. 959 and 961 to address a variety of issues (the "**2006 PTEP Proposed Regulations**").[6] However, those proposed regulations were never finalized. In Notice 2019-01, Treasury and the Service announced their intention to withdraw the 2006 PTEP Proposed Regulations and to issue new proposed regulations under Code Secs. 959 and 961.[7] On October 21, 2022, the 2006 PTEP Proposed Regulations were withdrawn.[8] Treasury and the IRS have yet to propose new regulations. Thus, while multinational groups have enormous amounts of PTEP in CFCs, final guidance addressing many common PTEP and PTEP basis issues have not yet been issued by the Treasury and the IRS.

Mid-Year PTEP Distributions

Some taxpayers questioned whether a PTEP distribution in the same year but not on the last day of the year (sometimes referred to a mid-year PTEP distribution) that the PTEP was generated could give rise to shareholder gain. Regulations under Code Sec. 961 provide that the increase in the U.S. shareholder's basis under Code Sec. 961(a) for a current year is made "as of the last day in the taxable year" of the CFC.[9] This treatment is consistent with the general rule that a U.S. shareholder includes any subpart F and GILTI in its income as of the last day of its taxable year.[10] On the other hand, regulations issued pursuant to Code Sec. 961(b) provide that a U.S. shareholder's basis in the stock of a first-tier CFC is reduced "as of the time" it receives a distribution of PTEP.[11] The effect of these regulations was unclear with a number of interpretations possible. Commentators have stated that, from a policy perspective, U.S. shareholders should be able to access their Code Sec. 961(a) basis from current year PTEP in the same year as the PTEP is recognized and that Treasury should resolve the issue to "clarify" that for purposes of determining gain under Code Sec. 961(b)(2).[12]

Recent IRS Ruling

In LTR 202304008,[13] the IRS recently ruled favorably on a mid-year PTEP distribution, suggesting that the IRS believes a PTEP distribution in the same year that the PTEP was generated ought to not give rise to shareholder gain. More specifically, in the ruling, a CFC distributed cash to its U.S. shareholder before the last day of its taxable year. For one or more shares of stock of the distributing CFC, the adjusted basis of the share at the time of the PTEP distribution and without regard to the Code Sec. 961(a) Basis Increase[14] will be less than the amount by which the adjusted basis of the share would be reduced under Code Sec. 961(b)(1) (determined as if the adjusted basis were permitted to be reduced below zero) as a result of the distribution. The IRS ruled as follows:

> For each share of [the distributing CFC] stock, [the U.S. shareholder] will take into account the appropriate portion of the Section 961(a) Basis

> Increase with respect to the share when determining the extent to which [the U.S. shareholder] is required to reduce the share's adjusted basis under section 961(b)(1) and recognize gain with respect to the share under section 961(b)(2) as a result of the [PTEP] Distribution.

Although private letter rulings may not be used or cited as precedent under Code Sec. 6110(k)(3), they often reflect the current thinking of the IRS on a particular issue.

Summary

Taxpayers who have significant PTEP should be aware of this ruling. If a taxpayer had reported gain under Code Sec. 961(b)(2) as a result of a mid-year PTEP distribution, the taxpayer should consider revisiting that reporting position. Perhaps most importantly, the ruling likely suggests the approach of upcoming regulations on PTEP.

ENDNOTES

1. *See* Code Sec. 951(a).
2. *See* Code Sec. 951A(a), 951A(f)(1)(A).
3. *See* Reg. §1.961-1(c), *Ex.1*.
4. Code Sec. 961(b)(1); *see also* Reg. §1.961-2(a), (b).
5. Code Sec. 961(b)(2); *see also* Reg. §1.961-2(c).
6. REG-121509-00, 71 FR 51155 (Aug. 29, 2006).
7. Notice 2019-01, IRB 2019-2, 275 addresses a number of issues, including stating that forthcoming regulations will confirm that distributions of PTEP reduce the 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.
8. *See* 87 FR 63981 (Oct. 21, 2022).
9. Reg. §1.961-1(a)(1).
10. Code Sec. 951(a)(1); Reg. §1.951-1(a), (b).
11. Reg. §1.961-2(a)(1).
12. *See* NYSBA Tax Section, Report on Previously Taxed Earnings under Code Sec. 959, Report No. 1402, October 11, 2018 ("There is no apparent policy rationale for requiring Code Sec. 961(b)(2) gain in the case of a PTI distribution during the year the Taxed Income was earned … Treasury should resolve the issue by modifying Reg. §§1.961-1(a)(1) and 1.961-2(a)(1) to clarify that for purposes of determining Code Sec. 961(b)(2) gain, basis decreases in CFC stock under Code Sec. 961(b) … and gain under Code Sec. 961(b)(2), do not occur prior to giving effect to basis increases under Code Sec. 961(a)").
13. The LTR supplemented LTR 202110015.
14. The taxpayer represented that the distributing CFC will, under Code Sec. 951(a)(1)(A), include in its gross income for Year 2 its *pro rata* share of the distributing CFC's subpart F income (within the meaning of Code Sec. 952(a)) for Year 2. The U.S. shareholder will, under Code Sec. 951A(a), include in its gross income for Year 2 its GILTI inclusion amount (within the meaning of Reg. §§1.951A-1(c)(1) and 1.1502-51). Any amount so included by the U.S. shareholder under Code Sec. 951(a)(1)(A), or under Code Sec. 951A(a) and allocated to the distributing CFC under Code Sec. 951A(f)(2) and Reg. §1.951A-5(b)(2), will, under Code Sec. 959, give rise to an increase (in Entity 2's functional currency) to the U.S. shareholder's PTEP accounts with respect to the CFC, and will under Code Sec. 961(a) give rise to an increase (in U.S. dollars) to the U.S. shareholder's adjusted basis in its stock of the CFC (such increase, the "Code Sec. 961(a) Basis Increase").

