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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[REG-121509-00]

RIN 1545-AY54

#### **Exclusion From Gross Income of Previously Taxed Earnings and Profits, and Adjustments to Basis of Stock in Controlled Foreign Corporations and of Other Property**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations that provide guidance relating to the exclusion from gross income of previously taxed earnings and profits under section 959 of the Internal Revenue Code (Code) and related basis adjustments under section 961 of the Code. These regulations reflect relevant statutory changes made in years subsequent to 1983. These regulations also address a number of issues that the current section 959 and section 961 regulations do not clearly answer. These regulations, in general, will affect United States shareholders of controlled foreign corporations and their successors in interest.

**DATES:** Written or electronic comments and requests for a public hearing must be received by November 27, 2006.

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-121509-00), Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044 or send electronically, via the IRS Internet site at <http://www.irs.gov/regs> or via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS REG-121509-00).

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Ethan Atticks, (202) 622-3840; concerning submissions of comments, Kelly Banks, (202) 622-0392 (not toll-free numbers).

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

This document contains proposed amendments to 26 CFR part 1 under sections 959 and 961. Section 959(a)(1) generally provides an exclusion from

the gross income of a United States shareholder for distributions of earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in a United States shareholder's gross income under section 951(a). Section 959(a)(2) excludes from the gross income of a United States shareholder earnings and profits attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) which would, but for section 959(a)(2), be again included in gross income of a United States shareholder under section 951(a)(1)(B) as an amount determined under section 956 (section 956 amounts). Earnings and profits of a foreign corporation included in a United States shareholder's gross income under section 951(a) are referred to as previously taxed earnings and profits or previously taxed income (PTI).

Section 959(b) generally provides that for purposes of section 951(a), PTI shall not, when distributed through a chain of ownership described in section 958(a), be included in the gross income of a controlled foreign corporation (CFC) in such chain for purposes of the application of section 951(a) to such CFC.

Section 959(c) generally provides for the allocation of distributions by a foreign corporation to three different categories of the corporation's earnings and profits: (1) PTI attributable to section 956 amounts that are included in the gross income of a United States shareholder under section 951(a)(1)(B) and section 956 amounts that would have been so included but for section 959(a)(2), (2) PTI attributable to amounts included in gross income under section 951(a)(1)(A), and (3) other earnings and profits (non-PTI). Section 959(f) provides for the allocation of section 956 amounts first to PTI arising from a United States shareholder's income inclusions under section 951(a)(1)(A) and then to non-PTI. In addition, section 959(f) provides a priority rule under which actual distributions of earnings and profits are taken into account before section 956 amounts.

Certain amounts are treated as amounts included in the gross income of a United States shareholder under section 951(a)(1)(A) for purposes of section 959. For example, section 959(e) generally provides that any amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 is treated for purposes of section 959 as an amount included in the gross income of such person under section 951(a)(1)(A).

Section 961 authorizes the Secretary of the Treasury to promulgate

regulations adjusting the basis of stock in a foreign corporation, as well as the basis of other property by reason of which a United States person is considered under section 958(a) to own stock in a foreign corporation. Section 961(a) generally provides for an increase in a United States shareholder's basis in its CFC stock, or in the property by reason of which it is considered to own such stock, by the amount required to be included in its gross income under section 951(a) with respect to such stock.

Under section 961(b), and the regulations thereunder, when a United States person receives an amount which is excluded from gross income under section 959(a), the adjusted basis of the foreign corporation stock or the property by reason of which the shareholder is considered to own such stock is reduced by the amount of the exclusion. In addition, section 961(c) generally provides for regulations under which adjustments similar to those provided for under section 961(a) and (b) are made to the basis of stock in a CFC which is owned by another CFC (and certain other CFCs in the chain) for the purpose of determining the amount included under section 951 in the gross income of a United States shareholder.

Section 959 was enacted so that PTI is excluded from gross income and, thus, not taxed again when distributed by the foreign corporation. Moreover, section 959 effects the relevant gross income exclusion at the earliest possible point. Thus, the "allocation of distribution" rules of section 959(c) ensure that distributions from the foreign corporation are to be paid first out of earnings and profits attributable to amounts that have been previously included in income by the United States shareholders. Accordingly, as a result of its section 951(a)(1) inclusion, a United States shareholder is made whole by receiving, without further U.S. tax, PTI attributable to its stock in a foreign corporation before it receives any taxable distributions from the foreign corporation. Section 961, which adjusts basis in the stock in a foreign corporation for PTI attributable to such stock, also ensures that PTI is not taxed twice if the stock in the foreign corporation is sold before the PTI is distributed.

The existing regulations under sections 959 and 961 were published in 1965. See TD 6795 (1965-1 CB 287). Minor amendments were made to the regulations in 1974, 1978, and 1983. See TD 7334 (1975-1 CB 246); TD 7545 (1978-1 CB 245); TD 7893 (1983-1 CB 132). The regulations have not been updated since 1983 to reflect relevant

statutory changes in subsequent years. For example, section 959(e) (described above) was added by the Deficit Reduction Act of 1984 (Pub. L. 98-369). Section 304(b)(6) was enacted by the IRS Restructuring and Reform Act of 1998 (Pub. L. 105-206) and provides that in the case of a section 304 transaction in which the acquiring corporation or the issuing corporation is a foreign corporation, the Secretary of the Treasury is to prescribe regulations providing rules to prevent the multiple inclusion of any item in income and to provide appropriate basis adjustments, including rules modifying the application of sections 959 and 961. The determination of the amount includible in a United States shareholder's gross income as a result of a CFC's investments in United States property under section 956 was modified by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66). Congress enacted section 961(c) (described in this preamble) as part of the Taxpayer Relief Act of 1997 (Pub. L. 105-34) and further modified the provision in the Gulf Opportunity Zone Act of 2005 (Pub. L. 109-135). Section 986 was added to the Code by the Tax Reform Act of 1986 (Pub. L. 99-514) and provides that earnings and profits of foreign corporations are maintained in the foreign corporation's functional currency and translated into United States dollars when taken into account by a United States person at the appropriate exchange rate specified in section 989.

Further, in addition to raising issues about the complexities of section 959 in cross-chain stock sales subject to section 304(a)(1), commentators and taxpayers have raised a number of other issues that the current section 959 regulations do not clearly answer. For example, issues have been raised about distributions of PTI through a chain of CFCs and the status of PTI when a United States shareholder's stock in a foreign corporation is sold to a foreign person. There are numerous other examples where the existing section 959 regulations simply do not provide sufficient guidance. As a result, additional regulatory guidance is needed to address these and other section 959 issues. In addition, the IRS and Treasury Department are currently studying the new section 954(c)(6) rule enacted by the Tax Increase Prevention and Reconciliation Act of 2005 (Pub. L. 109-222), which provides for look-through treatment of payments between related CFCs under the foreign personal holding company rules of section 954(c), to determine whether that rule

requires any additional regulatory guidance under section 959. Any such guidance will be included in a subsequent project.

### Explanation of Provisions

These proposed regulations provide guidance with respect to a number of issues that are not specifically addressed in the current regulations and also resolve some of the complexities raised regarding the application of sections 959 and 961. The guidance needed to answer open issues under sections 959 and 961 is intended to be consistent with the legislative intent of avoiding double taxation and allowing United States persons to receive the full benefit of their PTI at the earliest possible time.

In order to carry out this legislative intent, these regulations propose new rules that are primarily based on maintaining shareholder accounts for PTI. As described in this preamble, maintaining shareholder accounts for PTI will better ensure that taxpayers are able to receive distributions of PTI before receiving taxable distributions, provide consistency for treatment of PTI by taxpayers and also, provide more rational and clear rules for resolving many of the issues that have been raised by taxpayers since the current section 959 regulations were issued. Under the proposed rules, earnings and profits will still be maintained at the foreign corporation level in the PTI and non-PTI categories described in section 959(c) on an aggregate basis with respect to all of the foreign corporation's outstanding shares.

The proposed rules also would modify the current regulations to reflect amendments to the law since 1965, such as the addition of section 959(e) and section 961(c), and the modification of sections 304 and 956. Minor changes have also been proposed to reflect changes in IRS titles and organizational units used in the current regulations.

#### A. Shareholder-Level Exclusion Under Section 959(a)

##### 1. In General

Section 959 provides rules for the exclusion from gross income of PTI. Prop. Reg. § 1.959-1 describes the scope and purpose of the proposed regulations under section 959 in paragraph (a), and provides definitions in paragraph (b). Paragraph (c) generally provides for the exclusion from a covered shareholder's gross income of a distribution or section 956 amount based upon the amount of adjustments made to a shareholder's PTI accounts with respect to the relevant stock under Prop. Reg. § 1.959-3

because of that distribution or section 956 amount, as discussed below. A covered shareholder is defined to mean a person who is (1) a United States person who owns stock (within the meaning of section 958(a)) in a foreign corporation and who has had a section 951(a) inclusion with respect to its stock in such corporation, (2) a "successor in interest" (defined in this preamble), or (3) a corporation that is not described in (1) or (2) and that owns stock (within the meaning of section 958(a)) in a foreign corporation in which another corporation is a covered shareholder described in (1) or (2), if both corporations are members of the same consolidated group.

##### 2. Shareholder PTI Accounts

Prop. Reg. § 1.959-1(d)(1) requires each covered shareholder of a foreign corporation to maintain a PTI account for each share of stock in a foreign corporation that the shareholder owns directly, or indirectly under section 958(a). Although the PTI account is share specific, as a matter of administrative convenience, Prop. Reg. § 1.959-1(d)(1) permits a shareholder to maintain the account with respect to an entire block of stock in foreign corporation if the PTI attributable to each share in the block is the same. For a discussion of the rules for maintaining a PTI account, see Part C of this discussion.

##### 3. Successors in Interest

Section 959(a) extends the exclusion from gross income for PTI to any United States person who acquires from any person any portion of the interest of a United States shareholder (as the term is defined in section 951(b) or section 953(c)(1)(A)) in a foreign corporation, but only to the extent of that portion and subject to such proof of the identity of such interest as the Secretary of the Treasury may by regulations prescribe. Consequently, Prop. Reg. § 1.959-1(d)(2)(i) provides that a transferee of stock in a foreign corporation acquires the PTI account of the transferor for such stock and may exclude PTI from gross income under section 959(a) by reference to the PTI account for the stock acquired, if the transferee is a United States person that can prove the right to the exclusion (successor in interest).

In order to establish a United States person's right to the exclusion, the proposed regulations provide that a person must attach a statement to its return that provides that it is excluding amounts from gross income because it is a successor in interest and that provides the name of the foreign corporation.

Further, a person must be prepared to provide, within 30 days upon the request of the Director of Field Operations, certain additional information (e.g., evidence showing that the earnings and profits for which an exclusion is claimed are PTI and that such amounts were not previously excluded from the gross income of a United States person). The information that may be required under these proposed regulations remains substantially unchanged from the information that is currently required to be included in a statement with the United States person's return under § 1.959-1(d).

Moreover, Prop. Reg. § 1.959-1(d)(2)(ii) provides that the amount of the PTI account for stock that is transferred to someone who is not a successor in interest (e.g., a foreign person) is preserved unchanged during the period of such person's ownership of such stock. However, section 959(a) extends the section 959(a) exclusion to a United States person who acquires a United States shareholder's interest in a foreign corporation from any person. Accordingly, Prop. Reg. § 1.959-1(d)(2)(i) provides that if a United States person acquires stock in a foreign corporation from a person that is not a successor in interest, such as a foreign person, and the United States person qualifies as a successor in interest, the United States person acquires the PTI account attributable to the foreign corporation stock acquired and may exclude PTI from gross income under section 959(a) by reference to the PTI account for such stock.

#### *B. CFC-Level Exclusion Under Section 959(b)*

The earnings and profits of a CFC (lower-tier CFC) attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be also included in the gross income of the CFC receiving the distribution (upper-tier CFC) in such chain for purposes of the application of section 951(a) to such upper-tier CFC with respect to such United States shareholder. Prop. Reg. § 1.959-2 contains rules relating to the section 959(b) exclusion. These rules are intended to reflect the holding of Rev. Rul. 82-16 (1982-1 CB 106) as well as rules regarding cross-chain sales of stock in a foreign corporation by a CFC subject to section 304(a)(1).

In Rev. Rul. 82-16, an upper-tier CFC, 70 percent owned by a United States shareholder (USP) and 30 percent

owned by a foreign person, received a distribution of \$200x of earnings and profits from a lower-tier CFC wholly owned by the upper-tier CFC. The lower-tier CFC had earned \$100x of subpart F income for the year of the distribution (\$70x of which was included in USP's gross income under section 951(a)) and a \$100 of non-subpart F income. The ruling held that \$100x, rather than \$70x, was excluded from the gross income of the upper-tier CFC under section 959(b). If only \$70x were excluded, USP would be required to include in gross income \$21x of subpart F income with respect to the remaining \$30x included in the upper-tier CFC's gross income, resulting in a total inclusion in USP's gross income of \$91x ((70% × \$30) + (70% × \$100)).

Prop. Reg. § 1.959-2(a) addresses the issue raised in Rev. Rul. 82-16, and accordingly, provides that, the amount of the exclusion provided under section 959(b) is the entire amount distributed by the lower-tier CFC to the upper-tier CFC that gave rise (in whole or in part) to an adjustment of the United States shareholder's PTI accounts with respect to the stock it owns (within the meaning of section 958(a)) in the lower-tier and upper-tier CFC under Prop. Reg. § 1.959-3(e)(3) (discussed in this preamble). This amount shall not exceed the earnings and profits of the distributor CFC attributable to amounts described in section 951(a). Such amount is not limited to the amount of the adjustment to the United States shareholder's PTI account.

For example, under the facts of Rev. Rul. 82-16, the amount excluded from the upper-tier CFC's gross income for purposes of applying section 951(a) to USP under Prop. Reg. § 1.959-2(a) is \$100x. That is, the entire amount of the earnings and profits distributed by the lower-tier CFC that were attributable to amounts described in section 951(a) and that caused an adjustment to USP's PTI accounts in both the upper- and lower-tier CFCs under Prop. Reg. § 1.959-3(e)(3).

Prop. Reg. § 1.959-2(a) produces results consistent with Rev. Rul. 82-16, while ensuring that section 959(b) does not inappropriately prevent taxation under section 951(a) of a United States shareholder that has acquired stock in a CFC from a person who was not taxed on the subpart F income of a lower-tier CFC in the year such income was earned (e.g., a foreign person). For example, assume the same facts as those of Rev. Rul. 82-16, except that: (1) The subpart F income was earned by the lower-tier CFC in year 1, (2) another United States shareholder (DC) acquired the 30 percent interest in the upper-tier CFC in

year 2 from the foreign person with a zero PTI account, and (3) the lower-tier CFC did not distribute any property until year 3. Under Prop. Reg. § 1.959-2(a), the section 959(b) exclusion for the upper-tier CFC for purposes of calculating USP's section 951(a) inclusion is still \$100. In contrast, Prop. Reg. § 1.959-2(a) provides that the section 959(b) exclusion for the upper-tier CFC for purposes of determining DC's section 951(a) inclusion is zero because none of the earnings and profits distributed were attributable to amounts included in income under section 951(a) with respect to DC or the person to whom DC is a successor in interest. Therefore, DC may have an income inclusion under section 951(a).

In addition, Prop. Reg. § 1.959-2(b) provides guidance with respect to the application of section 959(b) in the context of stock sales subject to section 304(a)(1) where the selling corporation is a CFC. The proposed regulations clarify that in the case of a deemed redemption resulting from a transaction described in section 304(a)(1) in which earnings and profits of an acquiring foreign corporation or an acquired foreign corporation or both are deemed distributed to a selling CFC, the selling CFC is deemed for purposes of section 959(b) to receive such distributions through a chain of ownership described under section 958(a).

#### *C. Maintenance of PTI Accounts*

The proposed regulations contain detailed rules regarding the maintenance of shareholder PTI accounts and the maintenance of pools of PTI and non-PTI earnings and profits with respect to a foreign corporation, including rules for adjusting PTI accounts as a result of certain transactions. In addition, the proposed regulations provide rules for covered shareholders that have more than one share of stock in a foreign corporation and covered shareholders that are members of a consolidated group.

##### *1. Shareholder-Level Accounting of PTI*

The proposed regulations provide that a covered shareholder's PTI account with respect to its stock in a foreign corporation shall identify the amounts included in gross income by a United States shareholder under section 951(a)(1)(A) with respect to the stock (PTI described in section 959(c)(2)), and amounts that are included in the gross income of a United States shareholder under section 951(a)(1)(B) and section 956 amounts that would have been so included but for section 959(a)(2) (PTI described in section 959(c)(1)) by such shareholder who owns the stock or by

a successor in interest. A shareholder account must also reflect these amounts in the functional currency of the foreign corporation and the annual dollar basis of each category of PTI in the account.

## 2. Corporate-Level Accounting of PTI

The proposed regulations also provide that separate aggregate categories (with respect to all of the shareholders of a foreign corporation) of PTI described in section 959(c)(1) and section 959(c)(2) and non-PTI shall be maintained with respect to foreign corporations. These categories of earnings and profits of a foreign corporation shall be maintained in the functional currency of the foreign corporation.

The proposed regulations reflect the basic allocation rules under section 959(c) and (e). Those rules provide that distributions are considered to be made on a last-in first-out basis under section 316(a), first from any PTI described in section 959(c)(1), then from PTI described in section 959(c)(2), and finally from non-PTI earnings and profits. In addition, section 956 amounts are allocated first to section 959(c)(2) earnings and profits and then to non-PTI earnings and profits. Consequently, PTI resulting from section 956 amounts in a prior year cannot exclude section 956 amounts in a later year from otherwise being included in a United States shareholder's gross income under section 951(a)(1)(B).

The proposed regulations also provide that these allocations to PTI are made in conjunction with the shareholder-level adjustments to shareholder-level PTI accounts. In addition, any adjustments to earnings and profits required under section 312 or other sections of the Code or Treasury regulations shall generally be made only to non-PTI.

## 3. Foreign Currency and Foreign Tax Credit Rules

The proposed regulations also contain several rules that reflect the significant changes made to the foreign currency translation rules since the existing section 959 regulations were issued. The proposed regulations also contain rules regarding the foreign tax credit rules relating to PTI.

### a. Dollar Basis Pooling Election

The proposed regulations provide that a shareholder account must reflect the annual dollar basis of each category of PTI in the account. However, Prop. Reg. § 1.959-3(b)(2)(ii) allows taxpayers to elect to treat distributions as being made from a single pool of post-1986 PTI for purposes of computing foreign currency gain or loss under section 986(c) and basis adjustments under

section 961 with respect to distributions of PTI. Thus, the reduction of the basis of shares in a foreign corporation and the foreign currency gain (or loss) attributable to a PTI distribution may both be determined by assigning a pro rata portion of the shareholder's aggregate dollar basis in its PTI account to a distribution of PTI. Notice 88-71 (1988-2 C.B. 374) makes this pooled approach available to taxpayers for purposes of section 986(c) at the taxpayer's election, but it does not provide guidance as to how this election is made. The proposed regulations provide that the election is made by using a dollar basis pool to compute foreign currency gain or loss under section 986(c) with respect to distributions of PTI of a foreign corporation, or to compute gain or loss with respect to its stock in the foreign corporation, whichever occurs first. Any subsequent change in the taxpayer's method of assigning dollar basis may only be made with the consent of the Commissioner.

### b. Taxes and Other Expenses Attributable to PTI

Prop. Reg. § 1.959-3(c) provides that the corporate-level and shareholder-level PTI accounts are reduced by the functional currency amount of any income, war profits, or excess profits taxes imposed by any foreign country or a possession of the United States on or with respect to PTI as it is distributed by a foreign corporation to another foreign corporation through a chain of ownership described in section 958(a). The proposed regulations further provide that such taxes are not added to the foreign corporation's post-1986 foreign income taxes pool, which is maintained with respect to the foreign corporation's post-1986 undistributed earnings. Rather, such taxes are maintained in a separate account and allowed as a credit pursuant to section 960(a)(3) when the associated PTI is distributed to a United States shareholder (or its successor in interest). This rule ensures that amounts previously included in income that are used to pay creditable foreign taxes and so are unavailable for distribution to covered shareholders reduce the amount of PTI available for distribution but may be claimed as a foreign tax credit at the appropriate time. The proposed regulations also provide for corresponding adjustments to the covered shareholder's dollar basis of the PTI account.

Prop. Reg. § 1.959-3(d) provides that no expenses of a foreign corporation, other than creditable foreign income taxes described in Prop. Reg. § 1.959-

3(c), shall be allocated and apportioned to reduce PTI. By allocating all such expenses to non-PTI, this rule preserves the amount of PTI that may be distributed to a United States shareholder (or its successor in interest) in a non-taxable manner.

## 4. Adjustment of Shareholder PTI Accounts

The proposed regulations generally provide rules for the adjustment of a covered shareholder's PTI account upon an inclusion of income by the shareholder under section 951, an actual distribution of earnings and profits to the shareholder, or a determination of a section 956 amount with respect to the shareholder. The proposed regulations provide that the adjustment of PTI accounts occur according to the ordering rules of section 959 to determine the tax consequences of the various events. For purposes of determining the tax consequences to a covered shareholder in a foreign corporation, the proposed regulations provide that with respect to a foreign corporation's taxable year, and for the taxable year of the covered shareholder in which or with which such taxable year of the foreign corporation ends, the following events are taken into account in the following order: (1) The covered shareholder's inclusion of subpart F income or other amounts in gross income under section 951(a)(1)(A) for a taxable year, (2) any actual distributions of current or accumulated earnings and profits by a foreign corporation during the year, including redemptions treated as distributions of property to which section 301 applies pursuant to section 302(d); and (3) any investments in United States property by a CFC during the year resulting in a section 956 amount for one or more United States shareholders for the year. For purposes of the proposed regulations, amounts included in the gross income of any person as a dividend under section 1248(a) or (f) are generally treated as section 951(a)(1)(A) inclusions.

Thus, under Prop. Reg. § 1.959-3(e)(2), at the end of the foreign corporation's taxable year, a shareholder's PTI account is first adjusted upward by the amount of any subpart F income included in gross income by the shareholder under section 951(a) with respect to the shareholder's stock in the foreign corporation. Next, a shareholder's PTI account is adjusted downward by the amount of any distributions of PTI to the shareholder with respect to the stock during the year. However, a PTI account can never be reduced below zero. Third, to the extent that any section 956

amount for the year is equal to (or less than) the amount of PTI described in section 959(c)(2), an amount of such PTI equal to the section 956 amount is reclassified as PTI described in section 959(c)(1), but does not decrease the shareholder's PTI account. Finally, the shareholder's PTI account is adjusted upward by any section 956 amount in excess of the PTI described in section 959(c)(2) for the year. Corresponding adjustments are made to the dollar basis of the PTI account.

This sequence of adjustments may be affected by the PTI sharing rules discussed below. Although the sharing rules are described in greater detail in Prop. Reg. §§ 1.959–3(f) and (g), the order of the adjustments described in these sections are provided for in the steps described in Prop. Reg. § 1.959–3(e)(2).

The amount of a downward adjustment to the covered shareholder's PTI account under the second step described above is excluded from the shareholder's gross income under section 959(a)(1) and Prop. Reg. § 1.959–1(c)(1). Similarly, the amount of section 959(c)(2) PTI which is reclassified as section 959(c)(1) PTI under the third step described above is excluded from the covered shareholder's gross income under section 959(a)(2) and Prop. Reg. § 1.959–1(c)(2).

#### 5. Adjustment to PTI Accounts Upon Distributions to Intermediary CFCs

Where stock in a lower-tier CFC is owned indirectly by a United States shareholder (or successor in interest) through one or more upper-tier CFCs in a chain of ownership under section 958(a), the shareholder's PTI accounts with respect to stock in the relevant foreign corporations in the chain must be adjusted when the lower-tier CFC makes a distribution of PTI to an upper-tier CFC in the chain. Prop. Reg. § 1.959–3(e)(3) provides that the shareholder's PTI account with respect to stock in the distributing foreign corporation is decreased by the amount of PTI distributed with respect to such stock, and the shareholder's PTI account with respect to stock in the recipient foreign corporation is increased by the same amount (in addition to being increased by any non-PTI portion of the distribution that results in an inclusion in the shareholder's gross income under section 951(a) as subpart F income of the receiving CFC). Prop. Reg. § 1.959–3(e)(3) provides a spot rate translation convention for cases in which the distributing and receiving corporations use different functional currencies.

#### 6. Effect of Deficits in Earnings and Profits

Prop. Reg. § 1.959–3(e)(5) provides that a shareholder's PTI account is not adjusted to take into account any deficit in earnings and profits of the corporation for the taxable year. Deficits will reduce only the non-PTI of the corporation under section 312.

#### 7. Distribution in Excess of the PTI Account

Under Prop. Reg. § 1.959–3(e)(5), when a foreign corporation distributes to a shareholder an amount exceeding the PTI account with respect to the relevant stock, the treatment of the excess amount depends on the facts and circumstances. Subject to the PTI sharing rules discussed below, the excess amount of a distribution generally is treated as a dividend under section 316 to the extent of the distributing corporation's non-PTI, and thereafter as a return of capital (reducing the shareholder's basis in its stock in the foreign corporation) under section 301(c)(2). Any portion of the distribution remaining after the shareholder's basis of the stock in the foreign corporation is reduced to zero is treated as capital gain under section 301(c)(3).

#### 8. PTI Sharing Rules

The purpose of section 959 is to prevent double taxation of amounts that have been previously included in gross income by a United States shareholder under section 951(a) and, importantly, to prevent such double taxation at the earliest possible time. Section 951 subjects a United States shareholder to tax on undistributed income of a CFC, so the ordering rule of section 959(c) effectuates this statutory purpose by treating actual distributions to the shareholder as coming first out of PTI. As one of the goals of section 959 is to treat distributions as first coming from PTI, the IRS and Treasury Department believe that a United States shareholder (or successor in interest) should be entitled to exclude from gross income under section 959(a) all of a foreign corporation's distributions of earnings and profits and section 956 amounts to the extent of PTI associated with any of the United States person's stock in the foreign corporation, before that person is required to include additional distributions of earnings and profits or section 956 amounts of the foreign corporation in gross income.

The IRS and Treasury Department believe that similar rules should apply with respect to members of a consolidated group. Although the

taxation of a consolidated group represents a hybrid of single and separate entity treatment, consolidated attribute utilization is generally based on single entity treatment. For example, when determining consolidated taxable income for a given year, subject to certain limitations, the group is entitled to offset its income with any consolidated net operating losses that are carried forward to such year (regardless of which member or members recognized the income or incurred the losses). Given the broad regulatory authority of section 1502 and the statutory mandate in section 959 to allow United States shareholders (or successors in interest) to recover PTI at the earliest possible time, the IRS and Treasury Department believe that PTI is an attribute for which single entity treatment of United States consolidated groups is appropriate. As a result, the IRS and Treasury Department have concluded that a shareholder of a foreign corporation that is a member of a consolidated group should be entitled to exclude from gross income under section 959(a) all of a foreign corporation's distributions of earnings and profits, and section 956 amounts, to the extent of PTI associated with any stock in the foreign corporation owned by any member of the consolidated group (with appropriate adjustments). Therefore, the proposed regulations provide for sharing of PTI between accounts of different members of a consolidated group in a manner similar to the sharing of PTI between multiple accounts of a single shareholder, as described below.

#### a. Shareholder With Multiple PTI Accounts

Prop. Reg. § 1.959–3(f) provides a special rule that applies when a United States shareholder has more than one PTI account with respect to stock in a foreign corporation, and during its taxable year, the foreign corporation distributes earnings and profits in an amount that exceeds one or more of such PTI accounts. In that case, the shareholder's PTI accounts with respect to all of its other stock in the foreign corporation that it owns at the end of the foreign corporation's taxable year shall be reduced, in the aggregate, by the amount of the excess, on a pro rata basis by reference to the level of such PTI accounts (after such PTI accounts have first been adjusted to reflect any distributions of earnings and profits with respect to those blocks of stock).

The aggregate reduction in such PTI accounts produces a corresponding increase in the PTI account that would have been exceeded by the amount

distributed but for the operation of this sharing rule. That PTI account is then reduced to zero to reflect the amount of earnings and profits distributed with respect to that block of stock during the year.

Similarly, if the section 959(c)(2) portion of a PTI account for a share in a foreign corporation is exceeded by the section 956 amount attributable to the share, the aggregate amount of the section 959(c)(2) portion of the PTI accounts for all other stock of the foreign corporation owned by the shareholder on the last day of the foreign corporation's taxable year is available for purposes of excluding the section 956 amount from gross income under section 959(a)(2).

#### b. Shareholder That Is a Member of a Consolidated Group

Prop. Reg. § 1.959-3(g) provides similar sharing rules where stock in a foreign corporation is owned by two or more members of a consolidated group. For purposes of administrative convenience, however, this rule focuses on whether the shareholders are members of the same consolidated group at the end of the foreign corporation's taxable year and not at the time the PTI in question was generated. Specifically, if the total amount of a United States shareholder's PTI account or accounts for stock in a foreign corporation is exceeded by the amount of earnings and profits distributed by the corporation to the shareholder during the year, the PTI accounts of other members of the shareholder's consolidated group who own stock in the corporation are decreased on a pro rata basis (after adjustment) and the shareholder's PTI accounts or account, as the case may be, will be correspondingly increased and then adjusted downward to zero.

Similarly, if the total amount of the section 959(c)(2) portion of a shareholder's PTI account or accounts for stock in a foreign corporation is exceeded by the shareholder's section 956 amount for the year, the aggregate amount of the section 959(c)(2) portions of the PTI accounts of other members of the shareholder's consolidated group at the end of the foreign corporation's taxable year who own stock in the foreign corporation will be available to the shareholder for purposes of excluding the section 956 amount from gross income under section 959(a)(2).

#### 9. Redemptions, Including Section 304 Transactions

The proposed regulations provide rules for the adjustment of PTI accounts and the effect on the corporation's non-

PTI when a foreign corporation redeems its stock. The effect of a distribution in redemption of stock (redemption distribution) depends on whether the redemption distribution is treated as a payment in exchange for the stock under sections 302(a) or 303, or as a distribution of property to which section 301 applies pursuant to section 302(d).

##### a. Redemptions Treated as Sales or Exchanges

If a redemption distribution is treated as a sale or exchange, generally the amount chargeable to the earnings and profits of the redeeming corporation is limited by section 312(n)(7) to a ratable share of the earnings and profits. Where the redeeming corporation is a foreign corporation and there is a PTI account with respect to the redeemed stock, the proposed regulations provide that section 312(n)(7) is applied by limiting the reduction of the redeeming corporation's earnings and profits to an amount which does not exceed the sum of (1) the amount in the PTI account for the redeemed stock and (2) a ratable share of the corporation's non-PTI attributable to the redeemed shares, if any. This sum first reduces the PTI account with respect to the redeemed stock and then reduces the corporation's non-PTI.

The IRS and Treasury Department believe that, in the case where a foreign corporation redeems stock in a transaction treated as a sale or exchange for an amount that is less than the PTI account for that stock, it would be inappropriate to transfer the remainder of the PTI account to any other PTI accounts with respect to stock in the foreign corporation. Under section 961(a) and the regulations thereunder, the basis of stock in a foreign corporation is increased by the amount included in the shareholder's gross income under section 951(a), which is reflected in the PTI account with respect to such stock. The shareholder recovers this increase in basis upon a sale of the stock, preventing the shareholder from suffering double taxation on gain attributable to PTI (or in appropriate cases enabling the shareholder to recognize a loss). Consequently, under the proposed regulations, the remainder of the PTI account in the situation described above is not transferred to any other PTI account because it was already accounted for in the treatment of the redemption as a sale or exchange. Any corporate-level PTI attributable to the redeemed stock that remains after the reduction under section 312(n)(7) loses its character as PTI and is reclassified as non-PTI of the

corporation. The IRS and Treasury Department believe that because the redeemed shareholder is able to use the loss resulting from the redemption to offset other income, its excess PTI must become other earnings and profits that remain with the foreign corporation so that those earnings and profits can be subject to tax.

##### b. Redemptions Treated as Section 301 Distributions

If, under section 302(d), a redemption distribution is treated as a distribution of property to which section 301 applies, the proposed regulations provide that the rules of Prop. Reg. §§ 1.959-1 and -3 shall apply in the same manner as they do to any other distribution to which section 301(c) applies. The PTI account with respect to the redeemed stock is reduced by the amount of the redemption distribution. If the redemption distribution exceeds such PTI account, the sharing rules described above regarding nonredemptive distributions of earnings and profits will be applicable. If, instead, the PTI account with respect to the redeemed shares exceeds the amount of the redemption distribution, the excess PTI is reallocated to the PTI accounts with respect to the remaining stock in the foreign corporation in a manner consistent with, and in proportion to, the proper adjustments of the basis in the remaining shares of the foreign corporation pursuant to § 1.302-2(c). Accordingly, the proposed regulations also require proper adjustment of the basis of the shareholder's remaining stock in the redeeming corporation, and of stock in the redeeming corporation held by related persons (not limited to members of the shareholder's consolidated group).

##### c. Deemed Redemptions Under Section 304

With respect to amounts paid to acquire stock in a transaction described in section 304(a)(1) and to which section 301(c) applies, the rules of Prop. Reg. §§ 1.959-1 and -3 shall apply in the same manner as they do to any other distribution to which section 301(c) applies. As discussed below, the sharing rules described above are applicable to such redemption distributions that are treated as distributions of property to which section 301 applies. In addition, a covered shareholder receiving such a distribution of earnings and profits shall have a PTI account with respect to the stock of each foreign corporation deemed to have distributed its earnings and profits under section 304(b)(2).

The Senate Report on the IRS Restructuring and Reform Act of 1998 states with respect to the Secretary's authority to prescribe regulations resulting from the enactment of section 304(b)(6), "It is expected that such regulations will provide for an exclusion from income for distributions from earnings and profits of the acquiring corporation and the issuing corporation that represent previously taxed income under subpart F. It further is expected that such regulations will provide for appropriate adjustments to the basis of stock held by the corporation treated as receiving the distribution or by the corporation that had the prior inclusion with respect to the previously taxed income." S. Rep. No. 105-174 at 179 (1998). The Conference agreement on the Act follows the Senate amendment. H.R. Conf. Rep. No. 105-599 (1998).

In the case where members of a United States consolidated group own stock in the issuing corporation and the acquiring corporation in a section 304(a)(1) transaction, the PTI accounting and sharing rules are intended to prevent double taxation of PTI, as intended by Congress in enacting sections 304(b)(6) and 959. A lower-tier, cross-chain acquisition of stock is generally subject to section 304(a)(1) and the transferor is treated as having transferred the stock in the issuing corporation to the acquiring corporation in exchange for stock in the acquiring corporation in a transaction to which section 351(a) applies. The acquiring corporation is treated as having redeemed those shares pursuant to a redemption distribution to which section 301 applies. As a result, in accordance with these regulations, a PTI account with respect to the stock in the foreign corporation that is treated as redeemed under section 304(a)(1) would be considered to arise at the time of the transaction. Any PTI accounts with respect to stock in the foreign corporation owned by other members of the shareholder's consolidated group would be reduced, and the PTI account of the redeemed shareholder increased (and then reduced to zero), under the PTI sharing rules described above.

#### D. Basis Adjustments

The proposed regulations contain corresponding amendments to the regulations under section 961. These proposed regulations generally provide for increases and reductions in the basis of foreign corporation stock or other property through which foreign corporation stock is owned which match the increases and reductions in the PTI account with respect to such

stock under the section 959 proposed regulations. The proposed regulations provide translation conventions for determining dollar basis adjustments under section 961 as a result of inclusions under section 951(a), distributions, and the foreign income taxes imposed on PTI as it is distributed through tiers of foreign corporations.

The proposed regulations also implement section 961(c) by providing for adjustments to the basis of stock in a CFC that is held by another CFC in a chain of ownership described in section 958(a) for the purpose of determining the amount properly includible in gross income under section 951(a) by a United States shareholder upon a sale of stock in a lower-tier CFC.

The regulations also contain rules describing basis adjustments resulting from cross-chain sales of foreign corporation stock under section 304(a)(1).

#### E. Basis Adjustments of Consolidated Group Members

In the case where there is sharing of PTI among members of a U.S. consolidated group, the proposed regulations also clarify the interaction of the investment adjustment provisions in the consolidated return regulations with the section 961 basis adjustment provisions. Accordingly, the proposed regulations clarify that a consolidated group member who utilizes PTI of another member shall treat the increase in its PTI account as the receipt of tax exempt income under Prop. Reg. § 1.1502-32(b)(3)(ii)(D), and a member whose PTI is utilized shall treat the reduction in its PTI account as a noncapital nondeductible expense under Prop. Reg. § 1.1502-32(b)(3)(iii)(B) for purposes of making the investment adjustments required by § 1.1502-32.

#### F. Proposed Effective Date and Transition Rule

These regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date these regulations are published as final regulations in the **Federal Register**, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end. After these regulations become effective, foreign corporations and shareholders who are currently accounting for PTI in a manner other than that which is provided in these regulations may use any reasonable method to conform their current accounting of PTI to the rules provided in these regulations.

#### Request for Comments

##### A. Coordination of Shareholder-Level and Corporate-Level Accounts

Prop. Reg. § 1.959-3(e)(4) requires aggregate categories of PTI to be maintained at the corporate level and to be adjusted in accordance with adjustments made to the individual shareholder-level PTI accounts. No explicit rules are provided for how shareholder-level and corporate-level PTI information is to be shared between the shareholders of a foreign corporation. Comments are requested on whether such information sharing rules are necessary, and if so, how they should operate to ensure conformity between shareholder-level and corporate-level PTI accounting.

##### B. PTI and Consolidated Groups

The application of the PTI sharing rules in the proposed regulations result in corresponding adjustments to the basis of stock in the sharing member corporations (and potentially higher tier members) held by other members of the shareholder's consolidated group. As noted above, the IRS and Treasury Department believe that the PTI sharing rules result in the corresponding basis adjustments under the current investment adjustment provisions. There is some tension between single and separate entity treatment of a consolidated group regarding the PTI sharing rules, and the IRS and Treasury Department are continuing to study how to balance the policy in favor of minimizing multiple income inclusions with the policy of preserving the location of attributes within a consolidated group. In particular, the IRS and Treasury Department are concerned about the potential basis shifting that may occur as a result of the PTI sharing rules. The IRS and Treasury Department request comments on the proposed rules and whether there are more appropriate rules for determining the basis of: (1) The stock in a member of the consolidated group that transfers PTI to another member of the consolidated group under the proposed regulations, (2) the stock in the member of the consolidated group that receives the transferred PTI under the proposed regulations and (3) the stock in the higher tier members of the consolidated group that directly or indirectly own the stock in the members of the consolidated group whose PTI accounts are affected by the sharing rules in the proposed regulations.

The proposed regulations do not limit the application of the PTI sharing rules between members of a consolidated group to PTI earned by a foreign



corporation while the member with excess PTI was a member of such group. The IRS and Treasury Department did not adopt such a limitation out of concern that it would be overly complex and concern that such a limitation might not be consistent with the successor in interest rule. However, the IRS and Treasury Department recognize that some may believe that such a limitation might be more consistent with other attribute sharing rules in the consolidated group context. Consequently, the IRS and Treasury Department request comments as to whether a limitation on PTI sharing between members of a consolidated group similar to those of § 1.1502-21(c) is appropriate.

The IRS and Treasury Department believe that transactions described in section 304 are generally covered by the PTI sharing rules contained in Prop. Reg. §§ 1.959-3(h)(1) through (3) that are applicable to typical redemptions. However, a specific rule has also been provided in Prop. Reg. § 1.959-3(h)(4) that makes the PTI sharing rules explicitly applicable to transactions described in section 304(a)(1) that are treated as distributions of property to which section 301 applies. The IRS and Treasury Department request comments regarding whether the PTI sharing rules should also be made explicitly applicable to transactions described in section 304(a)(1) that are treated as sales or exchanges or to transactions described in section 304(a)(2). In addition, comments are requested on whether rules should be provided to address the proper allocation of PTI after a transaction described in section 355.

#### C. PTI and Section 367(b) Transactions

On November 15, 2000, the IRS and Treasury Department issued proposed regulations in the **Federal Register** (65 FR 69138) (REG-116050-99) addressing (1) the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in a section 367(b) transaction described in section 381, and (2) the allocation of certain tax attributes when a corporation distributes stock in another corporation in a section 367(b) transaction (a foreign divisive transaction). In the preamble to those proposed regulations, the IRS and Treasury Department indicated that further guidance under section 959 would be required prior to addressing PTI issues that arise under section 367(b). At that time the IRS and Treasury Department requested comments with respect to proposed § 1.367(b) regarding whether PTI should

be transferable and retain its character as PTI for section 959 purposes, as well as the various implications that result from that determination. Additionally, in the 2000 proposed regulations, the IRS and Treasury Department requested comments with respect to § 1.367(b)-8 of the proposed regulations regarding the proper adjustment of the PTI of a CFC following a foreign divisive transaction.

On August 8, 2006, the IRS and Treasury Department issued final regulations under §§ 1.367(b)-3 and -7 with respect to the carryover of non-PTI amounts, among other things, while reserving final regulations under § 1.367(b)-8 with respect to the allocation of tax attributes in foreign divisive transactions.

The IRS and Treasury Department invite comments regarding the proper extension of the principles in these proposed regulations (including shareholder-level accounting of PTI and the PTI sharing rules) to §§ 1.367(b)-3 and -7, as well as Prop. Reg. § 1.367(b)-8.

#### D. Foreign Currency Gain or Loss and Foreign Tax Credits With Respect to PTI Distributions

Under section 986(c) of the Code, foreign currency gain or loss with respect to distributions of PTI that is attributable to movements in exchange rates between the date(s) of the income inclusion that created the PTI and the distribution of such PTI shall be recognized and treated as ordinary income or loss from the same source as the associated income inclusion. The IRS and Treasury Department invite comments regarding additional guidance that may be needed under section 986(c) in light of the proposed regulations under section 959. The IRS and Treasury Department also invite comments regarding additional guidance that is needed to ensure that section 960(a)(3) provides appropriate foreign tax credit rules with respect to taxes imposed on PTI that is distributed through tiers of foreign corporations.

#### E. Section 962

The IRS and Treasury Department have not determined how the proposed accounting rules and basis rules should apply to a United States individual shareholder who has elected to be taxed as a corporation under section 962. Therefore, those rules are reserved for future study. The IRS and Treasury Department, however, invite comments about how the PTI rules and basis rules should apply for purposes of section 962.

#### F. Section 961(c) Basis Adjustments

Section 961(c) is by its terms only applicable for purposes of determining the amount included under section 951 in gross income of a United States shareholder. Consequently, the IRS and Treasury Department have so limited the application of Prop. Reg. § 1.961-3. In the event of a sale of a lower-tier CFC by an upper-tier CFC for which the rules of section 961(c) are implicated in determining the gain on the sale, the basis created in the lower-tier CFC stock for purposes of applying section 951 would not apply, for example, to determine the earnings and profits of the upper-tier CFC. However, the IRS and Treasury Department are concerned about the potential double taxation that may result in the event of the later distribution of these earnings and profits to a United States person.

#### G. Transition Rule

These regulations are proposed to apply to taxable years of foreign corporations beginning on or after the date these regulations are published as final regulations in the **Federal Register**, and taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end. After these regulations become effective, foreign corporations and shareholders who are currently accounting for PTI in a manner other than that which is provided in these regulations may use any reasonable method to conform their current accounting of PTI to the rules provided in these regulations. Comments are requested on whether more detailed transition rules should be provided, and, if so, how such transition rules should operate to conform existing methods of PTI accounting with the method of PTI accounting required by these regulations.

#### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because the proposed regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. Ch. 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.



## Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

## Drafting Information

The principal author of these regulations is Ethan Atticks, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

## List of Subjects in 26 CFR Part 1

Income Taxes, Reporting and recordkeeping requirements.

## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

### PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 is amended by removing all entries for § 1.1502–12 and § 1.1502–32 and by adding entries in numerical order to read, in part, as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*  
 Section 1.959–1 also issued under 26 U.S.C. 304(b)(6), 959 and 1502.  
 Section 1.959–2 also issued under 26 U.S.C. 304(b)(6) and 959.  
 Section 1.959–3 also issued under 26 U.S.C. 304(b)(6), 959 and 1502.  
 Section 1.959–4 also issued under 26 U.S.C. 304(b)(6) and 959. \* \* \*  
 Section 1.961–1 also issued under 26 U.S.C. 961.  
 Section 1.961–2 also issued under 26 U.S.C. 961.  
 Section 1.961–3 also issued under 26 U.S.C. 961.  
 Section 1.961–4 also issued under 26 U.S.C. 304(b)(6) and 961. \* \* \*  
 Section 1.1502–12 also issued under 26 U.S.C. 959, 961 and 1502. \* \* \*  
 Section 1.1502–32 also issued under 26 U.S.C. 301, 959, 961, 1502 and 1503. \* \* \*

**Par. 2.** Section 1.959–1 is revised to read as follows:

## § 1.959–1 Exclusion from gross income of United States persons of previously taxed earnings and profits.

(a) *In general.* Section 959(a) provides an exclusion whereby the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in a United States shareholder's gross income under section 951(a) are not taxed again when distributed (directly or indirectly through a chain of ownership described in section 958(a)) from such foreign corporation to such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary may by regulations prescribe). Section 959(a) also excludes from gross income of a United States shareholder earnings and profits attributable to amounts which are, or have been, included in the gross income of such shareholder under section 951(a) which would, but for section 959(a)(2), be again included in the gross income of such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary may by regulations prescribe) under section 951(a)(1)(B). Section 959(b) provides that for purposes of section 951(a), the earnings and profits of a CFC attributable to amounts that are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be included in the gross income of a CFC in such chain for purposes of the application of section 951(a) to such CFC with respect to such United States shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary may by regulations prescribe). Section 959(c) provides rules for the allocation of distributions to the various categories of previously taxed earnings and profits of a foreign corporation and the foreign corporation's non-previously taxed earnings and profits. Section 959(d) provides that, except as provided in section 960(a)(3), any distribution excluded from gross income under section 959(a) shall be treated as a

distribution which is not a dividend; except that such distributions shall immediately reduce earnings and profits. Section 959(e) provides that, for purposes of sections 959 and 960(b), any amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 shall be treated as an amount included in the gross income of such person (or, in any case to which section 1248(e) applies, of the domestic corporation referred to in section 1248(e)(2)) under section 951(a)(1)(A). Section 959(f)(1) provides rules for the allocation of amounts which would, but for section 959(a)(2), be included in gross income under section 951(a)(1)(B) to certain previously taxed earnings and profits of a foreign corporation and non-previously taxed earnings and profits. Section 959(f)(2) provides an ordering rule pursuant to which the rules of section 959 are applied first to actual distributions and then to amounts which would, but for section 959, be included in gross income under section 951(a)(1)(B). Paragraph (b) of this section provides a list of definitions. Paragraph (c) of this section provides rules for the exclusion from gross income under section 959(a)(1) of distributions of earnings and profits by a foreign corporation and the exclusion from gross income under section 959(a)(2) of amounts which would, but for section 959, be included in gross income under section 951(a)(1)(B). Paragraph (d) of this section provides for the establishment and acquisition of previously taxed earnings and profits accounts by shareholders of foreign corporations. Section 1.959–2 provides rules for the exclusion from gross income of a CFC of distributions of previously taxed earnings and profits from another CFC in a chain of ownership described in section 958(a). Section 1.959–3 provides rules for the allocation of distributions and section 956 amounts to the earnings and profits of a CFC and for the maintenance and adjustment of previously taxed earnings and profits accounts by shareholders of foreign corporations. Section 1.959–4 provides for the treatment of actual distributions that are excluded from gross income under section 959(a).

(b) *Definitions.* For purposes of this section through § 1.959–4 and § 1.961–1 through § 1.961–4, the terms listed in this paragraph are defined as follows:

(1) *Previously taxed earnings and profits* means the earnings and profits of a foreign corporation, computed in accordance with sections 964 and 986(b) and the regulations thereunder, attributable to section 951(a) inclusions.

(2) *Previously taxed earnings and profits account* means an account reflecting the previously taxed earnings and profits of a foreign corporation (if any) that are attributable to section 951(a) inclusions.

(3) *Dollar basis* means the United States dollar amounts included in income with respect to the previously taxed earnings and profits included in a shareholder's previously taxed earnings and profits account.

(4) *Covered shareholder* means a person who is one of the following—

(i) A United States person who owns stock (within the meaning of section 958(a)) in a foreign corporation and who has had a section 951(a) inclusion with respect to its stock in such corporation;

(ii) A successor in interest, as defined in paragraph (b)(5) of this section; or

(iii) A corporation that is not described in paragraphs (b)(4)(i) or (ii) of this section and that owns stock (within the meaning of section 958(a)) in a foreign corporation in which another corporation is a covered shareholder described in paragraph (b)(4)(i) or (ii) of this section, if both corporations are members of the same consolidated group.

(5) *Successor in interest* means a United States person who acquires, from any person, ownership (within the meaning of section 958(a)) of stock in a foreign corporation, for which there is a previously taxed earnings and profits account and who establishes to the satisfaction of the Director of Field Operations the right to the exclusion from gross income provided by section 959(a) and this section. To establish the right to the exclusion, the shareholder must attach to its return for the taxable year a statement that provides that it is excluding amounts from gross income because it is a successor in interest succeeding to one or more previously taxed earnings and profits accounts with respect to shares it owns in a foreign corporation. Included in the statement shall be the name of the foreign corporation. In addition, that shareholder must be prepared to provide the following information within 30 days upon request by the Director of Field Operations—

(i) The name, address, and taxable year of the foreign corporation and of all the other corporations, partnerships, trusts, or estates in any applicable chain of ownership described in section 958(a);

(ii) The name, address, and taxpayer identification number, if any, of the person from whom the stock interest was acquired;

(iii) A description of the stock interest acquired and its relation, if any, to a

chain of ownership described in section 958(a);

(iv) The amount for which an exclusion under section 959(a) and paragraph (c) of this section is claimed; and

(v) Evidence showing that the earnings and profits for which an exclusion is claimed are previously taxed earnings and profits, that such amounts were not previously excluded from the gross income of a United States person, and the identity of the United States shareholder who originally included such amounts in gross income under section 951(a). The acquiring person shall also furnish to the Director of Field Operations such other information as may be required by the Director of Field Operations in support of the exclusion.

(6) *Block of stock* shall have the meaning provided in § 1.1248-2(b) with the additional requirement that the previously taxed earnings and profits attributable to each share of stock in such block must be the same.

(7) *Consolidated group* shall have the meaning provided in § 1.1502-1(h).

(8) *Member* shall have the meaning provided in § 1.1502-1(b).

(9) *Section 951(a) inclusion* means a section 951(a)(1)(A) inclusion or an amount included in the gross income of a United States shareholder under section 951(a)(1)(B).

(10) *Section 951(a)(1)(A) inclusion* means—

(i) An amount included in a United States shareholder's gross income under section 951(a)(1)(A);

(ii) An amount included in the gross income of any person as a dividend by reason of subsection (a) or (f) of section 1248 (or, in any case to which section 1248(e) applies, an amount included in the gross income of the domestic corporation referred to in section 1248(e)(2)); or

(iii) An amount described in section 1293(c).

(11) *Section 956 amount* means an amount determined under section 956 for a United States shareholder with respect to a single share or, if a shareholder maintains a previously taxed earnings and profits account with respect to a block of stock, a block of such shareholder's stock in the CFC.

(12) *Section 959(c)(1) earnings and profits* means the previously taxed earnings and profits of a foreign corporation attributable to amounts that have been included in the gross income of a United States shareholder under section 951(a)(1)(B) (or which would have been included except for section 959(a)(2) and § 1.959-2) and amounts that have been included in gross income

under section 951(a)(1)(C) as it existed prior to its repeal (or which would have been included except for section 959(a)(3) as it existed prior to its repeal).

(13) *Section 959(c)(2) earnings and profits* means the previously taxed earnings and profits of a foreign corporation attributable to section 951(a)(1)(A) inclusions.

(14) *Non-previously taxed earnings and profits* means the earnings and profits of a foreign corporation other than the corporation's previously taxed earnings and profits.

(15) *CFC* means a controlled foreign corporation within the meaning of either section 953(c)(1)(B) or section 957.

(16) *United States shareholder* means a United States person who qualifies as a United States shareholder under either section 951(b) or section 953(c)(1)(A).

(c) *Amount excluded from gross income—(1) Distributions.* In the case of a distribution of earnings and profits to a covered shareholder with respect to stock in a foreign corporation, an amount shall be excluded from such shareholder's gross income equal to the total amount by which such shareholder's previously taxed earnings and profits account with respect to such stock is decreased under § 1.959-3 because of the distribution.

(2) *Section 956 amounts.* In a case where a covered shareholder has a section 956 amount for a CFC's taxable year, an amount shall be excluded from such shareholder's gross income equal to the amount of section 959(c)(2) earnings and profits in any shareholder's previously taxed earnings and profits account that are reclassified as section 959(c)(1) earnings and profits under § 1.959-3 because of that section 956 amount.

(d) *Shareholder accounts—(1) In general.* Any person who is subject to § 1.959-3 shall maintain a previously taxed earnings and profits account with respect to each share of stock it owns (within the meaning of section 958(a)) in a foreign corporation. Although the account is share specific, the account may be maintained with respect to each block of the stock in the foreign corporation. Such account shall be maintained in accordance with § 1.959-3.

(2) *Acquisition of account—(i) In general.* If any person acquires, from any other person, ownership of shares of stock in a foreign corporation (within the meaning of section 958(a)) the prior shareholder's previously taxed earnings and profits account with respect to such stock becomes the previously taxed earnings and profits account of the acquirer.

(ii) *Acquisition of account by a person other than a successor in interest.* If such acquirer is not a successor in interest (a foreign person for example), the previously taxed earnings and profits account with respect to the stock acquired shall remain unchanged for the period that the stock is owned by such acquirer. See also § 1.959-3(e), providing account adjustment rules that apply only for acquired PTI accounts if the acquirer is a successors in interest.

(3) The application of this paragraph (d) is illustrated by the following examples:

*Example 1. Shareholder previously taxed earnings and profits account.* (i) *Facts.* DP, a United States shareholder owns all of the 100 shares of the only class of stock in FC, a CFC. The 100 shares are a block of stock. DP and FC use the calendar year as their taxable year and FC uses the U.S. dollar as its functional currency. FC earns \$100x of subpart F income in year 1 and \$100x of non-subpart income. DP includes \$100x in gross income under section 951(a).

(ii) *Analysis.* As a result of DP's inclusion of \$100x of gross income under section 951(a), DP has a previously taxed earnings and profits account with respect to each of its 100 shares equal to \$1x or should DP choose to maintain its previously taxed earnings and profits account on a block basis, an account of \$100x with respect to its entire interest in FC.

*Example 2. Acquisition of previously taxed earnings and profits account.* (i) *Facts.* Assume the same facts as *Example 1*, but that in year 2, a nonresident alien, FP, contributes property to FC to acquire 1000 newly issued shares of FC of the same class held by DP. In year 10, DP sells all of its FC shares to FP. In year 15, FP sells all of its shares in FC to USP, a United States person. Any income earned by FC after year 1 is non-subpart F income. The only distributions by FC during this period are a \$100x pre-sale distribution to FP in year 15 and another \$100x distribution in year 16 to USP.

(ii) *Analysis.* In year 2, DP retains its previously taxed earnings and profits account of \$100x as a result of its section 951(a) inclusion in year 1 regardless of the fact that FC is no longer a CFC and DP no longer holds a sufficient interest in FC to be a United States shareholder with respect to FC. In year 10, pursuant to paragraph (d)(2)(i) of this section, FP acquires a \$100x previously taxed earnings and profits account with respect to DP's block of stock in FC that FP acquired. In year 15, FP receives a distribution of \$100x of earnings and profits from FC, but FP may not exclude any of this distribution from gross income because FP is a nonresident alien. Consequently, pursuant to paragraph (d)(2)(ii) of this section, even though it acquired a previously taxed earnings and profits account from DP of \$100x the account remains unchanged during FP's ownership of the FC stock. However, if USP can make the showing required in paragraph (b)(5) of this section, USP may exclude the \$100x distribution in year 16 under section 959(a)(1) and paragraph (c) of this section to

the extent that the distribution results in a decrease of the \$100x previously taxed earnings and profits account that USP acquired from FP pursuant to the account adjustment rules of § 1.959-3.

**Par. 3.** Section 1.959-2 is revised to read as follows:

**§ 1.959-2 Exclusion from gross income of CFCs of previously taxed earnings and profits.**

(a) *Exclusion from gross income—(1) In general.* The earnings and profits of a CFC (lower-tier CFC) attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when distributed through a chain of ownership described in section 958(a), be also included in the gross income of the CFC receiving the distribution (upper-tier CFC) in such chain for purposes of the application of section 951(a) to such upper-tier CFC with respect to such United States shareholder. The amount of the exclusion provided under this paragraph is the entire amount distributed by the lower-tier CFC to the upper-tier CFC that gave rise (in whole or in part) to an adjustment of the United States shareholder's previously taxed earnings and profits accounts with respect to the stock it owns (within the meaning of section 958(a)) in the lower- and upper-tier CFC under § 1.959-3(e)(3). This amount shall not exceed the earnings and profits of the lower-tier CFC attributable to amounts described in section 951(a)(1) (without regard to pro rata share). The exclusion from the income of such distributee CFC also applies with respect to any other United States shareholder who is a successor in interest.

(2) *Examples.* The application of this paragraph (a) is illustrated by the following examples:

*Example 1. Distribution attributable to subpart F income of lower-tier CFC.* (i) *Facts.* FC, a CFC, is 70% owned by DP, a United States person, and 30% owned by FP, a nonresident alien. FC owns all the stock in FS, a CFC. DP, FP, FC and FS all use the calendar year as their taxable year and FC and FS use the U.S. dollar as their functional currency. In year 1, FS earns \$100x of passive income described in section 954(c) and \$50x of non-subpart F income. On the last day of year 1, FS distributes \$100x to FC that would qualify as subpart F income of FC. On the last day of year 1, FC distributes \$70x to DP and \$30x to FP.

(ii) *Analysis.* DP is required to include \$70x in its gross income under section 951(a) as a result of FS's earning \$100x of subpart F income for the year. Consequently, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its indirect ownership of stock in FS is increased to \$70x. Under

§ 1.959-3(e)(3), as a result of the \$100x distribution paid by FS to FC, DP's previously taxed earnings and profits account is reduced by its pro rata share of the distribution (\$70x). In addition, FS's non-previously taxed earnings and profits are reduced by the remaining \$30x. Under paragraph (a) of this section, the amount of the exclusion under paragraph (a) is equal to the amount distributed, not to exceed the amount of earnings and profits that gave rise to the previously taxed income that is being distributed. Consequently, the entire \$100x distribution (as opposed to only \$70x) is excluded from FC's gross income for purposes of determining whether DP has an inclusion under section 951(a) as a result of FC's receiving the distribution from FS. The receipt of the distribution from FS increases FC's earnings and profits by \$100x (\$70x of which is previously taxed earnings and profits and \$30x of which is non-previously taxed earnings and profits).

*Example 2. Transferee shareholder.* (i) *Facts.* The facts are the same as in *Example 1* except that neither FS nor FC makes any distributions in year 1. In year 2, FP sells its stock in FC to DT, a United States person. On the last day of year 2, FS distributes \$100x to FC that would qualify as subpart F income of FC. FS has no earnings and profits for year 2, and FC has no earnings for year 2 other than the distribution from FS.

(ii) *Analysis.* With respect to DP, the analysis is the same as that in *Example 1*. However, for purposes of DT's determination of the amount includible in its gross income under section 951(a) with respect to FC for year 2, none of the \$100x distribution is excluded from FC's gross income for purposes of applying section 951(a) with respect to DT's interest in FC because none of earnings and profits distributed by FS to FC are attributable to amounts which are, or have been, included in the gross income of DT or the person to whom DT is a successor in interest (FP). Consequently, DT must include \$30x in gross income under section 951(a) for year 2 as its pro rata share of FC's subpart F income of \$100x ( $\$100x \times 30\%$ ). Thereafter, DT has a previously taxed earnings and profits account consisting of \$30x with respect to its stock in FC and FC has \$100x of previously taxed earnings and profits.

*Example 3. Mixed distribution.* (i) *Facts.* The facts are the same as in *Example 1*, except that on the last day of year 1, FS distributes \$150x to FC that would qualify as subpart F income of FC, which in turn distributes \$105x to DP and \$45x to FP.

(ii) *Analysis.* Under the analysis in *Example 1* and pursuant to paragraph (a) of this section, \$100x of the distribution from FS to FC is excluded from FC's gross income for purposes of determining DP's inclusion under section 951(a) with respect to FC's receipt of the distribution from FS. However, DP's pro rata share of the remaining \$50, or \$35 ( $\$50 \times 70\%$ ), is included in DP's gross income under section 951(a). Consequently, the previously taxed earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FC is increased from \$70x to \$105x pursuant to § 1.959-3(e)(2)(i). That account is then

reduced to \$0, however, as a result of the distribution of \$105x to DP pursuant to § 1.959-3(e)(2)(ii) and DP excludes the distribution of \$105x from FC from its gross income for year 1 under section 959(a)(1) and § 1.959-1(c).

(b) *Section 304(a)(1) transactions—(1) Deemed redemption treated as a distribution.* In the case of a stock acquisition under section 304(a)(1) treated as a distribution to which section 301 applies, the selling CFC shall be deemed for purposes of section 959(b) and paragraph (a) of this section to receive such distributions through a chain of ownership described under section 958(a).

(2) The application of this paragraph (c) is illustrated by the following example:

*Example. Cross-chain acquisition of CFC stock by a CFC from another CFC.* (i) *Facts.* DP, a domestic corporation, owns all of the stock in two foreign corporations, FX and FY. FX owns all of the stock in foreign corporation FZ. DP, FX, FY, and FZ all use the calendar year as their taxable year and the U.S. dollar as their functional currency. During year 1, FY purchases all of the stock in FZ from FX for \$80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of FZ's stock, FY has section 959(c)(2) earnings and profits of \$20x and non-previously taxed earnings and profits of \$10x, and FZ has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$0.

(ii) *Analysis.* Under section 304(a)(1), FX is deemed to have transferred the FZ stock to FY in exchange for FY stock in a transaction to which section 351 applies, and FY is treated as having redeemed, for \$80x, the FY stock deemed issued to FX. The payment of \$80x is treated as a distribution to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend (and the source) is made as if the distribution were made, first, by FY to the extent of its earnings and profits, \$30x, and then by FX to the extent of its earnings and profits, \$50x. Under paragraph (c)(1) of this section, FX is deemed to receive the distributions from FY and FZ through a chain of ownership described in section 958(a). Under paragraph (a) of this section, the amount of FY's previously taxed earnings and profits, \$20x, and the amount of FZ's previously taxed earnings and profits, \$50x, distributed to FX are excluded from the gross income of FX. Accordingly, only \$10x is included in FX's gross income.

**Par. 4.** Section 1.959-3 is revised to read as follows:

**§ 1.959-3 Maintenance and adjustment of previously taxed earnings and profits accounts.**

(a) *In general.* This section provides rules for the maintenance and adjustment of previously taxed earnings and profits accounts by shareholders and with respect to foreign corporations.

Paragraph (b) of this section provides general rules governing the accounting of previously taxed earnings and profits at the shareholder level and corporate level. Paragraph (c) of this section provides rules regarding the treatment of foreign taxes when previously taxed earnings and profits are distributed by a foreign corporation through a chain of ownership described in section 958(a). Paragraph (d) of this section provides rules regarding the allocation of other expenses to previously taxed earnings and profits. Paragraph (e)(1) of this section addresses the adjustment of shareholder-level previously taxed earnings and profits accounts as a result of certain transactions. Paragraph (e)(2) of this section provides rules establishing the order in which adjustments are to be made to a covered shareholder's previously taxed earnings and profits account. Paragraph (e)(3) of this section provides rules regarding distributions of previously taxed earnings and profits in a chain of ownership described in section 958(a). Paragraph (e)(4) of this section provides for the maintenance and adjustment of aggregate categories of previously taxed and non-previously taxed earnings and profits at the corporate level with adjustments to individual shareholder-level accounts. Paragraph (e)(5) of this section provides rules for the effect of a foreign corporation's deficit in earnings and profits on previously taxed earnings and profits. Paragraph (f) of this section provides rules regarding the treatment of previously taxed earnings and profits when a shareholder has multiple previously taxed earnings and profits accounts. Paragraph (g) of this section provides rules regarding the treatment of previously taxed earnings and profits when more than one shareholder in a foreign corporation is a member of the same consolidated group. Paragraph (h) of this section provides rules governing the adjustment of previously taxed earnings and profits accounts in the case of a redemption.

(b) *Corporate-level and shareholder-level accounting of previously taxed earnings and profits—(1) Shareholder-level accounting.* A shareholder's previously taxed earnings and profits account with respect to its stock in a foreign corporation shall identify the amount of section 959(c)(1) earnings and profits and the amount of section 959(c)(2) earnings and profits attributable to such stock for each taxable year of the foreign corporation and shall be maintained in the functional currency of such foreign corporation. A shareholder account must also reflect the annual dollar basis

of each category of previously taxed earnings and profits in the account. See § 1.959-3(e) of this section for rules regarding the adjustment of shareholder previously taxed earnings and profits accounts.

(2) *Corporate-level accounting.* Separate aggregate categories of section 959(c)(1), section 959(c)(2) and non-previously taxed earnings and profits (earnings and profits described in section 959(c)(3)) shall be maintained with respect to a foreign corporation. These categories of earnings and profits of the foreign corporation shall be maintained in the functional currency of the foreign corporation. For purposes of this section, distributions are allocated to a foreign corporation's earnings and profits under section 316(a) by applying first section 316(a)(2) and then section 316(a)(1) to each of these three categories of earnings and profits. Section 956 amounts shall be treated as attributable first to section 959(c)(2) earnings and profits and then to non-previously taxed earnings and profits. These allocations are made in conjunction with the rules for making corporate-level adjustments to previously taxed earnings and profits under § 1.959-3(e)(4).

(3) *Classification of earnings and profits—(i) In general.* For purposes of this section, earnings and profits are classified as to year and category of earnings and profits in the year in which such amounts are included in gross income of a United States shareholder under section 951(a) and are reclassified as to category of earnings and profits in the year in which such amounts would be so included but for the provisions of section 959(a)(2) and § 1.959-1(c)(2). Such classifications do not change by reason of a subsequent distribution of such amounts to an upper-tier corporation in a chain of ownership described in section 958(a). This paragraph shall apply to distributions by one foreign corporation to another foreign corporation and by a foreign corporation to a United States person.

(ii) *Dollar basis pooling election.* For purposes of computing foreign currency gain or loss under section 986(c) and adjustments to stock basis under section 961(b) and (c) with respect to distributions of previously taxed earnings and profits of any foreign corporation, in lieu of maintaining annual dollar basis accounts with respect to previously taxed earnings and profits described in paragraph (b)(1) of this section, a taxpayer may maintain an aggregate dollar basis pool that reflects the dollar basis of all of the corporation's previously taxed earnings

and profits described in sections 959(c)(1) and 959(c)(2) and treat a pro rata portion of the dollar basis pool as attributable to distributions of such previously taxed earnings and profits. A taxpayer makes this election by using a dollar basis pool to compute foreign currency gain or loss under section 986(c) with respect to distributions of previously taxed earnings and profits of the foreign corporation, or to compute gain or loss with respect to its stock in the foreign corporation, whichever occurs first. Any subsequent change in the taxpayer's method of assigning dollar basis may be made only with the consent of the Commissioner.

(4) *Examples.* The application of this paragraph (b) is illustrated by the following examples:

*Example 1. Distribution.* (i) *Facts.* DP, a United States shareholder, owns 100% of the only class of stock in FC, a CFC, which, in turn, owns 100% of the only class of stock in FS, a CFC. DP, FC and FS all use the calendar year as their taxable year. FC and FS both use the u as their functional currency. During year 1, FC earns 100u of non-subpart F income and invests 100u in United States property. DP must include 100u in its gross income for year 1 under section 951(a)(1)(B) with respect to FC. For year 2, FS has no subpart F income or investment of earnings in United States property but FS has 100u of non-previously taxed earnings and profits which it distributes to FC. The distribution of 100u to FC is subpart F income of FC and DP must include the 100u in its gross income for year 2 under section 951(a)(1)(A). Also in year 2, FC has non-subpart F income of 100u. The exchange rates at all times in year 1 and year 2, respectively, are  $1u = \$1$  and  $1u = \$1.20$ .

(ii) *Analysis.* With respect to FC, the earnings and profits are classified as follows: 100u of section 959(c)(1) earnings and profits from year 1, 100u of section 959(c)(2) earnings and profits from year 2, and 100u of non-previously taxed earnings and profits from year 2. The dollar basis with respect to the section 959(c)(1) earnings and profits is \$100 and the dollar basis with respect to the section 959(c)(2) earnings and profits is \$120.

*Example 2. Subsequent distribution in a later year.* (i) *Facts.* Assume the same facts as in *Example 1*, except that during year 3 neither FC nor FS has any earnings and profits or deficit in earnings and profits or section 956 amount, but FC distributes 100u to DP on December 31, year 3, at which time the spot exchange rate is  $1u = \$1.30$ .

(ii) *Analysis.* For purposes of section 959 and 961, the 100u distribution of FC shall be considered attributable to FC's section 959(c)(1) earnings and profits for year 1. The section 959(c)(1) earnings and profits are reduced by 100u and the dollar basis of the account is reduced by \$100. Since the spot rate at the time of the 100u distribution to DP is  $1u = \$1.30$ , DP recognizes foreign currency gain of \$30  $((100 \times 1.3) - (100 \times 1))$ .

*Example 3. Dollar basis pooling election.*

(i) *Facts.* Assume the same facts as in *Example 2*, except that DP elected to

maintain the dollar basis of its previously taxed earnings and profits account on a pooled basis for purposes of section 986(c) and section 961 as provided in paragraph (b)(3)(ii) of this section.

(ii) *Analysis.* The section 959(c)(1) earnings and profits are reduced by 100u, but the dollar basis of the account is reduced by \$110  $((100u/200u) \times \$220)$ . In addition, DP recognizes foreign currency gain under section 986(c) of \$20  $(\$130 - ((100u/200u) \times \$220))$ .

(c) *Treatment of certain foreign taxes.*

(1) For purposes of this section, when previously taxed earnings and profits are distributed by a foreign corporation through a chain of ownership described in section 958(a) such earnings and profits shall be reduced by the functional currency amount of any income, war profits, or excess profits taxes imposed by any foreign country or a possession of the United States on or with respect to such earnings and profits. Any such taxes shall not be included in the foreign corporation's pools of post-1986 foreign income taxes maintained for purposes of sections 902 and 960(a)(1). Such taxes shall be maintained in a separate account and allowed as a credit as provided under section 960(a)(3) when the associated previously taxed earnings and profits are distributed. The taxpayer's dollar basis in the previously taxed earnings and profits account shall be reduced by the dollar amount of such taxes, translated in accordance with section 986(a).

(2) The application of this paragraph (c) is illustrated by the following example:

*Example. Imposition of foreign taxes on a CFC.* (i) *Facts.* DP, a United States shareholder, owns 100% of the only class of stock in foreign corporation FC, a CFC, which, in turn, owns 100% of the only class of stock in FS, a CFC. DP, FC, and FS all use the calendar year as their taxable year. FC and FS both use the u as their functional currency. During year 1, FS earns 90u of subpart F income, after incurring 10u of foreign income tax allocable to such income under § 1.954-1(c), has earnings and profits in excess of 90u, and makes no distributions. DP must include 90u, translated at the average exchange rate for the year of  $1u = \$1$  as provided in section 989(b)(3), in its gross income for year 1 under section 951(a)(1)(A)(i). As of the end of year 1, FS has section 959(c)(2) earnings and profits of 90u. During year 2, FS has neither earnings and profits nor a deficit in earnings and profits but distributes 90u to FC, and, by reason of section 959(b) and § 1.959-2, such amount is not includable in the gross income of DP for year 2 under section 951(a) with respect to FC. FC incurs a withholding tax of 9u on the 90u distribution from FS (10% of 90u) and an additional foreign income tax of 11u by reason of the inclusion of the distribution in its taxable income for foreign tax purposes in

year 2. The average exchange rate for year 2 is  $1u = \$2$ .

(ii) *Analysis.* At the end of year 2, FS has section 959(c)(2) earnings and profits of 0  $(90u - 90u)$ ; and FC has section 959(c)(2) earnings and profits of 70u  $(90u - 9u - 11u)$ . DP's dollar basis in the 70u section 959(c)(2) earnings and profits account with respect to FC is \$50  $(\$90 \text{ inclusion} - \$18 \text{ withholding tax} - \$22 \text{ income tax})$ . The \$40 of foreign taxes imposed on FC with respect to the previously taxed earnings and profits are not included in FC's post-1986 foreign income taxes pool. A foreign tax credit with respect to the \$40 of foreign tax attributable to the 70u of previously taxed earnings and profits will be allowed under section 960(a)(3) upon distribution of such previously taxed earnings and profits.

(d) *Treatment of other expenses.* Except as provided in paragraph (c) of this section, no expense paid or accrued by a foreign corporation shall be allocated or apportioned to the previously taxed earnings and profits of such corporation.

(e) *Adjustments to previously taxed earnings and profits account—*(1) *In general.* A covered shareholder's previously taxed earnings and profits account (including the dollar basis in such account) is adjusted in the manner provided in paragraphs (e)(2), (f) and (g) of this section, except as otherwise provided in paragraph (e)(3) of this section. For adjustments to a previously taxed earnings and profits account in the case of redemptions, see paragraph (h) of this section.

(2) *Order and amount of adjustments.* As of the close of a foreign corporation's taxable year, and for the taxable year of the covered shareholder in which or with which such taxable year of the foreign corporation ends, the covered shareholder shall make any of the following adjustments that are applicable for that year to the previously taxed earnings and profits account for the stock owned for any portion of such year (within the meaning of section 958(a)) in the foreign corporation in the following order—

(i) *Step 1. Section 951(a)(1)(A) inclusion.* Increase the amount of section 959(c)(2) earnings and profits and the associated dollar basis in the account by the amount of the section 951(a)(1)(A) inclusion with respect to such stock;

(ii) *Step 2. Distributions on such stock.* (A) Decrease the amount of the section 959(c)(1) earnings and profits in the account (but not below zero), and then the amount of section 959(c)(2) earnings and profits in the account (but not below zero) by the amount of earnings and profits distributed to the covered shareholder during the year with respect to such stock, decrease the

dollar basis in the account by the dollar amount attributable to the distributed earnings and profits; and

(B) Increase the amount of the earnings and profits and associated dollar basis, in the account first to the extent provided under paragraph (f)(1) of this section and then to the extent provided under paragraph (g)(1) of this section and then reduce the account to zero;

(iii) *Step 3. Reallocation from other accounts with respect to redemptions.* Increase the amount of the earnings and profits and associated dollar basis in the account to the extent provided under paragraph (h)(3)(ii) of this section.

(iv) *Step 4. Section 956 amount.* Reclassify the section 959(c)(2) earnings and profits and associated dollar basis in such shareholder's previously taxed earnings and profits account with respect to such stock as section 959(c)(1) earnings and profits in an amount equal to the lesser of—

(A) The covered shareholder's section 956 amount for the taxable year with respect to such stock; or

(B) The amount of the section 959(c)(2) earnings and profits attributable to such stock.

(v) *Step 5. Reallocation to other accounts with respect to distributions.* Decrease the amount of section 959(c)(1) earnings and profits and associated dollar basis in the account, and thereafter the amount of section 959(c)(2) earnings and profits and associated dollar basis in the account to the extent provided under paragraph (f)(1) of this section and then under paragraph (g)(1) of this section;

(vi) *Step 6. Reclassification with respect to section 956 amounts.* Reclassify the section 959(c)(2) earnings and profits and the associated dollar basis attributable to such stock as section 959(c)(1) earnings and profits to the extent provided under paragraph (f)(2) of this section and then to the extent provided in paragraph (g)(2) of this section.

(vii) *Step 7. Further adjustment for section 956 amounts.* Increase the amount of section 959(c)(1) earnings and profits and the associated dollar basis in the account by any amount included in the covered shareholder's gross income for the year under section 951(a)(1)(B) with respect to such stock.

(3) *Intercorporate distributions.* If a foreign corporation receives a distribution of earnings and profits from another foreign corporation that is in a chain of ownership described in section 958(a), a covered shareholder's previously taxed earnings and profits accounts with respect to the stock in each foreign corporation in such chain

shall be adjusted at the end of the respective corporation's taxable year, and for the taxable year of the covered shareholder in which or with which such taxable year of the foreign corporation ends, as follows:

(i) The covered shareholder's previously taxed earnings and profits account with respect to stock in the distributor shall be decreased (but not below zero), at the same time that the covered shareholder would make adjustments under paragraph (e)(2)(ii) of this section, by the amount of the distribution and the associated dollar basis. Such decrease to the covered shareholder's previously taxed earnings and profits account shall be made first to the section 959(c)(1) earnings and profits and thereafter to the section 959(c)(2) earnings and profits in such account.

(ii) Except as provided in paragraph (c) of this section, the section 959(c)(1) earnings and profits and section 959(c)(2) earnings and profits in the covered shareholder's previously taxed earnings and profits account with respect to the stock in the distributee shall be increased, at the same time that the covered shareholder would make adjustments under paragraph (e)(2)(i) of this section, by an amount equal to the decrease under paragraph (e)(3)(i) of this section and to the extent the distribution is out of non-previously taxed earnings and profits of the distributor, to the extent provided under paragraph (e)(2) of this section. If the receiving corporation uses a non-dollar functional currency that differs from the functional currency used by the distributing corporation, then—

(A) The amount of increase shall be the spot value of the distribution in the receiving corporation's functional currency at the time of the distribution; and

(B) The dollar basis of the amount distributed shall be carried over from the distributing corporation to the receiving corporation.

(4) *Effect on foreign corporation's earnings and profits.* Adjustments to a shareholder's previously taxed earnings and profits account in accordance with this section shall result in corresponding adjustments to the appropriate aggregate category or categories of earnings and profits of the foreign corporation. If an adjustment to a foreign corporation's earnings and profits is required (other than as a result of the previous sentence) the adjustment shall be made only to the non-previously taxed earnings and profits of the corporation except to the extent provided in paragraph (h)(2)(i) of this section. Moreover, if a distribution to a

taxpayer exceeds such taxpayer's previously taxed earnings and profits account with respect to stock it owns (within the meaning of section 958(a)) in the foreign corporation making the distribution, the distribution may only be treated as a dividend under section 316 by applying section 316(a)(1) and (2) to the non-previously taxed earnings and profits of the foreign corporation.

(5) *Deficits in earnings and profits.* If a foreign corporation has a deficit in earnings and profits, as determined under section 964(a) and § 1.964-1, for any taxable year, a covered shareholder's previously taxed earnings and profits account with respect to its stock in such foreign corporation shall not be adjusted to take into account the deficit and the deficit shall be applied only to the non-previously taxed earnings and profits of the foreign corporation.

(6) *Examples.* The application of this paragraph (e) is illustrated by the following examples:

*Example 1. Distribution to a United States shareholder.* (i) *Facts.* DP, a United States shareholder, owns 100% of the only class of stock in FC, a CFC. Both DP and FC use the calendar year as their taxable year. FC uses the "u" as its functional currency. During year 1, FC derives 100u of subpart F income, and such amount is included in DP's gross income under section 951(a)(1)(A). The average exchange rate for year 1 is 1u = \$1. At the end of year 1, FC's current and accumulated earnings and profits (before taking into account distributions made during year 1) are 500u. Also, on December 31, year 1, when the spot exchange rate is 1u = \$1.10, FC distributes 50u of earnings and profits to DP.

(ii) *Analysis.* At the end of year 1, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are first increased from 0 to 100u, pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F inclusion of 100u and then reduced from 100u to 50u, pursuant to paragraph (e)(2)(ii) of this section as a result of the distribution. DP's dollar basis in the 100u of previously taxed earnings and profits is \$100 (the dollar amount of the income inclusion under section 951(a)(1)(A)). See section 989(b)(3). The 50u distribution is excluded from DP's gross income pursuant to § 1.959-1(c)(1). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of 50u and non-previously taxed earnings and profits of 400u. DP's dollar basis in the previously taxed earnings and profits account is reduced by a pro rata share of the dollar amount included in income under section 951(a)(1)(A), or by \$50 (50u distribution / 100u previously taxed earnings and profits x \$100 dollar basis). DP recognizes foreign currency gain under section 986(c) of \$5 (\$55 spot value of 50u distribution - \$50 basis).

*Example 2. Net deficit in earnings and profits.* (i) *Facts.* Assume the same facts as in *Example 1*, except that FC has a net deficit



in earnings and profits of 500u for year 2. At the end of Year 1, FC has 50u of section 959(c)(2) earnings and profits and 400u of non-previously taxed earnings and profits.

(ii) *Analysis.* At the end of year 2, DP's section 959(c)(2) earnings and profits for year 1 remains at 50u, pursuant to paragraph (e)(5) of this paragraph, because a shareholder's previously taxed earnings and profits account is not adjusted to take into account the CFC's deficit in earnings and profits. Pursuant to paragraph (e)(4) of this section, at the end of year 2, FC's non-previously taxed earnings and profits are reduced to (100u), and no adjustment is made to FC's previously taxed earnings and profits, which remains at 50u.

*Example 3. Distribution and section 956 inclusion in same year.* Assume the same facts as in *Example 1*, except that DP also has a section 956 amount for year 1 with respect to its stock in FC of 200u.

(ii) *Analysis.* At the end of year 1, adjustments are made to DP's previously taxed earnings and profits account in its FC stock in the following order: First, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are increased from 0 to 100u pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F inclusion. Then, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are reduced from 100u to 50u pursuant to paragraph (e)(2)(ii) of this section as a result of the distribution and the 50u distribution is excluded from DP's gross income pursuant to § 1.959-1(c)(1). Then, the remaining 50u of section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are reclassified as section 959(c)(1) earnings and profits pursuant to paragraph (e)(2)(iv) of this section as a result of FC's investment in United States property and 50u of the 200u section 956 amount is excluded from DP's gross income pursuant to § 1.959-1(c)(2). Finally, the remaining 150u section 956 amount equal to  $\$165 (150u \times 1.1)$  is included in DP's gross income pursuant to section 951(a)(1)(B) and the section 959(c)(1) earnings and profits in DP's previously taxed earnings and profits account are increased from 50u to 200u pursuant to paragraph (e)(2)(vii) of this section. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(1) earnings and profits of 200u and non-previously taxed earnings and profits of 250u. DP's dollar basis in the previously taxed earnings and profits account at the end of year 1 is \$215 (the \$50 attributable to the reclassified 50u of earnings and \$165 attributable to the 150u of section 956 inclusion). See section 989(b)(4).

*Example 4. Section 956 amount in following year.* (i) *Facts.* Assume the same facts as in *Example 3*, except that in year 2, DP has an additional section 956 amount of 200u with respect to its stock in FC and the spot exchange rate on December 31, year 2 is  $1u = \$1.20$ .

(ii) *Analysis.* As in *Example 3*, at the end of year 1, DP has a section 959(c)(1) earnings and profits account with respect to its stock in FC of 200u. Although DP has 200u of section 959(c)(1) earnings and profits in its previously taxed earnings and profits account with respect to its stock in FC, section

959(c)(1) earnings and profits are generated by the inclusion of a section 956 amount in a United States shareholder's gross income or the reclassification of section 959(c)(2) earnings and profits to exclude a section 956 amount from a United States shareholder's gross income and cannot be used to exclude any additional section 956 amounts from a United States shareholder's gross income. Consequently, at the end of year 2, the section 959(c)(1) earnings and profits in DP's previously taxed earnings and profits account are increased from 200u to 400u pursuant to paragraph (e)(2)(vii) of this section and the 200u section 956 amount is included in DP's gross income pursuant to section 959(a)(1)(B). Pursuant to paragraph (e)(4) of this section, at the end of year 2, FC has section 959(c)(1) earnings and profits of 400u and non-previously taxed earnings and profits of 50u. DP's dollar basis in its 200u of year 2 section 959(c)(1) earnings and profits is \$240.

*Example 5. Section 951(a)(1)(A) inclusion and distribution in following year.* (i) *Facts.* Assume the same facts as in *Example 4*, except that in year 3, FC derives 250u of subpart F income, which is included in DP's income under section 951(a)(1)(A), makes a 250u distribution to DP, and has 700u of current and accumulated earnings and profits (before taking into account distributions made during year 3). The average exchange rate for year 3 is  $1u = \$1.10$ , so DP includes \$275 in income ( $250u \times \$1.10/1u$ ).

(ii) *Analysis.* As in *Example 4*, at the end of year 2, DP has a previously taxed earnings and profits account with respect to its stock in FC of 400u of section 959(c)(1) earnings and profits. At the end of year 3, adjustments are made in the following order. First, DP's section 959(c)(2) earnings and profits are increased from 0 to 250u pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F inclusion. Then the section 959(c)(1) earnings and profits in DP's previously taxed earnings and profits account are reduced from 400u to 150u and the 250u distribution to DP is excluded from DP's gross income pursuant to § 1.959-1(c)(1). Pursuant to paragraph (e)(4) of this section, at the end of year 3, FC has 150u of section 959(c)(1) earnings and profits, 250u of section 959(c)(2) earnings and profits, and 50u of non-previously taxed earnings and profits. If DP has not made the dollar basis pooling election described in paragraph (b)(3)(ii) of this section, then the 250u distribution out of section 959(c)(1) earnings is assigned a dollar basis of \$293.75 ( $\$240$  basis in 200u of year 2 earnings and  $\$53.75$  basis in 50u of year 1 earnings ( $50u/200u \times \$215$ )). DP's remaining dollar basis in the year 1 section 959(c)(1) earnings is  $\$161.25 (\$215 - \$53.75)$ . If DP elected to maintain the dollar basis of its previously taxed earnings and profits account on a pooled basis as provided in paragraph (b)(3)(ii) of this section, then the 250u distribution out of section 959(c)(1) earnings is assigned a dollar basis of  $\$280.77 (250u/650u \times (\$215 + \$240 + \$275))$ , and DP's dollar basis in its remaining 400u previously taxed earnings accounts is  $\$449.23 (\$730 - \$280.77)$ .

*Example 6. Distribution to a United States shareholder and a foreign shareholder.* (i)

*Facts.* DP, a United States shareholder, owns 70% and FP, a nonresident alien, owns 30% of the only class of stock in FC, a CFC that uses the U.S. dollar as its functional currency. Both DP and FC use the calendar year as their taxable year. During year 1, FC derives \$100x of subpart F income, \$70x of which is included in DP's gross income under section 951(a)(1)(A). FC's current and accumulated earnings and profits (before taking into account distributions made during year 1) are \$500x. Also, during year 1, FC distributes \$50x of earnings and profits, \$35x distribution to DP and \$15x distribution to FP.

(ii) *Analysis.* At the end of year 1, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are increased from \$0 to \$70x, pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F inclusion. The section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account are then reduced from \$70x to \$35x, pursuant to paragraph (e)(2)(ii) of this section as a result of the distribution. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$35x and non-previously taxed earnings and profits of \$415x.

*Example 7. Intercorporate Distribution.* (i) *Facts.* DP, a United States shareholder, owns 70% and FP, a nonresident alien, owns 30% of the only class of stock in FC, a CFC. FC owns 100% of the only class of stock in FS, a CFC. FC uses the "u" as its functional currency and FS uses the "y" as its functional currency. DP, FC, and FS all use the calendar year as their taxable year. During year 1, FS derives 100y of subpart F income. The average y:\$ exchange rate for year 1 is  $1y = \$1$ . On December 31, year 2, FS distributes 100y to FC. The y:u exchange rate on December 31, year 2, is  $1y = 0.5u$ .

(ii) *Analysis.* (A) *Year 1.* At the end of year 1, DP's pro rata share of 70y of subpart F income is included in DP's gross income pursuant to section 951(a)(1)(A)(i) and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to the stock it indirectly owns in FS are correspondingly increased from 0 to 70y pursuant to paragraph (e)(2)(i) of this section as a result of the subpart F income. The dollar basis of the previously taxed earnings and profits in DP's account with respect to its stock in FS is \$70. At the end of year 2, FS has section 959(c)(2) earnings and profits of 70y and non-previously taxed earnings and profits of 30y.

(B) *Year 2.* Upon the distribution of  $100y = 50u$  from FS to FC on December 31, year 2, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to the stock it indirectly owns in FS are reduced from 70y to 0 and the section 959(c)(2) earnings and profits in DP's earnings and profits account with respect to its stock in FC are correspondingly increased from 0 to 35u pursuant to paragraph (e)(3) of this section. The entire  $100y = 50u$  distribution is excluded from FC's income for purposes of determining FC's subpart F income under section 951(a) for year 2 with respect to DP pursuant to § 1.959-2(a)(1). Pursuant to paragraph (e)(4)



of this section, at the end of year 2, FS has 0 earnings and profits and FC has section 959(c)(2) earnings and profits of 35u and non-previously taxed earnings and profits of 15u. DP's dollar basis in its 35u of section 959(c)(2) earnings and profits in its earnings and profits account with respect to its stock in FC is \$70, carried over from DP's original dollar basis in its 70y of section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to its stock in FS.

**Example 8. Sale of CFC stock.** (i) *Facts.* DP1, a United States shareholder, owns 100% of the only class of stock in FC, a CFC. At the beginning of year 1, DP1 has a zero basis in its stock in FC. Both DP1 and FC use the calendar year as their taxable year. FC uses the U.S. dollar as its functional currency. During year 1, FC derives \$100x of subpart F income and \$100x of other income. On December 31 of year 1, DP1 sells all of its stock in FC to DP2, a U.S. person for \$200x. Year 1 is a year beginning on or after December 31, 1962.

(ii) *Analysis.* First, DP1 includes the \$100x of subpart F income in gross income under section 951(a)(1)(A). The section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to its stock in FC are increased from \$0 to \$100x pursuant to paragraph (e)(2)(i) of this section and DP1's basis in its FC stock is increased from \$0 to \$100x pursuant to § 1.961-1(b). FC's section 959(c)(2) earnings and profits are increased from \$0 to \$100x and its non-previously taxed earnings and profits are correspondingly increased from \$0 to \$100x pursuant to paragraph (e)(4) of this section. Then pursuant to section 1248(a), because FC has \$100x of non-previously taxed earnings and profits attributable to DP1's stock that are attributable to a taxable year beginning on or after December 31, 1962 during which FC was a CFC and DP1 owned its stock in FC, the \$100x of gain recognized by DP1 on the sale of its stock (\$200x proceeds - \$100x basis) is included in DP1's gross income as a dividend. Consequently, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to its stock in FC are increased from \$100x to \$200x pursuant to paragraph (e)(2)(i) of this section. Upon the sale, DP2 acquires from DP1 a previously taxed earnings and profits account with respect to the FC stock of \$200x of section 959(c)(2) earnings and profits and takes a cost basis of \$200x in the FC stock pursuant to section 1012.

(f) *Special rule for shareholders with more than one previously taxed earnings and profits account.*—(1) *Adjustments for distributions.* If a covered shareholder owns (within the meaning of section 958(a)) more than one share of stock in a foreign corporation as of the last day of the foreign corporation's taxable year, to the extent that the total amount of any distributions of earnings and profits made with respect to any particular share for the foreign corporation's taxable year would exceed the

previously taxed earnings and profits account with respect to such share (an excess distribution amount), the following adjustments shall be made:

(i) *Adjustment of other accounts.* The covered shareholder's previously taxed earnings and profits accounts with respect to the shareholder's other shares of stock in the foreign corporation that are owned by the covered shareholder as of the last day of the CFC's taxable year shall be decreased, in the aggregate, by an amount equal to such excess distribution amount, but not below zero. Such decrease shall be made on a pro rata basis by reference to the amount of the previously taxed earnings and profits in those other accounts and shall be allocated to the section 959(c)(1) and (c)(2) earnings and profits in those accounts in the same manner as a distribution is allocated to such earnings and profits pursuant to the rules of section 959(c) and paragraph (e)(2)(ii)(A) of this section.

(ii) *Adjustment of deficient account.* The covered shareholder's previously taxed earnings and profits account for the first-mentioned share of stock shall correspondingly be increased by the same amount, and then shall be adjusted to zero as provided under paragraph (e)(2)(ii)(B) of this section.

(2) *Adjustments for section 956 amounts.* If a United States shareholder, who owns more than one share of stock in a CFC as of the last day of the CFC's taxable year, has a section 956 amount with respect to its stock in the CFC for a taxable year, to the extent that the section 956 amount with respect to any particular share of stock exceeds the section 959(c)(2) earnings and profits in such shareholder's previously taxed earnings and profits account with respect to such share (an excess section 956 amount), the covered shareholder's section 959(c)(2) earnings and profits in its previously taxed earnings and profits accounts with respect to its other shares of stock that are owned by the United States shareholder on the last day of the CFC's taxable year shall be reclassified as section 959(c)(1) earnings and profits, in the aggregate, by an amount equal to such excess section 956 amount. Such reclassification shall be made on a pro rata basis by reference to the amount of the section 959(c)(2) earnings and profits in each of the United States shareholder's other previously taxed earnings and profits accounts with respect to its stock in the CFC prior to reclassification under this paragraph (f)(2).

(3) *Examples.* The application of this paragraph (f) is illustrated by the following examples:

**Example 1. Two blocks of stock.** (i) *Facts.* DP, a United States shareholder, owns two blocks, block 1 and block 2, of shares of class A stock in FC, a CFC that uses the U.S. dollar as its functional currency. Both DP and FC use the calendar year as their taxable year. Entering year 1, DP has a previously taxed earnings and profits account with respect to its block 1 shares consisting of \$25x of section 959(c)(2) earnings and profits and a previously taxed earnings and profits account with respect to its block 2 shares consisting of \$65x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$90x and non-previously taxed earnings and profits of \$200x. During year 1, FC makes a distribution of earnings and profits on its Class A stock of \$50x on each of block 1 and block 2.

(ii) *Analysis.* First, as a result of the distribution, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are decreased from \$25x to \$0 and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$65x to \$15x pursuant to paragraph (e)(2)(ii) of this section. Because there are insufficient previously taxed earnings and profits with respect to block 1, DP may access its excess previously taxed earnings and profits with respect to its block 2 stock, after taking into account any distributions or section 956 amounts with respect to block 2. Accordingly, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$15x to \$0 pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are increased from \$0 to \$15x and then decreased from \$15x to \$0 pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section. The \$40x (\$25x + \$15x) of the distribution with respect to block 1 and \$50x of the distribution with respect to block 2 are excluded from DP's gross income pursuant to § 1.959-1(c)(1). The remaining \$10x of the distribution of earnings and profits with respect to block 1 is included in DP's gross income as a dividend. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$0 and non-previously taxed earnings and profits of \$190x.

**Example 2. Multiple classes of stock.** (i) *Facts.* Assume the same facts as in *Example 1*, except that DP also owns a block, block 3, of class B stock in FC. Entering year 1, DP has a previously taxed earnings and profits account with respect to block 3 consisting of \$60x of section 959(c)(2) earnings and profits. Entering year 1, FC has \$150x of section 959(c)(2) earnings and profits and \$200x of non-previously taxed earnings and profits.

(ii) *Analysis.* First, as in *Example 1*, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are decreased from \$25x to \$0 and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2

are decreased from \$65x to \$15x pursuant to paragraph (e)(2)(ii) of this section. Because there are insufficient previously taxed earnings and profits with respect to block 1, DP may access its excess previously taxed earnings and profits with respect to block 2 and block 3, after taking into account any distributions or section 956 amounts with respect to those blocks. In addition, the previously taxed earnings and profits from blocks 2 and 3 are decreased pro rata based on the relative previously taxed earnings and profits in the previously taxed earnings and profits accounts with respect to both blocks after taking into account any distributions or section 956 amounts with respect to those blocks. Thus, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$15x to \$10x ( $\$15x/\$75x \times \$25x$ ) and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 3 are decreased from \$60x to \$40x ( $\$60x/\$75x \times \$25x$ ) pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section. The section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$25x and then decreased from \$25x to \$0 pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section. The entire \$50x distribution with respect to block 1 and \$50x distribution with respect to block 2 are excluded from DP's gross income pursuant to § 1.959-1(c)(1). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$200x.

*Example 3. Distribution in excess of aggregate previously taxed earnings and profits.* (i) *Facts.* Assume the same facts as in *Example 2*, except that instead of a total distribution of \$100x on Class A shares in year 1, FC makes a total distribution of \$200x on its Class A shares in year 1, consisting of a \$100x distribution to block 1 and a \$100 distribution to block 2.

(ii) *Analysis.* First, as a result of the distribution, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are decreased from \$25x to \$0 and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$65x to \$0 pursuant to paragraph (e)(2)(ii) of this section. Because there are insufficient previously taxed earnings and profits in DP's previously taxed earnings and profits accounts with respect to blocks 1 and 2, DP may access its excess previously taxed earnings and profits in its previously taxed earnings and profits account with respect to block 3 after taking into account any distributions or section 956 amounts with respect to block 3. Consequently, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 3 are decreased from \$60x to \$0 pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section. Of the total \$200x distribution from FC to DP, \$150x is excluded from DP's gross income pursuant to § 1.959-1(c)(1). The remaining \$50x of the distribution is

included in DP's gross income pursuant to section 951(a)(1)(A). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$0 and non-previously taxed earnings and profits of \$150x.

*Example 4. Sale.* (i) *Facts.* Assume the same facts as in *Example 2*, except that DP sells block 3 before the end of year 1.

(ii) *Analysis.* First, as in *Example 2*, the distribution results in a decrease of the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 from \$25x to \$0 and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 from \$65x to \$15x pursuant to paragraph (e)(2)(ii) of this section. Because DP does not own block 3 on the last day of year 1, DP cannot use the previously taxed earnings and profits account with respect to block 3 to exclude a distribution in that year to block 1 or 2 from gross income. Therefore, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are decreased from \$15x to \$0 pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$15x and then decreased from \$15x to \$0 pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section. The \$40x ( $\$25x + \$15x$ ) of the distribution with respect to block 1 and \$50x of the distribution with respect to block 2 are excluded from DP's gross income pursuant to § 1.959-1(c)(1). The remaining \$10x of the distribution with respect to block 1 is included in DP's gross income as a dividend. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$60x and non-previously taxed earnings and profits of \$190x.

*Example 5. Section 956 amount.* (i) *Facts.* Assume the same facts as in *Example 2*, except that, in addition, during year 1, FC has a section 956 amount of \$30x, \$5x of which is allocable to each of blocks 1 and 2, and \$20x of which is allocable to block 3.

(ii) *Analysis.* Pursuant to paragraph (f)(2) of this section, account adjustments are made for the distribution from FC before any account adjustments are made for the section 956 amount. After account adjustments are made for the distribution from FC as illustrated in *Example 2*, DP has a previously taxed earnings and profits account with respect to each block as follows: Block 1: \$0, block 2: \$10x of section 959(c)(2) earnings and profits, block 3: \$40x of section 959(c)(2) earnings and profits. As a result of the section 956 amount with respect to block 2, pursuant to paragraph (e)(2)(vi) of this section, \$5x of DP's section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to block 2 is reclassified as section 959(c)(1) earnings and profits. Consequently, block 2 is left with a previously taxed earnings and profits account consisting of \$5x of section 959(c)(1) earnings and profits and \$5x of section 959(c)(2) earnings and profits. In addition, pursuant to paragraph (e)(2)(vi) of

this section, \$20x of DP's section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to block 3 are reclassified as section 959(c)(1) earnings and profits. Consequently, block 3 is left with a previously taxed earnings and profits account consisting of \$20x of section 959(c)(1) earnings and profits and \$20x of section 959(c)(2) earnings and profits. The total \$25x section 956 amount with respect to blocks 2 and 3 is excluded from DP's gross income pursuant to § 1.959-1(c)(2). Because there are insufficient previously taxed earnings and profits in the previously taxed earnings and profits account with respect to block 1, DP may access its excess previously taxed earnings and profits in the previously taxed earnings and profits accounts with respect to blocks 2 and 3 after taking into account any distributions or section 956 amounts with respect to those blocks. In addition, the previously taxed earnings and profits in the previously taxed earnings and profits accounts with respect to blocks 2 and 3 are reclassified pro rata based on the relative previously taxed earnings and profits in those accounts after taking into account any distributions or section 956 amounts with respect to those blocks. Accordingly, pursuant to paragraphs (e)(2)(vi) and (f)(2) of this section, an additional \$1x ( $\$5x/\$25x \times \$5x$ ) of the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 2 are reclassified as section 959(c)(1) earnings and profits and an additional \$4x ( $\$20x/\$25x \times \$5x$ ) of the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 3 are reclassified as section 959(c)(1) earnings and profits. The \$5x section 956 amount with respect to block 1 is also excluded from DP's gross income pursuant to § 1.959-1(c)(2). At the end of year 1, DP's previously taxed earnings and profits accounts with respect to its various blocks of stock are as follows: block 1 has no previously taxed earnings and profits, block 2 has \$6x ( $\$5x + \$1x$ ) of section 959(c)(1) earnings and profits and \$4x ( $\$5x - \$1x$ ) of section 959(c)(2) earnings and profits and block 3 has \$24x ( $\$20x + \$4x$ ) of section 959(c)(1) earnings and profits and \$16x ( $\$20x - \$4x$ ) of section 959(c)(2) earnings and profits. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has \$30x of section 959(c)(1) earnings and profits, \$20x of section 959(c)(2) earnings and profits, and \$200x of non-previously taxed earnings and profits.

(g) *Special rule for shareholder included in a consolidated group—(1) Adjustments for distributions—(i) In general.* In the case of a covered shareholder who is a member of a consolidated group, to the extent that the total amount of any distributions of earnings and profits with respect to such covered shareholder's stock in a foreign corporation during such foreign corporation's taxable year would exceed the covered shareholder's previously taxed earnings and profits account with respect to all of the covered shareholder's stock of the foreign

corporation (an excess distribution amount) the previously taxed earnings and profits accounts of the covered shareholder and of the other members of the covered shareholder's consolidated group that own stock in the same foreign corporation and are members of the covered shareholder's consolidated group on the last day of the foreign corporation's taxable year shall be adjusted as follows.

(A) *Adjustment of other members' accounts.* The previously taxed earnings and profits accounts of the other members of the consolidated group that own (within the meaning of section 958(a)) stock in the same foreign corporation and are members of the covered shareholder's consolidated group on the last day of the foreign corporation's taxable year shall be decreased, in the aggregate, by the amount of such excess distribution amount, but not below zero. Such decrease shall be made on a pro rata basis by reference to the amount of such other members' previously taxed earnings and profits accounts and shall be allocated to the section 959(c)(1) and (c)(2) earnings and profits in such accounts in the same manner as a distribution is allocated to such earnings and profits pursuant to section 959(c) and paragraph (e)(2)(ii)(A) of this section.

(B) *Adjustment of the deficient account.* The deficient previously taxed earnings and profits account of such covered shareholder shall correspondingly be increased by the same amount, and then adjusted to zero under paragraph (e)(2)(ii)(B) of this section.

(ii) *Insufficient previously taxed earnings and profits.* If more than one member of the consolidated group is a covered shareholder that has an excess distribution amount with respect to all of its stock in the foreign corporation and there is insufficient previously taxed earnings and profits available in the previously taxed earnings and profits accounts of other consolidated group members to exclude the combined excess distribution amounts of the covered shareholders, the other consolidated group members' previously taxed earnings and profits shall be allocated between the covered shareholders' deficient previously taxed earnings and profits accounts in proportion to each covered shareholder's excess distribution amount.

(2) *Adjustments for section 956 amounts—(i) In general.* If a United States shareholder, who is a member of a consolidated group, has a section 956 amount with respect to its stock in a

CFC for a taxable year, to the extent that the section 956 amount exceeds the section 959(c)(2) earnings and profits in such United States shareholder's previously taxed earnings and profits accounts with respect to all of its stock in the CFC (an excess section 956 amount), the section 959(c)(2) earnings and profits in the previously taxed earnings and profits accounts of consolidated group members, who are members of the United States shareholder's consolidated group on the last day of the CFC's taxable year, with respect to their stock in the CFC shall be reclassified as section 959(c)(1) earnings and profits, in the aggregate, by an amount equal to such excess section 956 amount. The amount that is reclassified with respect to each such account of such other members shall be proportionate to the amount of section 959(c)(2) earnings and profits in those accounts prior to reclassification under this paragraph (g).

(ii) *Insufficient section 959(c)(2) earnings and profits.* If more than one member of the consolidated group is a United States shareholder that has an excess section 956 amount with respect to its stock in the CFC for the taxable year and there is insufficient aggregate section 959(c)(2) earnings and profits in other consolidated group members' previously taxed earnings and profits accounts to exclude the combined excess section 956 amounts of the United States shareholders, the amount of any consolidated group members' section 959(c)(2) earnings and profits that are reclassified on behalf of each United States shareholder shall be proportionate to the excess section 956 amount for each such United States shareholder.

(3) *Stock basis adjustments of members.* See § 1.1502–32 for rules addressing investment adjustments resulting from the application of this paragraph.

(4) *Examples.* The application of this paragraph (g) is illustrated by the following examples:

*Example 1. Two consolidated group members.* (i) *Facts.* DP1, a United States shareholder, owns one block, block 1, of shares of Class A stock in FC, a CFC that uses the U.S. dollar as its functional currency. DP2, a United States shareholder and a member of DP1's consolidated group, owns one block, block 2, of shares of Class A stock in FC. DP1, DP2 and FC all use the calendar year as their taxable year and FC uses the U.S. dollar as its functional currency. Entering year 1, DP1 has a previously taxed earnings and profits account with respect to block 1 consisting of \$50x of section 959(c)(2) earnings and profits and DP2 has a previously taxed earnings and profits account with respect to block 2 consisting of \$200x

of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$250x and non-previously taxed earnings and profits of \$100x. In year 1, FC generates no earnings and profits and makes a distribution of earnings and profits on its stock Class A stock, a \$100x distribution of earnings and profits to block 1 and a \$100x distribution of earnings and profits to block 2.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$50x to \$0 and the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$200x to \$100x. Then, pursuant to paragraphs (e)(2)(v) and (g)(1)(i)(A) of this section, the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$100x to \$50x and, pursuant to paragraphs (e)(2)(ii)(B) and (g)(1)(i)(B) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$50x and then decreased from \$50x to \$0. Pursuant to section 959(a) and § 1.959–1(c), the entire \$100x distribution to block 1 and \$100x distribution to block 2 are excluded from DP1's and DP2's gross incomes respectively. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$100x.

*Example 2. Two consolidated group members; multiple classes of stock.* (i) *Facts.* Assume the same facts as in *Example 1*, except that DP1 also owns one block, block 3, of shares of class B stock in FC. DP1 has a previously taxed earnings and profits account with respect to block 3 consisting of \$40x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$290x and non-previously taxed earnings and profits of \$100x.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$50x to \$0 and the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$200x to \$100x. Then, pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 3 are decreased from \$40x to \$0 and, pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$40x and then decreased from \$40x to \$0. Finally, pursuant to paragraphs (e)(2)(v) and (g)(1)(i)(A) of this section, the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from

\$100x to \$90x and, pursuant to paragraphs (e)(2)(ii)(B) and (g)(1)(i)(B) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$10x and then decreased from \$10x to \$0. Pursuant to section 959(a) and § 1.959-1(c), the entire \$100x distribution to block 1 and \$100x distribution to block 2 are excluded from DP1's and DP2's gross incomes respectively. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$90x and non-previously taxed earnings and profits of \$100x.

**Example 3. Three consolidated group members; multiple classes of stock.** (i) *Facts.* Assume the same facts as in *Example 2*, except that DP3, a United States shareholder and a member of DP1's consolidated group, owns one block, block 4, of shares of class B stock in FC. DP3 has a previously taxed earnings and profits account with respect to block 4 consisting of \$25x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$315x and non-previously taxed earnings and profits of \$100x.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$50x to \$0 and the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$200x to \$100x. Then, pursuant to paragraphs (e)(2)(v) and (f)(1)(i) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 3 are decreased from \$40x to \$0 and, pursuant to paragraphs (e)(2)(ii)(B) and (f)(1)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$40x and then decreased from \$40x to \$0. Finally, pursuant to paragraphs (e)(2)(v) and (g)(1)(i)(A) of this section, the section 959(c)(2) earnings and profits in DP2's and DP3's previously taxed earnings and profits accounts with respect to blocks 2 and 4 are decreased pro rata from \$100x to \$92x and from \$25x to \$23x respectively, and, pursuant to paragraphs (e)(2)(ii)(B) and (g)(1)(i)(B) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are increased from \$0 to \$10x and then decreased from \$10x to \$0. Pursuant to section 959(a) and § 1.959-1(c), the entire amounts of the \$100x distribution to block 1 and the \$100x distribution to block 2 are excluded from DP1's and DP2's gross incomes respectively. Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$115x and non-previously taxed earnings and profits of \$100x.

**Example 4. Section 956 Amount.** (i) *Facts.* Assume the same facts as in *Example 3*, except that instead of a distribution of 200x on its class A stock, FC has a section 956 amount for year 1 of \$180x, 45x of which is allocable to each of blocks 1 through 4.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(iv) of this section, the section 959(c)(2) earnings and profits in each shareholder's previously taxed earnings profits account are reclassified as section 959(c)(1) earnings and profits leaving each block of stock with the following account: Block 1: \$45x of section 959(c)(1) earnings and profits, \$5x of section 959(c)(2) earnings and profits; block 2: \$45x of section 959(c)(1) earnings and profits and \$155x of section 959(c)(2) earnings and profits; block 3: \$40x of section 959(c)(1) earnings and profits and \$0 of section 959(c)(2) earnings and profits; block 4: \$25x of section 959(c)(1) earnings and profits and \$0 of section 959(c)(2) earnings and profits. After the above reclassifications, DP1 has an excess section 956 amount of \$5x with respect to block 3. Therefore, pursuant to paragraphs (e)(2)(vi) and (f)(2) of this section, the remaining \$5x of section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are reclassified as section 959(c)(1) earnings and profits, leaving DP1 with \$50x of section 959(c)(1) earnings and profits and \$0 of section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to block 1. The entire \$45x section 956 amount with respect to blocks 1 and 3 are excluded from DP1's gross income pursuant to paragraph (c)(2) of this section. After the above reclassifications, DP3 has an excess section 956 amount of \$20x with respect to block 4. Therefore, pursuant to paragraphs (e)(2)(vi) and (g)(2)(i) of this section, \$20x of the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are reclassified as section 959(c)(1) earnings and profits, leaving DP2 with \$65x of section 959(c)(1) earnings and profits and \$135x of section 959(c)(2) earnings and profits. The entire \$45x section 956 amount with respect to blocks 2 and 4 are excluded from DP2's and DP3's gross incomes, respectively, pursuant to § 1.959-1(c)(2). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(1) earnings and profits of \$180x, section 959(c)(2) earnings and profits of \$135x, and non-previously taxed earnings and profits of \$100x.

**Example 5. Ex-member.** (i) *Facts.* DP1, a United States shareholder, owns one block, block 1, of shares of Class A stock in FC, a CFC that uses the U.S. dollar as its functional currency. DP2 and DP3, both United States shareholders and members of DP1's consolidated group, own one block each, blocks 2 and 3 respectively, of shares of Class A stock in FC. DP1, DP2, DP3 and FC all use the calendar year as their taxable year. Entering year 1, DP1 has a previously taxed earnings and profits account with respect to block 1 consisting of \$50x of section 959(c)(2) earnings and profits, DP2 has a previously taxed earnings and profits account with respect to block 2 consisting of \$100x of section 959(c)(2) earnings and profits, and DP3 has a previously taxed earnings and profits account with respect to block 3 consisting of \$200x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$350x and non-previously taxed earnings and

profits of \$100x. On March 15 of year 1, FC makes a distribution of earnings and profits on its stock Class A stock consisting of a \$100x distribution of earnings and profits to each of blocks 1, 2 and 3. On July 4 of year 1, DP3 is sold to DP4, a United States person who is not a member of the consolidated group, and DP3 ceases to be a member of the consolidated group.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$50x to \$0, the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$100x to \$0, and the section 959(c)(2) earnings and profits in DP3's previously taxed earnings and profits account with respect to block 3 are decreased from \$200x to \$100x. Because DP3 was not a member of DP1's consolidated group on the last day of year 1, the remaining \$100x of section 959(c)(2) earnings and profits in DP3's previously taxed earnings and profits account with respect to its stock in FC cannot be used to exclude the remaining \$50x distribution to DP1 from DP1's gross income. Consequently, pursuant to § 1.959-1(c)(1), \$50x of the distribution to block 1, the entire \$100x of the distribution to block 2, and the entire \$100x of the distribution to block 3 are excluded from DP1's, DP2's, and DP3's gross incomes respectively. The remaining \$50x distribution to DP1 is included in DP1's gross income pursuant to section 951(a)(1)(a). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has section 959(c)(2) earnings and profits of \$150x and non-previously taxed earnings and profits of \$50x.

**Example 6. Insufficient excess previously taxed earnings and profits.** (i) *Facts.* DP1, a United States shareholder, owns one block, block 1, of shares of Class A stock in FC, a CFC that uses the U.S. dollar as its functional currency. DP2 and DP3, both United States shareholders and members of DP1's consolidated group, own one block each, blocks 2 and 3 respectively, of shares of Class A stock in FC. DP1, DP2, DP3 and FC all use the calendar year as their taxable year. Entering year 1, DP1 has a previously taxed earnings and profits account with respect to block 1 consisting of \$40x of section 959(c)(2) earnings and profits, DP2 has a previously taxed earnings and profits account with respect to block 2 consisting of \$60x of section 959(c)(2) earnings and profits, and DP3 has a previously taxed earnings and profits account with respect to block 3 consisting of \$150x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$250x and non-previously taxed earnings and profits of \$100x. On March 15 of year 1, FC makes a distribution of earnings and profits on its Class A stock consisting of a \$100x distribution of earnings and profits to each of blocks 1, 2 and 3.

(ii) *Analysis.* First, pursuant to paragraph (e)(2)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's previously taxed earnings and profits account with respect to block 1 are decreased from \$40x

to \$0, the section 959(c)(2) earnings and profits in DP2's previously taxed earnings and profits account with respect to block 2 are decreased from \$60x to \$0, and the section 959(c)(2) earnings and profits in DP3's previously taxed earnings and profits account with respect to block 3 are decreased from \$150x to \$50x. Then, pursuant to paragraph (g)(1)(i)(A) of this section, the section 959(c)(2) earnings and profits in DP3's previously taxed earnings and profits account with respect to its stock in FC are reduced from \$50x to \$0 and, pursuant to paragraphs (g)(1)(i)(B) and (g)(1)(ii) of this section, the section 959(c)(2) earnings and profits in DP1's and DP2's previously taxed earnings and profits accounts with respect to their stock in FC are increased from \$0 to \$30x ( $\$60x/\$100x \times \$50x$ ) and \$0 to \$20x ( $\$40x/\$100x \times \$50x$ ) respectively and then immediately reduce to \$0. Pursuant to § 1.959-1(c), \$70x ( $\$40x + \$30x$ ) of the distribution to DP1, \$80x ( $\$60x + \$20x$ ) of the distribution to DP2, and \$100x of the distribution to DP3 are excluded from gross income. The remaining \$30x distributed to DP1 and \$20x distributed to DP2 are included in gross income pursuant to section 951(a)(1)(A). Pursuant to paragraph (e)(4) of this section, at the end of year 1, FC has non-previously taxed earnings and profits of \$50x.

(h) *Adjustments in the case of redemptions*—(1) *In general.* In the case of a foreign corporation's redemption of stock (a redemption distribution), the effect on the covered shareholder's previously taxed earnings and profits account and on the earnings and profits of the redeeming corporation depends on whether the distribution is treated as a payment in exchange for stock or as a distribution of property to which section 301 applies. For the treatment of deemed redemption distributions in transactions described in section 304(a)(1), see paragraph (h)(4) of this section.

(2) *Exchange treatment*—(i) *Effect on foreign corporation's earnings and profits.* In the case of a redemption distribution that is treated as a payment in exchange for stock under section 302(a) or section 303, the amount of the distribution properly chargeable to the earnings and profits of the redeeming foreign corporation is the amount determined under section 312(a), subject to the limitation in section 312(n)(7) and this paragraph (h)(2)(i). For purposes of section 312(n)(7), the amount properly chargeable to the earnings and profits of the redeeming foreign corporation shall not exceed the sum of—

(A) The amount of the previously taxed earnings and profits account with respect to the redeemed shares of stock (without adjustment for any income inclusion under section 1248 resulting from the redemption); and

(B) A ratable portion of the redeeming corporation's non-previously taxed earnings and profits. Such chargeable amount of earnings and profits shall be allocated to earnings and profits in accordance with section 959(c) and this section.

(ii) *Cessation of previously taxed earnings and profits account.* In the case of a redemption distribution that is treated as a payment in exchange for stock, the redeemed covered shareholder's previously taxed earnings and profits account with respect to the redeemed shares ceases to exist and is not transferred to any other previously taxed earnings and profits account. In such a case, any previously taxed earnings and profits in the redeemed covered shareholder's previously taxed earnings and profits account, after being reduced under paragraph (h)(2)(i) of this section, become non-previously taxed earnings and profits of the foreign corporation.

(iii) *Examples.* The application of this paragraph (h)(2) is illustrated by the following examples:

*Example 1.* Complete redemption treated as exchange; previously taxed earnings and profits account is depleted. (i) *Facts.* DP, a United States shareholder, owns 70% and FP, a nonresident alien who is unrelated to DP under section 318, owns 30% of the only class of stock in FC, a CFC that uses the U.S. dollar as its functional currency. Both DP and FC use the calendar year as their taxable year and both DP and FC are wholly owned by the same domestic corporation, USP. DP has a previously taxed earnings and profits account consisting of \$50x of section 959(c)(2) earnings and profits with respect to its stock in FC and DP has a \$50 basis in its FC stock pursuant to section 961(a). FC has \$50x of section 959(c)(2) earnings and profits and \$50x of non-previously taxed earnings and profits attributable to taxable years of FC beginning on or after December 31, 1962 during which FC was a CFC and during which DP held its shares of stock in FC. FC redeems all of DP's stock for \$100x in a redemption that is treated as a payment in exchange for the stock under section 302(a).

(ii) *Analysis.* DP includes \$35x ( $\$50x \times 70\%$ ) in gross income as a dividend pursuant to section 1248(a) as a result of the deemed exchange. FC adjusts its earnings and profits as a result of the exchange under paragraph (h)(2)(i) of this section in the following manner: first, FC's section 959(c)(2) earnings and profits are reduced from \$50x to \$0; then, FC's non-previously taxed earnings and profits are decreased from \$50x to \$15x to reflect DP's \$35x ratable share of FC's non-previously taxed earnings and profits. DP's previously taxed earnings and profits account ceases to exist and is not transferred to any other previously taxed earnings and profits account.

*Example 2.* Complete redemption treated as exchange; previously taxed earnings and profits account is not depleted. (i) *Facts.* Assume the same facts as *Example 1*, except

that the amount of the redemption distribution by FC to DP is \$25x.

(ii) *Analysis.* DP recognizes a \$25x loss as a result of the deemed exchange. FC's section 959(c)(2) earnings and profits are decreased from \$50x to \$25x, pursuant to paragraph (h)(2)(i) of this section. DP's previously taxed earnings and profits account ceases to exist, and the remaining \$25x of section 959(c)(2) earnings and profits in such account is not transferred to any other previously taxed earnings and profits account. However, pursuant to paragraph (h)(2)(ii) of this section, the \$25x of previously taxed earnings and profits is converted to non-previously taxed earnings and profits of DC.

(3) *Distribution treatment*—(i) *Adjustment of shareholder previously taxed earnings and profits accounts and foreign corporation's earnings and profits.* In the case of a redemption distribution by a foreign corporation that is treated as a distribution of property to which section 301 applies, §§ 1.959-1 and this section shall apply in the same manner as they would apply to any distribution of property to which section 301 applies.

(ii) *Transfer to remaining shares.* To the extent that the previously taxed earnings and profits account with respect to stock redeemed in a transaction described in paragraph (h)(3)(i) of this section exceeds the amount chargeable to the earnings and profits of the corporation under the rules of that paragraph, the excess previously taxed earnings and profits shall be reallocated to the previously taxed earnings and profits accounts with respect to the remaining stock in the foreign corporation in a manner consistent with, and in proportion to, the proper adjustments of the basis in the remaining shares pursuant to § 1.302-2(c).

(iii) *Examples.* The application of this paragraph (h)(3) is illustrated by the following examples:

*Example 1.* Redemption in exchange for cash that is treated as a distribution. (i) *Facts.* DP, a United States shareholder, owns 100% of the stock in FC, a CFC that uses the U.S. dollar as its functional currency. Both DP and FC use the calendar year as their taxable year. DP owns two blocks of stock in FC, block 1 and block 2. At the beginning of year 1, DP has a previously taxed earnings and profits account with respect to block 1 consisting of \$50x of section 959(c)(2) earnings and profits and FC has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$100x. In year 1, FC redeems block 1 for \$100x in a redemption that is treated as a distribution of property to which section 301 applies under section 302(d).

(ii) *Analysis.* The section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are reduced from \$50x to \$0 and FC's section 959(c)(2) earnings and profits are

correspondingly reduced from \$50x to \$0. The remaining \$50x is included in DP's gross income as a dividend under section 301(c)(1) and FC's non-previously taxed earnings and profits are reduced from \$100x to \$50x.

*Example 2.* Redemption in exchange for cash that is treated as a distribution. (i) *Facts.* Assume the same facts as *Example 1*, except that DP is redeemed for \$25x.

(ii) *Analysis.* The section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are reduced from \$50x to \$25x and FC's section 959(c)(2) earnings and profits are correspondingly reduced from \$50x to \$25x. FC's non-previously taxed earnings and profits remain at \$100x. Pursuant to paragraph (h)(3)(ii) of this section the remaining \$25x of section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to block 1 are reallocated with respect to the remaining stock in FC in a manner consistent with, and in proportion to, the proper adjustments of the basis of the remaining FC shares pursuant to § 1.302-2(c).

(4) *Section 304 transactions—(i) Deemed redemption treated as a distribution.* In the case of a stock acquisition described in section 304(a)(1), that is treated as a distribution of property to which section 301 applies, a covered shareholder receiving an amount treated as a distribution of earnings and profits shall have a previously taxed earnings and profits account with respect to stock in each foreign corporation treated as distributing its earnings and profits under section 304(b)(2), even if such person did not otherwise have a previously taxed earnings and profits account with respect to stock in such corporation or corporations. In such a case, §§ 1.959-1 and this section shall apply in the same manner as these regulations would apply to any distribution to which section 301 applies.

(ii) The application of this paragraph (h)(4) is illustrated by the following example:

*Example.* Cross-chain acquisition of first-tier CFC. (i) *Facts.* DP, a domestic corporation, owns all of the stock in DS, a domestic corporation, and F1, a CFC. DP and DS are members of the same consolidated group. DS owns all of the stock in F2, a CFC. DP, DS, F1 and F2 all use the calendar year as their taxable year and F1 and F2 each use the U.S. dollar as its functional currency. During year 1, F1 purchases all the stock in F2 from DS for \$80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of F2's stock, DP has a previously taxed earnings and profits account consisting of \$20x of section 959(c)(2) earnings and profits with respect to its stock in F1, and F1 has previously taxed earnings and profits consisting of \$20x of section 959(c)(2) earnings and profits and non-previously

taxed earnings and profits of \$10x. At the end of year 1, before taking into account the purchase of F2's stock, DS has a previously taxed earnings and profits account consisting of \$50x of section 959(c)(2) earnings and profits with respect to its stock in F2, and F2 has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$0.

(ii) *Analysis.* Under section 304(a)(1), DS is deemed to have transferred the F2 stock to F1 in exchange for F1 stock in a transaction to which section 351(a) applies, and F1 is treated as having redeemed, for \$80x, the F1 stock deemed issued to DS. The payment of \$80x is treated as a distribution of property to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend is made as if the distribution were made, first, by F1 to the extent of its earnings and profits (\$30x), and then by F2 to the extent of its earnings and profits (\$50x). Before taking into account the deemed distributions, DS had a previously taxed earnings and profits account consisting of \$50x of section 959(c)(2) earnings and profits with respect to its stock in F2, and DP had a previously taxed earnings and profits account consisting of \$20x of section 959(c)(2) earnings and profits with respect to its stock in F1. Under paragraph (h)(4)(i) of this section, DS has a previously taxed earnings and profits account with respect to the stock in F1. Under paragraph (g)(1)(i) of this section, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to the F1 stock are reduced from \$20x to \$0 and the section 959(c)(2) earnings and profits in DS's previously taxed earnings and profits account with respect to the F1 stock are increased from \$0 to \$20x. The distribution by F1 causes the section 959(c)(2) earnings and profits in DS's previously taxed earnings and profits account with respect to F1 stock to be reduced from \$20x to \$0, and causes F1's section 959(c)(2) earnings and profits to be reduced from \$20x to \$0 and its non-previously taxed earnings and profits to be reduced from \$10x to \$0. The deemed distribution by F2 causes the section 959(c)(2) earnings and profits in DS's previously taxed earnings and profits account with respect to F2 stock to be reduced from \$50x to \$0, and causes F2's section 959(c)(2) earnings and profits to be reduced from \$50x to \$0. Of the distribution of \$80x, \$70x is excluded from DS's gross income pursuant to § 1.959-1(c)(1), and \$10x is included in DS's gross income as a dividend.

**Par. 5.** Section 1.959-4 is revised to read as follows:

**§ 1.959-4 Distributions of amounts excluded under section 959(a).**

Except as provided in section 960(a)(3) and § 1.960-1, any distribution excluded from gross income of a covered shareholder under section 959(a)(1) and § 1.959-1(c)(1) shall be treated, for purposes of chapter 1 (relating to normal taxes and surtaxes) of subtitle A (relating to income taxes) of the Internal Revenue Code as a distribution which is not a dividend,

except such a distribution shall immediately reduce earnings and profits.

**Par. 6.** Section 1.961-1 is revised to read as follows:

**§ 1.961-1 Increase in basis of stock in CFCs and of other property.**

(a) *Definitions.* See § 1.959-1(b) for a list of defined terms applicable to § 1.961-1 through § 1.961-4.

(b) *Increase in basis—(1) In general.* Except as provided in paragraphs (b)(2) and (b)(3) of this section, the adjusted basis of a United States shareholder's stock in a CFC or property (as defined in paragraph (c)(1) of this section) by reason of the ownership of which such United States shareholder is considered under section 958(a) as owning stock in a CFC shall be increased under section 961(a) each time, and to the extent that, such United States shareholder's previously taxed earnings and profits account with respect to the stock in that CFC is increased pursuant to the steps outlined in § 1.959-3(e)(2).

(2) *Limitation on amount of increase in case of election under section 962.* [Reserved].

(3) *Deemed inclusions under sections 1293(c) and 959(e).* Paragraph (b)(1) of this section shall not apply in the case of a deemed section 951(a) inclusion pursuant to section 1293(c) or 959(e).

(c) *Rules of application—(1) Property defined.* The property of a United States shareholder referred to in paragraph (b)(1) of this section shall consist of—

- (i) Stock in a foreign corporation;
- (ii) An interest in a foreign partnership; or
- (iii) A beneficial or ownership interest in a foreign estate or trust (as defined in section 7701(a)(31)).

(2) *Increase with respect to each share or ownership unit.* Any increase under paragraph (b) of this section in the basis of a United States shareholder's stock in a foreign corporation or property (as defined in paragraph (c)(1) of this section) by reason of the ownership of which such United States shareholder is considered under section 958(a) as owning stock in a foreign corporation shall be made on a pro rata basis with respect to each share of such stock or each ownership unit of such property.

(3) *Translation rules.* For purposes of determining an increase in basis under this section, in cases in which the previously taxed earnings and profits account is maintained in a non-United States dollar functional currency, section 951(a) inclusions shall be translated into United States dollars at the appropriate exchange rate as described in section 989(b). Any other increase in basis pursuant to paragraph



(b) of this section (for example, a basis increase resulting from the application of § 1.959-3(f) or (g)) shall be in the amount of the transferor's dollar basis attributable to the previously taxed earnings and profits transferred.

(c) *Examples.* The application of this section is illustrated by the following examples:

*Example 1. Basis adjustment for income inclusion.* (i) *Facts.* DP, a United States shareholder, owns 800 of the 1,000 shares of the one class of stock in FC and has a basis of \$50 in each of its shares. DP and FC use the calendar year as a taxable year and FC is a CFC. FC uses the u as its functional currency. The average exchange rate for year 1 is  $1u = \$1$ . In year 1, its first year of operation, FC has 100,000u of subpart F income after the payment of 11,250u of foreign income taxes. DP is required to include in gross income 80,000u ( $800/1,000 \times 100,000u$ ) equal to \$80,000 under section 951(a), and 9,000u ( $80,000u/100,000u \times 11,250u$ ) equal to \$9,000 under section 78.

(ii) *Analysis.* On December 31, of year 1, DP increases the section 959(c)(2) earnings and profits in its previously taxed earnings and profits account with respect to its stock in FC by 80,000u pursuant to § 1.959-3(e)(2)(i) to reflect the inclusion of 80,000u, or \$80,000, in DP's gross income pursuant to section 959(a), and correspondingly increases the basis of each share of its stock in FC by \$100 ( $\$80,000/800$ ) from \$50 to \$150 pursuant to paragraphs (b)(1) and (c)(2) of this section.

*Example 2. Sale of CFC stock.* (i) *Facts.* Assume the same facts as in *Example 1*, except that in year 2, DP sells all of its stock in FC to DP2, a United States person that is DP's successor in interest (as defined in § 1.959-1(b)(5)), for \$200 per share. At the time of sale, the exchange rate is  $1u = \$1$  and DP has a basis of \$150 per share in its FC stock and a previously taxed earnings and profits account with respect to its FC stock consisting of 80,000u of section 959(c)(2) earnings and profits with a dollar basis of \$80,000. Also, at the time of sale, FC has 50,000u of non-previously taxed earnings and profits, attributable to taxable years of FC beginning on or after December 31, 1962 during which FC was a CFC and DP held its shares of stock in FC.

(ii) *Analysis.* Pursuant to section 1248(a), because FC has 40,000u of non-previously taxed earnings and profits attributable to DP's stock ( $50,000u \times 800/1,000$ ), the \$40,000 of gain, equal to 40,000u, recognized by DP on the sale of its stock ( $\$200 - \$150 \times 800$ ) is included in DP's gross income as a dividend. Consequently, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FC are increased from 80,000u to 120,000u pursuant to § 1.959-3(e)(2)(i). DP's basis in each share of its stock in FC is not adjusted, pursuant to paragraph (b)(3) of this section, because the adjustment to DP's previously taxed earnings and profits account results from a deemed section 951(a) inclusion pursuant to section 959(e). Upon the sale, DP2 acquires a previously taxed earnings and profits account with respect to the FC stock

of 120,000u pursuant to § 1.959-1(d)(2)(i) and can utilize the account if it qualifies as a successor in interest under § 1.959-1(b)(5). DP2 takes a cost basis of \$200 per share in the FC stock pursuant to section 1012.

**Par. 7.** Section 1.961-2 is revised to read as follows:

**§ 1.961-2 Reduction in basis of stock in foreign corporations and of other property.**

(a) *Reduction in basis—(1) In general.* Except as provided in paragraph (a)(2) of this section, the adjusted basis of a covered shareholder's stock in a foreign corporation or property (as defined in § 1.961-1(c)) by reason of the ownership of which such covered shareholder is considered under section 958(a) as owning stock in a foreign corporation shall be reduced under section 961(b) each time, and to the extent, that such covered shareholder's dollar basis in a previously taxed earnings and profits account with respect to the stock in such foreign corporation is decreased pursuant to the steps outlined in § 1.959-3(e)(2) and shall also be reduced by the dollar amount of any foreign income taxes allowed as a credit under section 960(a)(3) with respect to the earnings and profits accounted for by that decrease.

(2) *Limitation on amount of reduction in case of election under section 962.* [Reserved].

(b) *Rules of application—(1) Reduction with respect to each ownership unit.* Any reduction under paragraph (a) of this section in the adjusted basis of a covered shareholder's stock in a foreign corporation or property (as defined in paragraph (b)(1) of this section) by reason of the ownership of which it is considered under section 958(a) as owning stock in a foreign corporation shall be made on a pro rata basis with respect to each share of such stock or each ownership unit of such property.

(2) *Translation rules.* For purposes of determining a decrease in basis under this section, in cases in which the previously taxed earnings and profits account is maintained in a non-United States dollar functional currency, distributions of previously taxed earnings and profits shall be translated using the dollar basis of the earnings distributed. See § 1.959-3(b)(1) and (b)(3)(ii) for rules regarding the dollar basis of previously taxed earnings and profits. If the covered shareholder elects to maintain dollar basis accounts of previously taxed earnings and profits as described in § 1.959-3(b)(3)(ii), the dollar basis of the earnings distributed shall be determined according to the following formula: (functional currency distributed/total functional currency

previously taxed earnings and profits)  $\times$  total dollar basis of previously taxed earnings and profits. See section 989(b)(1) for the appropriate exchange rate applicable to distributions for purposes of section 986(c).

(c) *Amount in excess of basis.* To the extent that the amount of the reduction in the adjusted basis of property provided by paragraph (a) of this section exceeds such adjusted basis, the amount shall be treated as gain from the sale or exchange of property.

(d) *Examples.* The application of this section is illustrated by the following examples:

*Example 1. Successor in interest.* (i) *Facts.* DP, a United States shareholder, owns all of the 1,000 shares of the one class of stock in FC, which owns all of the 500 shares of the one class of stock in FS. Each share of DP's stock in FC has a basis of \$200. DP, FC, and FS use the calendar year as a taxable year and FC and FS are CFCs throughout the period here involved. FC and FS both use the u as their functional currency. In year 1, FS has 100,000u of subpart F income after the payment of 50,000u of foreign income taxes. The average exchange rate for year 1 and year 2 is  $1u = \$1$ . For year 1, DP includes 100,000u in gross income under section 951(a) with respect to FS. In accordance with the provisions of § 1.961-1, DP increases the basis of each of its 1,000 shares of stock in FC to \$300 ( $\$200 + \$100,000/1,000$ ) as of December 31, of year 1. On July 31 of year 2, DP sells 250 of its shares of stock in FC to domestic corporation DT at a price of \$350 per share. DT satisfies the requirements of paragraph (d) of § 1.959-1 so as to qualify as DP's successor in interest. On September 30 of year 2, the earnings and profits attributable to the 100,000u included in DP's gross income under section 951(a) for year 1 are distributed to FC which incurs a withholding tax of 10,000u on such distribution (10% of 100,000u) and an additional foreign income tax of  $33\frac{1}{3}\%$  or 30,000u by reason of the inclusion of the net distribution of 90,000u ( $100,000u - 10,000u$ ) in its taxable income for year 2. On June 30 of year 3, FC distributes the remaining 60,000u of such earnings and profits to DP and DT: DP receives 45,000u ( $750/1,000 \times 60,000u$ ) and excludes such amount from gross income under section 959(a) and § 1.959-1(c); DT receives 15,000u ( $250/1,000 \times 60,000u$ ) and, as DP's successor in interest, excludes such amount from gross income under section 959(a) and § 1.959-1(c).

(ii) *Analysis.* As of June 30 of year 3, DP must reduce the adjusted basis of each of its 750 shares of stock in FC to \$200 ( $\$300$  minus  $\$45,000/750 + \$10,000/1,000 + \$30,000/1,000$ ); and DT must reduce the basis of each of its 250 shares of stock in FC to \$250 ( $\$350$  minus  $\$15,000/250 + \$10,000/1,000 + \$30,000/1,000$ ).

*Example 2. Sale of lower-tier CFC.* (i) *Facts.* Assume the same facts as in *Example 1*, except that in addition, on July 31 of year 2, FC sells its 500 shares of stock in FS to domestic corporation DT2 at a price of \$600 per share. DT2 satisfies the requirements of



§ 1.959–1(b)(5) so as to qualify as DP's successor in interest. On September 30 of year 2, FS distributes 100,000u of earnings and profits to DT2, which earnings and profits are attributable to the 100,000u included in DP's gross income under section 951(a) for year 1. As DP's successor in interest, DT2 excludes the 100,000u it receives from gross income under section 959(a) and § 1.959–1(c).

(ii) *Analysis.* As of September 30 of year 2, DT2 must reduce the basis of each of its 500 shares of stock in FS to \$400 (\$600 minus \$100,000/500).

*Example 3. Section 956 amount.* (i) *Facts.* DP, a United States shareholder, owns all of the 1,000 shares of the one class of stock in FC, which owns all of the 500 shares of the one class of stock in FS. Each share of DP's stock in FC has a basis of \$200. DP, FC, and FS use the calendar year as a taxable year and FC and FS are CFCs throughout the period here involved. FC and FS both use the u as their functional currency. In year 1, FS has 100,000u of subpart F income after the payment of 50,000u of foreign income taxes. The average exchange rate for year 1 and year 2 is 1u = \$1. For year 1, DP includes 100,000u in gross income under section 951(a) with respect to FS. In accordance with the provisions of § 1.959–3(e)(2)(i) and § 1.961–1, DP increases the section 959(c)(2) earnings and profits in its earnings and profits account with respect to its FC stock by 100,000u and correspondingly adjusts the basis of each of its 1,000 shares of stock in FC to \$300 (\$200+\$100,000/1,000) as of December 31, of year 1. In year 2, DP has a section 956 amount with respect to its stock in FC of 100,000u.

(ii) *Analysis.* On December 31 of year 2, DP reclassifies 100,000u of section 959(c)(2) earnings and profits as section 959(c)(1) earnings and profits pursuant to § 1.959–3(e)(2)(iv). DP's basis in each of its 1,000 shares of stock in FC remains unchanged at \$300 per share.

**Par. 8.** Section 1.961–3 is added to read as follows:

**§ 1.961–3 Basis adjustments in stock held by foreign corporation.**

(a) *Where the upper-tier entity is 100% owned by a single United States shareholder—(1) In general.* If a United States shareholder is treated under section 958(a) as owning stock in a CFC (lower-tier CFC) by reason of owning, either directly or pursuant to the application of section 958(a), stock in one or more other CFCs (each an “upper-tier CFC”), any increase to such United States shareholder's basis in stock or other property under § 1.961–1 of this section resulting from an adjustment to such United States shareholder's previously taxed earnings and profits account with respect to its stock in the lower-tier CFC shall also be made to each upper-tier CFC's basis in either the stock in the lower-tier CFC or the property by reason of which it is considered to own stock in the lower-

tier CFC under section 958(a), but only for purposes of determining the amount included under section 951 in the gross income of such United States shareholder or its successor in interest. In addition, any downward adjustment to such United States shareholder's (or its successor in interest's) previously taxed earnings and profits account with respect to its stock in a distributor under § 1.959–3(e)(3) shall result in a corresponding reduction of the basis of the distributee's stock in the distributor for purposes of determining the amount included in such United States shareholders gross income under section 951(a).

(2) *Examples.* The application of this paragraph (a) is illustrated by the following examples:

*Example 1. Intercorporate dividend from lower-tier CFC to upper-tier CFC.* (i) *Facts.* DP, a United States shareholder, owns all of the stock in FC, a CFC, and FC owns all of the stock in FS, a CFC. DP, FC and FS all use the calendar year as their taxable year and FC and FS both use the U.S. dollar as their functional currency. In year 1, FS has \$100x of subpart F income that is included in DP's gross income under section 951(a)(1). In year 2, FS pays a dividend of \$100x to FC.

(ii) *Analysis.* On December 31 of year 1, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FS are increased by \$100x pursuant to § 1.959–3(e)(2)(i) to reflect the inclusion of \$100x in DP's gross income under section 951(a)(1)(A). DP's basis in its stock in FC is correspondingly increased by \$100x pursuant to § 1.961–1(b). FC's basis in its stock in FS is also increased by \$100x pursuant to paragraph (a) of this section, but only for purposes of determining the amount included in DP's gross income under section 951. At the end of year 2, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FS are decreased by \$100x and its previously taxed earnings and profits account with respect to its stock in FC are increased by \$100x pursuant to § 1.959–3(e)(3) to reflect the transfer of the previously taxed earnings and profits from FS to FC. The \$100x distribution is excluded from FC's income for purposes of determining the amount included in DP's gross income pursuant to § 1.959–2(a). FC's basis in its stock in FS, for purposes of determining the amount included in DP's gross income under section 951, is decreased by \$100x pursuant to paragraph (a) of this section.

*Example 2. Sale of upper-tier CFC stock.* (i) *Facts.* DP, a United States shareholder, owns all of the stock in FC, a CFC. FC owns all of the stock in FS1, a CFC, and FS1 owns all of the stock in FS2, a CFC. DP, FC, FS1, and FS2 all use the calendar year as their taxable year and FC, FS1 and FS2 all use the U.S. dollar as their functional currency. In year 1, FS2 has \$100x of subpart F income which is included in DP's gross income under section 951(a)(1)(A). In year 2, FC sells FS1 to FT,

a nonresident alien, and recognizes \$100x of gain on the sale.

(ii) *Analysis.* On December 31 of year 1, the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to its stock in FS2 are increased by \$100x pursuant to § 1.959–3(e)(2)(i) to reflect the inclusion of \$100x in DP's gross income under section 951(a)(1). DP's basis in its stock in FC is correspondingly increased by \$100x under § 1.961–1(b). FC's basis in its stock in FS1 and FS1's basis in its stock in FS2 are also each increased by \$100x under paragraph (a) of this section, but only for purposes of determining the amount included in the gross income of DP under section 951. In year 2, the \$100x of gain on FC's sale of FS1 stock would be subpart F income that would be includible in DP gross income under section 951(a)(1)(A). However, since FC has an additional \$100x of basis in its stock in FS1 for purposes of determining the amount included in DP's gross income under section 951, the sale of FS1 by FC does not generate any subpart F income to DP.

(b) *Exception where the upper-tier entity is less than 100 percent owned by a single United States shareholder—(1) In general.* If United States shareholders are treated, under section 958(a), as owning stock in a CFC (lower-tier CFC) by reason of owning, either directly or pursuant to the application of section 958(a), stock in one or more other CFCs (each an “upper-tier CFC”), and if, in the aggregate, the lower-tier CFC is less than wholly owned by a single United States shareholder, any increase to any United States shareholder's basis in stock or other property under § 1.961–1(b) of this section resulting from an increase to such United States shareholder's previously taxed earnings and profits account with respect to its stock in such lower-tier CFC shall result in an increase to each upper-tier CFC's basis in either the stock in the lower-tier CFC or the property by reason of which such upper-tier CFC is considered to own stock in the lower-tier CFC under section 958(a), but only for purposes of determining the amount included under section 951 in the gross income of such United States shareholder or its successor in interest. The amount of the increase to each upper-tier CFC's basis in either the stock in the lower-tier CFC or the property by reason of which such upper-tier CFC is considered to own stock in the lower-tier CFC under section 958(a) shall be equal to the amount that would be excluded from the gross income of such upper-tier CFC pursuant to section 959(b) and § 1.959–2(a) if the amount that gave rise to the adjustment to the United States shareholder's previously taxed earnings and profits account with respect to its stock in the lower-tier CFC were actually distributed through a chain of ownership to such upper-tier CFC. In

addition, any decrease to such United States shareholder's (or successor in interest's) previously taxed earnings and profits account with respect to its stock in a distributor under § 1.959-3(e)(3) shall result in a corresponding reduction of the basis of the distributee's stock in the distributor. The reduction of the basis of the distributee's stock in the distributor shall be equal to the amount that would be excluded from the gross income of the distributee pursuant to section 959(b) and § 1.959-2(a).

(2) *Example.* The application of this paragraph (b) is illustrated by the following example:

*Example. Less than wholly owned CFC.* (i) *Facts.* DP, a United States shareholder, owns 70%, and FP, a nonresident alien, owns 30% of the stock in FC, a CFC. FC in turn owns 100% of the stock in FS, a CFC. Each of DP, FC, FN and FS use the calendar year as their taxable year and both FC and FS use the U.S. dollar as their functional currency. Entering year 1, DP has a basis of \$50x in FC and FC has a basis of \$50x in FS. In year 1, FS earns \$100x of subpart F income. In year 2, FC sells FS for \$150x.

(ii) *Analysis.* On December 31 of year 1, DP includes \$70x of the \$100x of subpart F income earned by FS in gross income under section 951(a)(1)(A). DP increases its section 959(c)(2) earnings and profits in its earnings and profits account with respect to its stock in FS by \$70x pursuant to § 1.959-3(e)(2)(i). DP increases its basis in FC from \$50x to \$120x pursuant to § 1.961-1(b). FC increases its basis in FS from \$50x to \$150x pursuant to paragraph (b)(1) of this section (but only for purposes of determining FC's subpart F income with respect to DP) because if the \$100x amount of subpart F income of FS that caused the \$70x increase to DP's previously taxed earnings and profits account with respect to its stock in FS had been distributed to FC, the entire \$100x would be excluded from FC's gross income pursuant to section 959(b) and § 1.959-2(a) for purposes of determining DP's inclusion under section 951(a)(1)(A). In year 2, when FC sells FS, for purposes of determining DP's subpart F inclusion, FC is treated as recognizing \$0 on the sale (\$150x sale proceeds - \$150x basis). Therefore, DP includes \$0 in income under section 951(a)(1)(A) as a result of the sale. Although the sale does not generate gain for purposes of determining DP's subpart F inclusion, it does cause FC's non-previously taxed earnings and profits to be increased by \$100x (\$150x sale proceeds - \$50x basis).

(c) *Translation rules.* Rules similar to those provided in § 1.961-1(c)(3) and § 1.961-2(b)(3) shall apply for purposes of determining the exchange rates used to reflect any change to the basis of stock or other property under this section.

**Par. 9.** Section 1.961-4 is added to read as follows:

**§ 1.961-4 Section 304 transactions.**

(a) *Deemed redemption treated as a distribution—(1) In general.* In the case of a stock acquisition described in section 304(a)(1) that is treated as a distribution of earnings and profits of a foreign acquiring corporation or a foreign issuing corporation or both, basis adjustments shall be made in accordance with the rules of §§ 1.961-1, 1.961-2, and 1.961-3.

(2) *Examples.* The application of this section is illustrated by the following examples:

*Example 1. Cross-chain acquisition of first-tier CFC.* (i) *Facts.* DP, a domestic corporation, owns all of the stock in DS, a domestic corporation, and F1, a CFC. DS owns all of the stock in F2, a CFC. DP, DS, F1 and F2 all use the calendar year as their taxable year and F1 and F2 use the U.S. dollar as their functional currency. During year 1, F1 purchases all of the stock in F2 from DS for \$80x in a transaction described in section 304(a)(1). At the end of year 1, before taking into account the purchase of F2's stock, DP has a previously taxed earnings and profits account consisting of \$20x of section 959(c)(2) earnings and profits with respect to its stock in F1, and F1 has section 959(c)(2) earnings and profits of \$20x and non-previously taxed earnings and profits of \$10x. At the end of year 1, before taking into account the purchase of F2's stock, DS has a previously taxed earnings and profits account consisting of \$50x of section 959(c)(2) earnings and profits with respect to its stock in F2 and F2 has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$0. Before taking into account the purchase of F2's stock, DP's basis in F1's stock is \$30x and DS's basis in F2's stock is \$60x.

(ii) *Analysis.* Under section 304(a)(1), DS is deemed to have transferred the F2 stock to F1 in exchange for F1 stock in a transaction to which section 351(a) applies, and F1 is treated as having redeemed, for \$80x, the F1 stock hypothetically issued to DS. The payment of \$80x is treated as a distribution to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend is made as if the distribution were made, first, by F1 to the extent of its earnings and profits (\$30x), and then by F2 to the extent of its earnings and profits (\$50x). Before taking into account the deemed distributions, DS had a previously taxed earnings and profits account of \$50x with respect to its stock in F2, and DP had a previously taxed earnings and profits account of \$20x with respect to its stock in F1. Under § 1.959-3(h)(4)(i), DS is deemed to have a previously taxed earnings and profits account with respect to stock in F1. Under § 1.959-3(g)(1), the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account with respect to F1 stock are reduced from \$20x to \$0. As a result, DP's basis in F1's stock is reduced from \$30x to \$10x under § 1.961-2(a). The deemed distribution of earnings and profits by F2 causes the section 959(c)(2) earnings and profits in DS's previously taxed earnings and

profits account with respect to F2 stock to be reduced from \$50x to \$0. Under § 1.961-2(a) and § 1.961-3(a), F1's basis in its newly acquired F2's stock is reduced from \$60x to \$10x. F1 has a transferred basis of \$10x in F2's stock.

*Example 2. Cross-chain acquisition of lower-tier CFC.* (i) *Facts.* DP, a domestic corporation, owns all of the stock in two CFCs, FX and FY. FX owns all of the stock in FZ, a CFC. FX, FY and FZ use the U.S. dollar as their functional currency. During year 1, FY purchases all of the stock in FZ from FX for \$80x in a transaction described in section 304(a)(1). On December 31 of year 1, before taking into account the purchase of FZ's stock, FY has section 959(c)(2) earnings and profits of \$20x and non-previously taxed earnings and profits of \$10x, and FZ has section 959(c)(2) earnings and profits of \$50x and non-previously taxed earnings and profits of \$0. Before taking into account FX's purchase of FZ's stock, DP's basis in FX's stock is \$60x; DP's basis in FY's stock is \$30x; and FX's basis in FZ's stock, for purposes of determining the amount includible in DP's gross income under section 951(a), is \$60x.

(ii) *Analysis.* Under section 304(a)(1), FX is deemed to have transferred the FZ stock to FY in exchange for FY stock in a transaction to which section 351(a) applies, and FY is treated as having redeemed, for \$80x, the FY stock hypothetically issued to FX. The payment of \$80x is treated as a distribution of property to which section 301 applies. Under section 304(b)(2), the determination of the amount which is a dividend is made as if the distribution were made, first, by FY to the extent of its earnings and profits, \$30x, and then by FX to the extent of its earnings and profits, \$50x. Under § 1.959-2(b), FX is deemed to receive the distributions from FY and FZ through a chain of ownership described in section 958(a), and \$70x is excluded from FX's gross income under section 959(b) and § 1.959-2(a). Under § 1.959-3(e)(3), the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account for the stock in FY are reduced from \$20x to \$0; the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account for the stock in FZ are reduced from \$50x to \$0; and the section 959(c)(2) earnings and profits in DP's previously taxed earnings and profits account for the stock in FX are increased from \$0 to \$70x (and such account is further increased to \$80x due to the inclusion of \$10x of subpart F income in DP's gross income under section 951(a)). Under § 1.961-2(a), DP's basis in the stock in FY is reduced from \$30x to \$10x. DP's basis in the stock in FX is first reduced by \$50x under § 1.961-2(a), and then increased by \$80x under § 1.961-1(b), for a net increase of \$30x, to \$90x. Under § 1.961-3(a), FY's basis in the stock in FZ, for purposes of determining the amount includible in DP's gross income under section 951(a), is reduced by \$50x to \$10x.

**Par. 10.** Section 1.1502-12 as amended by adding paragraph (s) to read as follows:

**§ 1.1502–12 Separate taxable income.**

\* \* \* \* \*

(s) The exclusion from gross income of previously taxed earnings and profits shall be determined by the rules of § 1.959–3(g).

**Par. 11.** In § 1.1502–32, add a sentence after the second sentence in paragraph (b)(3)(ii)(D), add a sentence after the fourth sentence in paragraph (b)(3)(iii)(B), and add *Example 11* in paragraph (b)(5)(ii) to read as follows:

**§ 1.1502–32 Investment adjustments.**

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(ii) \* \* \*

(D) \* \* \* Further, an increase to a member's previously taxed earnings and profits account under § 1.959–3(g)(1)(i)(B) that pursuant to section 961(a) and § 1.961–1(b) results in an increase to a member's basis in the stock in a CFC shall be treated as the receipt of tax exempt income. \* \* \*

(iii) \* \* \*

(B) \* \* \* Also included as a noncapital, nondeductible expense is a decrease to a member's previously taxed earnings and profits account under § 1.959–3(g)(1)(i)(A) that results in a decrease to a member's basis in the stock in a CFC pursuant to section 961(b) and § 1.961–2(a). \* \* \*

\* \* \* \* \*

(5) \* \* \*

(ii) \* \* \*

*Example 11.* (a) *Facts.* P owns all of the stock of S and S1. S, a United States shareholder, owns 50 percent of the stock in FC, a CFC that uses the U.S. dollar as its functional currency. S1, a United States shareholder owns the remaining 50 percent of the stock in FC. Entering year 1, S has a previously taxed earnings and profits account with respect to its stock in FC consisting of \$50x of section 959(c)(2) earnings and profits and S1 has a previously taxed earnings and profits account with respect to its stock in FC consisting of \$200x of section 959(c)(2) earnings and profits. Entering year 1, FC has section 959(c)(2) earnings and profits of \$250x and non-previously taxed earnings and profits of \$100x. In year 1, FC generates no earnings and profits and makes a \$100x distribution of earnings and profits on FC stock held by S and a \$100x distribution of earnings and profits on the FC stock held by S1.

(b) *Analysis.* First, pursuant to § 1.959–3(e)(2)(ii), the section 959(c)(2) earnings and profits in S's previously taxed earnings and profits account with respect to its FC stock are decreased from \$50x to \$0 and the section 959(c)(2) earnings and profits in S1's previously taxed earnings and profits account with respect to its FC stock are decreased from \$200x to \$100x. Then, pursuant to § 1.959–2(e)(2)(v) and (g)(1)(i)(A), the section 959(c)(2) earnings and profits in S1's

previously taxed earnings and profits account with respect to its FC stock are decreased from \$100x to \$50x and, pursuant to § 1.959–3(e)(2)(ii)(B) and (g)(1)(i)(B), the section 959(c)(2) earnings and profits in S's previously taxed earnings and profits account with respect to its FC stock are increased from \$0 to \$50x and then decreased from \$50x to \$0. Pursuant to § 1.959–1(c) of this section, the entire \$100x distribution to S and \$100x distribution to S1 are excluded from S's and S1's gross incomes. Pursuant to paragraph (b)(3)(ii)(D) of this section, the \$50x increase to the section 959(c)(2) earnings and profits in S's previously taxed earnings and profits account with respect to its FC stock pursuant to § 1.959–3(g)(1)(i)(B) is treated as the receipt of \$50x of tax-exempt income by S. Pursuant to paragraph (b)(2)(ii) of this section, P's basis in S's stock is increased by \$50x. Pursuant to paragraph (b)(3)(iii)(B) of this section, the \$50x decrease to the section 959(c)(2) earnings and profits in S1's previously taxed earnings and profits account with respect to its FC stock pursuant to § 1.959–3(g)(1)(i)(A) is treated as a noncapital nondeductible expense to S1. Pursuant to paragraph (b)(2)(iii) of this section, P's basis in S1's stock is decreased by \$50x.

\* \* \* \* \*

**Mark E. Matthews,***Deputy Commissioner for Services and Enforcement.*

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[REG–145154–05]

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**User Fees Relating to Enrollment****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed amendments to the regulations relating to user fees for the special enrollment examination to become an enrolled agent, the application for enrollment of enrolled agents, and the renewal of this enrollment. The charging of user fees is authorized by the Independent Offices Appropriations Act (IOAA) of 1952. This document also contains a notice of public hearing on these proposed regulations.

**DATES:** Written or electronically-generated comments must be received by September 28, 2006. Outlines of topics to be discussed at the public

hearing scheduled for September 29, 2006, must be received by September 28, 2006.

**ADDRESSES:** Comments are encouraged to be submitted to: CC:PA:LPD:PR (REG–145154–05), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be sent electronically via the IRS Internet site at <http://www.irs.gov/regs> or via the Federal eRulemaking Portal at <http://www.regulations.gov> (IRS–REG–145154–05).

**FOR FURTHER INFORMATION CONTACT:**

Concerning submissions of comments and/or to be placed on the building access list to attend the hearing, Richard Hurst at

[Richard.A.Hurst@irscounsel.treas.gov](mailto:Richard.A.Hurst@irscounsel.treas.gov) or at (202) 622–7180; concerning cost methodology, Eva Williams at (202) 622–6400; concerning the proposed regulations, Matthew Cooper at (202) 622–4940 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:****Background**

Section 330 of Title 31 of the United States Code authorizes the Secretary of the Treasury to regulate practice before the Treasury Department. Pursuant to section 330 of Title 31, the Secretary has published regulations governing practice before the IRS in 31 CFR part 10 and reprinted them as Treasury Department Circular No. 230 (Circular 230). These regulations are administered by the IRS Office of Professional Responsibility (OPR).

Section 10.3 of Circular 230 generally authorizes attorneys, certified public accountants, enrolled agents and enrolled actuaries to practice before the IRS. An enrolled agent is defined as an individual enrolled as an agent pursuant to the provisions of Circular 230. The provisions of Circular 230 provide that an individual desiring to become an enrolled agent is eligible for enrollment through either the successful passing of a written examination or through demonstration of sufficient expertise in tax administration based on former employment with the IRS. Specifically, section 10.4(a) authorizes the Director of OPR to grant enrollment to an applicant who demonstrates special competence in tax matters by passing a written examination administered by, or administered under the oversight of, the Director of OPR and who has not engaged in any conduct that would justify the censure, suspension, or disbarment of any practitioner under the provisions of Circular 230. Accordingly, every year OPR develops and administers a Special Enrollment