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Global Tax Perspectives

Better Watch Your PTEP! Potential Traps for the Unwary in the New Regime for Previously Taxed Earnings and Profits

By Ethan Kroll and David de Ruig*

Introduction

As has been widely reported since its enactment in December 2017, the Tax Cuts and Jobs Act (the "TCJA")[1] represented a sea change in the U.S. international tax landscape. The TCJA transformed some Code provisions (*e.g.*, Code Secs. 163(j), 367, 904, 958(b), 960), eliminated others (*e.g.*, Code Sec. 902), and introduced new provisions (*e.g.*, Code Secs. 59A, 245A, 250, 267A, 951A).[2] Yet, the TCJA left Code Sec. 959, which governs distributions of previously taxed earnings and profits ("PTEP"), largely untouched. In the absence of specific guidance from Congress, Treasury and the Service are now faced with the task of retooling the operation of Code Sec. 959 after the TCJA.

In this column, we focus on how Notice 2019-1 (the "Notice"),[3] the Service's first attempt at providing post-TCJA guidance under Code Sec. 959, interacts with three of the TCJA's key provisions—Code Sec. 951A ("Global Intangible Low-Taxed Income" ("GILTI")), Code Sec. 245A (the 100% dividends-received deduction), and amended Code Sec. 960 (the "deemed paid" foreign tax credit). We conclude that, while Treasury and the Service may have felt constrained by the existing statutory framework, the Notice nevertheless makes accessing PTEP, and taxes that are attributable to PTEP, less predictable, and therefore frustrates one of the TCJA's core policy objectives by complicating cash management for U.S.-parented multinational enterprises ("MNEs").

The Notice: A Cautionary Tale for Cash Management

Overview: Creation and Maintenance of Annual PTEP Accounts

The Notice reflects the Service's attempt to recalibrate the existing PTEP rules to accommodate the shift from the foreign tax credit pooling regime of Code Sec. 902 to Code Sec. 960's annual, "properly attributable" regime. The Notice thus builds on the proposed regulations under Code Sec. 960. The Notice also signals the Service's intent to withdraw the 2006 proposed regulations under Code Secs. 959 and 961.[4]

At a high level, the Notice requires a taxpayer to create and maintain an annual PTEP "account" within each Code Sec. 904 category (*e.g.*, Code Sec. 951A, general, passive).[5] The taxpayer must then segregate each account into 16 "groups."[6] Nine of the 16 groups are treated as Code Sec. 959(c)(1)—*i.e.*, Code Sec. 956—PTEP. Seven of the 16 groups are treated as Code Sec. 959(c)(2)—*i.e.*, Subpart F—PTEP.[7] The Notice, consistent with Code Sec. 959(c), sources a PTEP distribution first to PTEP described in Code Sec. 959(c)(1), then to PTEP described in Code Sec. 959(c)(2), and finally to earnings and profits ("E&P") described in Code Sec. 959(c)(3)—*i.e.*, non-previously taxed E&P—with PTEP in each Code Sec. 959 class generally allocated to a distribution on a "last in, first out" ("LIFO") basis.[8]

The Notice provides an exception to the general LIFO ordering rule for PTEP that arose under Code Sec. 965(a) and (b)(4).[9] Under the Notice, distributions of PTEP described in Code Sec. 959(c)(1) are sourced first to PTEP that arose under Code Sec. 965(a), and then to PTEP that arose under Code Sec. 965(b)(4), regardless of whether the taxpayer has more recent Code Sec. 959(c)(1) PTEP. Once the taxpayer exhausts its Code Sec. 965/959(c)(1) PTEP, the remainder of the distribution is sourced from the most recent annual layer of Code Sec. 959(c)(1) PTEP *pro rata*, across the remaining groups, until the taxpayer exhausts its Code Sec. 959(c)(1) PTEP.[10] The Notice then sources the distribution to Code Sec. 959(c)(2) PTEP, with Code Sec. 965 PTEP coming out first, and the remainder of the distribution sourced *pro rata* across each annual layer, as with Code Sec. 959(c)(1) PTEP, until the taxpayer exhausts its Code Sec. 959(c)(2) PTEP.[11]

The ordering rules set forth above address the source of PTEP distributions by group and by vintage, but do not address the situation where a taxpayer has PTEP in two or more Code Sec. 904 categories in the same group and of the same vintage. The Notice addresses this point as well. If a taxpayer has PTEP in a particular group, and of a particular vintage, in two or more Code Sec. 904 categories, the Notice treats the distribution as stemming from the Code Sec. 904 categories on a *pro rata* basis, starting with the most recent annual account.[12]

Consistent with the above, the proposed regulations under Code Sec. 960 allocate foreign taxes paid or accrued with respect to PTEP to the PTEP in the accounts and groups to which the taxes are properly attributable.[13] Thus, if a controlled foreign corporation ("CFC")[14] distributes PTEP, only those taxes that are properly attributable to the category, group, and vintage of the PTEP from which the distribution is sourced are treated as deemed paid for purposes of Code Sec. 960. For example, if an upper-tier CFC receives a distribution of PTEP from a lower-tier CFC, and that distribution is subject to, say, a withholding tax, only those taxes paid or accrued by the upper-tier CFC on the receipt of a PTEP distribution from the lower-tier CFC are attributable to that PTEP. Those taxes attach to the PTEP and follow the PTEP when the upper-tier CFC distributes the PTEP to its U.S. shareholder.

Importantly, the proposed regulations under Code Sec. 960 apply a pooling regime to taxes in a particular category, group, and vintage. Specifically, if a CFC receives a distribution of PTEP in a category, group, and vintage, the proposed regulations add that PTEP to the CFC's existing PTEP in the same category, group, and vintage and treat the taxes as attributable to the aggregate of the two.[15] That rule is significant because the proposed regulations deem a CFC or a U.S. shareholder that receives a PTEP distribution to have paid taxes that are properly attributable to the PTEP in proportion to the ratio of the PTEP that the CFC or U.S. shareholder receives to the total of the distributing CFC's PTEP in that category and group.[16] Thus, the Code Sec. 960 rules raise the possibility of foreign tax dilution in connection with distributions up the chain.

Moreover, there is at least some uncertainty as to whether the ratio looks to the vintage of the PTEP at all. By its terms, Proposed Reg. §1.960-3(b)(4) determines a U.S. shareholder's, or CFC's, "proportionate share" of taxes with respect to a PTEP group based solely on the ratio of the distribution to the total amount of PTEP in that group. Thus, if a CFC has significant low taxed PTEP in a group in multiple annual accounts, a distribution to that CFC in a different year of PTEP in that same group, which is subject to withholding tax, could result in taxes being even further diluted. In that case, the ratio would consider not only whether the CFC distributes PTEP from the year in which the taxes arose, but also whether the CFC distributes PTEP in the relevant group from every other year.[17]

The reading above would arguably be inconsistent with the remainder of Proposed Reg. §1.960-3, which expressly defines PTEP group taxes by reference to annual PTEP accounts.[18] In addition, this reading would be inconsistent with the rules for crediting taxes in connection with GILTI or Subpart F inclusions under Proposed Reg. §1.960-2, which determine a U.S. shareholder's proportionate share of CFC taxes on a year by year basis.[19] Accordingly, we think the more logical conclusion is that a U.S. shareholder, or a CFC, is deemed to pay taxes that are properly attributable to PTEP in proportion to the ratio of the amount of a distribution to the total amount in the PTEP group from the period to which the taxes relate. We encourage Treasury and the Service to confirm this conclusion in final guidance under Code Sec. 960.

The E&P Limitation: You Can't Have Your Cake or Eat It

As if a myriad of potential PTEP permutations aren't enough, the Notice adds another wrinkle to the PTEP management exercise. Specifically, the Notice explains that the Service expects to "clarify" that a "distribution will be a distribution of PTEP only to the extent it would have otherwise been a dividend under section 316."[20] Thus, only a CFC with current or accumulated E&P at the end of its tax year is eligible to distribute PTEP—and only to the extent of the sum of its current and accumulated E&P. As a result, a distribution that would otherwise be out of PTEP would be treated as a return of capital under Code Sec. 301(c)(2) or a sale/exchange under Code Sec. 301(c)(3) to the extent the distribution exceeds the CFC's E&P.[21]

The Notice confirms that a CFC may have a deficit in non-previously taxed E&P under Code Sec. 959(c)(3).[22] Yet, a CFC's E&P must equal the sum of the amounts in its Code Sec. 959(c)(1)–(c)(3) accounts.[23] As a result, it appears, as we discuss below, that at least some CFCs that generate significant "tested income" that gives rise to a GILTI inclusion under Code Sec. 951A may find it difficult to actually distribute the PTEP that is allocated to those CFCs because those CFCs may lack sufficient E&P to treat the distribution as a dividend under Code Sec. 301(c)(1). This result appears contrary to one of the key policy objectives of the TCJA, which was to facilitate the repatriation of previously taxed foreign earnings, as such, back to the United States.

As evidence of this potential conundrum, the Notice explains that future guidance under Code Sec. 959 will provide that "current E&P are first classified as section 959(c)(3) E&P and then section 959(c)(3) E&P are reclassified as section 959(c)(1) PTEP or section 959(c)(2) PTEP, as appropriate, which may have the effect of creating or increasing a deficit in section 959(c)(3) E&P."[24] The Notice then describes an example involving the allocation of a U.S. shareholder's GILTI inclusion amount to a CFC, where the GILTI allocation exceeds the CFC's current E&P.[25] The CFC's E&P described in Code Sec. 959(c)(3) increases first by the amount of CFC's current year E&P, and then decreases by the entire amount of the GILTI allocation, "possibly below zero."[26]

As we allude to above, limiting PTEP distributions to the aggregate of a CFC's E&P can have significant implications in the context of the GILTI regime because tested income does not necessarily correspond to E&P. Thus, it is entirely possible for a CFC to have PTEP that is attributable to tested income that exceeds the CFC's E&P, just as it is possible for a CFC to have E&P that exceeds its allocable share of a GILTI inclusion. It is therefore entirely possible for a U.S. shareholder to have paid tax on the net tested income of a CFC under the GILTI regime, and for that shareholder not to be able to access the CFC's cash due to the operation of the PTEP rules. We illustrate this issue in the following simple examples.

TABLE 1.

	Code Sec. 959(c)(1) PTEP	Code Sec. 959(c)(2) PTEP	Code Sec. 959(c)(3)	Total
1/1/Year 1		$100	$10	$110
E&P for Year 1			$10	$10
12/31/Year 1		$100	$20	$120

Example 1

The facts of this example are as follows. A U.S. MNE ("USP") owns all the stock of a CFC ("CFC"). CFC uses the U.S. dollar as its functional currency. Both USP and CFC are calendar year taxpayers. USP's tax basis in CFC's stock is $100. During Year 1, CFC distributes $30 to USP. CFC's E&P profile, without taking the distribution into account, is as follows (*see* Table 1).

As reflected in Table 1, CFC has, in the aggregate, positive current and accumulated E&P, as of the end of its Year 1 tax year. Consistent with the Notice, because CFC has sufficient E&P to support a distribution of up to $120 as a dividend under Code Sec. 316, it may thus distribute all of its PTEP without the distribution being treated as a return of capital distribution under Code Sec. 301(c)(2).

Put another way, because CFC's aggregate current and accumulated E&P as of the end of Year 1 ($120) exceeds its $30 distribution, the entire distribution qualifies as a PTEP distribution, even though CFC only has $20 of untaxed E&P described in Code Sec. 959(c)(3). The distribution of $30 reduces CFC's Code Sec. 959(c)(2) PTEP to $70, pursuant to the existing PTEP ordering rules under Code Sec. 959(c). USP's basis in CFC's stock as of 1/1 Year 2 is $70 ($100 – $30).[27]

Example 2

Now, assume that, in Year 2, CFC enjoys a successful year, and generates significant operating profits. The profits result in a GILTI inclusion of $200 to USP and a commensurate allocation of GILTI PTEP to CFC under Code Sec. 951A(f)(2). However, during Year 2, CFC only generates current E&P of $40 (*e.g.*, because it incurs a

TABLE 2.

	Code Sec. 959(c)(1) PTEP	Code Sec. 959(c)(2) PTEP	Code Sec. 959(c)(3)	Total
1/1/Year 2		$70	$20	$90
E&P for Year 2		$200	($160)	$40
12/31/Year 2		$270	($140)	$130

non-tested income loss of <$160>) and makes a distribution of $150. Before taking CFC's Year 2 distribution into account, CFC's E&P profile is as follows (*see* Table 2).

In this scenario, CFC has an aggregate amount of current and accumulated E&P of $130, which is insufficient to support its entire distribution of $150. Accordingly, only $130 of the Year 2 distribution qualifies as a dividend under Code Sec. 316, and thus as a PTEP distribution, notwithstanding the fact that CFC has "one or more annual PTEP accounts with respect to its stock" in CFC well in excess of the entire amount distributed.[28] The remaining portion of the Year 2 distribution ($20) reflects a return of capital under Code Sec. 301(c)(2), and USP's basis in its shares of CFC as of 1/1 Year 3 is $120 ($70 + $200 – $150).[29]

The issue that Example 2 raises is subtle but significant. The distribution in Example 2 decreases USP's tax basis in CFC whether the distribution is a PTEP distribution (*see* Code Sec. 961(b)) or a return of capital distribution (*see* Code Sec. 301(c)(2)). Likewise, the distribution could result in capital gain under Code Sec. 961(b)(2) or Code Sec. 301(c)(3) if USP were not to have tax basis in CFC's stock in amount equal to or greater than the amount of the distribution.[30]

Yet, Example 2 results in a mismatch between USP's basis in the stock of CFC and the PTEP that is attributable to CFC. That result has the potential to create a trap for USP in the future. If CFC begins to generate material earnings that do not give rise to a GILTI, or Subpart F income, inclusion and are eligible for the dividends received deduction under Code Sec. 245A, USP may want CFC to distribute a significant amount of cash. At this time, USP may have limited tax basis in CFC because prior distributions may have eliminated this tax basis under Code Sec. 961(b) and Code Sec. 301(c)(2). CFC may nevertheless have material PTEP. A distribution of those earnings could therefore cause USP to recognize gain under Code Sec. 961(b)(2) in respect of its CFC stock because (i) the distribution would stem first from PTEP and (ii) USP's tax basis in CFC might not be equal to or greater than the amount of that PTEP. Even then, Code Sec. 1248(j) ostensibly would apply to recharacterize the gain as a deemed dividend that benefits from Code Sec. 245A, in which case the transaction still likely would not result in U.S. tax for USP.[31] However, that conclusion assumes that the law when USP recognizes the gain is the same as the law today.

Equally important, the Notice may cause companies to recognize Subpart F income on a current-year basis in connection with the common fact pattern of distributions of cash up a multi-tier chain. Under Code Sec. 961 and the current, final Code Sec. 961 regulations, income that a U.S. shareholder recognizes under the Subpart F or GILTI regime with respect to a lower-tier CFC only results in a basis increase in the stock of the first CFC in the relevant chain.[32] Yet, Code Sec. 959 and the Notice require companies to maintain Code Sec. 959 accounts with respect to all CFCs in the chain. If a lower-tier CFC with a material balance in its Code Sec. 959(c)(1) or (2) PTEP account distributes cash to its CFC parent at a time when the lower-tier CFC has an E&P deficit, the distribution ostensibly does not constitute a PTEP distribution to which Code Sec. 959 applies. Yet, the distribution also does not constitute a dividend to which Code Sec. 954(c)(6) could apply because the distributing CFC does not have E&P. Accordingly, the distribution either reduces the recipient CFC's basis in the distributing CFC's stock under Code Sec. 301(c)(2) or results in capital gain under Code Sec. 301(c)(3). If there is limited organic basis in the CFC's stock due to, *e.g.*, a lack of historic capital contributions or reorganizations, and there is no basis attributable to Subpart F income or GILTI inclusions, the distribution likely results in capital gain under Code Sec. 301(c)(3). This gain likely constitutes Subpart F income at the level of the recipient CFC under Code Sec. 954(c)(1)(B), which is not recharacterized as a deemed dividend to which Code Sec. 245A applies under Code Sec. 964(e)(4) for the very reason there is gain in the first place—namely, because the distributing CFC is in an E&P deficit position.[33] The prospect of such a result could very well discourage taxpayers from moving cash associated with PTEP back to the United States—a consequence that would be directly contrary to the policy objectives of the TCJA, as we note above.

The point we wish to make is that the E&P limitation that the Notice prescribes for the PTEP regime has at least the potential to cause a U.S. shareholder to recognize gain in connection with a PTEP distribution. In addition, this limitation adds another compliance burden, and concern, for taxpayers without a clear rationale or benefit. If the GILTI regime creates PTEP whether the CFC has E&P or not, why should E&P determine whether a distribution is out of PTEP?[34] To address this concern, Treasury could propose rules to relax the E&P limitation in the case of PTEP that arises as a result of a U.S. shareholder's GILTI inclusion.

The Service's position in the Notice is not, or at least does not appear to be, new. For example, in Rev. Rul. 74-550, the Service addressed the availability of the deemed paid credit under former Code Sec. 902 in connection with distributions that a CFC made when it had an E&P deficit.[35] The Service concluded that the distribution was not a dividend under Code Sec. 316 and therefore ruled that taxes could not be deemed paid in connection with the distribution.

The Revenue Ruling highlights another implication of the Notice's E&P limitation. If, as Example 2 demonstrates, only a portion of a distribution is treated as a PTEP distribution, it would seem to follow that only a portion of any taxes properly attributable to the distribution (*e.g.*, withholding taxes) would be properly attributable to the relevant PTEP group under Code Sec. 960. If the distribution is instead a return of capital distribution, a U.S. shareholder that seeks to credit these taxes against its U.S. tax must argue that any tax on the distribution is attributable to a timing, and not a base, difference for purposes of Proposed Reg. §1.904-6(a)(1)(iv). The U.S. shareholder must further allocate and apportion the tax to the Code Sec. 904 category to which the tax would have been allocated and apportioned had the income been recognized for U.S. federal income tax purposes. But what is the appropriate category? Logically, the tax should be allocated and apportioned to PTEP, but the proposed regulations under Code Sec. 960 expressly state that only taxes that are in fact attributable to PTEP fall into this category.[36] The answer is unclear.

Examples 1 and 2 illustrate the implications of the Notice using an overly simplified multinational chain. As we allude to above, most U.S. MNEs have multiple CFCs, in different chains, with E&P and tax profiles that fluctuate from year to year. Assume instead the following facts. USP owns CFC1, and CFC1 owns CFC2. In Year 1, CFC1 generates $1,000 of tested income, CFC2 generates $10 of tested income, and USP has a GILTI inclusion of $1010. In Year 2, CFC2 remits $10 of Code Sec. 959(c)(2) PTEP to CFC1, and that $10 is subject to 20% withholding tax.

Under the Notice and the proposed regulations under Code Sec. 960, the $10 distribution, and the $2 of withholding tax, is allocated to the same CFC1 PTEP account and group as the $1,000.[37] If CFC1 then remits $100 to USP, USP is deemed to pay only $100/$1,010 of the $2 of withholding tax to which the distribution from CFC2 to CFC1 was subject.[38] While that result is arguably consistent with the operation of the former Code Sec. 902 pooling regime, it seems inconsistent with a regime that requires careful tracing of income and taxes. The more equitable approach, from our perspective, would be to segregate distributions from lower tier entities into separate accounts, and to provide, as with Code Sec. 965 PTEP, that distributions stem first from PTEP in those accounts. Although that approach would arguably create additional complexity, it also would incentivize taxpayers to repatriate cash to the United States by ensuring that they recover any tax cost associated with cash repatriation close to the point in time when they incur the cost. In addition, that approach would mitigate concerns that the Code Sec. 965 PTEP priority rule itself raises. Namely, if CFC1 has a significant amount of Code Sec. 965 PTEP, absent a similar priority rule for intercompany distributions that are subject to tax, it could take the company years before USP is able to access the taxes that are attributable to the PTEP distribution from CFC2 to CFC1.

This result becomes much more troubling if CFC1 and CFC2 are instead lower tier CFCs, and USP has an upper tier CFC with an E&P deficit. In this case, in addition to diluting taxes attributable to distributions of PTEP, the Notice and the proposed regulations under Code Sec. 960 can potentially trap taxes indefinitely, by converting otherwise *bona fide* PTEP distributions from the upper tier CFC to USP into return of capital distributions.

Mitigating the E&P Limitation: Pre-TCJA Planning in a Post-TCJA World

As we allude to above, the Notice's E&P limitation causes problems for taxpayers principally because of the disconnect between GILTI and E&P. First, E&P is irrelevant for purposes of calculating GILTI. Rather, Code Sec. 951A determines GILTI based on a CFC's income and allocable deductions, regardless of whether that CFC has E&P as determined under Code Sec. 964.[39] Thus, for example, a distribution could reduce E&P under Code Sec. 312(a)(3) without giving rise to a loss/deduction for tax purposes under Code Sec. 311(a), and a CFC's tested income could be materially greater than its E&P. Similarly, a taxpayer might have basis in property that gives rise to deductions that are not allocable to tested income, yet those deductions might reduce E&P, yielding a similar result. Code Sec. 951A nevertheless allocates back to a CFC a proportionate share of the U.S. shareholder's GILTI inclusion and characterizes that share as PTEP, thus placing GILTI within the ambit of the Code Sec. 959 rules.

At the risk of oversimplifying, the answer to problems that the E&P limitation raises is to generate E&P. There are a number of transactions U.S.-parented MNEs may undertake to do just that. Prepayments represent a clear example of a time-tested strategy for generating both income and E&P. If a CFC manufactures goods for, performs services for, or licenses/leases property to an affiliate, the affiliate can prepay for the goods/services/license/lease and increase both the tested income and the E&P of the CFC.[40] While such an arrangement may appear to yield the adverse result of increasing tested income, and thereby GILTI, if structured appropriately involving another CFC of the same U.S. shareholder, the expense at the level of the payor CFC should effectively net against the tested income of the payee CFC, resulting in no net GILTI increase, and an E&P bump.

It is prudent to start developing a strategy now, since PTEP in the wrong place is like money in someone else's bank—it's never there when you need it.

In addition, a company could restructure its foreign operations to integrate E&P positive entities with entities in an E&P deficit position, with the combined company eroding any deficits over time. The "check the box" rules could facilitate a U.S.-only restructuring into a holding company, mitigating most, if not all, of the non-U.S. tax and transaction costs a restructuring would otherwise entail.

Importantly, increasing E&P, and not tested income, should not prevent a taxpayer from using excess E&P as a vehicle for distributing cash up the chain. E&P that is not subject to tax under the GILTI or Subpart F regime should qualify for the 100% dividends received deduction under Code Sec. 245A. Therefore, to the extent a taxpayer overcorrects, and moves more E&P into a CFC than necessary to allow the CFC to distribute PTEP, that additional E&P can facilitate a distribution under Code Sec. 245A. A simple example illustrates this proposition. Assume that a U.S. shareholder owns two CFCs—CFC1 and CFC2. If CFC1 has $40 of tested loss, and CFC2 has $50 of tested income and E&P, the U.S. shareholder has a $10 GILTI inclusion, and CFC2 has $10 of GILTI PTEP. The $10 of CFC2's E&P supports a distribution of the $10 of PTEP, but what of the remaining $40? The answer should be that the additional $40 benefits from the Code Sec. 245A dividends received deduction, thereby allowing CFC2 to remit $50 to its U.S. shareholder tax free from a U.S. federal income tax perspective.

Conclusion

The Notice understandably reflects many of the complexities that characterize the new Code Sec. 960 "properly attributable" regime. Yet, the Notice does so in a manner that taxpayers (and advisors) may find counterintuitive and at odds with the objectives of the TCJA. Fortunately, the Notice does not have the force and effect of law, and Treasury has yet to finalize the proposed regulations under Code Sec. 960.[41] To this end, taxpayers may rightly wish to defer any PTEP planning until they have more certainty. We agree with this approach to a point. It is prudent to start developing a strategy now, since PTEP in the wrong place is like money in someone else's bank—it's never there when you need it.

ENDNOTES

* The views expressed by the authors are not necessarily those of Ernst & Young LLP or other members of the global EY organization.

1 An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (the "TJCA"), P.L. 115–97, 131 Stat. 2054 (Dec. 22, 2017).

2 All references to the "Code" are references to the Internal Revenue Code of 1986, as amended. All references to "Section" are to sections of the Code, and all references to "regulations" or "Treas. Reg. §" are to the Treasury Regulations issued under the Code. All references to the "Service" are references to the Internal Revenue Service. All references to the "Treasury" are references to the U.S. Department of the Treasury.

3 Notice 2019-1, IRB 2019-2, 275.

4 Notice 2019-1, Section 2. *See* Notice of Proposed Rulemaking (REG-121509-00), *Exclusion from Gross Income of Previously Taxed Earnings and Profits, and Adjustments to Basis of Stock in Controlled Foreign Corporations and of Other Property*, 71 FR 51155 (Aug. 29, 2006), corrected at 71 FR 71116 (Dec. 8, 2006).

5 Notice 2019-1, Section 3.

6 *Id.*

7 *Id.*

8 Notice 2019-1, Section 3.02.

9 *Id.*

10 *Id.*

11 *Id.* In this manner, the priority rule for distributions of Code Sec. 965(a) and (b)(4) PTEP operates only to prioritize Code Sec. 965 PTEP within the applicable Code Sec. 959(c)(1) or (c)(2) category. For example, if a CFC were to have Code Sec. 965 PTEP with respect to Code Sec. 959(c)(2), but not Code Sec. 959(c)(1), the Notice would not deem that PTEP to be distributed

before other non-Code Sec. 965 PTEP in a Code Sec. 959(c)(1) PTEP group.

12 Notice 2019-1, Section 3.01. The Notice provides an example of the *pro rata* rule in Example 1.

13 Proposed Reg. §1.960-3(c), (d).

14 As defined in Code Sec. 957.

15 *See* Proposed Reg. §1.960-3(c)(3), (d), (e).

16 *See* Proposed Reg. §1.960-3(b).

17 The preamble to the proposed regulations under Code Sec. 960 appears to support this reading: "The domestic corporation's proportionate share of foreign income taxes associated with a section 959(a) distribution from a PTEP group is determined by a fraction equal to the amount of the section 959(a) distribution attributable to the PTEP group over the total amount of previously taxed earnings and profits in the PTEP group." Notice of Proposed Rulemaking, Fed. Reg. Vol. 83, No. 235 at 63200 *et seq.* (Dec. 7, 2018).

18 *See* Proposed Reg. §1.960-3(d).

19 *See* Proposed Reg. §1.960-2(b)(3).

20 Notice 2019-1, Section 3.02.

21 PTEP distributions that a U.S. shareholder excludes from gross income under Code Sec. 959(a) are not treated as dividends for purposes of the Code, although they do reduce E&P of the distributing CFC. *See* Code Sec. 959(d).

22 Notice 2019-1, Section 3.03.

23 *Id*. The Notice also does not address how a CFC should address PTEP distributions where it has a hovering deficit account.

24 *Id*.

25 *Id*.

26 *Id*. The Notice also retains certain aspects of existing law. For example, the current regulations under Code Sec. 959 provide that a U.S. shareholder's *pro rata* share of a CFC's E&P deficit, for example, attributable to operating losses, reduces only current and accumulated E&P, if any, described in Code Sec. 959(c)(3). Reg. §1.959-3(c). Consistent with the regulations under Code Sec. 959, the Notice suggests that the Service will issue regulations addressing CFCs with deficits in current-year E&P. In that case, the deficit would only reduce the entity's untaxed E&P under Code Sec. 959(c)(3). Notice 2019-1, Section 3.03. Treasury and the Service's position in Rev. Rul. 86-131, 1986-2 CB 135, and GCM 39153 (Mar. 1, 1984), is arguably consistent with the viewpoint expressed in the Notice that the sum of a foreign corporation's E&P described in each of the Code Sec. 959(c) categories must equal the foreign corporation's total earnings and profits, even if it results in a deficit in E&P described in Code Sec. 959(c)(3). In addition, the GCM appears to *confirm* the Service's viewpoint in the Notice that a deficit in E&P may only be allocated to E&P described in Code Sec. 959(c)(3), not Code Sec. 959(c)(1) or (2).

27 *See* Code Sec. 961.

28 Notice 2019-1, Section 3.02. The Notice provides, as an example, that "if a foreign corporation has no current E&P or accumulated E&P at the end of a taxable year, a distribution from the corporation to a shareholder during the table year will be a return of basis or treated as gain from the sale or exchange of property under section 301(c)(2) or (3), respectively, regardless of whether the shareholder has one or more annual PTEP accounts with respect to its stock in the foreign corporation."

29 Code Sec. 961(a) requires a basis increase for the full amount of the GILTI inclusion ($200).

30 *See* Reg. §1.961-1(a)(1). At least under the current, final Code Sec. 961 regulations, the basis increase attributable to USP's Year 2 GILTI inclusion could be viewed as having not crystallized until year end.

31 Under Reg. §1.1248-1(b), gain that a shareholder recognizes under Code Sec. 301(c)(3) in connection with a distribution is treated as gain from the sale or exchange of stock of the distributing corporation. In contrast, a PTEP distribution is described in Code Sec. 301(c)(1), not (c)(3) (*see* Code Secs. 959(c) and 316).

32 *See* Reg. §1.961-1(c), Example 1.

33 A different reading of Code Sec. 961 might permit a company to use Code Sec. 961(a) basis to prevent CFC-to-CFC distributions from generating Subpart F or tested income.

34 *See* Notice of Proposed Rulemaking (REG-121509-00), *Exclusion from Gross Income of Previously Taxed Earnings and Profits, and Adjustments to Basis of Stock in* Controlled Foreign Corporations and of Other Property, 71 FR 51155 (Aug. 29, 2006), corrected at 71 FR 71116 (Dec. 8, 2006) (the "2006 proposed regulations"). At least one commentator has expressed the view that the 2006 proposed regulations do not necessarily require PTEP distributions to be wholly supported by an aggregate amount of positive E&P. *See, e.g.*, Thomas E. Taylor, *Distributions Cannot Reduce E&P Below Zero: Not Completely True*, Tax Notes International 1055–1063 (Mar. 24, 2008).

35 Rev. Rul. 74-550, 1974-2 CB 209.

36 Proposed Reg. §1.960-3(b)(3).

37 Proposed Reg. §1.960-3(c)(3), (d); *see also* Reg. §1.959-2(b).

38 *See* Proposed Reg. §1.960-3(e).

39 As noted above, Code Sec. 961(b) recognizes that there are times when a distribution of PTEP may exceed tax basis in the distributing CFC's stock. This rule places further importance on the presence of E&P at the level of the distributing CFC, given that any capital gain that the distributing CFC's shareholder recognizes under Code Sec. 961(b)(2) would likely be taxed at 21%.

40 *Accord* Code Sec. 451.

41 Under the Notice, forthcoming regulations will apply to taxable years of U.S. shareholders ending after December 14, 2018, and to taxable years of foreign corporations ending with or within such taxable years of U.S. shareholders. *See* Notice 2019-1, Section 4. Before Treasury issues the regulations, however, a shareholder may rely on the rules set forth in Section 3 of the Notice if the shareholder and each person related to the shareholder, as determined under Code Sec. 267(b) or 707(b), apply the rules consistently, subject to various constraints.

