

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

Number: **AM 2023-002**

Release Date: 3/10/2023

CC:INTL:B04

POSTS-117518-22

UILC: 961.00-00

date: March 01, 2023

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subject: Timing of Basis Increases under Section 961(a) for Purposes of Midyear PTEP Distributions

This advice may not be used or cited as precedent.

FACTS

USP is a domestic corporation that is not an S corporation. FS is a foreign corporation with a single share of common stock outstanding that is directly owned by USP at all relevant times. FS is a controlled foreign corporation (within the meaning of section 957(a)) (“CFC”), and USP is a United States shareholder (within the meaning of section 951(b)) with respect to FS. Each of USP and FS is a calendar year taxpayer and uses the United States dollar as its functional currency.

Immediately before the beginning of Year 1, USP’s adjusted basis in its stock of FS and USP’s section 959 previously taxed earnings and profits (“PTEP”) accounts with respect to FS are both \$0.

In Year 1, FS has \$10x of subpart F income (as defined in section 952(a)). USP’s pro rata share of FS’s subpart F income for Year 1 is \$10x, which USP includes in its gross income under section 951(a)(1)(A). Also in Year 1, USP includes in its gross income under section 951A(a) its GILTI inclusion amount of \$90x (within the meaning of Treas. Reg. § 1.951A-1(c)(1)), all of which is allocated to FS under section 951A(f)(2) and Treas. Reg. § 1.951A-5(b)(2). As a result, USP increases its PTEP accounts with

respect to FS by \$100x (\$10x + \$90x). The \$10x and \$90x included by USP with respect to FS are collectively referred to as the “Year 1 Inclusions.”

On June 30 in Year 1, FS distributes \$100x to USP (the “Midyear Distribution”). At the end of Year 1, without diminution for distributions, FS has earnings and profits of \$100x and thus the Midyear Distribution would be, without regard to section 959(d), a dividend. The distribution is treated as an amount described in section 959(a). Accordingly, the entirety of the Midyear Distribution is excluded from USP’s gross income. USP correspondingly decreases its PTEP accounts with respect to FS by \$100x.

## ISSUE

Does USP take into account the increase to the adjusted basis of its stock of FS under section 961(a) for the Year 1 Inclusions when determining the amount of gain, if any, required to be recognized under section 961(b)(2) due to the Midyear Distribution?

## LAW

Sections 959 and 961 are companion provisions the purpose of which is to prevent double taxation of a United States shareholder’s share of certain CFC earnings. Section 959 carries out this purpose by excluding PTEP from gross income, such as when PTEP is distributed by a CFC to a United States shareholder. Section 961, in relevant part, carries out this purpose through stock basis increases under section 961(a) that reflect the generation of PTEP,<sup>1</sup> and through stock basis reductions or gain recognition under section 961(b) upon the distribution of PTEP.

Specifically, under section 961(a) and Treas. Reg. § 1.961-1(a), a United States shareholder’s adjusted basis of CFC stock is increased by the amount required to be included in gross income under section 951(a) with respect to such stock. Section 951A(f)(1) and Treas. Reg. § 1.951A-5(b)(1) provide that an amount included in a United States shareholder’s gross income as a GILTI inclusion amount is treated in the same manner as an amount included under section 951(a) for purposes of applying section 961. Treasury Reg. § 1.961-1(a) provides that the increase occurs “as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation.”

Under section 961(b)(1) and Treas. Reg. § 1.961-2(a), the adjusted basis of stock with respect to which a United States shareholder receives an amount excluded from gross income under section 959(a) is generally reduced by the amount excluded and the amount of certain foreign taxes. Treasury Reg. § 1.961-2(a) provides that the reduction of adjusted basis occurs “as of the time such person receives such excluded amount.”

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<sup>1</sup> See H.R. Rep. No. 1447, at A106 (1962) (“To prevent doubling up of tax where stock in a controlled foreign corporation is sold at a gain which reflects the retained earnings already taxed to United States persons, the basis of stock would be adjusted.”).

Under section 961(b)(2) and Treas. Reg. § 1.961-2(c), a United States shareholder recognizes gain from the sale or exchange of property to the extent the reduction of adjusted basis under section 961(b)(1) and Treas. Reg. § 1.961-2(a) exceeds its adjusted basis of the stock with respect to which the excluded amount is received.

### ANALYSIS AND CONCLUSION

Under section 961(a) and Treas. Reg. § 1.961-1(a), USP increases its adjusted basis of its FS stock by \$100x, the amount of the Year 1 Inclusions. Under section 961(b) and Treas. Reg. § 1.961-2, USP decreases its adjusted basis of its FS stock by \$100x, the amount of the Midyear Distribution excluded from USP's gross income under section 959(a), and recognizes gain from the sale or exchange of property to the extent the Midyear Distribution exceeds the adjusted basis of USP's FS stock.

Section 961(b)(2) and Treas. Reg. § 1.961-2(c) do not specifically address a scenario like the Midyear Distribution. The timing rules in Treas. Reg. §§ 1.961-2(a) and -1(a) could be read to conclude that the adjusted basis of USP's FS stock is computed before or after taking into account the \$100x increase under section 961(a). The better interpretation—in light of the fact that the final amount of PTEP for the taxable year can be determined only at the end of the year—is that the increase in basis is taken into account when applying section 961(b)(2) and Treas. Reg. § 1.961-2(c) to the Midyear Distribution.<sup>2</sup> Not doing so would produce discordance between sections 959 and 961, as under section 959(c) the full amount of PTEP for a taxable year is available (without duplication) for distributions made at any time during the year, but under section 961 the basis related to such PTEP would protect against section 961(b)(2) gain only if the PTEP is distributed on or after the last day of the taxable year on which the foreign corporation is a CFC. Requiring gain recognition under section 961(b)(2) if the PTEP is distributed on any earlier day would be contrary to section 959 and section 961's common purpose of preventing double taxation.

Accordingly, for purposes of applying section 961(b)(2) and Treas. Reg. § 1.961-2(c) to the Midyear Distribution, USP's adjusted basis of its FS stock is \$100x.<sup>3</sup> Thus, USP does not recognize gain as a result of the Midyear Distribution. Further, as of the end of Year 1, USP's adjusted basis of its FS stock is \$0x, reflecting the \$100x increase under section 961(a) and the \$100x decrease under section 961(b)(1).

Please call Karen Li at (202) 317-6075 if you have any questions.

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<sup>2</sup> This interpretation is consistent with the "gain reduction rule" in Treas. Reg. § 1.965-2(g), which effectively takes into account the basis increase provided by section 961(a) when applying section 961(b)(2) to an inclusion year distribution of section 965 PTEP.

<sup>3</sup> The import of Treas. Reg. § 1.961-2(a)'s rule—that basis is reduced as of the time the United States shareholder receives the excluded amount—is that the amount is not again taken into account. Thus, to the extent the \$100x increase is taken into account under section 961(b)(2) and supports the Midyear Distribution, such amount will not again be taken into account when applying section 961(b)(2) to a subsequent distribution by FS in Year 1.