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IRS Advice Memorandum Addresses Mid-Year PTEP Distributions

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As taxpayers and practitioners await expected regulations addressing matters related to previously taxed earnings and profits (“PTEP”), the IRS Office of Chief Counsel (International) has issued a legal advice memorandum (AM 2023-002, released March 10, 2023) concluding that current-year CFC income inclusions are taken into account when determining basis for purposes of determining whether a mid-year distribution of PTEP generates gain. The operation of the PTEP and related basis adjustment rules to mid-year distributions has been a longstanding issue of interest to many U.S. multinationals. The memorandum reaches the same conclusion as a recent private letter ruling, providing further (albeit limited) explanation of the IRS’s legal analysis and likely previewing the IRS’s approach in the proposed regulations expected to be released in 2023.¹

Sections 959 and 961 work together to prevent double taxation of PTEP, i.e., CFC earnings included

in a U.S. shareholder’s gross income as subpart F income or global intangible low-taxed income (GILTI) under §951 and §951A, respectively.² Under §959(a)(1), distributions of PTEP are excluded from a U.S. shareholder’s gross income. Section §961 addresses basis adjustments related to PTEP. Under §961(a), a U.S. shareholder increases its basis in the stock of a directly-held CFC by the amount of PTEP generated. Section 961(b)(1) and the regulations thereunder generally provide that a U.S. shareholder that receives PTEP excluded from gross income under §959(a) decreases its basis in the CFC stock by such amount. Under §961(b)(2), to the extent that the amount of the distribution excluded from gross income under §959(a) exceeds the adjusted basis of the relevant CFC stock, the amount is treated as gain from the sale or exchange of property.

There has long been a concern about the timing of the §961(a) basis increase with respect to current-year CFC earnings where a taxpayer makes a mid-year distribution of PTEP. Under Reg. §1.961-1(a), the basis increase reflecting a U.S. shareholder’s inclusion with respect to CFC income occurs “as of the last day in the taxable year” of the CFC. Where PTEP is distributed, Reg. §1.961-2(a) provides that the §961(b) basis reduction occurs “as of the time such person receives such excluded amount.” Thus, where a PTEP distribution is made before the end of the year, there has been a concern that gain could be generated where a basis adjustment with respect to current-year income is needed to cover the full amount of the PTEP distribution and the basis adjustment is not taken into account until the last day of the year.

The advice memorandum addresses the following basic facts: USP is a domestic corporation that di-

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¹ See Michael Miller, *IRS Rules Favorably on Timing of §961 Basis Adjustments*, 52 Tax Mgmt. Int’l J. No. 3 (Mar. 3, 2023); Isabel Gottlieb, *IRS Plans Later 2023 Release of Previously Taxed Income Rule*, Daily Tax Rep. (Feb. 14, 2023).

² Section 951A(f)(1) and Reg. §1.951A-5(b)(1) provide that an amount included in a U.S. shareholder’s gross income as a GILTI inclusion amount is treated in the same manner as an amount included under §951(a) for purposes of applying §959 and §961.

rectly wholly owns FS, a CFC. USP and FS are calendar year taxpayers. Immediately before the beginning of Year 1, USP's adjusted basis in its stock of FS and USP's §959 PTEP accounts with respect to FS are both \$0. In Year 1, FS has \$10x of subpart F income, which USP includes in its gross income. USP also includes in its gross income for Year 1 a GILTI inclusion amount of \$90x with respect to FS. As a result, USP increases its PTEP accounts with respect to FS by \$100x (\$10x + \$90x). On June 30 in Year 1, FS distributes \$100x to USP. The distribution is treated as an amount described in §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.

The advice memorandum addresses whether USP takes into account the increase to the adjusted basis of its stock of FS under §961(a) for the \$100 Year 1 income inclusions when determining the amount of gain, if any, required to be recognized under §961(b)(2) due to the Midyear Distribution. The memorandum concludes that, for purposes of applying §961(b)(2) and Reg. §1.961-2(c) to the mid-year distribution, USP's adjusted basis of its FS stock is \$100x. As a result, USP does not recognize gain. As of the end of Year 1, USP's adjusted basis of its FS stock is \$0x, reflecting the \$100x increase under §961(a) and the \$100x decrease under §961(b)(1).

The legal analysis in the memorandum first observes that §961(b)(2) and Reg. §1.961-2(c) do not specifically address a mid-year distribution scenario. The memorandum states that the regulations 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 §961(a). The memorandum does not analyze these potential interpretations in detail but concludes that "the better interpretation" is that the increase in basis is taken into account to determine whether gain is recognized from the mid-year distribution. The memorandum recognizes that failing to permit an increase in basis would "produce discordance" between §959 and §961. The memorandum also notes that the final amount of PTEP for the taxable year can be determined only at the end of the

year and, under §959(c), the full amount of PTEP for a taxable year is available for distributions made at any time during the year. The memorandum observes that, if the basis increase with respect to such PTEP does not occur until the end of the year, the basis related to such PTEP would protect against §961(b)(2) gain only if the PTEP is distributed on or after the last day of the taxable year. The memorandum concludes that "[r]equiring gain recognition under §961(b)(2) if the PTEP is distributed on any earlier day would be contrary to §959 and §961's common purpose of preventing double taxation."

Like a private letter ruling, an IRS legal advice memorandum may not be used or cited as precedent.³ It is instructive, however, as it reflects the position of the IRS Office of Chief Counsel and will guide IRS examiners. The memorandum is also notable because it likely indicates that Treasury and the IRS will likely modify the existing regulations to address the mid-year distribution and basis adjustment issue explicitly. It is also possible that the IRS will address other vexing PTEP issues prior to the issuance of the proposed regulations through a similar process as the mid-year distribution issue, i.e., by issuing a private letter ruling and/or an advice memorandum.

³ In addition to AM 2023-002, the IRS Office of Chief Counsel (International) has in recent years issued advice memoranda on numerous other issues of interest, including the source and character of payments by a U.S. depository institution to a foreign corporation related to American Depositary Receipts programs (AM 2023-001, further addressing issues previously analyzed in AM 2013-003), whether tax consequences that would result from a transaction subject to adjustment under §482 or requiring income inclusions under §367(d)(1) and from realistic alternatives to that transaction must be considered to determine an arm's length result (AM 2022-006), treaty benefits with respect to distributions and gains with respect to stock of a Domestic International Sales Corporation (AM 2022-005), the active trade or business requirement under Reg. §1.367(a)-3(c)(3)(i)(A) (AM 2022-004), advance payments of annual §367(d) inclusions (AM 2022-0003), allocation and apportionment of deferred compensation expense for purposes of calculating foreign-derived intangible income (AM 2022-001), §482 adjustments for cost sharing agreements with reverse claw-back provisions (AM 2021-004), and issues involving the check-the-box regulations and foreign entities (AM 2021-001).