Demystifying IRS Form 5471 Schedule J and The New Proposed PTEP Regulations

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IRS Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) is an extremely complicated return. Form 5471 includes 12 schedules. This article discusses Schedule J of Form 5471, which schedule is used to report a foreign corporation's accumulated earnings and profits or "E&P."

Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) is used by certain U.S. persons who are officers, directors, or shareholders in respect of certain foreign entities that are classified as corporations for U.S. tax purposes. Form 5471 and its schedules are used to satisfy the reporting requirements of Code Sections 6038 and 6046.

Substantively, Form 5471 backstops various international sections of the Internal Revenue Code, including Sections 901 and 904 (foreign tax credits), Section 951(a) (subpart F income), Section 951A (global intangible low-taxed income or "GILTI"), Section 965 (one-time transition tax on a U.S. shareholder's deferred foreign income), and Section 482 (transfer pricing). Other forms associated with Form 5471 include Form 926 (Return by a U.S. Transferor of Property to a Foreign Corporation), Form 5713 (International Boycott Report), Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund), and Forms 1116 and 1118 (Foreign Tax Credit).

Form 5471 includes 12 schedules. This article discusses the Schedule J of Form 5471. This schedule is used to report a foreign corporation's accumulated earnings and profits or "E&P." Schedule J is also used to report the E&P of specified foreign corporations for limited purposes under Section 965(e)(2).

KEY TERMS FOR FORM 5471

Form 5471 provides for five general categories of filers, numbered 1 through 5. Two of these general categories are subdivided into three subtypes each, with each subtype being a separate filer category as well. The filer category that a taxpayer falls under dictates the schedule or schedules that the taxpayer must include with the form. In order to understand how these filer categories work, it is helpful to review some basic terms.

U.S. person.

Only U.S. persons who own stock in a foreign corporation can have a Form 5471 filing obligation. A U.S. person is generally a citizen or resident of the United States, a domestic partnership, a domestic corporation, or a domestic trust or estate, each as defined in Code Section 7701(a)(30)(A) through (E). A tax-exempt U.S. entity may have a Form 5471 filing obligation. In addition, an individual who relies on the residency provision of an income tax treaty to reduce his or her U.S. income tax liability (and files Form 8833) remains a U.S. person for purposes of Form 5471.[1] There are some slight modifications to the definition of a U.S. person which will be discussed in more detail below. All of the Form 5471 filer categories apply to U.S. persons.

U.S. shareholder.

Code Section 951(b) defines a "U.S. shareholder" as a U.S. citizen, resident alien, corporation, partnership, trust, or estate that owns 10% or more of the total combined voting power of all classes of voting stock of a foreign corporation, or 10% or more of the total value of all the outstanding stock of a foreign corporation. All forms of stock ownership — i.e., direct, indirect (ownership through intervening entities), and constructive (attribution of ownership from one related party to another) — are considered in applying the 10% test.

Controlled foreign corporation ("CFC").

A foreign corporation is a CFC if, on any day during its taxable year, all of its U.S. shareholders, taken together as a group, own more than 50% of the combined voting power of all classes of the foreign corporation's voting stock, or more than 50% of the total value of all of the foreign corporation's outstanding stock.[2] Only U.S. persons who constitute U.S. shareholders are considered in applying the 50% test. Just as in the case of the 10% test for determining whether a U.S. person is a U.S. shareholder, direct, indirect, and constructive ownership of stock are all considered in applying the 50% test for CFCs. The term "foreign," when applied to a corporation, means a corporation that is not domestic — i.e., a corporation that is not incorporated in a U.S. state or the District of Columbia.[3]

Reg. 301.7701-2(b)(8) provides a list of foreign entities that are conclusively

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treated as "per se" corporations for U.S. tax purposes. An individual preparing a Form 5471 should be aware that abbreviations in an entity name such as "Ltd." and "S.A." do not always stand for "Limited" or "Sociedad Anonima" (or "Societe Anonyme"). The preparer should confirm what the unabbreviated terms are, preferably from a charter or other official document from the relevant jurisdiction. If a foreign entity is not in the list of per se corporations, Reg. 301.7701-3(b)(2) provides that, unless a contrary election is made, the foreign entity will be treated as (1) an association taxable as a corporation if all its members have limited liability, (2) a partnership if it has two or more members (at least one of which does not have limited liability), or (3) a disregarded entity if it has a single owner who does not have limited liability.

Section 965 specified foreign corporation ("SFC").

An SFC is a foreign corporation that either is a CFC or has at least one U.S. shareholder that is a domestic corporation.[4] The term SFC includes not only CFCs, but also entities commonly referred to as "10/50 corporations." These foreign corporations have at least one U.S. shareholder, but are not CFCs because U.S. shareholders do not collectively own more than 50% of the corporation's stock either by vote or value.

Stock ownership.

For purposes of Form 5471, a U.S. person can own stock in a corporation in three possible ways. First, the person can own the stock "directly." For example, owning stock in a brokerage account constitutes direct ownership of the stock. Second, the U.S. person can own the stock "indirectly" through an intervening entity, such as a corporation, partnership, estate, or trust, in which the U.S. person owns an interest. In these cases, the stock owned by the intervening entity is typically considered to be owned proportionately by its shareholders, partners, or beneficiaries, as the case may be. For example, if a U.S. person directly owns 40% of the stock of a corporation and that corporation, in turn, directly owns 50% of the stock of a second corporation, then the U.S. person is considered to own indirectly 20% (i.e., 40% X 50%) of the stock of the second corporation. Indirect stock ownership can extend through several layers of intervening entities, where each intervening entity directly owns an interest in the one immediately below it. The third way that a U.S. person can own stock is by "constructively" owning the stock due to a relationship with another person. This relationship most commonly involves family members. For example, if a U.S. citizen mother directly owns 6% of a corporation's stock and her U.S. citizen daughter directly owns 5% of the same corporation's stock, then each of them is considered to own constructively the shares of the other. As a result, the mother and daughter are each considered to own 11% of the corporation's stock. Another less common relationship involves sister entities. This form of constructive ownership (referred to as downward attribution) arises when an individual or entity parent directly or indirectly owns stock in a corporation and, at the same time, owns an interest in another entity. Under downward attribution, the corporation's stock that the parent owns is attributed downward from the parent to the second entity. As a result, the second entity is considered to own constructively the same stock owned by the parent. Generally, the stock that is owned constructively by one person due to family or downward attribution cannot be further owned constructively by another.

> Only U.S. persons who own stock in a foreign corporation can have a Form 5471 filing obligation.

All three kinds of stock ownership apply when determining which Form 5471 filer category or categories a taxpayer falls under, but there are variations among the categories. For example, in Categories 2 and 3, constructive family ownership includes attribution of stock from siblings, grandparents, and nonresident aliens, whereas the other three categories do not allow for these attributions. Categories 1, 4, and 5 define indirect ownership to mean only indirect ownership through foreign intervening entities, and include indirect ownership through intervening U.S. entities as constructive upward attribution. Categories 2 and 3 specifically provide for indirect ownership, but only through entities that are foreign corporations or partnerships, and refer to this type of non-direct ownership as both indirect and constructive ownership. Constructive ownership in the form of downward attribution does not exist in Categories 2 and 3, but exists in Categories 1, 4, and 5. Category 4's version of downward attribution prohibits attribution of stock from a foreign entity to a U.S. person. Category 1 and 5's version, however, contains no such prohibition due to the Tax Cuts and Jobs Act of 2017 (the "TCJA"). All these variations, as well as others not described above, will need to be taken into account when preparing a Form 5471.

FILER CATEGORIES

Form 5471, together with its applicable schedules, must be completed (to the extent required on the form) and filed by the taxpayer according to the taxpayer's filer category. What follows is a description of each filer category.

Category 1 filer.

A Category 1 filer is a U.S. shareholder of a foreign corporation that is an SFC at any time during the corporation's taxable year. However, to be classified as a Category 1 filer, the U.S. shareholder of the SFC must also own the SFC's stock on the last day of the SFC's taxable year.

The stock ownership rules applicable to Category 1 (including Categories 1a, 1b, and 1c) are contained in Code Section 958, which incorporates and modifies the constructive stock ownership rules of Section 318(a). For Category 1 purposes, if a person does not directly own stock, the person can own stock as follows:

Indirect stock ownership through an intervening entity. The intervening entity (i.e., a corporation, partnership, estate, or trust) can only be a foreign entity. The person, who is to become the indirect owner of stock through the intervening entity, is not required to hold a minimum ownership interest (i.e., stock,

partnership interest, or beneficial interest) in the intervening foreign entity.

Constructive stock ownership from another person.

- *Attribution from family members.* A person can only be attributed stock owned by his or her parent, spouse, child, or grandchild. However, no attribution is permitted from a nonresident alien to a U.S. citizen or resident.
- *Upward attribution from entities.* The attributing entity can be either a U.S. or foreign entity. However, if the attributing entity is a corporation, the person to whom the stock is to be attributed must own at least 10% (by value) of the attributing entity's stock. Furthermore, if the stock to be attributed upward constitutes more than 50% of a corporation's voting stock, then the stock is deemed to constitute 100% of the corporation's voting stock when it gets proportionately allocated among the attributing entity's owners.
- *Downward attribution from persons.* The attributing person can be either an individual or entity. However, if the stock is to be attributed downward to a corporation, the attributing person must own at least 50% (by value) of that corporation's stock.

Category 1a, 1b, and 1c filers.

Category 1 is subdivided into Categories 1a, 1b, and 1c. Category 1a is a catchall category and applies to Category 1 filers who do not otherwise fall under either Category 1b or 1c. Categories 1b and 1c were added to Form 5471 as the result of Revenue Procedure 2019-40, which the IRS issued in response to the repeal of provisions in Section 958(b) that previously disapplied the constructive downward attribution rules of Section 318(a)(3) to the extent that they attributed stock owned by a foreign person to a U.S. person.

Categories 1b and 1c specifically apply to those SFCs that are considered to be foreign-controlled for purposes of Form 5471. Such an SFC, referred to herein as a "Foreign-Controlled SFC," is a foreign corporation that, although classified as an SFC, would not be so classified if the determination were made without applying Section 318(a)(3)'s downward attribution rules so as to consider a U.S. person as owning the stock owned by a foreign person.

A Category 1b filer is a U.S. shareholder who owns, directly or indirectly under Section 958(a) (but not constructively under Section 958(b)), the stock of a Foreign-Controlled SFC and is not related (within the meaning of Section 954(d)(3)) to that Foreign-Controlled SFC. Section 954(d)(3) defines two persons as being "related" to each other in terms of "control," where one person controls or is controlled by the other, or is controlled by the same person or persons who control the other. Here, control over a corporation means directly or indirectly owning more than 50% of the corporation's stock by either vote or value. A Category 1b filer is typically a shareholder who owns, directly or indirectly, stock in a foreign corporation but is not related to the foreign corporation because the common parent of both the shareholder and the foreign corporation does not control the foreign corporation.

For purposes of Form 5471, a U.S. person can own stock in a corporation in three possible ways.

A Category 1c filer is a U.S. shareholder who does not own, either directly or indirectly, the stock of a Foreign-Controlled SFC but is related (within the meaning of Section 954(d)(3)) to that Foreign-Controlled SFC. A Category 1c filer is typically a shareholder that owns the stock of a foreign corporation only because of constructive stock ownership under Section 318(a)(3) and the shareholder is related to the foreign corporation because each of them is under the control of a common parent.

A U.S. shareholder who does not own, either directly or indirectly, the stock of a Foreign-Controlled SFC and is not related (within the meaning of Section 954(d)(3)) to that Foreign-Controlled SFC, is neither a Category 1b nor 1c filer. Such U.S. shareholder is deemed not to fall under the Category 1a catchall and is exempt from the obligation to file Form 5471.

Category 2 filer.

A Category 2 filer is a U.S. person who is an officer or director of a foreign corporation in which there has been a substantial change in its U.S. ownership. A U.S. person can be a Category 2 filer even if the change relates to stock owned by another U.S. person and regardless of whether or not that other U.S. person is an officer or director of the foreign corporation. For Category 2 purposes, a U.S. person is defined as a U.S. citizen, resident alien, corporation, partnership, estate, or trust. However, Category 2 also expands the definition of a U.S. person to include a bona fide Puerto Rico resident, a bona fide possessions resident, and a nonresident alien as to whom a Section 6013(g) or (h) election is in effect (i.e., where a nonresident alien spouse has made an election to be taxed as a U.S. person). In regard to the definition of an officer or director, there is no clear answer as to what constitutes an officer or director for purposes of a Category 2 filer. Reg. 1.6046-1(d) provides that "persons who would qualify by the nature of their functions and ownership in such associations, etc., as officers, directors, or shareholders thereof will be treated as such for purposes of this section without regard to their designations under local law."

For purposes of Category 2, a substantial change in U.S. ownership in a foreign corporation occurs when any U.S. person (not necessarily the U.S. citizen or resident who is the officer or director) either (1) acquires stock that causes that U.S. person to own a 10% block of stock in that foreign corporation (by vote or value) or (2) acquires an additional 10% block of stock in that corporation (by vote or value). More precisely, if any U.S. person acquires stock that, when added to any stock previously owned by that U.S. person, causes the U.S. person to own stock meeting the 10% stock ownership requirement, the U.S. officers and directors of that foreign corporation must report. A disposition of shares in a foreign corporation by a U.S. person, however, does not create

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filing obligations under Category 2 for U.S. officers and directors of that foreign corporation.

The stock ownership rules applicable to Category 2 are contained in Code Section 6046(c) and Reg. 1.6046-1(i). For Category 2 purposes, if a person does not directly own stock, the person can own stock as follows:

Constructive stock ownership from another person.

- *Attribution from family members.* A person can only be attributed stock owned by his or her brother, sister, spouse, ancestors, and lineal descendants. Attribution from nonresident aliens is permitted.
- *Upward attribution from entities.* The attributing entity can be either a foreign corporation or a foreign partnership. The person, who is to become the constructive/indirect owner of stock through the attributing foreign corporation or partnership, is not required to hold a minimum ownership interest (i.e., stock or partnership interest) in the attributing foreign corporation or partnership. By negative implication, there is no attribution of stock from U.S. entities, or from foreign estates or trusts. Nevertheless, stock owned by U.S. entities that are not treated as entities separate from their owners for U.S. income tax purposes (i.e., grantor trusts and disregarded entities) should be attributable to their owners.

Category 3 filer.

A U.S. person who owns stock in a foreign corporation is a Category 3 filer if any one of the following events occurs during the taxable year:

1. The U.S. person acquires stock in the corporation that, when added to any stock already owned by the person, causes the person to own at least 10% (by vote or value) of the corporation's stock.
2. The U.S. person acquires stock that, without regard to any stock already owned by the person, constitutes at least 10% (by vote or value) of the corporation's stock.
3. The U.S. person becomes a U.S. person while owning at least 10% (by vote or value) of the corporation's stock.
4. The U.S. person disposes of sufficient stock in the corporation to reduce the person's interest to less than 10% (by vote or value) of the corporation's stock.
5. The U.S. person owns at least 10% (by vote or value) of the corporation's stock when the corporation is reorganized.

For Category 3 purposes, a U.S. person is defined as a U.S. citizen, resident alien, corporation, partnership, estate, or trust. However, Category 3 also expands the definition of a U.S. person to include a bona fide Puerto Rico resident, a bona fide possessions resident, and a nonresident alien as to whom a Section 6013(g) or (h) election is in effect (i.e., where a nonresident alien spouse has made an election to be taxed as a U.S. person).

Form 5471, together with its applicable schedules, must be completed and filed by the taxpayer according to the taxpayer's filer category.

The stock ownership rules applicable to Category 3 are the same as the ones applicable to Category 2, as described above under "Filer Categories–Category 2 Filer." These rules are contained in Code Section 6046(c) and Reg. 1.6046-1(i).

Category 4 filer.

A U.S. person is a Category 4 filer with respect to a foreign corporation for a taxable year if the U.S. person controls the foreign corporation. For Category 4 purposes, a U.S. person is defined as a U.S. citizen, resident alien, corporation, partnership, estate, or trust. However, Category 4 also expands the definition of a U.S. person to include a bona fide Puerto Rico resident, a bona fide possessions resident, and a nonresident alien as to whom a Section 6013(g) or (h) election is in effect (i.e., where a nonresident alien spouse has made an election to be taxed as a U.S. person).[5]

A U.S. person is considered to "control" a foreign corporation for purposes of Category 4 if at any time during the person's taxable year, such person owns more than 50% of the combined voting power of all classes of the foreign corporation's voting stock, or more than 50% of the total value of all of the foreign corporation's outstanding stock.[6] It is important to note that the concept of control here for Category 4 filers is distinct from the one in the definition of CFC, a term used for Category 1 and Category 5 filers. There, control over a foreign corporation exists when more than 50% (by vote or value) of the corporation's stock is owned by one or more U.S. shareholders, each of whom individually owns at least 10% of the corporation's stock. By contrast, a Category 4 filer is a single U.S. person who individually owns more than 50% (by vote or value) of the foreign corporation's stock.

The stock ownership rules applicable to Category 4 are contained in Code Section 6038(e)(2), which incorporates and modifies the constructive stock ownership rules of Section 318(a). For Category 4 purposes, if a person does not directly own stock, the person can own stock as follows:

Constructive stock ownership from another person.

- *Attribution from family members.* A person can only be attributed stock owned by his or her parent, spouse, child, or grandchild. Attribution from nonresident aliens is permitted.
- *Upward attribution from entities.* The attributing entity can be either a U.S. or foreign entity. However, if the attributing entity is a corporation, the person to whom the stock is to be attributed must own at least 10% (by value) of the attributing entity's stock. Furthermore, because Section 6038(e)(2) defines control for purposes of Category 5 as owning more than 50% (by vote or value) of a corporation's stock, if a person controls a corporation that, in turn, owns more than 50% (by vote or value) of the stock of a second corporation, then such person will be treated as in control of the second corporation as well.

- *Downward attribution from persons.* The attributing person can be either an individual or entity. However, if the stock is to be attributed downward to a corporation, the attributing person must own at least 50% (by value) of that corporation's stock. Furthermore, no downward attribution is allowed if it results in a U.S. person constructively owning stock that is owned by a foreign person (as the attributing person).

Category 5 filer.

A Category 5 filer is a U.S. shareholder of a foreign corporation that is a CFC at any time during the corporation's taxable year. However, to be classified as a Category 5 filer, the U.S. shareholder of the CFC must also own the CFC's stock on the last day of the CFC's taxable year.

The stock ownership rules applicable to Category 5 (including Categories 5a, 5b, and 5c) are the same as the ones applicable to Category 1 (including Categories 1a, 1b, and 1c), as described above under "Filer Categories–Category 1 Filer." These rules are contained in Code Section 958, which incorporates and modifies the constructive stock ownership rules of Section 318(a).

Category 5a, 5b, and 5c filers.

Category 5 is subdivided into Categories 5a, 5b, and 5c. Category 5a is a catchall category and applies to Category 5 filers who do not otherwise fall under either Category 5b or 5c. Categories 5b and 5c were added to Form 5471 as the result of Revenue Procedure 2019-40, which the IRS issued in response to the repeal of provisions in Section 958(b) that previously disapplied the constructive downward attribution rules of Section 318(a)(3) to the extent that they attributed stock owned by a foreign person to a U.S. person.

Categories 5b and 5c specifically apply to those CFCs that are considered to be foreign-controlled for purposes of Form 5471. Such a CFC, referred to herein as a "Foreign-Controlled CFC," is a foreign corporation that, although classified as a CFC, would not be so classified if the determination were made without applying Section 318(a)(3)'s downward attribution rules so as to consider a U.S. person as owning the stock owned by a foreign person.

A Category 5b filer is a U.S. shareholder who owns, directly or indirectly under Section 958(a) (but not constructively under Section 958(b)), the stock of a Foreign-Controlled CFC and is not related (within the meaning of Section 954(d)(3)) to that Foreign-Controlled CFC. Section 954(d)(3) defines two persons as being "related" to each other in terms of "control," where one person controls or is controlled by the other, or is controlled by the same person or persons who control the other. Here, control over a corporation means directly or indirectly owning more than 50% of the corporation's stock by either vote or value. A Category 5b filer is typically a shareholder who owns, directly or indirectly, stock in a foreign corporation but is not related to the foreign corporation because the common parent of both the shareholder and the foreign corporation does not control the foreign corporation.

> Anyone who wishes to complete Schedule J must understand the basketing and ordering rules of Code Section 959.

A Category 5c filer is a U.S. shareholder who does not own, either directly or indirectly, the stock of a Foreign-Controlled CFC but is related (within the meaning of Section 954(d)(3)) to that Foreign-Controlled CFC. A Category 5c filer is typically a shareholder that owns the stock of a foreign corporation only because of constructive stock ownership under Section 318(a)(3) and the shareholder is related to the foreign corporation because each of them is under the control of a common parent.

A U.S. shareholder who does not own, either directly or indirectly, the stock of a Foreign-Controlled CFC and is not related (within the meaning of Section 954(d)(3)) to that Foreign-Controlled CFC, is neither a Category 5b nor 5c filer. Such U.S. shareholder is deemed not to fall under the Category 5a catchall and is exempt from the obligation to file Form 5471.

SCHEDULE J, GENERALLY

Category 1a, 4, and 5a filers are required to file Schedule J to Form 5471, which is used to report a CFC's E&P, as computed under Code Sections 964(a) and 986(b). Schedule J is also used to report the E&P of an SFC that is only treated as a CFC for limited purposes under Section 965(e)(2). For purposes of Schedule J, as well as the rest of this article, all references to CFCs will include these SFCs treated as CFCs under Section 965(e)(2).

Each Category 1a, 4, and 5a filer is required to complete a separate Schedule J for each CFC with respect to which the filer is a U.S. shareholder. Furthermore, because each Schedule J is limited to reporting information on only one category of foreign source income, multiple Schedules J will need to be completed for each CFC whose income comprises multiple categories.

SCHEDULE J - CATEGORIES OF INCOME

Schedule J begins by asking the filer to complete Lines a and b of the Schedule. Line a requires the filer to determine the category of foreign source income applicable to the income in question and to enter its corresponding code. To do this, the filer refers to the instructions for IRS Form 1118 (Foreign Tax Credit–Corporations), which provide for the following nine income categories:

- Section 951A Category Income (Code 951A)
- Foreign Branch Category Income (Code FB)
- Passive Category Income (Code PAS)
- Section 901(j) Income (Code 901j)
- U.S. Source Passive Category Income Resourced by Treaty as Foreign Source Passive Category Income (Code RBT PAS)
- U.S. Source General Category Income Resourced by Treaty as Foreign Source General Category Income (Code RBT GEN)
- U.S. Source Foreign Branch Income Resourced by Treaty as Foreign Source Foreign Branch Category Income (Code RBT FB)

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- U.S. Source Section 951A Category Income Resourced by Treaty as Foreign Source Section 951A Category Income (Code RBT 951A)
- General Category Income (Code GEN)

Section 951A category income.

Section 951A category income is any amount of GILTI includible in gross income under Section 951A (other than passive category income). A separate Schedule J, however, should not be completed for any Section 951A category income. Reclassified Section 951A PTEP and Section 951A PTEP in the Section 951A category should instead be reported on the Schedule J for general category income.

Foreign branch category income.

Foreign branch income is defined under Section 904(d)(2)(J)(i) as the business profits of a U.S. person which are attributable to one or more qualified business units ("QBUs") in one or more foreign countries. The instructions to Form 1118 exclude this category of foreign source income from Schedule J.

Passive category income.

Passive income is generally the following:

1. Any income received or accrued that would be foreign personal holding company income ("FPHCI," as defined in Section 954(c)) if the corporation were a CFC. This income includes any gain on the sale or exchange of stock that is more than the amount treated as a dividend under Section 1248.
2. Any amount includible in gross income under Section 1293, which relates to certain passive foreign investment companies ("PFICs").

Passive income generally excludes certain types of income, such as export financing interest,[7] high-taxed income,[8] and active rents or royalties.[9]

Section 901(j) income.

Section 901(j) income is income that is earned from a country sanctioned by the United States. If Code "901j" is entered on Line a of the schedule, the two-letter country code for the sanctioned country (obtained from IRS.gov/countrycodes) must be entered on Line b.

Income re-sourced by treaty.

Certain U.S. income tax treaties provide a "resourcing" rule, under which a U.S. taxpayer may treat as foreign source any income that the other contracting state may tax under the treaty.

If a sourcing rule in a treaty treats any U.S. source income as foreign source, and the CFC elects to apply the treaty, the income will be treated as foreign source for U.S. tax purposes. Any U.S. source income that is so reclassified falls under this category and is to be broken out and coded as follows:

- "RBT PAS" for passive category income
- "RBT GEN" for general category income
- "RBT FB" for foreign branch category income
- "RBT 951A" for Section 951A (i.e., GILTI) category income

General category income.

The general category income includes all income not described in one of the above categories.

AGGREGATED SCHEDULE J

If multiple Schedules J are completed for a CFC, the filer must complete an additional Schedule J using the code "TOTAL" that aggregates all amounts listed in each line and Part I column of all the other Schedules J for that CFC.

SCHEDULE J - PART I - ACCUMULATED E&P OF CONTROLLED FOREIGN CORPORATION (CFC)

In Part I of the schedule, the filer is required to provide detailed information on the category of foreign source income entered on Line a. This information is to be broken out among six columns spanning across two pages, with the fifth column for Previously Taxed E&P ("PTEP"), designated as column (e), subdivided into ten columns numbered (e)(i) through (e)(x).

At the beginning of Part I, the filer is to check the box if the filer does not have "all U.S. shareholders' information necessary to complete any one of the PTEP amounts required to be included in column (e)." Anyone preparing Schedule J must understand that checking this box will likely invite an IRS audit. Thus, the filer should do everything possible to obtain all the CFC's books and records that are necessary to accurately prepare Schedule J.

Importance of categorizing a CFC's accumulated E&P.

Anyone who wishes to complete Schedule J must understand the basketing and ordering rules of Code Section 959. Virtually all CFCs annually generate subpart F income or, more likely, GILTI which becomes recharacterized as previously taxed earnings and profits (or PTEP). However, not all PTEP are treated equally. PTEP must be allocated into four separate categories or "baskets" set forth in Code Section 904(d). This allocation is made based on how the PTEP was generated. PTEP are also subject to a set of ordering rules that clarifies how distributions of PTEP are treated to the recipient.

The basketing and ordering rules matter in calculating the foreign tax credits that would reduce, on a dollar-for-dollar basis, the amount of U.S. income tax owed. The amount of foreign tax credits that can be taken, however, is subject to the limitations imposed in Section 904(a) for each basket of income. Income categorized in one basket cannot offset an income deficiency in another basket. There are baskets for passive category income, GILTI, foreign branch income, and a catchall general category basket for active business income. For example, any foreign taxes paid or accrued on GILTI are allocated to the GILTI basket. If a U.S. shareholder has excess foreign tax credits in the GILTI basket, but not in the general category basket, any excess foreign taxes allocated to the GILTI basket generally cannot be reallocated to the general category basket, or vice versa.

Where the E&P of a CFC consists in whole or in part of PTEP, special rules under Section 959 apply in determining the ordering and taxation of distributions of such PTEP. Amounts included in the gross income of a U.S. shareholder, such as subpart F income or GILTI, are not included in gross income again when such amounts are distributed to the shareholder, either directly, indirectly, or

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through a chain of ownership. A PTEP distribution is generally allocated in the following order of priority:

1. PTEP attributable to investments in U.S. property under Section 959(c)(1).
2. PTEP attributable to subpart F income under Section 959(c)(2).
3. General current and accumulated E&P under Section 959(c)(3).

For Section 959 purposes, a distribution is generally attributable to E&P according to the last in first out method ("LIFO").

By way of background, the U.S. Treasury Department and the IRS proposed several iterations of the rules for determining foreign tax credits for U.S. shareholders. Initially, it was proposed in November 2018 that CFCs be required to establish annual PTEP accounts for each of the four Section 904(d) baskets. Within each account, PTEP must be assigned to one of 10 different PTEP groups based on the U.S. shareholder's underlying income inclusion and Section 956 reclassifications. Under these rules, a CFC accounts for a Section 959(b) distribution by adding the amount distributed to the applicable annual PTEP account and PTEP group from which the CFC made the distribution. A CFC that makes a Section 959 distribution must similarly reduce the annual PTEP group from which the distribution is made by the distribution amount. A CFC must also reduce PTEP groups that relate to Section 959(c)(2) PTEP to account for reclassifications of amounts into those groups as Section 959(c)(1) PTEP (reclassified PTEP) and increase the PTEP group that corresponds to the reclassified amount.

In 2019, the U.S. Treasury Department and the IRS proposed to increase the number of PTEP groups from 10 to 16.[10] However, the final and proposed regulations issued later in December 2019 reduced the number of PTEP groups back to 10, consolidating the initially proposed groups with the ones contemplated by Notice 2019-01. These 10 PTEP groups are set forth in columns (e)(i) through (e)(x) of Part I of Schedule J, each of which will be discussed below under the heading "Column (e)."

Although Section 956 has virtually no significance following the availability of the 100% dividends received deduction of Section 245A, the final regulations state that the distribution-ordering rule of Section 959(c) requires U.S. shareholders to reclassify Section 959(c)(2) PTEP as Section 959(c)(1) PTEP whenever the CFC has a Section 956 investment in U.S. property that was included in the U.S. shareholder's gross income under Section 951(a)(1)(A), or would have been included except for Section 959(a)(2). In that case, the Section 959(c)(2) PTEP group is reduced by the functional currency amount of the reclassified PTEP, which is added to the corresponding Section 959(c)(1) PTEP group for the applicable Section 904(d) income bucket and the same annual PTEP account as the reduced Section 959(c)(2) PTEP group.[11]

> In order to complete Part II of Schedule J, the filer must understand how subpart F income is calculated.

Schedule J increased the Section 959(c)(2) PTEP categories to be disclosed on the schedule from one to five. It also expanded Section 959(c)(1) PTEP categories from one to five. In addition, Schedule J requires untaxed E&P to be allocated into E&P subject to the Section 909 anti-splitter rules, E&P carried over from certain nonrecognition transitions, and hovering deficits under Section 959(c)(3). In addition, Reg. 1.960-3 requires that CFC shareholders report PTEP attributable to Section 965 inclusions, Section 965(b) deficit offsets, Section 956 investments in U.S. property, GILTI inclusions, subpart F inclusions, Section 245A hybrid dividends, and Section 1248 amounts. Within these categories, CFC shareholders must state whether or not the PTEP should be allocated to a Section 959(c)(2) or Section 959(c)(1) PTEP. Furthermore, CFC shareholders must separately track each PTEP according to its foreign tax credit bucket, and must track movements of PTEPs between Section 959(c)(2) and Section 959(c)(1) categories.

SCHEDULE J - PART I - COLUMNS (A) THROUGH (E)

Amounts entered into Schedule J's Part I columns must be expressed in the CFC's functional currency. The functional currency is generally the "dollar."[12] However, the functional currency of a QBU, which could be a CFC, should be the currency of the "economic environment" in which a significant part of the QBU's activities is conducted and which is used by the QBU in keeping its books and records.[13]

Column (a).

Column (a) shows Section 959(c)(3) earnings and profits (E&P that have yet to be taxed) for post-2017 tax years. Column (a) asks for the CFC's opening balance, current year additions and subtractions, and the closing balance in the CFC's E&P described in Section 959(c)(3). In general, this is the E&P of the CFC that has not been included in gross income of a U.S. person under Section 951(a)(1). Thus, any post-2017 E&P that has not been taxed, which is classified as a Section 959(c)(3) balance, should be reported under column (a).

Column (b).

Column (b) shows Section 959(c)(3) earnings and profits (E&P that have yet to be taxed) for post-1986 tax years through pre-2018 tax years. Column (b) requires the shareholder to report undistributed post-1986 and pre-2018 Section 959(c)(3) balances. This is the opening balance, current year additions and subtractions, and the closing balance in the CFC's post-1986 undistributed earnings pool. In order to report Section 959(c)(3) balances in column (b), it is necessary for the preparer to determine the "post-1986 undistributed earnings pool" of a foreign corporation. This amount is the total earnings for years starting in 1987 through the end of 2017 in which a dividend was distributed, undiminished by any dividend distribution made during the year.[14] The corporation's pool of post-1986 foreign income taxes was reduced to reflect the portion of taxes deemed with respect to such dividends for purposes of computing foreign tax credits in subsequent years.

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Exhibit 1: Calculation of a "Post-1986 Undistributed Earnings Pool"

Gamma S.A., a corporation under the laws of Country M, is a wholly owned subsidiary of American Gamma Corporation, a U.S. corporation. Gamma S.A.'s post-1986 undistributed earnings (after payment of foreign taxes) and foreign taxes paid for years 1 through 3 were as follows:

	Post-1986 Undistributed Earnings Pool	Foreign Taxes
Year 1	$100,000	$30,000
Year 2	200,000	60,000
Year 3	300,000	90,000
Pools as of Dec. 31 of Year 3	$600,000	$180,000

Gamma S.A. paid a dividend of $600,000 to American Gamma on January 1 of year 3.

Undistributed Earnings Pool		Foreign Taxes Paid		Total
$600,000	–	$180,000	=	$420,000

Gamma S.A.'s post-1986 "undistributed earnings pool" as of year 4 would be $420,000.

Exhibit 1 provides a simple example calculating a "post-1986 undistributed earnings pool."

Column (c).

Column (c) shows Section 959(c)(3) earnings and profits (E&P that have yet to be taxed) for pre-1987 tax years. In column (c), the shareholder should report pre-1987 E&P not previously taxed Section 959(c)(3) balances. In order to correctly report Section 959(c)(3) pre-1987 E&P accumulated earnings, it is necessary to understand how earnings and profits of a CFC were determined prior to 1987. Before 1987, the earnings and profits of a foreign corporation were calculated year by year. If a dividend exceeded the earnings of a specified year, the excess of the dividend was deemed to be paid out of the after-tax accumulated earnings of the preceding year. If the remaining portion of the dividend exceeded the after-tax accumulated earnings of the preceding year, the dividend was treated as paid from the accumulated earnings of the next preceding year and so on until the dividend had been completely covered by accumulated earnings to the extent available.

Column (d).

Column (d) is used to report hovering deficits and deductions for suspended taxes. Column (d) applies to the carryover of the E&P and foreign income taxes in certain foreign-to-foreign nonrecognition transactions. Historically, a hovering deficit arose when two foreign corporations engaged in a transaction in which E&P and taxes carried over under Section 381 and either corporation had a deficit in post-1986 undistributed earnings in one or more foreign tax credit baskets.

If immediately prior to the foreign Section 381 transaction either the foreign acquiring corporation or the foreign target corporation has a deficit in one or more separate categories of post-1986 undistributed earnings or an aggregate deficit in pre-1987 accumulated profits, such deficit will be a hovering deficit in pre-1987 accumulated profits, and will be a hovering deficit of the foreign surviving corporation. A hovering deficit in a separate category of post-1986 undistributed earnings shall offset only E&P accumulated by the surviving corporation after the foreign Section 381 transaction (post-transaction earnings) in the same separate category of post-1986 undistributed earnings.

Post-1986 foreign taxes that are related to a hovering deficit in a separate category of post-1986 undistributed earnings shall only be added to the foreign surviving corporation's post-1986 foreign income taxes in that separate category on a pro rata basis as the hovering deficit is absorbed.

Exhibit 2 provides an example of the hovering deficit rules.

Column (e).

Column (e) is used to report the running balance of the foreign corporation's PTEP, Section 964(a) E&P accumulated since 1962 that have resulted in deemed inclusions under subpart F, or amounts treated as PTEP under Section 965(b)(4). Section 964(a) generally provides that the E&P of any foreign corporation, as well as the deficit in E&P of any foreign corporation, for any taxable year is determined according to rules substantially similar to those applicable to domestic corporations.

Column (e)(i).

A CFC shareholder will use Column (e)(i) to report previously taxed income reclassified as Section 965(a) PTEP under Section 959(c)(1)(A) as investments in U.S. property. The most frequent investment in U.S. property is a loan from the CFC to the U.S. shareholder or a person related to the U.S. shareholder. Section 965(a) requires U.S. shareholders to include in income an amount based on the accumulated post-1965 foreign earnings of specified foreign corporations (SFCs) as if those earnings had been

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Exhibit 2: Example of the Hovering Deficit Rules

Foreign corporations A and B are CFCs that were incorporated after 12/31/1986, have always been pooling corporations, and have always had calendar taxable years. None of the shareholders of foreign corporations A and B are required to include any income under Reg. 1.367(b)-4 as a result of the foreign Section 381 transaction. @P:Foreign corporations A and B (and all of their respective qualified business units, as defined in Section 989) maintain a "u" functional currency. Unless otherwise stated, any post-1986 undistributed earnings in the passive income category resulted from a look-through dividend that was paid by a lower-tier CFC out of earnings accumulated when the CFC was a noncontrolled Section 902 corporation and that qualified for the subpart F same-country exception under Section 954(c)(3)(A).

On 12/31/2006, foreign corporations A and B had the following post-1986 undistributed E&P and post-1986 foreign income taxes:

Foreign Corporation A

Separate Category	E&P	Foreign Taxes
General	300u	$60
Passive	100u	40
	400u	$100

Foreign Corporation B

Separate Category	E&P	Foreign Taxes
General	300u	$70

On 1/1/2007, foreign corporation B acquired the assets of foreign corporation A in a reorganization described in Section 368(a)(1)(C). Immediately following the foreign Section 381 transaction, the foreign surviving corporation is a CFC. Under Reg. 1.367(b)-7, the foreign surviving corporation has the following post-1986 undistributed E&P and post-1986 foreign income taxes.

Separate Category	E&P	Foreign Taxes
General	600u	$130
Passive	100u	$40
	700u	$170

During 2007, the foreign surviving corporation does not accumulate any E&P or pay or accrue any foreign taxes. On 12/31/2007, the foreign surviving corporation distributed 350u to its shareholders. Under Reg. 1.902-1(d)(1) and Reg. 1.367(b)-7, the distribution is made out of, and reduces, post-1986 undistributed E&P foreign income taxes in separate categories on a pro rata basis, as follows:

Separate Category	E&P	Foreign Taxes
General	300u	$65
Passive	50u	$20
	350u	$85

The foreign income taxes deemed paid by qualifying shareholders of the foreign surviving corporation upon the distribution are subject to generally applicable rules and limitations, such as those of Sections 78, 902, and 904(d). Immediately after the distribution, the foreign surviving corporation has the following post-1986 undistributed earnings and post-1986 foreign income taxes:

Separate Category	E&P	Foreign Taxes
General	300u	$65
Passive	50u	$20
	350u	$85

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repatriated to the United States. Any foreign earnings that are taxed under Section 965(a) become Section 965(a) PTEP for purposes of Schedule J. For Column (e)(i), the filer must state previously taxed Section 965(a) E&P reclassified under Section 959(c)(1)(A).

Column (e)(ii).

A CFC shareholder will use Column (e)(ii) to report previously taxed income reclassified as Section 965(b) PTEP under Section 959(c)(1)(A) (reclassified as investments in U.S. property). Section 965(b) permits U.S. shareholders to reduce Section 965(a) inclusions based on deficits in E&P accumulated by other SFCs. Under Section 965(b)(4)(A), the deferred foreign earnings that would have been included in the U.S. shareholder's income under Section 965(a), but were not included because of the sharing of an E&P deficit pursuant to Section 965(b), increases PTEP for the SFC that had positive earnings. Section 965(b)(4)(B) increases the E&P of a deficit foreign corporation by the amount of the E&P deficit taken into account under Section 965(b).

Column (e)(iii).

A CFC shareholder will use Column (e)(iii) to report general Section 959(c)(1) PTEP. Recall that Section 959(c)(1) PTEP are PTEP attributable to investments in U.S. property or reclassified investments in U.S. property. Investments in U.S. property include most tangible and intangible property owned by a CFC that has a U.S. situs, such as stock of a domestic corporation, an obligation of a U.S. person, and a right to use a patent, copyright, or other forms of intellectual property in the United States if acquired or developed by the CFC for that use. A CFC is also treated as owning a proportionate interest in U.S. property owned by a partnership in which the CFC is a partner. Column (e)(iii) will also be used by the U.S. shareholder to report PTEP attributable to Subpart F income inclusions reclassified as investments in U.S. property.

Column (e)(iv).

A CFC shareholder will use Column (e)(iv) to report PTEP originally attributable to inclusions under Section 951A GILTI, or GILTI reclassified as investments in U.S. property under Section 959(c)(1)(A).

Column (e)(v).

A CFC shareholder will use Column (e)(v) to report PTEP attributable in three subgroups discussed below (which are aggregated into a single PTEP group) reclassified as Section 959(c)(1)(A) PTEP.

1. *PTEP that is attributable to hybrid dividends under Section 245(e)(2) and reclassified as investments in U.S. property.* Code Section 245A(d) generally prohibits taxpayers from claiming credits or deductions for foreign income taxes paid or accrued (or treated as paid or accrued) on dividends for which a Section 245A deduction is allowed. Under Section 245A, an exception is allowed for certain foreign income of a domestic corporation that is a U.S. shareholder by means of a 100% DRD for the foreign source portion of dividends received from "specified 10% owned foreign corporations" by certain domestic corporations that are U.S. shareholders of those foreign corporations within the meaning of Section 951(b). Section 245A generally denies the DRD for hybrid dividends (i.e., amounts received from a CFC if the dividend gives rise to a local country deduction or other tax benefit).
2. *PTEP that is attributable to Section 1248 amounts under Section 959(e).* Under Section 1248(a), gain is recognized on a U.S. shareholder's disposition of CFC stock in cases where there is a deferral of E&P. For purposes of Section 959(e), 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.
3. *3.PTEP that is attributable to Section 1248 amounts from gain on the sale of a CFC by a CFC.* With respect to individual U.S. shareholders who sell stock in a CFC recharacterized under Section 1248(a), the gains are realized at ordinary rates. Section 1248(b) provides for a ceiling on the tax liability that may be imposed on the shareholder receiving a Section 1248(a) dividend if the taxpayer is an individual and the stock disposed of has been held for more than one year. The Section 1248(b) ceiling consists of the sum of two amounts. The first amount is the U.S. income tax that the CFC would have paid if the CFC had been taxed as a domestic corporation, after permitting a credit for all foreign and U.S. tax actually paid by the CFC on the same income (the "hypothetical corporate tax"). The second amount is the addition to the taxpayer's U.S. federal income tax for the year that results from including the amount in gross income as long-term capital gain equal to the excess of the Section 1248(a) amount over the hypothetical corporate tax (the "hypothetical shareholder tax").

Column (e)(vi).

A CFC shareholder will use Column (e)(vi) to report PTEP attributable to Section 965(a) classified under Section 959(c)(2) (attributable to Section 951 or 951A). Under the Section 965 transition tax, U.S. shareholders of CFCs in existence at the end of 2017 were typically required to include in their income all of the CFC's E&P. These earnings were generally taxed at a reduced rate through a sliding scale deduction allowable under Section 965(c).

Column (e)(vii).

A CFC shareholder will use Column (e)(vii) to report PTEP attributable to Section 965(b)(4)(A) classified under Section 959(c)(2) (attributable to Section 951 or 951A). Column (e)(vii) will apply if the U.S. shareholder owned multiple CFCs prior to the 2018 tax year and some of the CFCs had positive E&P and others had negative E&P.

Column (e)(viii).

A CFC shareholder will use Column (e)(viii) to report PTEP attributable to Section 951A classified under Section 959(c)(2). Column (e)(viii) will represent PTEP related to GILTI inclusions.

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Column (e)(ix).

A CFC shareholder will use Column (e)(ix) to report PTEP attributable to Section 245A(d) classified under Section 959(c)(2). This type of PTEP is created when a CFC is owned by a domestic corporation and the CFC receives a hybrid dividend from another CFC. In general, a dividend received by a domestic corporation from a CFC is a hybrid dividend if the dividend received by the domestic corporation from the CFC (or a related person) is or was allowed a deduction ("hybrid deduction") or other tax benefit under a relevant foreign law.

Column (e)(x).

A CFC shareholder will use Column (e)(x) to report PTEP attributable to Section 951(a)(1)(A) or subpart F income. Column (e)(x) will represent PTEP related to Subpart F inclusions.

These last three PTEP columns are the most frequently used PTEP columns on the Schedule J.

Column (f).

Column (f) is used to report the opening and closing balances of the foreign corporation's accumulated E&P. This amount is the sum of post-2017 E&P not previously taxed, post-1986 undistributed earnings, pre-1987 E&P not previously taxed, and PTEP.

SCHEDULE J - PART I - LINES 1 THROUGH 14 FOR EACH COLUMN

Line 1a.

Line 1a asks the filer to enter the balances for each column at the beginning of the tax year. These balances should equal the amounts reported as the ending balances in the prior year Schedule J.

Line 1b.

Line 1b states if there is a difference between last year's ending balance on Schedule J and the amount which should be last year's ending balance, enter the difference on Line 1b and attach an explanation for the difference. If there are multiple differences, the preparer should include the explanation and amount of each such difference on the attachment.

Line 1c.

If there is an adjustment entered on Line 1b, the filer is to enter the Line a balance, as adjusted by the Line 1b amount, on Line 1c.

Line 2a.

Line 2a asks the filer to disclose unsuspended taxes under Section 909. Under Section 909, where there is a "foreign tax credit splitting event" with respect to foreign income tax paid or accrued by a taxpayer, the foreign income tax is not taken into account for U.S. tax purposes. The definition of "foreign tax credit splitting event" is broad and could reach a variety of situations, such as disregarded payments, transfer pricing adjustments, contributions of property resulting in a shift of deductions, and timing differences under U.S. and foreign law. Specifically, a foreign tax credit splitting event arises with respect to a foreign income tax if the related income is taken into account for U.S. tax purposes by a covered person. A "covered person" is defined as any entity in which the payor holds, directly or indirectly, at least a 10% ownership interest (by vote or value); any person that holds, directly or indirectly, at least a 10% ownership interest (by vote or value) in the payor.

> In November 2024, Treasury and the IRS issued new proposed regulations governing PTEP. The new regulations provide guidance on multiple provisions, including Sections 959 and 961, two Code sections designed to prevent the double taxation of PTEP.

In the case of Column (d), this Line 2(a) is the unsuspended taxes under Section 909 resulting from related income taken into account by the foreign corporation, certain U.S. corporate owners of the foreign corporation, or a member of such U.S. corporate owner's consolidated group. The filer should report the unsuspended taxes on Line 2a of Column (d) as a positive number, and on Line 2a of Columns (a), (b), (c), or (e) as negative numbers.

Line 2b.

Line 2b asks the filer to disclose foreign taxes that are suspended in the current tax year. These amounts should be reported as negative numbers. This includes taxes suspended under Section 909 or under "hybrid instrument splitter arrangements." One example of a hybrid instrument splitter arrangement involves a U.S. equity instrument that is treated as debt for foreign purposes. This split in tax treatments permits an interest expense deduction for foreign purposes but not a corresponding taxable interest payment in the U.S. Another splitter arrangement, called a "reverse hybrid splitter arrangement," involves an entity that is a U.S. corporation that is treated as a fiscally transparent entity or a branch under the laws of the foreign country imposing the tax.

Line 2b of Column (d) accounts for foreign income taxes that are suspended in the current tax year. These amounts should be reported as negative numbers.

Line 3.

Line 3 asks the filer to disclose the current year E&P (or deficit in E&P) amount from the applicable line 5c of Schedule H. For example, if the preparer is completing Schedule J, enter the current year E&P (or deficit in E&P) amount from Schedule H, line 5c(ii), in the applicable Schedule J column. Line 3 should never have an amount entered in Column (e).

Line 4.

For Line 4, the filer should report as a positive number E&P attributable to distributions from lower-tier foreign corporations. The E&P of a CFC attributable to amounts which are, or have been, included in the gross income of a U.S. shareholder under Section 951(a), are not, when distributed through a chain of ownership described in Section 958(a), also included in the gross income of another CFC. (Under Section 958(a), stock owned directly or indirectly by or for a foreign corporation, foreign partnership, foreign trust, or foreign estate

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is considered as being owned proportionately by its shareholders, partners, or beneficiaries, as the case may be. Stock considered as owned is treated as actually owned for purposes of applying the direct and indirect ownership rules.)

Line 5a.

Line 5a asks the filer to enter earnings carried over to a surviving corporation after an acquisition by a foreign corporation of the assets of another foreign corporation in a Section 381 transaction. The tax attributes of a target corporation (e.g., its earnings and profits and net operating losses) generally carry over to the acquiring corporation under Section 381. The amounts carried over to the reporting CFC may be negative or positive numbers. Negative amounts are hovering deficits reported on Line 5a of Column (d).

Line 5b.

Line 5b asks the filer to list any E&P deficit of a foreign surviving corporation. If the foreign surviving corporation had a deficit prior to the Section 381 transaction, the deficit should be recharacterized as a hovering deficit. An amount equal to the E&P deficit reported in Column (a), (b), or (c) of Line 5a is included as a positive amount on Line 5b of Column (a), (b), or (c), respectively. An amount equal to the total hovering deficits reported on Line 5b of Columns (a), (b), and (c) is included as a negative number in Column (d) of Line 5b.

Line 6.

Line 6 asks the filer to attach a statement detailing the nature and amount of any adjustments not accounted for in the E&P determined before reduction for distributions. See Exhibit 3 for an example (taken from the IRS instructions for the December 2024 Schedule J) of an adjustment on Line 6 regarding a distribution of PTEP from a lower-tier foreign corporation.

Line 7.

Line 7 asks the filer to enter on Line 7 the CFC's E&P as of the close of the tax year before actual distributions or inclusions under Section 951(a)(1) or Section 951A during the year. For dividends paid by certain foreign corporations in U.S. tax years beginning before 1/1/2018, this number in Column (b) generally is the denominator of the deemed paid credit fraction under former Section 902(c)(1) used for foreign tax credit purposes.

Line 8.

Line 8 asks the filer to enter amounts included in gross income of the U.S. shareholder(s) under Section 951(a)(1)(A) or Section 951A with respect to the CFC.

Line 9.

Line 9 asks the filer to report actual distributions as negative numbers.

Line 10.

Line 10 asks the filer to report on Line 10 reclassifications of Section 959(c)(2) PTEP in Columns (e)(i) through (e)(x) to Section 959(c)(1) PTEP in Columns (e)(i) through 9(e)(x). A potential Section 951(a)(1)(B) inclusion results in a reclassification of Section 959(c)(2) PTEP, if any, to Section 959(c)(1) PTEP before reclassification out of the Section 959(c)(3) E&P balance. The amounts reclassified are reported as negative numbers in Columns (e)(vi) through (e)(x) and positive numbers in Columns (e)(i) through (e)(v).

Line 11.

Line 11 asks the filer to report on Line 11 E&P not previously taxed, which is treated as earnings invested in U.S. property and, therefore, reclassified as Section 959(c)(1) PTI (Column (e)(i)). The amounts reclassified are reported as negative numbers in Columns (a) through (d) and positive numbers in Column (e)(iii).

Line 12.

Line 12 asks the filer to attach a statement detailing the nature and amount of any adjustments in E&P not accounted for on Lines 8 through 11.

Line 13.

Line 13 asks the filer to list any hovering deficit offset included in Column (d) as reported as a positive number. The same amount entered in Column (d) is reported as a negative number on Line 13 of Column (a) or (b), as appropriate.

Line 14.

For Line 14, the filer must state the balance at the beginning of the next year.

SCHEDULE J - PART II - NONPREVIOUSLY TAXED E&P SUBJECT TO RECAPTURE AS SUBPART F INCOME (SECTION 952(C)(2))

Part II of Schedule J asks the filer to disclose nonpreviously taxed E&P subject to recapture as subpart F income in functional currency. In order to complete Part II of Schedule J, the filer must understand how subpart F income is calculated. The Internal Revenue Code allocates a pro rata share of subpart F income as a constructive dividend. Section 952(c)(1)(A) limits a CFC's subpart F income to its current E&P. In other words, a foreign corporation's subpart F income for a tax year is reduced to the amount of its current E&P, thus reducing the amount of the current inclusions to its U.S. shareholders under Section 951(a)(1)(A). Under this rule, a CFC's current losses from an activity that would not generate subpart F income may, in certain limited circumstances, reduce its subpart F income.

Exhibit 3: Adjustment on Line 6 Regarding Distribution of PTEP from Lower-Tier Foreign Corporation

Domestic Corp, a U.S. shareholder, wholly owns the only class of stock of CFC1, a foreign corporation. CFC1, in turn, wholly owns the only class of stock of CFC2, a foreign corporation. CFC2, in turn, wholly owns the only class of stock of CFC3, a foreign corporation. The functional currency of Domestic Corp, CFC1, CFC2, and CFC3 is the U.S. dollar. During Year 1, Domestic Corp reports an inclusion under Section 951(a)(1) of $100 as a result of subpart F income of CFC3. During Year 2, CFC3 distributes $40 to CFC2. CFC2 pays withholding tax of $4 on the distribution from CFC3. Such tax is related to previously taxed subpart F income. Domestic Corp reports on CFC2's Form 5471, Schedule J, Line 4, Column (e)(x), as a positive number, the $40 PTEP distribution. Domestic Corp reports on Line 6, Column (e)(x), as a negative number, the $4 of tax on the PTEP distribution.

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If a CFC has an excess of current earnings and profits over subpart F income, Section 952(c)(2) may recharacterize that excess as subpart F income to the extent of the prior reductions in subpart F income. Consequently, the U.S. shareholders of that CFC may have additional current inclusions of income under Section 951(a) in a later year as a result of this recharacterization rule. See Exhibit 4.

Accumulated deficits in a CFC's E&P from prior years generally do not reduce its subpart F income for the current tax year, except to the limited extent provided in Section 952(c)(1)(B). Moreover, a deficit of one CFC generally may not be used to reduce the subpart F income of a related CFC. Congress enacted these rules to prevent taxpayers sheltering passive investment income from U.S. tax by moving the passive investments into a CFC with prior deficits. Congress also wanted to restrict loss trafficking by preventing deficits in E&P incurred by a foreign corporation before its acquisition by a U.S. corporation from sheltering post-acquisition subpart F income of the foreign corporation from tax and by preventing a CFC from reducing its subpart F income with deficits of related CFCs attributable to different activities.[15]

2024 PROPOSED REGULATIONS FOR PTEP

On 11/29/2024, the U.S. Treasury Department and the IRS issued new proposed regulations governing PTEP. The new regulations provide guidance on multiple provisions, including Sections 959 and 961, two Code sections designed to prevent the double taxation of PTEP.

Under the proposed regulations, Section 959 would provide for PTEP accounting at both the shareholder and foreign corporation levels, including the maintenance of annual PTEP accounts, dollar basis, and PTEP tax pools. The proposed regulations provide for 10 PTEP groups and two subgroups, along with dollar basis pools and PTEP tax pools for so-called covered shareholders. A covered shareholder means any U.S. person, other than a domestic partnership or an S corporation.

The 10 PTEP groups would be divided into Section 959(c)(2) PTEP groups and Section 959(c)(1) PTEP groups. The Section 959(c)(2) PTEP groups would track PTEP resulting from subpart F income inclusions, GILTI inclusions, application of Section 965(a) or Section 965(b), or income inclusions to which Section 245A(d) applies. The Section 959(c)(1) PTEP groups would correspond to the Section 959(c)(2) PTEP groups and account for the reclassification of PTEP pursuant to Section 959(a)(2). PTEP arising from Section 956 inclusions would be combined with reclassified PTEP arising from subpart F income inclusions. These two PTEP groups would track PTEP resulting from income inclusions of certain covered shareholders, such as individuals making a Section 962 election. The proposed regulations would also require a covered shareholder to maintain a PTEP account to take into consideration the application of Section 965(a) or 965(b) and the percentage of a disallowed foreign tax credit or non-recognizable foreign currency gain.

Under the proposed regulations, CFC shareholders would be required to maintain dollar basis pools and PTEP pools. Dollar basis pools are used to determine foreign currency gain or loss. The dollar basis pools and PTEP tax pools are maintained on a year-by-year basis with a pool for each PTEP group, which is done to prevent commingling. The proposed regulations also provide guidance on adjustments made to annual PTEP accounts to reflect inclusions and transactions and the preservation of the character of PTEP. Adjustments are made successively from the lowest-tiered foreign corporation to the highest-tiered corporation. Depending on the type of PTEP, adjustments are made on the first day of the foreign corporation's tax year, concurrently with the transaction, or on the last day of the tax year. Regarding exclusions from gross income of distributing PTEP, the proposed regulations have a special rule under which a SFC that is not a CFC is treated as a CFC when applying the exclusion to Section 965 PTEP. Under these rules, PTEP is sourced from Section 959(c)(1) groups before Section 959(c)(2) groups and sourced on a LIFO basis, subject to a priority rule for Section 965.

Prop. Reg. 1.959-7 provides rules on successor transactions. Generally, PTEP is transferred to covered shareholders

Exhibit 4: Recharacterization Rule of Section 952(c)(2)
DC, a U.S. corporation, owns all of the stock of FC, a foreign corporation that is a controlled foreign corporation. During the current year, FC has foreign base company sales income of $100 (determined under Section 954), but its current earnings and profits (as calculated under Section 964) is $80. Thus, Section 952(c)(1)(A) limits FC's subpart F income to $80 for year 1 and DC would include the $80 in gross income under Section 951(a)(1)(A).
In year 2, FC has foreign base company sales income of $75 (determined under Section 954) and its current earnings and profits are $85. Under the recharacterization rule in Section 952(c)(2), the $10 excess of current earnings and profits of $85 over the subpart F income of $75 is recharacterized as additional subpart F income. Thus, FC is treated as having subpart F income of $85 and DC must include the $85 in gross income under Section 951(a)(1)(A).
In year 3, FC has foreign base company sales income of $50 (determined under Section 954) and its current earnings and profits are $80. Under the recharacterization rule in Section 952(c)(2), only $10 of the $30 excess of current earnings and profits of $80 over the subpart F income of $50 is recharacterized as subpart income. This is because the total amount recaptured under Section 952(c)(2) ($10 in year 2 and $10 in year 3) cannot exceed the reduction of subpart F income in year 1 by reason of the limit in Section 952(c)(1)(A) (i.e., $20).

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that acquire stock ownership in a foreign corporation. These successor rules generally ensure that PTEP is not subject to U.S. tax again in the hands of the acquiring covered shareholder when received in a distribution, even though that shareholder did not own the stock of the foreign corporation when the PTEP was generated and therefore did not have the inclusion that gave rise to the PTEP. In addition, the proposed regulations provide rules that ensure that E&P retains its PTEP status and, thus, remains subject to Section 959 and Section 961.

The proposed regulations provide guidance for basis adjustments. The proposed regulations would exclude PTEP resulting from covered gain to which Section 961(c) basis applies from a CFC's gross subpart F income and GILTI tested income. There are three types of property to which the proposed regulations apply: (1) Section 961(a) ownership units and adjusted basis for a covered shareholder; (2) derivative ownership units and derived basis for a partnership; and (3) Section 961(c) ownership units and Section 961(c) basis for a CFC. Under the proposed regulations, Section 961(c) basis is only for stock of a CFC directly owned by another CFC. The proposed regulations discuss basis adjustments under Section 961(a) in cases where stock of a CFC is owned through a foreign corporation that is not a CFC or where a CFC owns stock of a foreign corporation that used to be a CFC. Under these rules, the basis of a property unit is increased by an amount that would be distributed in a hypothetical distribution by the CFC equal to the dollar amount of the covered shareholder's income inclusions. This distribution is treated as being made through all tiers on the last relevant day of the CFC's tax year. In addition, the proposed regulations provide for an actual distribution rule, which applies if the CFC distributes PTEP before the last day of a tax year to match the basis of the distributions. The actual distribution rule of the proposed regulations applies chronologically to distributions of a CFC's PTEP. According to this rule, a basis increase in CFC stock cannot exceed a covered shareholder's income inclusions.

CONCLUSION

The IRS Form 5471 is an incredibly complicated return. Each year an international tax attorney should review direct, indirect, and constructive ownership of the reporting CFC to determine the impact of any changes in percentages, filer categories, and CFC status. Workpapers should also be prepared and maintained for each U.S. GAAP adjustment and foreign exchange. In addition, an accounting should be made for adjustments to prior and current year previously taxed E&P that become PTEPs on Schedule J, E-1, and P.

End Notes

1. See Reg. 301.7701(b)-7(a)(3).
2. See IRC Section 957(a).
3. See IRC Section 7701(a)(5).
4. See IRC Section 965(e)(1).
5. See Reg. 1.6038-2(d).
6. See IRC Section 6038(e)(2).
7. See IRC Section 904(d)(2)(G) and Reg. 1.904-4(h)(3).
8. See Reg. 1.904-4(c).
9. See Reg. 1.904-4(b)(2)(iii).
10. See IRS Notice 2019-01.
11. See "Curtail U.S. PTEP Reporting Complexity: Know Your P's and Q's" by Lewis J. Greenwald, Brainard L. Patton, and Brendan Sinnott, Tax Notes Federal, 8/2/2021, p. 731.
12. See IRC Section 985(b)(1)(A).
13. See IRC Section 985(b)(1)(B).
14. See Former IRC Section 902(c)(1).
15. See Staff of Joint Comm. on Tax'n, 100th Cong., 1st Sess, General Explanation of the Tax Reform Act of 1986, at 972 (1987).

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