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IRS Proposes Regulations Implementing CFC Pro Rata Share Rule

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The Treasury Department and IRS have released proposed regulations addressing the determination of a U.S. shareholder's pro rata share of subpart F income, tested income or tested loss of a controlled foreign corporation ("CFC") under Sections 951 and 951A (the "Proposed Regulations"). The Proposed Regulations implement the new ownership-period rules for CFC inclusions enacted as part of the One, Big Beautiful Bill Act of 2025 ("OBBBA"), the rules of which replaced the former "last day" rule, requiring inclusions only where certain U.S. shareholders owned stock of a CFC on the last day of the taxable year on which a foreign corporation was a CFC.

The Treasury Department and the IRS have requested comments by October 26, 2026 and expect to finalize the Proposed Regulations by January 4, 2027. The regulations are proposed to apply to taxable years of foreign corporations beginning after December 31, 2025, with certain transition rules applying to earlier tax years as discussed below. Taxpayers may rely on the Proposed Regulations prior to finalization.

OBBBA Background

- Prior to the OBBBA, Section 951 required U.S. shareholders (generally, U.S. persons who own, or are treated as owning, at least 10% of a CFC by voting power or value ("U.S. Shareholders")) to include in gross income their pro rata share of the CFC's subpart F income if (*i*) the corporation was a CFC at any time during the taxable year and (ii) the shareholder owned the CFC's stock on the last day of the taxable year on which the corporation was a CFC (the "CFC year"). A U.S. Shareholder's pro rata share was generally determined based on its proportionate share of a hypothetical year-end distribution by the CFC (with adjustments for actual distributions). Former Section 951A generally applied the same allocation rules with respect to inclusions by a U.S. Shareholder of a CFC's global intangible low-taxed income ("GILTI").

- The OBBBA amended Sections 951 and 951A, including by (*i*) requiring income inclusions for U.S. Shareholders that own CFC stock at *any* point in the CFC's taxable year and (*ii*) replacing the hypothetical distribution and reduction rules with rules that are based instead on subpart F income "attributable to" the U.S. Shareholder's stock ownership during the CFC year. The income is included in the U.S. Shareholder's taxable year that includes the last day on which the Shareholder owns stock during the CFC year. The OBBBA made similar changes to Section 951A, while also replacing and re-branding the GILTI regime with the broader concept of "net CFC tested income," or NCTI. The OBBBA did not alter the "last day" rule with respect to inclusions of earnings invested in U.S. property under Section 956.

Proposed Regulations

Determination of Pro Rata Share of Subpart F Income

- Treasury and the IRS made a basic design choice in the Proposed Regulations to allocate Subpart F income and NCTI arising within a CFC's taxable year on a strictly pro rata basis: there are no special rules for allocating extraordinary items to the portion of the year in which they arise and no there is no ability to close books within the CFC year. As discussed below, the main exception to this pro rata approach applies in connection with major changes in ownership that trigger a mandatory or elective close of the CFC's tax year.

- If a CFC has only one class of stock outstanding and there are no ownership changes during the taxable year, a U.S. Shareholder's pro rata share is generally equal to the percentage of CFC stock owned by the U.S. Shareholder (based on shares owned relative to total outstanding shares) multiplied by the portion of the CFC's taxable year during which the shareholder owned the stock while the corporation was a CFC. In this static fact pattern, the Proposed Regulations would not change the result under the "last day" rule.

- However, where there are changes in ownership of stock of the CFC during the CFC year, the Proposed Regulations generally would apply a daily proration method to determine a U.S. Shareholder's pro rata share of subpart F income, tested income or tested loss for the CFC year, based on the number of days in the year a U.S. Shareholder owned each block of stock in the CFC.

- For CFCs with multiple classes of stock, the Proposed Regulations first would apply a hypothetical distribution of the CFC's allocable earnings and profits (generally equal to the greater of the CFC's earnings and profits and its total subpart F income and tested income) among the outstanding classes of stock and then apply the daily proration method separately to each class of stock. In cases where the number of outstanding shares of the CFC fluctuates during the CFC year, the daily proration method and hypothetical distribution (if applicable) are determined as if a weighted-average share count were outstanding on each day of the CFC year.

Comment: The daily proration method adopted by the Proposed Regulations is less flexible than alternative approaches suggested by commenters, including an interim closing of the books approach or a daily proration method with exceptions for extraordinary items. While this method may be easier to administer, absent a mandatory or elective year closing as discussed below, when the CFC's ownership varies, the approach may result in allocations of income that do not align with the U.S. Shareholders' economic interest in items of income, gain or loss, particularly when the CFC has extraordinary items during the year.

Mandatory and Elective Closing of the Tax Year

- The Proposed Regulations require a foreign corporation to close its tax year when it becomes or ceases to be a CFC, for this purpose, looking through domestic partnerships and ignoring options to acquire stock (to test at the inclusion shareholder level). The mandatory closing of the tax year applies for all purposes of the Code and is intended to prevent items arising during a non-CFC period from affecting income attributable to a period where the foreign corporation is a CFC.

- In a favorable development, the Proposed Regulations also provide for a taxpayer election to close a CFC's tax year voluntarily when, as part of the same plan, U.S. Shareholders of the CFC collectively dispose of more than 50% of the CFC's stock (by vote or value) during the CFC's tax year (a "significant ownership variance"). "Specified transfers" taken into account for purposes of determining whether a significant ownership variance occurs include sales, exchanges, redemptions and issuances of CFC stock. If significant ownership variances involving multiple CFCs occur pursuant to a plan or series of related transactions, the election must be made consistently for all affected CFCs.

  Comment: The preamble indicates that the IRS chose the greater than 50% threshold because it tends to indicate that the seller or selling group has relinquished control of the CFC and thus would have a "heightened interest" in closing the CFC's tax year to avoid the risk that post-closing actions by a buyer impact the pro rata share determination. The IRS believes that a lower threshold could lead to taxpayer manipulation.

  Comment: In the same vein, the Proposed Regulations include an anti-abuse rule that would ignore a decrease in ownership of a CFC by a U.S. Shareholder to the extent a related U.S. person's percentage interest in the CFC increases.

- The election is made by *controlling* U.S. Shareholders of the CFC. However, under the Proposed Regulations, the controlling U.S. Shareholders may make the election only if *all* U.S. Shareholders agree to be bound by the election in writing. This creates a potential holdout concern for controlling U.S. Shareholders and requires coordination with minority U.S. Shareholders. Domestic partnerships that directly hold CFC stock may enter into a binding agreement on behalf of U.S. Shareholder partners, provided that the partners delegate such authority to the partnership in advance.

  Comment: Upon a mandatory or elective closing of the tax year, the tax year of the CFC closes at the end of the day of the transfer. Similarly, if there are multiple specified transfers that occur pursuant to the same plan, the significant ownership variance (and an elective closing of the tax year) occurs on the date of the last transfer. This is the case even when over 50% of the CFC's interests are transferred at an early stage in the plan. Taxpayers will need to consider whether contractual protection is appropriate in relation to significant income producing activities occurring on the closing date of a transaction, after the legal change in ownership, that would otherwise be included in the income of CFC shareholders prior to the closing of the tax year.

  Comment: M&A agreements should address the year-end closing elections explicitly, including required shareholder cooperation and access to books and records to make required determinations of income inclusions. In addition, partnership taxpayers should consider whether delegations of authority in their existing partnership agreements are sufficiently broad to allow the partnership to enter into binding agreements on behalf of U.S. Shareholder partners.

- The Proposed Regulations would allocate foreign taxes of a CFC that experiences a mandatory or elective closing based on the portion of the foreign taxable income attributable to each U.S. tax period using a closing of the books method.

Special Considerations for Partnership Structures

- The Proposed Regulations include a look-through rule that applies to ownership of CFC stock by domestic partnerships and certain S corporations, such that CFC status for purposes of the closing of the tax year requirement is determined by reference to U.S. Shareholders that are actually subject to income inclusions under Sections 951 and 951A.

- Under these rules, if a domestic corporation sells 100% of the stock of a CFC to a domestic partnership and not more than 50% of the domestic partnership is owned by partners that would be U.S. Shareholders of the CFC, the sale triggers a mandatory closing of the CFC's tax year (because the foreign corporation would be treated for this purpose as ceasing to be a CFC). This is the case even though the foreign corporation continues to be treated as a CFC for other purposes of the Code (e.g., for requiring subpart F and NCTI inclusions and Section 1248).

Comment: This rule results in additional monitoring obligations for partnerships. Partnerships that own CFCs should note that admitting, redeeming, transferring or issuing partnership interests could result in a mandatory closing of the tax year or count toward a significant ownership variance. Whether an acquisition (or disposition) of CFC interests by a domestic partnership results in the ability to close the CFC's tax year depends on both the U.S. Shareholder composition of the domestic partnership and the identity of the transferor (or transferee).

Comment: Although the Proposed Regulations provide detailed rules for allocating subpart F income and tested income or loss across multiple classes of CFC stock and for changes in the number of outstanding shares, they do not address how to determine a partner's indirect interest in a CFC where the partner holds a partnership interest with a percentage interest in profits that varies over time. For funds and other structures with tiered waterfalls, this remains an open question that is relevant for determining a partner's ownership in a CFC.

- If a CFC owns an interest in a partnership, that partnership's tax year does not close merely because the CFC's tax year closes. As a result, where the partnership's tax year straddles the CFC's early closing, the CFC includes its entire distributive share of the partnership's items for that straddle year in its short taxable year following the closing.

  Comment: Where the CFC's tax year closes in connection with a transfer, this rule results in the bunching of a full year of lower-tier partnership income into a short post-closing period and income being allocated to U.S. Shareholders for periods when they did not own the stock. The Treasury Department and the IRS requested comments on whether a closing of the CFC's tax year should trigger a deemed disposition of the CFC's interest in lower-tier partnerships for purposes of Section 706. Until this issue is resolved, parties should address the resulting income allocation and information-sharing risk by including appropriate provisions in transaction documents.

Withdrawal of Extraordinary Reduction Rule

- Under the Proposed Regulations, the "extraordinary reduction" rules in Treasury Regulations Section 1.245A-5(e) and (f) (which denied a Section 245A dividendsreceived deduction for certain "extraordinary reduction amounts") would no longer apply to CFCs, beginning for tax years after December 31, 2025.

***Comment*:** The extraordinary reduction rules were intended to prevent transactions that exploited mismatches arising because of the design of the pre-OBBBA "last day" rule, and that could permit significant earnings repatriation without tax. The 2022 U.S. District Court decision in *Liberty Global* found the "extraordinary reduction" regulations procedurally invalid but also found the particular transaction at issue to lack economic substance. The Tenth Circuit later affirmed the District Court's decision on economic substance grounds but declined to address the validity of the regulations. In light of the OBBBA's enactment of the new pro rata inclusion rule, the Proposed Regulations provide that the "extraordinary reduction" regulations would sunset for taxable years of foreign corporations beginning after December 31, 2025.

Transition Rule Applicable for 2025

- The Proposed Regulations provide further guidance on the transition rule, which also relates to the old "last day" rule. This transition rule guidance, previously announced in Notice 2025-75, provides that certain dividends paid (or deemed paid) by a CFC are not treated as dividends for purposes of the former Section 951(a)(2)(B) pro rata share reduction if such dividends did not increase the taxable income of a U.S. person subject to U.S. federal income tax. The rule covers certain dividends paid on or before June 28, 2025 and during a CFC tax year that includes such date, and to certain dividends paid after June 28, 2025 but before the CFC's first taxable year beginning after December 31, 2025.

- The Proposed Regulations require a U.S. Shareholder relying on the transition rule to reduce its pro rata share under former Section 951(a)(2)(B) to determine that the relevant dividend increased the taxable income of a U.S. person subject to U.S. federal income tax and attach a statement to Form 5471 describing the basis for that determination. The Treasury Department and the IRS declined to adopt a per se rule or safe harbor for satisfying this substantiation requirement, noting that appropriate supporting information depends on the relevant facts and circumstances.

Information Reporting

- The Proposed Regulations modify information reporting requirements mandatory for U.S. Shareholders under Section 6038 at the CFC and shareholder levels to reflect amended Sections 951 and 951A. For example, for every direct owner and indirect U.S. Shareholder-owner of Section 958(a) stock, the Form 5471 must include details regarding the classes of stock owned, opening share count and every change in ownership, including the relevant date, number of shares involved and post-transaction balance.

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