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DEPARTMENT OF THE TREASURY

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Internal Revenue Service

26 CFR Part 1

TD 9222

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Guidance under Section 951 for Determining Pro Rata Share

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 951(a) of the Internal Revenue Code (Code) that provide guidance for determining a United States shareholder's pro rata share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, and previously excluded subpart F income withdrawn from foreign base company shipping operations.

DATES: Effective Date: These regulations are effective August 25, 2005.

Applicability Date: For dates of applicability, see §1.951-1(e)(7). FOR

FURTHER INFORMATION CONTACT: Jeffrey L. Vinnik, (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On August 6, 2004, the IRS published in the **Federal Register** a notice of proposed rulemaking (REG-129771-04, 2004-36 I.R.B. 453) under section 951 of the

Code. Written comments were received in response to the notice of proposed rulemaking. No public hearing was requested or held on the notice of proposed rulemaking. After consideration of the comments received, the proposed regulations are adopted as final regulations with the modifications discussed below. This issue of the **Federal Register** also includes a notice of proposed rulemaking (REG-129782-05) setting forth special pro rata share rules that apply to (1) a CFC with more than one class of stock which has earnings and profits and subpart F income for the taxable year that are attributable to one or more deemed dividends arising from one or more transactions described in section 304 that are part of a plan a principal purpose of which is the avoidance of Federal income taxation, and (2) a CFC with certain cumulative preferred stock outstanding that is held by one or more persons who are not U.S. taxpayers.

Summary of Public Comments and Explanation of Changes

A. Amounts determined under section 956 of the Code.

Section 951(a)(1) requires a United States shareholder of a CFC to include in income the amount determined under section 956 with respect to such shareholder. The proposed regulations include a conforming change to replace increase in earnings invested in United States property with amount determined under section 956 to reflect statutory changes made to section 956 of the Code by the Omnibus Budget Reconciliation Act of 1993, Public Law 103-66 (107 Stat. 312). Commentators recommended that the pro rata rules for section 956 be addressed in a separate regulatory project because, after the statutory change to section 956, the section 951

pro rata rules are no longer relevant to a United States shareholder's inclusion of the amount determined under section 956.

The IRS and Treasury Department agree with this recommendation and accordingly have deleted all references to section 956 under §1.951-1(e). Provisions of §1.951-1(a) and (d) that concerned a United States shareholder's pro rata share of the CFC's increase in earnings invested in United States property have been revised and removed, respectively, to conform the regulations to the relevant post-1993 Code provisions. The IRS and Treasury Department are considering a separate regulations project regarding the amount determined under section 956.

B. One class of stock – Proposed §1.951-1(e)(2).

The proposed regulations state that if a CFC for a taxable year has only one class of stock outstanding, each United States shareholder's pro rata share of such corporation's subpart F income for the taxable year is determined by allocating the CFC's earnings and profits for such year on a per-share basis. A commentator asked that this rule be modified to clarify that the relevant earnings and profits are earnings and profits for such year unreduced by distributions during the year.

The IRS and Treasury Department agree with the comment and have clarified §1.951-1(e)(2) accordingly.

C. More than one class of stock – Proposed §1.951-1(e)(3)(i).

In general, the proposed regulations allocate subpart F income among multiple classes of stock by reference to the distributions that would be made with respect to each class if the CFC's earnings and profits for the year were distributed on the last day of the CFC's taxable year (the hypothetical distribution). A commentator

expressed concern that the hypothetical-distribution rule under the proposed regulations could allocate earnings and profits to preferred stock (including, e.g., preferred stock with a noncumulative dividend preference) without regard to whether or when dividends are or will be paid. The commentator recommended that the proposed regulations be amended to provide that dividend rights should not be taken into account if, as of an appropriate date, the dividends have not been paid.

The IRS and Treasury Department have considered this comment and have concluded that, if the terms of a class of preferred stock are such that an obligation to pay a dividend with respect to the stock may or may not arise during the CFC's taxable year, depending on an exercise of discretion by the CFC's board of directors or a similar governing body, then the stock should be considered to have discretionary distribution rights. In such case, the rule of §1.951-1(e)(3)(ii) would apply. Therefore, the suggested amendment was not adopted.

A commentator recommended that, in the case of mandatorily redeemable preferred stock with cumulative dividend rights, the regulation should include an anti-abuse rule to be applied where the amount of earnings and profits required to be allocated to such stock differs substantially on a present-value basis from the amount expected to be distributed on such stock. Additionally, a commentator recommended that an anti-abuse rule could target shareholder-level agreements that are inconsistent with the economic terms of the underlying stock.

The IRS and Treasury Department agree that it is appropriate to provide a special rule for the allocation of earnings and profits to certain mandatorily redeemable cumulative preferred stock held by persons who are not U.S. taxpayers.

This special rule is set forth in a notice of proposed rulemaking published in this issue of the **Federal Register** (REG-129782-05).

With respect to the comments regarding shareholder-level agreements, while the proposed regulations are finalized without modification in respect of that comment, the IRS and Treasury Department may issue regulations in the future if needed to address those issues based on experience following the publication of these regulations.

D. Discretionary power to allocate earnings to different classes of stock – Proposed §1.951-1(e)(3)(ii)(A).

The proposed regulations provide that, where the allocation of the amount of a CFC's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by the board of directors or a similar governing body of the CFC, earnings and profits shall be allocated to classes of shares with discretionary distribution rights by reference to the relative values of those classes at the time of the hypothetical distribution. Commentators suggested that the use of a value test could be complex, costly, and time consuming. They proposed an alternative facts-and-circumstances test, with the valuation approach being used as a fall back only in limited situations. At the same time, the commentators noted that stock with discretionary distribution rights generally does not appear to exist in the marketplace (apart from ordinary common stock).

The IRS and Treasury Department have considered these comments and in light of the latter comment do not believe that a value-based allocation is likely to be required in many cases. The IRS and Treasury Department are aware that valuation

is a sophisticated process but believe that the interests of sound tax policy and administration are served by requiring the value-based allocation in those instances covered by these regulations.

Under the proposed regulations, in cases where the value of each of two or more classes of stock with discretionary distribution rights is substantially the same, the allocation of earnings and profits to each such class is made as if such classes constituted one class of stock. A commentator suggested that values should be treated as substantially the same for this purpose if they are within a specified percentage of one another.

The IRS and Treasury Department have considered the comment and have concluded that the existing language is sufficient for the purposes of the regulations without the need to adopt a specified percentage range. However, Example 3 in the regulations dealing with this issue has been revised to indicate that values may be considered substantially the same even if the difference between them is more than de minimis.

E. Redemptions and scope of deemed distributions – Proposed §§1.951-1(e)(3)(ii)(B) and 1.951-1(e)(4).

The proposed regulations contain a special rule that provides that no amount shall be considered to be distributed with respect to a particular class of stock to the extent that such a distribution would constitute a distribution in redemption of stock, a distribution in liquidation, or a return of capital. Commentators suggested that this rule was too broad and that stock rights resulting in deemed dividends under sections

302 or 305 of the Code should not be disregarded in situations that are unlikely to be abusive.

The IRS and Treasury Department have considered the comments and have concluded that no change is required. The hypothetical distribution mandated by section 951(a) of the Code contemplates a pro rata distribution to shareholders with respect to stock owned on the relevant date, with no disposition of the stock or change in stock rights being made at the same time. Disregarding redemptions, liquidations, or return of capital distributions for this purpose serves the objectives of these regulations without creating undue potential for unfairness or traps for the unwary. A rule that provided that some deemed dividends under sections 302 and 305 of the Code are disregarded and some are regarded could be overly complex and difficult to administer.

The term deemed distributions in proposed §1.951-1(e)(4) has been changed to hypothetical distribution in order to conform to the language used in §1.951-1(e)(3).

F. Dividend arrearages – Proposed §1.951-1(e)(3)(iv).

The proposed regulations retained the rule in existing regulations with respect to arrearages in dividends with respect to classes of preferred stock of a CFC. Specifically, the earnings and profits of the CFC for the taxable year are attributable to such arrearage only to the extent the arrearage exceeds the earnings and profits remaining from prior taxable years beginning after December 31, 1962. Commentators suggested that this rule can lead to anomalous results, particularly where cumulative preferred stock is issued when a CFC has accumulated earnings

and profits. In such a case, a failure to pay dividends for some number of periods could cause the preferred stock to attract earnings and profits (and thus subpart F income) accumulated prior to the issuance of the preferred stock and thus fail to attract an appropriate share of the CFC's subpart F income. Commentators suggested that this could be addressed by allocating to dividend arrearages only earnings and profits that arise after the issuance of the preferred stock.

The IRS and Treasury Department have considered these comments and believe that such a rule is appropriate. The final regulations adopt such a rule.

G. Section 958 of the Code.

Commentators suggested that a separate project was needed to address the relationship between the indirect stock ownership rules and the pro rata share inclusion rules.

The IRS and Treasury Department have considered the comment. The need for a separate regulations project of the kind suggested may be considered at a later date.

H. Effective date.

The proposed regulations were proposed to apply for taxable years of a CFC beginning on or after January 1, 2005. Commentators recommended that the regulations provide transitional effective-date guidance to taxpayers that may need to take into account backward-looking provisions of the Code or regulations regarding the allocation of earnings and profits to stock of a CFC.

The IRS and Treasury Department have considered the comment and have provided a transitional effective date rule for cases in which the application of these

pro rata rules for purposes of applying a related Code section, such as section 1248 of the Code, would result in an allocation to the stock of the CFC of earnings and profits that have already been allocated to the stock for an earlier year under the prior rules of §1.951-1(e). In that case, the prior rules will continue to apply for purposes of applying the related Code section.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Jeffrey Vinnik, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.951-1 is amended as follows:

1. Revising paragraphs (a)(2)(i) and (a)(2)(iv).
2. Removing and reserving paragraph (d).
3. Revising paragraph (e), and reserving paragraphs (e)(3)(v), (e)(4)(ii) and (e)(6) Example 9.

The revisions read as follows:

§1.951-1 Amounts included in gross income of United States shareholders.

(a) * * *

(2) * * *

(i) Such shareholder's pro rata share (determined under paragraph (b) of this section) of the corporation's subpart F income (as defined in section 952) for such taxable year of the corporation,

* * * * *

(iv) The amount determined under section 956 with respect to such shareholder for such taxable year of the corporation (but only to the extent not excluded from gross income under section 959(a)(2)).

* * * * *

(d) [Reserved].

(e) Pro rata share defined--(1) In general. For purposes of paragraphs (b) and (c) of this section, a United States shareholder's pro rata share of the controlled foreign corporation's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, or previously excluded subpart F income withdrawn from investment in foreign base company shipping operations, respectively, for any taxable year is his pro rata share determined under §1.952-1(a), §1.955-1(c), or §1.955A-1(c), respectively.

(2) One class of stock. If a controlled foreign corporation for a taxable year has only one class of stock outstanding, each United States shareholder's pro rata share of such corporation's subpart F income or withdrawal for the taxable year under paragraph (e)(1) of this section shall be determined by allocating the controlled foreign corporation's earnings and profits on a per share basis.

(3) More than one class of stock--(i) In general. Subject to paragraphs (e)(3)(ii) through (e)(3)(v) of this section, if a controlled foreign corporation for a taxable year has more than one class of stock outstanding, the amount of such corporation's subpart F income or withdrawal for the taxable year taken into account with respect to any one class of stock for purposes of paragraph (e)(1) of this section shall be that amount which bears the same ratio to the total of such subpart F income or withdrawal for such year as the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits of such corporation for such year (not reduced by actual distributions during the year) were distributed on the last day of such corporation's taxable year on which such corporation is a controlled

foreign corporation (the hypothetical distribution date), bear to the total earnings and profits of such corporation for such taxable year.

(ii) Discretionary power to allocate earnings to different classes of stock--(A) In general. Subject to paragraph (e)(3)(iii) of this section, the rules of this paragraph apply for purposes of paragraph (e)(1) of this section if the allocation of a controlled foreign corporation's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by that body of persons which exercises with respect to such corporation the powers ordinarily exercised by the board of directors of a domestic corporation (discretionary distribution rights). First, the earnings and profits of the corporation are allocated under paragraph (e)(3)(i) of this section to any class or classes of stock with non-discretionary distribution rights (e.g., preferred stock entitled to a fixed return). Second, the amount of earnings and profits allocated to a class of stock with discretionary distribution rights shall be that amount which bears the same ratio to the remaining earnings and profits of such corporation for such taxable year as the value of all shares of such class of stock, determined on the hypothetical distribution date, bears to the total value of all shares of all classes of stock with discretionary distribution rights of such corporation, determined on the hypothetical distribution date. For purposes of the preceding sentence, in the case where the value of each share of two or more classes of stock with discretionary distribution rights is substantially the same on the hypothetical distribution date, the allocation of earnings and profits to such classes shall be made as if such classes constituted one class of stock in which each share has the same rights to dividends as any other share.

(B) Special rule for redemption rights. For purposes of paragraph (e)(3)(ii)(A) of this section, discretionary distribution rights do not include rights to redeem shares of a class of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)).

(iii) Special allocation rule for stock with mixed distribution rights. For purposes of paragraphs (e)(3)(i) and (e)(3)(ii) of this section, in the case of a class of stock with both discretionary and non-discretionary distribution rights, earnings and profits shall be allocated to the non-discretionary distribution rights under paragraph (e)(3)(i) of this section and to the discretionary distribution rights under paragraph (e)(3)(ii) of this section. In such a case, paragraph (e)(3)(ii) of this section will be applied such that the value used in the ratio will be the value of such class of stock solely attributable to the discretionary distribution rights of such class of stock.

(iv) Dividend arrearages. For purposes of paragraph (e)(3)(i) of this section, if an arrearage in dividends for prior taxable years exists with respect to a class of preferred stock of such corporation, the earnings and profits for the taxable year shall be attributed to such arrearage only to the extent such arrearage exceeds the earnings and profits of such corporation remaining from prior taxable years beginning after December 31, 1962, or the date on which such stock was issued, whichever is later.

(v) Earnings and profits attributable to certain section 304 transactions.

[Reserved].

(4) Scope of hypothetical distribution--(i) Redemption rights. Notwithstanding the terms of any class of stock of the controlled foreign corporation or any agreement

or arrangement with respect thereto, no amount shall be considered to be distributed as part of the hypothetical distribution with respect to a particular class of stock for purposes of paragraph (e)(3) of this section to the extent that a distribution of such amount would constitute a distribution in redemption of stock (even if such redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d)), a distribution in liquidation, or a return of capital.

(ii) Certain cumulative preferred stock. [Reserved].

(5) Restrictions or other limitations on distributions--(i) In general. A restriction or other limitation on distributions of earnings and profits by a controlled foreign corporation will not be taken into account, for purposes of this section, in determining the amount of earnings and profits that shall be allocated to a class of stock of the controlled foreign corporation or the amount of the United States shareholder's pro rata share of the controlled foreign corporation's subpart F income or withdrawal for the taxable year.

(ii) Definition. For purposes of this section, a restriction or other limitation on distributions includes any limitation that has the effect of limiting the allocation or distribution of earnings and profits by a controlled foreign corporation to a United States shareholder, other than currency or other restrictions or limitations imposed under the laws of any foreign country as provided in section 964(b).

(iii) Exception for certain preferred distributions. The right to receive periodically a fixed amount (whether determined by a percentage of par value, a reference to a floating coupon rate, a stated return expressed in terms of a certain amount of dollars or foreign currency, or otherwise) with respect to a class of stock

the distribution of which is a condition precedent to a further distribution of earnings or profits that year with respect to any class of stock (not including a distribution in partial or complete liquidation) is not a restriction or other limitation on the distribution of earnings and profits by a controlled foreign corporation under paragraph (e)(5) of this section.

(iv) Illustrative list of restrictions and limitations. Except as provided in paragraph (e)(5)(iii) of this section, restrictions or other limitations on distributions include, but are not limited to--

(A) An arrangement that restricts the ability of the controlled foreign corporation to pay dividends on a class of shares of the corporation owned by United States shareholders until a condition or conditions are satisfied (e.g., until another class of stock is redeemed);

(B) A loan agreement entered into by a controlled foreign corporation that restricts or otherwise affects the ability to make distributions on its stock until certain requirements are satisfied; or

(C) An arrangement that conditions the ability of the controlled foreign corporation to pay dividends to its shareholders on the financial condition of the controlled foreign corporation.

(6) Examples. The application of this section may be illustrated by the following examples:

Example 1. (i) Facts. FC1, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of one class of stock. Corp E, a domestic corporation and a United States shareholder of FC1, within the meaning of section 951(b), owns 60 shares. Corp H, a domestic corporation and a United States shareholder of FC1, within the meaning of section 951(b), owns 40 shares. FC1, Corp E, and Corp H each use the calendar year as a taxable year.

Corp E and Corp H are shareholders of FC1 for its entire 2005 taxable year. For 2005, FC1 has \$100x of earnings and profits, and income of \$100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). FC1 makes no distributions during that year.

(ii) Analysis. FC1 has one class of stock. Therefore, under paragraph (e)(2) of this section, FC1's earnings and profits are allocated on a per share basis. Accordingly, for the taxable year 2005, Corp E's pro rata share of FC1's subpart F income is \$60x ($60/100 \times \$100x$) and Corp H's pro rata share of FC1's subpart F income is \$40x ($40/100 \times \$100x$).

Example 2. (i) Facts. FC2, a controlled foreign corporation within the meaning of section 957(a), has outstanding 70 shares of common stock and 30 shares of 4-percent, nonparticipating, voting, preferred stock with a par value of \$10x per share. The common shareholders are entitled to dividends when declared by the board of directors of FC2. Corp A, a domestic corporation and a United States shareholder of FC2, within the meaning of section 951(b), owns all of the common shares. Individual B, a foreign individual, owns all of the preferred shares. FC2 and Corp A each use the calendar year as a taxable year. Corp A and Individual B are shareholders of FC2 for its entire 2005 taxable year. For 2005, FC2 has \$50x of earnings and profits, and income of \$50x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, FC2 distributes as a dividend \$12x to Individual B with respect to Individual B's preferred shares. FC2 makes no other distributions during that year.

(ii) Analysis. FC2 has two classes of stock, and there are no restrictions or other limitations on distributions within the meaning of paragraph (e)(5) of this section. If the total \$50x of earnings were distributed on December 31, 2005, \$12x would be distributed with respect to Individual B's preferred shares and the remainder, \$38x, would be distributed with respect to Corp A's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp A's pro rata share of FC1's subpart F income is \$38x for taxable year 2005.

Example 3. (i) Facts. The facts are the same as in Example 2, except that the shares owned by Individual B are Class B common shares and the shares owned by Corp A are Class A common shares and the board of directors of FC2 may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. The value of the Class A common shares on the last day of FC2's 2005 taxable year is \$680x and the value of the Class B common shares on that date is \$300x. The board of directors of FC2 determines that FC2 will not make any distributions in 2005 with respect to the Class A and B common shares of FC2.

(ii) Analysis. The allocation of FC2's earnings and profits between its Class A and Class B common shares depends solely on the exercise of discretion by the board of directors of FC2. Therefore, under paragraph (e)(3)(ii)(A) of this section, the allocation of earnings and profits between the Class A and Class B common shares will depend on the value of each class of stock on the last day of the controlled

foreign corporation's taxable year. On the last day of FC2's taxable year 2005, the Class A common shares had a value of \$9.30x/share and the Class B common shares had a value of \$10x/share. Because each share of the Class A and Class B common stock of FC2 has substantially the same value on the last day of FC2's taxable year, under paragraph (e)(3)(ii)(A) of this section, for purposes of allocating the earnings and profits of FC2, the Class A and Class B common shares will be treated as one class of stock. Accordingly, for FC2's taxable year 2005, the earnings and profits of FC2 are allocated \$35x ($70/100 \times \$50x$) to the Class A common shares and \$15x ($30/100 \times \$50x$) to the Class B common shares. For its taxable year 2005, Corp A's pro rata share of FC2's subpart F income will be \$35x.

Example 4. (i) Facts. FC3, a controlled foreign corporation within the meaning of section 957(a), has outstanding 100 shares of Class A common stock, 100 shares of Class B common stock and 10 shares of 5-percent nonparticipating, voting preferred stock with a par value of \$50x per share. The value of the Class A shares on the last day of FC3's 2005 taxable year is \$800x. The value of the Class B shares on that date is \$200x. The Class A and Class B shareholders each are entitled to dividends when declared by the board of directors of FC3, and the board of directors of FC3 may declare dividends with respect to one class of stock without declaring dividends with respect to the other class of stock. Corp D, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the Class A shares. Corp N, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the Class B shares. Corp S, a domestic corporation and a United States shareholder of FC3, within the meaning of section 951(b), owns all of the preferred shares. FC3, Corp D, Corp N, and Corp S each use the calendar year as a taxable year. Corp D, Corp N, and Corp S are shareholders of FC3 for all of 2005. For 2005, FC3 has \$100x of earnings and profits, and income of \$100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, FC3 distributes as a dividend \$25x to Corp S with respect to the preferred shares. The board of directors of FC3 determines that FC3 will make no other distributions during that year.

(ii) Analysis. The distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. Pursuant to paragraph (e)(3)(i) of this section, if the total \$100x of earnings were distributed on December 31, 2005, \$25x would be distributed with respect to Corp S's preferred shares and the remainder, \$75x would be distributed with respect to Corp D's Class A shares and Corp N's Class B shares. The allocation of that \$75x between its Class A and Class B shares depends solely on the exercise of discretion by the board of directors of FC3. The value of the Class A shares (\$8x/share) and the value of the Class B shares (\$2x/share) are not substantially the same on the last day of FC3's taxable year 2005. Therefore for FC3's taxable year 2005, under paragraph (e)(3)(ii)(A) of this section, the earnings and profits of FC3 are allocated \$60x ($\$800/\$1,000 \times \$75x$) to the Class A shares and \$15x ($\$200/\$1,000 \times \$75x$) to the Class B shares. For the 2005 taxable year, Corp D's pro rata share of FC3's subpart

F income will be \$60x, Corp N's pro rata share of FC3's subpart F income will be \$15x and Corp S's pro rata share of FC3's subpart F income will be \$25x.

Example 5. (i) Facts. FC4, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of participating, voting, preferred stock and 200 shares of common stock. The owner of a share of preferred stock is entitled to an annual dividend equal to 0.5-percent of FC4's retained earnings for the taxable year and also is entitled to additional dividends when declared by the board of directors of FC4. The common shareholders are entitled to dividends when declared by the board of directors of FC4. The board of directors of FC4 has discretion to pay dividends to the participating portion of the preferred shares (after the payment of the preference) and the common shares. The value of the preferred shares on the last day of FC4's 2005 taxable year is \$600x (\$100x of this value is attributable to the discretionary distribution rights of these shares) and the value of the common shares on that date is \$400x. Corp E, a domestic corporation and United States shareholder of FC4, within the meaning of section 951(b), owns all of the preferred shares. FC5, a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a), owns all of the common shares. FC 4 and Corp E each use the calendar year as a taxable year. Corp E and FC5 are shareholders of FC4 for all of 2005. For 2005, FC4 has \$100x of earnings and profits, and income of \$100x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, FC4's retained earnings are equal to its earnings and profits. FC4 distributes as a dividend \$20x to Corp E that year with respect to Corp E's preferred shares. The board of directors of FC4 determines that FC4 will not make any other distributions during that year.

(ii) Analysis. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. The allocation of FC4's earnings and profits between its preferred shares and common shares depends, in part, on the exercise of discretion by the board of directors of FC4 because the preferred shares are shares with both discretionary distribution rights and non-discretionary distribution rights. Paragraph (e)(3)(i) of this section is applied first to determine the allocation of earnings and profits of FC4 to the non-discretionary distribution rights of the preferred shares. If the total \$100x of earnings were distributed on December 31, 2005, \$20x would be distributed with respect to the non-discretionary distribution rights of Corp E's preferred shares. Accordingly, \$20x would be allocated to such shares under paragraphs (e)(3)(i) and (iii) of this section. The remainder, \$80x, would be allocated under paragraph (e)(3)(ii)(A) and (e)(3)(iii) of this section between the preferred and common shares by reference to the value of the discretionary distribution rights of the preferred shares and the value of the common shares. Therefore, the remaining \$80x of earnings and profits of FC4 are allocated \$16x ($\$100x/\$500x \times \$80x$) to the preferred shares and \$64x ($\$400x/\$500x \times \80) to the common shares. For its taxable year 2005, Corp E's pro rata share of FC4's subpart F income will be \$36x (\$20x + \$16x).

Example 6. (i) Facts. FC6, a controlled foreign corporation within the meaning of section 957(a), has outstanding 10 shares of common stock and 400 shares of 2-percent nonparticipating, voting, preferred stock with a par value of \$1x per share. The common shareholders are entitled to dividends when declared by the board of directors of FC6. Corp M, a domestic corporation and a United States shareholder of FC6, within the meaning of section 951(b), owns all of the common shares. FC7, a foreign corporation that is not a controlled foreign corporation within the meaning of section 957(a), owns all of the preferred shares. Corp M and FC7 cause the governing documents of FC6 to provide that no dividends may be paid to the common shareholders until FC6 cumulatively earns \$100,000x of income. FC6 and Corp M each use the calendar year as a taxable year. Corp M and FC7 are shareholders of FC6 for all of 2005. For 2005, FC6 has \$50x of earnings and profits, and income of \$50x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a). In 2005, FC6 distributes as a dividend \$8x to FC7 with respect to FC7's preferred shares. FC6 makes no other distributions during that year.

(ii) Analysis. The agreement restricting FC6's ability to pay dividends to common shareholders until FC6 cumulatively earns \$100,000x of income is a restriction or other limitation, within the meaning of paragraph (e)(5) of this section, and will be disregarded for purposes of calculating Corp M's pro rata share of subpart F income. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. If the total \$50x of earnings were distributed on December 31, 2005, \$8x would be distributed with respect to FC7's preferred shares and the remainder, \$42x, would be distributed with respect to Corp M's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp M's pro rata share of FC6's subpart F income is \$42x for taxable year 2005.

Example 7. (i) Facts. FC8, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of common stock and 10 shares of 4-percent voting preferred stock with a par value of \$50x per share. Pursuant to the terms of the preferred stock, FC8 has the right to redeem at any time, in whole or in part, the preferred stock. FP, a foreign corporation, owns all of the preferred shares. Corp G, a domestic corporation wholly owned by FP and a United States shareholder of FC8, within the meaning of section 951(b), owns all of the common shares. FC8 and Corp G each use the calendar year as a taxable year. FP and Corp G are shareholders of FC8 for all of 2005. For 2005, FC8 has \$100x of earnings and profits, and income of \$100x with respect to which amounts are required to be included in gross income of a United States shareholder under section 951(a). In 2005, FC8 distributes as a dividend \$20x to FP with respect to FP's preferred shares. FC8 makes no other distributions during that year.

(ii) Analysis. Pursuant to paragraph (e)(3)(ii)(B) of this section, the redemption rights of the preferred shares will not be treated as a discretionary distribution right under paragraph (e)(3)(ii)(A) of this section. Further, if FC8 were treated as having

redeemed any preferred shares under paragraph (e)(3)(i) of this section, the redemption would be treated as a distribution to which section 301 applies under section 302(d) due to FP's constructive ownership of the common shares. However, pursuant to paragraph (e)(4) of this section, no amount of earnings and profits would be allocated to the preferred shareholders on the hypothetical distribution date, under paragraph (e)(3)(i) of this section, as a result of FC8's right to redeem, in whole or in part, the preferred shares. FC8's redemption rights with respect to the preferred shares cannot affect the allocation of earnings and profits between FC8's shareholders. Therefore, the redemption rights are not restrictions or other limitations within the meaning of paragraph (e)(5) of this section. Additionally, the non-discretionary distribution rights of the preferred shares are not restrictions or other limitations within the meaning of paragraph (e)(5) of this section. Therefore, if the total \$100x of earnings were distributed on December 31, 2005, \$20x would be distributed with respect to FP's preferred shares and the remainder, \$80x, would be distributed with respect to Corp G's common shares. Accordingly, under paragraph (e)(3)(i) of this section, Corp G's pro rata share of FC8's subpart F income is \$80 for taxable year 2005.

Example 8. (i) Facts. FC9, a controlled foreign corporation within the meaning of section 957(a), has outstanding 40 shares of common stock and 60 shares of 6-percent, nonparticipating, nonvoting, preferred stock with a par value of \$100x per share. Individual J, a United States shareholder of FC9, within the meaning of section 951(b), who uses the calendar year as a taxable year, owns 30 shares of the common stock, and 15 shares of the preferred stock during tax year 2005. The remaining 10 common shares and 45 preferred shares of FC9 are owned by Individual N, a foreign individual. Individual J and Individual N are shareholders of FC9 for all of 2005. For taxable year 2005, FC9 has \$1,000x of earnings and profits, and income of \$500x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a).

(ii) Analysis. The non-discretionary distribution rights of the preferred shares are not a restriction or other limitation within the meaning of paragraph (e)(5) of this section. If the total \$1,000x of earnings and profits were distributed on December 31, 2005, \$360x ($0.06 \times \$100x \times 60$) would be distributed with respect to FC9's preferred stock and \$640x ($\$1,000x \text{ minus } \$360x$) would be distributed with respect to its common stock. Accordingly, of the \$500x with respect to which amounts are required to be included in gross income of United States shareholders under section 951(a), \$180x ($\$360x/\$1,000x \times \$500x$) is allocated to the outstanding preferred stock and \$320x ($\$640x/\$1,000x \times \$500x$) is allocated to the outstanding common stock. Therefore, under paragraph (e)(3)(i) of this section, Individual J's pro rata share of such amounts for 2005 is \$285x [$(\$180x \times 15/60) + (\$320x \times 30/40)$].

Example 9. [Reserved].

(7) Effective dates. This paragraph (e) applies for taxable years of a controlled foreign corporation beginning on or after January 1, 2005. However, if the application of this paragraph (e) for purposes of a related Internal Revenue Code provision, such as section 1248, results in an allocation to the stock of such corporation of earnings and profits that have already been allocated to the stock for an earlier year under the prior rules of §1.951-1(e), as contained in 26 CFR Part 1

revised April 1, 2005, then the prior rules will continue to apply to the extent necessary to avoid such duplicative allocation.

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/s/ Mark E. Matthews

Deputy Commissioner for Services and Enforcement.

Approved: August 9, 2005

/s/ Eric Solomon

Acting Deputy Assistant Secretary of the Treasury.