In 2006, FC10, a CFC, has outstanding 100 shares of common stock and 100 shares of 6-percent, voting, preferred stock with a par value of $10x per share. All of the common stock is held by Corp H, a foreign corporation, which invested $1000x in FC10 in exchange for the common stock. All of the preferred stock is held by Corp J, a domestic corporation, which invested $5000x in FC10 in exchange for the preferred stock. Corp H is unrelated to Corp J. In 2006, FC10 borrows $3000x from a bank and invests $5000x in preferred stock issued by FC11, a foreign corporation the common stock of which is owned by Corp J. Corp J's adjusted basis in its FC11 common stock is $5000x. FC11, which has no current or accumulated earnings and profits, distributes the $5000x to Corp J. Subsequently, in 2007, FC10 sells the FC11 preferred stock to FC12, a wholly-owned foreign subsidiary of FC11 that has $5000x of accumulated earnings and profits, for $5000x in a transaction described in section 304. FC10 repays the bank loan in full. For 2007, FC10 has $5000x of earnings and profits, all of which is subpart F income attributable to a section 304 dividend arising from FC10's sale of the FC11 preferred stock to FC12. At all relevant times, the value of the common stock of FC10 is $1000x and the value of the preferred stock of FC10 is $5000x.

The acquisition and sale of the FC11 preferred stock by FC10 was part of a plan a principal purpose of which was the avoidance of Federal income tax by depleting the earnings and profits of FC12 and allowing FC11 to make a distribution to Corp J that it characterizes entirely as a return of basis. FC10 has $5000x of earnings and profits for 2007 attributable to a dividend from a section 304 transaction which was part of such plan. These earnings and profits are allocated to the common and preferred stock of FC10 in accordance with the relative value of each class of stock ($1000x and $5000x, respectively). Thus, for taxable year 2007, $833x (1/6 X $5000x = $833x) of these earnings and profits is allocated to FC10's common stock and $4167x (5/6 X $5000x = $4167x) is allocated to its preferred stock.

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