FS, a controlled foreign corporation, has outstanding 70 shares of common stock and 30 shares of 4% nonparticipating, cumulative preferred stock with a par value of $10x per share. P Corp, a domestic corporation and a United States shareholder of FS, owns all of the common shares. Individual A, a United States shareholder, owns all of the preferred shares. Both FS and P Corp use the calendar year as their taxable year. Individual A and P Corp are shareholders of FS for all of Year 4. At the beginning of Year 4, FS had no dividend arrearages with respect to its preferred stock. For Year 4, FS has $100x of earnings and profits, $120x of tested income, and no subpart F income within the meaning of section 952. FS also has $1,500x of qualified business asset investment for Year 4.

(A) Determination of pro rata share of tested income. For purposes of determining P Corp’s pro rata share of FS’s tested income under Prop. Reg. 1.951A-1(d)(2), the amount of FS’s current earnings and profits for purposes of the hypothetical distribution described in §1.951-1(e)(1)(i) is $120x, the greater of its earnings and profits as determined under section 964 ($100x) or the sum of its subpart F income and tested income ($0 + $120x). Under Prop. Reg. 1.951A-1(d)(2) and §1.951-1(e)(3), the amount of FS’s current earnings and profits distributed in the hypothetical distribution is $12x (.04 x $10x x 30) with respect to Individual A’s preferred shares and $108x ($120x - $12x) with respect to P Corp’s common shares. Accordingly, under Prop. Reg. 1.951A-1(d)(2) and §1.951-1(e)(1), Individual A’s pro rata share of FS’s tested income is $12x, and P Corp’s pro rata share of FS’s tested income is $108x for Year 4.

(B) Determination of pro rata share of qualified business asset investment. The special rule of Prop. Reg. 1.951A-1(d)(3)(ii) applies because FS’s qualified business asset investment of $1,500x exceeds $1,200x, which is 10 times FS’s tested income of $120x. Under Prop. Reg. 1.951A-1(d)(3)(ii), Individual A’s and P Corp’s pro rata share of FS’s qualified business asset investment is the sum of their pro rata share determined under Prop. Reg. 1.951A-1(d)(3)(i) without regard to the excess QBAI plus their pro rata share with respect to the excess QBAI but without regard to tested income allocated to preferred stock under Prop. Reg. 1.951A-1(d)(2). Without regard to the excess QBAI of $300x, Individual A’s pro rata share of FS’s qualified business asset investment is $120x ($1,200x x $12x/$120x), and P Corp’s pro rata share of FS’s qualified business asset investment is $1,080x ($1,200x x $108x/$120x). Solely with respect to the excess QBAI and without regard to tested income allocated to the preferred stock under Prop. Reg. 1.951A-1(d)(2), Individual A’s pro rata share of FS’s qualified business asset investment is $0 ($300x x $0/$108x), and P Corp’s pro rata share of FS’s qualified business asset investment is $300x ($300x x $108x/$108x). Thus, Individual A’s pro rata share of FS’s qualified business asset investment is $120x ($120x + $0), and P Corp’s pro rata share of FS’s qualified business asset investment is $1,380x ($1,080x + $300x)

HUNDREDS of additional charts at www.andrewmitchel.com