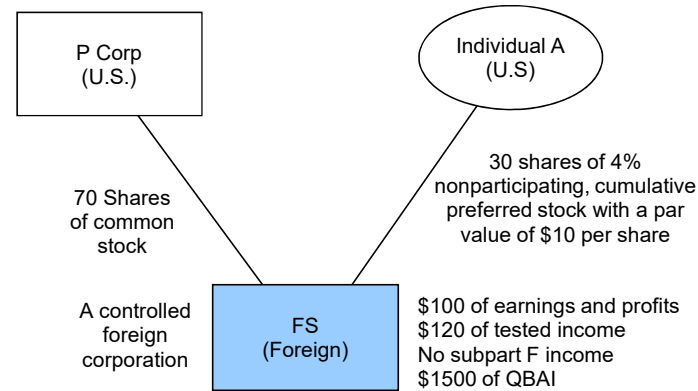


**Reg. 1.951A-1(d)(3)(iii),  
Example 2**

**Pro Rata Share of Tested Income & QBAI:  
Special Rule For Preferred Stock &  
Excess Hypothetical Tangible Return**

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(1) Facts. 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 citizen and a United States shareholder, owns all of the preferred shares. Individual A, 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.



**Hypothetical tangible return = 150 (1,500 x 10%)**  
**FS's E&P for purposes of the hypothetical distribution = 150,**  
**the greater of 964 E&P (100) and the sum of its Sub F (0) plus**  
**the hypothetical tangible return (150)**

(2) Analysis—(i) Determination of pro rata share of tested income. For purposes of determining P Corp's pro rata share of FS's tested income under paragraph (d)(2), the amount of FS's allocable 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) and the sum of its subpart F income and tested income (\$0 + \$120x). Under paragraph (d)(2) and §1.951-1(e)(3), the amount of FS's allocable earnings and profits distributed in the hypothetical distribution with respect to Individual A's preferred shares is \$12x (0.04 x \$10x x 30) and the amount distributed with respect to P Corp's common shares is \$108x (\$120x - \$12x). Accordingly, under paragraph (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.

(ii) Determination of pro rata share of qualified business asset investment. The special rule of paragraph (d)(3)(ii)(A) applies because FS's tested income of \$120x is less than FS's hypothetical tangible return of \$150x, which is 10% of FS's qualified business asset investment of \$1,500x. Under paragraph (d)(3)(ii)(A), Individual A's and P Corp's respective pro rata shares of FS's qualified business asset investment bears the same ratio to FS's qualified business asset investment as their respective pro rata shares of the hypothetical tangible return of FS bears to the total hypothetical tangible return of FS. Under paragraph (d)(3)(ii)(B), P Corp's and Individual A's respective pro rata share of FS's hypothetical tangible return is determined under paragraph (d)(2) in the same manner as their respective pro rata shares of the tested income of FS by treating the hypothetical tangible return as the amount of tested income. The amount of FS's allocable earnings and profits for purposes of the hypothetical distribution described in §1.951-1(e)(1)(i) is \$150x, the greater of its earnings and profits as determined under section 964 (\$100x) and the sum of its subpart F income and hypothetical tangible return (\$0 + \$150x). The amount of FS's allocable earnings and profits distributed in the hypothetical distribution is \$12x (.04 x \$10x x 30) with respect to Individual A's preferred shares and \$138x (\$150x - \$12x) with respect to P Corp's common shares. Accordingly, Individual A's pro rata share of FS's qualified business asset investment is \$120x (\$1,500x x \$12x/\$150x), and P Corp's pro rata share of FS's qualified business asset investment is \$1,380x (\$1,500x x \$138x/\$150x).