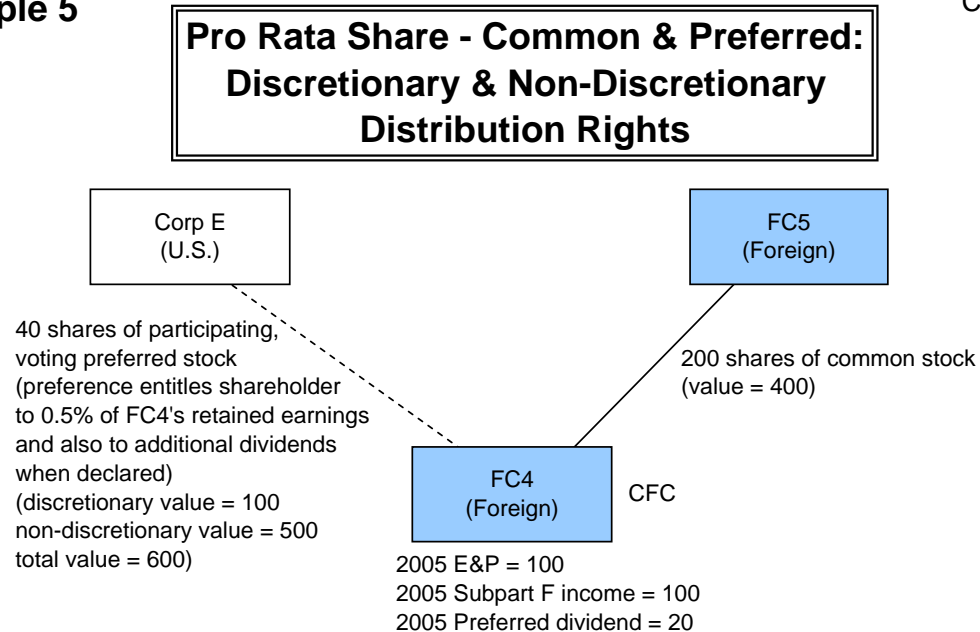


Reg. 1.951-1(e)(6), Example 5

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FC4, a CFC, 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, owns all of the preferred shares. FC5, a foreign corporation that is not a CFC, owns all of the common shares. 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. 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.

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. One must first 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. The remainder, \$80x, would be allocated 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).