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taxable income from sources partly within and partly without Formosa and Hong Kong which may be allocated to sources within Formosa and Hong Kong. The method of computing this income is similar to that described in part I (section 861 and following), subchapter N, chapter 1 of the Code, and the regulations thereunder.

§ 1.941–3 Illustration of principles.

The application of section 941 may be illustrated by the following example:

Example. (1) The A Company, a China Trade Act corporation, has taxable income (computed without regard to the deduction under section 941) for the calendar year 1954 of $200,000 and receives no dividends from domestic corporations. All of its stock on December 31, 1954, is owned on that date by persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, or individual citizens of the United States. It distributes a special dividend amounting to $100,000 on February 15, 1955, which is certified by the Secretary of Commerce as provided in section 941(b). For the purpose of the tax imposed by section 11, it is necessary in this example to make two computations, first, without allowing the special deduction from taxable income on account of income derived from sources within Formosa and Hong Kong, and, second, allowing such deduction. The computations are as follows:

(2) First computation; without allowing the special deduction from taxable income.

Taxable income	$200,000
Normal tax (section 11 (b))	60,000
Surtax (section 11 (c))	38,500
Total income tax	98,500

(3) Second computation; allowing the special deduction from taxable income.

Taxable income	$200,000

Since the total taxable income is derived from sources within Formosa and Hong Kong and since the par value of the shares of stock of the corporation owned on the last day of the taxable year by (a) persons resident in Formosa, Hong Kong, the United States, or possessions of the United States, and (b) individual citizens of the United States wherever resident, is 100 percent of the par value of the total number of shares of stock of the corporation outstanding on that day, 100 percent of such taxable income is deductible.

Special deduction from taxable income	$200,000
Amount of income subject to tax under section 11	None

(4) Since the special dividend ($100,000) exceeds the diminution of the tax ($98,500) on account of the allowance of the special deduction from taxable income, the entire amount of the special deduction is allowable and the corporation has no income tax liability for 1954.

§ 1.943–1 Withholding by a China Trade Act corporation.

Dividends paid by a China Trade Act corporation to a nonresident alien individual, foreign partnership, or foreign corporation are subject to withholding of tax at source under § 1.1441–1. However, see paragraph (c) of § 1.1441–4 for exemption applicable to dividends paid to residents of Formosa or Hong Kong.

[T.D. 6908, 31 FR 16769, Dec. 31, 1966]

CONTROLLED FOREIGN CORPORATIONS

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

(a) *In general.* If a foreign corporation is a controlled foreign corporation (within the meaning of section 957) for an uninterrupted period of 30 days or more (determined under paragraph (f) of this section) during any taxable year of such corporation beginning after December 31, 1962, every person—

(1) Who is a United States shareholder (as defined in section 951(b) and paragraph (g) of this section) of such corporation at any time during such taxable year, and

(2) Who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income for his taxable year in which or with which such taxable year of the corporation ends, the sum of—

(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,

(ii) Such shareholder's pro rata share (determined under paragraph (c)(1) of this section) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such taxable year of the corporation,

(iii) Such shareholder's pro rata share (determined under paragraph (c)(2) of this section) of the corporation's previously excluded subpart F income withdrawn from investment in

foreign base company shipping operations for such taxable year of the corporation, and

(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)).

(3) For purposes of determining whether a United States shareholder which is a domestic corporation is a personal holding company under section 542 and § 1.542–1, the character of the amount includible in gross income of such domestic corporation under this paragraph shall be determined as if such amount were realized directly by such corporation from the source from which it is realized by the controlled foreign corporation. See paragraph (a) of § 1.957–2 for special limitation on the amount of subpart F income in the case of a controlled foreign corporation described in section 957(b). See section 970(a) and § 1.970–1 which provides for the reduction of subpart F income of export trade corporations.

(b) *Limitation on a United States shareholder's pro rata share of subpart F income*—(1) *In general.* For purposes of paragraph (a)(2)(i) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's subpart F income for the taxable year of such corporation is—

(i) The amount which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in such corporation's taxable year, on which such corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount which bears the same ratio to its subpart F income for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year, reduced by—

(ii) The amount of distributions received by any other person during such taxable year as a dividend with respect to such stock, but only to the extent that such distributions do not exceed the dividend which would have been received by such other person if the distributions by such corporation to all its shareholders had been the amount which bears the same ratio to the subpart F income of such corporation for the taxable year as the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire taxable year.

(2) *Illustrations.* The application of this paragraph may be illustrated by the following examples:

Example 1. A, a United States shareholder, owns 100 percent of the only class of stock of M, a controlled foreign corporation throughout 1963. Both A and M Corporation use the calendar year as a taxable year. For 1963, M Corporation derives $100 of subpart F income, has $100 of earnings and profits, and makes no distributions. A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i).

Example 2. The facts are the same as in example 1, except that instead of holding 100 percent of the stock of M Corporation for the entire year, A sells 60 percent of such stock to B, a nonresident alien, on May 26, 1963. Thus, M Corporation is a controlled foreign corporation for the period January 1, 1963, through May 26, 1963. A must include $40 ($100×146/365) in his gross income for 1963 under section 951(a)(1)(A)(i).

Example 3. The facts are the same as in example 1, except that instead of holding 100 percent of the stock of M Corporation for the entire year, A holds 60 percent of such stock on December 31, 1963, having acquired such interest on May 26, 1963, from B, a nonresident alien, who owned such interest from January 1, 1963. Before A's acquisition of such stock, M Corporation had distributed a dividend of $15 to B in 1963 with respect to such stock. A must include $21 in his gross income for 1963 under section 951(a)(1)(A)(i), such amount being determined as follows:

Corporation M's Subpart F income for 1963		$100
Less: Reduction under section 951(a)(2)(A) for period (1–1–63 through 5–26–63) during which M Corporation is not a controlled foreign corporation ($100×146/365)		40
Subpart F income for 1963 as limited by section 951(a)(2)(A)		60
A's pro rata share of subpart F income as determined under section 951 (a)(2)(A) (60 percent of $60)		36
Less: Reduction under section 951(a)(2)(B) for dividends received by B during 1963 with respect to the stock acquired by A in M Corporation:		
(i) Dividend received by B	15	

(ii) B's pro rata share of the amount which bears the same ratio to M Corporation's subpart F income for 1963 ($100) as the period during which A did not own (within the meaning of section 958(a)) his stock (146 days) bears to the entire taxable year (365 days) (60 percent of ($100×146/365))	24	
(iii) Amount of reduction (lesser of (i) or (ii))		15
A's pro rata share of Subpart F income as determined under section 951(a)(2)		21

Example 4. A, a United States shareholder, owns 100 percent of the only class of stock of P, a controlled foreign corporation throughout 1963, and P owns 100 percent of the only class of stock of R, a controlled foreign corporation throughout 1963. A and Corporations P and R each use the calendar year as a taxable year. For 1963, R Corporation derives $100 of subpart F income, has $100 of earnings and profits, and distributes a dividend of $20 to P Corporation. Corporation P has no income for 1963 other than the dividend received from R Corporation. A must include $100 in his gross income for 1963 under section 951(a)(1)(A)(i) as subpart F income of R Corporation for such year. Such subpart F income is not reduced under section 951(a)(2)(B) for the dividend of $20 paid to P Corporation because there was no part of the year 1963 during which A did not own (within the meaning of section 958(a)) the stock of R Corporation. By reason of the application of section 959(b), the $20 distribution from R Corporation to P Corporation is not again includible in the gross income of A under section 951(a).

Example 5. The facts are the same as in example 4, except that instead of holding the stock of R Corporation for the entire year, P Corporation acquires 60 percent of the only class of stock of R Corporation on March 14, 1963, from C, a nonresident alien, after R Corporation distributes in 1963 a dividend of $35 to C with respect to the stock so acquired by P Corporation. The stock interest so acquired by P Corporation was owned by C from January 1, 1963, until acquired by P Corporation. A must include $36 in his gross income for 1963 under section 951(a)(1)(A)(i), such amount being determined as follows:

Corporation R's Subpart F income for 1963		$100
Less: Reduction under section 951(a)(2)(A) for period (1–1–63 through 3–14–63) during which R Corporation is not a controlled foreign corporation ($100×73/365)		20
Subpart F income for 1963 as limited by section 951(a)(2)(A)		80
A's pro rata share of subpart F income as determined under section 951 (a)(2)(A) (60 percent of $80)		48
Less: Reduction under section 951(a)(2)(B) for dividends received by C during 1963 with respect to the stock indirectly acquired by A in R Corporation:		
(i) Dividend received by C	35	
(ii) C's pro rata share of the amount which bears the same ratio to R Corporation's Subpart F income for 1963 ($100) as the period during which A did not indirectly own (within the meaning of section 958(a)(2)) his stock (73 days) bears to the entire taxable year (365 days) (60 percent of ($100×73/365))	12	
(iii) Amount of reduction (lesser of (i) or (ii))		12
A's pro rata share of Subpart F income as determined under section 951 (a)(2)		36

(c) *Limitation on a United States shareholder's pro rata share of previously excluded subpart F income withdrawn from investments*—(1) *Investments in less developed countries.* For purposes of paragraph (a)(2)(ii) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in less developed countries for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3), as in effect before the enactment of the Tax Reduction Act of 1975, and paragraph (c) of § 1.955–1) for such taxable year as the part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of § 1.955–1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(2) *Investments in foreign base company shipping operations.* For purposes of paragraph (a)(2)(iii) of this section, a United States shareholder's pro rata share (determined in accordance with the rules of paragraph (e) of this section) of the foreign corporation's previously excluded subpart F income withdrawn from investment in foreign base company shipping operations for the taxable year of such corporation shall not exceed an amount which bears the same ratio to such shareholder's pro rata share of such income withdrawn (as determined under section 955(a)(3) and paragraph (c) of § 1.955A–1) for such taxable year as the

part of such year during which such corporation is a controlled foreign corporation bears to the entire taxable year. See paragraph (c)(2) of § 1.955A–1 for a special rule applicable to exclusions and withdrawals occurring before the date on which the United States shareholder acquires his stock.

(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.* For taxable years of a controlled foreign corporation beginning on or after January 1, 2006, if a controlled foreign corporation has more than one class of stock outstanding and the corporation has earnings and profits and subpart F income for a taxable year attributable to a transaction described in section 304, and such transaction is part of a plan a principal purpose of which is the avoidance of Federal income taxation, the amount of such earnings and profits allocated to any one class of stock shall be that amount which bears the same ratio to the remainder of such earnings and profits 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 of the corporation, determined on the hypothetical distribution date.

(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.* For taxable years of a controlled foreign corporation beginning on or after January 1, 2006, if a controlled foreign corporation has one or more classes of preferred stock with cumulative dividend rights, such stock shall be considered for the purposes of this section as stock with discretionary distribution rights. As a result, the provisions of paragraph (e)(3)(ii) of this section shall apply for purposes of allocating earnings and profits to such stock, except that earnings and profits shall first be allocated to the stock under paragraph (e)(3)(i) of this section to the extent of any dividends paid with respect to the stock during the taxable year. Additional earnings and profits will be allocated to the stock only in an amount equal to the excess (if any) of the amount of earnings and profits allocated to the stock under paragraph (e)(3)(ii) of this section over the amount of such dividends. Notwithstanding the foregoing, if a class of redeemable preferred stock with cumulative dividend rights has a mandatory redemption date, and all dividend arrearages with respect to such stock compound at least annually at a rate that is not lower than the applicable Federal rate (as defined in section 1274(d)(1)) (AFR) that applies on the date the stock is issued for the term from such issue date to the mandatory redemption date, based on a comparable compounding assumption, such stock shall not be considered for purposes of this section as stock with discretionary distribution rights.

(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 × $100x) and Corp H's *pro rata* share of FC1's subpart F income is $40x (40 / 100 × $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 × $50x) to the Class A common shares and $15x (30 / 100 × $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 × $75x) to the Class A shares and $15x ($200 / $1,000 × $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 × $80x) to the preferred shares and $64x ($400x / $500x × $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 × $100x × 60) would be distributed with respect to FC9's preferred stock and $640x ($1,000x 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 × $500x) is allocated to the outstanding preferred stock and $320x ($640x / $1,000x × $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 × 15 / 60) + ($320x × 30 / 40)].

Example 9. (i) *Facts.* In 2006, FC10, a controlled foreign corporation within the meaning of section 957(a), 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 FC 11 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.

(ii) *Analysis.* 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. Under paragraph (e)(3)(v) of this section, 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

× $5000x = $833x) of these earnings and profits is allocated to FC10's common stock and $4167x (5/6 × $5000x = $4167x) is allocated to its preferred stock.

(7) *Effective dates.* Except as provided in paragraphs (e)(3)(v) and (e)(4)(ii) of this section, 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.

(f) *Determination of holding period.* For purposes of sections 951 through 964, the holding period of an asset (including stock of a controlled foreign corporation) shall be determined by excluding the day on which such asset is acquired and including the day on which such asset is disposed of. The application of this paragraph may be illustrated by the following example:

Example. On June 30, 1963, United States person E acquires 70 of the 100 shares of the only class of stock of foreign corporation A from nonresident alien B, who until such time owns all such 100 shares. E sells 10 shares of stock of such corporation on November 30, 1963, and 60 shares on December 31, 1963, to nonresident alien F. Corporation A is a controlled foreign corporation for the period beginning with July 1, 1963, and extending through December 31, 1963. As to the 10 shares of stock sold on November 30, 1963, E is treated as not owning such shares at any time after November 30, 1963, nor before July 1, 1963. As to the remaining 60 shares of stock, E is treated as not owning them before July 1, 1963, or after December 31, 1963.

(g) *United States shareholder defined*—(1) *In general.* For purposes of sections 951 through 964, the term ''United States shareholder'' means, with respect to a foreign corporation, a United States person (as defined in section 957(d)) who owns within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

(2) *Percentage of total combined voting power owned by United States person*—(i) *Meaning of combined voting power.* In determining for purposes of subparagraph (1) of this paragraph whether a United States person owns the requisite percentage of voting power of all classes of stock entitled to vote, consideration will be given to all the facts and circumstances in each case. In any case where—

(*a*) A foreign corporation has more than one class of stock outstanding, and

(*b*) One or more United States persons own (within the meaning of section 958) shares of any one class of stock which possesses the power to elect, appoint, or replace a person, or persons, who with respect to such corporation, exercise the powers ordinarily exercised by a member of the board of directors of a domestic corporation,

the percentage of the total combined voting power with respect to such corporation owned by any such United States person shall be his proportionate share of the percentage of the persons exercising the powers ordinarily exercised by members of the board of directors of a domestic corporation (described in (*b*) of this subdivision) which such class of stock (as a class) possesses the power to elect, appoint, or replace. In all cases, however, a United States person will be deemed to own 10 percent or more of the total combined voting power with respect to a foreign corporation if such person owns (within the meaning of section 958) 20 percent or more of the total number of shares of a class of stock of such corporation possessing one or more powers enumerated in paragraph (b)(1) of § 1.957–1. Whether a foreign corporation is a controlled foreign corporation for purposes of sections 951 through 964 shall be determined by applying the rules of section 957 and §§ 1.957–1 through 1.957–4.

(ii) *Illustration.* The application of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation S has two classes of capital stock outstanding, consisting of 60 shares of class A stock and 40

shares of class B stock. Each class of the outstanding stock is entitled to participate on a share for share basis in any dividend distributions by S Corporation. The owners of a majority of the class A stock are entitled to elect 7 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 3 of the 10 directors. Thus, the class A stock (as a class) possesses 70 percent of the total combined voting power of all classes of stock entitled to vote of S Corporation, and the class B stock (as a class) possesses 30 percent of such voting power. D, a United States person, owns 31 shares of the class A stock and thus owns 36,167 percent (31/60×70 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. By reason of the ownership of such voting power, D is a United States shareholder of S Corporation under section 951(b). For purposes of section 957, S Corporation is a controlled foreign corporation by reason of D's ownership of a majority of the class A stock, as illustrated in example 2 of paragraph (c) of §1.957–1. E, a United States person, owns eight shares of the class A stock and thus owns 9.333 percent (8/60×70 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. Since E owns only 9.333 percent of such voting power and less than 20 percent of the number of shares of the class A stock, he is not a United States shareholder of S Corporation under section 951(b). F, a United States person, owns 14 shares of the class B stock and thus owns 10.5 percent (14/40×30 percent) of the total combined voting power of all classes of stock entitled to vote of S Corporation. By reason of the ownership of such voting power, F is a United States shareholder of S Corporation under section 951(b).

Example 2. Foreign corporation R has three classes of stock outstanding, consisting of 10 shares of class A stock, 20 shares of class B stock, and 300 shares of class C stock. Each class of the outstanding stock is entitled to participate on a share for share basis in any distribution by R Corporation. The owners of a majority of the class A stock are entitled to elect 6 of the 10 corporate directors, and the owners of a majority of the class B stock are entitled to elect the other 4 of the 10 directors. The class C stock is not entitled to vote. D, E, and F, United States persons, each own 2 shares of the class A stock and 100 shares of the class C stock. As owners of a majority of the class A stock, D, E, and F elect 6 members of the board of directors. D, E, and F are United States shareholders of R Corporation under section 951(b) since each owns 20 percent of the total number of shares of the class A stock which possesses the power to elect a majority of the board of directors of R Corporation. For purposes of section 957, R Corporation is a controlled foreign corporation by reason of the ownership by D, E, and F of a majority of the class A stock, as illustrated in example 2 of paragraph (c) of §1.957–1.

[T.D. 6795, 30 FR 935, Jan. 29, 1965, as amended by T.D. 7893, 48 FR 22507, May 19, 1983; T.D. 9222, 70 FR 49866, Aug. 25, 2005; 70 FR 67906, Nov. 9, 2005; T.D. 9251, 71 FR 8944, Feb. 22, 2006]

§ 1.951–2 Coordination of subpart F with election of a foreign investment company to distribute income.

A United States shareholder who for his taxable year is a qualified shareholder (within the meaning of section 1247(c)) of a foreign investment company with respect to which an election under section 1247(a) and the regulations thereunder is in effect for the taxable year of such company which ends with or within such taxable year of such shareholder shall not be required to include any amount in his gross income for his taxable year under paragraph (a) of §1.951–1 with respect to such company for that taxable year of such company.

[T.D. 6795, 30 FR 937, Jan. 29, 1965]

§ 1.951–3 Coordination of subpart F with foreign personal holding company provisions.

A United States shareholder (as defined in section 951(b)) who is required under section 551(b) to include in his gross income for his taxable year his share of the undistributed foreign personal holding company income for the taxable year of a foreign personal holding company (as defined in section 552) which for that taxable year is a controlled foreign corporation (as defined in section 957) shall not be required to include in his gross income for his taxable year under section 951(a) and paragraph (a) of §1.951–1 any amount attributable to the earnings and profits of such corporation for that taxable year of such corporation. If a foreign corporation is both a foreign personal holding company and a controlled foreign corporation for the same period which is only a part of its taxable year, then, for purposes of applying the immediately preceding sentence, such corporation shall be deemed to be, for such part of such year, a foreign personal holding company and not a controlled foreign corporation and the