within the United States and is, therefore, included in gross income as income from sources within the United States. The balance of A's compensation as an employee of Corp N, $105,000 (which includes the $30,000 in fringe benefits that are attributable to the location of A's principal place of work in Country X), is compensation attributable to the final three quarters of her taxable year. During those three quarters, A's periodic performance of services in the United States does not result in distinct, separate, and continuous periods of time. Of the $75,000 paid for annual salary, $12,500 (30/180 x $75,000) is compensation that was attributable to the labor or personal services performed within the United States and $62,500 (150/180 x $75,000) is compensation that was attributable to the labor or personal services performed outside the United States. Pursuant to paragraphs (b)(2)(ii)(B) and (D)(*1*) and (*3*) of this section, A sourced the $25,000 received for the housing fringe benefit and the $5,000 received for the local transportation fringe benefit based on the location of her principal place of work, Country X. Accordingly, A included the $30,000 in fringe benefits in her gross income as income from sources without the United States.

Example 4. Same facts as in *Example 3.* Of the 150 days during which A performed services in Country X and in other foreign countries (during the final three quarters of A's taxable year), she performed 30 days of those services in Country Y. Country Y is a country designated by the Secretary of State as a place where living conditions are extremely difficult, notably unhealthy, or where excessive physical hardships exist and for which a post differential of 15 percent or more would be provided under section 5925(b) of Title 5 of the U.S. Code to any officer or employee of the U.S. government present at that place. Corp N has a policy of paying its employees a $65 premium per day for each day worked in countries so designated. The $65 premium per day does not exceed the maximum amount that the U.S. government would pay its officers or employees stationed in Country Y. Because A performed services in Country Y for 30 days, she earned additional compensation of $1,950. The $1,950 is considered a hazardous duty or hardship pay fringe benefit and is sourced under paragraphs (b)(2)(ii)(B) and (D)(*5*) of this section based on the location of the hazardous or hardship duty zone, Country Y. Accordingly, A included the amount of the hazardous duty or hardship pay fringe benefit ($1,950) in her gross income as income from sources without the United States.

Example 5. (i) During 2006 and 2007, Corp P, a domestic corporation, employed four United States citizens, E, F, G, and H to work in its manufacturing plant in Country V. As part of his or her compensation package, each employee arranged for local transportation unrelated to Corp P's business needs. None of the local transportation fringe benefit is excluded from the employee's gross income as a qualified transportation fringe benefit under section 132(a)(5) and (f).

(ii) Under the terms of the compensation package that E negotiated with Corp P, Corp P permitted E to use an automobile owned by Corp P. In addition, Corp P agreed to reimburse E for all expenses incurred by E in maintaining and operating the automobile, including gas and parking. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(*3*) of this section, E's compensation with respect to the fair rental value of the automobile and reimbursement for the expenses E incurred is sourced under paragraphs (b)(2)(ii)(B) and (D)(*3*) of this section based on E's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in E's gross income as income from sources without the United States.

(iii) Under the terms of the compensation package that F negotiated with Corp P, Corp P let F use an automobile owned by Corp P. However, Corp P did not agree to reimburse F for any expenses incurred by F in maintaining and operating the automobile. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(*3*) of this section, F's compensation with respect to the fair rental value of the automobile is sourced under paragraphs (b)(2)(ii)(B) and (D)(*3*) of this section based on F's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in F's gross income as income from sources without the United States.

(iv) Under the terms of the compensation package that G negotiated with Corp P, Corp P agreed to reimburse G for the purchase price of an automobile that G purchased in Country V. Corp P did not agree to reimburse G for any expenses incurred by G in maintaining and operating the automobile. Because the cost to purchase an automobile is not a local transportation fringe benefit as defined in paragraph (b)(2)(ii)(D)(*3*) of this section, the source of the compensation to G will be determined pursuant to paragraph (b)(2)(ii)(A) or (C) of this section.

(v) Under the terms of the compensation package that H negotiated with Corp P, Corp P agreed to reimburse H for the expenses that H incurred in maintaining and operating an automobile, including gas and parking, which H purchased in Country V. Provided that the local transportation fringe benefit meets the requirements of paragraph (b)(2)(ii)(D)(*3*) of this section, H's compensation with respect to the reimbursement for the expenses H incurred is sourced under paragraphs (b)(2)(ii)(B) and (D)(*3*) of this section based on H's principal place of work in Country V. Thus, the local transportation fringe benefit will be included in H's gross income as income from sources without the United States.

Example 6. (i) On January 1, 2006, Company Q compensates employee J with a grant of options to which section 421 does not apply that do not have a readily ascertainable fair market value when granted. The stock options permit J to purchase 100 shares of Company Q stock for $5 per share. The stock options do not become exercisable unless and until J performs services for Company Q (or a related company) for 5 years. J works for Company Q for the 5 years required by the stock option grant. In years 2006–08, J performs all of his services for Company Q within the United States. In 2009, J performs ½ of his services for Company Q within the United States and ½ of his services for Company Q without the United States. In year 2010, J performs his services entirely without the United States. On December 31, 2012, J exercises the options when the stock is worth $10 per share. J recognizes $500 in taxable compensation (($10–$5) X 100) in 2012.

(ii) Under the facts and circumstances, the applicable period is the 5-year period between the date of grant (January 1, 2006) and the date the stock options become exercisable (December 31, 2010). On the date the stock options become exercisable, J performs all services necessary to obtain the compensation from Company Q. Accordingly, the services performed after the date the stock options become exercisable are not taken into account in sourcing the compensation from the stock options. Therefore, pursuant to paragraph (b)(2)(ii)(A), since J performs 3½ years of services for Company Q within the United States and 1½ years of services for Company Q without the United States during the 5-year period, 7/10 of the $500 of compensation (or $350) recognized in 2012 is income from sources within the United States and the remaining 3/10 of the compensation (or $150) is income from sources without the United States.

* * * * *

(d) *Effective date.* * * * The first sentence of § 1.861–4(a)(1) and § 1.861–4(b) apply to taxable years beginning on or after publication of the Treasury Decision adopting these rules as final regulations in the **Federal Register**.

Mark E. Matthews,

Deputy Commissioner for Services and Enforcement.

[FR Doc. 04–17813 Filed 8–5–04; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–129771–04]

RIN 1545–BD49

Guidance Under Section 951 for Determining Pro Rata Share

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under section 951(a) of the Internal Revenue Code (Code) that provide guidance for determining a United States shareholder's *pro rata* share of a controlled foreign corporation's (CFC's) subpart F income, previously excluded subpart F income withdrawn from

investment in less developed countries, previously excluded subpart F income withdrawn from foreign base company shipping operations, and amounts determined under section 956. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by November 4, 2004. Outlines of topics to be discussed at the public hearing scheduled for Thursday, November 18, 2004, at 10 a.m. must be received by November 4, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–129771–04), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–129771–04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at *http://www.irs.gov/regs* or via the Federal eRulemaking Portal at *http://www.regulations.gov* (IRS and REG–129771–04). If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Jonathan A. Sambur, (202) 622–3840; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya Cruse (202) 622–4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 951(a) of the Code relating to the determination of a United States shareholder's *pro rata* share of a CFC's subpart F income, previously excluded subpart F income withdrawn from investment in less developed countries, previously excluded subpart F income withdrawn from foreign base company shipping operations, and amounts determined under section 956 (collectively, section 951(a)(1) amounts).

In general, section 951(a)(1) requires a United States shareholder that owns stock in a CFC to include its pro rata share of such section 951(a)(1) amounts in its gross income. *Pro rata* share is defined in section 951(a)(2) of the Code as the amount:

(A) 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 its taxable year, on which the corporation is a [CFC] it had distributed *pro rata* to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a [CFC] bears to the entire year, reduced by

(B) The amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) 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 year.

The current regulations provide rules for determining a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts in the case where the CFC has more than one class of stock outstanding. These regulations have remained unchanged since 1965. In the 39 years since the rules were issued, international business arrangements have become much more complex than contemplated in 1965, reflecting in particular more complex structures for determining return on capital. The current regulations do not take into account these developments. The IRS and Treasury Department, therefore, believe that updated guidance is necessary to ensure results that are more consistent with the economic interests of shareholders in a CFC.

Explanation of Provisions

A. In General

Section 1.951–1(e) defines *pro rata share* for purposes of section 951(a) of the Code. These proposed regulations replace existing § 1.951–1(e)(2) through (4) and are intended to provide allocations that are more consistent with the economic interests of shareholders in a CFC. The proposed regulations also include a conforming change to § 1.951–1(e)(1) to reflect the 1993 legislative amendment to section 956 of the Code.

B. Pro Rata Share Rules for CFCs With Only One Class of Stock

Proposed § 1.951–1(e)(2) adds an explicit rule to clarify the method by which a United States shareholder's pro rata share of a CFC's section 951(a)(1) amounts is determined in the case where the CFC has only one class of stock outstanding. In such a case, each United States shareholder's share of the CFC's section 951(a)(1) amounts shall be determined on a per share basis. *Example 1* of proposed § 1.951–1(e)(6) illustrates the application of this rule.

C. Pro Rata Share Rules for CFCs With More Than One Class of Stock

1. In General

Proposed § 1.951–1(e)(3) provides rules for determining a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts in the case where the CFC has more than one class of stock outstanding. Proposed § 1.951–1(e)(3)(i) retains the general rule in the current regulations, which provides that the amount of subpart F income, withdrawals, or amounts determined under section 956 which shall be taken into account with respect to any one class of stock shall be that amount which bears the same ratio to the total of such subpart F income, withdrawals, or amounts determined under section 956 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 were distributed on the last day of such corporation's taxable year on which such corporation is a CFC (the hypothetical distribution date) bear to the total earnings and profits of such corporation for such taxable year. *Examples 2* and *8* of proposed § 1.951–1(e)(6) illustrate the application of this general rule.

This general rule applies in cases where a CFC has more than one class of stock outstanding and where the allocation of the amount of the CFC's earnings and profits between or among different classes of stock does not depend upon the exercise of discretion by the board of directors or similar governing body of the CFC. The IRS and Treasury Department believe that this general rule, in practice, will apply in most cases in which a CFC has more than one class of stock outstanding.

2. Discretionary Power To Allocate Earnings to Different Classes of Stock

In the case where the allocation of the amount of a CFC's earnings and profits for the taxable year between two or more classes of stock depends upon the exercise of discretion by the board of directors or a similar governing body of the CFC, proposed § 1.951–1(e)(3)(ii)(A) provides a new general rule that determines the pro rata share of the CFC's section 951(a)(1) amounts. This new general rule allocates earnings and profits to classes of shares with discretionary distribution rights by reference to the relative values of such classes of shares on the hypothetical distribution date. Under this new rule, the allocation of earnings and profits to each class of stock with discretionary distribution rights generally will be the amount of earnings and profits that

bears the same ratio to the total earnings and profits allocated to all classes of stock with discretionary distribution rights as the value of all shares of such class determined on the hypothetical distribution date bears to the total value of all classes of stock with discretionary distribution rights. This allocation approach is analogous to the approach used for allocating adjustments among classes of stock for consolidated return purposes. *See* § 1.1502–32(c). For guidance with respect to the valuation of stock, see, *e.g., Framatome Connectors USA, Inc.* v. *Comm'r,* 118 T.C. 32 (2002) (establishing factors to be used to value stock of a CFC for purposes of determining whether the foreign corporation was a CFC pursuant to the value test in section 957(a)(2)); compare Rev. Rul. 59–60, 1959–1 C.B. 237 (valuing privately held stock for estate tax purposes). (*See* § 601.601(d)(2)(ii)(*b*)). In cases where the value of each share of two or more classes of stock with discretionary distribution rights is substantially the same, the allocation of earnings and profits to each class of stock shall be made as if such classes constituted one class of stock. *Examples 3* and *4* of proposed § 1.951–1(e)(6) illustrate the application of these rules.

The general rules of proposed § 1.951–1(e)(3)(i) and (ii)(A) both apply in certain cases where a CFC has more than two classes of stock outstanding. Specifically, these rules both apply where a CFC has at least two classes of stock with discretionary distribution rights and at least one class of stock with non-discretionary distribution rights. In general, a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts is determined by allocating earnings and profits to classes of shares with non-discretionary distribution rights (*e.g.*, nonparticipating preferred stock) in accordance with the rules of proposed paragraph (e)(3)(i), and then allocating the remaining earnings and profits, if any, to each remaining class of stock in accordance with the relative value rules of proposed paragraph (e)(3)(ii)(A).

The new rule in proposed § 1.951–1(e)(3)(ii)(A) is intended to ensure that the determination of a United States shareholder's pro rata share of a CFC's section 951(a)(1) amounts in cases where the United States shareholder's stock has discretionary distribution rights properly reflects the true economics of the shareholder's investment in the CFC. The IRS and Treasury Department believe that in the case of multiple classes of stock with discretionary distribution rights, the relative value of the classes of stock better reflects the economics of the investment in a CFC, and thus provides a better mechanism for determining a United States shareholder's *pro rata* share of a CFC's section 951(a)(1) amounts.

Proposed § 1.951–1(e)(3)(ii)(B) provides that the right to redeem stock of a CFC will not be considered a discretionary distribution right for purposes of determining a shareholder's *pro rata* share under proposed § 1.951–1(e)(3)(ii)(A), even if the resulting redemption would be treated as a distribution of property to which section 301 applies pursuant to section 302(d). *Example 7* of proposed § 1.951–1(e)(6) illustrates the application of this rule.

3. Special Allocation Rule for Stock With Mixed Distribution Rights

Proposed § 1.951–1(e)(3)(iii) provides a specific rule that applies the general rules of proposed § 1.951–1(e)(3)(i) and (ii)(A) in cases where a class of stock provides for both non-discretionary distribution rights and discretionary distribution rights (*e.g.*, participating preferred stock). In such a case, the proposed regulations require separate allocations of earnings and profits based upon the non-discretionary distribution rights and the relative value of the discretionary distribution rights. *Example 5* of proposed § 1.951–1(e)(6) illustrates the application of this rule.

4. Dividend Arrearages

Proposed § 1.951–1(e)(3)(iv) retains the existing rule with respect to arrearages in dividends with respect to classes of preferred stock of the CFC. The earnings and profits for the taxable year shall be attributable to such arrearage only to the extent the arrearage exceeds the earnings and profits remaining from prior taxable years beginning after December 31, 1962.

D. Scope of Deemed Distribution

Proposed § 1.951–1(e)(4) sets forth a special rule that provides that no amount shall be considered to be distributed with respect to a particular class of stock under proposed § 1.951–1(e)(3) to the extent that such a distribution would constitute a distribution in redemption of stock, a distribution in liquidation, or a return of capital. This rule would apply notwithstanding the terms of any class of stock of the CFC or any arrangement involving the CFC. Thus, for purposes of determining the allocation of earnings and profits to a class of stock of a CFC based on the earnings and profits which would be distributed with respect to such class of stock if all earnings and profits were distributed *pro rata* to its shareholders on the hypothetical distribution date, taxpayers may not consider any part of the hypothetical distribution as 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. The IRS and Treasury Department believe that such characterizations of the hypothetical distribution would not properly reflect a United States shareholder's economic interest in the CFC and thus should not be considered in determining a United States shareholder's *pro rata* share of section 951(a)(1) amounts. *Example 7* of proposed § 1.951–1(e)(6) illustrates the application of this rule.

E. Restrictions or Other Limitations on Distributions of Earnings and Profits by a CFC

Proposed § 1.951–1(e)(5) provides that, except in the case of a governmental restriction described in section 964(b) of the Code, a restriction or other limitation on the distribution of earnings and profits to a United States shareholder by a CFC will not be taken into account for purposes of determining the amount of earnings and profits allocated to a class of stock of a CFC or the amount of the United States shareholder's *pro rata* share of the CFC's section 951(a)(1) amounts. This rule applies in all cases, including cases where the restriction or limitation is the result of an arrangement between unrelated parties or an arrangement that has a non-tax motivated business purpose and economic substance. The IRS and Treasury Department believe that taking into account such restrictions or limitations in determining a United States shareholder's *pro rata* share is contrary to the purpose of section 951(a) and would not properly reflect a United States shareholder's economic interest in the CFC. *Example 6* of proposed § 1.951–1(e)(6) illustrates the application of this rule.

Proposed § 1.951–1(e)(5)(ii) provides a broad definition of *restrictions or other limitations on distributions* that are covered by this rule. Under proposed § 1.951–1(e)(5)(iii), the right to receive a preferred dividend is not considered a restriction or other limitation on the distribution of earnings and profits with respect to other classes of stock. Proposed § 1.951–1(e)(5)(iv) lists some instances where restrictions or other limitations will not be taken into account.

Proposed Effective Date

These regulations are proposed to apply for taxable years of a controlled foreign corporation beginning on or after January 1, 2005.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing has been scheduled for November 18, 2004, at 10 a.m. in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, *see* the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 4, 2004. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Comments are requested on all aspects of the proposed regulations, including those aspects for which specific requests for comments are set forth above.

Drafting Information

The principal author of these regulations is Jonathan A. Sambur, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.951–1 is amended by:

1. Removing the language ''increase in earnings invested in United States property'' in paragraph (e)(1) and adding ''amount determined under section 956'' in its place.

2. Revising paragraphs (e)(2) through (e)(4) and adding paragraphs (e)(5) through (e)(7).

The revisions and additions read as follows:

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

* * * * *

(e) * * *

(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, withdrawal, or amount determined under section 956, 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) and (e)(3)(iii) 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, withdrawal, or amount determined under section 956, 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, withdrawal, or amount determined under section 956 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 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.

(4) *Scope of deemed distribution.* 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 with respect to a particular class of stock for purposes of paragraph (e)(3) of this section to the extent that such distribution 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)), as a distribution in liquidation, or as a return of capital.

(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, withdrawal, or amounts determined under section 956 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 2004 taxable year. For 2004, 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 2004, 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 2004 taxable year. For 2004, FC1 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 2004, 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, 2004, $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 2004.

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 2004 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 2004 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 2004, the Class A common shares had a value of $9.71x/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 2004, 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 2004, 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 2004 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 2004. For 2004, 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 2004, 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, 2004, $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 2004. Therefore for FC3's taxable year 2004, 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 2004 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 2004 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. FC4 and Corp E each use the calendar year as a taxable year. Corp E and FC5 are shareholders of FC4 for all of 2004. For 2004, 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 2004, 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, 2004, $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 shareholders 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 2004, 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 2004. For 2004, 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 2004, 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, 2004, $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 2004.

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 2004. For 2004, 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 United States shareholder under section 951(a). In 2004, 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, 2004, $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 2004.

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 2004. The remaining 10 common shares and 45 preferred shares of FC9 are owned by Foreign Individual N, a foreign individual. Individual J and Individual N are shareholders of FC9 for all of 2004. For taxable year 2004, 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, 2004, $360x ($0.06 \times \$100x \times 60$) 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 \times \$500x$) is allocated to the outstanding preferred stock and $320x ($\$640x/\$1,000x \times \$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 2004 is $285x [($\$180x \times 15/60$)+($\$320x \times 30/40$)].

(7) *Effective date.* These regulations apply for taxable years of a controlled foreign corporation beginning on or after January 1, 2005.

Approved: July 16, 2004.

Nancy Jardini,

Acting Deputy Commissioner for Services and Enforcement.

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ENVIRONMENTAL PROTECTION AGENCY

40 CFR Parts 51, 72, 73, 74, 77, 78, and 96

[OAR–2003–0053; FRL–7794–4]

RIN 2060–AL76

Availability of Additional Information Supporting the Rule To Reduce Interstate Transport of Fine Particulate Matter and Ozone (Clean Air Interstate Rule)

AGENCY: Environmental Protection Agency (EPA).

ACTION: Notice of data availability for the Clean Air Interstate Rule (CAIR).

SUMMARY: The EPA is providing notice that it has placed in the docket for the CAIR (Docket No. OAR–2003–0053) additional information relevant to the rulemaking, including, among other things, a new modeling platform that EPA proposes to use to support the proposed rule. This new modeling platform consists of new meteorological data, updated emissions data, an updated air quality model, and revised procedures for projecting future air quality concentrations. The additional information also includes revised state NO_X budgets.

DATES: Documents were placed in the CAIR docket on or about July 27, 2004. Comments must be received on or before August 27, 2004. Please refer to **SUPPLEMENTARY INFORMATION** for additional information on the comment period.

ADDRESSES: Submit your comments, identified by Docket ID No. OAR–2003–0053, by one of the following methods:

A. Federal Rulemaking Portal: *http://www.regulations.gov.* Follow the on-line instructions for submitting comments.

B. Agency Web site: *http://www.epa.gov/edocket.* EDOCKET, EPA's electronic public docket and comment system, is EPA's preferred method for receiving comments. Follow the on-line instructions for submitting comments.

C. E-mail: *A-and-R-Docket@epa.gov*

D. Mail: Air Docket, Clean Air Interstate Rule, Environmental Protection Agency, Mail Code: 6102T, 1200 Pennsylvania Ave., NW., Washington, DC 20460.

E. Hand Delivery: EPA Docket Center, 1301 Constitution Avenue, NW., Room B108, Washington, DC. Such deliveries are only accepted during the Docket's normal hours of operation, and special arrangements should be made for deliveries of boxed information.

Instructions: Direct your comments to Docket ID No. OAR–2003–0053. The EPA's policy is that all comments received will be included in the public docket without change and may be made available online at *http://www.epa.gov/edocket,* including any personal information provided, unless the comment includes information claimed to be Confidential Business Information (CBI) or other information whose disclosure is restricted by statute. Do not submit information that you consider to be CBI or otherwise protected through EDOCKET, *regulations.gov,* or e-mail. The EPA EDOCKET and the Federal *regulations.gov* Web sites are ''anonymous access'' systems, which means EPA will not know your identity or contact information unless you provide it in the body of your comment. If you send an e-mail comment directly to EPA without going through EDOCKET or *regulations.gov,* your e-mail address will be automatically captured and included as part of the comment that is placed in the public docket and made available on the Internet. If you submit an electronic comment, EPA recommends that you include your name and other contact information in the body of your comment and with any disk or CD-ROM you submit. If EPA is unable to read your comment and contact you for clarification due to technical difficulties, EPA may not be able to consider your comment. Electronic files should avoid the use of special characters, any form of encryption, and