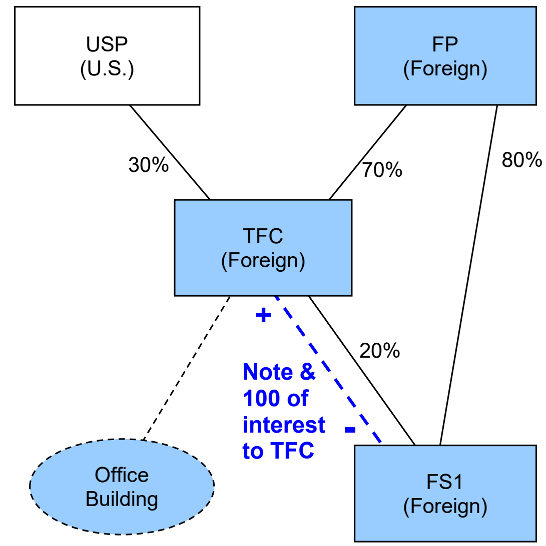
Prop. Reg. 1.1297-1(d)(2)(iv), Example

PFIC Testing: Dual Character Assets (Stock, a Note & a Building) Each Treated As Two Assets

USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 20% of the value of FS1, a foreign corporation, and FP owns the remaining 80% of the value of FS1. FP, TFC, and FS1 are not controlled foreign corporations within the meaning of section 957(a), and each has a calendar year taxable year. For purposes of section 1297(b)(2)(C), FP is a “related person” with respect to TFC because FP owns more than 50% of the vote or value of TFC, and FS1 is a “related person” with respect to TFC because FP owns more than 50% of the vote or value of both TFC and of FS1.

During Year 3, FP has only passive income, and FS1 has passive income of $200x and non-passive income of $800x. FS1 does not pay dividends during Year 3, but did pay $100x of dividends in Year 2 and $300x of dividends in Year 1. In Year 2, FS1 had current earnings and profits of $1000x, attributable to passive income of $100x and non-passive income of $900x; and, in Year 1, FS1 had current earnings and profits of $1000x, attributable to passive income of $500x and non-passive income of $500x. Throughout Year 3, TFC holds an obligation of FS1 with respect to which FS1 pays $100x of interest.

In addition to the stock in FS1 and the FS1 obligation, TFC holds an office building, 40% of which is rented to FP throughout Year 3 for $100x per quarter. For the first two quarters of Year 3, 60% of the office building is used by TFC in a trade or business generating non-passive income. For the last two quarters of Year 3, 60% of the office building is rented to an unrelated person for $300x per quarter, and TFC's own officers or staff of employees regularly perform active and substantial management and operational functions while the property is leased.



40% rented to FP all year (400). 60% used in TFCs business for the first two quarters & rented to an unrelated party for the last two quarters (600).

	Pass. / Nonp.	Div.
Yr. 1 pass. inc.	500 / 500	300
Yr. 2 pass. inc.	100 / 900	100
Yr. 3 pass. inc.	200 / 800	0

Under Reg. 1.1297(c)(3)(ii), the dividends paid by FS1 in Year 2 were characterized as 10% passive income and 90% non-passive income. Under Reg. 1.1297(c)(3)(ii), the dividends paid by FS1 in Year 1 were characterized as 50% passive income and 50% non-passive income. Accordingly, the average percentage of dividends for the previous two taxable years that were characterized as passive income is 40% (((10% × $100x) + (50% × $300x))/($100 × + $300x)), and the average percentage of dividends characterized as non-passive income is 60% (((90% × $100x) + (50% × $300x))/($100x + $300x)). Thus, under Reg. 1.1297(d)(2)(iii), 60% of each share of stock of FS1 is characterized as a non-passive asset and 40% is characterized as a passive asset for each quarter of Year 3 for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(2) Under Reg. 1.1297(c)(3)(i), the interest received by TFC from FS1 is characterized as 20% ($200x/($200x+$800x)) passive income and thus 80% non-passive income for purposes of applying section 1297(a)(1) to determine whether TFC is a PFIC. Accordingly, under Reg. 1.1297(d)(2)(i), 20% of the obligation of FS1 is characterized as a passive asset and 80% as a non-passive asset for each quarter of Year 3 for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(3) Under Reg. 1.1297(c)(3)(iii), the rent received from FP throughout Year 3 is characterized as 100% passive income. Under Reg. 1.1297(c)(1)(i)(A) and section 954(c)(2)(A), the rent received from the unrelated person during the last two quarters is characterized as 100% non-passive income. Accordingly, under Reg. 1.1297(d)(2)(i), 40% (($100x × 4)/(($100x × 4) + ($300x × 2))) of the office building is a passive asset, and 60% (($300x × 2)/(($100x × 4) + ($300x × 2))) is a non-passive asset for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC. Reg. 1.1297(d)(2)(ii) does not apply because both portions of the office building generate income during Year 3.