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.

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))/($100x + $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.

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