

**Internal Revenue Service**

Department of the Treasury

Washington, DC 20224

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CC:INTL:Br2, PLR-126245-00

Date:

March 9, 2001

Number: **200124016**  
Release Date: 6/15/2001  
Index Number: 1291.06-02, 1297.02-00

LEGEND:

Individual A                    =  
Trust A                         =  
Trust B                         =  
FC                                =

Dear

This private letter ruling is in response to your request dated November 13, 2000, for a ruling that Individual A is eligible to make the deemed dividend election under section 1298(b)(1) to terminate FC's status as a passive foreign investment company (PFIC) with respect to Individual A's holding period of FC's stock beginning after December 31, 1997, in which FC was both a PFIC and controlled foreign corporation (CFC). Individual A proposes to file an amended income tax return for the taxable year that includes December 31, 1997, to make the election.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer, and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of this request for ruling, such material is subject to verification upon examination.

FC is a foreign corporation organized under the laws of Switzerland. Individual A, a U.S. citizen, owns 42 percent of the outstanding common stock of FC through Trust A, a U.S. grantor trust. Individual A's brother, a U.S. citizen, also owns 42 percent of the outstanding common stock of FC through his own U.S. grantor trust. Trust B, a U.S. trust of which Individual A and her brother are the sole beneficiaries, owns the remaining 16 percent of the common stock of FC and 90 percent of FC's outstanding preferred stock. Former employees (or parties related to former employees) that are

unrelated to Individual A or her family own the remaining 10 percent of FC's preferred stock.

Since 1974, FC has primarily held passive assets consisting of securities, gold coins and cash. FC uses a fiscal year ending November 30<sup>th</sup>, and for taxable years beginning after December 31, 1986, FC was a PFIC within the meaning of section 1297(a).<sup>1</sup>

FC is also a CFC under section 957(a)(1) because more than 50% of the total combined voting power of all classes of FC stock is owned by United States shareholders. Section 951(b) defines a United States shareholder as any United States person that owns more than 10% of the total combined voting power of all classes of stock entitled to vote in a CFC. Individual A is a United States shareholder of FC because she owns more than 10 percent of the voting power of FC.

Section 1297(e) provides that, if a foreign corporation is both a PFIC and a CFC, the foreign corporation will not be treated as a PFIC with respect to a shareholder during the qualified portion of the shareholder's holding period with respect to the stock in the foreign corporation. Section 1297(e)(2) defines "qualified portion" as that portion of the shareholder's holding period which is after December 31, 1997, and during which the shareholder is a United States shareholder (as defined in section 951(b)) of the foreign corporation and such corporation is a CFC. Therefore, under section 1297(e), FC will not be treated as a PFIC with respect to Individual A for that portion of her holding period beginning after December 31, 1997, and during which FC is a CFC.

Section 1298(b)(1) provides that stock in a foreign corporation held by a taxpayer is treated as stock in a PFIC if, at any time during the holding period of the taxpayer with respect to such stock, the corporation (or any predecessor) was a PFIC that was not a qualified electing fund (QEF) ("once a PFIC, always a PFIC" rule). Since FC was treated as a PFIC with respect to a portion of Individual A's holding period of such stock (i.e. January 1, 1987 through December 31, 1997), section 1298(b)(1) applies to treat FC stock as stock in a PFIC notwithstanding section 1297(e).

However, section 1298(b)(1) provides that the "once a PFIC, always a PFIC" rule will not apply if the taxpayer elects to recognize gain (as of the last day of the last taxable year for which the company was a PFIC) under rules similar to the rules of section 1291(d)(2). Thus, the stock of FC continues to be treated as PFIC stock with respect to Individual A after December 31, 1997, unless Individual A makes the election under section 1298(b)(1) to recognize gain under rules similar to the rules of section 1291(d)(2). See section 1297(e)(3)(B).

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<sup>1</sup> Pub.L. No. 105-34, Sec. 1121, (1997) redesignated the provisions contained under section 1296 of the Code as section 1297, and redesignated the provisions under section 1297 as section 1298, effective as of August 5, 1997. For purposes of this document, the former section 1296 will be referred to herein as section 1297, and the former section 1297 will be referred to as section 1298.

The language of section 1298(b)(1) is ambiguous because it refers only to the election to recognize gain but cites section 1291(d)(2) which contains both the election to recognize gain (i.e. deemed sale) and the election to include in income the post-1986 earnings and profits of the foreign corporation as a dividend (i.e. deemed dividend). The legislative history of section 1297(e), however, provides that

[i]f a shareholder of a PFIC is subject to the rules applicable to nonqualified funds before becoming eligible for the special rules provided under the proposal for shareholders that are subject to subpart F, the stock held by such shareholder continues to be treated as PFIC stock unless the shareholder makes an election to pay tax and an interest charge with respect to the unrealized appreciation in the stock or the *accumulated earnings of the corporation* (emphasis added).

S. Rep. No. 105-33, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 95 (1997). See also H. Rep. No. 105-148, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 534 (1997).

In addition, the Joint Committee explanation of the provisions of section 1297(e) expressly provides:

Pursuant to section 1291(d)(2), the shareholder may elect either to recognize gain as if such stock were sold or, in the case of a CFC, to include in income the post-1986 earnings and profits of the corporation attributable to the stock.

Staff of the Joint Committee on Taxation, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess 310, General Explanation of Tax Legislation Enacted in 1997. Thus, the legislative history makes clear that a shareholder of a foreign corporation that is both a PFIC and CFC may make either the deemed sale or deemed dividend election to purge the PFIC taint for the nonqualified portion of its holding period of the stock of the foreign corporation.

Section 1291(d)(2)(B) and Treas. Reg. § 1.1291-9(a) provide rules for making the deemed dividend election for shareholders electing to treat the PFIC as a “pedigreed QEF” (i.e. a QEF that has been purged of the PFIC taint). Under these provisions, the shareholder of a foreign corporation elects to include in income, as a deemed dividend, its pro rata share of the post-1986 earnings and profits of the corporation attributable to the stock held by the shareholder on the qualification date, provided that on that date the corporation was both a PFIC and a CFC. The deemed dividend is taxed, under section 1291, as an excess distribution received on the qualification date. The excess distribution must be ratably allocated to those days in the shareholder’s holding period of the stock during which the foreign corporation was a PFIC.

For purposes of the deemed dividend inclusion, the post-1986 earnings and profits are the undistributed earnings and profits, within the meaning of section 902(c)(1), of the foreign corporation as of the day before the qualification date that were accumulated but not distributed in taxable years of the PFIC beginning after 1986 during which it was a PFIC. This determination is made without regard to whether the earnings relate to a

period during which the corporation was a CFC. Treas. Reg. § 1.1291-9(a)(2). The shareholder's pro rata share of the post-1986 earnings and profits does not include any amounts that were previously included in its income pursuant to another provision of the law. Treas. Reg. § 1.1291-9(a)(2)(ii)(B).

For purposes of an election under section 1298(b)(1), the "qualification date" is the termination date, as defined in Treas. Reg. § 1.1297-3T(a), which is the last day of the last taxable year of the foreign corporation during which it qualified as a PFIC. An election under section 1298(b)(1) is made in the time and manner prescribed in Treas. Reg. § 1.1297-3T(b).

Based on the facts presented, under section 1297(e), Individual A is eligible to apply the deemed dividend election rules of section 1291(d)(2)(B) to an election under section 1298(b)(1) with respect to the stock of FC that is owned through Trust A. As a result of this election, the FC stock held by Individual A, through Trust A, will not be treated as PFIC stock for Individual A's holding period beginning after December 31, 1997. Pursuant to this election, Individual A shall include in income as a dividend her pro rata share of the post-1986 earnings and profits of FC that is attributable to the FC stock held by Individual A through Trust A on the last day of the last taxable year during which FC qualified as a PFIC, December 31, 1997. For this purpose, FC's post-1986 earnings and profits will reflect reductions for previously taxed earnings and profits under Treas. Reg. § 1.1291-9(a)(2)(ii)(B). The procedures described under Temp. Reg. § 1.1297-3T(b) apply to Individual A's deemed dividend election, thus requiring the filing, within three years of the due date, as extended, an amended income tax return for Individual A's taxable year that includes December 31, 1997.

The ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter is to be attached to any return to which it is relevant with respect to a completed transaction.

In accordance with the power of attorney on file with this office, a copy of this ruling is forwarded to your representative.

Sincerely,

By: \_\_\_\_\_  
Valerie A. Mark  
Assistant to the Branch Chief, CC:INTL:Br2  
Office of Associate Chief Counsel (International)