

Notice of Proposed Rulemaking and Notice of Public Hearing

Electing Mark to Market for Marketable Stock

REG-112306-00

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains procedures for certain United States persons holding marketable stock in a passive foreign investment company (PFIC) to elect mark to market treatment for that stock under section 1296 and related provisions of sections 1291 and 1295. These proposed regulations affect United States persons owning marketable stock in a PFIC. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of oral comments to be presented at the public hearing scheduled for November 6, 2002, at 10 a.m., must be received by October 16, 2002.

ADDRESSES: Send submissions to: CC:IT&A:RU (REG-112306-00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:IT&A:RU (REG-112306-00), Courier's Desk, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: www.irs.gov/reg. The public hearing will be held in room 4718, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Mark Pollard at (202) 622-3850, concerning submissions and the hearing, Ms. Lanita

Vandyke (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Since the enactment of the Tax Reform Act of 1986, United States persons that own PFIC stock have been subject to two alternative tax regimes: the interest charge rules under section 1291 of the Internal Revenue Code (Code) and the qualified electing fund (QEF) rules under section 1293. Congress recognized that the interest charge rules are a substantial source of complexity for PFIC shareholders and that some shareholders would prefer the current inclusion method afforded by the QEF regime, but are unable to obtain the necessary information from the PFIC. See H.R. Rep. No. 105-148, at 533 (1997); S. Rep. No. 105-33 at 94 (1997). Accordingly, Congress enacted new section 1296 in the Taxpayer Relief Act of 1997 to provide shareholders with an alternative method to include income currently with respect to their interest in a PFIC by allowing them to elect to mark to market their PFIC stock provided the stock is marketable. In 1998, Congress enacted certain technical corrections to section 1296 and related provisions, including rules to address the overlap between the PFIC and other mark to market provisions in the Code. IRS Restructuring and Reform Act of 1998, section 6011(c).

Proposed § 1.1291-8 (INTL-656-87, 1992-1 C.B. 1124) had been published on April 1, 1992 (57 FR 11024). This proposed regulation would have provided an election for certain regulated investment companies (RICs) to use a mark to market method for their PFIC stock. Although § 1.1291-8 was originally proposed to be effective prospectively, the IRS subsequently notified taxpayers that the proposed regulations, when finalized, would permit this limited mark to market election to be made only for taxable years ending after March 31, 1992, and before April 1, 1993. Notice 92-53, 1992-2 C.B. 384. As a result of the enactment of section 1296, proposed § 1.1291-8 was withdrawn (64 FR 5015); see also Notice 99-14, 1999-1 C.B. 736.

On January 25, 2000, final regulations were published under section 1296(e) (2000 final regulations). T.D. 8867, 2000-1 C.B. 620 [65 FR 3817]. The 2000 final regulations provide guidance regarding the definition of marketable stock for purposes of section 1296.

In General

United States persons who own marketable stock (as defined in section 1296(e)) in a PFIC may elect to mark to market that stock annually pursuant to section 1296 (section 1296 election). United States persons making a section 1296 election with respect to PFIC stock (section 1296 stock) are not subject to the generally applicable interest charge regime of section 1291. The section 1296 election is available to United States persons and controlled foreign corporations (CFCs) that own, or are treated as owning, marketable stock in a PFIC.

Explanation of Provisions

A. Changes to Proposed § 1.1291-1(c): Coordination of PFIC Rules and other Mark to Market Provisions

Except for the coordination rules discussed herein, section 1291(d)(1) provides that the interest charge regime does not apply in the case of PFIC stock that is marked to market under (i) section 1296, or (ii) section 475 or any other provision of chapter 1 of the Code. This regulation revises § 1.1291-1(c), 57 FR 11024, proposed April 1, 1992, to incorporate this coordination rule and to clarify that the interest charge regime does not apply to a United States person that marks to market its PFIC stock under any provision of chapter 1 of the Code, without regard to whether such regime is mandatory or elective. Proposed § 1.1295-1(i)(3) and proposed § 1.1296-1(h)(3)(i) further clarify that, with respect to taxation under a mark to market provision other than under section 1296, this coordination rule applies without regard to whether the taxpayer also has made a section 1296 election or a QEF election with respect to such stock, by providing that either election is automatically terminated immediately following the close of the taxpayer's taxable year preceding the first taxable year for which the stock of the PFIC

is subject to the mark to market regime under another provision of chapter 1 of the Code.

The proposed regulations also provide a special rule for situations where a taxpayer owns PFIC stock that becomes subject to a mark to market regime other than section 1296 after the first taxable year of the taxpayer's holding period. In such instances, the taxpayer must apply the coordination rules of § 1.1291-1(c)(3)(ii) for the first taxable year that such other mark to market regime applies. Thereafter, the general rule above, overriding the application of the section 1291, QEF and PFIC mark to market regimes, applies for all subsequent taxable years provided that the PFIC stock continues to be marked to market under another provision of chapter 1 of the Code.

B. Changes to § 1.1295-1

1. Revocation of QEF election

The proposed regulations also provide guidance on the coordination of the mark to market provisions under section 1296 with the existing rules for QEFs. In general, the Service considered the circumstances in which a taxpayer would be permitted to switch from one regime to another in light of the relative administrative burdens imposed under each set of rules, and the stated intent of Congress that one of the purposes for enacting section 1296 was to provide another alternative to the interest charge rules of section 1291 that would be available in instances where taxpayers cannot obtain sufficient information to make a QEF election. See H.R. Rep. No. 105-148, at 533 (1997); S. Rep. No. 105-33 at 94 (1997). Accordingly, the proposed regulations are structured to facilitate an election for mark to market treatment by permitting a taxpayer with an existing QEF election to make a section 1296 election and terminate the existing QEF election without requiring consent of the Commissioner. In instances where a taxpayer has an existing section 1296 election, it is permitted to make a QEF election only if the section 1296 election is terminated as provided by section 1296 and the regulations thereunder (e.g., if the PFIC stock ceases to be marketable) or is revoked with consent of the Commissioner.

2. Re-election of QEF regime

The proposed regulations further provide that if the section 1296 election is subsequently terminated or revoked, other than because the taxpayer marks to market under another provision of the Code, (e.g., because the stock is no longer marketable), the shareholder will be subject to tax under section 1291, unless a new QEF election is made. Section 1.1295-1(i)(4) currently provides that without the Commissioner's consent, a shareholder whose QEF election was invalidated, terminated, or revoked may not make a new QEF election with respect to the PFIC before the sixth taxable year ending after the taxable year in which the invalidation, termination, or revocation became effective. The regulations propose to amend § 1.1295-1(i) to provide an exception for situations where a United States person's QEF election was terminated because it elected to mark to market such stock under section 1296, and the 1296 election was subsequently terminated because the stock ceased to be marketable. A similar exception is provided for situations where a United States person's QEF election is terminated because its PFIC stock is marked to market under another provision of chapter 1 of the Code, and such provision subsequently ceases to apply. In either circumstance, consent of the Commissioner will not be required for the United States person to re-elect QEF status prior to the sixth taxable year ending after the taxable year that its QEF election was terminated. In situations where a QEF election is terminated because a United States person makes a section 1296 election, and then this election terminates for some reason other than the stock ceasing to be marketable (e.g., pursuant to the consent of the Commissioner under proposed § 1.1296-1(h)(3)(A)), a taxpayer may request consent under § 1.1295-1(i) to make a new QEF election prior to such sixth taxable year.

Special issues arise in situations where a taxpayer makes a QEF election with respect to stock that was previously marked to market under section 1296 (or where a taxpayer re-elects QEF treatment after a termination of mark-to-market treatment). In such situations, the taxpayer shifts from annual inclusions under the mark to market rules that are based on the amount of unrealized gain (or loss) in the stock of the PFIC, to annual inclusions of a *pro rata*

share of the ordinary earnings and long-term capital gain of a PFIC under the QEF rules. For example, unrealized items that were reflected in annual mark to market inclusions could be taken into account subsequently under the QEF rules when realized. These issues presently are addressed through the respective basis adjustments provided for under the QEF and mark to market rules. See sections 1293(d) and 1296(b). Comments are requested on possible alternative approaches for addressing this situation with a view toward ensuring administrability and avoiding additional complexity.

C. Addition of § 1.1296-1

1. Effect of election

The proposed regulations provide that, on the last day of a taxable year to which a section 1296 election applies, the United States person recognizes gain to the extent that the fair market value of section 1296 stock exceeds its adjusted basis. Any such gain shall be treated as ordinary income. To the extent that the adjusted basis of section 1296 stock exceeds its fair market value, the United States person may take a deduction equal to the lesser of the amount of such excess or the unreversed inclusions with respect to such stock. Any such deduction will be treated as an ordinary loss.

Under former proposed § 1.1291-8, certain RICs were permitted to mark to market PFIC stock. For RICs that elect to mark to market their PFIC stock under section 1296, the unreversed inclusions include amounts that were included in gross income under former proposed § 1.1291-8 with respect to that stock for prior taxable years. See Notice 92-53, 1992-2 C.B. 384.

The proposed regulations also address the application of section 1296 in taxable years in which the foreign corporation has ceased to be a PFIC under section 1297(a), and is not treated as a PFIC under section 1298(b)(1) (the once a PFIC, always a PFIC rule). The proposed regulations clarify that there will be no mark to market inclusions or deductions for taxable years in which the foreign corporation is not a PFIC. The suspension of mark to market treatment while the foreign corporation is not a PFIC is consistent with § 1.1295-1(c)(2)(ii), which provides that a shareholder that has made a QEF election

ration is not required to include its *pro rata* share of ordinary income and capital gains under section 1293 for years in which the foreign corporation is not a PFIC.

In order to accomplish this suspension of mark to market treatment, the proposed regulations start a new holding period, for all purposes of the PFIC rules, in stock that is marked to market under section 1296 beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 applied. Accordingly, prior periods during which the foreign corporation was a PFIC, but for which the shareholder had a section 1296 election in effect, are not included in such shareholder's holding period for purposes of applying section 1298(b)(1).

Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1296 election (although a shareholder may request consent of the Commissioner to revoke the election in such instance, as discussed below). Thus, if the foreign corporation once again becomes a PFIC in any taxable year after a year in which it is not treated as a PFIC, the shareholder's original section 1296 election continues to apply and the shareholder must mark to market the PFIC stock for such year.

2. *Adjustment to basis*

The proposed regulations provide that a United States person will increase the adjusted basis of its section 1296 stock by the amount of mark to market gain recognized. Conversely, if the United States person is entitled to a deduction under this section, the adjusted basis of its section 1296 stock is decreased by the amount of such deduction.

If a United States person owns section 1296 stock through a foreign partnership, foreign trust, or foreign estate, the basis rules apply to both the United States person and the entity or entities through which the United States person is considered to own the stock. The increase or decrease in the adjusted basis of the stock in the hands of the foreign partnership, foreign trust, or foreign estate will be solely attributable to the electing United States person (in a manner similar to an adjustment under section 743(b)), and will apply only for purposes of determining the subsequent U.S. income tax treatment of the United States

person imposing reporting and record keeping requirements on the foreign entities to track the adjustments to the adjusted basis of any section 1296 stock they held directly or indirectly. The IRS decided not to adopt this approach in the proposed regulations because one of the motivations for the enactment of section 1296 was to provide an alternative tax regime to section 1291 for taxpayers that could not obtain sufficient information from a PFIC to make a QEF election. Comments are requested about other approaches for satisfying the compliance obligations of U.S. persons making a section 1296 election and the intervening entity or entities through which such stock is owned.

The taxpayer and the entity through which the taxpayer owns section 1296 stock may have different taxable years. Consistent with the general approach of sections 706(a), 652(c), and 662(c), a United States person who owns stock in a PFIC through any foreign partnership, foreign trust, or foreign estate determines the mark to market gain or mark to market loss with reference to the last day of the taxable year of the foreign partnership, foreign trust or foreign estate and then includes that gain or loss in the taxable year of such United States person that includes the last day of the taxable year of the entity.

Finally, if PFIC stock is acquired from a decedent by bequest, devise, or inheritance (or by the decedent's estate) and a mark to market election was in effect on the decedent's date of death, the adjusted basis of such stock in the hands of the recipient will be equal to the lesser of the basis determined under section 1014 or the adjusted basis of the stock in the hands of the decedent immediately prior to his or her death.

3. *Rule for individuals that become subject to United States income taxation*

The proposed regulations provide that if any individual becomes a United States person in a taxable year beginning after December 31, 1997, the adjusted basis (before any adjustments resulting from the mark to market election are made) of any stock in a PFIC owned by such individual on the first day of such taxable year shall be treated as being the greater of its fair market value on such first day or its adjusted basis on such first day. This special rule for

will apply only for purposes of section 1296 and the regulations thereunder. Accordingly, any gain or loss recognized on the disposition of section 1296 stock that is attributable to the period before the individual became a United States person will be subject to the general rules of the Code, including any limitation on the deductibility of a loss, for example, under section 1211.

4. *Indirect ownership of PFIC stock*

Except as discussed below in the case of eligible RICs, the proposed regulations apply the specific attribution rules of section 1296(g) in determining whether PFIC stock is considered owned by a taxpayer for purposes of section 1296 and, therefore, with respect to which the taxpayer is permitted to make a section 1296 election. Thus, a United States person will be permitted to make a section 1296 election with respect to stock owned through a foreign partnership, foreign trust, or foreign estate. In general, stock owned by or for such entities will be considered as being owned proportionately by its partners or beneficiaries. For purposes of this rule, stock owned, directly or indirectly, by or for a foreign trust described in sections 671 through 679, shall be considered as being owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock.

The section 1296(g) attribution rules do not attribute ownership through foreign corporations. Accordingly, a United States person will not be permitted to make a section 1296 election with respect to stock owned indirectly through a foreign corporation. However, as discussed below, in instances where the foreign corporation is a CFC, the foreign corporation is permitted to make a section 1296 election directly.

Special attribution rules for eligible RICs are provided in § 1.1296(e)–1(f). There is a different attribution rule for RICs because section 1296(e)(2), which provides a special rule for RICs, states that stock owned, directly or indirectly, by the RIC, without reference to the ownership attribution rules in section 1296(g), shall be treated as marketable stock. This approach is consistent with former proposed § 1.1291–8, which permitted certain RICs to mark to market PFIC stock that it owned

directly or indirectly.

An issue not addressed in these proposed regulations is the treatment of certain situations involving multiple tiers of PFICs. For example, assume a United States person owns marketable stock in a PFIC, that itself owns stock in a second PFIC, the ownership of which is attributable to the United States person under section 1298(a)(2). If the United States person makes a section 1296 election with respect to stock of the upper-tier PFIC, the annual mark to market inclusions of income under section 1296 will be based on the fair market value of the upper-tier PFIC stock, whose value should reflect the value of the lower-tier PFIC, as such stock is an asset of the upper-tier PFIC. However, under current law, the United States person continues to be subject to taxation with respect to its indirect ownership of the lower-tier PFIC under section 1291 on any excess distributions from the lower-tier PFIC or gain from an indirect disposition of the lower-tier PFIC stock (although the consequences from the tiered ownership may be ameliorated by adjustments to the basis of the upper-tier PFIC stock). See proposed §§ 1.1291–2(f), and 1.1291–3(e). Similar issues arise if the United States person makes a QEF election with respect to the lower-tier PFIC. Comments are requested regarding coordination rules or other adjustments that may be appropriate to address this situation and similar structures involving a United States person that owns stock directly and indirectly in tiers of PFICs.

5. Treatment of CFCs as United States persons

A CFC that owns PFIC stock is treated as a United States person for purposes of section 1296 and, as noted above, is permitted to make a section 1296 election directly. If a section 1296 election is made with respect to PFIC stock owned by a CFC directly, or treated as owned by a CFC applying the section 1296(g) attribution rules, then any mark to market gains are included in the gross income of the CFC as foreign personal holding company income under section 954(c)(1)(A) and any mark to market losses are treated as deductions allocable to such foreign personal holding company income for purposes of computing net foreign base company income under § 1.954–1(c).

Under the proposed regulations, if a section 1296 election is made for a CFC with respect to its PFIC stock, the PFIC rules do not also apply separately to any United States shareholder, as defined in section 951(b), with respect to its *pro rata* share of the PFIC stock held by the CFC. Instead, the United States shareholder generally will recognize the mark to market gain as an inclusion of income under section 951(a). Thus, United States shareholders of CFCs are appropriately excluded from the application of section 1291 if a section 1296 election is made by the CFC. This rule, however, does not apply to United States persons who own stock of the CFC but are not United States shareholders within the meaning of section 951(b). Those United States persons continue to be subject to the PFIC provisions with respect to the stock of such foreign corporation, and may avail themselves of a QEF election. This rule is consistent with the CFC/PFIC overlap rule in section 1297(e), which eliminates the application of the PFIC provisions solely for United States shareholders of the entity that is both a PFIC and a CFC. Finally, comments are requested about whether similar rules should apply to United States persons that are United States shareholders of a CFC solely by application of section 953(c)(1)(A).

6. Elections

The proposed regulations provide that a United States person may make a section 1296 election for a taxable year beginning after December 31, 1997, by the due date (including extensions) of the United States person's federal income tax return. The proposed regulations further provide that a section 1296 election of a CFC is made by its controlling United States shareholders by the due date (including extensions) of their federal income tax returns in accordance with the general rules for elections by a CFC under § 1.964–1(c)(5).

The proposed regulations provide that a section 1296 election applies to the year for which made and to each succeeding year unless the election is terminated or revoked. A section 1296 election automatically terminates when (i) the PFIC stock ceases to be marketable, or (ii) when the PFIC stock is marked to market under another provision of chapter 1 of the Code. A section 1296 election also may be revoked with the consent of the Commis-

sioner. Such consent will only be granted, however, upon a showing of a substantial change in circumstances. Similar rules apply in the case of the revocation of a QEF election.

7. Coordination rules for first year of election

Finally, the proposed regulations provide coordination rules that apply to the first taxable year to which section 1296 applies. A United States person (other than a RIC) whose holding period includes a period when the foreign corporation was a PFIC and for which a QEF election had not been made generally will be subject to section 1291 in the year of the election and subject to section 1296 in subsequent years. Special rules also apply to RICs for the first year in which a section 1296 election applies.

D. Changes to § 1.1296(e)–1(b)

As discussed above, a section 1296 election is only available for marketable stock of a PFIC. Section 1296(e) defines marketable stock to include any stock which is regularly traded on certain securities exchanges or other markets. The 2000 final regulations provide guidance regarding the definition of marketable stock for purposes of section 1296. In particular, the 2000 final regulations define regularly traded for these purposes to require that a class of stock be traded on at least 15 days during each calendar quarter for any calendar year. Taxpayers have noted that this rule would exclude stock issued as a result of an initial public offering (IPO) from qualifying as marketable stock for the year of issuance in many instances (*e.g.*, stock issued through a public offering occurring other than during the first quarter of the year). Therefore, these regulations propose modifying the current rule in such instances.

The proposed regulations provide that the stock issued in a public offering will qualify as regularly traded if the stock is traded on one or more qualified exchanges or other markets, other than in *de minimis* quantities, on 1/6 of the days remaining in the quarter in which the offering occurs, and on at least 15 days during each remaining quarter of the calendar year. If the public offering occurs in the fourth quarter of the calendar year, the stock will qualify as regularly traded if it is traded on such ex-

mis quantities, on the greater of 1/6 of the days remaining in the quarter in which the offering occurs, or 5 days. The proposed regulations also modify the anti-abuse rule in § 1.1296(e)-1(b)(2) to apply to these changes to the definition of regularly traded.

E. Amendment of § 1.6031(a)-1

In general, a foreign partnership that has U.S. source income is required to file a U.S. Federal income tax return pursuant to § 1.6031(a)-1(b)(1). An issue arises whether a filing obligation is created on behalf of a foreign partnership where a U.S. partner of the foreign partnership makes a section 1296 election with respect to the U.S. partner's share of the PFIC stock held by the partnership. The income of the partner arising as a result of the section 1296 election generally will be U.S. source. See sections 1296(c)(2) and 865(a), (i)(5). The proposed regulations resolve this issue by modifying § 1.6031(a)-1(b)(1) such that a foreign partnership will not be required to file a partnership return if the only reason for filing a return, but for this special rule, would be U.S. source income resulting from a direct or indirect partner's section 1296 election.

Special Analysis

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 has also 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 regulations do 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

signed original and eight (8) copies) that are submitted timely (in a manner described in the "ADDRESSES" portion of this preamble) to the IRS. The IRS and Treasury 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 is scheduled for November 6, 2002, beginning at 10:00 a.m. in room 4718, 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" portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to this hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by October 16, 2002. 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 reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of this regulation are Mark Pollard and Laurie Hatten-Boyd, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

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

Section 1.1296-1 also issued under 26 USC 1296(g) and 26 USC 1298(f). * * *

Par. 2. Section 1.1291-1, as proposed on April 1, 1992, at 57 FR 11024, is amended by:

1. Revising the headings to paragraphs (c) and (c)(1).
2. Redesignating the text of paragraphs (c)(1) and (c)(2) as (c)(1)(i) and (c)(1)(ii), respectively.
3. Adding new paragraphs (c)(2) and (c)(3).
4. Revising paragraph (j)(1).
5. Removing paragraph (j)(3).

The revisions and addition read as follows:

§ 1.1291-1 Taxation of U.S. persons that are shareholders of section 1291 funds.

* * * * *

(c) *Coordination with other PFIC rules—(1) Coordination with QEF rules.* * **

(2) *Coordination with section 1296: distributions and dispositions.* If PFIC stock is marked to market under section 1296 for any taxable year, then, except as provided in § 1.1296-1(i), section 1291 and the regulations thereunder shall not apply to any distribution with respect to section 1296 stock (as defined in § 1.1296-1(a)(2)), or to any disposition of such stock, for such taxable year.

(3) *Coordination with mark to market rules under chapter 1 of the Internal Revenue Code other than section 1296—(i) In general.* If PFIC stock is marked to market for any taxable year under section 475 or any other provision of chapter 1 of the Internal Revenue Code, other than section 1296, regardless of whether the application of such provision is mandatory or results from an election by the taxpayer or another person, then, except as provided in paragraph (c)(3)(ii) of this section, section 1291 and the regulations thereunder shall not apply to any distribution with respect to such PFIC stock or to any disposition of such PFIC stock for such taxable year. See §§ 1.1295-1(i)(3) and 1.1296-1(h)(3)(i) for rules regarding the automatic termination of an existing election under section 1295 or section 1296 when a tax-

payer marks to market PFIC stock under section 475 or any other provision of chapter 1 of the Internal Revenue Code.

(ii) *Coordination rule*—(A) Notwithstanding any provision in this section to the contrary, the rule of paragraph (c)(3)(ii)(B) of this section shall apply to the first taxable year in which a United States person marks to market its PFIC stock under a provision of chapter 1 of the Internal Revenue Code, other than section 1296, if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person's holding period (as defined in section 1291(a)(3)(A) and § 1.1296-1(f)) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(B) For the first taxable year of a United States person that marks to market its PFIC stock under any provision of chapter 1 of the Internal Revenue Code, other than section 1296, such United States person shall, in lieu of the rules under which the United States person marks to market, apply the rules of § 1.1296-1(i)(2) and (3) as if the United States person had made an election under section 1296 for such first taxable year.

* * * * *

(j) *Effective date*—(1) *In general*. Except as otherwise provided in this paragraph (j), §§ 1.1291-1 through 1.1291-7 apply on April 11, 1992. Section 1.1291-1(c)(2) and (3) apply as of the date final regulations are published in the **Federal Register**. Shareholders of 1291 funds, in determining their liability under sections 1291 through 1297 beginning after December 31, 1986, and before the effective date of these regulations, must apply reasonable interpretations of the statute and legislative history and employ reasonable methods to apply the interest charge.

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Par. 3. Section 1.1295-1 is amended by:

1. Redesignating paragraphs (i)(3) and (i)(4) as paragraphs (i)(4) and (i)(5), respectively.
2. Adding a new paragraph (i)(3).
3. Revising newly designated paragraph (i)(5).
4. Revising paragraph (k).

The revisions and addition read as follows:

§ 1.1295-1 *Qualified electing funds*

* * * * *

(i) * * *

(3) *Automatic termination*. If a United States person, or the United States shareholder on behalf of a controlled foreign corporation, makes an election pursuant to section 1296 and the regulations thereunder with respect to PFIC stock for which a QEF election is in effect, or marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, the QEF election is automatically terminated with respect to such stock that is marked to market under section 1296 or another provision of Chapter 1 of the Internal Revenue Code. Such termination shall be effective on the last day of the shareholder's taxable year preceding the first taxable year for which the section 1296 election is in effect or such stock is marked to market under another provision of chapter 1 of the Internal Revenue Code.

Example. A, a U.S. corporation, owns directly 100 shares of marketable stock in foreign corporation X, a PFIC. A also owns a 50 percent interest in Y, a foreign partnership that owns 200 shares of X. Accordingly, under section 1298(a)(3) and § 1.1296-1(e)(1), A is treated as indirectly owning 100 shares of X. A also owns 100 percent of the stock of Z, a foreign corporation that is not a PFIC. Z owns 100 shares of X, and therefore under section 1298(a)(2)(A), A is treated as owning the 100 shares of X owned by Z. For taxable year 2003, A has a QEF election in effect with respect to X that applies to all 300 shares of X stock owned directly or indirectly by A. See generally § 1.1295-1(c)(1). For taxable year 2004, A makes a timely election pursuant to section 1296 and the regulations thereunder. For purposes of section 1296, A is treated as owning stock held indirectly through a partnership, but not through a foreign corporation. Section 1296(g); § 1.1296-1(e)(1). Accordingly, A's section 1296 election covers the 100 shares it owns directly and the 100 shares it owns indirectly through Y, but not the 100 shares owned by Z. With respect to the first 200 shares, A's QEF election is automatically terminated effective December 31, 2003. With respect to the 100 shares A owns through foreign corporation Z, A's QEF election remains in effect unless invalidated, terminated, or revoked pursuant to this paragraph (i).

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(5) *Effect after invalidation, termination, or revocation*— (i) *In general*. Without the Commissioner's consent, a shareholder whose section 1295 election was invalidated, terminated, or revoked under this paragraph (i) may not make the section 1295 election with respect to the PFIC before the sixth taxable year in which the invalidation, termination, or revocation became effective.

(ii) *Special rule*. Notwithstanding paragraph (i)(5)(i) of this section, a shareholder whose section 1295 election was terminated pursuant to paragraph (i)(3) of this section, and either whose section 1296 election has subsequently been terminated because its PFIC stock ceased to be marketable or who no longer marks to market such stock under another provision of chapter 1 of the Internal Revenue Code, may make a section 1295 election with respect to its PFIC stock before the sixth taxable year in which its prior section 1295 election was terminated.

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(k) *Effective dates*. Except as otherwise provided, paragraphs (b)(2)(iii), (b)(3), (b)(4), and (c) through (j) of this section are applicable to taxable years of shareholders beginning after December 31, 1997. However, taxpayers may apply the rules under paragraphs (b)(4), (f) and (g) of this section to a taxable year beginning before January 1, 1998, provided the statute of limitations on the assessment of tax has not expired as of April 27, 1998, and, in the case of paragraph (b)(4) of this section, the taxpayers who filed the joint return have consistently applied the rules of that section to all taxable years following the year the election was made. Paragraph (b)(3)(v) of this section is applicable as of February 7, 2000, however, a taxpayer may apply the rules to a taxable year prior to the applicable date provided the statute of limitations on the assessment of tax for that taxable year has not expired. Paragraphs (i)(3) and (i)(5)(ii) of this section are applicable as of the date final regulations are published in the **Federal Register**.

Par. 4. Section 1.1296-1 is added to read as follows:

§ 1.1296-1 *Mark to market election for marketable stock*

(a) *Definitions*—(1) *Eligible RIC*. An *eligible RIC* is a regulated investment company that offers for sale, or has outstanding, any stock of which it is the issuer and which is redeemable at net asset value, or that publishes net asset valuations at least annually.

(2) *Section 1296 stock*. The term *section 1296 stock* means marketable stock in a passive foreign investment company (PFIC), including any PFIC stock owned directly or indirectly by an eligible RIC, for which there is a valid section 1296 election. Section 1296 stock does not include

ously had been a PFIC, and for which a section 1296 election remains in effect.

(3) *Unreversed inclusions*—(i) *General rule.* The term *unreversed inclusions* means with respect to any section 1296 stock, the excess, if any, of—

(A) The amount of mark to market gain included in gross income of the United States person under paragraph (c)(1) of this section with respect to such stock for prior taxable years; over

(B) The amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock for prior taxable years.

(ii) *Section 1291 adjustment.* The amount referred to in paragraph (a)(3)(i)(A) of this section shall include any amount subject to section 1291 under the coordination rule of paragraph (i)(2)(ii) of this section.

(iii) *Example.* An example of the computation of unreversed inclusions is as follows:

Example. A, a United States person, acquired stock in D, a foreign corporation, on January 1, 2003, for \$150. At such time and at all times thereafter, D was a PFIC and A's stock in D was marketable. For taxable years 2003 and 2004, D was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election with respect to the D stock, effective for tax year 2005. The fair market value of the D stock was \$200 as of December 31, 2004, and \$240 as of December 31, 2005. Additionally, D made no distribution with respect to its stock for the taxable years at issue. In 2005, pursuant to paragraph (i)(2)(ii) of this section, A must include the \$90 gain in the D stock in accordance with the rules of section 1291 for purposes of determining the deferred tax amount and any applicable interest. Nonetheless, for purposes of determining the amount of the unreversed inclusions pursuant to paragraph (a)(3)(ii) of this section, A will include the \$90 of gain that was taxed under section 1291 and not the interest thereon.

(iv) *Special rule for regulated investment companies.* In the case of a regulated investment company which had elected to mark to market the PFIC stock held by such company as of the last day of the taxable year preceding such company's first taxable year for which such company makes a section 1296 election, the amount referred to in paragraph (a)(3)(i)(A) of this section shall include amounts previously included in gross income by the company pursuant to such mark to market election with respect to such stock for prior taxable years. See Notice 92-53, 1992-2 C.B. 384.

(b) *Application of section 1296 election*—(1) *In general.* Any United States person and any controlled foreign corpo-

ration owning under this section, marketable stock, as defined in § 1.1296(e)-1, in a PFIC may make an election to mark to market such stock in accordance with the provisions of section 1296 and this section.

(2) *Election applicable to specific United States person.* A section 1296 election applies only to the United States person (or CFC that is treated as a U.S. person under paragraph (g)(2) of this section) that makes the election. Accordingly, a United States person's section 1296 election will not apply to a transferee of section 1296 stock.

(3) *Election applicable to specific corporation only.* A section 1296 election is made with respect to a single foreign corporation, and thus a separate section 1296 election must be made for each foreign corporation that otherwise meets the requirements of this section. A United States person's section 1296 election with respect to stock in a foreign corporation applies to all marketable stock of the corporation that the person owns directly, or is treated as owning under paragraph (e) of this section, at the time of the election or that is subsequently acquired.

(c) *Effect of election*—(1) *Recognition of gain.* If the fair market value of section 1296 stock on the last day of the United States person's taxable year exceeds its adjusted basis, the United States person shall include in gross income for its taxable year the excess of the fair market value of such stock over its adjusted basis (mark to market gain).

(2) *Character of gain.* (i) Mark to market gain, and any gain on the sale or other disposition of section 1296 stock, shall be treated as ordinary income.

(ii) *Example.* The following example illustrates this paragraph (c)(2):

Example. A, a United States person, purchases stock in C, a foreign corporation that is not a PFIC, in 1990 for \$1,000. On January 1, 2003, when the fair market value of the C stock is \$1,100, foreign corporation C becomes a PFIC. A makes a timely section 1296 election for year 2003. On December 31, 2003, the fair market value of the C stock is \$1,200. For taxable year 2003, A includes \$200 of mark to market gain (the excess of the fair market value of C stock (\$1,200) over A's adjusted basis (\$1,000)) in gross income as ordinary income.

(3) *Recognition of loss.* If the adjusted basis of section 1296 stock exceeds its fair market value on the last day of the United States person's taxable year, such person shall be allowed a deduction for such tax-

ation of such excess or the unreversed inclusions with respect to such stock (mark to market loss).

(4) *Character of loss*—(i) *Losses not in excess of unreversed inclusions.* Any mark to market loss allowed as a deduction under paragraph (c)(3) of this section, and any loss on the sale or other disposition of section 1296 stock, to the extent that such loss does not exceed the unreversed inclusions attributable to such stock, shall be treated as an ordinary loss, deductible in computing adjusted gross income.

(ii) *Losses in excess of unreversed inclusions.* (A) Any loss recognized on the sale or other disposition of section 1296 stock in excess of any prior unreversed inclusions will be subject to the rules generally applicable to losses provided elsewhere in the Internal Revenue Code and the regulations thereunder.

(B) The following example illustrates the treatment of losses in excess of unreversed inclusions:

Example. A, a United States person and a calendar year taxpayer, purchased marketable stock in FC, a foreign corporation that was a PFIC, for \$1,000 on January 31, 2003. A made a section 1296 election with respect to the stock of FC for 2003. At the close of 2003, the fair market value of A's stock in FC was \$1,200. Under paragraph (c)(1) and (2) of this section, A included \$200 of mark to market gain as ordinary income for 2003, and pursuant to paragraph (d)(1) of this section, increased his basis in the stock by that amount. On June 15, 2004, A sold his stock in FC for \$900. At that time, A's unreversed inclusions with respect to the stock in FC were \$200. Accordingly, A may deduct the amount equal to his unreversed inclusions, \$200, as an ordinary loss. The \$100 loss in excess of A's unreversed inclusions will be treated as a long term capital loss because A has held the FC stock for more than one year.

(5) *Application of election to separate lots of stock.* (i) In the case in which a United States person purchased or acquired shares of stock in a PFIC at different prices, the rules of this section shall be applied in a manner consistent with the rules of § 1.1012-1.

(ii) *Example.* The following example illustrates this paragraph (c)(5):

Example. On January 1, 2003, United States corporation A purchased 100 shares (first lot) of stock in foreign corporation X, a PFIC, for \$500 (\$5 per share). On June 1, 2003, A purchased 100 shares (second lot) of stock in X for \$1,000 (\$10 per share). A made a timely section 1296 election with respect to its stock in X for taxable year 2003. On December 31, 2003, the fair market value of X stock was \$8 per share. For taxable year 2003, A recognizes \$300 of gross income under paragraph (c)(1) of this section with respect to the first lot, and adjusts its basis in that lot

to \$800 pursuant to paragraph (d)(1) of this section. With respect to the second lot, A is not permitted to recognize a loss under paragraph (c)(3) of this section for taxable year 2003. Although A's adjusted basis in that stock exceeds its fair market value by \$200, A has no unreversed inclusions with respect to that particular lot of stock. On July 1, 2004, A sells 100 shares of X stock for \$900. Assuming that A adequately identifies (in accordance with the rules of § 1.1012-1(c)) the shares of X corporation stock sold as being from the second lot, A recognizes \$100 of long term capital loss pursuant to paragraph (c)(4)(ii) of this section.

(6) *Source rules.* The source of any amount included in gross income under paragraph (c)(1) of this section, or the allocation and apportionment of any amount allowed as a deduction under paragraph (c)(3) of this section, shall be determined in the same manner as if such amounts were gain or loss (as the case may be) from the sale of stock in the PFIC.

(d) *Adjustment to basis*—(1) *Stock held directly.* The adjusted basis of the section 1296 stock shall be increased by the amount included in the gross income of the United States person under paragraph (c)(1) of this section with respect to such stock, and decreased by the amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock.

(2) *Stock owned through certain foreign entities.* (i) In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the basis adjustments under paragraph (d)(1) of this section shall apply to such stock in the hands of the foreign entity actually holding such stock, but only for purposes of determining the subsequent treatment under chapter 1 of the Internal Revenue Code of the United States person with respect to such stock. Such increase or decrease in the adjusted basis of the section 1296 stock shall constitute an adjustment to the basis of partnership property only with respect to the partner making the section 1296 election. Corresponding adjustments shall be made to the adjusted basis of the United States person's interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock.

(ii) *Example.* The following example illustrates this paragraph (d)(2):

Example. FP is a foreign partnership. A, a U.S. corporation, owns a 20% interest in FP. B, a U.S. corporation, owns a 30% interest in FP. C, a foreign

corporation, with no direct or indirect shareholders that are U.S. persons, owns a 50% interest in FP. A, B, C, and FP are all calendar year taxpayers. In 2002, FP purchases stock in a PFIC for \$1,000. A makes a timely section 1296 election for taxable year 2003. On December 31, 2003, the fair market value of the PFIC stock is \$1,100. A includes \$20 of ordinary income in 2003 under paragraphs (c)(1) and (2) of this section. A increases its basis in its FP partnership interest by \$20. FP increases its basis in the stock to \$1,020 solely for purposes of determining the subsequent treatment of A, under chapter 1 of the Internal Revenue Code, with respect to such stock. In 2004, FP sells the stock for \$1,200. For purposes of determining the amount of gain of A, FP will be treated as having \$180 in gain of which \$20 is allocated to A. A's \$20 of gain will be treated as ordinary income under paragraph (c)(2) of this section. For purposes of determining the amount of gain attributable to B, FP will be treated as having \$200 gain, \$60 of which will be allocated to B.

(3) *Stock owned indirectly by an eligible RIC.* Paragraph (d)(2) of this section shall also apply to an eligible RIC which is an indirect shareholder under § 1.1296(e)-1(f) of stock in a PFIC and has a valid section 1296 election in effect.

(4) *Stock acquired from a decedent.* In the case of stock of a PFIC which is acquired by bequest, devise, or inheritance (or by the decedent's estate) and with respect to which a section 1296 election was in effect as of the date of the decedent's death, notwithstanding section 1014, the basis of such stock in the hands of the person so acquiring it shall be the adjusted basis of such stock in the hands of the decedent immediately before his death (or, if lesser, the basis which would have been determined under section 1014 without regard to this paragraph).

(5) *Transition rule for individuals becoming subject to United States income taxation*—(i) *In general.* If any individual becomes a United States person in a taxable year beginning after December 31, 1997, solely for purposes of this section, the adjusted basis, before adjustments under this paragraph (d), of any section 1296 stock owned by such individual on the first day of such taxable year shall be treated as being the greater of its fair market value or its adjusted basis on such first day.

(ii) An example of the transition rule for individuals becoming subject to United States income taxation is as follows:

Example. X, a nonresident alien individual, purchases marketable stock in a PFIC for \$50 in 1995. On January 1, 2003, X becomes a United States person and makes a timely section 1296 election with respect to the stock in accordance with paragraph (h) of this section. The fair market value of the stock on January 1, 2003, is \$100. The fair market value of the

stock on December 31, 2003, is \$110. Under paragraph (d)(5)(i) of this section, X computes the amount of mark to market gain or loss in 2003 by reference to an adjusted basis of \$100, and therefore X includes \$10 in gross income as mark to market gain under paragraph (c)(1) of this section. Additionally, under paragraph (d)(1) of this section, X's adjusted basis in the stock for purposes of this section is increased to \$110 (or to \$60 for all other tax purposes). X sells the stock in 2004 for \$120. For purposes of applying section 1001, X must use its original basis of \$50, with any adjustments under paragraph (d)(1) of this section, \$10 in this case, and therefore X recognizes \$60 of gain. Under paragraph (c)(2) of this section (which is applied using an adjusted basis of \$110), \$10 of such gain is treated as ordinary income. The remaining \$50 of gain from the sale of the stock is long-term capital gain because X held such stock for more than one year.

(e) *Stock owned through certain foreign entities*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, the following rules shall apply in determining stock ownership for purposes of this section. PFIC stock owned, directly or indirectly, by or for a foreign partnership, foreign trust (other than a foreign trust described in sections 671 through 679), or foreign estate shall be considered as being owned proportionately by its partners or beneficiaries. PFIC stock owned, directly or indirectly, by or for a foreign trust described in sections 671 through 679 shall be considered as being owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock. The determination of a person's proportionate interest in a foreign partnership, foreign trust or foreign estate will be made on the basis of all the facts and circumstances. Stock considered owned by reason of this paragraph shall, for purposes of applying the rules of this section, be treated as actually owned by such person.

(2) *Stock owned indirectly by eligible RICs.* The rules for attributing ownership of stock contained in § 1.1296(e)-1(f) will apply to determine the indirect ownership of PFIC stock by an eligible RIC.

(f) *Holding period.* Solely for purposes of sections 1291 through 1298, if section 1296 applied to stock with respect to the taxpayer for any prior taxable year, the taxpayer's holding period in such stock shall be treated as beginning on the first day of the first taxable year beginning after the last taxable year for which section 1296 so applied.

(g) *Special rules*—(1) *Certain dispositions of stock.* To the extent a United States

in a PFIC under paragraph (e) of this section, any disposition which results in the United States person being treated as no longer owning such stock, and any disposition by the person owning such stock, shall be treated as a disposition by the United States person of the stock in the PFIC.

(2) *Treatment of CFC as a United States person.* In the case of a CFC that owns, or is treated as owning under paragraph (e) of this section, section 1296 stock:

(i) Other than with respect to the sourcing rules in paragraph (c)(6) of this section, this section shall apply to the CFC in the same manner as if such corporation were a United States person. The CFC will be treated as a foreign person for purposes of applying the source rules of paragraph (c)(6).

(ii) For purposes of subpart F of part III of subchapter N of the Internal Revenue Code—

(A) Amounts included in the CFC's gross income under paragraph (c)(1) or (i)(2)(ii) of this section shall be treated as foreign personal holding company income under section 954(c)(1)(A); and

(B) Amounts allowed as a deduction under paragraph (c)(3) of this section shall be treated as a deduction allocable to foreign personal holding company income for purposes of computing net foreign base company income under § 1.954-1(c).

(iii) A United States shareholder, as defined in section 951(b), of the CFC shall not be subject to section 1291 with respect to any stock of the PFIC for the period during which the section 1296 election is in effect for that stock, and the holding period rule of paragraph (f) of this section shall apply to such United States shareholder.

(iv) The rules of this paragraph (g)(2) shall not apply to a United States person that is a shareholder of the PFIC for purposes of section 1291, but is not a United States shareholder under section 951(b) with respect to the CFC making a section 1296 election.

(3) *Timing of inclusions for stock owned through certain foreign entities.* In the case of section 1296 stock that a United States person is treated as owning through certain foreign entities pursuant to paragraph (e) of this section, the mark to market gain or mark to market loss is determined in ac-

tion of this section as of the last day of the taxable year of the foreign partnership, foreign trust or foreign estate and then included in the taxable year of such United States person that includes the last day of the taxable year of the entity.

(h) *Elections—(1) Timing and manner for making a section 1296 election—(i) United States persons.* A United States person that owns marketable stock in a PFIC, or is treated as owning marketable stock under paragraph (e) of this section, on the last day of the taxable year of such person, and that wants to make a section 1296 election, must make a section 1296 election for such taxable year on or before the due date (including extensions) of the United States person's income tax return for that year. The section 1296 election must be made on the Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund", included with the original tax return of the United States person for that year, or on an amended return, provided that the amended return is filed on or before the election due date.

(ii) *Controlled foreign corporations.* A section 1296 election by a CFC shall be made by its controlling United States shareholders, as defined in § 1.964-1(c)(5), and shall be included with the Form 5471, "Information Return of U.S. Persons With Respect To Certain Foreign Corporations", for that CFC by the due date (including extensions) of the original income tax returns of the controlling United States shareholders for that year. A section 1296 election by a CFC shall be binding on all United States shareholders of the CFC.

(iii) *Retroactive elections for PFIC stock held in prior years.* A late section 1296 election may be permitted only in accordance with § 301.9100 of this chapter.

(2) *Effect of section 1296 election—(i) In General.* A section 1296 election will apply to the taxable year for which such election is made and remain in effect for each succeeding taxable year unless such election is revoked or terminated pursuant to paragraph (h)(3) of this section.

(ii) *Cessation of a foreign corporation as a PFIC.* A United States person will not include mark to market gain or loss pursuant to paragraph (c) of this section with respect to any stock of a foreign corporation for any taxable year that such foreign corporation is not a PFIC under section

1298(b)(1) (taking into account the holding period rule of paragraph (f) of this section). Cessation of a foreign corporation's status as a PFIC will not, however, terminate a section 1296 election. Thus, if a foreign corporation is a PFIC in a taxable year after a year in which it is not treated as a PFIC, the United States person's original election (unless revoked or terminated in accordance with paragraph (h)(3) of this section) continues to apply and the shareholder must include any mark to market gain or loss in such year.

(3) *Revocation or termination of election—(i) In general.* A United States person's section 1296 election is terminated if the section 1296 stock ceases to be marketable; if the United States person elects, or is required, to mark to market the section 1296 stock under another provision of chapter 1 of the Internal Revenue Code; or if the Commissioner, in the Commissioner's discretion, consents to the United States person's request to revoke its section 1296 election upon a finding of a substantial change in circumstances. A substantial change in circumstances for this purpose may include a foreign corporation ceasing to be a PFIC.

(ii) *Timing of termination or revocation.* Where a section 1296 election is terminated automatically (e.g., the stock ceases to be marketable), section 1296 will cease to apply beginning with the taxable year in which such termination occurs. Where a section 1296 election is revoked with the consent of the Commissioner, section 1296 will cease to apply beginning with the first taxable year of the United States person after the revocation is granted unless otherwise provided by the Commissioner.

(4) *Examples.* The operation of the rules of this paragraph (h) are illustrated by the following examples:

Example 1. X, a United States person, owns stock in a PFIC. X makes a QEF election in 1996 with respect to such stock. For taxable year 1999, X makes a timely section 1296 election with respect to its stock, and thus its QEF election is automatically terminated pursuant to § 1.1295-1(i)(3). In 2000, X's stock ceases to be marketable, and therefore its section 1296 election is automatically terminated under paragraph (h)(3) of this section. Beginning with taxable year 2000, X is subject to the rules of section 1291 with respect to its stock in the PFIC unless it makes a new QEF election. See § 1.1295-1(i)(5).

Example 2. The facts are the same as in *Example 1*, except that X's stock in the PFIC becomes marketable again in 2001. X may make a new section 1296 election with respect to such stock for its tax year

2001, or thereafter. X will be subject to the coordination rules under paragraph (i) of this section unless it made a new QEF election in 2000.

(i) *Coordination rules for first year of election*—(1) *In general.* Notwithstanding any provision in this section to the contrary, the rules of this paragraph (i) shall apply to the first taxable year in which a section 1296 election is effective with respect to marketable stock of a PFIC if such foreign corporation was a PFIC for any taxable year, prior to such first taxable year, during the United States person’s holding period (as defined in paragraph (f) of this section) in such stock, and for which such corporation was not treated as a QEF with respect to such United States person.

(2) *Shareholders other than regulated investment companies.* For the first taxable year of a United States person (other than a regulated investment company) for which a section 1296 election is in effect with respect to the stock of a PFIC, such United States person shall, in lieu of the rules of paragraphs (c) and (d) of this section—

(i) Apply the rules of section 1291 to any distributions with respect to, or disposition of, section 1296 stock;

(ii) Apply section 1291 to the amount of the excess, if any, of the fair market value of such section 1296 stock on the last day of the United States person’s taxable year over its adjusted basis, as if such amount were gain recognized from the disposition of stock on the last day of the taxpayer’s taxable year; and

(iii) Increase its adjusted basis in the section 1296 stock by the amount of excess, if any, subject to section 1291 under paragraph (i)(2)(ii) of this section.

(3) *Shareholders that are regulated investment companies.* For the first taxable year of a regulated investment company for which a section 1296 election is in effect with respect to the stock of a PFIC, such regulated investment company shall increase its tax under section 852 by the amount of interest that would have been imposed under section 1291(c)(3) for such taxable year if such regulated investment company were subject to the rules of paragraph (i)(2) of this section, and not this paragraph (i)(3). No deduction or increase in basis shall be allowed for the increase in tax imposed under this paragraph (i)(3).

(4) The operation of the rules of this paragraph (i) is illustrated by the following examples.

Example 1. A, a United States person and a calendar year taxpayer, owns marketable stock in a PFIC that it acquired on January 1, 1995. At all times, A’s PFIC stock was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election effective for taxable year 2003. At the close of taxable year 2003, the fair market value of A’s PFIC stock exceeded its adjusted basis by \$10. Pursuant to paragraph (i)(2)(ii) of this section, A must treat the \$10 gain under section 1291 as if the stock were disposed of on December 31, 2003. Further, A will increase its adjusted basis in the PFIC stock by the \$10 in accordance with paragraph (i)(2)(iii) of this section.

Example 2. Assume the same facts as in *Example 1*, except that A is a RIC. In taxable year 2003, A would include \$10 of ordinary income under paragraph (c)(1) of this section, and such amount will not be subject to section 1291. A also must increase its tax imposed under section 852 by the amount of interest that would have been determined under section 1291(c)(3), and no deduction will be permitted for such amount. Finally, under paragraph (d)(1) of this section, A will increase its adjusted basis in the PFIC stock by \$10.

(j) *Effective Date.* The provisions in this section are applicable as of the date final regulations are published in the **Federal Register**.

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Par. 5. Section 1.1296(e)–1 is amended by:

1. Revising paragraph (b)(2).
2. Adding paragraph (b)(3).
3. Revising both references to “sections 958(a)(1) and (2)” in paragraph (f)(1) to read “section 1298(a)”.

The revision and addition reads as follows:

§ 1.1296(e)–1 Definition of marketable stock.

* * * * *

(b) * * *

(2) *Special rule for year of initial public offering.* For the calendar year in which a corporation initiates a public offering of a class of stock for trading on one or more qualified exchanges or other markets, as defined in paragraph (c) of this section, such class of stock meets the requirements of paragraph (b)(1) of this section for such year if the stock is regularly traded on such exchanges or markets, other than in *de minimis* quantities, on 1/6 of the days remaining in the quarter in which the offering occurs, and on at least 15 days during each remaining quarter of the taxpayer’s calendar year. In cases where a corporation initiates a public offering of a class of stock

in the fourth quarter of the calendar year, such class of stock meets the requirements of paragraph (b)(1) of this section in the calendar year of the offering if the stock is regularly traded on such exchanges or markets, other than in *de minimis* quantities, on the greater of 1/6 of the days remaining in the quarter in which the offering occurs, or 5 days.

(3) *Anti-abuse rule.* Trades that have as one of their principal purposes the meeting of the trading requirements of paragraph (b)(1) or (2) of this section shall be disregarded. Further, a class of stock shall not be treated as meeting the trading requirement of paragraph (b)(1) or (2) of this section if there is a pattern of trades conducted to meet the requirement of paragraph (b)(1) or (2) of this section. Similarly, paragraph (b)(2) of this section shall not apply to a public offering of stock that has as one of its principal purposes to avail itself of the reduced trading requirements under the special rule for the calendar year of an initial public offering. For purposes of applying the immediately preceding sentence, consideration will be given to whether the trading requirements of paragraph (b)(1) of this section are satisfied in the subsequent calendar year.

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Par. 6. Section 1.6031(a)–1 is amended by:

1. Redesignating the text of paragraph (b)(1) as (b)(1)(i).
 2. Adding a heading to newly designated paragraph (b)(1)(i).
 3. Adding paragraph (b)(1)(ii).
- The additions read as follows:

§ 1.6031(a)–1 Return of Partnership income.

* * * * *

(b) * * * (1) * * * (i) *Filing requirement.* * * *

(ii) *Special rule.* For purposes of this paragraph (b)(1) and paragraph (b)(3)(iii) of this section, a foreign partnership will not be considered to have derived income from sources within the United States solely because a U.S. partner marks to market his *pro rata* share of PFIC stock held by the foreign partnership pursuant to an election under section 1296.

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Robert E. Wenzel,
*Deputy Commissioner of
Internal Revenue*

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