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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9123

RIN 1545-AY17

Electing Mark to Market for Marketable Stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide 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 of the Internal Revenue Code and related provisions of sections 1291 and 1295. These final regulations affect United States persons owning marketable stock in a PFIC.

DATES: Effective Date: These regulations are effective May 3, 2004.

Applicability Date: For dates of applicability, see §§1.1291-1(j), 1.1295-1(k), and 1.1296-1(j).

FOR FURTHER INFORMATION CONTACT: Alexandra K. Helou, (202) 622-3840 (not a toll free number).

SUPPLEMENTARY INFORMATION:

**Background**

On July 31, 2002, the IRS published in the **Federal Register** a notice of proposed

rulemaking (REG-112306-00; 2002-44 I.R.B. 767) under section 1296 and related provisions of the Internal Revenue Code (Code). Two written comments were received in response to the notice of proposed rulemaking. No public hearing was requested or held on the notice of proposed rulemaking. After consideration of the comments, the proposed regulations are adopted as final regulations with the modifications discussed below.

## **Summary of Public Comments and Explanation of Changes**

### A. Deferral of Post-October PFIC Losses by Regulated Investment Companies (RICs) Under section 852(b)(10)

One commentator recommended that the regulations provide guidance regarding the determination of post-October “net reduction in value” of PFIC stock held by a RIC under section 852(b)(10). Section 852(b)(10) provides that taxable income of a RIC (other than a RIC to which an election under section 4982(e)(4) applies) shall be computed without regard to any net reduction in value occurring after October 31 of the taxable year of any stock of a PFIC with respect to which an election under section 1296(k) is in effect and that any such reduction shall be treated as occurring on the first day of the following taxable year.

To address concerns relating to a RIC’s post-October period, the commentator provided three recommendations. First, that the regulations clarify whether the deferral of post-October PFIC losses under section 852(b)(10) is elective or mandatory; second, that RICs be permitted to defer their post-October losses under rules similar to those that apply to foreign currency gains and losses under §1.852-11; and third, that RICs be allowed to include actual post-October dispositions of PFIC stock when computing losses eligible for deferral.

The IRS and Treasury have considered these recommendations and determined that the issues raised with respect to section 852(b)(10) are issues under the RIC tax provisions that are beyond the scope of this regulations project.

B. Situations Arising From Different Tax Years of RICs and the Foreign Corporations in Which They Invest

One commentator requested guidance in instances where the RIC and a foreign corporation in which it invests have different or “mismatching” taxable years. This commentator noted that a RIC may experience uncertainties with respect to determining its taxable income and minimum distribution amount in situations where, following the end of its taxable year, the RIC learns that a foreign corporation in which it has invested is a PFIC or that the foreign corporation no longer satisfies the income or asset tests of section 1297(a) for the current taxable year. To address administrative concerns arising in this situation, this commentator recommended that RICs be permitted to recognize a change in a foreign corporation’s PFIC status in the RIC’s taxable year within which the taxable year of the foreign corporation ends.

Issues arising from different taxable years are not specific to PFICs for which a taxpayer has made a section 1296 election. Accordingly, this issue is beyond the scope of this regulations project. However, comments are requested for approaches that address issues arising when a taxpayer and a PFIC have different taxable years. Such issues may be addressed in a future regulations project.

C. Situations Where a RIC Owns Stock in a Foreign Corporation That No Longer Satisfies the PFIC Definition in the Current Year

One commentator suggested that the regulations should address certain issues that arise with respect to a shareholder that has made a section 1296 election for its PFIC stock and the foreign corporation does not satisfy the income or asset test in section 1297(a) for the year. First, the commentator suggested that the regulations clarify that the character of gains from the disposition of the stock of the foreign corporation during the time that the corporation did not qualify as a PFIC should be capital gain. The commentator also requested that the regulations provide that the character of losses with respect to stock for which a section 1296 election was made but that is recognized in a taxable year during which the foreign corporation is not a PFIC be treated as ordinary income to the extent of any unreversed inclusions at the time of disposition.

After consideration of these comments, and in accordance with the statutory provisions of section 1296, the IRS and Treasury have adopted the first comment, but not the second comment. Accordingly, two examples were added to the regulations. Example 2 in §1.1296-1(c)(7) clarifies that any gain from the disposition of stock of a foreign corporation that does not qualify as a PFIC for the year of disposition will be capital gain because section 1296(c)(1)(A) no longer applies at such time. In the case of losses with respect to stock for which a section 1296 election was made but that is recognized in a taxable year during which the foreign corporation is not a PFIC, Example 4 in §1.1296-1(c)(7) was added to clarify that any loss from the disposition of such stock will be a capital loss because section 1296(c)(1)(B) no longer applies at such time.

Second, the commentator recommended that the regulations provide automatic consent for RICs to terminate a section 1296 election during a year that a foreign corporation no longer satisfies the requirements for PFIC status. The IRS and Treasury have not adopted this recommendation. The IRS and Treasury believe that it is appropriate to require consent of the Commissioner to terminate a section 1296 election. Under §1.1296-1(h)(3), a shareholder can request the consent of the Commissioner to revoke a section 1296 election upon a finding of a substantial change in circumstances, which may include a foreign corporation ceasing to be a PFIC.

D. Technical Coordination Issues Arising From Marking PFIC Stock to Market Under the Former Proposed §1.1291-8 and Notice 92-53

A commentator suggested that the regulations should clarify how the former proposed §1.1291-8 (see Notice 92-53 (1992-2 C.B. 384)) and the current statutory PFIC mark to market rules under section 1296 interact. For example, the commentator requested clarification concerning the RIC's adjustments to the basis of its PFIC stock to reflect gains previously included under the former proposed §1.1291-8.

The IRS and Treasury believe that no additional clarification is needed. To the extent a taxpayer increased its basis or received a new holding period under the former proposed §1.1291-8, those consequences will be respected even though the proposed regulations were withdrawn without being finalized following the enactment of current section 1296 (see 64 FR 5015 (February 2, 1999) withdrawing proposed §1.1291-8). As a result, the suggestion was not adopted.

This same commentator also recommended that Example 2 of proposed §1.1296-1(i)(4) be clarified by specifically providing that the RIC had not made a mark to market election under the former proposed §1.1291-8. The commentator suggested this modification to eliminate potential ambiguities that may arise over the relationship between an election under the former proposed §1.1291-8 and section 1296. This suggestion was adopted, and the example has been revised accordingly.

#### E. The Regulations Should Allow Qualified Shareholders to Make Protective and Retroactive Mark to Market Elections

One commentator recommended that the regulations should provide rules similar to those contained in the qualified electing fund (QEF) regime for purposes of making a retroactive QEF election. The IRS and Treasury have considered this comment and continue to believe that the appropriate process for retroactive relief for late mark to market elections is under the §301.9100 relief provisions, as set forth in §1.1296-1(h)(1)(iii). Accordingly, this suggestion was not adopted.

#### F. Termination of Existing Section 1296 Mark to Market Elections Without the Consent of the Commissioner

One commentator suggested permitting a taxpayer with an existing section 1296 election to make a QEF election and terminate its existing 1296 election without the consent of the Commissioner. The proposed regulations were 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 the consent of the Commissioner. Conversely, a taxpayer with an existing section

1296 election 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. This approach reflects consideration 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). After consideration of the comment, the IRS and Treasury continue to believe the rules coordinating QEF elections and mark to market elections under section 1296 are appropriate for the reasons discussed above. Accordingly, this recommendation was not adopted.

#### G. Proposals to Enhance the Utility of QEF Elections for RICs

One commentator provided two suggestions focused on enhancing the utility of QEF elections for RICs. Specifically, the commentator first suggested allowing RICs to use U.S. Generally Accepted Accounting Principles (U.S. GAAP) or International Financial Reporting Standards (IFRS) for purposes of computing QEF inclusions under section 1295(a)(2). The commentator also suggested revising the retroactive QEF election rules in cases where a RIC learns of the PFIC status of a foreign corporation immediately prior to the deadline for making a QEF election. These comments, which raise issues regarding the QEF rules, are beyond the scope of this regulation. Accordingly, these comments were

not adopted but will be considered in the context of any guidance to be issued under the appropriate substantive provisions.

#### H. Additional Revisions

The final regulations also clarify that the regulations apply to taxable years beginning on or after May 3, 2004. Additionally, the several examples in proposed §1.1296-1(c) have been grouped together in new §1.1296-1(c)(7) in order to make the regulation more readable.

#### **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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Drafting Information**

The principal author of these regulations is Alexandra K. Helou, 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.

## Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1--INCOME TAXES

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. §1.1291-0 (table of contents) is amended by revising the introductory text and by adding the entries for §1.1291-1 to read as follows:

§1.1291-0 Treatment of shareholders of certain passive foreign investment companies; table of contents.

This section contains a listing of the headings for §§1.1291-1, 1.1291-9, and 1.1291-10.

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

- (a) through (b) [Reserved].
- (c) Coordination with other PFIC rules.
- (1) and (2) [Reserved].
- (3) Coordination with section 1296: distributions and dispositions.
- (4) Coordination with mark to market rules under chapter 1 of the Internal Revenue Code other than section 1296.
  - (i) In general.
  - (ii) Coordination rule.
  - (d) [Reserved].
  - (e) Exempt organization as shareholder.
    - (1) In general.

- (2) Effective date.
- (f) through (i) [Reserved].
- (j) Effective date.

\* \* \* \* \*

Par. 3. Section 1.1291-1 is amended by:

1. Revising paragraphs (a) through (d).
2. Adding paragraphs (f) through (j).

The revisions and additions read as follows:

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

(a) and (b) [Reserved].

(c) Coordination with other PFIC rules.

(1) and (2) [Reserved].

(3) 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.

(4) 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)(4)(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 taxpayer 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)(4)(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.

(d) [Reserved].

\* \* \* \* \*

(f) through (i) [Reserved].

(j) Effective dates. This section applies for taxable years beginning on or after May 3, 2004, except as otherwise provided in paragraph (e)(2) of this section.

Par. 4. §1.1295-0 (table of contents) is amended by:

1. Revising the entries for §1.1295-1(i)(3) and (i)(4) and adding paragraph (i)(5), (i)(5)(i), and (i)(5)(ii).
2. Revising the entry for §1.1295-1(k).

The revisions and addition read as follows:

§1.1295-0 Table of contents. \* \* \*

§1.1295-1 Qualified electing funds.

\* \* \* \* \*

(i) \* \* \*

- (3) Automatic termination.
  - (4) Effect of invalidation, termination or revocation.
  - (5) Election after invalidation, termination or revocation.
- (i) In general.
- (ii) Special rule.

\* \* \* \* \*

(k) Effective dates.

\* \* \* \* \*

§1.1295-1 Qualified electing funds.

Par. 5. 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. Corp Y, a domestic corporation, owns directly 100 shares of marketable stock in foreign corporation FX, a PFIC. Corp Y also owns a 50 percent interest in FP, a foreign partnership that owns 200 shares of FX stock. Accordingly, under section 1298(a)(3) and ' 1.1296-1(e)(1), Corp Y is treated as indirectly owning 100 shares of FX stock. Corp Y also owns 100 percent of the stock of FZ, a foreign corporation that is not a

PFIC. FZ owns 100 shares of FX stock, and therefore under section 1298(a)(2)(A), Corp Y is treated as owning the 100 shares of FX stock owned by FZ. For taxable year 2005, Corp Y has a QEF election in effect with respect to all 300 shares of FX stock that it owns directly or indirectly. See generally ' 1.1295-1(c)(1). For taxable year 2006, Corp Y makes a timely election pursuant to section 1296 and the regulations thereunder. For purposes of section 1296, Corp Y 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, Corp Y's section 1296 election covers the 100 shares it owns directly and the 100 shares it owns indirectly through FP, but not the 100 shares owned by FZ. With respect to the first 200 shares, Corp Y's QEF election is automatically terminated effective December 31, 2005. With respect to the 100 shares Corp Y owns through foreign FZ, Corp Y's QEF election remains in effect unless invalidated, terminated, or revoked pursuant to this paragraph (i).

\* \* \* \* \*

(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.

\* \* \* \* \*

(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 for taxable years beginning on or after May 3, 2004.

Par. 6. 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 stock of a foreign corporation that previously 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 Corp X, a foreign corporation, on January 1, 2005 for \$150. At such time and at all times thereafter, Corp X was a PFIC and A's stock in Corp X was marketable. For taxable years 2005 and 2006, Corp X was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election with respect to the X stock, effective for taxable year 2007. The fair market value of the X stock was \$200 as of December 31, 2006, and \$240 as of December 31, 2007. Additionally, Corp X made no distribution with respect to its stock for the taxable years at issue. In 2007, pursuant to paragraph (i)(2)(ii) of this section, A must include the \$90 gain in the X 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. For further guidance, see Notice 92-53 (1992-2 C.B. 384) (see also 601.601(d)(2) of this chapter).

(b) Application of section 1296 election--(1) In general. Any United States person and any controlled foreign corporation (CFC) that owns directly, or is treated as owning under this section, marketable stock, as defined in ' 1.1296-2, 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. Mark to market gain, and any gain on the sale or other disposition of section 1296 stock, shall be treated 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 taxable year equal to the lesser of the amount 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. 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.

(5) Application of election to separate lots of stock. 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.

(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.

(7) Examples. The following examples illustrate this paragraph (c):

Example 1. Treatment of gain as ordinary income. A, a United States individual, purchases stock in FX, a foreign corporation that is not a PFIC, in 1990 for \$1,000. On January 1, 2005, when the fair market value of the FX stock is \$1,100, FX becomes a PFIC. A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the FX stock is \$1,200. For taxable year 2005, A includes \$200 of mark to market gain (the excess of the fair market value of FX stock (\$1,200) over A's adjusted basis (\$1,000)) in gross income as ordinary income and pursuant to paragraph (d)(1) of this section increases his basis in the FX stock by that amount.

Example 2. Treatment of gain as capital gain. The facts are the same as in Example 1. For taxable year 2006, FX does not satisfy either the asset test or the income test of section 1297(a). A does not revoke the section 1296 election it made with respect to the FX stock. On December 1, 2006, A sells the FX stock when the fair market value of the stock is \$1,500. For taxable year 2006, A includes \$300 of gain (the excess of the fair market value of FX stock (\$1,500) over A's adjusted basis (\$1,200)) in gross income as long-term capital gain because at the time of sale of the FX stock by A, FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period for non-PFIC purposes was more than one year.

Example 3. Treatment of losses as ordinary where they do not exceed unreversed inclusions. The facts are the same as in Example 1. On December 1, 2006, A sells the stock in FX for \$1,100. At that time, A's unreversed inclusions (the amount A included in income as mark to market gain) with respect to the stock in FX are \$200. Accordingly, for taxable year 2006, A recognizes a loss on the sale of the FX stock of \$100, (the fair market value of the FX stock (\$1,100) minus A's adjusted basis (\$1,200) in the stock) that is treated as an ordinary loss because the loss does not exceed the unreversed inclusions attributable to the stock of FX.

Example 4. Treatment of losses as long-term capital losses. The facts are the same as in Example 3, except that FX does not satisfy either the asset test or the income test of section 1297(a) for taxable year 2006. For taxable year 2006, A's \$100 loss from the sale of the FX stock is treated as long-term capital loss because at the time of the sale of the FX stock by A FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period in the FX stock for non-PFIC purposes was more than one year.

Example 5. Long-term capital loss treatment of losses in excess of unreversed inclusions. The facts are the same as in Example 3, except that A sells his FX stock for \$900. At the time of A's sale of the FX stock on December 1, 2006, A's unreversed inclusions with respect to the FX stock are \$200. Accordingly, the \$300 loss recognized by A on the disposition is treated as an ordinary loss to the extent of his unreversed inclusions (\$200). The amount of the loss in excess of A's unreversed inclusions (\$100) will be treated as a long-term capital loss because A's holding period in the FC stock for non-PFIC purposes was more than one year.

Example 6. Application of section 1296 election to separate lots of stock. On January 1, 2005, Corp A, a domestic corporation, purchased 100 shares (first lot) of stock in FX, a PFIC, for \$500 (\$5 per share). On June 1, 2005, Corp A purchased 100 shares (second lot) of FX stock for \$1,000 (\$10 per share). Corp A made a timely section 1296 election with respect to its FX stock for taxable year 2005. On December 31, 2005, the fair market value of FX stock was \$8 per share. For taxable year 2005, Corp A includes \$300 of gain in gross income as ordinary 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, Corp A is not permitted to recognize a loss under paragraph (c)(3) of this section for taxable year 2005. Although Corp A's adjusted basis in that stock exceeds its fair market value by \$200, Corp A has no unreversed inclusions with respect to that particular lot of stock. On July 1, 2006, Corp A sells 100 shares of FX stock for \$900. Assuming that Corp A adequately identifies (in accordance with the rules of ' 1.1012-1(c)) the shares of FX stock sold as being from the second lot, Corp A recognizes \$100 of long term capital loss pursuant to paragraph (c)(4)(ii) of this section.

(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 persons' 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. Corp A, a domestic corporation, owns a 20 percent interest in FP. Corp B, a domestic corporation, owns a 30 percent interest in FP. Corp C, a foreign corporation, with no direct or indirect shareholders that are U.S. persons, owns a 50% interest in FP. Corp A, Corp B, and FP all use a calendar year for their taxable year. In 2005, FP purchases stock in FX, a foreign corporation and a PFIC, for \$1,000. Corp A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the PFIC stock is \$1,100. Corp A includes \$20 of ordinary income in taxable year 2005 under paragraphs (c)(1) and (2) of this section. Corp A increases its basis in its FP partnership interest by \$20. FP increases its basis in the FX stock to \$1,020 solely for purposes of determining the subsequent treatment of Corp A, under chapter 1 of the Internal Revenue Code, with respect to such stock. In 2006, FP sells the FX stock for \$1,200. For purposes of determining the amount of gain of Corp A, FP will be treated as having \$180 in gain of which \$20 is allocated to Corp A. Corp 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 Corp B, FP will be treated as having \$200 gain, \$60 of which will be allocated to Corp 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 ' 1.1296-2(f) of stock in a PFIC and has a valid section 1296 election in effect with respect to the PFIC stock.

(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. A, a nonresident alien individual, purchases marketable stock in FX, a PFIC, for \$50 in 1995. On January 1, 2005, A 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 FX stock on January 1, 2005, is \$100. The fair market value of the FX stock on December 31, 2005, is \$110. Under paragraph (d)(5)(i) of this section, A computes the amount of mark to market gain or loss for the FX stock in 2005 by reference to an adjusted basis of \$100, and therefore A 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, A's adjusted basis in the FX stock for purposes of this section is increased to \$110 (and to \$60 for all other tax purposes). A sells the FX stock in 2006 for \$120. For purposes of applying section 1001,

A must use its original basis of \$50, with any adjustments under paragraph (d)(1) of this section, \$10 in this case, and therefore A 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 FX stock is long term capital gain because A 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 ' 1.1296-2(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 person is treated as actually owning stock 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 accordance with paragraphs (c) and (i)(2)(ii) 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<sup>®</sup>, 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) 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 1297 or treated as 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) is illustrated by the following examples:

Example 1. A, a United States person, owns stock in FX, a PFIC. A makes a QEF election in 1996 with respect to the FX stock. For taxable year 2005, A 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 2006, A's stock in FX ceases to be marketable, and therefore its section 1296 election is automatically terminated under paragraph (h)(3) of this section. Beginning with taxable year 2006, A is subject to the rules of section 1291 with respect to its FX stock 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 A's stock in FX becomes marketable again in 2007. A may make a new section 1296 election with respect to the FX stock for its taxable year 2007, or thereafter. A will be subject to the coordination rules under paragraph (i) of this section unless it made a new QEF election in 2006.

(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 FX, a PFIC that it acquired on January 1, 1992. At all times, A's FX stock was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election effective for taxable year 2005. At the close of taxable year 2005, the fair market value of A's FX 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 FX stock were disposed of on December 31, 2005. Further, A increases its adjusted basis in the FX 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 that had not made an election prior to 2005 to mark to market the PFIC stock. In taxable year 2005, A includes \$10 of ordinary income under paragraph (c)(1) of this section, and such amount is not subject to section 1291. A also increases its tax imposed under section 852 by the amount of interest that would have been determined under section 1291(c)(3), and no deduction is permitted for such amount. Finally, under paragraph (d)(1) of this section, A increases its adjusted basis in the FX stock by \$10.

(j) Effective date. The provisions in this section are applicable for taxable years beginning on or after May 3, 2004.

Par. 7. Section 1.1296(e)-1 is redesignated as §1.1296-2 and amended by:

1. Revising paragraph (b)(2).
2. Adding paragraph (b)(3).
3. Revising both references to Asections 958(a)(1) and (2)@in paragraph (f)(1) to read Asection 1298(a)@.

The revisions and addition read as follows:

' 1.1296-2 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.

\* \* \* \* \*

Par. 8. 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.

\* \* \* \* \*

Mark E. Matthews,  
Deputy Commissioner of Services and Enforcement.

Approved: April 7, 2004.

Gregory F. Jenner,  
Acting Assistant Secretary of the Treasury.