[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-113744-98]

RIN 1545-AW69

Passive Foreign Investment Companies; Definition of marketable stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the new mark to market election for stock of a passive foreign investment company (PFIC). The proposed regulations interpret changes made by the Taxpayer Relief Act of 1997. The proposed regulations affect persons holding PFIC stock that is regularly traded on certain U.S. or foreign exchanges or markets or holding stock in certain PFICs comparable to U.S. regulated investment companies (RICs). The proposed regulations also reserve treatment of and request comments on making the mark to market election for options on marketable stock.

DATES: Written comments or requests for a public hearing must be received by May 3, 1999.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG-113744-98), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-110524-98), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Robert Laudeman, (202) 622-3840; concerning submissions, LaNita VanDyke, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This notice contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) regarding the taxation of U.S. holders of PFIC stock.

Since the enactment of the Tax Reform Act of 1986, U.S. holders of PFIC stock have been subject to two alternative sets of inclusion rules: the interest charge rules under section 1291 of the Internal Revenue Code and the qualified electing fund (QEF) rules under section 1293.

The interest charge rules apply to shareholders of PFICs that are not QEFs or for which a QEF election is unavailable. Under the interest charge rules, the PFIC shareholders pay tax and an interest charge that is attributable to the value of deferral on receipt of certain distributions and on disposition of the PFIC stock. By contrast, PFIC shareholders who make a QEF election include currently in gross income their respective shares of the PFIC's total earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.

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 election, but are unable to make the election because they cannot obtain the necessary information from the PFIC. Congress accordingly enacted new section 1296 in the Tax Reform Act of 1997 to provide PFIC shareholders with an alternative method to include income currently with respect to their interests in a PFIC by allowing PFIC shareholders to elect to mark to market PFIC stock that qualifies as marketable stock.

In general, a PFIC shareholder who elects under section 1296 to mark to market the marketable stock of a PFIC includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. A shareholder is also generally allowed a deduction for the excess, if any, of the adjusted basis of the PFIC stock over the fair market value as of the close of the taxable year. Deductions under this rule, however, are allowable only to the extent of any net mark to market gains with respect to the stock included by the shareholder for prior taxable years.

Section 1296(e)(1) defines marketable stock as including several categories of stock. First, section 1296(e)(1)(A) states that marketable stock includes any stock which is regularly traded on (i) a national securities exchange which is registered with the Securities and Exchange Commission (SEC) or the national market system established pursuant to section 11A of the Securities Exchange Act of 1934, or (ii) any exchange or other market which the Secretary determines has rules adequate to carry out the purposes of the PFIC provisions. With respect to (ii) above, the conference report specifies that "PFIC stock is considered marketable if it is regularly traded on any exchange or market that the Secretary of the Treasury determines has rules sufficient to ensure that the market price represents a legitimate and sound fair market value." H.R. Conf. Rep. No. 2014, 105th Cong., 1st Sess. 625 (1997). Second, section 1296(e)(1)(B) states that, to the extent provided in regulations, stock in any foreign corporation which is comparable to a RIC and which offers for sale or has outstanding any stock of which it is the issuer and which is redeemable at its net asset value will be marketable stock. Third, section 1296(e)(1)(C) states that, to the extent provided in regulations, any option on stock described in section 1296(e)(1)(A) or (B) will constitute marketable stock.

Section 1296(e)(2) provides that in the case of any RIC which is offering for sale or has outstanding any stock of which it is the issuer and which is redeemable at net asset value, all stock in a PFIC which it owns directly or indirectly shall be treated as marketable stock for purposes of section 1296. Section 1296(e)(2) further provides that except as provided in regulations, similar treatment as marketable stock shall apply in the case of any other RIC which publishes net asset valuations at least annually.

The proposed regulations define marketable stock for purposes of section 1296. Specifically, the proposed regulations define regularly traded and list attributes that a foreign exchange or market must have in order for PFIC stock traded on such an exchange or market to be eligible for the mark to market election. The definition of regularly traded and the attributes required of foreign exchanges or markets are intended to ensure that the prices of PFIC shares listed on the exchange or market represent legitimate and sound fair market values. The proposed regulations also list the attributes that a foreign corporation must satisfy to be comparable to a RIC, and thus for its stock to be marketable stock. The attributes are intended to ensure that the foreign corporation is an investment vehicle similar in relevant respects to a U.S. mutual fund and that its representations of net asset value represent a legitimate fair market value.

Explanation of Provisions

Regularly Traded

Under the proposed regulations, the class of PFIC stock held by the shareholder must be traded, other than in de minimis quantities, on at least 15 days during each calendar quarter. The proposed regulations also include an anti-abuse rule to prevent persons from manipulating the number of trades in order to meet this test.

Exchange or Other Market

The proposed regulations require that a foreign exchange or market be regulated or supervised by a governmental authority of the country in which the market is located. This requirement will help to ensure that the prices of the stock listed by the exchange are legitimate and sound fair market values. Because the degree of governmental regulation or supervision for each foreign exchange or market may vary by exchange or market or country, the proposed regulations also list additional characteristics that the foreign exchange or market must have for stock that is regularly traded on the exchange or market to be considered marketable stock for purposes of section 1296.

First, the exchange must have trading volume, listing, financial disclosure and other requirements, designed to prevent fraud, perfect the mechanism of a free and open market, and protect investors. See section 6 of the Securities Exchange Act of 1934, 15 U.S.C. 78f. There must be actual enforcement of these requirements by the exchange and government of the country in which the exchange is located.

Second, the rules of the exchange must ensure active trading of listed stocks.

Finally, the IRS and Treasury Department invite comments on whether PFIC stock that is regularly traded on any other type of exchange or market, such as an over-the-counter market, should be considered marketable stock. Additional comments are requested about what features those exchanges or markets should have to ensure that the stock prices quoted on such markets are legitimate and sound fair market values.

Stock in Certain PFICs

The proposed regulations provide that stock in certain PFICs will be marketable stock if the PFIC is a corporation described in section 1296(e)(1)(B) (foreign corporations comparable to RICs) and if the PFIC offers for sale or has outstanding stock of which it is the issuer and which is redeemable at its net asset value. A PFIC will be a corporation described in section 1296(e)(1)(B) if the PFIC satisfies the conditions listed in the proposed regulations and described below, with respect to the class of shares held by the electing taxpayer. These conditions are intended to describe PFICs that are comparable to U.S. RICs in relevant respects and to implement the intent of the statute by ensuring that the net asset valuations of such companies represent legitimate and sound fair market values for the companies' stock.

First, the class of stock held by an electing shareholder must be held by one hundred or more unrelated shareholders. The relationships set forth in section 267(b) are used to define related shareholders that are excluded from satisfying this test. This condition is consistent with the requirements for RICs under section 851(a) and §1.851-1 of the income tax regulations.

Second, the applicable class of shares of the foreign corporation must be regularly available for purchase by the general public at its net asset value in initial amounts not greater than $10,000 (U.S.). The IRS and Treasury Department invite comments on whether $10,000 is the appropriate ceiling to ensure that the shares of the company will be widely available to the general public. The IRS and Treasury Department also invite comments on whether and under what conditions the regulations should allow shares of a foreign corporation to be purchased at amounts different from their net asset value, such as for a price that includes a sales load. Additional comments are requested about whether the regulations should cover foreign corporations that otherwise qualify but are closed to new investors.

Third, the proposed regulations require that quotations for the class of shares of the foreign corporation be determined and published on a daily basis in a widely-available medium, such as a newspaper of general circulation. This requirement approximates the practice of U.S. RICs and is intended to ensure that shareholders and prospective purchasers have regular access to publicly available price information.

Fourth, financial statements of the foreign corporation prepared by independent auditors that include balance sheets (statements of assets, liabilities, and net assets) and statements of income and expenses, must be prepared and made available to the public no less frequently than annually. This requirement approximates the requirements imposed on U.S. mutual funds by the SEC and is intended to ensure that shareholders and prospective purchasers have regular access to financial information for the foreign corporation.

Fifth, the foreign corporation must be supervised or regulated as an investment company by a foreign government or an agency or instrumentality thereof. This condition is intended to approximate the SEC’s regulation of U.S. RICs while taking into account the variety of regulatory regimes used by different governments.

Sixth, the foreign corporation may not have any senior securities authorized or outstanding, including any debt other than de minimis amounts. This requirement is similar to the requirement imposed on U.S. RICs by the SEC.

Finally, the foreign corporation must meet the PFIC income and asset tests in sections 1297(a)(1) and (2) with the requisite percentages increased from 75 percent to 90 percent and from 50 percent to 90 percent respectively. This condition is intended to approximate the characteristic of U.S. RICs as passive investment vehicles.

The proposed regulations also include an anti-abuse rule to prevent a foreign corporation from improperly manipulating its net asset valuations to reduce the U.S. tax under section 1296 of one or more shareholders of the corporation.

Options on Marketable Stock

The proposed regulations reserve the paragraph for defining how and when options on marketable stock, as defined by these regulations, will be eligible for mark to market treatment. The IRS and Treasury Department invite comments regarding the conditions under which the regulations should define options on marketable stock to be marketable stock.

Special Rules for RICs

The proposed regulations clarify that shares in a PFIC that are owned directly or indirectly by a U.S. RIC, which is offering for sale or has outstanding any stock of which it is the issuer and which is redeemable at net asset value, shall be treated as marketable stock for purposes of section 1296. The IRS and Treasury Department invite comments regarding situations where PFIC stock held by other U.S. RICs that publish asset valuations at least annually should not be treated as marketable stock for purposes of section 1296.

Proposed Effective Date

The regulations are proposed to be applicable for shareholders whose taxable years end on or after the date these regulations are published as final regulations in the **Federal Register**. In addition, it is proposed that shareholders may elect to apply these regulations to taxable years beginning after December 31, 1997.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has 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 requirement for the 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 Internal Revenue 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 Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department 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 may be scheduled if requested by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register**.

Drafting Information

The principal author of these regulations is Robert Laudeman, Office of the 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.

Proposed Amendments to the Regulations

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

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

Section 1.1296(e)-1 also issued under 26 U.S.C. 1296(e). * * *

Par. 2. Section 1.1296(e)-1 is added to read as follows:

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

(a) General rule. For purposes of section 1296, the term marketable stock means--

(1) Passive foreign investment company (PFIC) stock that is regularly traded, as defined in paragraph (b) of this section, on a qualified exchange or other market, as defined in paragraph (c) of this section;

(2) Stock in certain PFICs, as described in paragraph (d) of this section; and

(3) Options on stock that is described in paragraph (a)(1) or (2) of this section, to the extent provided in paragraph (e) of this section.

(b) Regularly traded--(1) General rule. For purposes of paragraph (a)(1) of this section, a class of stock that is traded on one or more qualified exchanges or other markets, as defined in paragraph (c) of this section, is considered to be regularly traded on such exchanges or markets for any calendar year during which such class of stock is traded, other than in de minimis quantities, on at least 15 days during each calendar quarter.

(2) Anti-abuse rule. Trades that have as one of their principal purposes the meeting of the trading requirement of paragraph (b)(1) of this section shall be disregarded. Further, a class of stock shall not be treated as meeting the trading requirement of paragraph (b)(1) of this section if there is a pattern of trades conducted to meet the requirement of paragraph (b)(1) of this section.

(c) Qualified exchange or other market--(1) General rule. For purposes of paragraph (a)(1) of this section, the term qualified exchange or other market means, for any taxable year--

(i) A national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities Exchange Act of 1934 (15 U.S.C. 78f); or

(ii) A foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and which has the following characteristics--

(A) The exchange has trading volume, listing, financial disclosure, and other requirements designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open market, and to protect investors; and the laws of the country in which the exchange is located and the rules of the exchange ensure that such requirements are actually enforced; and

(B) The rules of the exchange ensure active trading of listed stocks.

(2) <u>Exchange with multiple tiers</u>. If an exchange in a foreign country has more than one tier or market level on which stock may be separately listed or traded, each such tier shall be treated as a separate exchange.

(d) <u>Stock in certain PFICs</u>--(1) <u>General rule</u>. Except as provided in paragraph (d)(2) of this section, a foreign corporation will be a corporation described in section 1296(e)(1)(B), and paragraph (a)(2) of this section, if the foreign corporation offers for sale or has outstanding stock of which it is the issuer and which is redeemable at its net asset value and if the foreign corporation satisfies the following conditions with respect to the class of shares held by the electing taxpayer--

(i) The foreign corporation has one hundred or more shareholders with respect to the class, other than shareholders who are related under section 267(b);

(ii) The class of shares of the foreign corporation is readily available for purchase by the general public at its net asset value by new investors in initial amounts not greater than $10,000 (U.S.);

(iii) Quotations for the class of shares of the foreign corporation are determined and published on a daily basis in a widely-available medium, such as a newspaper of general circulation;

(iv) No less frequently than annually, independent auditors must prepare financial statements of the foreign corporation that include balance sheets (statements of assets, liabilities, and net assets) and statements of income and expenses, and those statements must be made available to the public;

(v) The foreign corporation is supervised or regulated as an investment company by a foreign government or an agency or instrumentality thereof;

(vi) The foreign corporation has no senior securities authorized or outstanding, including any debt other than in de minimis amounts;

(vii) Ninety percent or more of the gross income of the foreign corporation for its taxable year is passive income, as defined in section 1297(a)(1) and the regulations thereunder; and

(viii) The average percentage of assets held by the foreign corporation during its taxable year which produce passive income or which are held for the production of passive income, as defined in section 1297(a)(2) and the regulations thereunder, is at least 90 percent.

(2) Anti-abuse rule. If a foreign corporation undertakes any action with a principal purpose of manipulating the net asset value of a class of its shares in order to reduce the United States tax under section 1296 of one or more of its shareholders, the class of shares will not qualify as marketable stock for purposes of paragraph (d)(1) of this section.

(e) [Reserved]

(f) Special rules for regulated investment companies (RICs) --(1) General rule. In the case of any RIC which is offering for sale or has outstanding any stock of which it is the issuer and which is redeemable at net asset value, its stock in any passive foreign investment company which it owns directly or indirectly, as defined in sections 958(a)(1) and (2), shall be treated as marketable stock owned by that RIC for purposes of section 1296.

(2) [Reserved]

(g) Effective date. This section applies to shareholders whose taxable year ends on or after the date these regulations are published as final regulations in the **Federal Register** for stock in a foreign corporation whose taxable year ends with or within the shareholder’s taxable year. In addition, shareholders may elect to apply these regulations to any taxable year beginning after December 31, 1997, for stock in a foreign corporation whose taxable year ends with or within the shareholder’s taxable year.

Robert E. Wenzel

Deputy Commissioner of Internal Revenue