INVESTMENT COMPANY INSTITUTE

MEMO# 3671

April 3, 1992

PROPOSED REGULATIONS ON PASSIVE FOREIGN INVESTMENT COMPANIES CONTAIN MARK-TO-MARKET SYSTEM FOR OPEN- AND CLOSED-END FUNDS

- 1 - April 3, 1992 TO: TAX MEMBERS NO. 23-92 ACCOUNTING/TREASURERS MEMBERS NO. 20-92 CLOSED-END FUND MEMBERS NO. 19-92 INTERNATIONAL MEMBERS NO. 7-92 RE: PROPOSED REGULATIONS ON PASSIVE FOREIGN INVESTMENT COMPANIES CONTAIN MARK-TO-MARKET SYSTEM FOR OPEN- AND CLOSED-END FUNDS ____ As you know, the passive foreign investment company ("PFIC") provisions of the Internal Revenue Code cause a regulated investment company ("RIC") which sells at a gain shares of a PFIC held by the RIC in more than one tax year to incur a fund-level tax which cannot be avoided by distributing the gain. The Institute has been working to eliminate this tax either legislatively or through regulations. The recent, vetoed tax bill contained a mark-to-market regime which would have resolved this problem. (See Institute Memorandum to Board of Governors No. 19-92, Tax Members No. 15-92, Closed-End Fund Members No. 13- 92, Unit Investment Trust Members No. 20-92, Accounting/ Treasurers Members No. 12-92, Operations Members No. 11-92, International Committee No. 7-92, Institutional Funds Committee No. 3-92 and Transfer Agent Advisory Committee No. 14-92, dated March 23, 1992.) We are pleased to announce that the Treasury Department has issued proposed regulations on PFICs which include the mark-to- market system for RICs that the Institute has sought. Although there are a few minor technical problems with the regulations, they contain essentially all of the provisions requested by the Institute. The proposed regulations would allow all open-end RICs and closed-end RICs which publish their net asset value at least weekly to elect to mark to market all shares of PFICs (referred to in the proposed regulations as "section 1291 funds") as of the end of each tax year. Among the consequences of the election are the following: o Any gain on such marking-to-market would be ordinary income and treated as an excess distribution; any loss would not be recognized. - 2 - Because the income would all be recognized in a single tax year, however, it would be gross income to the RIC and could be distributed to avoid a fund-level tax. o Any section 1291 fund stock which had been marked- to-market would be considered to restart its holding period at the beginning of each year, even if marking-to-market resulted in an unrecognized loss. o The basis of any section 1291 fund stock with mark- to-market gain would be adjusted to avoid double inclusion of income. o Marking-to-market would have no effect on the treatment of the section 1291 fund for other PFIC purposes. Therefore, distributions from such a fund would remain taxable under the general PFIC rules. Gain on disposition of a section 1291 fund also would be treated as an excess distribution; thus, even actual disposition gain would be ordinary income. Although the proposed regulations are not retroactive, they do provide for a transition rule under which a RIC may make an election for its first taxable year ending after the date the regulations are finalized to include as ordinary income all of the gain on each section 1291 fund and to pay a nondeductible interest charge. Similarly, if a RIC discovers an "undiscovered PFIC", it may elect to recognize the prior years' gains on the discovered stock in the year of discovery and pay the nondeductible interest charge. Currently, no public hearing has been scheduled. Please call the undersigned at (202) 955-3521 by Monday, April 20, 1992, if you have any comments on the proposed regulations. Although this requested comment deadline is significantly ahead of the date set by the Treasury for comments, the Institute plans to file comments as soon as possible requesting that the proposed regulations be finalized promptly or, in the alternative, that they be issued in Temporary form, so that RICs may sooner take advantage of the transition rule. We will keep you informed of further developments. David J. Mangefrida Jr. Assistant Counsel - Tax Attachment

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