

MEMO# 10771

March 3, 1999

PROPOSED REGULATIONS DESCRIBE STOCK ELIGIBLE FOR PASSIVE FOREIGN INVESTMENT COMPANY MARK-TO-MARKET ELECTION

1 Pursuant to this election, a US shareholder generally includes in income each year an amount equal to the excess, if any, of the fair market value of the shareholder's PFIC stock as of the close of the taxable year over the shareholder's adjusted basis in such stock. Deductions for losses are allowable only to the extent of any net mark-to-market gains with respect to the stock included in income by the shareholder for prior taxable years. [10771] March 3, 1999 TO: TAX MEMBERS No. 13-99 UNIT INVESTMENT TRUST COMMITTEE No. 5-99 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 10-99 RE: PROPOSED REGULATIONS DESCRIBE STOCK ELIGIBLE FOR PASSIVE FOREIGN INVESTMENT COMPANY MARK-TO-MARKET ELECTION

Introduction

The attached proposed regulations describe when passive foreign investment company ("PFIC") stock held by a US shareholder is treated as "marketable" and, thus, eligible for the mark-to-market election of section 1296 of the Internal Revenue Code.¹ Under the statute, all PFIC stock held directly or indirectly by open-end regulated investment companies ("RICs") is eligible for the mark-to-market election. Similar statutory treatment is provided for PFIC stock held by closed-end RICs that publish net asset values ("NAVs") at least annually, except as provided in regulations. Accordingly, two aspects of the proposed regulations are particularly relevant to RICs. First, the preamble to the proposed regulations requests comments regarding situations where PFIC stock held by closed-end RICs should not be treated as eligible for the mark-to-market election. As discussed below, the Institute will submit comments to the Internal Revenue Service supporting the treatment of PFIC stock directly or indirectly held by all RICs (including closed-end RICs) as eligible for the PFIC mark-to-market election. Second, the proposed regulations clarify that "direct or indirect" ownership of PFIC stock by RICs is determined under sections 958(a)(1) (direct ownership) and 958(a)(2) (indirect ownership). The statutory reference to section 958(a)(2) confirms that a RIC may mark-to-market PFIC stock that it owns indirectly through another foreign corporation, a foreign partnership or a foreign trust or estate. The remainder of this memorandum discusses when PFIC stock held by non-RIC shareholders (including unit investment trusts treated for federal income tax purposes as grantor trusts) will be treated as "marketable." Requirements to Treat PFIC Stock as "Marketable" PFIC stock held by non-RIC shareholders (including unit investment trusts treated for federal income tax purposes as grantor trusts) will be treated as "marketable" under the statute if it is "regularly" traded on certain US exchanges or, to the extent provided in regulations, on foreign exchanges or

other markets. Subject to an anti-abuse rule, the proposed regulations provide that PFIC stock will be “regularly” traded for any calendar year during which trades occur “other than in de minimis quantities” on at least 15 days during each calendar quarter. PFIC stock regularly traded on a foreign securities exchange will be treated as “marketable” if such exchange is regulated or supervised by a local governmental authority and generally has rules sufficient to ensure that the market prices for traded securities reflect fair market value. The preamble to the proposed regulations requests 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 and what features any such exchange or markets should have to ensure that quoted stock prices reflect fair market value. PFIC stock held by non-RIC shareholders also will be treated as “marketable” under the statute if, to the extent provided in regulations, the PFIC is “comparable” to an open-end RIC. Subject to an anti-abuse rule, the proposed regulations provide that a widely-held PFIC whose stock is redeemable at NAV generally will be “comparable” to an open-end RIC if (i) it is regulated or supervised as an investment company by a foreign government or agency, (ii) it passes a 90 percent threshold for passive income and assets, (iii) its shares are regularly available for purchase by the public at NAV in initial amounts not greater than \$10,000 USD, (iv) it determines and publishes NAVs daily and (v) it is subject to annual independent audits, the results of which are made available to the public. The preamble to the proposed regulations requests comments on whether \$10,000 USD is an appropriate ceiling to ensure that shares of the PFIC will be widely available to the general public. Comments are further requested on whether and under what conditions the regulations should allow PFIC shares to be purchased at other than NAV, such as for a price that includes a sales load. Comments also are requested on whether the regulations should address PFICs that otherwise qualify as “comparable” to an open-end RIC but are closed to new investors. Finally, the statute provides that any option on “marketable” PFIC stock also will be treated as “marketable,” to the extent provided in regulations. The preamble to the proposed regulations requests comments regarding the conditions under which the regulations should define options on marketable stock to be marketable stock.

Proposed Effective Date The regulations are proposed to apply to taxable years of shareholders ending on or after the date they are issued as final regulations. In addition, it is proposed that shareholders may elect to apply the regulations to taxable years beginning after December 31, 1997. In conjunction with the proposed regulations, the Internal Revenue Service has withdrawn Prop. Treas. Reg. section 1.1291-8, relating to PFIC mark-to-market elections by RICs.

Written Comments Written comments or requests for a public hearing with respect to the proposed regulations are due to the Internal Revenue Service by May 3, 1999. The Institute will submit comments to the Service supporting the treatment of PFIC stock directly or indirectly held by all RICs (including closed-end RICs) as eligible for the PFIC mark-to-market election.

ACTION REQUESTED: Please contact the undersigned (dflores@ici.org or 202.371.5436) no later than March 29, 1999 with any comments to be included in the Institute’s submission to the Internal Revenue Service with respect to the attached proposed regulations.

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