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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8867]

RIN 1545-AW69

Passive Foreign Investment Companies; Definition of marketable stock

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations under section 1296 relating to the new mark-to-market election for stock of a passive foreign investment company (PFIC). The final regulations interpret changes made by the Taxpayer Relief Act of 1997. The final 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).

DATES: Effective Date: January 25, 2000.

Applicability Dates: For dates of applicability see section 1.1296(e)-1(g) of these regulations.

FOR FURTHER INFORMATION CONTACT: Robert Laudeman, (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On February 2, 1999, the IRS published in the **Federal Register** proposed regulations (REG-113744-98, 64 FR 5014)

regarding the taxation of U.S. holders of PFIC stock. Three written comments regarding the proposed regulations were received. Because no one requested to speak at a public hearing, no hearing was held. After consideration of all of the comments received, the proposed regulations under section 1296 are adopted as final regulations with some changes. The changes are discussed below.

The preamble to the proposed regulations (64 FR 5014) provides a detailed discussion of the mark-to-market election for shareholders of PFIC stock and the proposed regulations.

Summary of Public Comments and Changes

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. 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 marketable stock for purposes of section 1296. Specifically, the proposed regulations require that the exchange 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.

The final regulations add a surveillance requirement and add the concept of perfecting a fair and orderly market to the requirements for exchanges. These changes are intended to

clarify the characteristics that an exchange or other market must have in order to be a qualified exchange or market for purposes of section 1296 and to more closely represent common characteristics of foreign markets. See International Federation of Stock Exchanges (FIBV), 1998 Market Principles, available by request from secretariat@fibv.com, and International Organization of Securities Commissions (IOSCO), Supervisory Framework for Markets, Report by the Technical Committee, May 1999 (visited Oct. 5, 1999) <<http://www.iosco.org/iosco.html>>.

Stock in Certain PFICs

The proposed regulations provide that stock in certain PFICs is marketable stock if the PFIC both is a corporation described in section 1296(e)(1)(B) (foreign corporations comparable to RICs) and offers for sale or has outstanding stock of which it is the issuer and which is redeemable at its net asset value. The proposed regulations further provide that a PFIC is a corporation described in section 1296(e)(1)(B) only if the PFIC satisfies eight conditions listed in the proposed regulations with respect to the class of shares held by the electing taxpayer. The conditions are intended to describe PFICs that are comparable to 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.

Two commentators asserted that the statute and legislative history indicate that Congress was only concerned that PFICs

redeem stock at net asset values and that such values represent sound and legitimate fair market values and, therefore, it is not necessary that the PFIC resemble a RIC. The commentators suggest that the regulations be modified to include PFICs that redeem their stock at its net asset value but do not otherwise resemble RICs. Because the plain language of the statute clearly requires that the stock in any foreign corporation be comparable to a RIC, the final regulations retain the approach of requiring PFICs to be comparable to RICs in order for their stock to be marketable stock for purposes of section 1296(e)(1)(B).

The proposed regulations provide that a foreign corporation must have one hundred or more unrelated shareholders. One commentator recommended that the number be reduced to ten unrelated shareholders, arguing that a corporation with ten unrelated shareholders as opposed to one hundred unrelated shareholders has the same susceptibility to legal liabilities if valuations are inaccurate. Requiring that a PFIC have one hundred or more unrelated shareholders is comparable to the requirement imposed on RICs by section 851(a). In addition, the IRS and the Treasury Department believe that there will be less likelihood of share price manipulation with corporations that have one hundred or more unrelated shareholders. Consequently, the above described rule in the proposed regulations is not changed except that "one hundred or more" is corrected to read "more than one hundred" unrelated shareholders.

The proposed regulations require that the class of shares of

the foreign corporation be 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.). One commentator recommended that this condition not be included in the final regulations because an investment ceiling will not make the valuation easier or less likely to be manipulated.

The condition in the proposed regulations regarding initial investments is not an investment ceiling. Rather, the condition specifies that the foreign corporation not require a minimum initial investment of greater than \$10,000 (U.S.) and that shares of the foreign corporation be readily available for purchase by the general public at net asset values. For example, a foreign corporation that requires new investors to purchase shares for a minimum initial investment of \$5,000 (U.S.) satisfies the condition. However, a foreign corporation that requires new investors to purchase shares for a minimum initial investment of \$20,000 (U.S.) does not satisfy the condition. There is not any limit, however, on the total amount that a shareholder can invest. The final regulations clarify that this condition is not an investment ceiling.

Two additional requirements in the proposed regulations are that shares be available for purchase by the general public and that, no less frequently than annually, financial statements prepared by independent auditors be available to the public. One commentator asserted that availability to the general public of the shares of the foreign corporation and of the financial

statements is not necessary and should not be required because it will not necessarily ensure a legitimate and sound fair market value for the foreign corporation's stock.

Availability of shares for purchase by the general public is comparable to the requirement of availability of shares of RICs for purchase by the general public. In addition, availability of shares for purchase by the the general public for net asset value (in addition to current investors being able to redeem shares for the same net asset value), will ensure that the net asset values are legitimate and sound. However, shares will not be considered available for purchase by the general public if the shares are only available to individuals with high annual incomes or high net worth. For example, limiting investors to individuals with annual incomes in excess of \$200,000 or net worth in excess of \$1 million will not be considered available for purchase by the general public.

Similarly, availability to the general public of audited financial statements is comparable to conditions imposed on RICs and will help to ensure that the foreign corporation's financial information is readily available to potential and current investors, which, in turn, will help ensure that the net asset values are legitimate and sound. Availability of financial statements to the general public requires no more than that the statements be available upon request to potential and current investors.

The proposed regulations require that quotations for the

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. One commentator asserted that the condition is not necessary because the mark-to-market election is made on an annual basis at the close of the taxpayer's taxable year. The commentator recommended that the condition be changed to require that values be communicated to shareholders, on at least an annual basis, in written form that serves as support for such valuation.

The final regulations do not adopt the commentator's recommendation. The publication of quotations for the shares is not intended to serve solely as a means for a current shareholder of the PFIC to determine the value of the PFIC on the mark date. The publication of quotations for the shares is comparable to the practice of RICs and helps to ensure that asset valuations are legitimate and sound by allowing potential investors as well as current shareholders to have ready access to price information.

Because quotations for the shares of some PFICs may not be published on a daily basis, the daily publication requirement in the proposed regulations is changed to require that quotations for the shares of the foreign corporation be determined and published no less frequently than weekly. In addition, the publication requirement is changed to clarify that the quotations must be published in a permanent medium not controlled by the issuer of the shares, such as an independent trade publication. The requirement that the medium be permanent does not require the

medium to be saved in a printed form; archived electronic data not susceptible to subsequent alteration are permanent. This change is intended to assist shareholders and the IRS in verifying valuations.

The proposed regulations require that the foreign corporation be supervised or regulated as an investment company by a foreign government or instrumentality thereof. One commentator suggested that the condition be clarified with respect to the meaning of governmental supervision. In particular, the commentator asks whether a foreign jurisdiction that requires a local corporation to file information upon incorporation with the local government or agency would qualify as supervision or regulation.

The condition in the proposed regulations is intended to require that the PFIC be supervised or regulated as an investment company in a manner comparable, but not identical, to RICs. Consequently, the final regulations clarify the type of supervision or regulation required. The final regulations provide that sufficient supervision or regulation requires that the government or agency have broad inspection and enforcement authority and effective oversight over investment companies to ensure that such companies provide complete and accurate disclosure of relevant financial information to shareholders and potential investors and to provide adequate sanctions for false or inadequate disclosure. The mere filing of information upon incorporation does not qualify as supervision or regulation.

Finally, the proposed regulations require that the foreign corporation have no senior securities authorized or outstanding, including any debt other than de minimis amounts. In addition, the proposed regulations require that the foreign corporation 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. One commentator asserted that these conditions not be included in the final regulations because there is no basis for requiring a PFIC to have the same borrowing restrictions, asset composition, and characteristics of RICs in order for the PFIC's stock to be marketable stock under section 1296.

Conditions regarding debt and asset composition are essential characteristics of RICs. The IRS and the Treasury Department believe that Congress intended to provide mark-to-market treatment to shares of PFICs that are, in fact, comparable to RICs.

Special Rules for RICs

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

One commentator explained why PFIC stock held by any closed-end RIC that publishes net asset values at least annually should be treated as marketable stock. In particular, that commentator pointed out that closed-end RICs are subject to many of the same regulatory requirements as open-end RICs. In addition, that commentator explained that an industry practice has developed under which closed-end RICs typically determine and publish current share prices, together with net asset values, on a weekly basis in print and other media.

At this time, the IRS and Treasury Department know of no reason not to treat PFIC stock held by closed-end funds that publish net asset values at least annually as marketable stock. Consequently, as provided by section 1296(e)(2), PFIC stock held by any closed-end RIC that publishes net asset values at least annually shall be treated as marketable stock. The final regulations, however, continue to reserve this issue in the event that it is determined that situations exist where PFIC stock held by closed-end RICs that publish net asset valuations at least annually should not be treated as marketable stock for purposes of section 1296. If such a situation is found to exist, the reservation will be replaced at that time by a new regulatory exception.

Special Analyses

It has been determined that these regulations are not significant regulatory actions 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, 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 Robert Laudeman of the 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.

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 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 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 calendar year--

(i) A national securities exchange that 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, surveillance, 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, fair and orderly, 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 effectively promote active trading of listed stocks.

(2) Exchange with multiple tiers. 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) Stock in certain PFICs--(1) General rule. Except as provided in paragraph (d)(2) of this section, a foreign corporation is 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) At all times during the calendar year, the foreign corporation has more than one hundred shareholders with respect to the class, other than shareholders who are related under section 267(b);

(ii) At all times during the calendar year, the class of shares of the foreign corporation is readily available for purchase by the general public at its net asset value and the foreign corporation does not require a minimum initial investment of greater than \$10,000 (U.S.);

(iii) At all times during the calendar year, quotations for the class of shares of the foreign corporation are determined and published no less frequently than on a weekly basis in a widely-available permanent medium not controlled by the issuer of the shares, such as a newspaper of general circulation or a trade publication;

(iv) No less frequently than annually, independent auditors 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 are 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 that has broad inspection and enforcement authority and effective oversight over investment companies;

(vi) At all times during the calendar year, 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 actions that have as one of their principal purposes the manipulation of the net asset value of a class of its shares, for the calendar year in which the manipulation occurs, the shares are not 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 that is offering for sale, or has outstanding, any stock of which it is the issuer and which is redeemable at net asset value, if the RIC owns directly or indirectly, as defined in sections 958(a)(1) and (2), stock in any passive foreign investment company, that stock will be treated as marketable stock owned by that RIC for purposes of section 1296. Except as provided in paragraph (f)(2) of this section, in the case of any other RIC that publishes net asset valuations at least annually, if the RIC owns directly or indirectly, as defined in sections 958(a)(1) and (2), stock in any passive foreign investment company, that stock will 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 January 25, 2000 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.

Deputy Commissioner of Internal Revenue

Approved:

Assistant Secretary of the Treasury