

employment at the ASC (or promotion therein) the disclosures of which would compromise the objectivity or fairness of the testing, evaluation or examining process.

By the Appraisal Subcommittee of the Federal Financial Institutions Examination Council

Dated: March 22, 1992.

Fred D. Finke,
Chairman.

[FR Doc. 92-7358 Filed 3-31-92; 8:45 am]

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DEPARTMENT OF TRANSPORTATION

Federal Aviation Administration

14 CFR Part 39

[Docket No. 92-CE-11-AD]

Airworthiness Directives: EMBRAER EMB-110 Series Airplanes

AGENCY: Federal Aviation Administration, DOT.

ACTION: Notice of proposed rulemaking (NPRM).

SUMMARY: This notice proposes to adopt a new airworthiness directive (AD) that would be applicable to EMBRAER (Empresa Brasileira de Aeronautica S.A.) EMB-110 series airplanes. The proposed action would require modifications to the rudder trim tab actuating system, reinforcement of the vertical stabilizer rear spar, repetitive inspections of the rudder trim tab actuating system for excessive free play, and modification if the free play exceeds established limits. The Federal Aviation Administration (FAA) has received numerous reports of vibration of the rudder trim tab actuating system on the affected airplanes. The actions specified in the proposed AD are intended to prevent severe vibration or loss of control of the airplane caused by excessive free play and lack of rigidity of the rudder trim tab actuating system.

DATES: Comments must be received on or before June 12, 1992.

ADDRESSES: Submit comments on the proposal in triplicate to the FAA, Central Region, Office of the Assistant Chief Counsel, Attention: Rules Docket No. 92-CE-11-AD, room 1558, 601 E. 12th Street, Kansas City, Missouri 64106. Comments may be inspected at this location between 8 a.m. and 4 p.m., Monday through Friday, holidays excepted.

Service information that is applicable to this AD may be obtained from EMBRAER, P.O. Box 343-CEP, 12.200 Sao Jose dos Campos, Sao Paulo, Brazil;

or EMBRAER Aircraft Corporation, 276 SW 34th Street, Fort Lauderdale, Florida 33315. This information also may be examined at the Rules Docket at the address above.

FOR FURTHER INFORMATION CONTACT:

Mr. Curtis Jackson, Aerospace Engineer, Airframe Branch, Atlanta Aircraft Certification Office, 1669 Phoenix Parkway, suite 210C, Atlanta, Georgia 30349; Telephone (404) 991-2910; Facsimile (404) 991-3606.

SUPPLEMENTARY INFORMATION:

Comments Invited

Interested persons are invited to comment on this rule by submitting such written data, views, or arguments as they may desire. Communications should identify the Rules Docket number and be submitted in triplicate to the address specified above. All communications received on or before the closing date for comments will be considered, and this rule may be amended in light of the comments received. Factual information that supports the commenter's ideas and suggestions is extremely helpful in evaluating the effectiveness of the AD action and determining whether additional rulemaking action would be needed. Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the rule that might suggest a need to modify the rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket for examination by interested persons. A report that summarizes each FAA-public contact concerned with the substance of this AD will be filed in the Rules Docket.

Commenters wishing the FAA to acknowledge receipt of their comments submitted in response to this notice must submit a self-addressed, stamped postcard on which the following statement is made: "Comments to Docket No. 92-CE-11-AD." The postcard will be date stamped and returned to the commenter.

Availability of NPRMs

Any person may obtain a copy of this NPRM by submitting a request to the FAA, Central Region, Office of the Assistant Chief Counsel, Attention: Rules Docket No. 92-CE-11-AD, room 1558, 601 E. 12th Street, Kansas City, Missouri 64106.

Discussion

The FAA has received numerous reports of vibration of the rudder trim tab actuating system on EMBRAER EMB-110 series airplanes. After extensive evaluation and analysis of the

incidents leading to these reports, the FAA has determined that EMBRAER EMB-110 series airplanes could experience excessive free play in the rudder trim tab actuating system and that a lack of rigidity exists in this system. This condition, if not detected and corrected, could result in severe vibration or loss of control of the airplane.

EMBRAER has issued Service Bulletin (SB) 110-027-0089, dated July 19, 1991, which specifies installation procedures for a new rudder trim tab actuator and reinforcements to the vertical stabilizer rear spar. This service bulletin also establishes a new free play limit.

The affected airplane model is manufactured in Brazil and is type certificated for operation in the United States under the provisions of § 21.29 of the Federal Aviation Regulations and the applicable airworthiness agreement. The Centro Tecnico Aeroespacial (CTA) and the Departamento de Aviacao Civil (DAC), which are the airworthiness authorities for Brazil, issued CTA AD 91-07-01 to require the modification and installations specified in EMBRAER SB 110-027-0089, dated July 19, 1991, in order to assure the airworthiness of these airplanes in Brazil. After examining the circumstances and reviewing all available information related to the incidents described above, the FAA has determined that AD action is necessary for products of this type design that are certificated for operation in the United States.

Since this condition is likely to exist or develop in other EMBRAER EMB-110 series airplanes of the same type design, the proposed AD would require (1) a modification to the rudder trim tab actuating system; (2) installation of reinforcements to the vertical stabilizer rear spar, repetitive inspections of the rudder trim tab actuating system for excessive free play; and (3) modification if free play exceeds 1.0 mm. The trim tab actuating system modification and the installations proposed by this AD would be accomplished in accordance with the instructions in EMBRAER SB 110-027-0089, dated July 19, 1991. The free play inspection and possible free play modification would be accomplished in accordance with the applicable maintenance manual.

The proposed modification changes the free play limit from 3.3 mm to 1.0 mm. The proposed AD would also allow repetitive inspections of the trim tab actuating system for excessive free play with subsequent modification if free play exceeds 3.3 mm provided that (1) parts are unavailable and the operator has ordered the parts from the

manufacturer; and (2) the operator terminates the repetitive inspections and accomplishes the modification when parts become available. The modification procedures in the maintenance manual for the rudder trim tab actuating system if excessive free play exists would be the same whether the criteria is 1.0 mm or 3.3 mm. The only difference would be the magnitude of the free play.

The FAA estimates that 84 airplanes in the U.S. registry would be affected by the proposed AD, that it would take approximately 32 hours per airplane to accomplish the proposed action, and that the average labor rate is approximately \$55 an hour. Parts cost approximately \$1,000 per airplane. Based on these figures, the total cost impact of the proposed AD on U.S. operators is estimated to be \$231,840.

The regulations proposed herein would not have substantial direct effects on the States, on the relationship between the national government and the States, or on the distribution of power and responsibilities among the various levels of government. Therefore, in accordance with Executive Order 12612, it is determined that this proposal would not have sufficient federalism implications to warrant the preparation of a Federalism Assessment.

For the reasons discussed above, I certify that this action (1) is not a "major rule" under Executive Order 12291; (2) is not a "significant rule" under DOT Regulatory Policies and Procedures (44 FR 11034, February 26, 1979); and (3) if promulgated, will not have a significant economic impact, positive or negative, on a substantial number of small entities under the criteria of the Regulatory Flexibility Act. A copy of the draft regulatory evaluation prepared for this action has been placed in the Rules Docket. A copy of its may be obtained by contacting the Rules Docket at the location provided under the caption ADDRESSES.

List of Subjects in 14 CFR Part 39

Air transportation, Aircraft, Aviation safety, Safety.

The Proposed Amendment

Accordingly, pursuant to the authority delegated to me by the Administrator, the Federal Aviation Administration proposes to amend 14 CFR part 39 of the Federal Aviation Regulations as follows:

PART 39—AIRWORTHINESS DIRECTIVES

1. The authority citation for part 39 continues to read as follows:

Authority: 49 U.S.C. 1354(a), 1421 and 1423; 49 U.S.C. 106(g); and 14 CFR 11.89.

§ 39.13 [Amended]

2. Section 39.13 is amended by adding the following new airworthiness directive:

EMBRAER: Docket No. 91-CE-82-AD.

Applicability: EMB-110 Series airplanes (all serial numbers), certificated in any category.

Compliance: Required as indicated, unless already accomplished.

To prevent severe vibration or loss of control of the airplane caused by excessive free play and lack of rigidity of the rudder trim tab actuating system, accomplish the following:

Note 1: The compliance times referenced in this AD take precedence over those cited in the referenced service information.

(a) Within the next 500 hours time-in-service (TIS), modify the rudder trim tab actuating system and install reinforcements to the vertical stabilizer rear spar in accordance with the instructions and Figures 1, 2, and 3 of EMBRAER Service Bulletin (SB) 110-027-0089, dated July 19, 1991.

Note 2: EMBRAER SB 110-27-0089 specifies that the airplane should be modified in accordance with EMBRAER SB 110-27-0060—"Replacement of Spherical Bearings of Aileron and Rudder Trim Tab Control Systems Rod Ends". This action is required for the affected airplanes by AD 87-01-05, Amendment 39-5490.

(b) Within 300 hours TIS after accomplishing the modifications required by paragraph (a) of this AD, and thereafter at intervals not to exceed 300 hours TIS, inspect the rudder trim tab actuating system for excessive free play in accordance with the applicable maintenance manual. If free play exceeds 1.0 mm., prior to further flight, modify the rudder trim tab actuating system in accordance with the applicable maintenance manual.

(c) If the parts required by paragraph (a) of this AD have been ordered, but are not available, within the initial 500 hours TIS required by paragraph (a) of this AD, accomplish the following:

(1) Inspect the rudder trim tab actuating system for excessive free play in accordance with the applicable maintenance manual.

(2) If free play exceeds 3.3 mm., prior to further flight, modify the rudder trim tab actuating system in accordance with the applicable maintenance manual.

Note 3: The modification procedures in the maintenance manual for the rudder trim tab actuating system if excessive free play exists are the same whether the criteria is 1.0 mm or 3.3 mm. The only difference is the magnitude of the free play.

(3) Reinspect in accordance with paragraphs (c)(1) and (c)(2) of this AD at intervals not to exceed 100 hours TIS until the modifications required by paragraph (a) of this AD are accomplished, but not to exceed three 100-hour TIS repetitive inspection intervals.

(4) When parts become available or 100 hours TIS after the third repetitive inspection

required by paragraph (c)(3) of this AD, whichever occurs first, prior to further flight, accomplish the modification required by paragraph (a) of this AD.

(d) Special flight permits may be issued in accordance with FAR 21.197 and 21.199 to operate the airplane to a location where the requirements of this AD can be accomplished.

(e) An alternative method of compliance or adjustment of the initial or repetitive compliance times that provides an equivalent level of safety may be approved by the Manager, Atlanta Aircraft Certification Office, 1669 Phoenix Parkway, suite 210C, Atlanta, Georgia 30349. The request should be forwarded through an appropriate FAA Maintenance Inspector, who may add comments and then send it to the Manager, Atlanta Aircraft Certification Office.

Note 4: Information concerning the existence of approved alternative methods of compliance with this AD, if any, may be obtained from the Atlanta Aircraft Certification Office.

(f) All persons affected by this directive may obtain copies of the documents referred to herein upon request to EMBRAER, P.O. Box 343-CEP, 12.200 Sao Jose dos Campos, Sao Paulo, Brazil; or EMBRAER Aircraft Corporation, 276 SW 34th Street, Fort Lauderdale, Florida 33315. The service information may be examined at the FAA, Central Region, Office of the Assistant Chief Counsel, Room 1558, 601 E. 12th Street, Kansas City, Missouri 64106.

Issued in Kansas City, Missouri, on March 26, 1992.

Barry D. Clements,

Manager, Small Airplane Directorate Aircraft Certification Service.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[INTL-941-86; INTL-656-87; INTL-704-87]

RIN 1545-AI33; RIN 1545-AC06; RIN 1545-AL35]

Treatment of Shareholders of Certain Passive Foreign Investment Companies

AGENCY: Internal Revenue Service, Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed income tax regulations concerning the taxation of shareholders of certain passive foreign investment companies (PFICs) upon payment of distributions by such companies or upon disposition of the stock of such companies. These rules were enacted by

the Tax Reform Act of 1986, and amended by the Technical and Miscellaneous Act of 1988.

DATES: Written comments and requests for a public hearing must be received by July 30, 1992.

ADDRESSES: Send written comments and requests for a public hearing to Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attention: CC:CORP:T:R (INTL-656-87), room 5228, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Gayle E. Novig of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (Attention: CC:CORP:T:R (INTL-656-87)) (202-377-9059, not a toll free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504 (h)). Comments on the collections of information should be sent to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attention: IRS Reports Clearance Officer T:FP, Washington, DC 20224.

The collections of information in these regulations are in 26 CFR 1.1291-1(i), 1.1291-2 (f)(2)(ii), 1.1291-3(e)(5)(iii), 1.1291-6(g), 1.1291-8(g), 1.1291-9(d), and 1.1291-10(2)(vii). The collections of information found in 26 CFR 1.1291-9(d) and 1.1291-10(d)(2)(vii) are also being published as temporary rules in the rules and regulations section of this issue of the *Federal Register*. This information is required by the Internal Revenue Service to identify PFICs and their shareholders, administer shareholder elections, verify amounts reported, and track transfers of stock of certain PFICs. The likely respondents and/or recordkeepers are individuals or households, business or other for-profit institutions, non-profit institutions, and small businesses or organizations.

These estimates are an approximation of the average time expected to be necessary for a collection of information. They are based on such information as is available to the Internal Revenue Service. Individual respondents/recordkeepers may require

greater or less time, depending on their particular circumstances.

Estimated total annual reporting and/or recordkeeping burden for filing Form 8621 reported in OMB No. 1545-1002; 31,680 hours.

The estimated total annual burden per respondent/recordkeeper for the other requirements in this regulation is 8,750 hours, with an estimated average of one hour.

Estimated number of respondents and/or recordkeepers: 8,750.

Estimated frequency of responses: Annually.

Background

This document contains proposed Income Tax Regulations (26 CFR part 1) under sections 1291, 1293, 1295, and 1297 of the Internal Revenue Code of 1986. These provisions were added to the Internal Revenue Code of 1986 by section 1235 of the Tax Reform Act of 1986 (Pub. L. 99-514, 100 Stat. 2320), and amended by section 1012(p) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647, 102 Stat. 3342). With the exceptions of different effective dates for the rules concerning certain pledges of PFIC stock outstanding on the effective date of the statute (1.1291-3(d)(6)), and the mark-to-market election available to regulated investment companies (1.1291-8), these regulations are proposed to be effective April 1, 1992. However, as sections 1291 through 1297 of the Code are effective for taxable years of foreign corporations beginning after 1986, shareholders of PFICs are subject to those provisions with respect to transactions occurring during those taxable years.

Explanation of Provisions

Overview of Statute

The Tax Reform Act of 1986, as amended by the Technical and Miscellaneous Revenue Act of 1988, established special rules for the taxation of U.S. persons that are shareholders of PFICs. For taxable years beginning after December 31, 1986, a foreign corporation will be classified as a PFIC if either 75 percent or more of its gross income for the taxable year is passive, or the average percentage of its assets (by value) for the taxable year that produce passive income or are held for the production of passive income is at least 50 percent, subject to certain exceptions, passive income for these purposes generally is foreign personal holding income as defined in section 954(c) of the Internal Revenue Code of 1986.

Sections 1291 through 1297 provide two different and sometimes overlapping sets of rules for taxing U.S.

persons that are shareholders of a PFIC. In general, shareholders are subject to a special tax regime under section 1291 that applies to distributions by the PFIC and dispositions of PFIC stock. In the proposed regulations, if section 1291 applies to a particular shareholder with respect to a PFIC, the PFIC is referred to as a section 1291 fund with respect to the shareholder. A significant consequence of being treated as a section 1291 fund is that the foreign corporation will continue to be treated as a PFIC, and therefore, the shareholder will continue to be subject to section 1291, even after the corporation ceases to satisfy either the income or the asset test for PFIC status under section 1296.

Each shareholder, however, may elect under section 1295 to treat a PFIC as a qualified electing fund (QEF); if such an election is made, the shareholder will be taxed currently under section 1293 on its pro rata share of the earnings of the QEF. A shareholder that makes a QEF election may or may not continue to be subject to the special tax regime under section 1291. Stated differently, a PFIC that is a QEF with respect to a particular shareholder may or may not continue to be a section 1291 fund with respect to that shareholder. If the shareholder makes the QEF election for the foreign corporation's first taxable year as a PFIC that is included in the shareholder's holding period for the stock of the PFIC, section 1291 will not apply to the shareholder. If the shareholder makes the QEF election at a later time, but also makes an election under section 1291(d)(2) to purge the PFIC stock that it holds of its taint as a section 1291 fund, the shareholder will accelerate the application of section 1291 to the PFIC stock that it holds, and section 1291 will not apply to the shareholder thereafter. In both cases, the proposed regulations refer to such a PFIC as a pedigreed QEF with respect to the electing shareholder, and the PFIC is not considered to be a section 1291 fund with respect to that shareholder.

On the other hand, if the shareholder makes the QEF election at a later time and does not make a purging election, section 1291 will continue to apply to the shareholder notwithstanding the application of section 1293. The proposed regulations refer to such a PFIC as an unpedigreed QEF in respect of the shareholder. Because section 1291 applies to the shareholder of an unpedigreed QEF, the QEF continues to be a section 1291 fund.

Pursuant to section 1291, a U.S. person that is a shareholder of a section 1291 fund pays tax and an interest charge on

receipt of certain distributions and upon disposition of stock of the section 1291 fund. Under this rule, gain from a disposition or the portion of any distribution that is an excess distribution (defined in section 1291(b)) is treated as ordinary income earned ratably over the shareholder's holding period of the stock of the section 1291 fund. The portion allocated to the current year, and to years when the corporation was not a PFIC, are included in the shareholder's gross income for the year of the distribution; the remainder is not included in gross income, but the shareholder must pay a deferred tax amount (defined in section 1291(c)) with respect to that portion. The deferred tax amount is, in general, the amount of tax that would have been owed if the allocated amount had been included in income in the earlier year, plus interest.

Section 1291(f) provides regulatory authority for taxing transfers of stock of a section 1291 fund notwithstanding an otherwise applicable nonrecognition provision of the Code or regulations. Accordingly, gifts, transfers at death, and exchanges of stock pursuant to nonrecognition provisions will be taxable to the extent provided in the regulations.

Section 1297(a) provides attribution rules for determining whether a U.S. person is an indirect shareholder of a PFIC. Section 1297(b)(5) provides that, under regulations, a U.S. person treated as an indirect shareholder of a PFIC under section 1297(a) will be taxable on any distribution paid by the PFIC to the actual owner of the PFIC stock (indirect distributions), and on any disposition by the U.S. person or the actual owner if, as a result of the disposition, the U.S. person is no longer treated under section 1297(a) as owning the stock of the PFIC (indirect disposition).

Section 1297(d) grants authority to the Secretary to prescribe such regulations as may be necessary or appropriate to carry out the purposes of sections 1291 through 1297.

Explanation of Proposed Regulations

Definitions and General Rules

Section 1.1291-1(b) defines the terms PFIC, QEF, pedigreed QEF, unpedigreed QEF, nonqualified fund, and section 1291 fund. As explained above, whether a corporation is a PFIC, QEF (pedigreed or unpedigreed), nonqualified fund, or section 1291 fund is determined on a shareholder by shareholder basis. In general, section 1291 and the proposed regulations under that section do not apply to determine the taxation of a shareholder of a pedigreed QEF with

respect to a distribution paid by the pedigreed QEF or a disposition of its stock.

It should be noted that the definition of the term nonqualified fund in the proposed regulations differs from the definition of the same term in the current Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund. (In the form, the term has the same meaning as the term section 1291 fund in the proposed regulations.) The form will be revised to eliminate this difference.

Section 1.1291-1(b)(3), (4), and (5) define the terms prePFIC year, prior PFIC year, and current shareholder year, terms relevant to the determination of the tax consequences under section 1291 of a distribution by, or a disposition of, a section 1291 fund. A prePFIC year is a taxable year (or portion thereof) of the shareholder included wholly or partly in the shareholder's holding period, either before the shareholder became a United States person (within the meaning of section 7701(a)(30)), or before the section 1291 fund qualified as a PFIC. A prior PFIC year is a taxable year (or portion thereof), other than the current shareholder year, included in the shareholder's holding period during which the section 1291 fund was a PFIC. The term current shareholder year refers to the shareholder's taxable year in which the taxable event occurs.

The term shareholder includes any person that owns an equity interest in the PFIC directly or indirectly, as provided in § 1.1291-1(b)(8). Section 1.1291-1(b)(8) defines the term indirect shareholder as a U.S. person that indirectly owns stock of a PFIC, and provides attribution rules for ownership of a PFIC through a person other than an individual.

Stock directly or indirectly owned by a U.S. person generally is not attributed to another U.S. person. However, pursuant to section 1297 (a) and (d), stock owned directly or indirectly by an S corporation or domestic partnership, trust or estate is treated as owned proportionately by its shareholders, partners or beneficiaries. Moreover, stock may be attributed through a domestic C corporation in some circumstances if, absent such attribution, the stock of a PFIC would not be treated as owned by any U.S. person.

As described above, under the proposed regulations a beneficiary of a trust or estate is a shareholder of a proportionate amount of the PFIC stock owned directly or indirectly by the trust or estate. Comment is solicited whether different attribution rules, such as the

indirect ownership rules in § 25.2701-6 (relating to special valuation rules for purposes of estate and gift taxes), should be adopted for purposes of determining whether a beneficiary of a trust or estate is an indirect shareholder of a PFIC.

Stock of a section 1291 fund owned directly or indirectly by a regulated investment company (RIC) or a real estate investment trust (REIT) is not attributed to the shareholders of the RIC or REIT. A RIC or REIT that is a shareholder of a section 1291 fund is taxable on direct or indirect distributions and dispositions. For a special mark-to-market rule applicable to RICs, see § 1.1291-8.

Under section 1297(a)(4) and the regulations, a person that holds an option to acquire PFIC stock is treated as a shareholder of PFIC stock. Section 1.1291-1(d) provides that such a person will be treated as a shareholder of a section 1291 fund subject to section 1291 on a disposition (other than by exercise) of that option. For purposes of sections 1291 through 1297, the holding period of stock of a PFIC acquired upon exercise of an option will include the period that the option was held. If the shareholder elects to treat the PFIC as a QEF, the PFIC will be an unpedigreed QEF because of the PFIC years in the shareholder's holding period attributable to the period the person held the option. The shareholder may make a section 1291(d)(2) election to purge those years from its holding period in order for the PFIC to be pedigreed QEF.

In limited circumstances, an exempt organization that is a direct or indirect shareholder of a section 1291 fund may be subject to tax under section 1291 and these regulations. Section 1.1291-1(e) provides that an exempt organization will be taxable under section 1291 and the regulations with respect to a distribution from a section 1291 fund or a disposition of its stock if a dividend from that corporation would be taxable to the exempt organization pursuant to subchapter F.

With certain exceptions, the general Code and regulatory rules apply for purposes of determining a shareholder's holding period of PFIC stock. The proposed regulations also provide that generally, unless a shareholder previously held the stock directly, an indirect shareholder's holding period of stock of a PFIC begins on the first day that ownership of the stock of the PFIC is attributed to the person under section 1297(a). A shareholder will get a new holding period in the stock of a PFIC only after the shareholder recognizes all

the gain with respect to the stock. If stock of a section 1291 fund is acquired in a transaction to which section 1223(1) or 1223(2) applies, the character of the years in the shareholder's tacked holding period as prePFIC or priorPFIC is determined by reference to the character of the holding period of the property transferred in the exchange (section 1223(1)) or received from the transferor (section 1223(2)).

Section 1.1291-1(i) sets forth the annual reporting requirements of direct and indirect shareholders of all PFICs.

Section 1.1291-2—Taxation of Excess Distributions

In general

Section 1.1291-2 provides rules for taxing a direct or indirect shareholder of a section 1291 fund on a distribution by the fund. Section 1.1291-2(b) defines the term distribution for purposes of section 1291. The term does not include a nontaxable distribution that qualifies under section 305(a) or 355(a). In addition, distributions that are treated as in exchange for stock, such as liquidation distributions and section 302(a) redemptions, are not distributions to which § 1.1291-2 applies. Those distributions are treated as dispositions subject to § 1.1291-3.

The proposed regulations at § 1.1291-2(b)(3) provide that the shareholder has an excess distribution to the extent section 304(b)(2) treats the distribution as being paid out of the earnings and profits of an issuing corporation that is a section 1291 fund. In addition, the section 304 transaction will be a taxable disposition of stock of a section 1291 fund to the extent the shareholder's interest in the issuing corporation that is a section 1291 fund is reduced as a result of the transaction. Finally, the regulations provide that an amount paid by an acquiring corporation that is a section 1291 fund will be an excess distribution. It is possible that there may be multiple taxation under these rules. Comments are therefore solicited about how to better coordinate sections 304 and 1291, without permitting avoidance of section 1291.

Section 1.1291-2(c) provides rules for determining the nonexcess distribution and the total excess distribution for the current shareholder year. These amounts are calculated on a per share basis without regard to the earnings and profits of the section 1291 fund. The total excess distribution is the amount by which the total distribution for the current shareholder year, with certain adjustments, exceeds the nonexcess distribution. The nonexcess distribution is defined as the portion of the total

distribution that does not exceed 125 percent of the average of the distributions made with respect to the stock during the preceding three taxable years included in the shareholder's holding period. For purposes of calculating the excess distribution, the portion of a prior year's excess distribution that was not included in income (the portion subject to the deferred tax amount) is not considered a distribution made in a prior year. If the section 1291 fund makes more than one distribution during the current shareholder year, and there is a total excess distribution for the year, a ratable portion of each distribution is an excess distribution.

Section 1.1291-2(c)(3)(ii) provides that the total excess distribution is zero in the taxable year of the shareholder in which the shareholder's holding period begins. This rule applies only to distributions, and not to excess distributions arising from dispositions of section 1291 fund stock.

The excess distribution is calculated using the U.S. dollar. In general, each distribution if a foreign currency is converted into U.S. dollars at the spot rate on the date of the distribution. However, if all relevant distributions have been made in a single foreign currency, the excess distribution is calculated in that currency and then converted into the U.S. dollar at the spot rate on the date of the current shareholder year distribution.

The earnings and profits of a section 1291 fund are generally irrelevant for purposes of section 1291. For that reason, as stated above, the excess distribution is calculated without regard to the earnings and profits of the section 1291 fund. If the earnings and profits can be calculated, the shareholder can avoid the interest charge and other disadvantages under section 1291 by making the QEF election.

However, the earnings and profits of a section 1291 fund are relevant for purposes of claiming the foreign tax credit for deemed paid taxes and determining the taxation of a nonexcess distribution. For these purposes, § 1.1291-2(e)(3) provides that earnings and profits are allocated proportionately between the nonexcess distribution and the total excess distribution.

Special Rules

Pursuant to proposed § 1.1291-2(b)(2), neither an inclusion of income under section 951(a)(1), 551(b) or 1293(a), nor an actual distribution of an amount previously taxed under one of those sections, is a distribution for purposes of section 1291. Accordingly, an inclusion in income sections 951, 551, or 1293 is

neither subject to section 1291 in the year of inclusion nor treated as a distribution made in a prior year when calculating a nonexcess distribution. In addition, distributions of previously taxed amounts are not taken into account when calculating the nonexcess distribution. Therefore, the total distribution for the current year is first reduced by the amount that is not included in gross income by reason of section 959, 551(d), or 1293(c). In developing these rules, treatment of inclusions in income under sections 951, 551, or 1293 in prior years as distributions was considered. However, such a rule was not adopted because such amounts were not subject to section 1291 in the year of inclusion.

Proposed regulation § 1.1291-2(d)(1) provides that, for purposes of calculating the average of distributions made during the preceding three taxable years, a shareholder whose holding period begins after the first day of the shareholder's taxable year may take into account distributions paid during that year but before the shareholder's holding period began. Consideration was given to other methods of annualizing distributions (for example, extrapolation from distributions actually received), but such methods were rejected because they tended to produce distorted results.

Pursuant to section 1291(b)(3)(G), § 1.1291-2(d)(5) provides rules for adjusting an excess distribution received by a trust that is entitled to deduct the amount of its fixed annual charitable obligation from gross income under section 642(c).

The proposed regulations at § 1.1291-2(d)(6) provide a rule for calculating the excess distribution in a taxable year of the shareholder during which the foreign corporation was a PFIC for only part of that year. Under this rule, all distributions paid during the year with respect to the stock owned or treated as owned by the shareholder are taken into account for purposes of calculating the excess distribution, but only those distributions made after the foreign corporation became a PFIC are taxed under section 1291.

Taxation of a Distribution

Section 1.1291-2(e) provides the rules for the taxation of a nonexcess distribution and an excess distribution. A nonexcess distribution is taxed according to the general rules applicable to corporate distributions. To determine the taxation of an excess distribution, the excess distribution is allocated pro rata to each day in the shareholder's holding period (treated as ending on the

date of the distribution) without regard to whether the corporation actually derived earnings and profits during the years to which the excess distribution is allocated.

The portions of an excess distribution allocated to the current shareholder year and to the prePFIC years are included in the shareholder's ordinary income and are not subject to the deferred tax amount. The portions of an excess distribution allocated to the prior PFIC years are not included, or treated as included, in gross income for any purpose. Therefore, any losses in the current shareholder year or prior years may not offset the portions of an excess distribution allocated to the prior PFIC years. The amounts allocated to prior PFIC years are subject to the deferred tax amount, determined under § 1.1291-4, which includes an interest charge.

Indirect Distributions

An indirect distribution is a distribution by a section 1291 fund to the actual shareholder of stock of a section 1291 fund that a shareholder is considered to own under § 1.1291-1(b)(8). Generally, a shareholder is taxable on its pro rata share of the total distribution paid by the section 1291 fund. The nonexcess distribution and total excess distribution are calculated at the indirect shareholder level.

The proposed regulations provide an exception to the general rule that all indirect distributions are taxable. A shareholder is not taxable on an indirect distribution paid by a section 1291 fund to its sole shareholder that is a section 1291 fund owned directly by the shareholder, provided the distributing fund has distributed all its earnings each year included in the shareholder's holding period of the distributing fund. Comment is solicited on whether there are additional circumstances in which an indirect shareholder of a section 1291 fund should not be taxed on distributions by, or dispositions of the stock of, a section 1291 fund.

The proposed regulations require partnerships and S corporations to provide information to their partners and shareholders. This information is intended to assist the indirect shareholders in calculating their excess distributions. Information reporting obligations of trusts and estates are reserved.

Other than the guidance provided in § 1.1291-2(f)(6) (adjustments for trusts permitted to take the section 642(c) deduction) § 1.1291-6(d)(3) (section 643(e)(3) election), the regulations do not provide explicit rules for determining the tax consequences to a trust or estate (or a beneficiary thereof) that directly or

indirectly owns stock of a section 1291 fund. Until such rules are issued, the shareholder must apply the PFIC rules and subchapter J in a reasonable manner that triggers or preserves the interest charge. Comments are invited about the manner in which excess distributions paid with respect to stock directly or indirectly owned by trusts or estates should be taxed under section 1291.

Dispositions of Stock of Section 1291 Funds

Section 1.1291-3 provides general rules for determining the tax consequences of transfers of stock of section 1291 funds. Unless otherwise provided, gain recognized on a direct or indirect disposition of a share of stock of a section 1291 fund is taxed as an excess distribution in the manner provided in § 1.1291-2(e)(2).

A loss that is recognized on the disposition of a share of stock of a section 1291 fund does not offset the gain recognized on another share. The general rules applicable to losses recognized on a disposition of stock apply to losses realized and recognized on the disposition of stock of a section 1291 fund.

Definition of Disposition

Section 1.1291-3(b)(1) defines the term disposition for purposes of section 1291. A disposition includes a gift, a transfer by reason of death, and a transfer that qualifies for nonrecognition treatment under another provision of the Code. Paragraphs (b)(2) and (d) of proposed § 1.1291-3 contain special rules providing that the change of residence or citizenship status of a U.S. resident alien or citizen to nonresident alien status, and a pledge of section 1291 fund stock constitute dispositions. Under § 1.1291-3 (c), (d), and (e), dispositions of stock of a section 1291 fund are generally taxable unless an exception applies.

Indirect Dispositions

An indirect disposition includes a disposition of the stock of a section 1291 fund by its actual owner and a disposition by the indirect shareholder or other person of any interest in a person if by virtue of such interest a U.S. person is treated as an owner of the stock of the section 1291 fund. The former rule applies without regard to whether the disposition reduces or terminates the shareholder's interest in the PFIC. The later rule, however, does not apply if the transaction does not affect the shareholder's interest in the PFIC or the actual owner's basis in the PFIC. The proposed regulations also

provide that an indirect disposition includes a transaction that reduces or eliminates the indirect shareholder's interest in the PFIC.

The scope of the indirect disposition rules in the proposed regulations is broader than the scope of the rule in section 1297(b)(5). The rules have been expanded under the authority of section 1297(d) to prevent avoidance of section 1291 (for example, through transactions between affiliated foreign companies).

In the case of an indirect disposition, the gain that is treated as an excess distribution to the indirect shareholder is the shareholder's proportionate share of the actual owner's gain with respect to the stock of the fund (whether or not such gain is realized by the actual owner). Thus, the amount taxable to the indirect shareholder is determined without regard to the amount the shareholder would recognize on a disposition of the interest through which the shareholder is considered to own the stock of the section 1291 fund.

Generally, the excess distribution is allocated over the indirect shareholder's holding period. However, § 1.1291-1(h)(4)(iii) provides that an S corporation shareholder uses the holding period of the S corporation if the S corporation directly or indirectly owned the stock of the PFIC prior to its election under section 1362. In addition, the deferred tax amount owed by the S corporation shareholders is calculated using the applicable rate of tax under section 1, even for years during which the S corporation was a C corporation that are included in the shareholders' holding period, pursuant to § 1.1291-4(c)(2).

The S corporation also may be taxable on a disposition of section 1291 fund stock as provided in section 1374. If the S corporation pays built-in gain tax pursuant to section 1374 on the disposition of the section 1291 fund, the S corporation shareholders' excess distribution, pursuant to section 1366(f)(2), does not include the built-in gain tax paid by the S corporation. However, the proposed regulations provide that the section 1366(f)(2) deduction is disregarded when calculating the aggregate amount of interest under section 1291(c)(3).

Transfers With a Consolidated Group

Proposed regulation § 1.1291-3(f) provides a special rule for transfers of stock of a section 1291 fund between members of a consolidated return group. Comments are solicited on how to coordinate this rule with the consolidated return regulations.

Installment Sales

Section 1.1291-3(g) provides rules for applying section 1291 to installment sales of section 1291 fund stock. The gain portion of each installment is an excess distribution. For purposes of allocating each excess distribution under § 1.1291-2(e), the holding period of the transferred stock is treated as ending on the date the installment payment is received. A deferred tax amount is owed for each installment received. This rule applies section 1291(a)(3), which provides that the holding period ends on the date of each excess distribution.

Coordination With Sections 1246 and 1248

Section 1.1291-3(i) provides that neither section 1246 nor section 1248 applies to the disposition of stock of a section 1291 fund. However, as provided in § 1.1291-5(e), a shareholder may calculate a foreign tax credit on a disposition of stock of a section 1291 fund taking into account the indirect foreign tax credits to which the shareholder would have been entitled if section 1248 would have applied to the disposition of the section 1291 fund stock but for section 1291.

Deferred Tax Amount

Section 1.1291-4 provides the rules for determining the deferred tax amount. The tax deferred tax amount is calculated with respect to that portion of the excess distribution that is allocated to prior PFIC years and not included in income. It is the sum of the aggregate increases in taxes and the aggregate amount of interest determined with respect to the increases in taxes.

An increase in tax is calculated for each portion of an excess distribution allocated to a prior PFIC year. It is the product of the portion of the excess distribution allocated to a prior PFIC year and the highest rate of tax in effect in that prior year under section 1 or 11, as applicable. The aggregate increases in taxes are the sum of all increases in tax calculated with respect to an excess distribution. The aggregate increases in taxes are additional taxes owed in the current shareholder year regardless of the shareholder's tax position in that year or any of the prior PFIC years. Therefore, if unpaid, they will result in penalties and interest in the same manner as other taxes on income.

The aggregate amount of interest, the interest charge component of the deferred tax amount, is interest under section 6601 for the underpayment of tax. Interest is owed on each increase in tax calculated for a prior PFIC year

(reduced by foreign tax credits pursuant to § 1.1291-5) as if the portion of the excess distribution allocated to that prior PFIC year was distributed in that year but the tax thereon was not paid until the return due date for the current shareholder year. The interest charge is calculated, using the rates and method provided in section 6621, for the period beginning on the due date (without regard to extensions) for the shareholder's return for the prior PFIC year, and ending on the due date (without regard to extensions) for the shareholder's return for the current shareholder year.

Coordination With the Foreign Tax Credit Rules

Section 1.1291-5 provides the steps for determining the foreign tax credit a shareholder may claim against the increases in tax on an excess distribution, including in certain cases the excess distribution on a disposition of stock of a section 1291 fund. The foreign tax credit under these steps is determined separately for distributions received from different section 1291 funds and for each excess distribution. Excess foreign tax credits calculated with respect to an increase in tax may not be used to offset any other increase in tax or any other federal income tax. The calculation of the foreign tax credit for foreign taxes paid on the portion of the excess distribution subject to the deferred tax amount is separate from the calculation of the credit for other foreign taxes paid during the current shareholder year.

Nonrecognition Transfers of Stock of Section 1291 Funds

In General

Section 1.1291-6 provides rules for the recognition of gain by a shareholder on a direct or indirect disposition of stock of a section 1291 fund that results from a transaction in which, but for section 1291(f), there would not be full recognition of gain. The general rule of § 1.1291-6 is that the U.S. person recognizes gain unless an exception set forth in § 1.1291-6(c) applies. Gain from the disposition therefore is generally recognized and taxed as an excess distribution notwithstanding any other provision of the Code or regulations.

Exceptions to the Gain Recognition Rule

Generally, a shareholder will not be required to recognize gain if the shareholder receives a direct or indirect interest of equivalent value in a PFIC in exchange for the PFIC stock transferred. In addition, a shareholder will not be required to recognize gain if,

immediately after the transfer, the transferred stock is owned by a U.S. person (the U.S. transferee) that will be taxed under section 1291 on subsequent distributions and dispositions of the transferred stock, provided the U.S. transferee's adjusted basis in the stock is less than or equal to the shareholder's basis, and the U.S. transferee's holding period of the stock is at least as long as the shareholder's holding period.

Nothing in § 1.1291-6 is to be interpreted as overriding any other provision of the Code or regulations requiring recognition of gain or loss. If, under § 1.1291-6(c), an exception to the gain recognition rule applies to a transfer that is taxable under another provision, such as section 367 and the regulations under that section, the gain is taxable as a distribution or disposition, as appropriate, under section 1291. Section 1.1291-6 also does not require or permit the recognition of loss unless the loss is recognized under another section of the Code or regulations.

Basis and Holding Period Rules

If gain is recognized under the gain recognition rule of § 1.1291-6, the basis of the transferred stock and the basis of any stock received in exchange therefor are increased by the amount of gain recognized. If all gain realized is recognized, the holding period of such stock begins on the day after the transfer. If a shareholder realizes a loss on a transfer to which the gain recognition rule would have applied had a gain been realized, the shareholder does not recognize the loss, but the shareholder's holding period begins on the day after the transfer. If stock is transferred at death to a U.S. person and gain is not recognized, the basis of the transferred stock is the lower of the fair market value or adjusted basis of the transferred stock in the hands of the decedent shareholder on the date of death. The U.S. beneficiary's holding period of that stock includes the period the decedent held the stock. The days in the holding period of stock received by a shareholder or transferee in a transfer to which an exception to the gain recognition rule applies retain the PFIC character those days had with respect to the stock transferred.

Mark-to-Market Election by a Regulated Investment Company

In General

Section 1.1291-8 of the proposed regulations permits a RIC to make a mark-to-market election with respect to the stock of section 1291 funds of which

it is a direct or indirect shareholder. Because RICs in many instances have not been able to obtain the information necessary to make the QEF election under section 1295, the election under § 1.1291-8 is needed as a means to coordinate the rules of section 1291 with the rules of sections 851 through 855.

The deferred tax amount generally will be avoided with respect to stock of section 1291 funds because stock that was marked to market at the end of a year get a new holding period at the beginning of the following year. Any excess distribution with respect to stock subject to the election thereafter will be allocated under § 1.1291-2(e)(2) only to days in the current year.

Nothing in the proposed regulation precludes a RIC from electing under section 1295 to treat as a QEF a section 1291 whose stock was previously marked to market under § 1.1291-8.

Scope

The mark-to-market election is only available to a RIC that is either an open-end RIC or a closed-end RIC that determines and publishes weekly its net asset value. In such cases, the election will apply to all section 1291 fund stock of which the RIC is a shareholder. Comment is solicited on whether, and how, the election should be extended to other RICs.

Effect of the Election

The election applies to the year in which made and to each succeeding year unless revoked with the consent of the Commissioner. At the end of each of the RIC's taxable years to which the election applies, the RIC recognizes, on a share-by-share basis, the amount by which the fair market value of the section 1291 fund stock exceeds its adjusted basis. No loss may be recognized as a result of making the election. The holding period of stock that was marked to market, including stock of a section 1291 fund with respect to which there was no mark-to-market gain, begins on the first day of each taxable year of the RIC. The proposed regulations also provide for basis adjustments to avoid double taxation of the mark-to-market gain.

Except as provided in § 1.1291-8, the election otherwise has no effect on the manner in which a distribution by a section 1291 fund or a disposition of its stock is taxed to the electing RIC. Accordingly, distributions by a section 1291 fund will be taxable to the RIC pursuant to the general rules of the proposed regulations. Similarly, gain from the disposition of stock of the section 1291 fund will be treated as an excess distribution.

The proposed regulations provide a transition rule pursuant to which a RIC that makes the mark-to-market election in the first taxable year ending after [INSERT DATE THIS DOCUMENT IS PUBLISHED AS FINAL REGULATIONS] must include as ordinary income in that year all appreciation in the section 1291 stock as of the beginning of that year and pay a nondeductible interest charge. In addition, if the RIC failed to make a mark-to-market election in a prior year because it reasonably believed that it was not a shareholder of a section 1291 fund or did not apply a previously made election to a corporation because it reasonably believed that the corporation was not a section 1291 fund, the proposed regulations permit the RIC to elect to recognize the mark-to-market gains for the prior years with respect to the discovered stock in the year of discovery. All the mark-to-market gains is included in income in the year of discovery, subject to a nondeductible interest charge.

Although the objective of the mark-to-market election is to eliminate the RIC's liability for the deferred tax amount, the RIC may nevertheless owe such tax in the first year in which the election applies with respect to stock with a holding period that includes a prior PFIC year if it did not make the election in the first year in which it is permitted to do so. In that case, the transition rule will not apply to the RIC if it makes the election in a subsequent year; any gain recognized will be allocated over the entire holding period, triggering the deferred tax amount. Similarly, if the RIC does not elect the remedy in § 1.1291-8(e) of the proposed regulations in the year of discovery, the RIC may be liable for the deferred tax amount arising from excess distributions with respect to the discovered stock.

Purging Elections

Deemed Dividend Election

Section 1.1291-9 specifies the time and manner for making the election under section 1291(d)(2)(B). This election may be made by a U.S. person that is a direct or indirect shareholder of an unpedigreed QEF that also is a CFC. A shareholder that makes the section 1291(d)(2)(B) election is treated as receiving a dividend on the first day of its taxable year in which it makes the QEF election (qualification date).

The fact that the qualification date falls on a day other than the first day of the CFC's first taxable year as a QEF will have no effect on the amount that the shareholder must include in income pursuant to section 1293(a) for that first QEF year. As provided in section 1293,

the shareholder includes in income its pro rata share of the ordinary earnings and net capital gain of the QEF for the taxable year of the QEF that ends during the shareholder's taxable year. However, the amount of the deemed dividend will not include the portion of the current earnings that the shareholder demonstrates are included in the shareholder's income that year under section 1293(a).

Section 1.1291-9(h)(2) provides that a shareholder may not make the deemed dividend election of section 1291(d)(2)(B) if the CFC will not qualify as a PFIC under section 1296(a) for the first taxable year for which the QEF election was made. In that case, the shareholder of an unpedigreed QEF that no longer qualifies as a PFIC under section 1296(a) may make only the deemed sale election provided in section 1297(b)(1) and § 1.1297-3T.

Deemed Sale Election

The proposed regulations differ from § 1.1291-10, as proposed, in two significant respects. First, the proposed regulations change the qualification date for deemed sale elections made after May 1, 1992. This change is consistent with the definition of qualification date for the deemed dividend election described above.

Secondly, the proposed regulations clarify the amount of gain a shareholder recognizes when it makes a deemed sale election with respect to a PFIC of which it is an indirect shareholder. An indirect shareholder recognizes the amount of gain the actual shareholder of the stock would realize if the actual owner sold or otherwise disposed of the PFIC stock that the shareholder is considered to own.

Section 1293

Proposed § 1.1293-1(a) provides that section 1293 applies to pedigreed QEF shareholders only with respect to taxable years of the QEF in which the QEF satisfies either the income test or the asset test of section 1296(a). The proposed regulation also provides that if the PFIC is an unpedigreed QEF with respect to the shareholder, section 1293 applies to the shareholder in all years that the PFIC is a section 1291 fund, including those years in which the corporation does not satisfy either the income or asset test.

Application of Section 1295 Election

Section 1.1295-1 of the proposed regulations provides specific rules concerning the application of the section 1295 election to the electing shareholder, transferees of the shareholder, stock

acquired after the election was made, stock received in exchange for the QEF stock, and corporations that are successors of QEFs. The proposed regulations, however, do not provide guidance for making the section 1295 election. Until publication of regulations providing such guidance, taxpayers wishing to make the section 1295 election may continue to rely on Notice 88-125, 1988-2 C.B. 535.

The QEF election applies only to the shareholder that makes the election and not to any other shareholder of the PFIC or to a transferee of the QEF stock. Furthermore, the QEF election only applies to the corporation for which the shareholder makes the election and not to a successor corporation. Nevertheless, proposed regulation § 1.1291-1(b)(2)(i) permits a shareholder who transferred stock of a QEF in a nonrecognition transaction before a certain date to make a retroactive section 1295 election to treat the successor corporation as a QEF.

Distributions Described in Section 367(e)

The proposed regulations amend proposed §§ 1.367(e)-(1) and 1.367(e)-2 to provide that § 1.1291-3 and, in certain cases, § 1.1291-6 apply to determine the taxation of distributions of stock of a section 1291 fund described in section 367(e) (1) and (2). The proposed regulations also amend proposed § 1.367(e)-2(c)(3)(iv) to cross-reference to the rule that provides that the liquidation of a section 1291 fund may be an indirect disposition taxable to the indirect shareholder.

Effective Dates

Proposed § 1.1291-1(j) provides that, with certain exceptions, the regulations are effective April 1, 1992. Although the regulations are proposed to be effective prospectively, sections 1291 through 1297 are nevertheless effective for taxable years of foreign corporations beginning after December 31, 1986. Shareholders of corporations that qualified as PFICs after that date therefore must apply the statute in determining the tax consequences of distributions by section 1291 funds and dispositions of stock of section 1291 funds that were effected before the effective date of the proposed regulations. Such shareholders must apply reasonable interpretations of the Code. The Department of the Treasury and the Internal Revenue Service regard these regulations as a reasonable interpretation of the Code.

Certain provisions of the proposed regulations have other effective dates. Section 1.1291-3(d)(6) of the proposed

regulations, which concerns pledges of PFIC stock outstanding on the effective date of the statute, will be effective retroactively to taxable years of PFICs beginning after December 31, 1986. Section 1.1291-8 permits regulated investment companies to make a market-to-market election with respect to their section 1291 fund stock in taxable years ending after [INSERT DATE THIS DOCUMENT IS PUBLISHED AS A FINAL REGULATION].

Special Analyses

It has been determined that these proposed rules are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, an initial Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Request for a Public Hearing

Before adopting these proposed regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the Internal Revenue Service. All comments will be available for public inspection and copying. A public hearing will be held upon written request by any person who submits written comments as prescribed in the proposed rules. Notice of the time and place for the hearing will be published in the Federal Register.

Drafting Information

The principal author of these proposed regulations is Gayle E. Novig of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. Other personnel from the IRS and Treasury Department participated in developing the regulations.

List of Subjects

26 CFR 1.361-1 through 1.367(3)-2T

Income taxes, Reporting and recordkeeping requirements.

26 CFR 1.1231-1 through 1.1297-3T

Income taxes.

26 CFR Part 602

Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Paragraph 1. The authority citation for part 1 is amended by adding the following citation:

Authority: Sec. 7805, 68A Stat. 917; 26 U.S.C. 7805 * * * Sections 1.1291-1 through 1.1291-10 also issued under the authority of 26 U.S.C. 446, 26 U.S.C. 1291 (a) through (g), 26 U.S.C. 1293(a), 26 U.S.C. 1295 (a) through (b), and 26 U.S.C. 1297 (a) through (d). * * *

Par. 2. Section 1.367(e)-1T is amended by adding the text of paragraph (d)(4) to read as follows:

§ 1.367(e)-1T Distributions described in section 367(e)(1) (temporary).

(d) * * *

(4) *Distribution of stock of a passive foreign investment company.* With respect to a distribution that results in a disposition of stock of a PFIC that is a section 1291 fund within the meaning of § 1.1291-1(b)(2)(v), see § 1.1291-3. For the rule that section 1291 does not apply to a distribution of stock of a PFIC that is a pedigreed QEF within the meaning of § 1.1291-1(b)(2)(ii), see § 1.1291-(c)(1).

Par. 3. Section 1.367 (e)-2T is amended by adding the text of paragraphs (b)(3)(iv) and (c)(3)(iv) to read as follows:

§ 1.367(e)-2T Distributions described in section 367(e)(2) (temporary).

(b) * * *

(3) * * *

(iv) *Distribution of stock of a passive foreign investment company.* With respect to a distribution that results in a disposition of stock of a PFIC that is a section 1291 fund, see § 1.1291-3. For the rule that section 1291 does not apply to a distribution of stock of a PFIC that is a pedigreed QEF, see § 1.1291-1(c)(1).

(c) * * *

(3) * * *

(iv) *Distribution of stock of a passive foreign investment company.* With respect to distribution that results in an indirect disposition of stock of a PFIC that is a section 1291 fund, see §§ 1.1291-3 and 1.1291-6. For the rule

that section 1291 does not apply to a distribution of stock of a PFIC that is a pedigreed QEF, see § 1.1291-1(c)(1).

Par. 4. Section 1.1291-0 is added to read as follows:

§ 1.1291-0 Passive foreign investment companies—Table of contents.

This paragraph contains a listing of the major headings in §§ 1.1291-1 through 1.1291-10, 1.1293-1, 1.1294-1, 1.1295-1 and 1.1297-3

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 - (f) Transfers within a consolidated group.
 - (g) Installment sales.
 - (h) Series of liquidation distributions.
 - (i) Sections 1246 and 1248 inapplicable.
 - (j) Estate tax deduction.

§ 1.1291-4 The deferred tax amount.

- (a) In general.
- (b) Character of deferred tax amount.
- (c) Increase in tax.
 - (1) In general.
 - (2) Rate of tax in effect.
 - (3) Reduction for foreign taxes.
 - (4) Net increase in tax.
 - (5) Aggregate increases in taxes.
- (d) Aggregate amount of interest.
 - (1) In general.
 - (2) Reduction for interest paid under section 453A(c).
 - (e) Examples.

§ 1.1291-5 Coordination with the foreign tax credit rules.

- (a) Scope.
- (b) Distributions from section 1291 funds to shareholders that are not entitled to a foreign tax credit for taxes deemed paid.
 - (1) Rule.
 - (2) Carryovers disallowed.
- (c) Distributions from section 1291 funds that are CFCs.
 - (1) Rule.
 - (2) Carryovers disallowed.
 - (3) Example.
 - (d) Distributions from section 1291 funds that are noncontrolled section 902 corporations.
 - (e) Section 1248 gain.

§ 1.1291-6 Nonrecognition transfers of stock of section 1291 funds.

- (a) In general.
- (1) Scope.
- (2) Nonrecognition transfers.
- (3) Application of section to transfer of stock of a pedigreed QEF.
- (b) Recognition of gain or loss.
- (1) In general.
- (2) Coordination with other recognition provisions.
- (3) No recognition of loss.
- (4) Special basis rules.
- (i) Direct shareholders.
- (ii) Indirect shareholders.
- (iii) Stock acquired by reason of death.
- (iv) Assets distributed in certain subsidiary liquidations.
- (5) Special holding period rule for transfers subject to gain recognition rule.
- (c) Exceptions to general rule.
- (1) Transfer of section 1291 fund stock for PFIC stock.
- (2) Transfer to U.S. person.
- (i) In general.
- (ii) Transitory ownership.
- (iii) Transfer by reason of death.
- (A) In general.
- (B) Exception.
- (iv) Section 355 distribution of stock of section 1291 fund.
- (v) Gifts incurring gift tax.
- (vi) Exception inapplicable.
- (3) Transfers involving pass-through entities.
- (i) Section 721 transfer to partnership.
- (ii) Section 731 distribution by partnership.
- (iii) Transfer to S corporation.
- (iv) Transfer to grantor trust.
- (4) Transfer to nonresident alien spouse who files joint return.
- (d) Special rules.
- (1) Section 367 or 1492 transfer.
- (i) Gain recognition transfer.
- (ii) Disposition to which exception applies.
- (2) Taxable year of disposition by reason of death.
- (3) Section 643(e)(3) election.
- (e) Receipt of nonqualifying property.
- (f) Examples.
- (g) Reporting requirements for transfers entitled to nonrecognition treatment under this section.
- (h) Transfers involving QEF stock.

§ 1.1291-7 Section 1291 (e) rules similar to section 1246. [Reserved]

§ 1.1291-8 Mark-to-market election by regulated investment companies.

- (a) In general.
- (b) Effect of election.
- (1) Recognition of gain.
- (2) Treatment of gain.
- (i) In general.
- (ii) Sections 851(b)(3) and 4982.
- (3) No recognition of loss.
- (4) Adjustment to basis.
- (i) Stock held directly.
- (ii) Stock held indirectly.
- (5) Holding period.
- (6) Treatment under section 1291.
- (7) Coordination with subpart F.
- (8) Transition rule.
- (i) In general.
- (ii) Treatment of gain.
- (iii) Nondeductible interest charge.
- (iv) Adjustment to basis and holding period.

- (c) Eligible RIC.
- (d) Definitions.
- (1) Open-end RIC.
- (2) Closed-end RIC.
- (3) Fair market value.
- (e) Special election for PFIC stock held in prior years.
- (1) In general.
- (2) Effect of election.
- (3) Limitation for 10 percent shareholder.
- (4) Application to stock sold during the year.
- (f) Time for making the election.
- (g) Manner of making the election.
- (1) In general.
- (2) Statement attached to return.
- (3) Annual requirement.
- (h) Revocation of election.

§ 1.1291-9 Deemed dividend election by a shareholder of a CFC that is a qualified electing fund.

- (a) Deemed dividend election.
- (1) In general.
- (2) Post-1986 earnings and profits defined.
- (i) In general.
- (ii) Pro rata share of post-1986 earnings and profits attributable to shareholder's stock.
- (A) In general.
- (B) Reduction for previously taxed amounts.
- (b) Who may make the election.
- (c) Time for making the election.
- (d) Manner of making the election.
- (1) In general.
- (2) Attachment to Form 8821.
- (e) Elections made on or before May 1, 1992.
- (f) Adjustment to basis; treatment of holding period.
- (g) Coordination with section 959 (e).
- (h) Election inapplicable to shareholder of former PFIC.
- (1) Coordination with section 1297(b)(1).
- (2) Unpedigreed QEF.
- (i) Definitions.
- (1) QEF.
- (2) Pedigreed QEF.
- (3) Unpedigreed QEF.
- (4) Section 1291 fund.

§ 1.1291-10 Election by a United States person to recognize gain in a qualified electing fund.

- (a) Purpose and scope.
- (b) Election to recognize gain.
- (1) In general.
- (2) Qualification date.
- (i) Elections to be made on or before May 1, 1992.
- (ii) Elections to be made after May 1, 1992.
- (3) Exception.
- (4) Election by indirect shareholder.
- (c) Time for making the election.
- (d) Manner of making the election.
- (1) In general.
- (2) Information to be included in the election.
- (e) Adjustments to basis.
- (1) In general.
- (2) Adjustment to basis for section 1293 inclusion.
- (f) Treatment of holding period.

§ 1.1293-1 Current taxation of income from qualified electing funds.

- (a) In general.
- (b) Other rules. [Reserved]

§ 1.1294-1 Election to extend the time for payment of tax on undistributed earnings of a qualified electing fund.

- (a) Purpose and scope.
- (b) Election to extend time for payment of tax.
- (1) In general.
- (2) Exception.
- (3) Undistributed earnings.
- (i) In general.
- (ii) Effect of loan, pledge or guarantee.
- (c) Time for making the election.
- (1) In general.
- (2) Exception.
- (d) Manner of making the election.
- (1) In general.
- (2) Information to be included in the election.
- (e) Termination of the extension.
- (f) Undistributed PFIC earnings tax liability.
- (g) Authority to require a bond.
- (h) Annual reporting requirement.

§ 1.1295-1 Qualified electing funds.

- (a) In general.
- (b) Application of section 1295 election.
- (1) Election personal to shareholder.
- (2) Election applicable to specific corporation only.
- (i) In general.
- (ii) Stock of QEF received in a nonrecognition transfer.

§ 1.1297-3 Deemed sale election by a United States person that is a shareholder of a passive foreign investment company.

- (a) In general.
- (b) Time and manner for making the election.
- (1) In general.
- (2) Information to be included in the election.
- (3) Adjustment to basis; treatment of holding period.

Par. 5. Sections 1.1291-1 through 1.1291-10 are added to read as follows:

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

(a) *In general.* A U.S. person that is a shareholder (within the meaning of paragraph (b)(7) of this section) of a section 1291 fund (as defined in paragraph (b)(2)(v) of this section) is subject to the special rules under section 1291 and these regulations with respect to gain recognized on direct and indirect dispositions of stock of the section 1291 fund and upon certain direct and indirect distributions by the section 1291 fund. This section provides definitions and rules applicable to all PFICs and their shareholders. For rules governing the taxation of distributions and dispositions, see §§ 1.291-2 and 1.1291-3, respectively. For rules governing the determination of the deferred tax amount, see § 1.1291-4. For rules governing the determination of the foreign tax credit that a shareholder of a

section 1291 fund may claim on distributions and certain dispositions, see § 1.1291-5. For rules governing the recognition of gain on a direct or indirect disposition of stock of a section 1291 fund notwithstanding an otherwise applicable nonrecognition provision, see § 1.1291-6. For guidance for regulated investment companies making a market-to-market election, see § 1.1291-8. For the time and manner of making the deemed sale and dividend elections under section 1291(d)(2), see §§ 1.1291-9 and 1.1291-10, respectively.

(b) *Definitions*—(1) *PFIC*—(i) *In general*. A passive foreign investment company (PFIC) is a foreign corporation that satisfies either the income test of section 1296(a)(1) or the asset test of section 1296(a)(2). A corporation will not be treated as a PFIC with respect to a shareholder for those days included in the shareholder's holding period before the shareholder became a United States person within the meaning of section 7701(a)(30).

(ii) *PFIC characterization continued*. A corporation will be treated as a PFIC with respect to a shareholder even if the corporation satisfies neither the income test nor the asset test of section 1296(a), if the corporation (or its predecessor in a reorganization described in section 368(a)(1)(F)) was a section 1291 fund with respect to the shareholder at any time during the shareholder's holding period of the corporation's stock.

(2) *Types of PFICs*—(i) *QEF*. A PFIC is a qualified electing fund (QEF) with respect to a shareholder that has elected under section 1295 to be taxed currently on its share of the PFIC's earnings and profits pursuant to section 1293.

(ii) *Pedigreed QEF*. A PFIC is a pedigreed QEF with respect to a shareholder if the PFIC has been a QEF with respect to the shareholder for all taxable years that are included wholly or partly in the shareholder's holding period of the PFIC stock and during which the corporation was a PFIC.

(iii) *Unpedigreed QEF*. A PFIC is an unpedigreed QEF for a taxable year if—

(A) An election under section 1295 is in effect for that year;

(B) The PFIC has been a QEF with respect to the shareholder for at least one, but not all, of the taxable years that are included wholly or partly in the shareholder's holding period of the PFIC stock and during which the corporation was a PFIC; and

(C) The shareholder has not made an election under section 1291(d)(2) and § 1.1291-9 or 1.1291-10 with respect to the PFIC to purge the prior PFIC years from the shareholder's holding period.

For the effect on a shareholder's holding period of an election under

section 1291(d)(2), see §§ 1.1291-9(f) and 1.1291-10(f).

(iv) *Nonqualified fund*. A PFIC is a nonqualified fund with respect to a shareholder if the shareholder has not elected under section 1295 to treat the PFIC as a QEF.

(v) *Section 1291 fund*. A section 1291 fund is an unpedigreed QEF or a nonqualified fund.

(3) *PrePFIC year and day*. A prePFIC year is a taxable year (or portion thereof) of the shareholder, included in its holding period of the stock of a corporation, during which the corporation was not a PFIC within the meaning of paragraph (b)(1) of this section. A prePFIC day is a day in a prePFIC year of the shareholder. Thus, the days in a taxable year of a shareholder beginning after 1986 that are included in a taxable year of the corporation that began before 1987 are prePFIC days.

(4) *Prior PFIC year and day*. A prior PFIC year is a taxable year (or portion thereof) of a shareholder, other than the current shareholder year, included in its holding period of stock of a corporation during which the corporation was a section 1291 fund. A prior PFIC day is a day in a prior PFIC year of a shareholder.

(5) *Current shareholder year*. The current shareholder year is the taxable year of the shareholder in which occurs a distribution by, or disposition of stock of, a section 1291 fund.

(6) *Stock*. The term stock includes any equity interest in a corporation, without regard to whether there is a certificate or other representation of the equity interest in the corporation. For a rule that treats an option holder as a shareholder of a section 1291 fund, see § 1.1291-1(d).

(7) *Shareholder*. A shareholder is a U.S. person that directly owns stock (as defined in paragraph (b)(6) of this section) of a PFIC, or that is an indirect shareholder (as defined in paragraph (b)(8)(i) of this section). For purposes of these regulations, a partnership or S corporation is treated as a shareholder of a PFIC only for purposes of the information reporting requirements of §§ 1.1291-1(i), 1.1291-2(f)(2)(ii), 1.1291-3(e)(5)(iii), and 1.1291-6(g).

(8) *Indirect shareholder*—(i) *In general*. An indirect shareholder of a PFIC is a U.S. person that indirectly owns stock of a PFIC. A person indirectly owns stock if it is treated as owning stock of a corporation owned by another person (the actual owner) under this paragraph (b)(8). In applying this paragraph (b)(8), the determination of a person's indirect ownership is made on the basis of all the facts and

circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purpose of section 1291. Cf. § 1.958-1(c)(2).

(ii) *Ownership through a corporation*—(A) *Ownership through a nonPFIC*. A person that directly or indirectly owns 50 percent or more in value of the stock of a foreign corporation that is not a PFIC is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by that foreign corporation.

(B) *Ownership through a PFIC*. A person that directly or indirectly owns stock of a PFIC is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the PFIC.

(C) *Ownership through a domestic corporation*. If stock of a section 1291 fund is not treated as owned indirectly by a U.S. person under the rules of paragraph (b)(8) of this section (determined without regard to this paragraph (b)(8)(ii)(C)), but would be treated as owned by a U.S. person if paragraph (b)(8)(ii)(A) of this section applied to domestic corporations as well as foreign corporations, then such stock is considered owned by such U.S. person.

(iii) *Ownership through pass-through entities*—(A) *Partnerships*. If a partnership directly or indirectly owns stock, the partners of the partnership are considered to own a proportion of such stock in accordance with their ownership interests in the partnership.

(B) *S corporations*. If an S corporation directly or indirectly owns stock, each S corporation shareholder is considered to own a proportion of such stock equal to the proportion of the S corporation stock owned by that shareholder.

(C) *Estates and trusts*. If an estate or trust (other than an employee's trust described in section 401(a) that is exempt from tax under section 501(a)) directly or indirectly owns stock, the beneficiaries of such estate or trust will be considered to own a proportionate amount of such stock.

(c) *Coordination with QEF rules*—(1) *Pedigreed QEFs*. Section 1291 and these regulations do not apply to direct and indirect distributions by, and direct and indirect dispositions of stock of, a PFIC that, with respect to the shareholder, is a pedigreed QEF as defined in paragraph (b)(2)(ii) of this section.

(2) *Unpedigreed QEFs*. Section 1291 and these regulations apply to direct and indirect distributions by, and direct and indirect dispositions of stock of, a PFIC that, with respect to the

shareholder, is an unpedigreed QEF, as defined in paragraph (b)(2)(iii) of this section. For the treatment under section 1291 and these regulations of inclusions in income under section 1293(a) and distributions of amounts not includible in income by reason of section 1293(c), see § 1.1291-2(b)(2).

(d) *Option holder as shareholder.* If a U.S. person has an option to acquire stock of a PFIC (other than stock with respect to which the PFIC is a pedigreed QEF), such option is considered to be stock of a section 1291 fund for purposes of applying section 1291 and these regulations to a disposition of the option. For purposes of this paragraph (d), the exercise of an option is not a disposition to which section 1291 applies. For purposes of this paragraph (d), an option to acquire an option, and each one of a series of such options, are considered an option to acquire stock. For the holding period of stock acquired upon the exercise of an option, see § 1.1291-1(h)(3).

(e) *Exempt organization as shareholder.* If the shareholder of a section 1291 fund is an organization exempt from tax under this chapter, section 1291 and these regulations apply to such shareholder only if a dividend from the section 1291 fund would be taxable to the organization under subchapter F.

(f) *Excess distribution from sources within Puerto Rico.* A deferred tax amount, as defined in § 1.1291-4, will be determined under section 1291 and these regulations on amounts derived from sources within Puerto Rico (within the meaning of section 933(1)) by an individual shareholder who is a bona fide resident of Puerto Rico, but only to the extent such amounts are allocated under § 1.1291-2(e)(2) to a taxable year in the shareholder's holding period during which the shareholder was not entitled to the benefits of section 933.

(g) *Regulated investment companies and real estate investment trusts.* A regulated investment company, as defined in section 851, and a real estate investment trust, as defined in section 856, that are shareholders of a section 1291 fund are taxable under section 1291 and these regulations on direct or indirect distributions from a section 1291 fund and on direct or indirect dispositions of the stock of a section 1291 fund, and are therefore liable for the deferred tax amount, as defined in section 1291(c) and § 1.1291-4. For a mark-to-market election that may be made by a regulated investment company that is a shareholder of a section 1291 fund, see § 1.1291-8.

(h) *Holding period—(1) In general.* Except as otherwise provided in this

paragraph (h), § 1.1291-6(b)(5), 1.1291-9(f), or 1.1291-10(f), a shareholder's holding period of stock of a PFIC is determined under the general rules of the Code and regulations concerning the holding period of stock. The following example illustrates the rule of this paragraph (h)(1).

Example. T purchased the stock of FC, a foreign corporation, on December 31, 1985. FC has qualified as a PFIC since its taxable year beginning January 1, 1987. For purposes of sections 1291 through 1297 and the regulations under those sections, as well as other provisions of the Code and regulations, T's holding period of the FC stock began on January 1, 1986.

(2) *Stock acquired from U.S. decedent or domestic estate.* For purposes of section 1291 and these regulations, a shareholder's holding period of a share of stock of a PFIC includes the period the share was held by another U.S. person if the shareholder acquired the share by reason of the death of that other U.S. person (the decedent), the PFIC was a section 1291 fund with respect to the decedent, and the decedent did not recognize gain pursuant to § 1.1291-6(c)(2)(iii) (or would not have recognized gain had there been any) on the transfer to the shareholder.

(3) *Stock acquired upon exercise of option.* The holding period of a share of stock of a PFIC acquired upon the exercise of an option includes the period the option was held. The following example illustrates the rule of this paragraph (h)(3).

Example. X is a domestic corporation that owns all of the stock of Y, a PFIC. On January 1, 1993, X issues a debt instrument to G, a U.S. person. Under the terms of the instrument, G may convert the debt instrument into 20 shares of the stock of Y on any date prior to the maturity date of December 31, 2002. On August 14, 1997, G exercises the conversion right and receives 20 shares of Y stock. Pursuant to § 1.1291-1(h)(3), G's holding period of the Y stock begins at the time of the acquisition of the debt instrument, not at the time of acquisition of the Y stock.

(4) *Stock owned directly and indirectly—(i) In general.* Except as provided in paragraph (h) (2), (3), (4)(ii), (5), or (6) of this section, 1.1291-6(b)(5), 1.1291-9(f), or 1.1291-10(f), a shareholder's holding period of stock of a PFIC owned indirectly begins on the first day that a shareholder is considered to own stock of the PFIC (or of another PFIC that was a predecessor of that PFIC) under § 1.1291-1(b)(8). If a shareholder has owned a share of stock of a PFIC both directly and indirectly, the shareholder's holding period of that share begins on the earlier of—

(A) The first day that the shareholder owned the stock of the PFIC directly; or

(B) The first day that the shareholder was an indirect shareholder with respect to the share of stock of the PFIC (or of another PFIC that was a predecessor of that PFIC).

(ii) *Examples.* The following examples illustrate the operation of the rule of paragraph (h)(4)(i) of this section.

Example 1. A's holding period of stock of X began on August 14, 1990. X is a corporation that always has been an S corporation. At the time A acquired the X stock, X held stock of FC, a PFIC. For purposes of sections 1291 through 1297, A's holding period of the FC stock began on August 14, 1990, even though X's holding period of that stock began on an earlier day.

Example 2. B, a U.S. person, owns all the stock of FP, a foreign corporation that is not a PFIC; under section 1223, B's holding period of the FP stock began on August 1, 1987. FP owns 50 percent of the stock of FS, a foreign corporation that is not a PFIC; FP's holding period of the FS stock began on December 13, 1987. FS owns 10 percent of FC, a PFIC; under section 1223, FS's holding period of the FC stock began on November 20, 1986. For purposes of section 1291, B's holding period of the FC stock began on December 13, 1987, the first day that ownership of the FC stock is attributed to B under § 1.1291-1(b)(8).

(iii) *Section 1291 fund stock held by former C corporation.* For purposes of § 1.1291-2(e)(2)(i), if an S corporation's holding period of stock of a section 1291 fund includes any period during which the S corporation was a C corporation, the S corporation shareholder's holding period is the S corporation's holding period of such stock.

(5) *New holding period.* If a shareholder recognizes all of the gain realized on a direct or indirect disposition of stock of a section 1291 fund, within the meaning of § 1.1291-3(c), (d), or (e), but continues to be a shareholder with respect to such stock immediately after such disposition, the shareholder's holding period for such stock will be treated as beginning on the day after the disposition. For an illustration of this rule as applied to a disposition pursuant to § 1.1291-3(d) (regarding pledged stock), see § 1.1291-3(d)(7), *Example 1*.

(6) *Stock transferred to a member of a consolidated return group.* For the holding period of stock of a section 1291 fund transferred from one member of a consolidated return group to another member of the group for purposes of § 1.1291-2(e)(2)(i), see § 1.1291-3(f).

(7) *PFIC character of holding period—(i) In general.* If a shareholder's holding period of stock of a PFIC includes a period described in section 1223(1), the character of the days in such latter

period as prePFIC or prior PFIC days is determined by reference to the character of those days in the shareholder's holding period immediately prior to the exchange. If a shareholder's holding period of stock of a PFIC includes a period described in section 1223(2), the character of the days in such latter period as prePFIC or prior PFIC days is determined by reference to the character, immediately prior to the transfer, of those days in the holding period of the person from whom the stock was acquired.

(ii) *Anti-avoidance rule.* If a shareholder's holding period of stock of a PFIC includes a period described in section 1223(1), the character of the days in such latter period will be deemed to be prior PFIC days if a purpose for the exchange described in section 1223(1) was avoidance of the interest charge rules under section 1291.

(i) *Annual reporting requirements.* Except as otherwise provided in this paragraph (i), a U.S. person must file annually, with its federal income tax return for that year, a separate Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Fund, for each PFIC of which the person is a shareholder during the taxable year. Generally, an S corporation and its shareholders, a domestic partnership and its partners that are U.S. persons, and a domestic trust or estate and its beneficiaries that are U.S. persons considered to own stock of a PFIC under § 1.1291-1(b)(8)(iii)(C), must file Form 8621 annually. However, an S corporation shareholder, a partner, or beneficiary is not required to file Form 8621 for its taxable year in which ends the taxable year of the S corporation, partnership, trust or estate if—

(1) The S corporation, partnership, trust or estate files Form 8621; and

(2) The S corporation shareholder, partner, or beneficiary does not have to include any amount in income under section 1291 or 1293, report a nonrecognition transfer pursuant to § 1.1291-6(g), or report the status of a section 1294 election.

If a U.S. person is not required to file an income tax return or other return for the taxable year during which it was a direct or indirect shareholder of a PFIC, the shareholder files Form 8621 with the Philadelphia Service Center, P.O. 21086, Philadelphia, PA 19114, on or before the 15th day of the fourth month after the close of the shareholder's taxable year. For special reporting requirements for direct and indirect dispositions entitled to nonrecognition treatment under § 1.1291-6, see § 1.1291-6(g).

(j) *Effective date.*—(1) *In general.* Except as otherwise provided in this

paragraph (j), §§ 1.1291-1 through 1.1291-9 and the new parts of § 1.1291-10 are effective on April 1, 1992. However, sections 1291 through 1297, inclusive, are effective for taxable years of foreign corporations beginning after December 31, 1988. Accordingly, shareholders of PFICs are subject to sections 1291 through 1297 with respect to transactions occurring within those taxable years. Shareholders of section 1291 funds, in determining their liability under sections 1291 through 1297 during those years, must apply reasonable interpretations of the statute and legislative history and employ reasonable methods to preserve the interest charge.

(2) *Section 1.129-3(d)(6).* For purposes of applying section 1297(b)(6), concerning a disposition resulting from the use of PFIC stock as security for a loan, the transition rule provided in § 1.1291-3(d)(6) is effective for taxable years of foreign corporations beginning after 1986.

(3) *Section 1.1291-8.* Section 1.1291-8 is effective for taxable years of RICs ending after [INSERT DATE OF PUBLICATION OF THIS DOCUMENT AS A FINAL REGULATION].

§ 1.1291-2 Taxation of distributions by section 1291 funds.

(a) *In general.* Notwithstanding section 301 and the regulations under that section, a shareholder is subject to the rules of section 1291, this section, and § 1.1291-4 with respect to a distribution (including an indirect distribution as defined in paragraph (f) of this section) by a section 1291 fund, if any portion of such distribution is an excess distribution. An excess distribution is defined in paragraph (c)(1) of this section. Under paragraph (e)(2)(i) of this section, the excess distribution is allocated ratably over the shareholder's holding period of the stock of the section 1291 fund. The portions of the excess distribution allocated to the current shareholder year and to prePFIC years are included in the shareholder's gross income as ordinary income in the current shareholder year under paragraph (e)(2)(ii) of this section. The portions of the excess distribution allocated to prior PFIC years are not included in the shareholder's gross income pursuant to paragraph (e)(2)(iii) of this section. Instead, the shareholder incurs tax plus interest (the deferred tax amount) on those portions of the excess distribution, as provided in § 1.1291-4.

(b) *Distribution.*—(1) *In general.* For purposes of section 1291 and these regulations, unless otherwise provided in this paragraph (b), a distribution is any actual or constructive transfer of

money or property by a section 1291 fund with respect to its stock. For example, a distribution includes a transfer of stock taxable pursuant to section 305 (b) and (c), a transfer in redemption of stock taxable under section 301 pursuant to section 302(d), and an amount treated as a dividend under section 78. A distribution, however, does not include a transfer that qualifies under section 305(a) or 355(a). Transfers with respect to stock that are treated as dispositions of the stock under § 1.1291-3 are not treated as distributions under this section. For transfers with respect to stock (including transfers that qualify under section 355(a)) that are treated as dispositions, see § 1.1291-3.

(2) *Coordination with current inclusion rules.*—(i) *Deemed dividend or income inclusions; distributions of previously taxed amounts.* Amounts included in gross income under section 551(a), 951(a), or 1293(a), and transfers of amounts not included in gross income by reason of section 551(d), 959, or 1293(c), are not treated as distributions for purposes of this section. The following example illustrates the rule of this paragraph (b)(2)(i).

Example. USP, a domestic corporation, purchased in 1989 10 percent of the stock of FC, a section 1291 fund that also is a CFC. Both USP and FC use the calendar year as their taxable year. In 1989, USP, pursuant to section 951(a)(1), included in income \$100 of subpart F income of FC, none of which was distributed in 1989. The \$100 of subpart F income is not treated as a distribution taxable under section 1291. In 1990, FC did not have any subpart F income. In that year, FC distributed \$200 to USP. Of the \$200 distribution, \$100 had been previously taxed to USP. Because \$100 of the \$200 distribution is not included in gross income by reason of section 959, pursuant to § 1.1291-2(b)(2) that amount is not treated as a distribution for purposes of § 1.1291-2(c)(2)(i). Therefore, the total distribution, for purposes of calculating the excess distribution for 1990, is \$100.

(ii) *Other rules.* For treatment of amounts that would be taxable in the same taxable year under section 951(a) or 1293(a) and section 1291, see §§ 1.1291-2(f)(3) and 1.1291-3(e)(4)(ii).

(3) *Section 304 transactions.*—(i) *In general.* If, in a transaction described in section 304(a), the issuing corporation is a section 1291 fund, any amount treated as paid out of the earnings and profits of such section 1291 fund by virtue of section 304(b)(2) is treated as an excess distribution by such fund for purposes of section 1291 and this section. In addition, the transfer of the stock of such fund will be treated as a disposition to which §§ 1.1291-3 and 1.1291-6 apply. If, in a transaction

described in section 304(a), the acquiring corporation is a section 1291 fund, and amount paid by such corporation to the transferor is treated as a distribution by such fund (notwithstanding the provisions of section 304(b)(2)), and the transferor is treated for purposes of section 1291 and this section as the owner of any stock of the fund that it owns directly or constructively under section 304(c). The following example illustrates the rule of this paragraph (b)(3)(i).

Example. USP, a domestic corporation, owns all the stock of FS1 and FS2. FS1 and FS2 each have accumulated earnings and profits of \$100 that were not previously taxed under any other section of the Code. FS1, but not FS2, is a PFIC. USP has not elected under section 1295 to treat FS1 as a QEF. However, USP plans to make a section 1295 election to treat FS1 as a QEF, as well as the deemed dividend election under section 1291(d)(2)(B) to purge USP's holding period of the FS1 stock of its prior PFIC years. Before it makes those elections, USP plans to sell the stock of FS1 to FS2 for its fair market value of \$200. The transfer of the FS1 stock to FS2 is a transaction to which section 304 applies. Section 304(b)(2) provides that \$100 of the \$200 payment to USP is treated as paid directly by FS1 out of its earnings and profits. Pursuant to § 1.1291-2(b)(3)(i), the \$100 distribution to USP is taxable as an excess distribution. The transfer will not be a taxable disposition under § 1.1291-3 because USP's interest in FS1 is not reduced as a result of the transfer. See section 304(a)(1) and § 1.1291-8 (c)(1)(i).

(ii) *Limitation.* [Reserved]

(c) *Excess distribution and nonexcess distribution.*—(1) *Excess distribution.* An excess distribution is that portion of any direct or indirect distribution with respect to a share of stock of a section 1291 fund during the current shareholder year that is the ratable portion (as defined in paragraph (c)(4) of this section) of the total excess distribution (as defined in paragraph (c)(3) of this section), if any. Except as provided in § 1.1291-5, an excess distribution and the taxation thereof are determined without regard to the amount or character of the earnings and profits of the section 1291 fund. Except as provided in paragraph (d)(2) of this section (concerning shares of stock having the same holding period), the excess distribution is calculated separately for each share of stock held.

(2) *Nonexcess distribution.*—(i) *In general.* A nonexcess distribution with respect to a share of section 1291 stock is the portion of the total amount of all distributions during the current shareholder year with respect to the share that does not exceed 125 percent of the average amount of the distributions with respect to the share

during the three taxable years of the shareholder's holding period (or during the lesser number of taxable years in the shareholder's holding period) that immediately precede the current shareholder year. Distributions in any of the preceding three (or fewer) taxable years of the shareholder included in the shareholder's holding period that began before 1987 are included in determining the nonexcess distribution.

(ii) *Amount not included in income.* The portion of an excess distribution in a prior taxable year that was not included in income pursuant to § 1.1291-2(e)(2)(iii) is not treated as a distribution in that prior year for purposes of paragraph (c)(2)(i) or (iii) of this section. For an illustration of the rule of this paragraph (c)(2)(ii), see paragraph (e)(4), *Example 1*, of this section.

(iii) *Distributions received by predecessors.* If a shareholder's holding period of the stock of a section 1291 fund includes the period the stock was held by another person, distributions made during the holding period of such other person with respect to the stock will be treated as if they had been received by the shareholder for purposes of paragraph (c)(2)(i) of this section.

(3) *Total excess distribution.*—(i) *In general.* The total excess distribution with respect to a share of stock of a section 1291 fund is the excess, if any, of—

(A) The total amount of all distributions during the current shareholder year with respect to the share, over

(B) The nonexcess distribution with respect to that stock.

(ii) *Exception.* Notwithstanding paragraph (c)(3)(i) of this section, the total excess distribution is zero for the taxable year of the shareholder in which the shareholder's holding period of the stock begins. The following example illustrates the rule of this paragraph (c)(3)(ii).

Example. On January 1, 1989, X, a U.S. person, gave his son Y, also a U.S. person, one share of stock of FC, a section 1291 fund, that X had purchased in 1986. Y purchased another share of FC stock on January 3, 1989. Y did not make the section 1295 election with respect to FC. In 1989, FC distributed \$100 for each outstanding share of its stock. Pursuant to § 1.1291-2(c)(3)(ii), no portion of the distribution in respect of the share Y purchased in 1989 is treated as an excess distribution. However, the distribution paid to Y with respect to the stock given to him by his father may be wholly or partly an excess distribution. Although Y first held that share of FC stock in 1989, Y's holding period includes the period X held that share of stock, as provided in section 1223 (2), and therefore does not begin in 1989.

(4) *Ratable portion.* The total excess distribution is allocated ratably to each distribution received with respect to a share of stock during the current shareholder year. A distribution's ratable portion of the total excess distribution is the product of the total excess distribution and the ratio of the distribution to the total distribution with respect to the share of stock during the current shareholder year. Each ratable portion of the total excess distribution is an excess distribution.

(d) *Special rules.* The following rules apply for purposes of calculating the nonexcess distribution and the total excess distribution—

(1) *Stock acquired during the year.* In general, a distribution in a prior taxable year with respect to a share of stock may only be taken into account in determining a nonexcess distribution under paragraph (c)(2)(i) of this section if the shareholder was a shareholder at the time of such distribution, or the distribution was received by a person whose holding period of the stock is included in the shareholder's holding period. However, with respect to a prior taxable year during which a person became a shareholder, the shareholder may instead take into account the total amount (or portion thereof) that the shareholder determines was actually paid by the section 1291 fund with respect to that share of stock during that taxable year. No other annualization rule will apply under section 1291 (b)(3)(C). The following example illustrates the rule of this paragraph (d)(1).

Example. R, a U.S. person, became an indirect shareholder of one share of FC stock on August 1, 1991. R did not elect under section 1295 to treat FC, a PFIC, as a QEF. R and FC both use the calendar year as their taxable years. R determines, based on dividend information provided in FC's 1991 annual report, that FC distributed \$100 with respect to each outstanding share of its stock at the end of each quarter during that year. For purposes of calculating nonexcess distributions in 1992, 1993, and 1994, R may treat \$400 as the amount received in 1991. If R had been unable to determine the amount distributed in 1991 before August 1, the 1991 distribution would have been limited to the \$200 actually distributed after August 1 with respect to the one share of FC stock attributed to R.

(2) *Calculations for shares with same holding period.* The calculation of the nonexcess distribution and the total excess distribution may be made on an aggregate basis for shares of stock having the same holding period (block of stock). The following example illustrates the rule of this paragraph (d)(2).

Example. (i) *Facts.* X, a U.S. person that is a calendar year taxpayer, owns 12 shares of stock of FC, a PFIC. X has not elected under section 1295 to treat FC as a QEF. X acquired two of the 12 shares on December 31, 1986 (Block #1), four shares on December 31, 1987 (Block #2), and six shares on December 31, 1988 (Block #3). On June 30 of 1987 and 1988, FC distributed \$10 in respect of each outstanding share of its stock; no portion of either distribution was an excess distribution. On June 30, 1989, FC distributed \$30 in respect of each outstanding share of its stock. For purposes of determining the taxation of the 1989 distribution, the excess distribution may be calculated for each of the three blocks of stock held by X instead of on a share-by-share basis.

(ii) *Block #1 excess distribution.* The nonexcess distribution for Block #1 is \$25 $\{125\% \text{ times } \$20 [(\$20 + \$20) / 2]\}$. The total excess distribution for Block #1 is \$35 $(\$60 - \$25)$.

(iii) *Block #2 excess distribution.* The nonexcess distribution for Block #2 is \$50 $(125\% \text{ times } \$40, \text{ the distribution made in the only preceding taxable year in the holding period of the Block #2 shares})$. The total excess distribution for Block #2 is \$70 $(\$120 - \$50)$.

(iv) *Block #3.* There is no excess distribution with respect to the Block #3 stock because the first taxable year of the holding period of that block of stock is 1989, the taxable year of the distribution.

(3) *Effect of nontaxable distribution or exchange—(i) Tax-free distributions of stock.* A distribution with respect to a share of stock, made during the shareholder's holding period for the share but before a distribution of stock under section 305 (a) with respect to that share, will be treated ratably as a distribution with respect to the shares in the block of stock composed of the original share and the shares distributed with respect to that share pursuant to the stock distribution.

(ii) *Nontaxable exchange of stock.* Distributions with respect to stock include distributions with respect to stock exchanged therefor in a nonrecognition transfer in which gain was not recognized pursuant to § 1.1291-6(c).

(iii) The following example illustrates the rule of paragraph (d)(3) of this section.

Example. On December 31, 1985, X, a U.S. person, purchased one share of stock of FC, a corporation. FC has been a section 1291 fund with respect to X since FC's taxable year that began January 1, 1987. In both 1986 and 1987, FC distributed \$6 with respect to each share of its stock. FC transferred all its assets and liabilities to F, a PFIC, in a transaction that qualified as a reorganization defined in section 368(a)(1)(C) and that was effective on January 1, 1988. X exchanged his share of FC stock for one share of stock of F in an exchange to which section 354 applied and no gain was recognized pursuant to § 1.1291-6(c)(1). On December 31, 1988, F distributed

\$3 with respect to each share of its stock. No part of the 1986, 1987, and 1988 distributions was an excess distribution. On December 31, 1989, F distributed \$10 with respect to each share of its stock. In calculating the total excess distribution for 1989, the \$6 distributions paid in 1986 and 1987 by FC with respect to the FC stock held by X, as well as the \$3 distribution paid by F in 1988 on the F stock received in exchange for the FC stock, are taken into account. Accordingly, the total excess distribution for 1989 is \$3.75 $\{ \$10 - [125\% \times \$5 \text{ (the average distribution for the three preceding taxable years)}] \}$.

(4) *Distributions in a foreign currency—(i) In general.* Except as provided in paragraph (d)(4)(ii) of this section, the nonexcess distribution and the total excess distribution are determined in U.S. dollars. Each distribution that must be taken into account for purposes of the calculation is translated into the U.S. dollar at the spot rate (within the meaning of § 1.988-1T(d)) on the date on which such distribution was made. The following example illustrates the rule of this paragraph (d)(4)(i).

Example. USP, a domestic corporation, purchased on December 31, 1986, five percent of the stock of FC, a country X corporation that is a section 1291 fund with respect to USP. The functional currency of FC is the "LC", the currency of country X. FC made no distributions during 1987. FC distributed \$100 to USP on August 1, 1988; LC20 on November 20, 1989; and 100 units of country Y currency on December 13, 1990. In order to calculate the 1989 and 1990 excess distributions, USP must convert the 1989 distribution of LC20 into U.S. dollars at the spot rate on November 20, 1989, and the 1990 distribution of 100 units of country Y currency into U.S. dollars at the spot rate on December 13, 1990.

(ii) *Exception.* If all distributions that must be taken into account for purposes of calculating the nonexcess distribution and the total excess distribution for the current shareholder year were made in a single currency (other than the U.S. dollar), the nonexcess distribution and total excess distribution will be determined in the currency in which the distributions were made. Each ratable portion of a total excess distribution determined in a foreign currency is translated into U.S. dollars at the spot rate on the date of the distribution to which the ratable portion is allocated.

(5) *Adjustments for section 642(c) charitable deduction—(i) In general.* A trust that is permitted to deduct the amount of its fixed annual charitable obligation from gross income pursuant to section 642(c)(1) (the section 642(c) deduction) generally may adjust an excess distribution from a section 1291 fund as provided in this paragraph (d)(5) by the amount of the section 642(c) deduction. Except as otherwise provided

in this paragraph (d)(5), the trust may adjust an excess distribution if, in satisfaction of its fixed annual obligation, it distributes—

(A) amounts received from the section 1291 funds;

(B) The stock of a section 1291 fund; or

(C) The proceeds from the sale thereof, to an organization described in section 170(c), as required under the terms of the governing instrument of the trust. The adjustment provided in this paragraph (d)(5) is limited to the amount of the trust's fixed annual charitable obligation.

(ii) *Exception.* This paragraph (d)(5) does not apply to a grantor of a trust if the grantor deducted from income, as provided in section 170(f)(2)(B), the value of an interest in any share of stock of the section 1291 fund upon its transfer to the trust.

(iii) *Adjustments—(A) Corpus consisting only of section 1291 fund stock.* Where the assets of the trust consist only of stock of one or more section 1291 funds, the section 642(c) deduction first reduces the nonexcess distributions, if any, determined under paragraph (c)(2)(i) of this section. The amount of the section 642(c) deduction remaining after reduction of the nonexcess distributions reduces the portions of the excess distributions allocated to the prePFIC and current shareholder years. Finally, the amount of the section 642(c) deduction remaining after the prior two reductions reduces pro rata the portions of the excess distributions allocated to the prior PFIC years. The deferred tax amount, as defined in § 1.1291-4, is determined with respect to the adjusted allocations of the excess distributions.

(B) *Corpus consisting of section 1291 fund stock and other property—(1) Income from both section 1291 fund stock and other property.* A distribution of income in satisfaction of a fixed annual charitable obligation is treated as distributed out of income, if any, derived from the trust property other than the stock of a section 1291 fund to the extent thereof, before being treated as distributed out of amounts received from a section 1291 fund. An adjustment will be permitted in the manner provided in paragraph (d)(5)(iii)(A) of this section only after the deduction permitted under section 642(c) has reduced income from other property to zero.

(2) *Use of corpus to satisfy obligation.* The trust will not be entitled to the adjustment permitted under this paragraph (d)(5) if the trust uses stock of a section 1291 fund instead of its other

property to satisfy its fixed annual charitable obligation.

(6) *PFIC for part of current shareholder year.* This paragraph (d)(6) applies if the section 1291 fund first qualified as a PFIC for its taxable year beginning after the first day of the current shareholder year and therefore is a section 1291 fund for only a portion of the current shareholder year. Distributions during the portion of the current shareholder year before the corporation qualified as a PFIC are taken into account for purposes of calculating the nonexcess distribution and the total excess distribution. However, those distributions are taxable under the general rules applicable to distributions by a corporation to its shareholder with respect to its stock, notwithstanding that a ratable portion thereof may be an excess distribution within the meaning of paragraph (c)(1) of this section. The following example illustrates the rule of this paragraph (d)(6).

Example. X, a U.S. person, purchased one share of stock of FC, a corporation, on December 31, 1986. X uses the calendar year as its taxable year. FC's taxable year ends November 30. FC first qualified as a PFIC for its taxable year that began December 1, 1990. X did not elect under section 1295 to treat FC as a QEF. X received a distribution of \$100 in 1987, but did not receive another distribution from FC until August 1, 1990, when FC distributed \$100 per share. On December 13, 1990, FC made another \$100 per share distribution. The August distribution is taken into account for purposes of calculating the nonexcess distribution and total excess distribution for 1990 and the ratable portion of the December 13 distribution that is an excess distribution. However, pursuant to § 1.1291-2(d)(6), the August distribution is not subject to section 1291 notwithstanding that a ratable portion of that distribution is an excess distribution within the meaning of § 1.1291-2(c)(1). The August distribution is included in X's 1990 gross income to the extent provided in section 301(c).

(e) *Taxation of a distribution and effect on earnings and profits—(1) Nonexcess distribution.* A nonexcess distribution, as defined in paragraph (c)(2)(i) of this section, is taxable to a shareholder according to the general rules of taxation applicable to distributions made by a corporation to a shareholder with respect to its stock. *see, e.g.,* section 301 and the regulations under that section.

(2) *Excess distribution—(i) In general.* To determine the taxation of an excess distribution, the excess distribution is first allocated pro rata to each day in the shareholder's holding period (as determined under § 1.1291-1(h)) of the share of stock with respect to which the distribution was made. The holding

period of a share of stock of a section 1291 fund is treated as ending on (and including) the date of each excess distribution solely for purposes of allocating the excess distribution.

(ii) *Allocations included in income.* The portions of an excess distribution allocated to prePFIC years and the current shareholder year are included in the shareholder's gross income for the current shareholder year as ordinary income.

(iii) *Allocations not included in income.* The portions of an excess distribution allocated to prior PFIC years are not included in the shareholder's gross income for purposes of this title. These amounts are subject to the deferred tax amount. The deferred tax amount is an additional liability of the shareholder for tax and interest for the current shareholder year. For the calculation of the deferred tax amount and the foreign tax credit that may be taken to reduce the deferred tax amount, *see* §§ 1.1291-4 and 1.1291-5.

(3) *Allocation of earnings and profits.* For purposes of determining the taxation of a nonexcess distribution and calculating the foreign tax credit under § 1.1291-5, the earnings and profits of a section 1291 fund are allocated proportionately between the nonexcess distribution (as defined in paragraph (c)(2)(i) of this section) and the total excess distribution (as defined in paragraph (c)(3) of this section) and reduced (but not below zero) by the amounts thereof.

(4) *Examples.* The following examples illustrate the operation of paragraphs (c), (d), and (e) of this section.

Example 1. —(i) Facts. X, a U.S. person, purchased a share of stock of FC, a corporation, on December 31, 1985. FC has been a section 1291 fund since its taxable year that began January 1, 1987. X received distributions from FC of \$50 on December 31, 1987, \$80 on December 31, 1988, and \$150 on December 31, 1989. FC made no distributions in 1986.

(ii) *1987 excess distribution.* Because X did not receive a distribution from FC during 1986, the only preceding taxable year in its holding period, the total distribution of \$50 is the total excess distribution for 1987. That amount is allocated pro rata over X's two-year holding period, as provided in § 1.1291-2(e)(2)(i): \$25 is allocated to 1986, a prePFIC year, and \$25 to 1987, the current shareholder year. The entire \$50 therefore is included in X's gross income for 1987 as ordinary income.

(iii) *1988 excess distribution.* In 1988, of the \$80 total distribution, \$31.25 {125% times \$25 [(0 + \$50)/2]} is the nonexcess distribution, and is taxable as a corporate distribution as provided in section 301(c). The total excess distribution for 1988, \$48.75 (\$80 - \$31.25), is allocated over X's three-year holding period; \$16.25 is allocated to each year. The portions of the excess distribution allocated to the

prePFIC year (1986) and the current shareholder year (1988) total \$32.50; that amount is included in X's gross income as ordinary income. The \$16.25 portion of the excess distribution allocated to 1987, the prior PFIC year, is not included in X's gross income, but is subject to the deferred tax amount. Of the \$80 distribution, \$63.75 (\$31.25 + \$32.50) is included in X's gross income in 1988.

(iv) *1989 excess distribution.* In 1989, of the \$150 total distribution, \$47.40 {125% times \$37.90 [(90 + \$50 + \$63.75)/3]} is the nonexcess distribution, and is taxable as a corporate distribution as provided in section 301(c). The total excess distribution for 1989, \$102.60 (\$150 - \$47.40), is allocated over X's four-year holding period; \$25.65 is allocated to each year. The portions of the excess distribution allocated to the prePFIC year (1986) and the current shareholder year (1989) total \$51.30; that amount is included in X's gross income as ordinary income. The portions of the excess distribution allocated to the prior PFIC years (1987 and 1988) total \$51.30; that amount is not included in X's gross income but is subject to the deferred tax amount. Of the total \$150 distribution, \$98.70 (\$47.40 + \$51.30) is included in X's gross income in 1989.

Example 2. —(i) Facts. X, a U.S. person with a calendar taxable year, purchased 1,000 shares of stock of FC, a corporation, on December 31, 1985. FC has been a section 1291 fund since its taxable year that began January 1, 1987. FC distributed \$100,000 to X on January 31, 1989, and \$200,000 to X on July 31, 1989. X determined the total excess distribution for 1989 to be \$150,000.

(ii) *January 31 distribution.* The excess distribution allocated to the January 31 distribution, which is the ratable portion of the total excess distribution allocated to the \$100,000 distribution made on that date, is \$50,000 [\$150,000 × (\$100,000/\$300,000)]. For purposes of allocating the \$50,000 excess distribution over X's holding period, X's holding period is treated as ending on (and including) January 31, 1989. X thus held the stock for 1,127 days (365 days in both 1986 and 1987, 366 days in 1988, and 31 days in 1989) at the time of the January 31 distribution. The \$50,000 excess distribution allocated to the January 31 distribution is allocated pro rata to the 1,127 days; approximately \$44.37 is allocated to each day in the holding period. The total allocations to each of the taxable years in X's holding period are as follows:

| Taxable year | Total allocation per year |
|---------------------|---------------------------|
| 1986 | \$16,193.70 |
| 1987 | 16,193.70 |
| 1988 | 16,237.70 |
| 1989 | 1,374.90 |
| Excess distribution | 50,000.00 |

The allocation to 1986, the prePFIC year, and the allocation to 1989, the current shareholder year, are included in X's gross income for 1989 as ordinary income. The allocations to

1987 and 1988, the prior shareholder years, are not included in X's gross income in 1989, but are subject to the deferred tax amount.

(iii) *July 31 distribution.* The excess distribution allocated to the July 31 distribution, which is the ratable portion of the total excess distribution allocated to the distribution made on that date, is \$100,000 [$\$150.00 \times (\$200,000/\$300,000)$]. For purposes of the allocation of this excess distribution, X's holding period is treated as ending on July 31, 1989. X thus held the stock for 1,308 days (365 days in both 1986 and 1987, 366 days in 1988, and 212 days in 1989) at the time of the July 31 distribution. The \$100,000 excess distribution allocated to the July 31 excess distribution is allocated pro rata to the 1,308 days; approximately \$76.45 is allocated to each day in the holding period. The total allocations of the July 31 excess distribution to each of the taxable years in X's holding period are as follows:

| Taxable year | Total allocation per year |
|--------------------------|---------------------------|
| 1986..... | \$27,905.20 |
| 1987..... | 27,905.20 |
| 1988..... | 27,981.65 |
| 1989..... | 16,207.95 |
| Excess distribution..... | 100,000.00 |

The portions of the excess distribution allocated to 1986, the prePFIC, and to 1989, the current shareholder year, are included as ordinary income in X's gross income for 1989.

The portions of the excess distribution allocated to 1987 and 1988, the prior PFIC years, are not included in X's gross income in 1989, but are subject to the deferred tax amount.

Example 3—(i) Facts. X, a U.S. person, holds six shares of the stock of FC, a section 1291 fund. Two shares were purchased on December 31, 1986 (Block #1), and four shares were purchased on December 31, 1987 (Block #2). On June 30 of 1987 and 1988, FC distributed \$10,000 in respect of each outstanding share of its stock. No portion of the distributions in either year was an excess distribution. On June 30, 1989, FC distributed \$30,000 in respect of each outstanding share of its stock.

(ii) *Calculation of the 1989 excess distributions.* The excess distribution is determined separately for each block of stock.

(A) *Block #1 excess distribution.* The nonexcess distribution for Block #1 is \$25,000 [$125\% \text{ times } [(\$20,000 + \$20,000)/2]$]. The total excess distribution for Block #1 is \$35,000 ($\$60,000 - \$25,000$).

(B) *Block #2 excess distribution.* The nonexcess distribution for Block #2 is \$50,000 [$125\% \text{ times } \$40,000$ (the distribution received in the only preceding taxable year included in X's holding period)]. The total excess distribution for Block #2 is \$70,000 ($\$120,000 - \$50,000$).

(iii) *Block #1 allocation.* The holding period of the Block #1 stock began on January 1, 1987, and ended, for purposes of section 1291, on June 30, 1989, for a total of 912 days (365 days in 1987, 366 days in 1988 and 181

days in 1989). The \$35,000 excess distribution for Block #1 is allocated pro rata to each of the 912 days. Accordingly, approximately \$38.38 is allocated to each day. The total allocations to each of the taxable years in X's holding period are as follows:

| Taxable year | Total allocation per year |
|--------------------------|---------------------------|
| 1987..... | \$14,007.70 |
| 1988..... | 14,046.10 |
| 1989..... | 6,946.20 |
| Excess distribution..... | 35,000.00 |

The portion of the excess distribution allocated to 1989, the current shareholder year, of \$6,946.20, is included as ordinary income in X's gross income for 1989. The portions of the excess distribution allocated to the prior PFIC years, 1987 and 1988, an aggregate of \$28,053.80, are not included in X's gross income in 1989, but are subject to the deferred tax amount.

(iv) *Block #2 allocation.* The holding period of the Block #2 stock began on January 1, 1988, and ended, for purposes of section 1291, on June 30, 1989, for a total of 547 days (366 days in 1988 and 181 days in 1989). The excess distribution of \$70,000 in respect of the Block #2 stock is allocated pro rata to each of the 547 days. Accordingly, approximately \$127.97 is allocated to each day. The total allocations to each of the taxable years in X's holding period are as follows:

| Taxable year | Total allocation per year |
|--------------------------|---------------------------|
| 1988..... | \$46,837.40 |
| 1989..... | 23,162.60 |
| Excess distribution..... | 70,000.00 |

The portion of the excess distribution allocated to 1989, the current shareholder year, of \$23,162.60, is included as ordinary income in X's gross income for 1989. The portion of the excess allocated to 1988, \$46,837.40, is not included in X's gross income in 1989, but is subject to the deferred tax amount.

Example 4. X is a U.S. person that owns all the stock of FC, a section 1291 fund. At the end of its 1991 taxable year, FC has accumulated earnings and profits, before reduction for distributions made during the year, of \$100, none of which was previously taxed to X under section 951 or 1293. FC distributes \$200 to X on the last day of FC's taxable year. X determines that, of the \$200 distribution, \$50 is a nonexcess distribution, and \$150 is the total excess distribution. FC's earnings and profits of \$100 are allocated proportionately between the nonexcess distribution of \$50 and the excess distribution of \$150, and reduced to zero. Accordingly, \$25 of FC's earnings and profits are allocated to the nonexcess distribution and \$75 of FC's earnings and profits are allocated to the excess distribution. Therefore, \$25 of the \$50 nonexcess distribution is taxable as a dividend under section 301(c)(1), and the

remaining \$25 is taxable to the extent provided in section 301(c)(2) and (3). The excess distribution of \$150 is taxable as provided in § 1.1291-2(e)(2).

(f) *Indirect distributions—(1) In general.* A distribution (as defined in § 1.1291-2(b)) by a section 1291 fund to the actual owner of stock of the section 1291 fund is an indirect distribution if such stock is considered owned by a U.S. person pursuant to § 1.1291-1(b)(8). Except as otherwise provided in this paragraph (f), an indirect shareholder is taxable on the total distribution paid by the section 1291 fund with respect to the stock attributed to the indirect shareholder, as if the indirect shareholder had actually received that amount. The following example illustrates the rule of this paragraph (f)(1).

Example. (i) X, an S corporation under section 1361, purchased 100 shares of stock of FC, a corporation, on December 31, 1985. FC has been a section 1291 fund since its taxable year that began January 1, 1987. A purchased 10 percent of the stock of X on December 31, 1986, and thus became an indirect shareholder of 10 shares of FC stock. Pursuant to § 1.1291-1(h)(4)(i), A's holding period of the FC stock began on January 1, 1987.

(ii) FC distributed \$5 per share of stock to its shareholders in 1986, and \$8 per share in 1987. In 1987 A is treated as receiving a distribution of \$80 from FC. A did not have a total excess distribution in 1987, the taxable year in which A's holding period of the FC stock began.

(iii) FC distributed \$12 per share in 1988, all of which was paid on June 30, 1988. A therefore is treated as receiving a distribution of \$120 from FC. The nonexcess distribution is \$100 [$125\% \text{ times } \$80$]. Accordingly, the excess distribution is \$20 ($\$120 - \$100$). That amount is allocated under § 1.1291-2(e)(2)(i) to each day in A's holding period of the FC stock, which began on January 1, 1987, and ended, for purposes of the allocation of the excess distribution, on June 30, 1988.

(2) *Pass-through entities—(i) Taxation of trusts, estates, and their beneficiaries.* [Reserved]

(ii) *Information reporting—(A) In general.* A domestic partnership that is a direct or indirect shareholder of a section 1291 fund must separately state the total distribution as a distribution from a section 1291 fund on its federal income tax return (if any) and on any Schedule K-1 filed by the partnership or provided to a partner to which a distributive share of the distribution from the section 1291 fund is allocated pursuant to section 704. In addition, the partnership must state on the Schedule K-1 the information needed by the partner to compute its excess distribution with respect to such total distribution, and provide the name,

address and stock basis, where appropriate, of the actual owner of the section 1291 fund that paid the distribution (or whose stock was transferred in an indirect disposition). Any partner receiving such a Schedule K-1 that is itself a domestic partnership is in turn obligated to separately state such information according to the same rules. Similar rules apply to S corporations.

(B) *Trusts and estates.* [Reserved]

(3) *Coordination with subpart F.* If, but for this paragraph (f)(3), an indirect distribution would be taxable to an indirect shareholder under this section and also included in the gross income of the indirect shareholder under section 551(a), 951(a)(1), or 1293(a), the indirect distribution is taxable only under this section.

(4) *Exceptions—(i) Distribution to sole shareholder.* A distribution by a section 1291 fund (distributing fund) to another section 1291 fund (distributee fund) will not be taxable to the direct shareholder of the distributee fund if—

(A) The distributee fund owns all the stock of the distributing fund; and

(B) The distributing fund distributed all its earnings and profits in the current shareholder year and annually distributed all its earnings and profits for each year that is included in the shareholder's holding period of the distributing fund.

(ii) *Other exceptions.* [Reserved]

(5) *Adjustment to basis.* The shareholder's adjusted basis of the stock or other property that is owned directly by the shareholder and through which ownership of the section 1291 fund is attributed to the shareholder is increased by the amount of the indirect distribution taxed to the shareholder pursuant to paragraph (f)(1) of this section.

(6) *Treatment of previously taxed amounts.* The principles of sections 959 and 961 apply with respect to amounts previously taxed under this paragraph (f). The following example illustrates the rule of this paragraph (f)(6).

Example. USP owns 50% of CFC1. CFC1 and its wholly owned subsidiary, CFC2, are both controlled foreign corporations within the meaning of section 957(a), but are not PFICs. CFC2 owns 10% of the stock of NQF, a PFIC. USP is an indirect shareholder of NQF pursuant to § 1.1291-1(b)(8)(ii). USP has not elected to treat NQF as a QEF. In 1992, NQF distributes \$100 to CFC2, and CFC1 distributes \$100 to USP, but CFC2 makes no distributions to CFC1. At the end of 1992, CFC1 has accumulated earnings and profits of \$200, none of which was previously taxed to USP under section 951(a)(1). USP is taxable pursuant to § 1.1291-2(f) on its pro rata share of the indirect distribution paid to CFC2, and also is taxable on CFC1's

distribution pursuant to section 301(c). No part of the distribution by CFC1 to USP is attributable to the amount taxed to USP under § 1.1291-2(f) because no part of the distribution can be attributed to NQF's distribution to CFC2.

§ 1.1291-3 Dispositions.

(a) *Purpose and scope.* Any direct or indirect disposition of stock of a section 1291 fund within the meaning of paragraphs (b), (c), (d), and (e) of this section is taxable to the extent provided in section 1291, this section, and § 1.1291-6. For dispositions of stock of a section 1291 fund that qualify for nonrecognition treatment, see § 1.1291-6. Gain is determined on a share-by-share basis and is taxed as an excess distribution as provided in § 1.1291-2(e)(2). Unless otherwise provided under another provision of the Code, a loss realized on a disposition of stock of a section 1291 fund is not recognized.

(b) *Disposition—(1) In general.* For purposes of this section, a disposition is any transaction or event that constitutes an actual or deemed transfer of property for any purpose of the Code and the regulations thereunder, including (but not limited to) a sale, exchange, gift, or transfer at death, an exchange pursuant to a liquidation or section 302(a) redemption, or a distribution described in section 311, 336, 337, 355(c) or 361(c). For purposes of this paragraph (b), any person receiving a distribution that qualifies under section 355 will be treated as disposing of all of its stock in the distributing corporation (whether or not there is an actual disposition of such stock) in exchange for stock of the distributing corporation, the controlled corporation, or both, as the case may be.

(2) *Change of U.S. residence or citizenship.* If a shareholder of a section 1291 fund becomes a nonresident alien for U.S. tax purposes, the shareholder will be treated as having disposed of the shareholder's stock in the section 1291 fund for purposes of section 1291 on the last day that the shareholder is a U.S. person. Termination of an election under section 6013 (g) is treated as a change of residence (within the meaning of this paragraph (b)(2)) of the spouse who was a resident solely by reason of the section 6013 (g) election.

(c) *Direct disposition of stock of a section 1291 fund.* Except to the extent provided in § 1.1291-6, a direct shareholder of a section 1291 fund recognizes all gain that it realizes on a disposition of the stock of such fund.

(d) *Stock of a section 1291 fund used as security for an obligation—(1) In general.* Except to the extent provided in paragraph (d) (3) and (6) of this section, the use of stock of a section 1291 fund as

security for the performance of an obligation of a direct or indirect shareholder (or of a person related within the meaning of section 267(b) to that shareholder), in connection with a loan, guarantee, margin account, or otherwise (a pledge of stock), is a transaction that results in a disposition of the stock of the section 1291 fund within the meaning of paragraph (b) of this section. Such pledged stock will be treated as having been disposed of on the later of the date when such stock is first used as security with respect to such obligation or the first day of the first taxable year of the foreign corporation as a PFIC. Such pledged stock will be treated as having been disposed of for consideration equal to the lesser of—

(i) The unpaid principal of the obligation secured by the stock on the date of disposition; or

(ii) The fair market value of the stock immediately before such disposition.

(2) *Indirect pledge.* A pledge of stock of a section 1291 fund, as described in paragraph (d)(1) of this section, will be deemed to occur if such stock serves indirectly as security for the performance of an obligation described in that paragraph, and a principal purpose for the structure of the security arrangement was to avoid the rule of that paragraph.

(3) *Requirement of gain realized.* This paragraph (d) does not apply if the shareholders would realize a loss on an actual disposition of the stock of the section 1291 fund at the time the obligation was secured by the stock.

(4) *Increase in value of pledged stock.* An increase in the value of stock being used to secure the performance of an obligation will not be treated as a disposition of the stock unless the pledge stock is used to secure additional principal or new indebtedness.

(5) *Adjustment of basis; holding period.* If stock of a section 1291 fund is treated as disposed of under this paragraph (d), adjustments to basis will be made in accordance with rules similar to those in § 1.1291-6(b)(4). For the holding period of pledged stock, see § 1.1291-1(h)(5).

(6) *Transition rule.* Stock of a section 1291 fund that secured an obligation within the meaning of paragraph (d)(1) of this section as of the effective date of section 1297(b)(6) is not treated as disposed of as of the first day of the first taxable year of the foreign corporation as a PFIC, unless such stock continued to secure such obligation 180 days after the effective date. For a special effective date pertaining to this rule, see § 1.1291-1(j)(2).

(7) *Examples.* The following examples illustrate the operation of this paragraph (d).

Example 1. On November 20, 1995, X, a U.S. person that was a shareholder of FC, a section 1291 fund, used its stock in FC, valued immediately before the loan at \$120,000, as security for a \$100,000 loan. X's basis in the stock is \$70,000. The pledge is treated as a disposition of the stock for \$100,000, which is the lesser of the loan principal secured by the stock and the fair market value of the stock. S recognizes \$30,000 on the disposition, which gain is taxed as an excess distribution under section 1291 and § 1.1291-2(e)(2). X's basis in the FC stock is increased by \$30,000, the amount of gain recognized on the deemed disposition. The holding period of the pledge stock is not adjusted to reflect the disposition because the full amount of the gain inherent in the stock was not recognized (see § 1.1291-1(h)(5)).

Example 2. The facts are the same as in *Example 1*. In addition, On August 12, 1996, X borrows an additional \$30,000 (for a total outstanding loan balance on that day of \$130,000). The value of the FC stock immediately before the additional loan is \$130,000. Pursuant to § 1.1291-3(d)(4), there is a disposition within the meaning of § 1.1291-3(d)(1) to the extent the value of the FC stock exceeds additional indebtedness. The FC stock first secured a loan of \$100,000, which was less than its full value. The second loan results in a disposition to the extent that the previously unrecognized appreciation and any additional appreciation secure additional indebtedness. Accordingly, there is an excess distribution of \$30,000. X's basis in its FC stock is increased by \$30,000, the amount of gain recognized. X's holding period in the FC stock for section 1291 purposes is treated as beginning on the day after the effective date of the second borrowing (see § 1.1291-1(h)(5)).

(e) *Indirect dispositions*—(1) *In general.* Except as otherwise provided in this paragraph (e) and § 1.1291-6, an indirect shareholder of a section 1291 fund is taxable under section 1291 and this section on an indirect disposition of stock of the section 1291 fund.

(2) *Indirect disposition defined.* An indirect disposition is—

(i) Any disposition of stock of a section 1291 fund by its actual owner if such stock is attributed to an indirect shareholder in § 1.1291-1(b)(8);

(ii) Any disposition, by an indirect shareholder or any other person, of any interest in a person, if by virtue of such interest the indirect shareholder was treated as owning stock of a section 1291 fund under § 1.1291-1(b)(8); or

(iii) Any other transaction as a result of which an indirect shareholder's ownership of a section 1291 fund is reduced or terminated. Paragraph (e)(2)(i) of this section applies without regard to whether the indirect shareholder's ownership of a section 1291 fund is changed by the

disposition. However, paragraph (e)(2)(ii) of this section does not apply if the disposition does not result in a reduction in the indirect shareholder's ownership of the fund or an increase in the basis of the stock of the fund in the hands of the actual owner.

(3) *Examples.* The following examples illustrate paragraph (e)(2) of this section.

Example 1. T, a U.S. person, and M, a foreign person, are equal partners of FP, a foreign partnership that owns 10 shares of stock of FC, a PFIC. Pursuant to § 1.1291-1(b)(8)(iii), T is an indirect shareholder of one-half of the shares of FC stock held by FP. T did not elect under section 1295 to treat FC as a QEF. On August 14, 1994, H, a U.S. person, joins the partnership as an equal partner. As a result of H's acquisition of one-third of FP, H is an indirect shareholder of one-third of the FC stock held by FP. H's acquisition of the FP interest is a disposition pursuant to § 1.1291-3(e)(iii), taxable to T, of one-third of T's interest in the FC stock.

Example 2. E, a U.S. person, and R, a foreign person, each own 50% of the outstanding stock of Distributing, a foreign corporation that is not a PFIC or a controlled foreign corporation within the meaning of section 957(a). Distributing owns all the stock of Controlled, a PFIC. Pursuant to § 1.1291-1(b)(8)(ii)(A), E is an indirect shareholder of Controlled. E did not elect under section 1295 to treat Controlled as a QEF. In a transaction that qualifies under section 355(a), Distributing distributes all the Controlled stock to R. As a result of the distribution, E's interest in Controlled is terminated. The distribution is an indirect disposition of E's ownership of Controlled, within the meaning of § 1.1291-3(e)(2)(i), taxable to E under § 1.1291-3(e).

Example 3. C, a U.S. person, owns 51% of the stock of CFC, a foreign corporation that is not a PFIC. Several foreign persons own the remaining 49% of CFC. CFC owns 100 shares of FYZ, a PFIC. Pursuant to § 1.1291-1(b)(8)(ii)(A), C is an indirect shareholder of 51 shares of the FYZ stock held by CFC. C did not elect under section 1295 to treat FYZ as a QEF. To raise capital, CFC makes a public offering of its stock. After the offering, C owns only 35% of the CFC stock. The reduction of C's ownership of CFC terminated C's indirect ownership of the FYZ stock, pursuant to § 1.1291-3(e)(2)(iii), taxable to C under § 1.1291-3(e).

(4) *General rules*—(i) *Amount and treatment of gain.* If a shareholder with respect to a share of stock of a section 1291 fund is taxable on an indirect disposition of that share, the shareholder is treated as recognizing an amount of gain with respect to that share equal to the shareholder's pro rata share of the gain realized by the actual owner of that share (in the case of a disposition described in paragraph (e)(2)(i) of this section), or the gain the actual owner would have realized on an actual disposition of such stock (in the case of other dispositions). The gain taxable to the shareholder is an excess

distribution, taxable in the manner provided in § 1.1291-2(e)(2). The gain is allocated over the shareholder's holding period of the stock of the section 1291 fund as determined in § 1.1291-1(h)(4).

(ii) *Coordination with current inclusion rules.* If gain from an indirect disposition would be taxable to a shareholder under this section, and would, but for this paragraph (e)(4)(ii), also be included in the gross income of the shareholder under section 551(a), 951(a)(1), or 1293(a), the indirect disposition is taxable only under this section.

(iii) *Adjustment to basis; holding period.* The shareholder's adjusted basis of the stock or other property that is owned directly by the shareholder and through which ownership of the section 1291 fund is attributed to the shareholder is increased by the amount of gain recognized by the shareholder pursuant to paragraph (e) (4) (i) of this section. In addition, solely for purposes of determining the subsequent treatment under the Code of a direct or indirect shareholder of the stock of the section 1291 fund treated as transferred in an indirect disposition, the adjusted basis of the actual owner of the stock of the section 1291 fund is increased by the amount of gain recognized by the shareholder. For the holding period rule for stock that is treated as disposed of under paragraph (e) (2) of this section, see § 1.1291-1 (h)(5).

(iv) *Treatment of previously taxed amounts.* The principles of sections 959 and 961 apply with respect to distributions by a foreign corporation through which a shareholder was considered to own stock of a section 1291 fund, to the extent that such distributions are attributable to amounts previously taxed under this paragraph (e) on a disposition of the stock of such fund.

(5) *Pass-through entities*—(i) *Section 1291 fund stock held by former C corporation.* Solely for purposes of calculating the aggregate amount of interest under § 1.1291-4 (d) (1), the S corporation shareholder's gain is determined without regard to section 1366 (f) (2). Accordingly, the excess distribution for this purpose includes the amount of the S corporation's liability for tax attributable to the built-in gain in the stock of the section 1291 fund pursuant to section 1374. For an illustration of the rule of this paragraph (e) (5) (i), see § 1.1291-4 (e), *Example 2*. For the taxation of the S corporation on the disposition of the stock of a section 1291 fund, see section 1374.

(ii) *Taxation of trusts, estates, and their beneficiaries.* [Reserved]

(iii) *Information reporting.* The information reporting obligations to which pass-through entities are subject with respect to indirect distributions also apply with respect to indirect dispositions. See § 1.1291-2 (f) (2) (ii).

(6) *Exceptions—(i) Disposition of PFIC's wholly-owned PFIC.* A direct shareholder of a section 1291 fund (first-tier fund) will not be taxable on an indirect disposition of a section 1291 fund (second-tier fund) that is a wholly owned subsidiary of the first-tier fund if the second-tier fund annually distributed all its earnings and profits for each year that is included in the shareholder's holding period of the second-tier fund.

(ii) *Other exceptions.* [Reserved]

(f) *Transfers within a consolidated group.* For purposes of applying sections 1291 through 1297 to the stock of a PFIC, transfers by one member of a consolidated group to another member are ignored. Thus, the basis of the transferred stock in the hands of the transferee is the adjusted basis of such stock in the hands of the transferor, and the holding period of such stock held by a member of the consolidated group includes the holding period of all members of the group that have transferred the stock.

(g) *Installment sales.* If the gain from a disposition of a share of stock of a section 1291 fund is reported on the installment basis, there is an excess distribution on the receipt of each installment or portion thereof in the amount of the gain to be reported in accordance with section 453 with respect to such share. For purposes of allocating each excess distribution under § 1.1291-2 (e) (2) (i), the holding period of the transferred stock, which begins on the date determined under § 1.1291-1 (h), is treated as ending on the date of each installment.

(h) *Series of liquidation distributions.* For purposes of allocating the gain recognized on a distribution of property that is one of a series of distributions in liquidation of a section 1291 fund, the holding period of the stock of the liquidating corporation, which begins on the date determined under § 1.1291-1 (h), is treated as ending on the date of each liquidation distribution with respect to which gain is recognized.

(i) *Sections 1246 and 1248 inapplicable.* Sections 1246 and 1248 do not apply to the disposition of stock of a section 1291 fund that is taxable under section 1291. See sections 1246 (g) and 1248 (g) (2).

(j) *Estate tax deduction.* If a shareholder acquired the stock of a section 1291 fund from a decedent (other than a decedent who was a nonresident

alien at all times during the holding period of the stock), and the decedent did not recognize any gain on the transfer of his or her stock at death pursuant to § 1.1291-6 (c) (2) (iii) (A), the shareholder may deduct from gross income, for the taxable year of the disposition of the stock of the section 1291 fund that is taxable to the shareholder, an amount equal to that portion of the decedent's estate tax deemed paid which is attributable to the excess of (A) the value at which such stock was taken into account for purposes of determining the value of the decedent's gross estate, over (B) the value at which it would have been so taken into account if such value had been the basis of the stock in the hands of the shareholder determined under § 1.1291-6 (b) (4) (iii).

§ 1.1291-4 The deferred tax amount.

(a) *In general.* The deferred tax amount is the sum of the aggregate increases in taxes (defined in paragraph (c)(5) of this section and the aggregate amount of interest (defined in paragraph (d) of this section) determined with respect to the aggregate increases in taxes. The deferred tax amount is computed for the portions of each excess distribution allocated to different prior PFIC years, as defined in § 1.1291-1(b)(4).

(b) *Character of deferred tax amount.* The aggregate increases in taxes are an additional amount of tax imposed on the shareholder for the current shareholder year. The aggregate increases in taxes are treated as an income tax for purposes of subtitle F (Procedure and Administration), and therefore will be assessed, collected, paid, and subject to penalties and interest in the same manner as other taxes on income. The aggregate amount of interest is treated as interest under section 6601. To determine the extent to which such interest may be deducted for federal income tax purposes, see section 163 and the regulations under that section.

(c) *Increase in tax—(1) In general.* An increase in tax is determined for each portion of an excess distribution allocated to a prior PFIC year. Each increase in tax is determined by multiplying the amount of the excess distribution allocated to the prior PFIC year by the highest statutory rate of tax in effect under either section 1 or section 11, as applicable, for that prior PFIC year.

(2) *Rate of tax in effect.* The highest statutory rate of tax is determined without regard to the actual rate of tax to which the shareholder was subject in that prior PFIC year. The rate of tax in effect in the case of a distribution or

disposition taxable to an indirect shareholder is the rate in effect for the indirect shareholder. For taxable years of the shareholder beginning after 1987 and before January 1, 1991, the highest statutory rate of tax in effect under section 1 is 28 percent. If there was a change of tax rates during a taxable year, the highest rate of tax is determined in the manner described in section 15(e) using the highest statutory rates of tax in effect before and after the change of rates.

(3) *Reduction for foreign taxes.* To the extent provided in section 1291(g) and § 1.1291-5, each increase in tax is reduced by the foreign tax credit calculated with respect to the increase in tax.

(4) *Net increase in tax.* The net increase in tax is the amount of the increase in tax after reduction for creditable foreign taxes. See paragraph (d) of this section.

(5) *Aggregate increases in taxes.* The term aggregate increases in taxes means the sum of all net increases in tax calculated for an excess distribution.

(d) *Aggregate amount of interest—(1) In general.* The aggregate amount of interest is the sum of the interest charges computed on all net increases in tax calculated for an excess distribution. An interest charge is computed separately for the interest period of each net increase in tax by using the applicable rates and method under section 6621. The interest period for a net increase in tax is the period beginning on the due date of the income tax return for the prior PFIC year for which the net increase in tax was computed and ending on the due date for the income tax return for the current shareholder year. For purposes of this paragraph, the term due date means the date prescribed by law, determined without regard to extensions, for filing the income tax return for the taxable year of the shareholder.

(2) *Reduction for interest paid under section 453A(c).* A disposition may be subject to both sections 1291 and 453A(c). The aggregate amount of interest determined in paragraph (d)(1) of this section is reduced by the amount of interest paid under section 453(c) that is attributable to an excess distribution arising from the disposition. The shareholder may use any reasonable method of determining the amount of the reduction.

(e) *Examples.* The following examples illustrate the rules of this section.

Example 1. (i) Facts. X is a domestic corporation that is a calendar year taxpayer. The due date (without regard to extensions) for its federal income tax return is March 15.

X acquired a share of stock of FC, a corporation, on December 31, 1986, for \$500. FC has been a section 1291 fund with respect to X since FC's taxable year that began January 1, 1987. On December 31, 1990, X sold the FC stock for \$1000. X did not incur any foreign tax on the disposition of the FC stock. X's gain on the sale, \$500, is taxed as an excess distribution. The excess distribution is allocated pro rata over X's four-year holding period. Accordingly, \$125 is allocated to each year in X's holding period. The \$125 allocated to 1990, the current shareholder year, is included in X's ordinary income for that year. The allocations to 1987, 1988 and 1989, the prior PFIC years, are subject to the deferred tax amount under § 1.1291-4.

(ii) *Calculation of the 1987 increase in tax.* The increase in tax for the \$125 allocated to 1987 is determined in the manner described in section 15(e) by using a weighted average rate. The weighted average rate is 40 percent;

| | | Percent |
|---------------|-------------------------|---------|
| 46% rate..... | $181/365 \times 46\% =$ | 22.81 |
| 34% rate..... | $184/365 \times 34\% =$ | 17.14 |
| | | 39.95 |

The increase in tax for 1987 is \$49.94 (\$125 × 39.95%).

(iii) *Calculation of the other increases in tax.* The highest statutory rate of tax applicable to X that was in effect for both 1988 and 1989 was 34 percent. The increase in tax for each of 1988 and 1989 is \$42.50 (\$125 × 34%).

(iv) *Aggregate increases in taxes.* The aggregate increases in taxes are \$134.94 (\$49.94 + \$42.50 + \$42.50).

(v) *Interest charge.* Interest on each of the three increases in tax (\$49.94, \$42.50, and \$42.50) is computed using the rates and method provided in section 6621 for the respective interest period. The following are the interest periods:

| Year of allocation | Increase in tax | Interest period | |
|--------------------|-----------------|---------------------|-----------------|
| | | Beginning on | Ending on |
| 1987..... | \$49.94 | March 15, 1988..... | March 15, 1991. |
| 1988..... | 42.50 | March 15, 1989..... | March 15, 1991. |
| 1989..... | 42.50 | March 15, 1990..... | March 15, 1991. |

Example 2. (i) *Facts.* The facts are the same as in Example 1 except that X was a C corporation until it elected to be treated as an S corporation effective for its taxable year beginning January 1, 1988. A is a U.S. person who has been a shareholder of X since January 1, 1988. A's holding period of the FC stock began on January 1, 1988, pursuant to § 1.1291-1(h)(4)(i). As of January 1, 1988, the FC stock had appreciated in value to \$800; X therefore had \$300 of built-in gain within the meaning of section 1374. Assume X pays a built-in gain tax of \$102 because of the sale of the FC stock in 1990.

(ii) *Calculation of the aggregate increases in taxes owed by A.* The \$500 gain recognized, reduced as provided in section 1366(f)(2) by the amount of built-in gain tax of \$102 paid by X pursuant to section 1374 to \$398, is taxable to A as an excess distribution as provided in § 1.1291-2(e)(2). The \$398 excess distribution is allocated pro rata over X's four-year holding period (not A's three-year holding period) as provided in § 1.1291-3(e)(5). The allocation of \$99.50 to 1990, the

current shareholder year, is included in A's ordinary income. The allocations of \$99.50 to 1987, 1988, and 1989 are not included in income, but are subject to the deferred tax amount. The aggregate increases in taxes are determined based on those \$99.50 allocations.

(A) *Calculation of the 1987 increase in tax.* The highest statutory rate of tax applicable to A that was in effect in 1987 was 38.5 percent. The increase in tax for the portion of the excess distribution allocated to 1987 is \$38.31 (\$99.50 × 38.5%).

(B) *Calculation of the other increases in tax.* The highest statutory rate of tax applicable to A that was in effect for both 1988 and 1989 is 28 percent. The increase in tax for each of 1988 and 1989 is \$27.86 (\$99.50 × 28%).

(C) *Calculation of the aggregate increases in taxes.* The aggregate increases in taxes are \$94.03 (\$38.31 + \$27.86 + \$27.86).

(iii) *Calculation of the aggregate amount of interest.* For purposes of calculating the aggregate amount of interest, the reduction provided under section 1366 (f)(2) is

disregarded and the excess distribution is \$500. Accordingly, for purposes of calculating the aggregate amount of interest, \$125 is allocated to 1987, 1988, and 1989.

(A) *Calculation of the 1987 hypothetical increase in tax.* The highest statutory rate of tax applicable to A that was in effect in 1987 was 38.5 percent. The hypothetical increase in tax for the portion of the excess distribution allocated to 1987 is \$48.12 (\$125 × 38.5%).

(B) *Calculation of the other hypothetical increases in tax.* The highest statutory rate of tax applicable to A that was in effect for both 1988 and 1989 is 28 percent. The hypothetical increase in tax for each of 1988 and 1989 is \$35.00 (\$125 × 28%).

(C) *Interest charge.* Interest on each of the three hypothetical increases in tax (\$48.12, \$35, and \$35) is computed using the rates and method provided in section 6621 for the respective interest period. The following are the interest periods:

| Year of allocation | Increase in tax | Interest period | |
|--------------------|-----------------|---------------------|-----------------|
| | | Beginning on | Ending on |
| 1987..... | \$48.12 | April 15, 1988..... | April 15, 1991. |
| 1988..... | 35.00 | April 15, 1989..... | April 15, 1991. |
| 1989..... | 35.00 | April 15, 1990..... | April 15, 1991. |

(iv) *The deferred tax amount.* The deferred tax amount is the sum of the aggregate increases in taxes determined in (ii) and the aggregate amount of interest determined in (iii).

§ 1.1291-5 Coordination with the foreign tax credit rules.

(a) *Scope.* This section provides rules for determining the amount of foreign tax credit that a shareholder may claim on a distribution from a section 1291

fund, and in certain cases, on a disposition of stock of a section 1291 fund. This section applies to a shareholder that has chosen under section 901 for the current shareholder year to claim a credit for foreign taxes paid. The rules of this section apply separately with respect to each section 1291 fund in which the shareholder directly or indirectly owns stock. For purposes of this section, an S

corporation is treated as a partnership, and its shareholders as partners of the partnership. See section 1373.

(b) *Distributions from section 1291 funds to shareholders that are not entitled to a foreign tax credit for foreign taxes deemed paid—(1) Rule.* If a section 1291 fund makes a distribution with respect to which a shareholder (other than a shareholder described in paragraph (c) of this section) is subject

to tax under § 1.1291-2, and the shareholder would be entitled to a foreign tax credit for foreign taxes paid (including withholding taxes) with respect to such distribution, but not for foreign taxes deemed paid with respect to such distribution (determined in both cases without regard to section 1291 and this section), the foreign tax credit with respect to that distribution is determined under the steps provided in this paragraph (b). The excess distribution is treated as foreign source income described in section 904(d)(1)(A).

(i) *Step 1.* The shareholder determines the total excess distribution under § 1.1291-2(c)(3), and the excess distribution taxes. The excess distribution taxes are the creditable foreign taxes (within the meaning of section 1291(g)(2)(A)), paid or accrued with respect to the total distribution for the current shareholder year, allocated to the total excess distribution as follows:

$$\frac{\text{Foreign taxes paid with respect to the total distribution}}{\text{Total excess distribution}} \times \text{Total distribution}$$

The remainder of the creditable foreign taxes are allocated to the nonexcess distribution.

(ii) *Step 2.* The shareholder allocates the total excess distribution and the excess distribution taxes ratably to each distribution received during the shareholder's taxable year in the manner provided in § 1.1291-2(c)(4). The shareholder then allocates each excess distribution and the excess distribution taxes allocated to that distribution to each taxable year included in the shareholder's holding period based on the number of days in each such taxable year.

(iii) *Step 3.* The shareholder determines the tentative increase in tax for each prior PFIC year. The term tentative increase in tax means the increase in tax determined in the manner provided in § 1.1291-4(c) for each prior PFIC year. The tentative increase in tax for a prior PFIC year is the foreign tax credit limitation for the excess distribution taxes allocated to the prior PFIC year.

(iv) *Step 4.* The shareholder claims as a foreign tax credit with respect to an increase in tax for a prior PFIC year the lesser of the tentative increase in tax for that year determined in *Step 3* or the excess distribution taxes allocated to that prior PFIC year in *Step 2*.

(v) *Step 5.* The shareholder determines the net increase in tax for each prior PFIC year by reducing the tentative

increase in tax for a prior PFIC year determined in *Step 3* by the foreign tax credit determined for that year in *Step 4*. For the calculation of the interest charge for each net increase in tax, see § 1.1291-4(d).

(vi) *Step 6.* The portions of the excess distribution and excess distribution taxes allocated to the current shareholder year and pre-PFIC years, if any, as well as the creditable foreign taxes allocated to the nonexcess distribution, are taken into account in the current shareholder year under the general foreign tax credit rules.

(2) *Carryovers disallowed.* The amount by which the excess distribution taxes allocated to a prior PFIC year exceed the tentative increase in tax for that year may not be claimed as a foreign tax credit against any federal income tax.

(c) *Distributions from section 1291 funds that are CFCs—(1) Rule.* If a controlled foreign corporation (CFC) (as defined in section 904(d)(4)) that is a section 1291 fund makes a distribution with respect to which a United States shareholder (also as defined in section 904(d)(4)) is subject to tax under § 1.1291-2, the foreign tax credit with respect to that excess distribution is determined by applying the rules of section 1291(g) on a separate category basis within the meaning of section 904. See section 904(d)(3)(A) and the regulations under that section. A distribution described in this paragraph (c) from a section 1291 fund is foreign source income except to the extent the distribution is determined to be derived from U.S. sources pursuant to section 904(g). The foreign tax credit of a United States shareholder with respect to a distribution by a CFC that is taxable as an excess distribution to the shareholder under § 1.1291-2(e)(2) is determined according to the following steps.

(i) *Step 1.* The shareholder determines—

(A) The separate category or categories (as defined in § 1.904-5(a)(1)) to which the total distribution (including the amount of the gross-up determined under section 78) for the taxable year is allocable under the rules of section 904(d)(3) and the regulations under that section (see § 1.904-5(c)(4));

(B) The creditable foreign taxes, which are the foreign taxes paid or deemed paid on the distribution (determined without regard to section 1291 and this section) with respect to each separate category under the rules of sections 901, 902, 904, and 960 and the regulations under those sections (see § 1.904-6(b)(3)); and

(C) The portion of the total distribution (including the gross-up) in

each separate category that is from U.S. sources pursuant to section 904(g) (see § 1.904-5(m) (4) and (6)).

Solely for purposes of section 1291, any portion of the total excess distribution that would not be allocated to a separate category under normally applicable rules because it exceeds the fund's earnings and profits is deemed to be foreign source income allocated to the separate category defined in section 904(d)(1)(A).

(ii) *Step 2.* The shareholder determines—

(A) The total excess distribution under § 1.1291-2(c)(3) with respect to the total distribution (including the gross-up); and

(B) The portion of the total excess distribution allocable to each separate category (the separate category excess distribution).

Each separate category excess distribution is calculated as follows:

$$\frac{\text{Distribution allocable to a separate category (including gross-up) (Step 1 (A))}}{\text{Total distribution (including gross-up)}} \times \text{Total excess distribution (Step 2 (A))}$$

(iii) *Step 3.* The shareholder determines the U.S. source portion of each separate category excess distribution as follows:

$$\frac{\text{U.S. source portion of distribution allocable to a separate category (Step 1 (C))}}{\text{Total distribution allocable to that category (Step 1 (A))}} \times \text{Separate category excess distribution (Step 2 (B)) to}$$

(iv) *Step 4.* The shareholder determines the excess distribution taxes with respect to each separate category (separate category excess distribution taxes) as follows:

$$\frac{\text{Creditable foreign taxes with respect to the distribution and allocable to the separate category (Step 1 (B))}}{\text{Total distribution allocable to that category (Step 1 (A))}} \times \text{Separate category excess distribution (Step 2 (B))}$$

(v) *Step 5.* (A) The shareholder allocates—

(1) The separate category excess distribution;

(2) The separate category excess distribution taxes; and

(3) The U.S. source portion of the separate category excess distribution ratably to each distribution received during the shareholder's taxable year in the manner provided in § 1.1291-2(c)(4).

(B) The shareholder then allocates—

(1) The amount determined in Step 5 (A)(1) for each distribution to each taxable year included in the shareholder's holding period based on the number of days in each such taxable year;

(2) The amount determined in Step 5 (A)(2) for each distribution to each taxable year included in the shareholder's holding period based on the number of days in each such taxable year; and

(3) The amount determined in Step 5 (A)(3) for each distribution to each taxable year included in the shareholder's holding period based on the number of days in each such taxable year.

Solely for purposes of determining the foreign tax credit limitation for the current shareholder year, the portion of an excess distribution that is allocated to the current shareholder year and prePFIC years, and included in income, is treated as a dividend from a CFC that is not a PFIC. The excess distribution taxes allocated to that portion of the excess distribution are treated as foreign taxes paid with respect to a dividend from a CFC that is not a PFIC and taken into account in the current shareholder year under general foreign tax credit rules.

(vi) *Step 6.* The shareholder determines a tentative increase in tax for each prior PFIC year for each allocation of a separate category excess distribution determined under Step 5 (B)(1) (separate category tentative increase in tax).

(vii) *Step 7.* The shareholder determines a foreign tax credit limitation for each prior PFIC year to which the separate category excess distribution is allocated. The limitation is determined as follows:

| Separate category tentative increase in tax for prior PFIC year (Step 6) | × | Foreign source separate category excess distribution allocated to that prior PFIC year (Step 5 (B)(1) — Step 5 (B)(3)) |
|---|---|--|
| Separate category excess distribution allocated to that prior PFIC year (Step 5 (B)(1)) | | |

(viii) *Step 8.* The shareholder may claim a foreign tax credit for each separate category tentative increase in tax. The foreign tax credit for a prior PFIC year is the lesser of the foreign tax credit limitation determined in Step 7 for the prior PFIC year or the amount of the separate category excess distribution taxes allocated to that prior PFIC year under Step 5(B)(2).

(ix) *Step 9.* The shareholder determines the separate category net increase in tax for each prior PFIC year by reducing the separate category tentative increase in tax determined for that year in Step 6 by the amount of the foreign tax credit determined for that year in Step 8. For the calculation of the interest charge on each net increase in tax, see § 1.1291-4(d).

Carryovers disallowed. The amount by which the excess distribution taxes allocated to a prior PFIC year exceed the separate category tentative increase in tax for that year may not be claimed as a foreign tax credit against any federal income tax.

(3) *Example.* The following example illustrates the rules of paragraph (c) of this section.

Example. (i) *Facts.* USP, a domestic corporation, has been a United States shareholder of FC, a CFC that is a section 1291 fund, since December 31, 1986. USP and FC both use the calendar year as their taxable year. USP has not included any amount in income under section 951 with respect to FC. On March 31, 1989, FC distributed \$1000 to USP. As of that date, USP had held the FC stock for 821 days (365 days in 1987, 366 days in 1988, and 90 days in 1989). USP elects to credit foreign taxes for 1989, and determines the total creditable taxes with respect to the distribution from FC to be \$485, \$425 of which are deemed paid taxes and \$60 of which are withholding taxes. The total distribution for 1989, including the section 78 gross-up, is \$1425.

(ii) *Step 1: Determination of separate category income, U.S. source portions, and foreign taxes.* Applying the look through rules of section 904(d)(3), USP determines that \$1125 of the total distribution of \$1425 is allocable to distributions from a noncontrolled section 902 corporation, and that the remaining \$300 is allocable to general limitation income. USP determines that \$390 of creditable foreign taxes were paid and deemed paid with respect to the distributions from the noncontrolled section 902 corporation, and \$95 were paid and deemed paid with respect to the general limitation income. USP determines that the distributions from the noncontrolled section 902 corporation and the general limitation income are from foreign sources. Accordingly, Steps 3 and 5(i)(C) will not be performed.

(iii) *Step 2: Calculation of total excess distribution and separate category excess distributions.* USP determines, based on FC distributions during the preceding three taxable years, that the total excess

distribution for the current taxable year is \$800. Of that amount, \$631.58

{[\$1125 (distribution allocable to distributions from a noncontrolled section 902 corporation) / \$1425 (total distribution)] × \$800 (total excess distribution)} is allocable to distributions from a noncontrolled section 902 corporation, and \$168.42 {[\$300 (distribution allocable to general limitation income) / \$1425 (total distribution)] × \$800 (total excess distribution)} is allocable to general limitation income.

(iv) *Step 4: Calculation of separate category excess distribution taxes.* USP calculates the excess distribution taxes (EDT) allocable to the separate category excess distributions. The noncontrolled section 902 corporation excess distribution taxes are \$218.95 {[\$390 (creditable foreign taxes paid and deemed paid with respect to distributions from a noncontrolled section 902 corporation) × [\$631.58 (noncontrolled section 902 corporation excess distribution) / \$1125 (distribution from noncontrolled section 902 corporation)]}, and the general limitation excess distribution taxes are \$53.33 {[\$95 (creditable foreign taxes paid and deemed paid with respect to general limitation income) × [\$168.42 (general limitation income excess distribution) / \$300 (distribution allocable to general limitation income)]}.

(v) *Step 5: Allocations of separate category excess distributions and excess distribution taxes over holding period.* The separate category excess distributions and the separate category EDT are allocated to each taxable year in USP's holding period based on the number of days in each such taxable year. (Discrepancies may be observed in the following presentation. These discrepancies reflect rounding to the nearest penny of the different calculations performed.)

(A) *Noncontrolled section 902 corporation excess distribution:* \$.77 of the noncontrolled section 902 corporation excess distribution (\$631.58 / 821 days) and \$.27 of EDT (\$218.95 / 821 days) are allocated to each day. The allocations to each taxable year are as follows:

| Taxable year in holding period | Allocations to taxable year | |
|--------------------------------|-----------------------------|---------|
| | Excess distribution | EDT |
| 1987 (365 days)..... | \$281.05 | \$98.55 |
| 1988 (366 days)..... | 281.82 | 98.82 |
| 1989 (90 days)..... | 69.30 | 24.30 |

(B) *General limitation excess distribution:* \$.21 of the general limitation excess distribution (\$168.42 / 821 days) and \$.065 of EDT (\$53.33 / 821 days) are allocated to each day. The allocations to each taxable year are as follows:

| Taxable year in holding period | Allocations to taxable year | |
|--------------------------------|-----------------------------|---------|
| | Excess distribution | EDT |
| 1987 (365 days)..... | \$76.65 | \$23.73 |
| 1988 (366 days)..... | 76.86 | 23.79 |
| 1989 (90 days)..... | 18.90 | 5.85 |

(vi) *Step 6: Calculation of separate category tentative increases in taxes.* USP determines the tentative increases in tax (TIIT) for the allocations of each separate category excess distribution to 1987 and 1988, the prior PFIC years in USP's holding period. The noncontrolled section 902 corporation excess distribution TIIT for 1987 is \$112.28 [\$281.05 (allocation of noncontrolled section 902 corporation excess distribution to 1987) x 39.95% (the highest corporate tax rate in effect in 1987)], and for 1988, \$95.82 [\$281.82 (allocation of noncontrolled section 902 corporation excess distribution to 1988) x 34% (highest corporate tax rate in effect in 1988)]. The general limitation excess distribution TIIT for 1987 is \$30.62 [\$76.65 (allocation of general limitation income excess distribution to 1987) x 39.95% (highest corporate tax rate in effect in 1987)], and for 1988, \$26.13 [\$76.86 (allocation of general limitation income excess distribution to 1988) x 34% (highest corporate tax rate in effect in 1988)].

(vii) *Step 7: Calculation of the foreign tax credit limitations.* USP determines the foreign tax credit (FTC) limitations for each prior PFIC year on a separate category basis. The FTC limitations are the same as the tentative

increases in tax because none of the separate category distributions are from U.S. sources. Therefore, the FTC limitation for the noncontrolled section 902 corporation excess distribution for 1987 is \$112.28, and for 1988, \$95.82. The FTC limitation for the general limitation excess distribution for 1987 is \$30.62, and for 1988, \$26.13.

(viii) *Step 8: Calculation of the foreign tax credit.* The FTC for the noncontrolled section 902 corporation excess distribution for 1987 is \$98.55 [lower of \$112.28 (1987 noncontrolled section 902 corporation FTC limitation) and \$98.55 (1987 noncontrolled section 902 corporation EDT)], and for 1988, \$95.82 [lower of \$95.82 (1988 noncontrolled section 902 corporation FTC limitation) and \$98.82 (1988 noncontrolled section 902 corporation EDT)]. The FTC for the general limitation excess distribution for 1987 is \$23.73 [lower of \$30.62 (1987 general limitation income EDT)], and for 1988 is \$23.79 [lower of \$26.13 (1988 general limitation income FTC limitation) and \$23.79 (1988 general limitation EDT)].

(ix) *Step 9: Calculation of the separate category net increases in taxes.* As provided in § 1.1291-4(c)(3), USP determines the net increase in tax (NIIT) for each separate

category excess distribution allocated to a prior PFIC year. The noncontrolled section 902 corporation NIIT for 1987 is \$13.73 [\$112.28 (1987 noncontrolled section 902 corporation TIIT) less \$98.55 (1987 noncontrolled section 902 corporation FTC)], and the noncontrolled section 902 corporation NIIT for 1988 is 0 [\$95.82 (1988 noncontrolled section 902 corporation TIIT) less \$95.82 (1988 noncontrolled section 902 corporation FTC)]. The general limitation income NIIT for 1987 is \$6.89 [\$30.62 (1987 general limitation income TIIT) less \$23.73 (1987 general limitation income FTC)], and the general limitation NIIT for 1988 is \$2.34 [\$26.13 (1988 general limitation income TIIT) less \$23.79 (1988 general limitation income FTC)]. An interest charge is calculated for each NIIT as provided in § 1.1291-4(d). The \$3 excess of noncontrolled section 902 EDT allocated to 1988 (\$98.82) over the FTC limitation calculated for the 1988 allocation of the noncontrolled section 902 excess distribution (\$95.82) may not be used to reduce any federal income tax. The calculations of Steps 5 through 9 are summarized as follows:

(A) *Noncontrolled section 902 corporation excess distribution—*

| Taxable year (days) in holding period | Allocations to taxable year—Step 5 | | Step 6 TIIT | Step 8 FTC | Step 9 NIIT |
|---------------------------------------|------------------------------------|---------|-------------|------------|-------------|
| | Excess distribution | EDT | | | |
| 1987 (365) | \$281.05 | \$98.55 | \$112.28 | \$98.55 | \$13.73 |
| 1988 (366) | 281.82 | 98.82 | 95.82 | 95.82 | 0 |
| 1989 (90) | 69.30 | 24.30 | | | |

(B) *General limitation income excess distribution—*

| Taxable year (days) in holding period | Allocations to taxable year—Step 5 | | Step 6 TIIT | Step 8 FTC | Step 9 NIIT |
|---------------------------------------|------------------------------------|---------|-------------|------------|-------------|
| | Excess distribution | EDT | | | |
| 1987 (365) | \$76.65 | \$23.73 | \$30.62 | \$23.73 | \$6.89 |
| 1988 (366) | 76.86 | 23.79 | 26.13 | 23.79 | 2.34 |
| 1989 (90) | 69.30 | 24.30 | | | |

(x) *Current shareholder year foreign tax credit.* The allocations of the separate category excess distributions to 1989, the current shareholder year, are included in USP's ordinary income. Such income is treated as a dividend from a CFC that is not a PFIC, and the EDT allocated to that income are treated as foreign taxes paid with respect to a dividend from a CFC that is not a PFIC.

(d) *Distribution from section 1291 funds that are noncontrolled section 902 corporations.* If a noncontrolled section 902 corporation (as defined in section 904(d)(2)(E) and the regulations under that section) that is a section 1291 fund makes a distribution with respect to which a domestic shareholder (as defined in section 902 and the regulations under that section) is subject

to tax under § 1.1291-2, the rules of paragraph (c) of this section apply for purposes of determining the amount of the foreign tax credit with respect to that distribution; however, the only separate category is described in section 904(d)(1)(E). This paragraph (d) does not apply to United States shareholder of a CFC to whom paragraph (c) of this section applies.

(e) *Section 1248 gain.* For purposes of determining the foreign tax credit under this section, a shareholder treats gain from a disposition of stock of a section 1291 fund as a distribution only to the extent that the gain would be, but for section 1291, includible in gross income as a dividend under section 1248.

§ 1.1291-6 Nonrecognition transfers of stock of section 1291 funds.

(a) *In general—(1) Scope.* This section provides rules concerning the recognition of gain by a shareholder on a direct or indirect disposition of stock of a section 1291 fund that results from a transaction in which, but for section 1291 and these regulations, there would not be full recognition of gain under the Code and regulations (the transaction hereinafter referred to as a nonrecognition transfer). This section also provides coordination between section 1291 and other provisions of the Code and regulations under which gain must be recognized in transactions that would otherwise be entitled to nonrecognition.

(2) *Nonrecognition transfers.* A nonrecognition transfer includes, but is not limited to, a gift, a transfer by reason of death, a distribution to a beneficiary by a trust or estate (other than a distribution to which section 643(e)(3) applies), and a transfer in which gain or loss is not fully recognized pursuant to any of the following provisions: Sections 311(a), 332, 336(e), 337, 351, 354, 355, 361, 721, 731, 852(b)(6), 1036, and 1041.

(3) *Application of section to transfer of stock of a pedigreed QEF.* This section does not apply to a nonrecognition transfer of stock of a pedigreed QEF. The following example illustrates the rule of this paragraph (a)(3).

Example. X is a U.S. person that is a shareholder of FC, a corporation. FC owns all the stock of FS. Both FC and FS are pedigreed QEFs with respect to X. Pursuant to a plan of complete liquidation, satisfying the requirements of section 332, FS distributes all its assets and liabilities to FC. No gain or loss will be recognized to FC, FS, or X under section 1291(f) or 1297(b)(5).

(b) *Recognition of gain or loss—(1) In general.* Unless otherwise provided in paragraph (c) of this section, a shareholder recognizes gain on any direct or indirect disposition of stock of a section 1291 fund in accordance with the rules of § 1.1291-3, without regard to whether the disposition is a result of a nonrecognition transfer as defined in paragraph (a)(2) of this section.

(2) *Coordination with other recognition provisions.* A direct or indirect disposition of stock which an exception to the gain recognition rule of paragraph (b)(1) of this section applies will nevertheless be a disposition taxable under § 1.1291-3 if the gain must be recognized pursuant to another provision of the Code or regulations. For coordination with section 367, see paragraph (d)(1) of this section.

(3) *No recognition of loss.* This section does not permit or require the recognition of loss on a direct or indirect disposition of stock of a section 1291 fund if such loss would not otherwise be recognized under another section of the Code or regulations. For the effect on the holding period of a disposition resulting from a nonrecognition transfer that would be subject to the gain recognition rule but for the fact that a loss is realized, see paragraph (b)(5) of this section.

(4) *Special basis rules—(i) Direct shareholders.* If the gain recognition rule of paragraph (b)(1) of this section applies to a nonrecognition transfer in which a direct shareholder transfers stock of a section 1291 fund, proper adjustment is made to the basis of such

stock in the hands of the transferee, as well as to the basis of the property, if any, received by the shareholder in the transaction.

(ii) *Indirect shareholders.* If the gain recognition rule of paragraph (b)(1) of this section applies to a disposition by an indirect shareholder that results from a nonrecognition transfer, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder through which ownership of the section 1291 fund is attributed to the shareholder is increased by the amount of gain recognized by the shareholder. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a direct or indirect shareholder of the stock of the section 1291 fund treated as disposed of, the adjusted basis of the actual owner of the stock of the section 1291 fund is increased by the amount of gain recognized by the shareholder.

(iii) *Stock acquired by reason of death.* Unless all of the gain is recognized to a shareholder (the decedent) pursuant to paragraph (c)(2)(iii)(B) of this section, the basis of stock received on the death of the decedent by the decedent's estate (other than a foreign estate within the meaning of section 7701(a)(3)), or directly by another U.S. person, is the lower of the fair market value or adjusted basis of the transferred stock in the hands of the shareholder immediately before death. If gain is recognized by the decedent, the decedent's adjusted basis of the stock of the section 1291 fund is increased by the gain recognized with respect thereto.

(iv) *Assets distributed in certain subsidiary liquidations.* The bases of the assets of a section 1291 fund distributed to an 80 percent corporate distributee (within the meaning of section 337(c)), in complete liquidation of the section 1291 fund pursuant to section 332, is increased by the amount by which the gain recognized by the shareholder exceeds the amount that would have been taxed as a dividend under section 367(b). Except as otherwise provided in this paragraph (b)(4)(iv), the adjusted basis of each distributed asset is increased (but not in excess of its fair market value) by a pro rata portion of the excess described in the preceding sentence, based on the realized but unrecognized gain with respect to such asset relative to the realized but unrecognized gain with respect to all distributed assets. For purposes of the preceding sentence, money is not treated as an asset. The adjusted basis of a receivable may not be increased pursuant to this paragraph (b)(4)(iv) to an amount that exceeds the receivable's face amount.

(5) *Special holding period rule for transfers subject to gain recognition rule.* If a loss is realized on a direct or indirect disposition of stock of a section 1291 fund in a transaction in which any gain, if realized, would have been recognized under this section, the shareholder's holding period for stock received in the transaction, if any, as well as the transferee's holding period of the transferred stock, begins on the day after the disposition, but only for purposes of applying sections 1291 through 1297 to the shareholder or the transferee with respect to such stock, as appropriate.

(c) *Exceptions to general rule—(1) Transfer of section 1291 fund stock for PFIC stock.* Gain is not recognized on a direct or indirect disposition of stock of a section 1291 fund that results from a nonrecognition transfer if in the transfer, stock of the section 1291 fund, or an interest in another person that causes the shareholder to be an indirect shareholder, is exchanged solely for either—

(i) Stock of the same or another corporation that either qualifies under section 1296(a) as a PFIC for its taxable year that includes the day after the nonrecognition transfer or is the acquiring corporation in a section 368(a)(1)(F) reorganization; or

(ii) An interest in another person that owns directly or indirectly stock of the transferred section 1291 fund or of another PFIC, but only to the extent (by value) that the shareholder is treated under § 1.1291-1(b)(8) as owning after the transfer at least as great an interest in the section 1291 fund or other PFIC that the indirect shareholder owned before the transfer. Stock in another PFIC owned before the transfer is not taken into account for purposes of the preceding sentence. For the definition of an indirect disposition, see generally § 1.1291-3(e)(2).

(2) *Transfer to U.S. person—(i) In general.* Unless otherwise provided, a shareholder does not recognize gain on a direct or indirect disposition of stock of a section 1291 fund that results from a nonrecognition transfer if immediately after the transfer such stock is owned or considered owned by a U.S. person (U.S. transferee), provided that—

(A) The basis of the stock that is the subject of the disposition, in the hands of its actual owner immediately after the transfer, is no greater than the basis of such stock in the hands of its actual owner immediately before the transfer;

(B) The U.S. transferee's holding period for the transferred stock is at least as long as the holding period of the

shareholder immediately before the transfer; and

(C) The aggregate ownership (determined under § 1.1291-1(b)(8)) of the shareholder and the U.S. transferee immediately after the transfer (determined without regard to stock held by the U.S. transferee prior to the transfer) is the same as or greater than the shareholder's proportionate ownership immediately before the transfer.

This paragraph (c)(2) does not apply to a transfer to a partnership, S corporation, trust or estate. For those rules, see paragraph (c)(3) of this section.

(ii) *Transitory ownership.* Gain is not recognized to a domestic corporation that is a party to a reorganization within the meaning of section 358(b) if, pursuant to a plan of reorganization, the corporation acquires stock of a PFIC that is a party to the reorganization in exchange for the domestic corporation's assets, and transfers the PFIC stock under section 361(c) to a shareholder that is a U.S. person in exchange for the shareholder's stock of the domestic corporation.

(iii) *Transfer by reason of death—(A) In general.* Except as provided in paragraph (c)(2)(iii)(B) of this section, gain is not recognized to a shareholder upon a disposition of stock of a section 1291 fund that results from a nonrecognition transfer to the shareholder's domestic estate or directly to another U.S. person upon the death of the shareholder.

(B) *Exception.* Gain is recognized to a shareholder on the transfer of stock of a section 1291 fund to the shareholder's domestic estate that either—

(1) has a foreign beneficiary; or
(2) establishes a trust to which the stock of the section 1291 fund may be transferred under the terms of the will.

(iv) *Section 355 distribution of stock of section 1291 fund.* Gain is not recognized to a shareholder that is the distributing corporation upon a direct or indirect disposition of stock of a section 1291 fund that results from the distribution of stock of a controlled corporation to another U.S. person (the distributee) in a transaction qualifying under section 355(a) if the distributee is a shareholder with respect to such stock immediately after the distribution. The distributee in such a transaction takes a holding period in the stock of the controlled corporation equal to the longer of the holding period determined under section 1223(1) or the distributing corporation's holding period of the stock of the controlled corporation. If the controlled corporation is itself the section 1291 fund, the distributee in such

a transaction takes a basis in the stock of the controlled corporation equal to the lesser of the adjusted basis determined under section 358 or the distributing corporation's adjusted basis of the stock of the controlled corporation immediately prior to the distribution.

(v) *Gifts incurring gift tax.* If a shareholder makes a gift of stock of a section 1291 fund to a U.S. person and thereby incurs gift tax, the shareholder will not recognize gain, but will be liable for the deferred tax amount as if the shareholder recognized gain in the amount of the gift tax that is added to the basis of the transferred stock under section 1015(d). The adjusted basis of the transferred stock may only be increased, to the extent provided in section 1015(d), by the amount of gift tax paid. The following example illustrates the rule of this paragraph (c)(2)(v).

Example. M, a U.S. person, purchased 1,000 shares of NQF, a PFIC, on December 31, 1989. M did not elect to treat NQF as a QEF. M gave the NQF stock to her daughter, H, also a U.S. person, on December 31, 1993. M paid \$100x of gift tax. As provided in section 1015(a) and (d)(6), H's adjusted basis in the NQF stock is M's adjusted basis, increased by \$60x of gift tax paid. As a result, pursuant to § 1.1291-6(c)(2)(v), M is liable for the deferred tax amount that M would have owed if M recognized \$60x of gain on a taxable transfer of the NQF stock. For purposes of calculating the deferred tax amount, the \$60x is allocated over M's four-year holding period, with the deferred tax amount calculated with respect to the \$45x allocated to 1991, 1992, and 1993. Other than for the \$60x of gift tax paid, there are no further adjustments to H's basis in the NQF.

(vi) *Exception inapplicable.* Paragraph (c)(2) of this section does not apply to a disposition of stock of a section 1291 fund that results from a nonrecognition transfer of stock of a section 1291 fund if the U.S. transferee is—

(A) An organization that will not be subject to section 1291 and these regulations pursuant to § 1.1291-1(e) with respect to that section 1291 fund; or

(B) A trust, including a testamentary trust or other irrevocable trust, that is not a grantor trust or beneficiary-owned section 678 trust to which paragraph (c)(3)(iv) of this section applies.

(3) *Transfers involving pass-through entities—(i) Section 721 transfer to partnership.* Gain is not recognized to a shareholder on a disposition of stock of a section 1291 fund that results from a transfer to a partnership under section 721, but only to the extent that the shareholder is treated as owning such stock immediately after the transfer pursuant to § 1.1291-1(b)(8)(iii)(A).

(ii) *Section 731 distribution by partnership.* Gain is not recognized to a

partner on a disposition of stock of a section 1291 fund that results from a distribution under section 731, but only to the extent that the partner is treated as owning such stock immediately after the distribution pursuant to § 1.1291-1(b)(8).

(iii) *Transfer to S corporation.* Gain is not recognized to a shareholder on a disposition of stock of a section 1291 fund that results from a transfer to an S corporation under section 351, but only to the extent that the shareholder is treated as owning such stock immediately after the transfer pursuant to § 1.1291-1(b)(8)(iii)(B).

(iv) *Transfer to grantor trust.* Gain is not recognized on a disposition of stock of a section 1291 fund that results from a nonrecognition transfer to a trust by the grantor of the trust if the grantor is treated as owning the portion of the trust that includes both the income and corpus portions of the stock that is disposed of. If a person other than the grantor is treated as the owner of the portion of a beneficiary-owned section 678 trust that includes the income and corpus portions of the stock transferred to the trust, that person is treated as acquiring the stock by gift from the grantor, which is a transfer subject to the general rules of this section. Stock owned directly or indirectly by a grantor of a grantor trust or by a beneficiary of a beneficiary-owned section 678 trust will be treated as transferred by the grantor or other person considered the owner thereof for purposes of this section at the time the grantor or beneficiary is no longer considered the owner of both the income and corpus portions of the stock of the section 1291 fund. For special rules applicable to a grantor or beneficiary-owned section 678 trust, see sections 671 through 679 and the regulations under those sections.

(4) *Transfer to nonresident alien spouse who files joint return.* Gain is not recognized on a disposition of stock of a section 1291 fund that results from a nonrecognition transfer to the shareholder's nonresident alien spouse who has made the election under section 6013(g) and is treated as a resident for purposes of chapter 1 of the Code. A termination of the election pursuant to section 6013(g)(4) will be treated as a disposition of the stock by the transferee spouse as provided in § 1.1291-3(b)(2).

(d) *Special rules—(1) Section 367 or 1492 transfer—(i) Gain recognition transfer.* If the gain recognition rule of paragraph (b)(1) of this section applies to a disposition of stock of a section 1291 fund that results from a transfer with respect to which section 367 or

1492 requires the shareholder to recognize gain or include an amount in income as a distribution under section 301, the gain realized on the transfer is taxable as an excess distribution as provided in § 1.1291-2 (e)(2). The excess, if any, of the amount to be included in income pursuant to section 367(b) over the gain realized is taxable as provided in the regulations under section 367(b).

(ii) *Disposition to which exception applies.* If an exception to the gain recognition rule of paragraph (b)(1) of this section applies to a disposition to which section 367(b) applies, and section 367(b) requires the shareholder to include an amount in income as a distribution taxable under section 301, that amount is an excess distribution taxable as provided in § 1.1291-2(e)(2).

(2) *Taxable year of disposition by reason of death.* A disposition of stock of a section 1291 fund by reason of a shareholder's death, to which the gain recognition rule of paragraph (b)(1) or (c)(2)(iii)(B) of this section applies, will be treated as a disposition by the shareholder effected immediately before death and taxable to the shareholder in the shareholder's last taxable year.

(3) *Section 643(e)(3) election.* An election by a foreign estate or trust under section 643(e)(3) will not apply to stock of a section 1291 fund distributed to a U.S. person if the gain recognized by reason of the election is not taxable in the United States.

(e) *Receipt of nonqualifying property.* If a nonrecognition transfer results in a disposition of stock of section 1291 fund to which an exception to the gain recognition rule of paragraph (b)(1) of this section would apply but for the fact that the property received in the transfer includes money or property (nonqualifying property) in addition to property permitted to be received pursuant to the paragraph (c) of this section, gain is recognized only to the extent of the nonqualifying property. If such nonqualifying property is treated as a distribution by the section 1291 fund under otherwise applicable provisions of the Code, the distribution will be taxable on an excess distribution as provided in § 1.1291-2(e)(2).

(f) *Examples.* The following examples illustrate the operation of this section.

Example 1. A is a shareholder of PFIC, a corporation organized under the laws of Country X. PFIC is a section 1291 fund with respect to A. To avoid expropriation of the assets of PFIC by the government of Country X, PFIC's management has decided to relocate to Country Y. To effect the relocation, PFIC adopted a plan of reorganization pursuant to which PFIC will transfer all of its assets to Newco, a newly organized Country Y corporation, in

exchange for Newco stock and the assumption of PFIC's liabilities in a transaction that will qualify as a reorganization described in section 368(a)(1)(F). PFIC will distribute the Newco stock to its shareholders in exchange for its stock. A will transfer all of its PFIC stock in exchange for Newco stock of equal value. A will not recognize gain on the transfer of PFIC stock in exchange for Newco stock pursuant to section 354 and § 1.1291-6 (c)(1)(i), and the days in A's holding period of the Newco stock will retain the pre-PFIC and prior PFIC character of the days in A's holding period of the PFIC stock pursuant to § 1.1291-1(h)(7). See § 1.1291-1(b)(1)(ii).

Example 2. X is a domestic corporation that owns 75 percent of F, a foreign corporation that is not a PFIC. F owns 100 percent of the stock of FS, a PFIC. X is treated under § 1.1291-1(b)(8)(ii)(A) as owning 75 percent of the stock of FS. X has not elected under section 1295 to treat FS as a QEF. FC, a foreign corporation, will acquire substantially all the assets of F in exchange for FC stock and the assumption of the liabilities of F in a transaction that will qualify as a reorganization described in section 368(a)(1)(C). FC never qualified as a PFIC and will not qualify as a PFIC at the beginning of the day after the transaction. F will distribute the FC stock to its shareholders in exchange for their F stock. X will transfer all its F stock to F in exchange for FC stock of equal value. After the reorganization, X will hold 49 percent of the outstanding FC stock, and therefore will no longer be treated under § 1.1291-1(b)(8)(ii)(A) as owning stock of FS. Pursuant to §§ 1.1291-6(b)(1) and 1.1291-3(e)(1), X will be taxed on the indirect disposition of the FS stock.

Example 3. X, a domestic corporation, owns stock of PFIC, a corporation that is a section 1291 fund with respect to X. Pursuant to a plan of reorganization, X will transfer to FC, a foreign corporation, substantially all of its assets in exchange for FC voting stock and FC's assumption of the liabilities of X in a transaction that will qualify as a reorganization described in section 368(a)(1)(C). It is assumed that the transaction is not taxable under section 367(a) (including section 367(a)(5)). X will distribute the FC stock to its shareholders in exchange for their X stock. FC is not a PFIC and will not qualify as a PFIC for the taxable year that includes the day after the transfer. In addition, after the reorganization, no U.S. person will own 50 percent or more of FC. Pursuant to § 1.1291-6(b)(1), section 361(a) will not apply to X's transfer of the PFIC stock to FC. X therefore will recognize the gain realized on the transfer or the stock of PFIC. The gain will be taxed to X as an excess distribution pursuant to § 1.1291-3.

Example 4. X, a domestic corporation, satisfies the stock ownership requirements specified in section 332(b) with respect to PFIC, a corporation that is a section 1291 fund with respect to X. Pursuant to a plan of complete liquidation, PFIC will distribute all its assets and liabilities to X in exchange for its stock and liquidate. Pursuant to § 1.1291-6(b)(1) and (d)(1)(i), section 332(a) will not apply to the complete liquidation of PFIC. X therefore will recognize gain on the

disposition of the stock of PFIC, which gain will be taxed as an excess distribution pursuant to § 1.1291-3. The adjusted basis of the assets of X will be increased as provided in § 1.1291-6(b)(4)(iv).

Example 5. USP, a domestic corporation, owns all the stock of USS, also a domestic corporation. USS owns stock of FS, a corporation that is a section 1291 fund with respect to USS. Pursuant to a plan of reorganization that will qualify under section 368(a)(1)(C), USS will transfer substantially all its assets to FC, a PFIC, in exchange for FC stock and the assumption by FC of the liabilities of USS. USS will transfer the FC stock to USP in exchange for its stock. Pursuant to § 1.1291-6(c)(1), section 361 applies to USS's transfer to FC of the FS stock. As provided in § 1.1291-6(c)(2)(ii), USS will not recognize any gain on the transfer of the FC stock to USP in exchange for its stock.

Example 6. A, a U.S. person, owns all the stock of FC, a corporation that is both controlled foreign corporation and a section 1291 fund with respect to A. Pursuant to a reorganization plan, FC will transfer all its assets to F, a foreign corporation that is a PFIC but not a controlled foreign corporation after the transfer, in exchange for F stock and the assumption of FC's liabilities in a transaction that will qualify as a reorganization described in section 368(a)(1)(C). FC will distribute the F stock to A in exchange for A's FC stock. A will not recognize gain on the transfer of FC stock in exchange for F stock pursuant to section 354 and § 1.1291-6(c)(1). However, the regulations under section 367(b) require A to include a certain amount in gross income as a distribution taxable under section 301. As provided in § 1.1291-6(d)(1)(ii), A will treat that amount as an excess distribution taxable as provided in § 1.1291-2(e)(2).

Example 7. M, a U.S. person, purchased 100 shares of the stock of NQF on December 31, 1989, for \$100. NQF is a corporation that is a section 1291 fund with respect to M. On January 1, 1992, when the 100 shares of NQF stock had a fair market value of \$200, M transferred its NQF stock to P, a domestic partnership, of which M and N, also a U.S. person, are equal partners. After the transfer to P, M will be considered to own only 50 shares of the NQF stock pursuant to § 1.1291-1(b)(8)(iii)(A), notwithstanding that gain recognized with respect to all 100 shares would be allocated to M pursuant to section 704(c). M therefore is taxable on the disposition of 50 shares of NQF stock in accordance with § 1.1291-6(c)(3)(i).

(g) *Reporting requirements for transfers entitled to nonrecognition treatment under this section.* If an exception to the gain recognition rule of paragraph (b)(1) of this section applies wholly or partly to a disposition of stock of a section 1291 fund that results from a nonrecognition transfer, the shareholder must provide the following information in an attachment to Form 8621, which must be filed with the shareholder's federal income tax return for the taxable year in which the transfer occurs:

(1) A complete description of the transfer, including a complete description of the stock, securities or other property received directly or indirectly in the transfer.

(2) The name, address, and taxpayer identification number (if available) of the transferor and transferee of the transferred property.

(3) A statement citing the applicable exception to the gain recognition rule and stating why the exception is applicable.

(h) *Transfers involving QEF stock.* For rules concerning the effect of a transfer of stock of a QEF on the section 1295 election, see § 1.1295-1.

§ 1.1291-7 Section 1291(e) rules similar to section 1246. [Reserved]

§ 1.1291-8 Mark-to-market election by regulated investment companies.

(a) *In general.* To the extent provided in this section, a regulated investment company within the meaning of section 851(a) (RIC) may elect to mark to market all the stock of section 1291 funds of which the RIC is a shareholder at the close of the first taxable year of the RIC for which the election is effective and of each succeeding taxable year.

(b) *Effect of election—(1) Recognition of gain.* On the last day of each taxable year of the RIC to which an election under this section applies, the RIC recognizes as gain the excess, as of the last business day of the taxable year, of the fair market value of each share of stock of a section 1291 fund over the actual owner's adjusted basis in that share (mark-to-market gain).

(2) *Treatment of gain—(i) In general.* Except as otherwise provided in this paragraph (b)(2), mark-to-market gain is treated as an excess distribution resulting from a disposition, taxable as provided in § 1.1291-2(e)(2).

(ii) *Sections 851(b)(3) and 4982.* For purposes of section 851(b)(3), mark-to-market gain is treated as gain derived from securities held for not less than three months. For purposes of section 4982, mark-to-market gain is treated in the same manner as foreign currency gain which is attributable to a section 988 transaction under section 4982(e)(5).

(3) *No recognition of loss.* An election under this section will not result in the recognition of any loss not otherwise recognized under the Code.

(4) *Adjustment to basis—(i) Stock held directly.* The adjusted basis of a share of stock of a section 1291 fund owned directly by a RIC is increased by the amount of mark-to-market gain recognized under this section with respect to that share.

(ii) *Stock held indirectly.* If a RIC is an indirect shareholder of a section 1291 fund, the RIC's adjusted basis of the stock or other property owned directly, through which ownership of a share of stock of the section 1291 fund is attributed to the RIC, is increased by the amount of mark-to-market gain recognized by the RIC with respect to such share. In addition, solely for purposes of determining the subsequent treatment of the RIC with respect to such share under this title, the adjusted basis of the actual owner of the share is increased by the amount of mark-to-market gain recognized by the RIC under this section with respect to the share.

(5) *Holding period.* For purposes of sections 1291 through 1297 and the regulations under those sections, if an election under this section applies to any taxable year of a RIC, a new holding period of each share of stock of a section 1291 fund begins on the first day of the next taxable year. This paragraph (b)(5) applies whether or not there was mark-to-market gain with respect to that share in the taxable year. This paragraph (b)(5) does not apply, however, to prior taxable years for stock that is discovered stock in the current shareholder year, as provided in paragraph (e) of this section.

(6) *Treatment under section 1291.* Except as otherwise provided in this section, an election under this section has no effect on the manner in which an excess distribution is determined or taxed. Thus, a RIC that makes the election under this section is taxable as provided in section 1291 and these regulations with respect to any direct or indirect distribution from any section 1291 fund and any direct or indirect disposition of stock of any section 1291 fund.

(7) *Coordination with subpart F.* If a RIC is a U.S. shareholder of a controlled foreign corporation (CFC), both as defined in section 904(d)(4), that also is a section 1291 fund, sections 951 through 964 apply with respect to the taxation of the RIC on the income of such corporation before the determination of the amount of gain to be recognized under this section. Mark-to-market gain is not foreign personal holding company income within the meaning of section 954(c).

(8) *Transition rule—(i) In general.* A RIC that makes the election under this section for its first taxable year ending after [INSERT DATE THIS DOCUMENT IS PUBLISHED AS A FINAL REGULATION] must recognize as of the beginning of that year the excess of the fair market value of each share of stock of a section 1291 fund

over the actual owner's adjusted basis in that share and pay the interest charge described in paragraph (b)(8)(iii) of this section. The transition rule of this paragraph (b)(8) applies only to stock of section 1291 funds owned or considered owned by the RIC under § 1.1291-1(b)(8) as of the beginning of that first taxable year. The fair market value of each share of stock is determined as of the close of the immediately preceding taxable year. No losses may be recognized.

(ii) *Treatment of gain.* The gain recognized by the RIC under paragraph (b)(8)(i) of this section is included in gross income as ordinary income of the RIC in the taxable year of the election.

(iii) *Nondeductible interest charge.* A RIC that recognizes gain under paragraph (b)(8) of this section will pay the interest charge determined under this paragraph (b)(8)(iii). The interest charge is determined in the same manner that the aggregate amount of interest defined in § 1.1291-4(d)(1) is determined, except that such determination is based on hypothetical aggregate increases in taxes (defined in § 1.1291-4(c)(5)). For purposes of the immediately preceding sentence, the hypothetical aggregate increases in taxes are calculated using the highest rate of tax in effect under section 1 or section 11 in each of the prior PFIC years in the holding period of the share of stock (determined without regard to the rate otherwise applicable to the RIC or to its shareholders for any such year). The interest paid by the RIC under this paragraph (b)(8)(iii) is not deductible for purposes of this title, notwithstanding any other provision of the Code.

(iv) *Adjustment to basis and holding period.* For the adjustments to basis of stock with respect to which gain is recognized under this paragraph (b)(8), see paragraph (b)(4) of this section. If the transition rule of this paragraph (b)(8) applies to a RIC, a new holding period of each share of stock of a section 1291 fund begins on the first day of the first taxable year ending after [INSERT DATE THIS DOCUMENT IS PUBLISHED AS A FINAL REGULATION], without regard to whether gain was recognized with respect to each such share.

(c) *Eligible RIC.* A RIC may take the election under this section only if it is an open-end RIC or a closed-end RIC the net asset value of which is determined and published in a publication of general circulation no less frequently than weekly.

(d) *Definitions—(1) Open-end RIC.* A RIC is an open-end RIC if the RIC is offering for sale or has outstanding any

redeemable security, as defined in section 2(a)(32) of the Investment Company Act of 1940, of which it is the issuer.

(2) *Closed-end RIC.* A RIC is a closed-end RIC if it is not an open-end RIC as defined in paragraph (d)(1) of this section.

(3) *Fair market value.* The fair market value of a share of stock is the fair market value of such share established for purposes of determining the RIC's net asset value.

(e) *Special election for PFIC stock held in prior years—(1) In general.* If a RIC that is a shareholder of a section 1291 fund in the current shareholder year failed to apply a mark-to-market election under this section to such stock in a prior taxable year for either of the reasons described in this paragraph (e)(1), the RIC may apply the special gain recognition rule set forth in paragraph (e)(2) of this section to such stock (discovered stock):

(i) The RIC has not previously made a timely election under this section because it reasonably believed in all prior years that it was not a shareholder of any PFIC (other than a PFIC that was a pedigreed QEF as to the RIC in such prior years) at the close of such prior years; or

(ii) The RIC previously made a timely election under this section but did not recognize mark-to-market gain with respect to the section 1291 fund in prior years because, prior to the current shareholder year, the RIC reasonably believed that the issuer of such discovered stock was not a PFIC.

(2) *Effect of election.* If a RIC described in paragraph (e)(1) of this section makes the election under this paragraph (e), the RIC is required to recognize gain and pay interest as provided in this paragraph (e)(2).

(i) The RIC must include in income in the current shareholder year the sum of mark-to-market gains that would have been recognized with respect to discovered stock in taxable years of the RIC beginning with the initial taxable year and continuing through the current shareholder year (determined as if the RIC had made an election under this section in the initial year). For purposes of the preceding sentence, the initial taxable year is the later of the RIC's taxable year that includes *[INSERT DATE THIS DOCUMENT IS PUBLISHED AS A FINAL REGULATION]*, or the taxable year in which the RIC first acquired the discovered stock.

(ii) The RIC must pay an interest charge computed as follows:

(A) If the mark-to-market gain described in paragraph (e)(2)(i) includes

gain that would have been eligible for the transition rule in paragraph (b)(8) of this section, the interest charge with respect to such gain is the interest charge determined under paragraph (b)(8)(iii) of this section, plus any additional interest determined for the period beginning on the due date of the return for the taxable year (determined without regard to extensions) that includes *[INSERT DATE THIS DOCUMENT IS PUBLISHED AS A FINAL REGULATION]* and ending on the due date of the return for the current shareholder year (without regard to extensions) by applying the rates and method applicable under section 6621 for underpayments of tax for such period.

(B) The interest charge with respect to any other mark-to-market gain is determined in the same manner that the aggregate amount of interest defined in § 1.1291-4(d)(1) is determined, except that such determination is based on hypothetical aggregate increases in taxes (defined in § 1.1291-4(c)(5)). For purposes of the immediately preceding sentence, the hypothetical aggregate increases in taxes are calculated by multiplying the separate mark-to-market gain for each prior taxable year determined under paragraph (e)(2)(i) of this section by the highest statutory rate in effect under section 1 or section 11 for that prior year (determined without regard to the rate otherwise applicable to the RIC or to its shareholders for such year).

(iii) The interest paid by the RIC under this paragraph (e)(2)(ii) is not deductible for purposes of this title, notwithstanding any other provision of the Code.

(3) *Limitation for 10 percent shareholder.* An election may not be made under this paragraph (e) with respect to stock of a foreign corporation of which the RIC was a 10 percent or greater shareholder in a prior taxable year to which the election would otherwise have applied.

(4) *Application to stock sold during the year.* The RIC may apply this paragraph (e) with respect to discovered stock that the RIC transferred in a direct or indirect disposition (within the meaning of § 1.1291-3 (b), (c), (d), (e)) during the current shareholder year, recognizing as gain (loss) on such disposition (in addition to the sum of the mark-to-market gains recognized under this paragraph (e) with respect to the period ending with the immediately preceding taxable year) the amount by which the fair market value on the date of disposition of each share of discovered stock exceeds (is less than)

its adjusted basis on the first day of the current shareholder year.

(f) *Time for making the election.* A RIC may make an election under this section for any taxable year ending on or after *[INSERT DATE THIS DOCUMENT IS PUBLISHED AS A FINAL REGULATION]*, by the due date (including extensions) of its Federal income tax return for that year. For purposes of section 4982, an election under this section applies to the calendar year in which the taxable year of the RIC ends.

(g) *Manner of making the election—(1) In general.* A RIC makes the mark-to-market election by—

(i) Attaching a statement, entitled “§ 1.1291-8 Election by a RIC”, to its federal income tax return for the first taxable year that the election is to be effective, setting forth the information described in paragraph (g)(2) or this section; and

(ii) Making a notation, at the top of each Form 8621 filed for a section 1291 fund, that a § 1.1291-8 election applies to that fund.

(2) *Statement attached to return.* A RIC making the election under this section must provide the following information in the statement described in paragraph (g)(1) of this section:

(i) A statement indicating whether the RIC is an open-end RIC described in § 1.1291-8(c)(1) or a closed-end RIC described in § 1.1291-8(c)(2).

(ii) A list of all the section 1291 funds of which the RIC is a shareholder, identifying the actual owner (whether the RIC or another person) of the stock, the actual owner's adjusted basis in each share, and the acquisition date of each share (or block of shares).

(iii) The fair market value of the stock of each section 1291 fund and the valuation date.

(iv) In the case of any section 1291 fund for which an election described in paragraph (e) of this section is made, a statement that the requirements of paragraph (e) of this section are satisfied; the information described in this paragraph (g)(2) as of the close of each prior year for which gain is being recognized in the current shareholder year; and the amount of interest owed as a result of the election described in paragraph (e) of this section.

(v) If the transition rule of paragraph (b)(8) of this section applies, the gain recognized and the amount of interest owed under that rule.

(3) *Annual requirements.* The RIC must satisfy the requirements of this paragraph (g) in each taxable year of the RIC in which the election is in effect.

(h) *Revocation of election.* The mark-to-market election may be revoked only with the consent of the Commissioner. In addition, the Commissioner may revoke the election for cause. For example, if on audit the Commissioner determines that the RIC used inaccurate valuations for purposes of determining the amount of gain to be recognized under this section, the Commissioner may revoke the election, or in the Commissioner's discretion, redetermine the mark-to-market gain based on accurate valuations.

§ 1.1291-9 Deemed dividend election by a shareholder of a CFC that is a qualified electing fund.

(a) *Deemed dividend election*—(1) *In general.* This section provides rules for making the election under section 1291(d)(2)(B). Under that section, a U.S. person that is a direct or indirect shareholder of an unpedigreed QEF, as defined in paragraph (i)(3) of this section, that also is a controlled foreign corporation (CFC) within the meaning of section 957(a), may elect to include in income as a dividend the shareholder's pro rata share of the post-1986 earnings and profits of the CFC attributable to the stock owned or considered owned on the first day of the shareholder's taxable year in which it elects to treat the CFC as a QEF (qualification date). The deemed dividend is taxed as an excess distribution received on the qualification date. The excess distribution determined under this paragraph (a) is allocated under section 1291(a)(1)(A) only to those days in the shareholder's holding period during which the CFC qualified as a PFIC. For purposes of the preceding sentence, the holding period of the CFC stock with respect to which the election is made ends on the qualification date. This section does not apply to a shareholder of a pedigreed QEF, as defined in paragraph (i)(2) of this section.

(2) *Post-1986 earnings and profits defined*—(i) *In general.* For purposes of this section, the term post-1986 earnings and profits means the undistributed earnings and profits, within the meaning of section 902(c)(1), as of the qualification date that were accumulated and not distributed in taxable years of the CFC beginning after 1986 during which the CFC was a PFIC, but without regard to whether the earnings relate to a period in which the section 1291 fund was a CFC.

(ii) *Pro rata share of post-1986 earnings and profits attributable to shareholder's stock*—(A) *In general.* A shareholder's pro rata share of the post-1986 earnings and profits of the CFC attributable to the stock owned or

considered owned by the shareholder on the qualification date is the amount of post-1986 earnings and profits of the CFC accumulated during any portion of the shareholder's holding period ending on the qualification date and attributable, under the principles of section 1248 and the regulations under that section, to the CFC stock owned or considered owned on the qualification date.

(B) *Reduction for previously taxed amounts.* A shareholder's pro rata share of the post-1986 earnings and profits of the CFC does not include any amount that the shareholder demonstrates to the satisfaction of the Commissioner (in the manner provided in paragraph (d)(2) of this section) was, pursuant to another provision of the law, previously included in the income of the shareholder, or of another U.S. person if the shareholder's holding period of the CFC stock includes the period during which the stock was owned or considered owned by that other U.S. person.

(b) *Who may make the election.* A direct or indirect shareholder of an unpedigreed QEF that also is a CFC may make the deemed dividend election, without regard to whether such shareholder is a United States shareholder within the meaning of section 951(b). A deemed dividend election may be made by a shareholder whose pro rata share of the post-1986 earnings and profits of the CFC attributable to the CFC stock owned or considered owned on the qualification date is zero.

(c) *Time for making the election.* The shareholder may make the deemed dividend election in the shareholder's tax return for the taxable year that includes the qualification date. The election must be made either by the due date, as extended, for the return, or by filing an amended tax return within three years of the due date, as extended, for the shareholder's tax return for the taxable year that includes the qualification date.

(d) *Manner of making the election*—(1) *In general.* A shareholder makes the deemed dividend election by providing the attachment to Form 8621 described in paragraph (d)(2) of this section, reporting the deemed dividend as an excess distribution, and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed dividend election after the due date of the return (determined without regard to extensions) for the taxable year that includes the qualification date must pay additional interest, pursuant to section 6601, on the

amount of the underpayment of tax for that year.

(2) *Attachment to Form 8621.* The shareholder must attach a schedule to Form 8621 that demonstrates the calculation of the shareholder's pro rata share of the post-1986 earnings and profits of the CFC that are treated as distributed to the shareholder pursuant to this section. If the shareholder is claiming an exclusion from its pro rata share of the post-1986 earnings and profits for an amount previously included in its income or the income of another U.S. person, the shareholder also must include the following information:

(i) The name, address, and taxpayer identification number of the U.S. person that previously included the amount in income;

(ii) A description of the transaction pursuant to which the shareholder acquired, directly or indirectly, the stock of the CFC from another U.S. person, and the provisions of law pursuant to which the shareholder's holding period includes the period the other U.S. person owned or was considered to own the CFC stock; and

(iii) A schedule showing each amount previously included in income by a U.S. person, the name of the U.S. person who included the amount in income, the provision of the law pursuant to which the amount was previously included in income, and the taxable year of inclusion of each amount.

(e) *Elections made on or before May 1, 1992.* A shareholder that made the section 1291(d)(2)(B) on or before May 1, 1992, will satisfy the requirements of paragraphs (c) and (d) of this section by providing the information and representations required by paragraph (d) of this section not previously filed with the shareholder's return for the taxable year that includes May 1, 1992. A shareholder that made a deemed dividend election on or before May 1, 1992 and included the deemed dividend in income as of the date described in § 1.1291-10(b)(2)(i) will not be required to amend any federal income tax return to include the deemed dividend in income as of the qualification date defined in paragraph (a) of this section.

(f) *Adjustment to basis; treatment of holding period.* A shareholder increases its adjusted basis of the stock of the CFC owned directly by the amount of the deemed dividend. If the shareholder made the deemed dividend election with respect to a CFC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder through which ownership of

the section 1291 fund is attributed to the shareholder is increased by the amount of the deemed dividend. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a direct or indirect shareholder of the stock of the CFC, the adjusted basis of the actual owner of the stock of the CFC is increased by the amount of the deemed dividend. For purposes of applying sections 1291 through 1297 to the shareholder after the deemed dividend, the shareholder's holding period of the stock of the CFC begins on the qualification date; for other purposes of the Code and regulations, the shareholder's holding period of the stock of the CFC includes the period the shareholder owned or was considered to own the stock prior to the qualification date.

(g) *Coordination with section 959(e).* For purposes of section 959(e), the entire deemed dividend is treated as included in gross income under section 1248(a).

(h) *Election inapplicable to shareholder of former PFIC—(1) Coordination with section 1297(b)(1).* The rules of this section do not apply to an election under section 1297(b)(1).

(2) *Unpedigreed QEF.* The election under this section may not be made if the corporation does not qualify as a PFIC under section 1296(a) (1) or (2) for the first taxable year for which a section 1295 election is intended to apply.

(i) *Definitions—(1) QEF.* A PFIC is a qualified electing fund (QEF) with respect to a shareholder that has elected under section 1295 to be taxed currently on its share of the PFIC's earnings and profits pursuant to section 1293.

(2) *Pedigreed QEF.* A PFIC is a pedigreed QEF with respect to a shareholder if it has been a QEF with respect to the shareholder for all taxable years during which it was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock.

(3) *Unpedigreed QEF.* A PFIC is an unpedigreed QEF for any taxable year if—

(i) An election under section 1295 is in effect for that year;

(ii) It has been a QEF with respect to the shareholder for one or more, but not all, of the taxable years during which it was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock; and

(iii) The shareholder has not elected under section 1291(d)(2) and § 1.1291-9 or 1.1291-10 to purge the non-QEF years from the shareholder's holding period.

(4) *Section 1291 fund.* A section 1291 fund with respect to a shareholder is an unpedigreed QEF or a PFIC that the

shareholder has not elected under section 1295 to treat as a QEF.

§ 1.1291-10 Election by a United States person to recognize gain in a qualified electing fund.

(a) *Purpose and scope.* This section provides rules for making the election under section 1291(d)(2). Under that section, a U.S. person may elect to recognize gain with respect to stock in a qualified electing fund (QEF) held on the first day of the QEF's first taxable year during which it is a QEF. In general, a QEF is a foreign corporation that is a passive foreign investment company (PFIC), as defined in section 1296, and that has made the election under section 1295. For rules concerning the election by a PFIC under section 1295, see § 1.1295-1.

(b) *Election to recognize gain—(1) In general.* A U.S. person may elect to recognize gain under the provisions of this § 1.1291-10 if such person was a shareholder of a QEF on the qualification date. A person that makes such an election shall be treated as having sold on the qualification date for its fair market value stock of the QEF that the person held on that date. The deemed sale is taxed as a disposition pursuant to section 1291. Under that section, the gain is considered earned pro rata over the shareholder's holding period in the stock, and is taxed as ordinary income. The tax on the gain attributable to post-1986 taxable years during which the corporation is a PFIC is based on the value of tax deferral and includes an interest charge. An election may be made by a shareholder that would realize a loss on the deemed sale. Any loss realized on the deemed sale may not be recognized.

(2) *Qualification date—(i) Elections to be made on or before May 1, 1992.* The qualification date with respect to any shareholder of a QEF that, pursuant to § 1.1291-10(c), made this election on or before May 1, 1992 is the first day of the QEF's first taxable year as a QEF.

(ii) *Elections to be made after May 1, 1992.* The qualification date with respect to any shareholder of a QEF that, pursuant to § 1.1291-10(c), makes this election after May 1, 1992 is the first day of the shareholder's taxable year in which the shareholder elects to treat the section 1291 fund as a QEF.

(3) *Exception.* This election does not pertain to a shareholder that held stock in a PFIC which was a QEF for all of the PFIC's taxable years beginning after 1986 during which it qualified as a PFIC and that are included in whole or in part in the shareholder's holding period. See section 1291(d)(1).

(4) *Election by indirect shareholder.* An indirect shareholder may make the deemed sale election in the manner provided in this section. The amount of gain to be recognized and taxed as an excess distribution is the amount of gain that the actual owner of the stock of the unpedigreed QEF would have realized on an actual sale or other disposition of the stock indirectly owned by the shareholder.

(c) *Time for making the election.* Except as provided below, an election under this § 1.1291-10 must be made with the filing of the electing shareholder's tax return for the taxable year which includes the qualification date. The election may be made by filing an amended tax return within three years of the due date, as extended, for the shareholder's tax return for the taxable year which includes the qualification date.

(d) *Manner of making the election—(1) In general.* The election shall be made by filing Form 8621 or a statement containing the information and representations required by paragraph (d)(2) of the section, reporting the gain on the income tax return as required by section 1291(a)(2), and by paying the tax on the gain as required by section 1291 (including the payment of the deferred tax amount required under section 1291(a)(1)(C) and 1291(c)). The electing shareholder that makes the election under this section after the due date of the return (determined without extensions) shall pay interest, pursuant to section 6601, on the underpayment of tax for the taxable year that includes the qualification date.

(2) *Information to be included in the election.* If a statement is used in lieu of Form 8621, the statement should be identified, in a heading, as an election under section 1291(d)(2). The statement must contain the following information and representations:

(i) The name, address and taxpayer identification number of the electing shareholder;

(ii) The name, address and taxpayer identification number of the QEF, the stock of which is the subject of the election;

(iii) A statement that the shareholder is making the election under section 1291(d)(2);

(iv) A representation that the person making the election was a shareholder in the QEF on the qualification date;

(v) The qualification date;

(vi) A schedule of the shares held by the electing shareholder in the QEF on the qualification date, listing the date(s) of acquisition, the number of shares acquired on each date listed, and the

electing shareholder's tax basis in each of those shares;

(vii) The fair market value of the stock in the QEF as of the qualification date and a brief statement about the manner in which the fair market value was determined; and

(viii) A schedule showing the computation of the gain recognized on the deemed sale, and the calculation of the deferred tax amount, as defined in section 1291(c).

(e) *Adjustments to basis*—(1) *In general.* An electing shareholder increases its adjusted basis in the stock owned directly by the amount of the gain recognized on the deemed sale. If the shareholder made the election under this section with respect to a PFIC of which it is an indirect shareholder, the electing shareholder's adjusted basis of the stock or other property owned directly by the electing shareholder through which ownership of the PFIC is attributed to the electing shareholder is increased by the amount of gain recognized by the electing shareholder. In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a direct or indirect shareholder of the stock of the PFIC, the adjusted basis of the actual owner of the stock of the PFIC is increased by the amount of gain recognized by the electing shareholder. An electing shareholder shall not adjust the basis of any stock with respect to which the shareholder realized a loss on the deemed sale.

(2) *Adjustment to basis for section 1293 inclusion.* For purposes of determining the amount of gain on the deemed sale, the adjusted basis of the stock includes the electing shareholder's section 1293(a) inclusion that is attributable to the period beginning with the first day of the PFIC's taxable year as a QEF and ending with the qualification date.

(f) *Treatment of holding period.* For purposes of applying sections 1291 through 1297 to the electing shareholder after the deemed sale, the electing shareholder's holding period of the stock of the PFIC begins on the qualification date without regard to whether it recognized gain on the deemed sale; for other purposes of the Code and regulations, the electing shareholder's holding period of the stock of the PFIC includes the period the electing shareholder owned or was considered to own the stock of the QEF prior to the qualification date.

Par. 6. Section 1.1293-1 is added to read as follows:

§ 1.1293-1 Current taxation of income from qualified electing funds.

(a) *In general.* Pursuant to section 1293(a)(1), every U.S. person that is a direct or indirect shareholder of a PFIC during a taxable year of the PFIC for which the shareholder has in effect a section 1295 election (within the meaning of 1.1295-1(a)) includes in gross income the shareholder's pro rata share of the ordinary earnings and net capital gain of such fund for that taxable year. Such amounts are included in income in the taxable year of the shareholder in which or with which the taxable year of the PFIC ends. Section 1293 applies to a shareholder of a pedigreed QEF (as defined in § 1.1291-1(b)(2)(ii)) only for those taxable years during which the corporation qualifies as a PFIC under section 1296(a). Section 1293 applies to a shareholder of an unpedigreed QEF (as defined in § 1.1291-1(b)(2)(iii)) for those taxable years during which the corporation is a PFIC (as defined in § 1.1291-1(b)(1)).

(b) *Other rules.* [Reserved]

Par. 7. Section 1.1295-1 is added to read as follows:

§ 1.1295-1 Qualified electing funds.

(a) *In general.* This section provides certain rules under section 1295 applicable to a U.S. person that has elected to treat a PFIC (as defined in § 1.1291-1(b)(1)) as a QEF (as defined in § 1.1291-1(b)(2)(i)). A U.S. person that has elected to treat a PFIC as a QEF is taxable annually, pursuant to section 1293, on its pro rata share of the ordinary earnings and net capital gain of the QEF.

(b) *Application of section 1295 election*—(1) *Election personal to shareholder.* An election under section 1295 and this section (section 1295 election) applies only to the shareholder that makes the election. Accordingly, a shareholder's section 1295 election will not apply to a U.S. transferee (as defined in § 1.1291-6(c)(2)(i)) of stock of a PFIC with respect to which the shareholder made a section 1295 election. A section 1295 election made by a common parent of a consolidated group as agent for members of the group is considered made by each member of the group that owns stock of the PFIC at the time of the election and at any time thereafter.

(2) *Election applicable to specific corporation only*—(i) *In general.* Only a corporation with respect to which a shareholder makes a section 1295 election is a QEF. The shareholder's section 1295 election applies to all the stock of the QEF that the shareholder owns at the time of the election or acquires thereafter. Except as provided

in paragraph (b)(2)(ii) of this section, if a shareholder transfers stock of a QEF in exchange for stock of another PFIC, the latter PFIC is not a QEF unless the shareholder makes a section 1295 election to treat it as a QEF. If a shareholder disposes of stock of a QEF in exchange for stock of another PFIC in a nonrecognition transfer (as defined in § 1.1291-6(a)(2)) effected prior to April 1, 1992, and the shareholder has consistently treated the other PFIC as a QEF, the shareholder may make a section 1295 election with respect to the other PFIC whose stock was received for the taxable year of the PFIC that includes the day the transfer was effected. Such election must be made by the later of—

(A) The due date provided in section 1295(b); or

(B) The due date for the return for the taxable year of the shareholder that includes April 1, 1992.

For the deadline for making the section 1295 election in the case of nonrecognition transfers effected after April 1, 1992, see section 1295(b).

(ii) *Stock of QEF received in a nonrecognition transfer.* If a U.S. person is a U.S. transferee (as defined in § 1.1291-6(c)(2)(i)) of stock of a PFIC in a nonrecognition transfer in which the shareholder disposing of such stock does not fully recognize the gain with respect to such stock, and the U.S. transferee, at the time of the transaction, has in effect a section 1295 election with respect to that PFIC, the section 1295 election will apply to the newly acquired stock on the day after the transaction. The newly acquired stock will be treated as stock of an unpedigreed QEF for which an election under section 1291(d)(2) and § 1.1291-9 or § 1.1291-10 may be made. For purposes of making a section 1291(d)(2) election pursuant to this paragraph (b)(2)(ii), the qualification date is the day after the nonrecognition transaction. The following example illustrates the rule of this paragraph (b)(2)(ii).

Example. (i) X, a domestic corporation, owns stock of NQF, a section 1291 fund with respect to X, and stock of FC, a pedigreed QEF with respect to X. Pursuant to a plan of reorganization, X and the other shareholders of NQF exchange their NQF stock for voting stock of FC in a transaction that qualifies as a reorganization described in section 368(a)(1)(C). Pursuant to § 1.1291-6(c)(1), the gain recognition rule of § 1.1291-6(b)(1) does not apply to X's disposition of NQF stock. X therefore does not recognize gain on the exchange of NQF stock for FC stock. X's adjusted basis in the FC stock received in the reorganization is equal to X's adjusted basis in the NQF stock immediately prior to the transfer. The holding period of the FC stock

received includes the period during which X held the NQF stock, and, as provided in § 1.1291-1(h)(7), the character of the days during that period as prePFIC and prior PFIC carry over to the FC stock.

(ii) As provided in § 1.1295-1(b)(2)(ii), the section 1295 election that X made with respect to FC applies to the FC stock received in the reorganization. However, because the holding period of the FC stock received in exchange for the NQF stock includes days that are treated as prior PFIC days, the FC stock received in the reorganization is treated as stock of an unpedigreed QEF. X may make an election under section 1291(d)(2) to purge the holding period of the FC stock received of the prior PFIC days carried over with the NQF holding period.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. Section 602.101(c) is amended by adding the following entries in the table:

§ 602.101 OMB control numbers.

| CFR part or section where identified and described | Current OMB control No. |
|--|-------------------------|
| 1.1291-1 | 1545-1304 |
| 1.1291-2 | 1545-1304 |
| 1.1291-3 | 1545-1304 |
| 1.1291-4 | 1545-1304 |
| 1.1291-5 | 1545-1304 |
| 1.1291-6 | 1545-1304 |
| 1.1291-8 | 1545-1304 |
| 1.1291-9 | 1545-1304 |
| 1.1291-10 | 1545-1028 |
| | 1545-1034 |

David G. Blattner,
Acting Commissioner of Internal Revenue.
[FR Doc. 92-6705 Filed 3-31-92; 8:45 am]
BILLING CODE 4830-01-M

ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 180

[PP 2E2756/P532; FRL-4004-9]
RIN 2070-AC18

Pesticide Tolerance for Beta-([1,1'-Biphenyl]-4-Yloxy)-Alpha-(1,1-Dimethylethyl)-1H-1,2,4-Triazole-1-Ethanol

AGENCY: Environmental Protection Agency (EPA).

ACTION: Proposed rule.

SUMMARY: This document proposes that a tolerance be established for the residues of the fungicide beta-([1,1'-biphenyl]-4-yloxy)-alpha-(1,1-dimethylethyl)-1H-1,2,4-triazole-1-ethanol (also referred to in this document as bitertanol) in or on the raw agricultural commodity (RAC) imported bananas (whole) at 0.2 part per million (ppm). This proposal to establish a maximum permissible level of residues of the pesticide in or on this commodity was requested by Mobay Corp.

DATES: Comments, identified by the document control number [PP 2E2756/P532] must be received on or before June 1, 1992.

ADDRESSES: By mail, submit written comments to: Public Response and Program Resources Branch, Field Operations Division (H7506C), Office of Pesticide Programs, Environmental Protection Agency, 401 M St., SW., Washington, DC 20460. In person, bring comments to: Rm. 1128, CM #2, 1921 Jefferson Davis Highway, Arlington, VA 22202.

Information submitted as a comment concerning this document may be claimed confidential by marking any part or all of that information as "Confidential Business Information" (CBI). Information so marked will not be disclosed except in accordance with procedures set forth in 40 CFR part 2. A copy of the comment that does not contain CBI must be submitted for inclusion in the public record. Information not marked confidential may be disclosed publicly by EPA without prior notice. All written comments will be available for public inspection in rm. 1128 at the address given above, from 8 a.m. to 4 p.m., Monday through Friday, excluding legal holidays.

FOR FURTHER INFORMATION CONTACT: By mail: Cynthia Giles-Parker, Product Manager (PM) 22, Registration Division (H7505C), Office of Pesticide Programs, Environmental Protection Agency, 401 M St., SW., Washington, DC 20460. Office location and telephone number: Rm. 229, CM #2, 1921 Jefferson Davis Highway, Arlington, VA 22202, 703-305-5540.

SUPPLEMENTARY INFORMATION: The Mobay Corp., P.O. Box 4913, Kansas City, MO 64120-0013, has submitted pesticide petition (PP) 2E2756 to EPA. This petition requested that the Administrator, pursuant to section 408(e) of the Federal Food, Drug, and Cosmetic Act (FFDCA) (21 U.S.C. 346a(e)), establish a tolerance for residues of the fungicide bitertanol in or on the RAC bananas at 0.2 ppm. EPA issued a notice, published in the *Federal Register* of November 3, 1982 (47 FR

49892), that Mobay Chemical Corp. had filed this petition to establish a tolerance for bitertanol in or on the RAC bananas at 0.5 ppm. EPA subsequently issued a notice published in the *Federal Register* of July 13, 1983 (48 FR 32078), that Mobay Chemical Corp. had amended the petition by decreasing the tolerance from 0.5 to 0.2 ppm. There were no comments received in response to the notice of filing. Mobay Corp. subsequently amended the petition by limiting the RAC to imported bananas.

The data submitted in the petition and other relevant material have been evaluated. The pesticide is considered useful for the purpose for which the tolerance is sought. The toxicological data considered in support of the proposed tolerance include:

1. A rat acute oral study with an LD₅₀ greater than 5,000 milligrams/kilogram (mg/kg) for males only.

2. A mouse acute oral study with an LD₅₀ = 4,488 mg/kg for males and with an LD₅₀ = 4,202 mg/kg for females.

3. A 90-day rat feeding study with a no-observed-effect level (NOEL) of 100 mg/kg and a lowest effect level (LEL) of 300 mg/kg with decreased body weight and increased alkaline phosphatase activity in males.

4. A rat teratology study using dosage levels of 0, 10, 30, and 100 mg/kg/day with a NOEL for fetotoxicity of 10 mg/kg/day and an LEL of 30 mg/kg/day based on stunted growth and slight bone anomalies of the sternum and a developmental toxicity NOEL of 30 mg/kg/day with an LEL of 100 mg/kg/day based on malformations (cleft palate, kinked tail, rib dysplasia) and with a NOEL from maternal toxicity of 30 mg/kg/day with an LEL of 100 mg/kg/day based on reduced body weight, diarrhea, and being unthrifty.

5. A rabbit teratology study using dosage levels of 0, 10, 50, 150, and 250 mg/kg/day with a NOEL for developmental toxicity of 50 mg/kg/day and an LEL of 150 mg/kg/day based on altered growth (lower fetal weight) and with a maternal NOEL of 50 mg/kg/day and an LEL of 150 mg/kg/day based on reduced body weight gain and food consumption.

6. A 2-year dog feeding study using dosage levels of 0, 10, 40, and 160 ppm (0.25, 1, and 4 mg/kg/day, respectively) and a followup 1-year dog-feeding study using dosage levels of 0, 3, and 25 ppm (0.08 and 0.63 mg/kg/day, respectively) for 12 months and 200 ppm (5 mg/kg/day) for 20 months with a NOEL of 25 ppm (0.63 mg/kg/day) and an LEL of 40 ppm (1.0 mg/kg/day) based on liver and eye effects.