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DEPARTMENT OF THE TREASURY

Treasury Decision 8701

Treatment of Shareholders of Certain Passive Foreign Investment Companies

*1997-1 C.B. 173; T.D. 8701; 1997 IRB LEXIS 1941*

January 1997

[\*1]

**SUBJECT MATTER:** Section 1291.-Interest on Tax Deferral

**APPLICABLE SECTIONS:**

26 CFR 1291-9: Deemed dividend election. Internal Revenue Service 26 CFR Parts 1 and 602

**TEXT:**

**AGENCY:**

Internal Revenue Service (IRS), Treasury

**ACTION:**

Final and temporary regulations.

**SUMMARY:**

This document contains final regulations that provide rules for making the deemed sale and deemed dividend elections under *section 1291 (d) (2)*. These regulations reflect changes to the law made by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988, and apply to a shareholder of a passive foreign investment company (PFIC) that elects under *section 1295* to treat the PFIC as a qualified electing fund (QEF) for a taxable year after the first taxable year during the shareholder's holding period that the foreign corporation was a PFIC.

**DATES:**

These regulations are effective December 27, 1996.

Applicability: For the specific dates of applicability, see *1.1291-9 (k)* and *1.1291-10 (i)*.

**SUPPLEMENTARY INFORMATION:**

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (*44 U.S.C. 3507*) under control [\*2] numbers 1545-1028 and 1545-1304. All of these paperwork requirements will be consolidated under control number 1545-1507. Responses to these collections of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent varies from .75 hour to 1 hour, depending on individual circumstances, with an estimated average of .76 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## Background

This document contains final [\*3] regulations to be added to the Income Tax Regulations (26 CFR part 1) under *section 1291 (d) (2) of the Internal Revenue Code*. The final regulations provide rules for making a deemed sale or deemed dividend election to purge a shareholder's holding period of stock of a PFIC of those taxable years during which the PFIC was not a QEF. The Tax Reform Act of 1986 added *section 1291 (d) (2) (A)*, relating to the deemed sale election, effective for taxable years of foreign corporations beginning after December 31, 1986. The Technical and Miscellaneous Revenue Act of 1988 amended *section 1291 (d) (2)* to add new *section 1291 (d) (2) (B)*, relating to the deemed dividend election, effective for taxable years of foreign corporations beginning after December 31, 1986.

On March 2, 1988, temporary regulations (*T.D. 8178 [1988-1 C.B. 313]*) relating to the deemed sale election under *section 1291 (d) (2) (A)*, in addition to elections under *sections 1294, 1295, and 1297*, were published in the **Federal Register** (53 FR 6770). A notice of proposed rulemaking (INTL-941-86 [1988-1 C.B. 916]) cross-referencing the temporary regulations was also published in the **Federal Register** for the same day (53 FR 6781).

On [\*4] April 1, 1992, temporary regulations (*T.D. 8404 [1992-1 C.B. 296]*) relating to both the deemed sale and deemed dividend elections under *section 1291 (d) (2) (A) and (B)*, were published in the **Federal Register** (57 FR 10992). A notice of proposed rulemaking (INTL-941-86; INTL-656-87; INTL-704-87 [1992-1 C.B. 1124]) cross-referencing the temporary regulations was published in the **Federal Register** for the same day (57 FR 11024).

Written comments responding to these notices were received. No public hearing was held for the notice of proposed rulemaking published on March 2, 1988. A public hearing was held November 23, 1992, for the notice of proposed rulemaking published April 1, 1992. After consideration of all the comments, the proposed regulations under *section 1291 (d) (2)* are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed. Substantive revisions are discussed below. All other revisions are stylistic, and are primarily intended to conform the regulations under 1.1291-10 to those under 1.1291-9.

## Explanation of Provisions and Revisions and Summary of Comments

### 1. Introduction

A shareholder of a foreign corporation that qualifies as [\*5] a PFIC under the income or asset test of *section 1296* is subject to the special interest charge regime of *section 1291* with respect to certain distributions by the PFIC and dispositions of the stock of the PFIC. Provided the PFIC complies with certain election requirements, a shareholder may elect under *section 1295* to treat the PFIC as a QEF. If the election is made, the shareholder is subject to the current inclusion regime of *section 1293*. If the shareholder makes the *section 1295* election for the first year of its holding period for the foreign corporation during which year the foreign corporation is a PFIC, the shareholder is only subject to PFIC taxation under the current inclusion regime. Such a PFIC is a *pedigreed QEF* with respect to the shareholder. However, if the shareholder makes the *section 1295* election for a later year, the shareholder is subject to both the interest charge regime of *section 1291* and the current inclusion regime of *section 1293*. Such a PFIC is an *unpedigreed QEF* with respect to the shareholder. To limit its PFIC taxation to the current inclusion regime of *section 1293*, a shareholder that makes the *section 1295* election may also make a *section 1291 (d) (2)* [\*6] election to purge its holding period of the years, or parts of years, before the effective date of the QEF election during which the foreign

corporation was a PFIC (nonQEF years). Thereafter, the PFIC will be treated as a pedigreed QEF with respect to the shareholder.

*Section 1291 (d) (2)* provides two methods to purge the nonQEF years from a shareholder's holding period of PFIC stock. A shareholder may elect under *section 1291 (d) (2) (A)* to be treated as having sold the stock of the PFIC. The gain on the deemed sale is subject to the interest charge regime and therefore taxed as an excess distribution under *section 1291*. Alternatively, if the PFIC is a controlled foreign corporation (CFC), any U.S. person that is a shareholder of the PFIC may elect under *section 1291 (d) (2) (B)* to be treated as receiving a dividend in the amount of its pro rata share of the post-1986 undistributed earnings and profits of the PFIC. The deemed dividend is taxed to the shareholder as an excess distribution under the interest charge regime. If either election is made, the shareholder's holding period is treated, for purposes of the PFIC rules, as beginning on the date of the deemed sale or dividend (qualification [\*7] date).

## 2. Revisions to the Regulations

*Section 1.1291-9* provides the rules for making the deemed dividend election under *section 1291 (d) (2) (B)* with respect to a PFIC that is a CFC. *Section 1.1291-10* provides the rules for making the deemed sale election under *section 1291 (d) (2) (A)*. The final regulations generally follow the proposed regulations with the exceptions described below.

### a. Qualification Date

The 1988 temporary regulations under 1.1291-10T provided that, in general, the date of the deemed sale, referred to as the qualification date, is the first day of the first taxable year of the corporation that it is treated as a QEF under *section 1295* (first QEF year). However, the temporary and proposed amendments to 1.1291-10T published in 1992 changed the qualification date for elections made after May 1, 1992, to the first day of the taxable year for which the shareholder made the QEF election (shareholder's election year). Similarly, under the temporary and proposed 1.1291-9 regulations, the qualification date is the first day of the shareholder's election year.

Commenters described a potential problem with the designation of the first day of the shareholder's election year [\*8] as the qualification date where the corporation and the shareholder have different taxable years. In this circumstance, the purging election would not avoid application of the interest charge regime to distributions and dispositions during the period between the first day of the corporation's first QEF year and the first day of the shareholder's election year.

In response to comments, the final regulations adopt the definition of qualification date used in the 1988 temporary regulations for purposes of both the deemed sale and deemed dividend elections made on or after January 27, 1997. For the period after March 31, 1995, to January 26, 1997, the final regulations adopt the definition of qualification date of the 1992 temporary regulations. In addition, the final regulations permit a shareholder that made the deemed sale or deemed dividend election after May 1, 1992 and on or before January 27, 1997, to amend its election and treat the deemed sale or deemed dividend as occurring on the first day of the PFIC's first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired.

In response [\*9] to comments, the final regulations also clarify that if the shareholder's holding period under *section 1223* includes the first day of the first QEF year, the shareholder will be treated as holding the stock on that date. Therefore, the shareholder may make a *section 1291 (d) (2)* election for the first QEF year.

### b. Elections made with respect to former PFICs

*Section 1.1291-9 (h)* of the proposed regulations provides that a shareholder cannot apply the deemed dividend rules of *section 1291 (d) (2) (B)* to purge PFIC taint, pursuant to *section 1297 (b) (1)*, from the stock of a foreign corporation that no longer is a PFIC under either the asset or income test of *section 1296 (a)*, but whose stock nevertheless is treated as stock of a PFIC with respect to a shareholder pursuant to *section 1297 (b) (1)* (former PFIC). In addition, the proposed regulations provide that the *section 1291 (d) (2) (B)* election cannot be made with respect to a corporation that will not qualify as a PFIC under *section 1296 (a) (1)* or *(2)* in the first QEF year.

Several commenters disagreed with the position taken in 1.1291-9 (h) of the proposed regulations. *Section 1.1291-9 (i) (1)* of the final regulations does not accept [\*10] these comments and adopts the rule of the proposed regulation denying application of the rules of *section 1291 (d) (2) (B)* for purposes of a *section 1297 (b) (1)* election. In

addition, *1.1291-9 (i) (2)* modifies the rule of proposed *regulation 1.1291-9 (h) (2)* to clarify that the section 1295 and 1291-(d) (2) (B) elections cannot be made with respect to a former PFIC. Section 1.1291-10 (h) of the final regulations adopts a similar rule, clarifying that shareholder of a former PFIC cannot make the section 1295 and 1291 (d)-(2) (A) elections. Thus, *section 1295* and *section 1291 (d) (2)* elections may only be made with respect to a foreign corporation that is a PFIC by definition under *section 1296*. Accordingly, the deemed sale election of *section 1297-(b) (1)* remains the only means by which a shareholder may purge a former PFIC of its PFIC taint.

#### c. Qualification as a CFC

The final regulations, in response to comments, clarify that a shareholder may make the deemed dividend election provided the PFIC qualifies as a CFC for its first QEF year.

#### d. Time for making the elections

In response to comments, the final regulations clarify the time for making the deemed sale and dividend elections. [\*11] The regulations provide that if the shareholder and the PFIC have the same taxable year, and therefore the first day of the shareholder's election year and the qualification date are the same, the shareholder may make the election in the same return in which it makes the *section 1295* election or in an amended return. The regulations also provide that if the shareholder and the PFIC have different taxable years and therefore the qualification date precedes the first day of the shareholder's election year, the shareholder must make the deemed sale or deemed dividend election in an amended return. If the shareholder is making the *section 1291 (d) (2)* election in an amended return, the amended return must be filed within three years of the due date, as extended under *section 6081*, for the return for the taxable year that includes the qualification date.

#### e. Post-1986 accumulated earnings and profits

The proposed regulations provide that the shareholder's old holding period for purposes of the PFIC rules ends on the qualification date, but also provide that its new holding period begins on the qualification date. These rules may have caused confusion concerning the last day of the holding [\*12] period for purposes of determining post-1986 accumulated earnings and profits. The final regulations revise the holding period rules to provide that the shareholder's holding period ends on the day before the qualification date for purposes of calculating the amount of the deemed dividend.

#### Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that *section 553 (b)* of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. These regulations, which have a retroactive effective date, satisfy the Administrative Procedure Act's requirement in *section 553 (d)* for good cause because they provide necessary guidance for the period after March 31, 1995, and because they are not detrimental to taxpayers. These regulations are necessary because they provide taxpayers with the rules needed to make the elections under *section 1291 (d) (2)*. [\*13] Pursuant to *section 7805 (f) of the Internal Revenue Code*, the notices of proposed rulemaking preceding these regulations were submitted to the Small Business Administration for comment on their impact on small business.

\* \* \*

26 CFR Part 602

Reporting and recordkeeping requirements.

#### Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

**PART 1-INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by removing the entry for section 1.1291-9T and the entry for sections 1.1291-10T, 1.1294-1T, 1.1295-1T, and 1.1297-3T, and by adding entries in numerical order to read as follows:

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

Section 1.1291-9 also issued under 26 U.S.C. 1291 (d) (2).

Section 1.1291-10 also issued under 26 U.S.C. 1291 (d) (2).

Section 1.1294-1T also issued under 26 U.S.C. 1294.

Section 1.1297-3T also issued under 26 U.S.C. 1297 (b) (1). \* \* \*

Par. 2. Section 1.1291-0 is added to read as follows:

**1.1291-0 Treatment of shareholders of certain passive foreign investment companies; table of contents.**

This section contains a listing of the headings for 1.1291-9 and 1.1291-10.

**1.1291-9 Deemed dividend election.**

(a) Deemed dividend election.

(1) [\*14] 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 8621

(e) Qualification date.

(1) In general.

(2) Elections made after March 31, 1995, and before January 27, 1997.

(i) In general.

(ii) Exception.

- (3) Examples.
- (f) Adjustment to basis.
- (g) Treatment of holding period.
- (h) Coordination with section 959 (e).
- (i) Election inapplicable to shareholder of former PFIC.
- (1) Coordination with *section 1297 (b) (1)*.
- (2) Former PFIC.
- (j) Definitions.
- (1) Passive foreign investment company (PFIC).
- (2) Types of PFICs.
- (i) Qualified electing fund (QEF).
- (ii) Pedigreed QEF.
- (iii) Unpedigreed QEF.
- (iv) Former PFIC.
- (3) Shareholder.
- (k) Effective date.

**1.1291-10 Deemed sale election.**

- (a) Deemed sale election.
- (b) Who may make the election.
- (c) Time for making the election.
- (d) Manner of making the election.
- (e) Qualification date.
- (1) In general.
- (2) Elections made after March 31, 1995, and before January 27, 1997.
- (i) In general.
- (ii) [\*15] Exception.
- (f) Adjustments to basis.
- (1) In general.
- (2) Adjustment to basis for section 1293 inclusion with respect to deemed sale election made after March 31, 1995, and before January 27, 1997.
- (g) Treatment of holding period.
- (h) Election inapplicable to shareholder of former PFIC.
- (i) Effective date.

**1.1291-0T [Amended]**

Par. 3. Section 1.1291-0T is amended as follows:

1. Remove from the introductory text the language "1.1291-9T, 1.1291-10T,".
2. Remove the entries for 1.1291-9T and 1.1291-10T from the table.

Par. 4. Section 1.1291-9 is added to read as follows:

**1.1291-9 Deemed dividend election.**

(a) *Deemed dividend election-(1) In general.* This section provides rules for making the election under section 1291 (d) (2) (B) (deemed dividend election). Under that section, a shareholder (as defined in paragraph (j) (3) of this section) of a PFIC that is an unpedigreed QEF may elect to include in income as a dividend the shareholder's pro rata share of the post-1986 earnings and profits of the PFIC attributable to the stock held on the qualification date (as defined in paragraph (e) of this section), provided the PFIC is a controlled foreign corporation (CFC) within the meaning of section 957 (a) [\*16] for the taxable year for which the shareholder elects under section 1295 to treat the PFIC as a QEF (section 1295 election). If the shareholder makes the deemed dividend election, the PFIC will become a pedigreed QEF with respect to the shareholder. The deemed dividend is taxed under section 1291 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 foreign corporation qualified as a PFIC. For purposes of the preceding sentence, the holding period of the PFIC stock with respect to which the election is made ends on the day before the qualification date. For the definitions of PFIC, QEF, unpedigreed QEF, and pedigreed QEF, see paragraph (j) (1) and (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 day before the qualification date, that were accumulated and not distributed in taxable years of the PFIC beginning [\*17] after 1986 and during which it was a PFIC, but without regard to whether the earnings relate to a period during which the PFIC 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 PFIC attributable to the stock held by the shareholder on the qualification date is the amount of post-1986 earnings and profits of the PFIC accumulated during any portion of the shareholder's holding period ending at the close of the day before the qualification date and attributable, under the principles of section 1248 and the regulations under that section, to the PFIC stock held 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 PFIC 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 PFIC stock [\*18] includes the period during which the stock was held by that other U.S. person.

(b) *Who may make the election.* A shareholder of an unpedigreed QEF that is a CFC for the taxable year of the PFIC for which the shareholder makes the section 1295 election may make the deemed dividend election provided the shareholder held stock of that PFIC on the qualification date. A shareholder is treated as holding stock of the PFIC on the qualification date if its holding period with respect to that stock under section 1223 includes the qualification date. A shareholder may make the deemed dividend election without regard to whether the 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 PFIC attributable to the PFIC stock held on the qualification date is zero.

(c) *Time for making the election.* The shareholder makes the deemed dividend election in the shareholder's return for the taxable year that includes the qualification date. If the shareholder and the PFIC have the same taxable year, the shareholder makes the deemed dividend election in either the [\*19] original return for the taxable year for which the shareholder makes the section 1295 election, or in an amended return for that year. If the shareholder and the PFIC have different taxable years, the deemed dividend election must be made in an amended return for the taxable year that includes the qualification date. If the deemed dividend election is made in an amended return, the amended return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original 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 filing Form 8621 and the attachment to Form 8621 described in paragraph (d) (2) of this section with the return for the taxable year of the shareholder that includes the qualification date, reporting the deemed dividend as an excess distribution pursuant to *section 1291 (a) (1)*, 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 [\*20] 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 PFIC that is treated as distributed to the shareholder on the qualification date 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 must include the following information:

- 1.
- 2.

1. The name, address, and taxpayer identification number of each U.S. person that previously included an amount in income, the amount previously included in income by each such U.S. person, the provision of the law pursuant to which the amount was previously



included in income, and the taxable year or years of inclusion of each amount; and

- 3.
- 4.
1. A description of the transaction pursuant to which the shareholder acquired, directly or indirectly, the stock of the PFIC from another U.S. person, and the provisions of law pursuant to which [\*21] the shareholder's holding period includes the period the other U.S. person held the CFC stock.

(e) *Qualification date*-(1) *In general*. Except as otherwise provided in this paragraph (e), the qualification date is the first day of the PFIC's first taxable year as a QEF (first QEF year).

(2) *Elections made after March 31, 1995, and before January 27, 1997*-(i) *In general*. The qualification date for deemed dividend elections made after March 31, 1995, and before January 27, 1997, is the first day of the shareholder's election year. The shareholder's election year is the taxable year of the shareholder for which it made the section 1295 election.

(ii) *Exception*. A shareholder who made the deemed dividend election after May 1, 1992, and before January 27, 1997, may elect to change its qualification date to the first day of the first QEF year, provided the periods of limitations on assessment for the taxable year that includes that date and for the shareholder's election year have not expired. A shareholder changes the qualification date by filing amended returns, with revised Forms 8621 and the attachments described in paragraph (d) (2) of this section, for the shareholder's election year and [\*22] the shareholder's taxable year that includes the first day of the first QEF year, and making all appropriate adjustments and payments.

(3) *Examples*. The rules of this paragraph (e) are illustrated by the following examples:

*Example 1*-(i) *Eligibility to make deemed dividend election*. A is a U.S. person who files its income tax return on a calendar year basis. On January 2, 1994, A purchased one percent of the stock of M, a PFIC with a taxable year ending November 30. M was both a CFC and a PFIC, but not a QEF, for all of its taxable years. On December 3, 1996, M made a distribution to its shareholders. A received \$100, all of which A reported in its 1996 return as an excess distribution as provided in *section 1291 (a) (1)*. A decides to make the *section 1295* election in A's 1997 taxable year to treat M as a QEF effective for M's taxable year beginning December 1, 1996. Because A did not make the *section 1295* election in 1994, the first year in its holding period of M stock that M qualified as a PFIC, M would be an unpedigreed QEF and A would be subject to both *sections 1291* and *1293*. A, however, may elect under *section 1291 (d) (2)* to purge the years M was not a QEF from A's holding period. [\*23] If A makes the *section 1291 (d) (2)* election, the December 3 distribution will not be taxable under *section 1291 (a)*. Because M is a CFC, even though A is not a U.S. shareholder within the meaning of *section 951 (b)*, A may make the deemed dividend election under *section 1291 (d) (2) (B)*.

(ii) *Making the election*. Under paragraph (e) (1) of this section, the qualification date, and therefore the date of the deemed dividend, is December 1, 1996. Accordingly, to make the deemed dividend election, A must file an amended return for 1996, and include the deemed dividend in

income in that year. As a result, M will be a pedigreed QEF as of December 1, 1996, and the December 3, 1996, distribution will not be taxable as an excess distribution. Therefore, in its amended return, A may report the December 3, 1996, distribution consistent with section 1293 and the general rules applicable to corporate distributions.

*Example 2.* X, a U.S. person, owned a five percent interest in the stock of FC, a PFIC with a taxable year ending June 30. X never made the section 1295 election with respect to FC. X transferred her interest in FC to her granddaughter, Y, a U.S. person, on February 14, 1996. The transfer [\*24] qualified as a gift for federal income tax purposes, and no gain was recognized on the transfer (see Regulation Project INTL-656-87, published in 1992-1 C.B. 1124; see 601.601 (d) (2) (ii) (b) of this chapter). As provided in section 1223 (2), Y's holding period includes the period that X held the FC stock. Y decides to make the section 1295 election in her 1996 return to treat FC as a QEF for its taxable year beginning July 1, 1995. However, because Y's holding period includes the period that X held the FC stock, and FC was a PFIC but not a QEF during that period, FC will be an unpedigreed QEF with respect to Y unless Y makes a section 1291 (d) (2) election. Although Y did not actually own the stock of FC on the qualification date (July 1, 1995), Y's holding period includes that date. Therefore, provided FC is a CFC for its taxable year beginning July 1, 1995, Y may make a section 1291 (d) (2) (B) election to treat FC as a pedigreed QEF.

(f) *Adjustment to basis.* A shareholder that makes the deemed dividend election increases its adjusted basis of the stock of the PFIC owned directly by the shareholder by the amount of the deemed dividend. If the shareholder makes the deemed dividend [\*25] election with respect to a PFIC 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 PFIC 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 shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of the deemed dividend.

(g) *Treatment of holding period.* 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 PFIC begins on the qualification date. For other purposes of the Code and regulations, this holding period rule does not apply.

(h) *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).

(i) *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 made under section 1297 (b) (1).

(2) [\*26] *Former PFIC.* A shareholder may not make the section 1295 and deemed dividend elections if the foreign corporation is a former PFIC (as defined in paragraph (j) (2) (iv) of this section) with respect to the shareholder. For the rules regarding the election by a shareholder of a former PFIC, see 1.1297-3T.

(j) *Definitions-(1) Passive foreign investment company (PFIC).* 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 when the shareholder, or a person whose holding period of the stock is included in the shareholder's holding period, was not a United States person within the meaning of section 7701 (a) (30).

(2) *Types of PFICs*-(i) *Qualified electing fund (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 [\*27] if the PFIC has been a QEF with respect to the shareholder for all taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock.

(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 during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock; and
- (C) The shareholder has not made an election under *section 1291 (d) (2)* and this section or 1.1291-10 with respect to the PFIC to purge the nonQEF years from the shareholder's holding period.

(iv) *Former PFIC*. A foreign corporation is a former PFIC with respect to a shareholder if the corporation satisfies neither the income test of *section 1296 (a) (1)* nor the asset test of *section 1296 (a) (2)*, but whose stock, held by that shareholder, is treated as stock of a PFIC, pursuant to *section 1297 (b) (1)*, because at any time during the shareholder's holding period of the stock the corporation was a PFIC that [\*28] was not a QEF.

(3) *Shareholder*. A shareholder is a U.S. person that is a direct or indirect shareholder as defined in Regulation Project INTL-656-87 published in *1992-1 C.B. 1124*; see 601.601 (d)-(2) (ii) (b) of this chapter.

(k) *Effective date*. The rules of this section are applicable as of April 1, 1995.

#### **1.1291-9T [Removed]**

Par. 5. Section 1.1291-9T is removed.

Par. 6. Section 1.1291-10 is added to read as follows:

#### **1.1291-10 Deemed sale election.**

(a) *Deemed sale election.* This section provides rules for making the election under *section 1291 (d) (2) (A)* (deemed sale election). Under that section, a shareholder (as defined in *1.1291-9 (j) (3)*) of a PFIC that is an unpedigreed QEF may elect to recognize gain with respect to the stock of the unpedigreed QEF held on the qualification date (as defined in paragraph (e) of this section). If the shareholder makes the deemed sale election, the PFIC will become a pedigreed QEF with respect to the shareholder. A shareholder that makes the deemed sale election is treated as having sold, for its fair market value, the stock of the PFIC that the shareholder held on the qualification date. The gain recognized on the deemed sale is taxed under *section 1291* [\*29] as an excess distribution received on the qualification date. In the case of an election made by an indirect shareholder, the amount of gain to be recognized and taxed as an excess distribution is the amount of gain that the direct owner of the stock of the PFIC would have realized on an actual sale or other disposition of the stock of the PFIC indirectly owned by the shareholder. Any loss realized on the deemed sale is not recognized. For the definitions of PFIC, QEF, unpedigreed QEF, and pedigreed QEF, see *1.1291-9 (j) (1)* and (2).

(b) *Who may make the election.* A shareholder of an unpedigreed QEF may make the deemed sale election provided the shareholder held stock of that PFIC on the qualification date. A shareholder is treated as holding stock of the PFIC on the qualification date if its holding period with respect to that stock under *section 1223* includes the qualification date. A deemed sale election may be made by a shareholder that would realize a loss on the deemed sale.

(c) *Time for making the election.* The shareholder makes the deemed sale election in the shareholder's return for the taxable year that includes the qualification date. If the shareholder and the PFIC have [\*30] the same taxable year, the shareholder makes the deemed sale election in either the original return for the taxable year for which the shareholder makes the *section 1295* election, or in an amended return for that year. If the shareholder and the PFIC have different taxable years, the deemed sale election must be made in an amended return for the taxable year that includes the qualification date. If the deemed sale election is made in an amended return, the amended return must be filed by a date that is within three years of the due date, as extended under *section 6081*, of the original return for the taxable year that includes the qualification date.

(d) *Manner of making the election.* A shareholder makes the deemed sale election by filing Form 8621 with the return for the taxable year of the shareholder that includes the qualification date, reporting the gain as an excess distribution pursuant to *section 1291 (a)*, and paying the tax and interest due on the excess distribution. A shareholder that makes the deemed sale 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, [\*31] pursuant to *section 6601*, on the amount of the underpayment of tax for that year. A shareholder that realizes a loss on the deemed sale reports the loss on Form 8621, but does not recognize the loss.

(e) *Qualification date-(1) In general.* Except as otherwise provided in this paragraph (e), the qualification date is the first day of the PFIC's first taxable year as a QEF (first QEF year).

(2) *Elections made after March 31, 1995, and before January 27, 1997-* (i) *In general.* The qualification date for deemed sale elections made after March 31, 1995, and before January 27, 1997, is the first day of the shareholder's election year. The shareholder's election year is the taxable year of the shareholder for which it made the *section 1295* election.

(ii) *Exception.* A shareholder who made the deemed sale election after May 1, 1992, and before January 27, 1997, may elect to change its qualification date to the first day of the first QEF year, provided the periods of limitations on assessment for the taxable year

that includes that date and for the shareholder's election year have not expired. A shareholder changes the qualification date by filing amended returns, with revised Forms 8621, for the [\*32] shareholder's election year and the shareholder's taxable year that includes the first day of the first QEF year, and making all appropriate adjustments and payments.

(f) *Adjustments to basis-(1) In general.* A shareholder that makes the deemed sale election increases its adjusted basis of the PFIC stock owned directly by the amount of gain recognized on the deemed sale. If the shareholder makes the deemed sale election with respect to a PFIC 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 PFIC 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 shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of gain recognized on the deemed sale. A shareholder shall not adjust the basis of any stock with respect to which the shareholder realized a loss on the deemed sale.

(2) *Adjustment of basis for section 1293 inclusion with respect to deemed sale* [\*33] *election made after March 31, 1995, and before January 27, 1997.* For purposes of determining the amount of gain recognized with respect to a deemed sale election made after March 31, 1995, and before January 27, 1997, by a shareholder that treats the first day of the shareholder's election year as the qualification date, the adjusted basis of the stock deemed sold includes the shareholder's section 1293 (a) inclusion attributable to the period beginning with the first day of the PFIC's first QEF year and ending on the day before the qualification date.

(g) *Treatment of holding period.* For purposes of applying sections 1291 through 1297 to the shareholder after the deemed sale, the shareholder's holding period of the stock of the PFIC begins on the qualification date, without regard to whether the shareholder recognized gain on the deemed sale. For other purposes of the Code and regulations, this holding period rule does not apply.

(h) *Election inapplicable to shareholder of former PFIC.* A shareholder may not make the section 1295 and deemed sale elections if the foreign corporation is a former PFIC (as defined in 1.1291-9 (j) (2) (iv)) with respect to the shareholder. For the rules [\*34] regarding the election by a shareholder of a former PFIC, see 1.1297-3T.

(i) *Effective date.* The rules of this section are applicable as of April 1, 1995.

#### **1.1291-10T [Removed]**

Par. 7. Section 1.1291-10T is removed.

#### **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.

**602.101 [Amended]**

Par. 9. In 602.101, paragraph (c) is amended by removing the entries for 1.1291-9T and 1.1291-10T from the table and adding entries in numerical order to the table to read as follows:

**602.101 OMB Control numbers.**

\* \* \*

(c) \* \* \*

CFR part or section where identified and described.	Current OMB control No
	* * *
1 1291 9	1545-1507
1.1291-10	1545-1507
	* * *

Margaret Milner Richardson,  
*Commissioner of Internal Revenue.*  
Approved December 12, 1996.  
Donald C. Lubick,  
*Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on December 26, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 27, 1996, 61 F.R. 68149)