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Reg. Section 1.1296-1(c)(3)

Mark to market election for marketable stock

(a) Definitions.

(1) Eligible RIC. An eligible RIC is a regulated investment company that offers for sale, or has outstanding, any stock of which it is the issuer and which is redeemable at net asset value, or that publishes net asset valuations at least annually.

(2) Section 1296 stock. The term section 1296 stock means marketable stock in a passive foreign investment company (PFIC), including any PFIC stock owned directly or indirectly by an eligible RIC, for which there is a valid section 1296 election. Section 1296 stock does not include stock of a foreign corporation that previously had been a PFIC, and for which a section 1296 election remains in effect.

(3) Unreversed inclusions.

(i) General rule. The term unreversed inclusions means with respect to any section 1296 stock, the excess, if any, of-

(A) The amount of mark to market gain included in gross income of the United States person under paragraph (c)(1) of this section with respect to such stock for prior taxable years; over

(B) The amount allowed as a deduction to the United States person under paragraph (c)(3) of this section with respect to such stock for prior taxable years.

(ii) Section 1291 adjustment. The amount referred to in paragraph (a)(3)(i)(A) of this section shall include any amount subject to section 1291 under the coordination rule of paragraph (i)(2)(ii) of this section.

(iii) Example. An example of the computation of unreversed inclusions is as follows:

Example. A, a United States person, acquired stock in Corp X, a foreign corporation, on January 1, 2005 for $150. At such time and at all times thereafter, Corp X was a PFIC and A's stock in Corp X was marketable. For taxable years 2005 and 2006, Corp X was a nonqualified fund subject to taxation under section 1291. A made a timely section 1296 election with respect to the X stock, effective for taxable year 2007. The fair market value of the X stock was $200 as of December 31, 2006, and $240 as of December 31, 2007. Additionally, Corp X made no distribution with respect to its stock for the taxable years at issue. In 2007, pursuant to paragraph (i)(2)(ii) of this section, A must include the $90 gain in the X stock in accordance with the rules of section 1291 for purposes of determining the deferred tax amount and any applicable interest. Nonetheless, for purposes of determining the amount of the unreversed inclusions pursuant to paragraph (a)(3)(ii) of this section, A will include the $90 of gain that was taxed under section 1291 and not the interest thereon.

(iv) Special rule for regulated investment companies. In the case of a regulated investment company which had elected to mark to market the PFIC stock held by such company as of the last day of the taxable year preceding such company's first taxable year for which such company makes a section 1296 election, the amount referred to in paragraph (a)(3)(i)(A) of this section shall include amounts previously included in gross income by the company pursuant to such mark to market election with respect to such stock for prior taxable years. For further guidance, see Notice 92-53 (1992-2 C.B. 384) (see also 601.601(d)(2) of this chapter).

(b) Application of section 1296 election.

(1) In general. Any United States person and any controlled foreign corporation (CFC) that owns directly, or is treated as owning under this section, marketable stock, as defined in §1.1296-2, in a PFIC may make an election to mark to market such stock in accordance with the provisions of section 1296 and this section.

(2) Election applicable to specific United States person. A section 1296 election applies only to the United States person (or CFC that is treated as a U.S. person under paragraph (g)(2) of this section) that makes the election. Accordingly, a United States person's section 1296 election will not apply to a transferee of section 1296 stock.

(3) Election applicable to specific corporation only. A section 1296 election is made with respect to a single foreign corporation, and thus a separate section 1296 election must be made for each foreign corporation that otherwise meets the requirements of this section. A United States person's section 1296 election with respect to stock in a foreign corporation applies to all marketable stock of the corporation that the person owns directly, or is treated as owning under paragraph (e) of this section, at the time of the election or that is subsequently acquired.

(c) Effect of election.

(1) Recognition of gain. If the fair market value of section 1296 stock on the last day of the United States person's taxable year exceeds its adjusted basis, the United States person shall include in gross income for its taxable year the excess of the fair market value of such stock over its adjusted basis (mark to market gain).

(2) Character of gain. Mark to market gain, and any gain on the sale or other disposition of section 1296 stock, shall be treated as ordinary income.

(3) Recognition of loss. If the adjusted basis of section 1296 stock exceeds its fair market value on the last day of the United States person's taxable year, such person shall be allowed a deduction for such taxable year equal to the lesser of the amount of such excess or the unreversed inclusions with respect to such stock (mark to market loss).

(4) Character of loss.

(i) Losses not in excess of unreversed inclusions. Any mark to market loss allowed as a deduction under paragraph (c)(3) of this section, and any loss on the sale or other disposition of section 1296 stock, to the extent that such loss does not exceed the unreversed inclusions attributable to such stock, shall be treated as an ordinary loss, deductible in computing adjusted gross income.

(ii) Losses in excess of unreversed inclusions. Any loss recognized on the sale or other disposition of section 1296 stock in excess of any prior unreversed inclusions will be subject to the rules generally applicable to losses provided elsewhere in the Internal Revenue Code and the regulations thereunder.

(5) Application of election to separate lots of stock. In the case in which a United States person purchased or acquired shares of stock in a PFIC at different prices, the rules of this section shall be applied in a manner consistent with the rules of §1.1012-1.

(6) Source rules. The source of any amount included in gross income under paragraph (c)(1) of this section, or the allocation and apportionment of any amount allowed as a deduction under paragraph (c)(3) of this section, shall be determined in the same manner as if such amounts were gain or loss (as the case may be) from the sale of stock in the PFIC.

(7) Examples. The following examples illustrate this paragraph (c):
Example (1). Treatment of gain as ordinary income. A, a United States individual, purchases stock in FX, a foreign corporation that is not a PFIC, in 1990 for $1,000. On January 1, 2005, when the fair market value of the FX stock is $1,100, FX becomes a PFIC. A makes a timely section 1296 election for taxable year 2005. On December 31, 2005, the fair market value of the FX stock is $1,200. For taxable year 2005, A includes $200 of mark to market gain (the excess of the fair market value of FX stock ($1,200) over A's adjusted basis ($1,000)) in gross income as ordinary income and pursuant to paragraph (d)(1) of this section increases his basis in the FX stock by that amount.

Example (2). Treatment of gain as capital gain. The facts are the same as in Example 1. For taxable year 2006, FX does not satisfy either the asset test or the income test of section 1297(a). A does not revoke the section 1296 election it made with respect to the FX stock. On December 1, 2006, A sells the FX stock when the fair market value of the stock is $1,500. For taxable year 2006, A includes $300 of gain (the excess of the fair market value of FX stock ($1,500) over A's adjusted basis ($1,200)) in gross income as long-term capital gain because at the time of sale of the FX stock by A, FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period for non-PFIC purposes was more than one year.

Example (3). Treatment of losses as ordinary where they do not exceed unreversed inclusions. The facts are the same as in Example 1. On December 1, 2006, A sells the stock in FX for $1,100. At that time, A's unreversed inclusions (the amount A included in income as mark to market gain) with respect to the stock in FX are $200. Accordingly, for taxable year 2006, A recognizes a loss on the sale of the FX stock of $100, (the fair market value of the FX stock ($1,100) minus A's adjusted basis ($1,200) in the stock) that is treated as an ordinary loss because the loss does not exceed the unreversed inclusions attributable to the stock of FX.

Example (4). Treatment of losses as long-term capital losses. The facts are the same as in Example 3, except that FX does not satisfy either the asset test or the income test of section 1297(a) for taxable year 2006. For taxable year 2006, A's $100 loss from the sale of the FX stock is treated as long-term capital loss because at the time of the sale of the FX stock by A FX did not qualify as a PFIC, and, therefore, the FX stock was not section 1296 stock at the time of the disposition. Further, A's holding period in the FX stock for non-PFIC purposes was more than one year.

Example (5). Long-term capital loss treatment of losses in excess of unreversed inclusions. The facts are the same as in Example 3, except that A sells his FX stock for $900. At the time of A's sale of the FX stock on December 1, 2006, A's unreversed inclusions with respect to the FX stock are $200. Accordingly, the $300 loss recognized by A on the disposition is treated as an ordinary loss to the extent of his unreversed inclusions ($200). The amount of the loss in excess of A's unreversed inclusions ($100) will be treated as a long-term capital loss because A's holding period in the FC stock for non-PFIC purposes was more than one year.

Example (6). Application of section 1296 election to separate lots of stock. On January 1, 2005, Corp A, a domestic corporation, purchased 100 shares (first lot) of stock in FX, a PFIC, for $500 ($5 per share). On June 1, 2005, Corp A purchased 100 shares (second lot) of FX stock for $1,000 ($10 per share). Corp A made a timely section 1296 election with respect to its FX stock for taxable year 2005. On December 31, 2005, the fair market value of FX stock was $8 per share. For taxable year 2005, Corp A includes $300 of gain in gross income as ordinary income under paragraph (c)(1) of this section with respect to the first lot, and adjusts its basis in that lot to $800 pursuant to paragraph (d)(1) of this section. With respect to the second lot, Corp A is not permitted to recognize a loss under paragraph (c)(3) of this section for taxable year 2005. Although Corp A's adjusted basis in that stock exceeds its fair market value by $200, Corp A has no unreversed inclusions with respect to that particular lot of stock. On July 1, 2006, Corp A sells 100 shares of FX stock for $900. Assuming that Corp A adequately identifies (in accordance with the rules of §1.1012-1(c)) the shares of FX stock sold as being from the second lot, Corp A recognizes $100 of long term capital loss pursuant to paragraph (c)(4)(ii) of this section.

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