Internal Revenue Service

Department of the Treasury

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Taxpayer =
X corporation =

Y corporation =

Z corporation =

This is in reply to your letter of November 5, 1998. On behalf of Taxpayer you have requested rulings on the application of the reduction in basis rules of §§ 1291(e) and 1246(e) of the Internal Revenue Code to stock in a passive foreign investment company (PFIC) for which the taxpayer has made elections under §§ 1291(d)(2)(B) and 1295.

FACTS

Taxpayer, a U.S. citizen, currently owns 100 percent of X corporation which in turn owns 100 percent of the stock of Y corporation. X corporation was created for the sole purpose of holding the stock of Y corporation. In addition, Taxpayer currently owns 70 percent of the stock of Z corporation (the remaining 30 percent is owned by Taxpayer's late husband's estate).

Throughout Taxpayer's late husband's life, the only activities of Y corporation and Z corporation were: purchasing, holding and renewing bank term deposits and certificates of deposit; purchasing holding and selling or redeeming stocks or bonds;

and holding gold coins and silver bars for safekeeping. Since its creation X corporation has been a holding company whose only asset has been the stock of Y corporation.

Y corporation, and Z corporation have been PFICs , as defined in § 1297(a) since the PFIC rules became effective on January 1, 1987. X corporation has been a PFIC since its creation in 1994. In addition all three corporations have always been, and continue to be, controlled foreign corporations (CFCs), as defined in § 957.

Taxpayer elected under § 1295(b) to treat her stock in Y corporation and Z corporation, effective beginning January 1, 1996, and in X corporation, effective beginning on January 1, 1997, as stock in a qualified electing fund (QEF). In addition, taxpayer elected under § 1291(d)(2)(B) to treat, as a deemed dividend received on January 1, 1996, her pro rata share of the post-1986 earnings and profits of Y corporation and Z corporation accumulated during her holding period when those corporations were PFICs. Taxpayer made the same § 1291(d)(2)(B) election with respect to X corporation effective on January 1, 1997. Taxpayer represents that she will not revoke the QEF elections with respect to X corporation, Y corporation, or Z corporation during her lifetime.

RULINGS REQUESTED

1. Taxpayer requests a ruling that the reduction in basis rule of § 1291(e) will not preclude a step-up in basis at Taxpayer's death with respect to stock in X corporation or Z corporation.

2. Taxpayer also requests a ruling that the reduction in basis rule of § 1246(e)(1) will not preclude a step-up in basis with respect to stock in X corporation or Z corporation because none of the three corporations was a foreign investment company (FIC) as defined in § 1246(b).

LAW

Section 1296 provides that a foreign corporation is a PFIC if (1) 75 percent or more of the gross income of the corporation for the taxable year is passive income, or (2) the average percentage of assets (by value) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.

Under § 1291, U.S. persons who are direct and indirect shareholders of PFICs are subject to a special tax and interest charge for certain distributions made by the PFIC and upon disposition of their PFIC stock.

If the shareholder elects to treat the PFIC as a QEF under § 1295, the shareholder will be subject to the current inclusion rules of § 1293. Under that section, the shareholder annually includes in gross income its pro rata share of the ordinary earnings and net capital gain of the QEF, whether or not distributed. If a shareholder does not elect to treat the PFIC as a QEF, then the PFIC is a nonqualified fund with regard to the shareholder and is subject to the special tax and interest charge provisions of § 1291.

Section 1291 will not apply to certain distributions and dispositions of PFIC stock if a shareholder makes a QEF election for the first year in its holding period that the corporation qualifies as a PFIC. Section 1291(d)(1). However, if the shareholder makes the QEF election after the first year in its holding period that the corporation qualifies as a PFIC, then the PFIC remains a nonqualified fund as well as a QEF with regard to the shareholder. Therefore, both § 1291 and § 1293 apply to the shareholder's PFIC stock.

A shareholder may purge its PFIC stock of its taint as a nonqualified fund by making an election under § 1291(d)(2). Under § 1291(d)(2)(A), the shareholder elects to treat the stock as sold on the first day of the taxpayer's taxable year to which the § 1295 (QEF) election applies. The shareholder must make the election in the first taxable year to which the QEF election applies. Section 1291(a) taxes the gain recognized on the deemed sale as an excess distribution.

However, the shareholder of a PFIC that is also a CFC may purge its stock of the nonqualified fund taint by making the deemed dividend election under § 1291(d)(2)(B). The Code treats the electing shareholder as receiving a dividend in the amount of the shareholder's pro rata share of the post 1986 earnings and profits of the CFC accumulated during the shareholder's holding period when the corporation was a nonqualified fund. Section 1291(a) taxes the deemed dividend as an excess distribution received on the first day of the shareholder's taxable year to which the QEF election applies.

Section 1291(d)(2)(C) treats the holding period of a shareholder electing under either § 1291(d)(2)(A) or 1291(d)(2)(B) as beginning on the first day of the taxable year for which the shareholder made the QEF election. Consequently, the election purges from the shareholder's holding period all years to which the QEF election did not apply. Thereafter, the PFIC will be treated as a QEF, and not as a nonqualified fund with regard to the shareholder, and the shareholder will be subject to taxation only under § 1293.

Section 1291(e) generally incorporates the foreign investment company rules of § 1246(c), (d), (e) and (f). Under § 1246(e)(1), the basis of stock of a FIC, as

determined under § 1014, acquired by bequest, devise, or inheritance (or by the decedent's estate) from a decedent dying after December 31, 1962 is reduced (but not below the adjusted basis of such stock in the hands of the decedent immediately before the decedent's death) by the amount of the decedent's ratable share of the earnings and profits of such company accumulated after December 31, 1962.

Section 1291(e) modifies the reduction to basis rule in § 1246(e)(1), providing that the reduction is the excess of the basis determined under § 1014 over the adjusted basis of the stock immediately before the decedent's death. In effect, § 1291(e) denies to stock in a PFIC acquired by a beneficiary a step-up in basis which would otherwise be permitted under § 1014.

It is not clear from the statute whether Taxpayer will be subject to § 1291(e) after Taxpayer makes the QEF and deemed dividend elections. However, legislative material prepared at the time of enactment of the Tax Reform Act of 1986 (Pub. L. No. 99-514, 100 Stat. 2085) indicates that Congress intended § 1291(e) to apply only to shareholders of nonqualified funds. According to the General Explanation of the Tax Reform Act of 1986, prepared by the Staff of the Joint Committee on Taxation, "[t]he Act generally incorporates the anti-avoidance rules in present and prior law section 1246 (relating to foreign investment companies) and applies these rules to U.S. persons who hold stock in nonqualified funds. Among other things, these rules ... deny a basis step-up for PFIC stock acquired from a decedent (other than from a foreign decedent)." 100th Cong. 1st Sess. (1987) at 1028.

Because Taxpayer has made the elections under § 1295 and § 1291(d)(2)(B), Taxpayer will not be treated as a shareholder of a nonqualified fund. Accordingly, § 1291(e) will not apply to Taxpayer's X corporation and Z corporation stock in the taxable year for which Taxpayer made the indicated elections, and it will not apply in subsequent taxable years provided Taxpayer's § 1295 election is not terminated, invalidated or revoked.

Congress added § 1297(e) to the Code as part of the Taxpayer Relief Act of 1997, (Pub. L. No. 105-34, 111 Stat. 788). Section 1297(e)(1) provides that for purposes of the PFIC provisions a corporation will not be treated as a PFIC with respect to a shareholder during the qualified portion of the shareholders holding period with respect to stock in such corporation. Section 1297(e)(2) defines the "qualified portion" of the shareholder's holding period as the portion of the shareholder's holding period which is after December 31, 1997 and during which the shareholder is a United States shareholder (as defined in section 951(b)) of the corporation and the corporation is a CFC. The effect of these provisions is to generally eliminate the overlap between subpart F and the PFIC provisions by treating a PFIC that is also a CFC as not a PFIC

with respect to certain 10 percent shareholders. No provision of subpart F denies a step-up in basis at a shareholder's death.

Taxpayer has represented that she is, and will continue to be, a United States shareholder with respect to both X corporation and Z corporation and that both corporations will continue to be CFC's until Taxpayer's death. Therefore, pursuant to § 1297(e), neither X corporation nor Z corporation will be treated as PFICs with respect to Taxpayer at her death and, consequently, § 1291(e) will not apply.

Under § 1.1295-1T(c)(2)(ii), although neither X corporation nor Z corporation will be treated as QEFs for any of their taxable years that they are not PFICs under § 1296(a) and are not treated as PFICs under § 1297(b)(1), cessation of either corporations' status as a PFIC will not terminate a § 1295 election.

Section 7.01 of Rev. Proc. 98-1, 1998-1 I.R.B. 23, provides that the national office ordinarily will not issue letter rulings in certain areas because of the factual nature of the problem involved or because of other reasons. Rev. Proc. 98-3, 1998-1 I.R.B. 100, provides a list of these areas. This list is not all-inclusive because the Service may decline to issue a letter ruling when appropriate in the interest of sound tax administration or on other grounds whenever warranted by the facts or circumstances of a particular case. Section 4.02(1) of Rev. Proc. 98-3 states that the Service will not ordinarily issue letter rulings in any matter in which the determination requested is primarily one of fact.

You asked us to rule on whether § 1246(e)(1) will preclude a step up in basis with respect to the stock in X corporation and Z corporation. That ruling request requires a determination of whether the companies' were engaged primarily in the business of investing, reinvesting or trading in securities for U.S. income tax purposes and thus whether the companies are FICs as defined in § 1246. Because the question of whether investment activities constitute a "business" for U.S. income tax purposes is a question of fact the Service is unable to issue the requested ruling.

Based solely on the information and representations submitted, Taxpayer will not be treated as a shareholder of a nonqualified fund. Therefore, § 1291(e) will not apply to Taxpayer's X corporation or Z corporation stock.

No opinion is expressed concerning whether X corporation, Y corporation or Z corporation are FICs under § 1246 because this is a factual determination. No opinion was requested, and none is expressed, concerning Corp X's qualification as a PFIC under § 1296 in any year. No opinion was requested, and none is expressed, concerning whether X corporation, Y corporation or Z corporation are foreign personal holding companies (FPHCs) under § 551. Finally, no opinion is expressed about the

tax treatment of the transaction under other provisions of the Code and regulations or about the tax treatment of any conditions existing at the time of, or effects resulting from, the transactions that are not specifically covered by the above ruling.

A copy of this letter must be attached to any income tax return to which it is relevant.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(j)(3) provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to the taxpayer.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Philip L. Garlett

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(International)