

and other documents necessary for the shareholder to calculate the amounts of ordinary earnings and net capital gain.

Notice 88-125 provides that a domestic partnership makes the section 1295 election rather than each individual partner that is an indirect shareholder of the PFIC by reason of the partner's interest in the partnership. The notice also provides that an S corporation makes the section 1295 election. This entity-level election in the case of domestic partnerships and S corporations reflects the view that multiple elections by the partners or S corporation shareholders would be more burdensome than the single entity-level election. The temporary regulations adopt the rules of the notice with respect to elections by domestic pass through entities, clarifying that the section 1295 election with respect to stock owned directly or indirectly by a domestic trust or estate generally is also made at the entity level. The temporary regulations also adopt the rules of the notice with respect to interests held by foreign pass through entities. Interest holder in foreign partnerships, trusts, and estates must make the section 1295 election with respect to their indirect interests in PFICs held through those entities; foreign entities may not make the section 1295 election.

Partnerships, S corporations, trusts, and estates are referred to as pass through entities in the temporary regulations. The regulations clarify that an election made by a domestic pass through entity is made in the pass through entity's capacity as a shareholder, as specially defined in temporary regulation § 1.1295-1T(j) for purposes of the section 1295 election provisions. Thus, the domestic pass through entity takes the section 1293 inclusion into account in its return for the year in which or with which the PFIC's taxable year ends, and the interest holders in the pass through entity take the section 1293 inclusion into account under the rules applicable to inclusions of income from the pass through entity. In addition, the temporary regulations clarify that if an interest holder in a domestic pass through entity transfers stock of a PFIC subject to a section 1295 election to the pass through entity, the section 1295 election continues to apply to the interest holder whether or not the pass through entity makes the section 1295 election.

Similarly, the temporary regulations clarify the effect of the termination under section 708(b) of a partnership on a section 1295 election made by the partnership. Section 1.1295-1T(b)(3)(iii) provides that, notwithstanding the

termination of section 1295 election when a partnership terminates, the partners of the former partnership that are partners of the new partnership are bound by the section 1295 election made by the former partnership whether or not the new partnership makes a section 1295 election.

Notice 88-125 does not provide any special rules concerning tax-exempt entities. As provided in proposed regulations under section 1291 (see Regulation Project INTL-656-87, published at 1992-1 C.B. 1124), section 1291 and the regulations under section 1291 apply to a tax-exempt organization that is a shareholder of a PFIC that is not a pedigreed QEF, within the meaning of § 1.1291-9(j)(2)(ii), only if a dividend from the PFIC would be taxable to the organization under subchapter F. Section 1.1291-1T(e) of these temporary regulations provides the same rule. To prevent such a tax-exempt organization from being subject to an unnecessary section 1295 election that may have adverse consequences to the tax-exempt entity (e.g., an excise tax on gross investment income of a private foundation that arises as a consequence of a section 1295 election), the temporary regulations provide a rule that precludes a tax-exempt entity that is not taxable with respect to dividends from a PFIC from making a section 1295 election with respect to that PFIC or from being subject to a pass through entity level election.

Commenters indicated that Notice 88-125 is unclear about which taxable year of the PFIC is the first taxable year to which the section 1295 election applies. Temporary regulation § 1.1295-1T(c)(2) clarifies that the section 1295 election is effective with respect to the taxable year of the foreign corporation that ends during the shareholder's election year. Because certain shareholders may have misinterpreted Notice 88-125, the Commissioner will respect a section 1295 election made prior to February 2, 1998 that was intended to be effective for the taxable year of the PFIC that began during the shareholder's election year provided that it is clear from all the facts and circumstances that the shareholder intended the election to be effective for that taxable year of the foreign corporation. For example, a calendar year shareholder that made the section 1295 election in its 1995 return with respect to a foreign corporation whose taxable year began in 1995 and ended in 1996, with the intention that the election first apply to the foreign corporation's taxable year ended in 1996, will be treated as having made a valid section 1295 election with respect to that year.

2. Additional Clarifications

A. Options

Options with respect to PFIC stock present unique problems under section 1295. Section 1297(a)(4) provides that, under regulations, an option to acquire stock may be treated as ownership of stock.

Proposed regulations under section 1291 (see Regulation Project INTL-656-87, published in 1992-1 C.B. 1124) provide that options are treated like stock for purposes of section 1291. Under proposed regulation § 1.1291-1(d), an option is considered to be stock of a PFIC that is not a pedigreed QEF for purposes of applying section 1291 to a disposition of the option, unless the holder of the actual stock which is subject to the option is currently including income from the stock under section 1293. Under proposed regulation § 1.1291-1(h)(3), the holding period of stock acquired upon exercise of an option treated as stock under § 1.1291-1(d) includes the period the option was held. These rules recognize that the value of an option is linked to the value of the underlying stock and therefore such an option should be subject to the PFIC rules.

Because of the potential for application of section 1291 to options or stock acquired upon exercise of options, some option holders have requested that regulations provide rules for making a section 1295 election with respect to an option. Application of a section 1295 election and the section 1293 current inclusion regime to options would present serious computational issues and would be administratively burdensome. Therefore, the temporary regulations continue the rule that any shareholder's section 1295 election with respect to stock of a PFIC does not apply to options to acquire stock of the PFIC and that an option holder may not make a section 1295 election with respect to the optioned stock. Accordingly, if a shareholder of stock subject to a section 1295 election exercises an option to purchase additional shares of stock of that PFIC, the stock received will be subject to the section 1295 election made by the shareholder, but, because of the rules of proposed regulation § 1.1291-1(h)(3), the stock may be treated as stock of an unpedigreed QEF.

Comments are requested concerning the option rule. In particular, comments are requested that identify any administratively feasible mechanisms that would permit a shareholder to make a section 1295 election that will apply to options.