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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Marking to Market Trade Receivables; I.R.C. § 475

This Field Service Advice responds to your memorandum dated July 2, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

<u>Taxpayer</u>	=
<u>State</u>	=
<u>Date 1</u>	=
<u>Date 2</u>	=
<u>Date 3</u>	=
<u>Date 4</u>	=
<u>Date 5</u>	=
<u>Year 1</u>	=
<u>Year 2</u>	=
<u>Year 3</u>	=
<u>X</u>	=
<u>Y</u>	=

ISSUES:

1. Whether Taxpayer is treated as a dealer in securities for purposes of I.R.C. § 475.
2. Whether Taxpayer's trade receivables are securities for purposes of section 475.

3. Whether Taxpayer is entitled to mark to market its trade receivables under section 475 for its Year 1 and Year 2 tax years.

CONCLUSIONS:



FACTS:

The facts are taken from your request for Field Service Advice and the materials submitted therewith. Taxpayer designs, manufactures and rents a line of specialized beds. The main manufacturing facility and the corporate headquarters are based in State. Taxpayer also manufactures and distributes specialized therapeutic surfaces and rents medical equipment to health care providers worldwide.

A notice of deficiency was issued to Taxpayer on Date 1 proposing adjustments to income for Year 1 and Year 2. Taxpayer did not request a change in accounting method with respect to trade receivables during the audit of its Year 1 and Year 2 tax years, nor did the agent address section 475 issues. Subsequently, however, Taxpayer filed Forms 1120X, Amended U.S. Corporation Income Tax Return, for its Year 1 and Year 2 tax years on Date 2 and Date 3, respectively. Attached to the amended return for Year 1 were executed Forms 3115, Application for Change in Accounting Method.

In the Form 3115 applications, Taxpayer requested permission to automatically change its method of accounting for securities for its subsidiaries pursuant to Rev. Proc. 97-43, 1997-2 C.B. 494. Taxpayer elected out of the customer paper exception in accordance with Treas. Reg. § 1.475(c)-1(b)(4) and Rev. Proc. 97-43, § 4.02. Taxpayer also elected out of the negligible sales exception in accordance with Treas. Reg. § 1.475(c)-1(c)(1)(ii) and Rev. Proc. 97-43, § 4.03. As a result, Taxpayer requested that its subsidiaries be treated as dealers in securities as defined by section 475(c)(1) and to mark its securities to market in accordance with section 475. Taxpayer used a special identification regime under Holding 15 of Rev. Rul. 97-39, 1997-2 C.B. 62, to identify trade receivables acquired before the date of election as transition securities.

Taxpayer filed a petition for redetermination with the Tax Court on Date 4 and affirmatively raised its election to change its method of accounting for marketable securities pursuant to section 475 effective for its Year 1 and Year 2 tax years. The election resulted in additional deductions for its Year 1 tax year in the amount of \$ X and an increase in income for its Year 2 tax year in the amount of \$ Y.

LAW AND ANALYSIS:

Section 475 generally requires a dealer in securities to account for its securities on a mark-to-market method of accounting. Section 475(a). Section 475(c)(1) defines a “dealer in securities” as a taxpayer who either: (1) regularly purchases securities from or sells securities to customers in the ordinary course of its trade or business; or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. The term security includes a note, bond, debenture, or other evidence of indebtedness. Section 475(c)(2)(C).

Treas. Reg. § 1.475(c)-1(b) generally excludes from the dealer definition a taxpayer who would not be a dealer in securities but for its purchase and sale of debt instruments that are customer paper. A debt instrument is customer paper with respect to a person at a point in time if: (1) the person's principal activity is selling nonfinancial goods or providing nonfinancial services; (2) the debt instrument was issued by a purchaser of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and (3) at all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a member of the same consolidated group as that person. Treas. Reg. § 1.475(c)-1(b)(2).

Under Treas. Reg. § 1.475(c)-1(b)(4)(i), a taxpayer may elect to waive the customer paper exception. The waiver may be elected for a year ending on or before December 24, 1996, by attaching a statement to an amended return filed not later than October 31, 1997. See Rev. Rul. 97-39, Holding 13. An election under Treas. Reg. § 1.475(c)-1(b)(4)(i) also is deemed to be an election to waive the exemption from the application of section 475(a) provided by Treas. Reg. § 1.475(c)-1(c) for taxpayers with negligible sales of securities. See Rev. Rul. 97-39, Holdings 17 and 18.

Rev. Proc. 97-43 provides procedures for a taxpayer to obtain the automatic consent of the Commissioner to change its method of accounting to reflect the application of section 475 as a result of making the election under Treas. Reg. § 1.475(c)-1(b)(4)(i). Rev. Proc. 97-43 became effective on September 10, 1997.



Section 475(a) provides the general rule that a dealer in securities must mark to market all of its securities. Section 475(b)(1)(A), (B), and (C) provide that section 475(a) does not apply to: (1) any security held for investment; (2) certain securities that are not held for sale; and (3) any security that is a hedge of an item that is not subject to the mark-to-market rules. Further, under section 475(b)(2), a security is not treated as described in section 475(b)(1)(A), (B), or (C) unless it is clearly identified in the dealer's records as being described in such subparagraph before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe). An exception to this same-day identification rule is contained in Holding 15 of Rev. Rul. 97-39.

Holding 15 of Rev. Rul. 97-39 provides a special identification regime for a taxpayer that: (1) made an election out of the customer paper exemption, the negligible sales exemption, or both; and (2) was not treated as a dealer in securities under Treas. Reg. § 1.475(c)-1T. 

The special identification regime applies only to securities ("transition securities") for which an identification would have been timely under the general rule (described in Holding 14 of Rev. Rul. 97-39) and only if made on or before October 31, 1997. Rev. Rul. 97-39, Holding 15. Under the special identification regime, a transition security was properly identified as exempt for the purposes of section 475(b)(2) or (c)(2)(F)(iii) if the information that was contained in the

¹ Section 475(c)(4), added by RRA 98, P.L. 105-206, applies to tax years ending after July 22, 1998, and, therefore, does not apply to the tax years in issue, Year 1, and Year 2. Section 475(c)(4) provides, in general, that the definition of security for purposes of section 475 shall not include any nonfinancial customer paper. Nonfinancial customer paper is defined as any receivable which (i) is a note, bond, debenture, or other evidence of indebtedness; (ii) arises out of the sale of nonfinancial goods or services by a person the principal activity of which is the selling or providing of nonfinancial goods or services; and (iii) is held by such person (or person who bears a relationship to such person described in section 3267(b) or 707(b)) at all times since issue. I.R.C. § 475(c)(4)(B).

taxpayer's books and records and that was entered substantially contemporaneously with the date of acquisition of the transition security supports a conclusion that the transition security was described by section 475(b)(1)(A), (B), or (C). Id. This rule applies even if the information in the taxpayer's books and records does not meet the specificity that Holding 5 of Rev. Rul. 97-39 generally requires for identification. Id.

Holding 15 also states that a taxpayer must, by October 31, 1997, place in its books and records a statement resolving ambiguities, if any, concerning which transition securities are properly identified under the special identification regime. Any information that supports treating a transition security as being described in section 475(b)(2) or (c)(2)(F)(iii) must be applied consistently.

[REDACTED]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[REDACTED]

[REDACTED]

In this context, fair market value is a hypothetical sales price between a willing seller and willing buyer, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Cf. § 20.2031-1(b)(estate tax valuation rules).

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

Please call if you have any further questions.

By: _____
CAROL P. NACHMAN
Special Counsel
Financial Institutions & Products
Branch

cc: William F. Hammack
CC:MSR