



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MATTHEW J. FRITZ  
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HEAVY MANUFACTURING, CONSTRUCTION &  
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CC:LM:MCT:CIN:2

FROM: LON B. SMITH  
ACTING ASSOCIATE CHIEF COUNSEL (FINANCIAL  
INSTITUTIONS AND PRODUCTS) CC:FIP

SUBJECT: Mark to Market Issue

This Chief Counsel Advice responds to your memorandum dated June 5, 2001. In accordance with Section 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Parent =  
Product =  
Taxpayer =  
Subsidiary =  
State A =  
Corporation =  
Trust =  
Date 1 =  
Dollar 1 =

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Amount 1 =

Date 2 =

Date 3 =

Date 4 = \_\_\_\_\_

Dollar 2 =

Dollar 3 =

Dollar 4 =

Dollar 5 = \_\_\_\_\_

Dollar 6 =

Dollar 7 =

Dollar 8 =

Dollar 9 = \_\_\_\_\_

Dollar 10 = \_\_\_\_\_

**ISSUE:**

Whether Taxpayer may mark its securities to market pursuant to section 475 of the Internal Revenue Code.

**FACTS:**

The facts, as set forth in your FSA request, are as follows: Parent is a global developer, manufacturer, and supplier of Product. Parent is the parent company of a consolidated group that includes Taxpayer and Subsidiary. Taxpayer and Subsidiary are State A corporations. Subsidiary is engaged in the sale of Product. According to Parent, Taxpayer was formed to improve Subsidiary’s balance sheet while delivering operational results acceptable to shareholders.

On Date 1, Taxpayer and Subsidiary entered into the Purchase Agreement. The stated purpose of the Purchase Agreement was the sale of Subsidiary's receivables from the sale of Product. Subsidiary was designated as the Originator and Servicer, and Taxpayer was designated as the Buyer. Pursuant to the

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Purchase Agreement, Subsidiary sold its U.S. receivables derived from Product to Taxpayer for an amount determined to approximate the fair market value of the receivables. Subsidiary continued to service the receivables, and its customers were unaware of the sale of the receivables to Taxpayer.

Subsidiary contributed Dollar 1 to Taxpayer as a contribution to capital to finance Taxpayer's purchase of the receivables. In exchange for the receivables, Taxpayer gave Subsidiary a subordinated note with an interest rate equal to one-month LIBOR on Eurodollar deposits plus Amount 1 basis points.

For the tax years ending Date 3 and Date 4, the amounts due under the subordinated note were Dollar 2 and Dollar 3, respectively. According to Parent, Taxpayer paid Subsidiary Dollar 4 and Dollar 5 for service fees in the years ending Date 3 and Date 4.

Also on Date 1, the Receivables Purchase Agreement was entered into between Subsidiary, as Servicer; Taxpayer, as Seller; Corporation, as Buyer; and Trust, as Administrative Agent. Subsidiary was responsible for the administration, servicing, and collection of the receivables. Taxpayer was liable for the payment of all taxes or charges payable in connection with the receivables and their creation or satisfaction. The obligors on the receivables (Subsidiary's customers) were unaware of any transfer of the receivables. As set forth in the Receivables Purchase Agreement, the agreement constituted a security agreement under the Uniform Commercial Code, with Taxpayer granting Trust a security interest in the receivables for the benefit of certain banks and financial institutions. The Receivables Purchase Agreement gave Trust the right to conduct audits and inspections of Taxpayer's and Subsidiary's property, records, internal controls and procedures.

The Receivables Purchase Agreement provided Subsidiary and Taxpayer with a line of credit, the Net Investment, from a consortium of banks and financial institutions arranged by Trust. At its discretion, Taxpayer selected incremental amounts, Tranches, of at least Dollar 10 for certain periods, by issuing Tranche Selection Notices to Corporation and Trust. The amount of the Tranche, discounted by a Tranche rate established by Trust, was transferred from the consortium of banks and financial institutions, through Corporation, to Taxpayer. Ultimately Taxpayer transferred the Tranche amount to Subsidiary as payment on its subordinated note. The aggregate amount of all Tranches was equal to the outstanding amount of the Net Investment to Taxpayer from the consortium of banks and financial institutions.

The Receivables Purchase Agreement further provided that, in exchange for the line of credit, the consortium of banks and financial institutions received a percentage interest (Buyer's Percentage Interest) in all outstanding receivables calculated monthly from the (1) Net Investment; (2) a Buyer's Discount; (3) a

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Deferred Purchase Price; and (4) the Net Receivables Balance. To calculate the Buyer's Percentage Interest, the Net Investment, Buyer's Discount, and Deferred Purchase Price were added together and divided by the Net Receivables Balance.

As Subsidiary received payments from its customers, the Buyer's Percentage Interest was deposited to a lockbox account for the benefit of Corporation, Trust, and the consortium of banks and financial institutions.

The consolidated group of which Parent, Subsidiary, and Taxpayer are members has not made an election under section 1.475(c)-1(a)(3)(iii) of the Income Tax Regulations (the intragroup-customer election). Taxpayer does not hold any other securities other than those related to the Purchase Agreement and the Receivables Purchase Agreement (the receivables). On its Date 2 tax return, Subsidiary made an election under section 1.475(c)-1(b)(4). But, on its Date 3 tax return, Subsidiary did not mark to market any of its U.S. receivables.<sup>1</sup>

For the tax year ending Date 3, on Parent's consolidated income tax return, Taxpayer claimed a loss of Dollar 6, based on a mark-to-market valuation of Dollar 7 of receivables. On Parent's consolidated return for the tax year ending Date 4, Taxpayer claimed a Dollar 8 loss based on a mark-to-market valuation of Dollar 9 of receivables. The basis for such treatment was Parent's assertion on Form 3115 attached to its consolidated return for its tax year ending Date 4 that "[Taxpayer] meets the definition of a dealer in securities under section 475; thus this entity uses mark-to-market to value its securities at the end of each taxable year."

## **LAW AND ANALYSIS**

Section 475(a)(2) of the Internal Revenue Code provides that any securities that are not inventory and are held at the end of the year by a dealer in securities are marked to market at the end of each taxable year. A dealer in securities is defined as a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or 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. See Section 475(c)(1).

The term security includes a note, bond, debenture, or other evidence of indebtedness. See Section 475(c)(2)(C). For years ending after July 22, 1998, the term security does not include nonfinancial customer paper. See Section 475(c)(4)(A). Nonfinancial customer paper includes any receivable that is a note, bond, debenture, or other evidence of indebtedness, arising out of the sale of non-

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<sup>1</sup> If Subsidiary had any receivables at the end of the year ending Date 3, it should have marked to market the receivables. Once the election under section 1.475(c)-1(b)(4) is made, it applies to all future years unless the election is revoked with the consent of the Commissioner. See Section 1.475(c)-1(b)(4)(ii).

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financial goods or services by a person the principal activity of which is the selling or providing of nonfinancial goods and services, and that is held by such person (or a person who bears a relationship to such person described in section 267(b) or 707(b)) at all times since issue. See Sections 475(c)(4)(B)(i)-(iii).

Whether a dealer is transacting business with customers is determined on the basis of all the facts and circumstances. See Section 1.475(c)-1(a). Solely for purposes of section 475(c)(1) (concerning the definition of dealer in securities) and except as provided in section 1.475(c)-1(a)(3)(iii) (the intragroup-customer election), a taxpayer's transactions with other members of its consolidated group are not with customers. Section 1.475(c)-1(a)(3)(ii). The intragroup-customer election is made by filing a statement that says, "[Insert name and employer identification number of common parent] hereby makes the Intragroup-Customer Election (as described in § 1.475(c)-1(a)(3)(iii) of the income tax regulations) for the taxable year ending [describe the last day of the year] and for subsequent taxable years." The statement must be signed by the common parent and attached to a timely filed federal income tax return for the consolidated group for that taxable year. See Section 1.475(c)-1(a)(3)(iii)(B). If a consolidated group makes the intragroup-customer election, section 1.475(c)-1(a)(3)(ii) does not apply to members of the group. See Section 1.475(c)-1(a)(3)(iii)(A).

Section 1.1502-13(a) provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. Under section 1.1502-13(a), the selling member and the buying member are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The timing and character of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined to produce the effect of transactions between divisions of a single corporation. See Section 1.1502-13(a)(2). An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. See Section 1.1502-13(b)(1).

Section 1.1502-13(c) provides a matching rule for the accounting of the buyer's corresponding items and the seller's intercompany items. Section 1.1502-13(c)(7) provides examples that illustrate the matching rule of section 1.1502-13(c). Example 11 of section 1.1502-13(c)(7) involves section 475 where a dealer in securities sells securities to a member of its consolidated group that is not a dealer in securities. The example provides that, under the matching rule, attributes must be redetermined by treating the seller and the buyer as divisions of a single corporation. As a result of the seller's activities, the single corporation is treated as a dealer with respect to the securities, and the buyer must continue to mark to market the security acquired from the seller.

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The Purchase Agreement is an intercompany transaction because the transaction is between members of the same consolidated group. See Section 1.1502-13(b)(1). As such, the matching rule of section 1.1502-13(c)(7) applies to account for the Purchase Agreement transactions. The matching rule of section 1.1502-13(c)(7) is illustrated in the examples listed in that section. Example 11 of section 1.1502-13(c)(7) describes a situation where a dealer in securities sells securities to a member of its consolidated group that is not a dealer in securities. In this case, Subsidiary, a dealer in securities<sup>2</sup>, sells, under the Purchase Agreement, its receivables to Taxpayer, a member of its consolidated group. Under Example 11 of section 1.1502-13(c)(7), Taxpayer, as the buyer, would have to account for the receivables using the mark-to-market method, even if Taxpayer is not a dealer. In accordance with the example, Taxpayer and Subsidiary would be treated as a single division of a corporation, with the single corporation treated as a dealer. See Example 11 of section 1.1502-13(c)(7). Therefore, whether or not Taxpayer meets the definition of dealer in securities under section 475(c)(1), Taxpayer must mark its receivables to market to comply with the requirements of section 1.1502-13(c)(7).

Because Taxpayer is required to mark its receivables to market pursuant to section 1.1502-13(c)(7), it is not necessary to determine whether Taxpayer is a dealer in securities under section 475(c)(1). However, we note that to meet the definition provided in section 475(c)(1), Taxpayer must either purchase securities from customers or sell securities to customers.

Taxpayer has purchased receivables from Subsidiary pursuant to the Purchase Agreement. These are the only securities held by Taxpayer. However, the purchase of the receivables from Subsidiary is not a purchase from a customer. Unless an election is made pursuant to section 1.475(c)-1(a)(3)(iii) (the intragroup-customer election), a taxpayer's transactions with other members of its consolidated group are not transactions with customers. See Section 1.475(c)-1(a)(3)(ii).

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<sup>2</sup> Subsidiary would not be a dealer in securities but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to Subsidiary. However, Subsidiary has elected out of the exception for purchasers or sellers of nonfinancial goods or services. See section 1.475(c)-1(b). If Subsidiary regularly purchases (or originates) securities from customers in the ordinary course of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) but engages in no more than negligible sales of the securities so acquired, Subsidiary would not be a dealer in securities for purposes of section 475(c)(1) unless Subsidiary elected to be so treated. See section 1.475(c)-1(c)(1)(i). In addition to making the election under section 1.475(c)-1(b)(4), if Subsidiary's sales were negligible under section 1.475(c)-1(c), Subsidiary has elected to be treated as a dealer in securities by filing a federal income tax return reflecting the application of section 475(a) in computing its taxable income. See section 1.475(c)-1(c)(1)(ii).

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Because the consolidated group of which Parent, Subsidiary, and Taxpayer are members has not made the intragroup-customer election and Subsidiary is a member of the same consolidated group as Taxpayer, Taxpayer's transactions with Subsidiary are not purchases from a customer. See Sections 1.475(c)-1(a)(3)(ii) and (iii).

Taxpayer could still be a dealer in securities, however, if it sold the receivables to customers. If the Receivables Purchase Agreement constituted a sale of the receivables, Taxpayer would meet the definition of dealer in securities by virtue of its sales of receivables (which are securities for the year ending Date 3) to customers.<sup>3</sup> However, your analysis of the facts submitted indicates that the Receivables Purchase Agreement is a financing transaction rather than a sale of the receivables.

In general, federal income tax consequences are governed by the substance of a transaction. See Gregory v. Helvering, 293 U.S. 465, 470 (1935). The term sale is given its ordinary meaning and is generally defined as a transfer of the ownership of property for money or for a promise to pay money. Commissioner v. Brown, 380 U.S. 563, 570-71 (1965). Whether a transaction is a sale is a question of fact which must be ascertained from the intent of the parties as evidenced by the written agreements read in light of the attending facts and circumstances. Haggard v. Commissioner, 24 T.C. 1124, 1129 (1955), aff'd, 241 F.2d 288 (9<sup>th</sup> Cir. 1956). A transaction is a sale if the benefits and burdens of the ownership have passed to the purported purchaser. Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981). Courts have considered the following factors relevant in determining whether the benefits and burdens of ownership passed: (1) Whether the transaction was treated as a sale. United Surgical Steel Col, Inc. v. Commissioner, 54 T.C. 1215, 1229-30, 1231 (1970), acq., 1971-2 C.B. 3; (2) Whether the obligors on the notes were notified of the transfer of the notes. Id., (3) Which party serviced the notes. Id.; Town & Country Food Co., Inc. v. Commissioner, 51 T.C. 1049, 1057 (1969); (4) Whether payments to the transferee corresponded to collections on the notes. United Surgical, 54 T.C. at 1229-30; Town & Country Food Co., Inc., 51 T.C. at 1057; (5) Whether the transferee imposed restrictions on the operations of the transferor that are consistent with a lender-borrower relationship. United Surgical, 54 T.C. at 1230; Yancey Bros. Co. V. United States, 319 F. Supp. 441, 446 (N.D. Ga. 1970); (6) Which party had the power of disposition. American National Bank of Austin v. United States, 421 F.2d 442, 452 (5<sup>th</sup> Cir. 1970); cert. denied, 400 U.S. 819 (1970); (7) Which party bore the risk of loss. Union Planters Nat'l Bank of

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<sup>3</sup> If the Receivables Purchase Agreement constitutes a sale, Taxpayer would not fall within the exception for purchasers and sellers of nonfinancial goods and services (section 1.475(c)-1(b)(1)) because a member of its consolidated group uses a method of accounting that allows for recognition of unrealized gains and loss. See Section 1.475(c)-1(b)(3)(iii).

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Memphis v. United States, 426 F.2d 115, 118 (6<sup>th</sup> Cir. 1970), cert. denied, 400 U.S. 827 (1970); and (8) Which party had the potential for gain. United Surgical, 54 T.C. at 1229; Town & Country Food Co., Inc., 51 T.C. at 1057. Although the potential for gain and amount of risk have been deemed the pivotal factors, the overall concentration should lie on the economic substance of the transaction. Mapco, Inc. v. United States, 556 F.2d 1107, 1111 (Ct. Cl. 1977).

Applying the factors set forth above, it appears reasonably clear that at least three of the factors indicate that the Receivables Purchase Agreement is more properly characterized as a financing. First, the servicing responsibilities were retained by Subsidiary, and Taxpayer was liable for all taxes or charges payable in connection with the receivables and their creation or satisfaction. Furthermore, the obligors on the receivables were not notified of any transfer of the receivables. Also, consistent with the characterization of the transaction as a financing, Trust was given the right to audit and inspect Taxpayer's and Subsidiary's property, records, internal controls and procedures. These rights seem more consistent with a borrower-lender relationship.

On the other hand, the treatment of the Receivables Purchase Agreement as a sale is less clear. While the parties use terms throughout the agreement that are consistent with a sales contract, the agreement also provides that the agreement is a security agreement under the Uniform Commercial Code. Furthermore, whether the Receivables Purchase Agreement is properly characterized as a sale or financing, we believe, would be dependant on a more complete development and analysis of the facts and economics pertaining to the transaction. For example, we believe further factual and economic development and analysis would be needed to analyze the economics of the transaction to determine which party bears the opportunity for gain and risk of loss.

As stated above, it is not necessary to determine whether the Receivables Purchase Agreement constitutes a sale, and whether Taxpayer meets the definition of a dealer in securities under section 475(c)(1), to reach the conclusion that Taxpayer must mark its receivables to market. Whether or not Taxpayer is a dealer in securities, section 1.1502-13(c)(7) requires that Taxpayer mark its receivables to market.

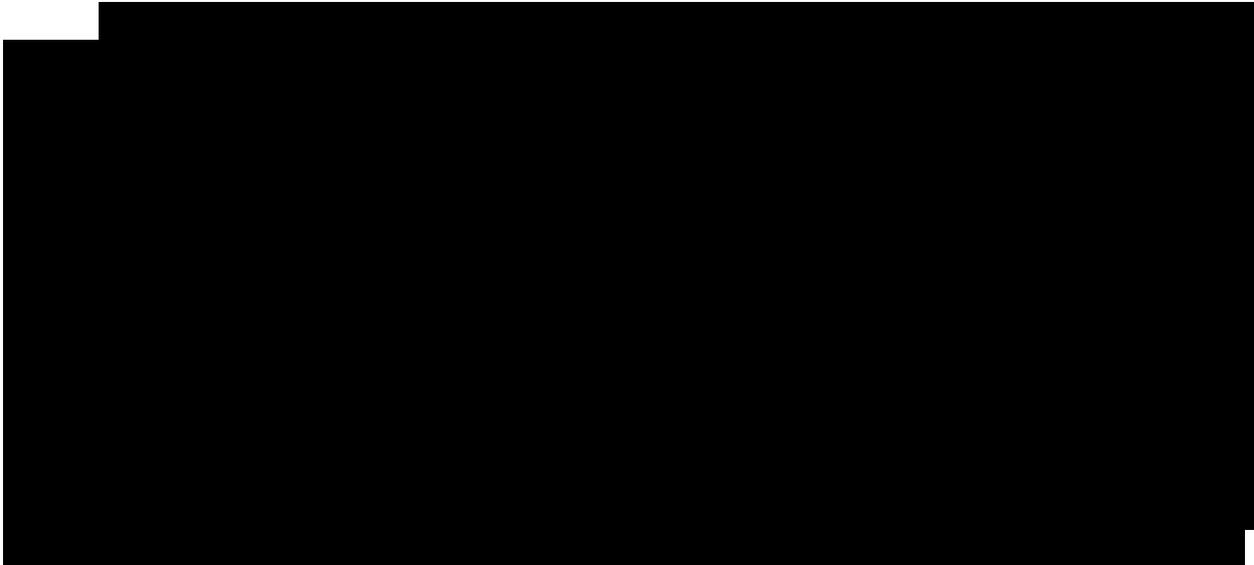
### 1998 Tax Year

Section 475(c)(4)(A) was added to the Code to exclude nonfinancial customer paper from the definition of security, effective for tax years ending after July 22, 1998. Nonfinancial customer paper includes any receivable that is a note, bond, debenture, or other evidence of indebtedness, arising out of the sale of non-financial goods or services by a person the principal activity of which is the selling or providing of nonfinancial goods and services and that is held by such person (or a person who bears a relationship to such person described in section 267(b) or

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707(b)) at all times since issue. See Sections 475(c)(4)(B)(i)-(iii). Taxpayer's receivables fall within the definition of nonfinancial customer paper and therefore are not securities. The receivables held by Taxpayer arose out of the sale of Product by Subsidiary, a person the principal activity of which is the selling or providing of nonfinancial goods and services, and the receivables were held at all times since issue by Subsidiary and Taxpayer, a person who bears a relationship to Subsidiary that is described in section 267(b). Therefore, Taxpayer may not mark its receivables for any year ending after July 22,1998.

**CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS.**



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