



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

DISTRICT COUNSEL

Attn:

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

SUBJECT: I.R.C. § 475 - Mark-to-Market Rules

This Field Service Advice responds to your memorandum dated February 19, 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:

- Corporation =
- Loan =
- Agreements =
- Fee =
- Sale =
- Year 1 =
- v =
- w =
- x =
- y =
- z =

ISSUES:

1. Whether the Agreements at issue constitute “securities” within the meaning of Section 475(c)(2)(E) of the Internal Revenue Code (“Code”).
2. If the answer to Issue 1, above, is answered in the affirmative, how should the Agreements be valued for purposes of marking the Agreements to market pursuant to section 475.
3. Whether x that the taxpayer used in its Sales transactions should be marked to market under section 475 even though the taxpayer had purportedly identified the x as being held for investment?

CONCLUSIONS:

1. We conclude that the Agreements at issue constitute “securities” for purposes of section 475.
2. Additional factual development is necessary to determine this amount.
3. We conclude that this issue requires additional factual development.

FACTS:

During the year in issue, Corporation acquired Loans in its ordinary course of business. In addition, Corporation entered into Agreements with prospective Loan sellers to acquire a specified principal amount of Loans for future delivery by a specified date. No payment was made at the time the parties entered into an Agreement. Instead, Corporation paid the seller cash or x when the Loans were delivered to Corporation.

To the extent a seller failed to deliver to Corporation loans sufficient to satisfy the terms of an Agreement, the seller was required to pay Corporation a Fee typically equal to y% of the amount of the Agreements that were not delivered. In some instances the parties negotiated a lower Fee.

For Year 1, Corporation marked the Agreements to market for financial accounting purposes. Corporation valued the Agreements at \$z, which Corporation represented equaled the aggregate value of Fees Corporation estimated that it would receive in the event every seller failed to deliver on the Agreements.

Corporation pooled these Loans and used them to either serve as collateral for securities called x that it sold to investors or to serve as security for x that Corporation retained for investment purposes. The majority of Corporation’s retained x were identified as being held for investment.

In Year 1, approximately w% of Corporation's total outstanding balance of x that were held for investment were actually used in its Sales transactions. In a Sale, Corporation sold x to dealers and underwriters of Loans and Loan-type transactions pursuant to a repurchase agreement to buy back the same or similar x. Only Loans that were v old or younger were used in the Sales. It has been suggested that a portion of the retained x were held to facilitate the Sales transactions with the dealers and underwriters that required x.

We assume that the repurchase agreements in the Sales were sales of the x for Federal income tax purposes.

LAW AND ANALYSIS:

In general, section 475 requires mark-to-market accounting for securities held by a dealer in securities. Section 475(a). The term "dealer in securities" is defined to include a taxpayer who (A) regularly purchases securities from customers in the ordinary course of a trade or business; or (B) regularly offers to enter into positions in securities with customers in the ordinary course of a trade or business. Section 475(c)(1)(A) and (B). A "security" is defined to include a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust. Section 475(c)(2)(B). A security is also defined to include a note, debenture, or other evidence of indebtedness. Section 475(c)(2)(C). In addition, section 475(c)(2)(E) provides that the term "security" includes an evidence of an interest in, or a derivative financial instrument (such as an option or a forward contract) in a note, debenture or other evidence of indebtedness.

Section 475(b)(1) provides exceptions to the general mark-to-market rule. Specifically section 475(b) provides that section 475(a) shall not apply: (A) if the security has been identified as held for investment; (B) if the security (or obligation to acquire a security) was acquired in the ordinary course of trade or business and is not held for sale; and (C) any security that is a hedge of certain property. A security that is subject to any of the exceptions to marking to market must be clearly identified in the dealer's records as being held for investment, acquired in the ordinary course of trade or business, or as a hedge, before the close of the day on which the security was acquired, originated or entered into pursuant to section 475(b)(2). Additionally, a security that ceases to be exempt pursuant to section 475(b)(1) at any time after it was identified as such under section 475(b)(2), shall be subject to the mark-to-market rule of section 475(a) pursuant to section 475(b)(3) after the cessation.

If a security that has been identified pursuant to section 475(b)(2) has been improperly identified, then that security shall be subject to the mark-to-market rule of section 475(a), except that any loss on the security prior to its disposition shall

be recognized only to the extent of gain previously recognized pursuant to section 475(d). Section 475(d)(2).

Pursuant to the regulations effective for the tax year at issue, Temp. Treas. Reg. § 1.475(b)-1T(a) states that “a security is held for investment (within the meaning of section 475(b)(1)(A)) or not held for sale (within the meaning of section 475(b)(1)(B)) if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer’s trade or business.” These temporary regulations, made final pursuant to T.D. 8505, 1994-1 C.B. 152, are effective for tax years ending on or after December 31, 1993.

Pursuant to Temp. Treas. Reg. § 1.475(b)-2T(a)(1), “If, as of the close of the last taxable year ending before December 31, 1993, a security was identified under section 1236 as a security held for investment, the security is treated as being identified as held for investment for purposes of section 475(b).”

Given the facts as received, we conclude that the Agreements are securities for purposes of section 475. The Corporation’s Agreements fit within the plain language of section 475(c)(2)(E). Since Loans are securities described in section 475(c)(2)(C), the Corporation’s Agreements are evidence of an interest in securities described in section 475(c)(2)(E), and they are also derivative financial instruments in such securities.

The legislative history of section 475 also supports a conclusion that the Corporation’s Agreements are securities for purposes of section 475.

The Agreements should be valued on the last business day of the taxable year. Additional factual development is necessary on this issue.

Each x at issue is a security because it represents a beneficial ownership interest in a widely held or publicly traded trust, pursuant to section 475(c)(2)(B). There is information that Corporation identified the x in its retained portfolio of x as held for investment under section 475(b)(1)(A).

We have not been provided with sufficient facts to determine whether the x are properly excepted from the mark-to-market rules pursuant to section 475(b)(1)(A) on the grounds that they were primarily held for investment. Accordingly, we recommend additional factual development on this issue.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Further factual development is necessary regarding the procedures by which a seller exercised its contractual right to deliver to the Corporation the amount of Loans specified in the contract. In addition, factual development is necessary to detail Corporation's rights and obligations once seller exercised its contractual right. For example, after the option was exercised, did Corporation have the right to require seller to sell Corporation the Loans underlying the Agreement? Did Corporation have remedies in the event of nonperformance, such as breach of contract or specific performance?

In addition, how did the parties to the Agreements set the amount of the Fee? How often did the Corporation reduce or waive the Fee in the event the seller failed to deliver loans underlying the Agreements?

For purposes of valuing the Agreements, a projected estimate of the Fees that the Corporation had a legal right to receive pursuant to the Agreements appears to be a reasonable valuation method. The Corporation disclosed in its Year 1 Consolidated Fair Balance Sheet that it valued the Agreements at \$z; \$z was also the value of the Fees disclosed in the Year 1 Annual Report. We recommend that you confirm these facts. We also recommend that you obtain a valuation expert to review the value placed on the Agreements.

Whether the x used in the Sales transactions should be marked to market pursuant to section 475(a) will depend on whether the x were properly identified in the Corporation's books and records as being primarily held for investment, and whether w% accurately represents the total percentage of outstanding x that were identified as held for investment that were used in the Sales. We recommend determining the facts and circumstances surrounding the identification of the x held for investment, and suggest the following questions as guidelines:

1. How and when did Corporation identify its x as held for investment in Year 1, and how long were they to be held for investment? Was each x identified pursuant to section 475(b)(1)(A) or (B)? Were the identifications of the x valid? Did Corporation identify the x as being held pursuant to I.R.C. § 1236? What percentage of Corporation's total number of x were identified as held for investment?
2. What are the criteria for use of the x in the Sales? Why did Corporation use x from its pool of x identified as held for investment for the Sales transactions instead

of x held in all other accounts? Were there any x used in the Sales that were not identified as held for investment? What percentage of the total number of x were those that were used in the Sales in Year 1 and subsequent tax years? When was it determined that x would be eligible or not for the Sales? For an x ineligible for a Sale, was there anything to suggest that the identification was improper?

3. Was each Loan identified as held for investment pursuant to section 475(b)(1)(A) or (B)? How and when did Corporation identify the Loans as held for investment for Year 1? Were these identifications valid? What percentage of Corporation's total number of Loans were identified as held for investment?

4. What are the criteria for each Loan selected for each x and for each Sale? Why are only the x that contain Loans that are y old or younger used in the Sales? What percentage of all Loans that were eligible for x and for the Sales were used in x and the Sales in Year 1 and subsequent tax years? What percentage of Corporation's total number of Loans were used in the x and Sales in Year 1 and subsequent tax years?

5. How many Sales transactions did Corporation enter into in Year 1 and subsequent tax years?

6. If Corporation's primary purpose for holding x was for investment to maturity, then why did Corporation engage in the Sales using x that were identified as held for investment?

We also recommend that you develop these additional facts:

1. What is Corporation's policy on "primarily held for investment" as used in Temp. Treas. Reg. § 1.475(b)-1T?

2. What do the x represent in the underlying Loans?

3. Corporation has stated that it views the Sales program as an important source of income. How much "profit" did Corporation generate from these Sales in Year 1 and in subsequent years? If Corporation intended to generate a "profit" from the Sales, then why did Corporation report expenses in excess of income from the Sales on its Federal income tax return for Year 1?

In addition, we have assumed that Corporation sold its x in the Sales transactions. We recommend that you confirm that these transactions constitute sales for Federal income tax purposes. If the x were not sold in the Sales, then the x may have been continuously held for investment purposes and excepted from marking to market under section 475(b).

Please call if you have any further questions.

By: _____
JOEL E. HELKE

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Branch Chief
Financial Institutions & Products Branch
Field Service Division

cc: