REPORT #781

TAX SECTION

New York State Bar Association

Report on Section 475

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TAX SECTION
New York State Bar Association

February 28, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: <u>Mark to Market Regulations</u>

Dear Secretary Samuels and Commissioner Richardson:

Enclosed are copies of a report by the New York State Bar Association Tax Section on the temporary and proposed regulations under section 475 of the Internal Revenue Code, relating to mark to market treatment for securities dealers.

The Report strongly commends the Treasury Department and the Internal Revenue Service for so promptly issuing guidance under section 475, and generally supports the substance of the regulations. The Report also makes a number of suggestions for changes and clarifications to the regulations, which suggestions are summarized at the beginning of the Report.

More generally, the Report points out that the structure of the statute is to broadly define “dealer in securities” and “securities”, in both cases in a manner that goes well beyond the commonly understood meanings of those terms. The statute then permits such dealers in securities to elect (on an asset by asset basis on the respective asset acquisition dates) whether or not any securities not in fact held for sale to customers are to be marked to market. Many of the securities in question will have no readily ascertainable fair market value.

The Report points out that this regime may present whipsaw potential against the government as well as an impossible audit situation, because of the ability of taxpayers both to select among assets to be marked to market and to determine annual values for nontraded assets to be marked to market. Moreover, this regime may permit assets to be marked to market that were not so intended by the drafters of the statute, and might allow banks the equivalent of loan loss reserves. The Report concludes that regulations as well as technical corrections to the statute may be necessary to prevent unintended results.

Very truly yours,

Michael L. Schler
Chair

cc: Peter Cobb, Esq.

Tax Report #781

NEW YORK STATE BAR ASSOCIATION TAX SECTION
COMMITTEE ON FINANCIAL INSTRUMENTS

REPORT ON SECTION 475 MARK TO MARKET REGULATIONS

February 28, 1994

This Report[1] comments on Temporary Regulations (T.D. 8505) and identical Proposed Regulations (together, the "Regulations") released on December 28, 1993, under section 475.[12] Section 475, added to the Code by the Revenue Reconciliation Act of 1993, requires that dealers in securities use a mark to market method of accounting for all securities held by them, with certain exceptions. The provision is effective for taxable years ending on or after December 31, 1993.

We believe the Regulations are extremely helpful to taxpayers in clarifying the scope of section 475. Most importantly, the Regulations clarify the scope of that section by excluding from coverage certain taxpayers and transactions that appear not to have been within the intended scope of the provision. We strongly commend the Treasury Department and the Internal Revenue Service for so promptly issuing this (as well as previous)[3] guidance. We believe it was clearly correct to

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[1] The principal authors of this Report are David P. Hariton and Michael L. Schler. Helpful comments were provided by Carolyn Joy Lee, Richard O. Loengard, Jr., Richard L. Reinhold, and Esta E. Stecher.

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code (the "Code") as currently in effect.

[3] Notice 93-45, 1993-29 IRB 73; Rev. Rul. 93-76, 1993-35 IRB 11. See also Rev. Rul. 94-7, 1994-3 IRB 6.

promptly issue the Regulations and the other guidance to resolve a number of critical issues, even though further clarifications and the resolution of additional issues were thereby delayed to subsequent versions of the Regulations.

Summary

We make a number of comments below suggesting clarifications, modifications, and additions to the Regulations. However, as an initial matter we wish to emphasize one overriding theme of this Report. The structure of the statute and the Regulations is to broadly define “dealer in securities” and “securities” (which are subject to mark to market in the hands of a “dealer in securities”), in both cases in a manner that goes well beyond the commonly understood meaning of those terms. The statute then permits such dealers in securities to elect (on an asset by asset basis on the respective asset acquisition dates) whether or not any such securities not in fact held for sale to customers are to be marked to market. Many of the securities in question will have no readily ascertainable fair market value.

We believe this regime may present whipsaw potential against the government and an impossible audit situation, because of the ability of taxpayers to select among assets to be marked to market, and in particular because of the ability of taxpayers to determine annual values for nontraded assets to be marked to market. Moreover, this regime may permit assets to be marked to market that were not so intended by the drafters of the statute, and may have unexpected results such as permitting banks the equivalent of loan loss reserves. We believe a major effort, including anti-abuse rules, may be necessary to prevent unintended results. Moreover, because many of the potentially unintended results are squarely within the literal scope of the statute, technical corrections to the statute may prove to be necessary. These issues are discussed primarily in Sections E.3, F.4, H.l, and H.3 below.

Our more technical suggestions for changes and clarifications in the Regulations may be summarized as follows:

1. Final regulations should clarify that a nonfinancial taxpayer does not become a dealer in securities regardless of the manner in which it sells customer receivables. Section A.3 below.

2. A finance company that is a member of such a nonfinancial taxpayer's consolidated group should not be a dealer in securities solely by virtue of financing that taxpayer's sales and selling the resulting customer receivables. Section A.4 below.

3. A specific definition of “negligible” should be established for purposes of the rule that a taxpayer is not a dealer in securities if it only sells a negligible portion of its securities. Section B.2 below.

4. A de minimis exemption from dealer status should apply to a taxpayer that only occasionally makes loans to customers. Section B.4 below.

5. The concept of purchasing or selling from or to “customers” should be clarified, both for purposes of determining dealer status and for determining whether securities are eligible for exemption from mark to market in the hands of a dealer. Purchasing or selling loan participations should not be

considered engaging in transactions with customers, nor should various methods of securitizing loans. Sections C and E.4 below.

6. The scope of the exclusion from the definition of “security” for “liabilities” of the taxpayer should be clarified, particularly in light of the fact that many dealer positions will have negative value and notional principal contracts may have embedded loans. Sections D.l and D.2 below.

7. Clarification should be made concerning the ability of dealers to selectively treat portions of their securities not held in a dealer capacity as subject to mark to market, and the remaining such securities as not subject to mark to market. Section E.3 below.

8. It should be confirmed that if a dealer enters into a position with a customer in order to hedge a dealer asset that is not subject to mark to market, the position is also not subject to mark to market. Section E.5 below.

9. The definition of property always exempt from mark to market in the hands of a dealer should be narrowed in certain respects. Section F.2 below. It should be broadened in certain other respects. Sections F.3 and F.4 below.

10. Consideration should be given to extending transitional relief beyond January 31, 1994. Section G. below.

11. Consideration should be given to the determination of fair market value of certain assets subject to mark to market, such as contracts with negative value, contracts whose values may fluctuate on a regular basis as the counterparties make scheduled

payments to each other, bank loans, and other nontraded securities. Section H. below.

Background

Section 475(c) defines a “dealer in securities” as a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business (or who regularly offers to enter into, assume, or terminate positions in securities with customers in the ordinary course of business). A “security” is, in general, a share of stock, a note or other evidence of indebtedness, a notional principal contract, a derivative or other position with respect to the foregoing or any currency, or an identified hedge with respect to the foregoing.

Under section 475(a), the operative provision, a dealer in securities holding a security as inventory must include it in inventory at its fair market value, and a dealer in securities holding a security other than in inventory is treated as selling the security at its fair market value on the last day of the year. Section 475(b)(1) provides, however, that section 475(a) does not apply to a security held for investment (section 475(b)(1)(A)), a debt security acquired (including originated) in the ordinary course of business and not held for sale (section 475(b)(1)(B)), and a hedge with respect to an item that is not a security or that is a security not subject to mark to market, unless (to the extent provided in regulations) the hedge is held by the taxpayer in its capacity as a dealer in securities (section 475(b)(1)(C)). However, section 475(b)(2) provides that a security is not treated as described in section 475(b)(1), and thus is subject to the general mark to market rule in section 475(a), unless it is so identified in the dealer's records by the close of the day on which it was acquired (unless regulations allow a longer period).

Comments

The definition of dealer in section 475(c) and the Regulations is critical to an understanding of the mark to market rules of section 475(a) and the exceptions thereto in section 475(b). We therefore comment first on the section 475(c) Regulations, and thereafter on the section 475(b) regulations. There are no Regulations under section 475(a), although at the end of this Report we raise some issues under that subsection.

A. Reg. Sec. 1.475(c)-lT(a); Exemption from dealer status for providers of nonfinancial goods and services

As noted above, section 475(c)(1) includes as a “dealer in securities” a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or who regularly offers to enter into positions in securities in the ordinary course of business. Moreover, a security includes any evidence of indebtedness. As a result, the statute can be read to treat any taxpayer that sells goods or services to customers on credit (perhaps even on open account indebtedness) as a dealer in securities because it either “purchases” evidences of indebtedness from customers or “enters into” positions in evidences of indebtedness with customers.[4/]

[4/] See also section 475(b)(1)(B), referring to securities “acquired (including originated)” by the taxpayer in the ordinary course of business.

The Regulation states, however, that if the principal activity of a taxpayer is providing nonfinancial goods or services, the taxpayer is not a dealer in securities by virtue of the fact that it extends credit to purchasers of its nonfinancial goods and services, even if the taxpayer sells the evidences of indebtedness so received (unless the taxpayer otherwise claims the receivables are inventory under section 471).

1. We strongly approve of this provision of the Regulations. First, it is consistent with Congressional intent; there is no hint in the legislative history that the term "dealer in securities" was intended to cover every retailer selling goods on credit, and every service-provider (including law and accounting firms) providing services on credit.[5/] The acquisition of trade receivables is simply a necessary byproduct of the principal activity of the taxpayer, selling goods and services, rather than a separate independent business of the taxpayer. Second, there is no good reason to apply the mark to market rule to trade receivables of the type in question, since such receivables are generally short term and do not generally vary much in value. Third, treating every retailer as a dealer in securities would largely be a trap for the unwary, since knowledgeable dealers could generally elect out of mark to market under section 475(b), discussed below. Finally, treating every retailer as a securities dealer would leave open the possibility of a significant revenue loss to the Treasury from whipsaw, since (i) such "dealers" whose receivables are generally worth more than their face amount (generally because of a high interest rate, such as certain store-sponsored credit card receivables) and are not held for sale to customers could elect out of mark to

[5/] H. WMCP 103-11, 103rd Cong., 1st Sess. at 223 (1993)("H. Rep."); S. Prt. 103-36, 103rd Cong., 1st Sess. at 274 (1993) ("S. Rep."); H. Conf. Rep. No. 103-213, 103rd Cong. 1st Sess. at 611 (1993) ("Conf. Rep.")

market under section 475(b)(2), while (ii) such “dealers” whose receivables are generally worth less than their face amount (such as noninterest bearing trade receivables) and are not held for sale to customers could nevertheless decline to make that election and thereby create a deemed sale at a loss which would be ordinary under section 1221(4).[6/] Of course, a dealer with both types of receivables could elect to mark to market only the latter.

2. It would be helpful if the term “financial services” were defined. We assume it is intended to mean services typically provided by banks, other entities in the business of lending money, and insurance companies.[7/] To avoid uncertainty, a specific definition should be provided.

3. It would be helpful if the regulation were clarified to provide that a nonfinancial taxpayer described in the regulation would not become a dealer in securities regardless of the manner in which the customer receivables were sold (unless they were sold to customers in the ordinary course of the taxpayer's business). The present Regulation may be read to mean that only an occasional bulk sale to a single purchaser (such as a factor) is permitted. However, receivables may be sold in a variety of ways, including (i) daily sales to a factor, (ii) sales to a securitization trust that issues debt or equity interests in the trust to the public, or (iii) sales to a “grantor trust” which issues certificates to the public representing for tax purposes a direct ownership interest in the

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[6/] In both cases the retailer has an amount realized upon the sale of goods (and initial tax basis in the receivables) equal to the face amount of the receivable.

[7/] See, e.g., Code section 133(a)(l)-(3); Treas. Reg. § 1.904-4(e)(3). We would likewise define financial institution for purposes of section 475 in a manner similar to the usage in these provisions.

receivables. None of these transactions should make the retailer a dealer in securities under section 475(c), since none of them involve sales of receivables to "customers" of the retailer (as required by that section for dealer status to apply to persons not buying securities from customers).

4. We believe the Regulations should also exclude from dealer status a finance company filing a consolidated return with a nonfinancial taxpayer described in the Regulation, where the finance company would be a dealer in securities solely because it is (i) financing customers of the nonfinancial taxpayer and (ii) selling customer receivables in a manner that would be permitted for a nonfinancial taxpayer under the Regulation. For example, if XYZ Corp., an appliance manufacturer, sells to its customers on credit, it is not a dealer in securities even if it sells receivables. However, suppose instead that a customer of XYZ Corp. desiring to buy an appliance on credit in form receives a cash loan from XYZ Finance Corp., a wholly owned subsidiary of XYZ Corp., and in form uses the cash to purchase the appliance from XYZ Corp. XYZ Finance Corp. appears to be a "financial" taxpayer under the Regulations and (assuming it sells more than a small amount of loans, as discussed below) would be a dealer in securities.

It is extremely common for finance corporations to play the role described above, for a variety of good business reasons (such as to allow the finance corporation to borrow without creditors being at the risk of the operating business). Moreover, the substance of the transaction is the same in both cases. We see no reason other than form to explain why XYZ Corp. would not be a dealer in securities if it received customer notes directly, but XYZ Finance Corp. would be a dealer in securities if it received customer notes in exchange for cash used to purchase the same products from XYZ Corp. As to form, the finance company financing only customers of a related retailer is somewhere between a bank (and thus a dealer) and a retailer (and thus a nondealer), and so the form does not mandate dealer status. Finally, if a finance company affiliate was a dealer in securities, as discussed above each nonfinancial taxpayer could freely elect to create a finance company and then further elect under section 475(b)(2) whether each loan not held for sale to customers should be subject to mark to market; whipsaw would again be possible.

B. Reg. Sec. 1.475(c)-lT(b): Exemption from dealer status for those selling a negligible portion of their securities

This provision of the Regulations states that if a taxpayer regularly purchases securities from customers in the ordinary course of business, including regularly making loans in the ordinary course of the business of making loans, the taxpayer is not a dealer in securities if it does not sell more than a negligible portion of securities so acquired. There is no comparable statutory exclusion from the definition of dealer in securities.

1. We likewise support this provision of the Regulations. Since the regulatory exemption from dealer status only applies if a taxpayer rarely sells loans, we believe the regulation establishes an appropriate de minimis rule that has the effect of a deemed election under section 475(b)(2) in that case. We see no pressing need to include such a taxpayer within the definition of “securities dealer” and to require it to then make the election under section 475(b)(2) to exclude its loans from that section. This requirement would be a trap for the unwary for those taxpayers who do not normally think of

themselves as securities dealers (such as banks that do not sell loans). Moreover, if such a taxpayer were treated as a securities dealer with the opportunity (but not the obligation) to make the election out of mark to market for each of its loans, the whipsaw potential against the Treasury arising from selective elections would be magnified.

2. It would be helpful if the Regulation were expanded to provide more guidance on when a taxpayer was deemed to sell more than a negligible portion of its securities. The Regulation has examples illustrating that sales are negligible where a taxpayer regularly acquires loans and during the year sells (i) fewer than 60 loans, or (ii) more than 60 loans but loans having a tax basis less than 5% of the total tax basis of loans acquired during the year.

It is not clear whether failure to satisfy these numerical tests automatically disqualifies the taxpayer from the specific exemption from dealer status. If more sales are not automatically disqualifying, a taxpayer with more sales could still claim nondealer status on the grounds that its sales were “negligible” under all the facts and circumstances, and <u>the government</u> could claim that a taxpayer with more sales was not a dealer despite the taxpayer's claim to be a dealer.

It should be noted that dealer status can frequently be beneficial to taxpayers, and it may not be in the interest of the Treasury to have an automatic rule that a taxpayer is a dealer merely because it sells a specified but small number of loans. Nevertheless, enormous consequences turn on whether or not a taxpayer is a dealer under the statute, and we do not believe it is in the interests of taxpayers or the government to have a large gray area. We therefore recommend that there be a bright line rule stating that sales below a specified level will be considered negligible, and sales above that level will not be considered negligible.

3. The question has been raised as to whether the automatic exception from dealer status should be broader. For example, an automatic exemption might apply to all financial institutions that sell any amount of loans, as long as such sales are not made to customers by the taxpayer acting as a dealer. Such a rule would bring the section 475 definition of “dealer in securities” within the common meaning of the term. However, we believe it would be difficult to justify this result under the statute, particularly since section 475(b) already makes mark to market treatment elective for nontraditional dealers.

4. We believe, however, that an additional de minimis exemption from dealer status would be appropriate. Suppose a financial taxpayer occasionally (but “regularly”) makes loans to customers in the ordinary course of a lending business, that such loans represent only a small portion of its overall business, and that the taxpayer sells more than a negligible portion of such customer loans. The taxpayer is literally a dealer in securities (because it regularly makes loans to customers) and would not be eligible for the exemptions (because it is in a financial business and sells more than a negligible amount of loans it makes). It thus would be required to mark to market all securities held by it unless it elected out under section 475(b)(2). For example, an insurance company could have a large volume of investment securities and would nevertheless become a dealer if it occasionally (but regularly) made policy loans and occasionally sold some policy loans. It is not clear that mark to market was intended to apply in this situation, and as above we question whether such a taxpayer should be permitted elective

mark to market for each of its securities even though none may be held for sale to customers.

C. Suggestion for regulation under section 475(c) defining "customer" in determining dealer status

We believe some clarification should be provided as to the meaning of "customer" for purposes of the rule that a dealer is one who regularly purchases securities from customers or regularly sells securities to customers in the ordinary course of a trade or business.

As to purchases, a bank or finance company making loans is clearly covered, because the loans are to "customers" of the lender. However, what about (i) a "bank" that does not make its own loans or sell loans to customers, but regularly buys loan participations from other banks or (ii) an insurance company that does not make "loans" but regularly buys private placement securities upon their initial issuance, or perhaps only in the secondary market? We do not believe these transactions should be viewed as purchases from customers.

As to sales, these issues are discussed under section E.4 below in the context of section 475(b)(1), which (as interpreted by the Regulations) allows a dealer to elect out of mark to market for securities not held for sale to customers in the ordinary course of business. To the extent a transaction is not deemed to be a sale to customers under that Regulation, a taxpayer that engages only in such transactions (and is not a dealer by virtue of making loans to customers) should not be a dealer under section 475(c).

D. Reg. Sec. 1.475(c)-2T: Items that are never securities

This regulation excludes certain items from the definition of "security", and thus exempts them from mark to market in the hands of a dealer, whether or not an election out of mark to market is made under section 475(b)(2). Among the excluded items are stock of the taxpayer (including an option to buy or sell such stock) and "a liability of the taxpayer".

1. We believe the Regulation should further discuss the scope of the exclusion for liabilities of the taxpayer. For example, any position of a dealer in a notional principal contract is a liability as well as an asset, even if the contract as a whole has positive value. Moreover, the contract as a whole may have initially been at market (i.e., worth exactly zero) but come to have negative value at some point in time because of a change in interest or other rates. Finally, a dealer that writes a put or call option holds a contract that always has negative value. We have no doubt that the dealer in each of these cases is intended to be required to mark the contract as a whole to market without regard to the exclusion for liabilities. However, the Regulation should be clarified to make this clear.

2. A more difficult case is a notional principal contract that involves an initial payment received by the dealer in exchange for taking an off-market position. Under Reg. Sec. 1.446-3, the initial payment to the dealer may create a debt obligation of the dealer for federal income tax purposes. Future regulations may deem such debt obligations to arise in additional situations such as deep-in-the-money options.[8/]

[8/] See Preamble to section 446 regulations on notional principal contracts, T.D. 8491, 58 Fed. Reg. 53125 (Oct. 14, 1993).

The issue is whether in such situations the entire contract should be marked to market, or only the contract net of the embedded loan (the loan balance of which will generally decrease over time in the case of notional principal contracts). It could be argued that it is most consistent with the purposes of Reg. Sec. 1.446-3 that the embedded loan be excluded from the contract for purpose of determining the "security" to be marked to market.

However, this bifurcation approach would considerably increase the difficulty of the calculation because of the need to periodically value both the contract and the loan. Moreover, this approach would be difficult to reconcile with the rule that where the dealer makes a large upfront payment to the counterparty on a notional principal contract, the entire value of the contract in the hands of the dealer would be marked to market (because even if the embedded loan were treated separately it would be a separate security in the hands of the dealer). For example, the dealer might enter into two fully hedged mirror positions with different counterparties, pursuant to which it would receive a large upfront payment under one position and pay the same upfront amount under the other position; since the latter position must be fully marked to market, anomalous results would arise if only a portion of the former position were marked to market. As a result, we recommend that the exclusion for liabilities not apply to deemed liabilities under Reg. Sec. 1.446-3.

E. Reg. Sec. 1.475(b)-lT(a): Securities eligible for election out of mark to market

As noted above, section 475(b)(1)(A) excludes from the definition of security (and thus exempts from mark to market in the hands of a dealer) a security held for investment, section

475(b)(1)(B) excludes from the definition of security a debt security acquired in the ordinary course of business and not held for sale, and section 475(b)(2) only permits a security to be deemed described in (b)(1)(A) or (B) if an election is made on the security acquisition date or later date permitted by regulations. Under a literal reading of these provisions, a security held by a dealer in a trading account would always be subject to mark to market, as would a loan made by a lender and held for sale to noncustomers (because neither such security is held for investment, and both are held for sale). In other words, once a taxpayer was determined to be a "dealer in securities", all "securities" <u>held by the dealer for sale in any capacity</u> (whether or not as a dealer and whether or not to "customers") would be subject to mandatory mark to market. This would be so even though the securities would not be inventory and any gain or loss under the mark to market regime would be capital gain or loss (unless subject to a special rule such as section 582 for bank loans or section 1221(4) for trade receivables).

The Regulation modifies this result in the statute by providing that a security is held for investment (within the meaning of (b)(1)(A)) or not held for sale (within the meaning of (b)(1)(B)) if it is not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. As a result, in the examples above, a dealer can elect out of mark to market for a trading account, and a bank can elect out of mark to market for bank loans not held for sale to customers.

1. We support the result of the regulation. It conforms section 475(b)(1)(A) to (b)(1)(B), and conforms each to the concept in section 1236 that a security is held for investment if it is not held for sale to customers in the ordinary course of business. We believe the Code is complicated

enough without having entirely different tax regimes for three (rather than two) classes of securities held by dealers. Moreover, we doubt the statute was intended to require mark to market for a broad range of assets (going far beyond the types of assets described in section 1256) for which a dealer would be entitled to capital gain or loss. Finally, requiring mandatory mark to market for dealer assets generating capital gain or loss would cause enormous and unexpected burdens on dealers subject to limitations on capital loss carrybacks (such as individuals).

2. We believe one aspect of the Regulation should be clarified. The Regulation now states that a security is held for investment or not held for sale within the meaning of section 475(b)(1)(A) and (B) if not held primarily for sale to customers. The Regulation could be read literally to adopt a per se rule, even though section 475(b)(2) is clear that a security is not treated as described in those sections unless it is properly identified as such by the taxpayer. The Preamble to the Regulation makes clear that the stated rule was intended to be subject to compliance with section 475(b)(2),[9] and the Regulation should be conformed.

3. Further in connection with sections 475(b)(1) and (2), it seems clear from the structure of the statute and the Regulation that if a dealer in securities holds other securities not for sale to customers in the ordinary course of business, the dealer has complete discretion whether to (i) identify a security under section 475(b)(2) and have it be exempted from mark to

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[9] The Preamble states that as a result of the Regulation, a dealer "may" identify a trading security as held for investment. See also the contrasting language in Reg. Sec. 1.475-lT(b)(1), which states that certain securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified under section 475(b)(2).

market, or (ii) not identify and have it be subject to mark to market.

It should be pointed out, however, that if the conclusion in the preceding paragraph is correct, whipsaw against the Treasury may be possible. For example, suppose a bank is in the business of making loans, occasionally sells loans, but does not hold any loans for sale to customers. Absent valid regulations to the contrary, it appears that section 475 provides the bank with complete freedom, on a loan by loan basis, to identify (on the loan acquisition date) any of its loans as being exempt from mark to market and the remaining loans as being subject to mark to market. Could a bank, for example, identify (i) as exempt, all its loans to good credits, as well as its portfolio of credit card receivables (generally initially worth more than their face amount), and (ii) as nonexempt, all its loans to risky credits?

As to the bank loans to be marked to market, note that a bank will generally make profits from interest and fees on risky loans, and have those profits partly offset by future bad debts on some of the loans. Thus, marking initially risky loans to market will simply accelerate the bad debt deductions, and will resemble the allowance of a reserve for bad debts intended to be disallowed by section 585(c). It is also unlikely that a bank will ever concede that any of its risky high-interest loans are ever worth more than their face amount because the credit of the borrower has improved, leaving an impossible audit situation for an IRS examiner.

This issue of selective mark to market will arise for every “dealer in securities” as broadly defined, and as to each “security” not held for sale to customers. Section 475(e) authorizes regulations to carry out the purposes of the section, and the legislative history indicates that this authority permits regulations to prevent “arrangements to take unintended advantage” of the section.[10] We urge the Treasury to make clear in regulations its position as to whether a dealer in fact does have complete freedom, as literally allowed by the statute, to select eligible securities to be subject to (or exempt from) mark to market, whether some consistency requirement is to be imposed, or whether some other conditions are to be imposed.

We recognize that the Treasury may feel constrained by the literal language of the statute to impose, at most, a “clear reflection of income” requirement based on section 446. In addition, if the Treasury intends to propose amendments to the statute to further reduce the ability to make selective elections, we believe it should promptly announce its intention to do so. In any event, we believe that the fundamental issue of the ability of taxpayers to make selective mark to market elections should not be left open to create the potential for years of future litigation.

4. We believe the Regulation should clarify the definition of “customer” for purposes of the rule that an election out of mark to market can be made for a security not held primarily for sale to customers in the ordinary course of business. In general, we believe this condition should be satisfied unless the holder of the security holds itself out as making a market in the security or regularly available to sell the security to customers. In particular, we do not believe any

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[10] Conf. Rep. at 615. Note that the Service also has broad authority under section 446(b) to require that a taxpayer's method of accounting clearly reflect income, see, e.g., Ford Motor Co. v. Comm'r, 102 T.C. No. 6 (Jan. 31, 1994).

of the following should be viewed as a sale to customers: (i) a bank participating out a loan to other banks under normal practices; or (ii) an originator of receivables selling receivables to a trust or other entity which issues debt or equity interests therein in a public offering or private placement (whether or not the trust is disregarded as a "grantor trust" for income tax purposes). Neither of these transactions is typically thought of as a dealer transaction, and the purchasers in these transactions would not normally be viewed as "customers" of the sellers.

5. The Regulation clarifies sections 475(b)(1)(A) and (B), but does not refer to section 475(b)(1)(C). That section provides an elective exemption from mark to market treatment to a dealer for an identified security that is a hedge with respect to a security itself not subject to mark to market, or a hedge with respect to a position not a security; however, the section goes on to provide that it does not apply to a security held by a dealer in its capacity as such, to the extent provided in regulations.

We are not sure what it would mean for a dealer to hold a hedge in its capacity as a dealer, when the asset being hedged is not itself being held as a dealer. For example, a dealer might hold a hedge to protect against fluctuations in (i) the value of another asset identified as held for investment, or (ii) interest rates on a long term liability of the dealer. The Regulation should clarify that discretionary authority will not be exercised to cause these types of hedges to be marked to market, even if the dealer <u>entered into</u> the hedge in its capacity as a dealer. Entering into such a hedge with a regular customer would be the normal method for a dealer to create the hedge, even though thereafter the hedge is not being held in the capacity of a dealer.

F. Reg. Sec. 1.475(b)-lT(b): Securities deemed held for investment and thus out of mark to market

This Regulation provides that certain securities are always treated as held for investment and properly identified as such, including stock of a corporation the taxpayer controls and a partnership or ownership interest in a widely held or publicly traded partnership or trust that the taxpayer controls.[11] Control means direct or indirect ownership of 50% or more of the voting power of stock in a corporation, the capital or profits interest in a widely held partnership, or the beneficial interest in a widely held trust. There is no comparable provision in the statute.

1. We support this Regulation. We do not believe elective mark to market for stock of a controlled affiliate would ever be appropriate because of the difficulty in valuing such stock and the inappropriate discretion taxpayers would have in transferring nonfinancial assets to a subsidiary and marking that subsidiary stock to market. We believe the Regulation properly effectuates the statutory purpose and is an appropriate exercise of regulatory authority under section 475(e).

2. However, we believe the per se rule of the Regulation may be too broad in certain circumstances. For example, suppose corporation X is a dealer and corporation Y is a subsidiary in X's consolidated group. All stock of Y held by X

[11] Section 475(c)(2) includes within the definition of security all corporate stock, but an interest in a partnership or trust only if the entity is widely held or publicly traded.

would automatically be deemed held for investment. However, Y might have a class of nonvoting preferred stock held entirely by the public, or 20% of Y's common stock might be publicly traded. It would not be unusual for X to make a market in such stock. We do not believe stock of this type should automatically be excluded from mark to market, and we suggest that such stock should be subject to mark to market if it is held in a traditional dealer capacity.

A similar issue would arise if X were a partner in partnership Z. X might hold one class of interest that represented more than 50% of the profits, while another class of interest could be publicly traded. Alternatively, there could be an unrelated general partner of Z, all the limited partnership interests in Z could be publicly traded, and X could at times hold more than half the interests in Z. We likewise do not believe these interests held by X should be considered per se held for investment. A rule similar to that proposed above for stock should apply in these cases.

3. We believe the per se exclusions from securities held for investment should be expanded to cover certain debt securities. If an ownership interest in an entity would be deemed held for investment, it would seem that a debt obligation of the same entity should likewise be deemed held for investment, at least where the debt is held by a related party other than in a traditional market making capacity. For example, dealer X might loan money to wholly owned subsidiary Y; it does not seem appropriate that X could choose to mark to market that debt obligation any more than it could choose to mark to market Y's stock.

4. The *per se* exclusions may also be so narrow in other respects as to permit unintended results. For example, if X and Y were unrelated securities dealers and were willing to jointly own real estate, they could achieve the effects of mark to market on the real estate by holding the real estate in either (i) a new corporation in which they each owned 49% of the stock or (ii) a partnership in which they each owned 45%, where the remaining 10% of the partnership interests were publicly traded. If X and Y were individuals, it appears that the real estate holding corporation could be a Subchapter S corporation. Alternatively, X (an individual or corporation) could without the participation of Y hold real estate through a corporation in which X owned all the common stock (having 49% of the aggregate voting power), so long as the corporation issued a small amount of preferred stock having 51% of the vote; the preferred stock might be auction rate preferred callable at the option of the corporation.[12/]

These examples suggest that perhaps all equity interests held by a dealer that represent more than some percentage (say 10%) of the value or profit share of an entity should be automatically deemed identified as held for investment unless in fact held in a traditional dealer capacity. In addition, all stock of a Subchapter S corporation should be in that category.

[12/] Of course, mark to market may well not be attractive to the taxpayer on the facts described in the text, because any losses would be capital losses, the taxpayer risks accelerating capital gains, and (in some cases) the real estate ends up in a nonconsolidated corporation. Nevertheless, in light of the taxpayer's control over future appraisals of the property, we suspect that mark to market would be attractive to many taxpayers that expect to be able to use capital losses.

G. Reg. Sec. 1.475(b)-2T; Transition rules

This regulation provides certain transitional rules, and generally allows identifications of securities held for investment to be made by January 31, 1994.

1. We question whether the one-month time period following issuance of the Regulations is sufficient. As indicated in the discussion in this Report, a number of difficult issues exist and many taxpayers may legitimately require more time to comply.

H. Sec. 475(a): Consequences of mark to market

The Regulations do not cover section 475(a), which is the operative provision requiring a security that is inventory to be included at fair market value and a security that is not inventory to be deemed sold at fair market value on the last day of the year. We wish to raise some issues that will have to be dealt with in future regulations.

1. Suppose a dealer received an upfront cash payment to enter into a contract that must or may be marked to market.[13/] For example, the cash could be received as an initial payment on a swap, or the dealer might write a put or call option. In any of these cases the contract would have negative value to the dealer immediately upon its creation, and the dealer would have an unjustified windfall if it were allowed an immediate loss under mark to market. It would seem that some kind of “negative basis account” would have to be created so that only changes in value from that initial negative basis would be taken into account.

[13/] It is assumed herein that “bifurcation” under Reg. Sec. 1.446-3 is not applicable for this purpose. See Section D.2 above.

A multitude of issues similar to the above could arise. For example, in a simple swap a dealer might receive a gross fixed payment on each December 31 and make a gross floating payment on each January 1. Suppose the swap has a zero value on December 30 and January 2, because all future payments are expected to be exactly equal in amount. Neither party to the swap will have any net income or deduction for the year then ending. Nevertheless, at midnight on December 31 the dealer owing funds the next day would have a swap with a negative value equal to the payment due the next day. Serious consideration will have to be given to the mechanics of mark to market in these situations.

2. Consider a bank that makes loans to customers and occasionally sells loans to noncustomers, and chooses not to make the section 475(b)(2) election with respect to all or part of its loans. When the loans are marked to market, what is their fair market value?

It is doubtful that the statute was intended to allow large banks to recreate their loan loss reserves recently disallowed by section 585(c). To reach the intended result, therefore, the valuation of a pool of loans <u>as a pool</u> would have to be prohibited, because the value of the pool (<u>i.e.</u>, the price a willing buyer would pay) would certainly take into account the fact that a predictable percentage of the loans would default (even though those particular loans might not yet be identifiable). Thus, each loan would have to be valued separately.

Even under this approach, the result would be an (ordinary) loss for the decline in actual value of loans for which the borrower's credit has weakened, an (ordinary) gain for loans where the borrower's credit standing had improved, and additional gain or loss on all loans to reflect changes in market interest rates since the loan origination date.[14/] As partly indicated in E.3 above, we believe even this approach is likely to prove a benefit to banks as compared to current law, because (i) to the extent a decline in credit quality can be identified the bank will have a faster deduction than under current law, and (ii) improvements in credit quality will be less likely to be conceded on a return, and in any event will provide smaller increases in values than the decreases in values resulting from credit declines. In fact, even if all valuations are assumed to be accurate, mark to market on debt instruments appears generally to result in faster recognition of losses than under current law.[15/]

[14/] It is possible that GAAP valuation principles or bank regulatory principles could be used (or would at least provide helpful guidance) in many cases for purposes of marking securities to market. However, we have not examined the specific GAAP rules or bank guidelines that would be applicable in these situations. Moreover, caution would have to be taken not to adopt any such principles that valued loans as a pool and in effect allowed loan loss reserves. These principles might also be useful if the Treasury wished to require banks to treat loans as held for investment under section 475 if they were not treated as held for sale for GAAP or regulatory purposes.

[15/] On the whole, any specified portfolio of debt securities (other than Treasuries), whether or not publicly traded, is expected to return less than its face amount, which expected loss to a holder paying face is offset by a current yield above the Treasury rate. Absent mark to market, even though interest is all taken into income currently, the expected net losses can be deducted by the holder only at approximately the time of actual default on the securities. Under mark to market, the losses would properly be recognized at an earlier time as credit quality declined. Even under perfect methods of valuation there would be no offsetting gains, because the expectation is a net loss, and an ultimate net gain is impossible to a holder paying face.

3. Extremely difficult valuation issues will arise under the mark to market regime. The reason is that a dealer in securities is permitted to elect mark to market for many "securities" that are not readily marketable, such as minority interests or warrants in closely held corporations. The dealer may in practice have considerable discretion as to the values to claim for such assets on an annual basis, and the tax incentive will obviously be to claim values as low as might possibly be defensible. The Service will obviously have a difficult if not impossible audit situation in reviewing the values of these assets.

Additional difficulties for the Treasury will arise in multi-asset situations. For example, consider an investment bank that makes risky LBO loans in exchange for debt and warrants. Assume that the money that the bank loses on loans to borrowers that fail is, in practice, offset by the vastly increased value of the warrants issued by the borrowers that prosper. In practice, little or nothing is likely to be allocated to the warrant in a loan/warrant package, almost guaranteeing a net gain on the warrants and a net loss on the loans. Of course, the bank will elect mark to market on the loans but not on the warrants.

The Conference Report to section 475 states that the conferees expect the Treasury to authorize valuation methods "that will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for Federal income tax purposes."[16/] However, we see no practical solution under the statute to the problems to the Treasury and the Service that might well arise

[16/] Conf. Rep. at 616.

from elective mark to market for nontraded property. This problem may further indicate a basic flaw in a statutory scheme that permits mark to market treatment for all securities that are held by dealers even though the securities are not held for sale to customers.