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The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Mark-to-Market Rules Under Section 475

Dear Commissioner Koskinen:

Enclosed please find comments on potential challenges to administering the mark-to-market rules under section 475 ("Comments"). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,



Armando Gomez
Chair, Section of Taxation

Enclosure

cc: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Tom West, Tax Legislative Counsel, Department of the Treasury
William J. Wilkins, Chief Counsel, Internal Revenue Service
Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
Helen Hubbard, Associate Chief Counsel (Financial Institutions and Products), Internal Revenue Service

**AMERICAN BAR ASSOCIATION
SECTION OF TAXATION**

SECTION 475 “CLEAN-UP” PROJECT

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing and reviewing these Comments was exercised by Chip Harter, Alan Munro, Erika Nijenhuis, William Pomierski, Jo Lynn Ricks, Steven Rosenthal, Michael Yaghmour, and Jonathan Zelnik of the Section’s Financial Transactions Committee (the “Committee”). Helpful comments were provided by Timothy Shapiro and Eileen Marshall. These Comments were reviewed by Lucy W. Farr, the Section’s Council Director for the Committee, Kevin Keyes, on behalf of the Committee on Government Submissions, and Peter H. Blessing, the Section’s Vice Chair (Government Relations).

Although many of the members of the Section who participated in preparing these issues have clients who may be affected by the federal tax principles addressed herein or who have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 7, 2015

DISCUSSION

These Comments respond to an informal request from the Internal Revenue Service (the “Service”) to identify issues for a section 475¹ “clean up” project. We have identified two categories of issues that pose challenges to administering the mark-to-market rules under section 475: Category 1 consists of issues arising under the proposed and final regulations and Category 2 consists of other important issues. In most cases, our Comments identify potential solutions that the Department of the Treasury (“Treasury”) and the Service might consider, without recommending a particular solution.

Category 1: Issues regarding proposed regulations and critical issues for final regulations

1. Revise the section 475 and debt instrument rules in Proposed Regulation section 1.475(a)-1.² As currently drafted, Proposed Regulation section 1.475(a)-1 requires taxpayers that are on the mark-to-market method of accounting under section 475(a) to first apply tax accounting rules for debt instruments (including the original issue discount (“OID”), market discount, bond premium and bad debt rules) prior to the mark. For many taxpayers, applying the tax accounting rules for debt instruments prior to the mark will not affect, in any manner, the taxpayer’s taxable income—that is, any increase or decrease of interest income rather than ordinary gain or loss would not matter to the taxpayer’s overall tax position. Accordingly, Treasury and the Service should consider drafting final regulations to allow taxpayers to elect not to apply the regulation (*i.e.*, to allow the taxpayer to mark debt instruments to market without first (or later) applying the tax accounting rules for debt) where application of the tax accounting rules for debt instruments is not expected to have a significant effect on the taxpayer’s federal income tax. This could reduce administrative burdens for the taxpayer as well as for the Service upon examination.
2. Clarify Proposed Regulation section 1.475(a)-2(a) and the mark upon disposition rule in a consolidated return context.³ The proposed regulations contain the rule that when the dealer “ceases to be the owner of a security for federal income tax purposes,” the dealer must mark the security immediately before disposition and take gain or loss into account at that time. Some practitioners believe that a transfer of a security by one consolidated group member to another is a deferred intercompany transaction notwithstanding a contrary conclusion (that gain on sale was not deferred intercompany gain) in the proposed regulation.⁴ Similarly, some practitioners

¹ References to a “section” are to a section of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

² 60 Fed. Reg. 397 (1995).

³ *Id.*

⁴ See the further discussion of deferred intercompany transactions in point 10(c), *infra*. This clarification would need to be coordinated with the suggested change to the character of a security in a consolidated return regulations example, Reg. § 1.1502-13(c)(7)(ii), Example 11(d).

question whether a transfer to a related party might trigger section 267(a)(1) given the potentially broad scope of section 267(a)(1) and Regulation section 1.267(a)-1(a). Consistent with legislative history,⁵ we recommend that Treasury and the Service consider revising the regulation to provide explicit coordination rules clarifying that the mark would occur prior to the transfer (so, for example, there would be no loss to be deferred under section 267).

Further, we recommend that the regulations list examples of the transactions to which the mark before disposition rule applies. Although the preamble to the proposed regulations contains a partial list of such transactions, we recommend that the list be placed in the text of the final regulations.

3. Clarify exemption of securities in certain securitization transactions in Proposed Regulation section 1.475(b)-3.⁶ As currently drafted, Proposed Regulation section 1.475(b)-3 can create a number of unnecessary compliance issues for taxpayers that securitize and sell some but not all of their debt assets. At its core, the proposed regulation appears to establish or further certain basic principles, two of which are: (i) where securities are contributed to a trust for which the resulting securities are treated for federal income tax purposes as continued ownership of the underlying contributed securities (for example, a fixed investment trust treated as a grantor trust), the resulting securities must be identified in the same manner as the contributed securities and (ii) where securities are contributed to any securitization vehicle, the contributed securities may only be exempted from mark-to-market treatment as held for investment or not held for sale to customers if the taxpayer expects all of the resulting securities to be so held.

The main concern with the first principle is that a taxpayer may contribute securities to a trust, some of which have been identified under section 475(b)(1) and some of which have not. Where the resulting security represents continued ownership of both the marked and unmarked securities, the proposed regulation may be impossible to apply because the underlying loans may no longer be separately tracked or priced. Moreover, if implemented properly, allowing the taxpayer to identify (or not identify) the resulting security in a manner that is different from the contributed security will not, in our view, lead to abuse.⁷ As long as contributed securities that are subject to mark-to-market accounting are required to be marked on contribution and contributed securities not subject to mark-to-market accounting can only be marked for subsequent changes in value, a taxpayer cannot predict whether such securities will increase or decrease in value. Additionally, there is precedent for treating the

⁵ H.R. Rep. No. 103-111, at 661 n. 37 (1993), *as reprinted in* 1993 U.S.C.C.A.N. 378, 392, states: “For purposes of this provision, a security is treated as sold to a person that is not related to the dealer even if the security is itself a contract between the dealer and a related person. Thus, for example, sections 267 and 707(b) of the Code are not to apply to any loss that is required to be taken into account under this provision.”

⁶ 60 Fed. Reg. 397 (1995).

⁷ If there is a concern for abuse, we believe an anti-abuse rule could be drafted that is presumed to apply where the taxpayer retains a large portion (*e.g.*, greater than 50%) of the resulting securities.

resulting securities from a grantor trust securitization in a manner that is different from the treatment of the contributed securities; section 1272(a)(6) provides that OID on a pool of loans is calculated in a manner different from the calculation of OID on loans that are held individually. Thus, where individual loans are pooled in a fixed investment trust, the tax rules in place already provide situations where the taxable income from the resulting security may be different from the aggregate taxable income of the contributed securities.

The second principle creates issues for taxpayers that are uncertain as to whether or not their debt assets will be securitized. For example, taxpayers may buy mortgage loans and leverage the purchase. The leverage may be accomplished through the use of rolling repo lending or other conventional types of leverage, but may also be accomplished using a real estate mortgage investment conduit (“REMIC”) where the senior REMIC tranches are sold for leverage. At the time of purchase of the mortgage loans, the taxpayer may not know which of the types of leverage will be used, as the decision depends on the cost of funding. Similar to the discussion above, we suggest that the Service consider that the identification of the contributed securities not be linked to the identification of the resulting securities. Where a taxpayer does not know upon purchase whether certain assets will be securitized, the taxpayer should be able to appropriately identify them as exempt even if they are later securitized.⁸

4. Expand a trader’s ability to elect mark-to-market accounting in Proposed Regulation section 1.475(f)-1.⁹¹⁰ A taxpayer generally must file the trader election no later than the due date (without extension) of the original federal income tax return for the taxable year immediately preceding the election year, thus tolerating some element of hindsight.¹¹ The statement must be attached either to that return, or to a request for an extension of time to file that return. If a taxpayer subject to this rule becomes a trader after that filing date, the taxpayer is precluded from making the trader election for its trading activities for that year. The taxpayer must wait until the following tax year to make a timely trader election.

By comparison, a “new taxpayer” (defined as a taxpayer for which no federal income tax return was required to be filed for the taxable year immediately preceding the election year) makes the trader election by placing the election statement in its books

⁸ We also note that certain informal guidance from the Service has taken the position that sales to REMICs should be treated as sales to customers. This is in contrast to the proposed regulation, which appears to look through the securitization vehicle (even when in REMIC form) to determine whether the contributed securities were appropriately identified under section 475(b)(1). However, the approach suggested above (de-linking the contributed securities from the resulting securities) arguably is inconsistent with the informal guidance because it would permit loans that may be contributed to a REMIC to be identified as exempt from mark-to-market treatment.

⁹ 64 Fed. Reg. 4374 (1999).

¹⁰ These comments also apply to a dealer in commodities.

¹¹ Section 5.03(1) of Rev. Proc. 99-17, 1999-1 C.B. 503.

and records no later than two months and 15 days after the first day of the election year.¹²

We recommend that Treasury and the Service revise Proposed Regulation section 1.475(f)-1 (or Rev. Proc. 99-17¹³) to permit a taxpayer (whether existing or new) that begins its trading business after the applicable return filing date to make a trader election by placing an election statement in its books and records no later than 2 months and 15 days after becoming a trader. This time frame is the same time frame that a “new taxpayer” has to make the election, and gives both existing and new taxpayers that begin a trading business after the applicable return filing date the same 2-month and 15-day period in making the election. However, if Treasury and the Service believe that a taxpayer ought not to be given this time frame for making the election at year end, they may wish to add a cut-off date so that the election can be made no later than one month before year-end.

5. Clarify character of section 481(a) adjustment for electing traders in Proposed Regulation section 1.475(f)-1.¹⁴ A taxpayer that makes a trader election may need to change its method of accounting for its trading securities subject to mark-to-market accounting under section 475(f).¹⁵ This change in method of accounting results in a section 481(a) adjustment equal to the difference between the fair market value of the securities held by the taxpayer at the beginning of the year of change and the taxpayer’s basis in such securities.¹⁶ However, there is no specific guidance regarding the character of the section 481(a) adjustment.

Because the purpose of the section 481(a) adjustment is to treat the taxpayer as if it were always on the mark-to-market method, then it follows that the character of the section 481(a) adjustment ought to be ordinary. However, one could take the position that the character of the section 481(a) adjustment ought to relate back to the capital character of the trading activity from which it arose. Given the lack of guidance on this issue, we recommend that the proposed trader regulations provide specific guidance on the character of the section 481(a) adjustment when a trader makes the section 475(f) election.

6. Provide guidance permitting a trader in securities to make a section 475(f) election for some but not all of its separate business activities of trading securities in Proposed Regulation section 1.475(f)-1.¹⁷ For a person that is a dealer in securities, all securities are required to be marked-to-market (or included in inventory at fair market value), except those securities that are described in section 475(b). A person that is engaged in a trade or business as a trader in securities may elect under section 475(f)

¹² Section 5.03(2) of Rev. Proc. 99-17, 1999-1 C.B. 503.

¹³ 1999-1 C.B. 503.

¹⁴ These comments also apply to a trader in commodities.

¹⁵ Section 6.01 of Rev. Proc. 99-17, 1999-1 C.B. 503.

¹⁶ Section 6.03 of Rev. Proc. 99-17, 1999-1 C.B. 503.

¹⁷ These comments also apply to a trader in commodities.

to apply section 475(a) to the securities that are “held in connection” with such trade or business. Based on the language of the statute and the application of section 475 to dealers in securities, it is unclear whether a trader that makes a section 475(f) election must apply that election to all of the securities that are part of its trading activities, even if the person maintains separate trading books and those activities constitute separate trades or businesses.

In Chief Counsel Advice (“CCA”) 201432016,¹⁸ the Service concluded that the election under section 475(f) is made on an entity-by-entity basis, not a separate trade or business basis, and only in the case of separate commodities and securities businesses can a taxpayer make separate elections. The basis for that conclusion appears to be the legislative history expressing concern about the issues of taxpayer selectivity in making identifications out of marking. CCA 201432016 says that Congress did not want a taxpayer to selectively mark to market only some securities, and notes that Congress especially did not want a taxpayer to be able to do so using hindsight. Finally, CCA 201432016 concludes that to address that concern, Congress placed a higher burden of proof for electing securities traders to identify securities as not subject to section 475 that is applicable to securities dealers.

The Committee agrees that Congress was particularly concerned about taxpayers using hindsight to decide securities that are marked and securities that are not marked. As discussed below in paragraph 8, the Committee believes that adequate protection against the use of hindsight can be achieved through the identification process recommended in that paragraph. As to whether Congress intended that section 475(f) be made on an entity-by-entity basis rather than on a separate trade or business basis is not clear from either the statutory language of section 475(f) or the legislative history. Section 475(f) itself is ambiguous on this point—“In the case of a person who is engaged in a trade or business as a trader in securities and who elects to have this paragraph apply to *such* trade or business (i) such person shall recognize gain or loss on any security held in connection with *such* trade or business” (emphasis added). The Conference Report states the following:

The conference agreement clarifies that if a securities trader elects application of the provision, all securities held in connection with its trading business will generally be subject to mark-to-market accounting. An exception is provided for securities that have no connection with activities as a trader and that are identified on the day acquired (or such other times as provided in Treasury regulations).¹⁹

An entity can have more than one trade or business for U.S. federal income tax purposes. We requests that Treasury and the Service reconsider the conclusion reached in CCA 201432016 and provide guidance clarifying whether a taxpayer that is a trader in securities and that maintains separate books and records for each securities trade or business may elect under section 475(f) to apply section 475(a) to

¹⁸ April 10, 2014.

¹⁹ H.R. Rep. No. 105-220, at 515 (1997) (Conf. Rep.).

some but not all of such trades or businesses. As noted in CCA 201432016, a person that is both a trader in securities and a trader in commodities may make an election under section 475(f) for its trading in securities or in commodities without making it for both such activities.

It is our understanding that Treasury and the Service may have concerns that a rule that would permit the mark to apply to some but not all of a person's trading securities (or commodities) would enable taxpayers to manipulate the rules to cherry-pick securities and decide after acquisition whether those securities (or commodities) are to be marked under section 475 without leaving an audit trail. In our view, rules can be crafted to protect against such manipulation. For example, we expect that the rules could require a taxpayer to maintain contemporaneous documentation that clearly and unambiguously identifies the securities or commodities composing each separate trading trade or business. If merely maintaining separate trading books would not adequately protect against taxpayer selectivity, consider requiring a taxpayer with multiple trades or businesses of trading to segregate among separate legal entities or possibly separate accounts maintained with third parties those trading books to which section 475(a) will apply and those to which it will not apply.

7. Clarify when a security is held in connection with a trade or business in Proposed Regulation section 1.475(f)-2(a)(2).²⁰²¹ A securities dealer must mark to market each of its securities, unless the dealer identifies one or more of them as exempt (*e.g.*, as held for investment). By comparison, a securities trader may elect to mark its securities that are "held in connection" with a securities trade or business. If the trader makes a mark-to-market election, the trader may only exempt a security that is "established to the satisfaction of the Secretary as having no connection to the activities of such person as a trader."

Under proposed regulations, a trader may identify a security as exempt only with "clear and convincing evidence that a security has no connection to its trading activities."²² There is no proposed guidance on what evidence would be "clear and convincing," or on how to determine the scope of "trading activities." As a result, a securities trader that makes a mark-to-market election often is uncertain as to which securities may (or must) be marked.

The current statute and proposed regulations simply confuse taxpayers that make a trading election. We suggest providing guidance on what constitutes "clear and convincing evidence" and what defines the scope of "trading activities." We also suggest the proposed guidance require securities traders to identify upfront the scope of their trading business and the nature and type of securities that are connected to that business. Once identified, those securities, and only those securities, may be marked.

²⁰ 64 Fed. Reg. 4374 (1999).

²¹ These comments also apply to a trader in commodities.

²² Prop. Reg. § 1.475(f)-2(a)(2).

8. Change Proposed Regulation section 1.475(f)-2(a)(3) identification rule for non-trading securities where taxpayer both trades and invests in the same security.²³ Under section 475(f)(1)(B), a trader in securities can exempt from mark-to-market accounting any security which has no connection to the taxpayer's activities as a trader. However, the security must be clearly identified in the trader's records as such before the close of the day on which the security was acquired, originated, or entered into (or such other time as the Secretary may prescribe by regulations). Proposed Regulation section 1.475(f)-2(a)(3) places an additional, non-statutory requirement for certain non-trading securities to be identified as exempt from mark-to-market accounting. Under Proposed Regulation section 1.475(f)-2(a)(3), a trader in securities that both trades and invests in the same security can only identify the investment securities out of mark-to-market accounting if they are placed in a separate, non-trading account maintained with a third party.

The requirement that these investment securities be placed in a separate, non-trading account maintained with a third party is inconsistent with the plain language of section 475(f). Section 475(f)(1)(B)(ii) only requires that non-trading securities be clearly identified as such in the trader's records. The Service permits securities dealers to identify securities as exempt from mark-to-market accounting under section 475(b)(2) by placing them in a separate account identified as containing only securities covered by a specific exemption.²⁴ We believe that the interests of the government are adequately protected if the trader identifies the non-trading securities by placing them in a separate account in the trader's own books and records. Accordingly, we recommend that Treasury and the Service should not finalize Proposed Regulation section 1.475(f)-2(a)(3) as currently drafted.

9. Change Proposed Regulation section 1.475(f)-2(a)(4) and (5) regarding the timing rule for investment securities not identified.²⁵ Proposed regulations provide that if an electing trader holds a security that is not held in connection with its trading business, and it fails to identify it out of mark-to-market accounting under section 475(f)(1)(B)(ii), then (1) the loss is taken into account only to the extent of gain previously recognized under section 475; and (2) the character of the gain or loss on the security is ordinary.²⁶ Notwithstanding this rule, the Commissioner can treat the security as if it were timely identified as exempt from section 475(f).²⁷

The higher of cost or market rule is not found in either the statute or the legislative history of section 475(f). Further, the rule is inconsistent with the treatment of investment securities not identified by a dealer in securities. If a dealer in securities fails to identify a security as exempt from mark-to-market accounting under section 475(b)(2), the security is marked to market. Distinguishing securities (or

²³ These comments also apply to a trader in commodities.

²⁴ Holding 6 of Rev. Rul. 97-39, 1997-2 C.B. 62.

²⁵ These comments also apply to a trader in commodities.

²⁶ Prop. Reg. § 1.475(f)-2(a)(4).

²⁷ Prop. Reg. § 1.475(f)-2(a)(5).

commodities, for a commodities trader) not held in connection with a trading business from those securities (or commodities) that are part of the trading business can be very difficult and subjective. We recommend that the final regulations adopt a rule similar to the rule for securities dealers that ensures mark-to-market treatment for all securities (or commodities) held by an electing trader in respect of a trading business unless the trader makes a timely identification under section 475(f)(1)(B)(ii).

Moreover, we recommend eliminating the Service's ability to identify such a security out of section 475(f). At a minimum, regulations are needed to provide objective standards for when the Service's authority will be invoked. Presumably, it would be invoked only in situations deemed abusive, but without objective standards, it is not clear what situations would be considered abusive.

10. Clarify the ordinary character rule for securities dealers under section 475(d)(3)(B)(ii).²⁸ Section 475(d)(3)(A) generally provides for ordinary treatment for a security that is subject to mark-to-market accounting. However, under section 475(d)(3)(B)(ii), ordinary treatment does not apply to gain or loss allocable to the period the security is "held other than in connection with" the taxpayer's activities as a dealer in securities. Under this rule, the character of the gain or loss can flip from ordinary to capital, or capital to ordinary, based on the capacity in which the security is held. On the other hand, Treasury regulations provide that if a security is never held in connection with the taxpayer's activities as a securities dealer, then the general rule for ordinary gain or loss treatment does not apply.²⁹

- a) Clarify the meaning of "held in connection". There is no definition of when a security is held in connection with dealing activities, which makes it difficult to determine the scope of the rule. Second, there are no rules to determine the amount of ordinary gain or loss when the security moves from "held in connection" with to not "held in connection" with dealer status. We recommend that Treasury and the Service clarify the scope of the term "held in connection," and provide transition rules to implement the change in character (*e.g.*, mark-to-market before the change in dealer capacity).
- b) Clarify the change in character rules. The interrelationship between the character rule in the final regulations and the character rule in the statute is unclear. For example, suppose a security was held in connection with the dealer business, and then was held in a non-dealer capacity. Some practitioners have interpreted the final regulations to mean that if a security was ever held in connection with the taxpayer's dealing business, then the gain or loss could never be treated as capital—a once ordinary, always ordinary rule. Thus, the security would continue to be marked and ordinary in character. Other practitioners interpret the final regulations to only apply to trading or investment securities that were never held as part of the dealer's business. Under this approach, the security could flip from ordinary to capital treatment (under the statutory rule) because the regulatory rule

²⁸ These comments also apply to a dealer in commodities.

²⁹ Reg. § 1.475(d)-1.

simply would not apply. We recommend that Treasury and the Service clarify the interpretation of the final regulations when a security changes from “held in connection with the dealer’s business” to “held in a non-dealer capacity” (or vice versa).

- c) Clarify Regulation section 1.1502-13(c)(7)(ii), Example 11(d). In Example 11 of Regulation section 1.1502-13(c)(7), S, a dealer in securities under section 475(c), holds a security for sale to customers that is subject to mark-to-market treatment. S subsequently sells the security to B, another group member that is not a dealer in securities, who holds the security for investment. Under the matching rule, attributes are redetermined by treating S and B as divisions of a single corporation. As a result of S’s activities, the single corporation is treated as a dealer in securities, and B must continue to mark-to-market the security acquired by S. Thus, B’s corresponding items and the recomputed corresponding items are determined by continuing to treat the security as not within an exception to marking-to-market. The example further provides that S’s gain when it disposes of the security to B is ordinary in character, while B’s gain from the sale of a security to a third party is capital in character.

The analysis in the regulation is based on the statutory approach that the character of a security can flip from ordinary to capital when it changes from being held in connection with dealer activities to being held in a non-dealer capacity. However, as discussed above, this approach may be inconsistent with Regulation section 1.475(d)-1 and difficult to administer in practice. Accordingly, Treasury and the Service should consider a rule that continues to treat the non-dealer’s gain or loss as ordinary.

Even if Treasury and the Service do not change the approach in the example, there are instances when transferring a security from a dealer to a nondealer can still result in the security being held in connection with the securities dealer’s activities. For example, a dealer may transfer dealer securities into a special purpose vehicle as collateral in connection with its dealer activities. Those securities would remain “part of the dealer business” even if that special purpose vehicle were a regarded subsidiary. We recommend that the example be revised to make clear that the security in the hands of B is not held in connection with S’s dealer business, which is the standard in section 475(d)(3)(B)(ii).

Category 2: Important issues that need guidance

11. Extend valuation safe harbor of Regulation section 1.475(a)-4 to taxpayers who have made section 475(f) trader elections.³⁰ An “eligible taxpayer” (as defined in the regulations) may elect under Regulation section 1.475(a)-4 to use the values of positions as reported on its “applicable financial statements” (as defined in the regulations) as the fair market values of those positions for section 475 purposes.

An “eligible taxpayer” is defined under the regulations as a dealer in securities and a taxpayer that has elected to be taxed as a dealer in commodities. Taxpayers that have elected to be taxed as securities and/or commodities traders under section 475(f) are currently precluded from taking advantage of the valuation safe harbor for their trading activities.

There are, however, numerous situations where a taxpayer that has elected to be taxed as a trader in securities and/or commodities would satisfy the requirements of this valuation safe harbor but for the limitation on eligible taxpayers. We recommend that this valuation safe harbor be extended by revising the definition of an eligible taxpayer to include taxpayers that have made trader elections under section 475(f).

12. Clarify that daily or monthly marking is consistent with section 475.³¹ Section 475 provides that any security that is inventory in the hands of a dealer in securities is included in inventory at its fair market value.³² Further, for non-inventory securities held at the close of the taxable year, the dealer must recognize gain or loss as if the security were sold for its fair market value on the last business day of the tax year, and any gain or loss is taken into account for the taxable year.³³

Some section 475 dealers mark to market their inventory and non-inventory securities on a daily or monthly basis for book purposes, and want to use this mark-to-market convention for tax purposes. Although section 475 is generally thought of as an annual mark, marking to market securities more frequently than annually (*e.g.*, on a daily or monthly basis) is consistent with the plain language of section 475.

Support for a daily or monthly mark-to-market can be found in the valuation safe harbor regulations. Under the valuation safe harbor, a dealer in securities or commodities can use financial statement values for purposes of section 475 if the mark-to-market method for financial reporting is “sufficiently consistent” with the requirements of a mark-to-market method under section 475.³⁴ To be sufficiently consistent with the mark-to-market method of section 475, the financial reporting

³⁰ These comments also apply to a trader in commodities.

³¹ These comments also apply to a dealer in commodities and to a trader in securities or commodities.

³² I.R.C. § 475(a)(1).

³³ I.R.C. § 475(a)(2).

³⁴ Reg. § 1.475(a)-4(d)(1).

method must require a valuation of the position no less frequently than annually, including a valuation as of the last business day of the taxable year.³⁵

Further, permitting a taxpayer to use a daily or monthly mark would not prejudice the interests of the government. The amount of the mark-to-market gain or loss would be the same for the whole year, or upon the sale of the security during the year, whether there is one mark at the end of the year, or more frequent marks during the year. Moreover, the proposal relieves an administrative burden on the Service because it is more efficient for an agent to audit the mark-to-market amounts used for book purposes for tax.

Accordingly, we recommend that Treasury and the Service make clear that a mark-to-market method that requires a valuation of the position no less frequently than annually, including a valuation at the end of the year, which the taxpayer uses for financial reporting purposes, is consistent with the requirements of a mark-to-market method under section 475, even if the dealer did not make an election to use the valuation safe harbor.

13. Restate the rule that financial accounting classification is not dispositive for purposes of section 475 in Regulation section 1.475(b)-2. A dealer must mark all of its securities to market, except those that are properly identified as exempt under section 475(b). Dealers may classify a security for financial accounting purposes one way and apply section 475 to the security in a manner that appears inconsistent with the financial accounting classification (such as exempting the securities for tax and yet marking-to-market for financial accounting purposes). We suggest amending the regulations to incorporate Holding 4 of Rev. Rul. 97-39,³⁶ which provides that classification of a security under financial accounting principles, including U.S. GAAP, is not dispositive for purposes of the section 475(b) determination of whether a security is held for investment or not held for sale. Although the holding of the ruling is clear, it may be overlooked by practitioners and incorporating it into the regulations would resolve confusion regarding the rule.
14. Transition rules for existing taxpayers that become section 475 dealers in securities. Section 475 provides no transition rules for a person that is not a new taxpayer and becomes a dealer in securities other than by electing out of the negligible sales exemption of Regulation section 1.475(c)-2(c). The lack of any transition guidance creates uncertainty on a number of issues and is a potential trap for the unwary.
 - a) Change in circumstances, method of accounting and automatic consent. Uncertainty exists about whether a taxpayer must obtain the Commissioner's approval to change its method of accounting in connection with becoming a dealer in securities. The Service's position is that marking to market is a method of accounting.³⁷ If a taxpayer becomes a dealer in securities as a result of changes

³⁵ Reg. § 1.475(a)-4(d)(2)(i).

³⁶ 1997-2 C.B. 62.

³⁷ Holdings 19 and 20 of Rev. Rul. 97-39, 1997-2 C.B. 62.

in its business activities, it is unclear whether that change in circumstances is a change in underlying facts that makes the Commissioner's approval to apply section 475(a) to existing and newly acquired securities unnecessary because of the rule in Regulation section 1.446-1(e)(2)(ii)(b), which provides that a "change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts." In the absence of guidance on this point, it is our understanding that similar taxpayers (and their advisors) take varying positions. Guidance on this point would have the benefit of eliciting more consistent treatment among taxpayers.

If the Service concludes instead that becoming a dealer due to a change in circumstances does require an existing taxpayer to obtain the Commissioner's consent to change its method of accounting to conform with section 475, we request that it be automatic (*i.e.*, allowing a taxpayer that becomes a dealer in securities as a result of a change in circumstances to obtain automatic consent to change its method of accounting). We note that a taxpayer that elects out of the negligible sales exemption may obtain automatic consent to change its method of accounting to use section 475(a).³⁸

- b) Transition rule for securities held when a taxpayer becomes a dealer in securities. We request transition rules under which a person that becomes a dealer in securities due to a change in circumstances may identify securities it holds before it becomes a dealer as being covered by one of the exceptions in section 475(b)(1). A taxpayer may become a dealer in securities due to a variety of changes in circumstances. A bank may cease satisfying the negligible sales exemption. A taxpayer may start a new trade or business of dealing. A non-dealer taxpayer may merge with or acquire a dealer. Although Holding 1 of Rev. Rul. 97-39,³⁹ provides a method for a taxpayer to avoid applying section 475(a) to securities it holds when it becomes a dealer due to a change in circumstances, it is our experience that few taxpayers know about the rule, and of those that do, most do not or cannot implement a process for making the required identification statements, because most taxpayers that are not dealers in securities do not expect to become dealers. Notably, a protective election must be made when the security is acquired, which may be far in advance of the facts that cause a change in status. For example, a taxpayer may no longer want the election to apply to all of the securities so identified when the taxpayer does become a dealer, but given the burden imposed in Regulation section 1.475(b)-1(a), a taxpayer may not have an opportunity to change the identification done when it was not a dealer. Finally, even if such an identification regime is adopted, being able to track such identifications can be difficult if made years in the past.

If taxpayer selectivity is a concern, one approach to consider is a transition rule that permits a taxpayer to elect to treat all or none of the securities it holds as covered by one of the exceptions in section 475(b)(1). Another (or possibly

³⁸ Rev. Proc. 97-43, 1997-2 C.B. 494.

³⁹ 1997-2 C.B. 62.

complementary approach) would be to permit a taxpayer to identify certain securities as covered by one of the exceptions in section 475(b)(1) but restrict the amount of any negative section 481(a) adjustment that may be accounted for in the year of change or subsequent years. For example, a rule similar to section 475(d)(2) would limit the amount of any negative section 481(a) adjustment in the event that a taxpayer elects to identify some but not all of the securities it holds as covered by one of the exceptions in section 475(b)(1).

- c) Reconsider the rule for taxpayers that elect out of the negligible sales exemption. Under section 5.02 of Rev. Proc. 97-43,⁴⁰ any built-in gain or loss as of the beginning of the year of change must be taken into account under rules similar to Regulation section 1.475(a)-3(b)(2) (which provides that built-in gain or loss is taken into account at the time, and has the character, provided by the sections of the Code that would apply to the built-in gain or loss as if section 475(a) did not apply to the security). Notably, such a rule does not apply to a taxpayer that becomes a dealer in securities as a result of a change in circumstances or that elects to apply section 475(a) under section 475(e) or section 475(f). Depending on what if any transition rules Treasury and the Service decide to adopt for taxpayers that become dealers in securities, we request that Treasury and the Service consider adopting conforming rules for taxpayers that elect out of the negligible sales exemption under Regulation section 1.475(c)-1(c)(1)(ii). If Treasury and the Service decide not to provide transition rules under which taxpayers may identify held securities as covered by one of the exceptions in section 475(b)(1), we request that Treasury and the Service consider providing some method of allowing a taxpayer that elects out of the negligible sales exemption to elect to apply section 475(a) to all changes in value of securities rather than limiting the application of section 475(a), subject to a rule like section 475(d)(2) that would limit the amount of any negative section 481(a) adjustment.

15. Clarify when an interest in a partnership or trust is a security in Regulation section 1.475(c)-2. A “partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust” is a security for purposes of section 475. But what is a widely held or publicly traded partnership or trust? Is a widely held fixed investment trust, as described under Regulation section 1.671-5, widely held for purposes of section 475?

Further, can an interest in a partnership or trust that is not widely held or publicly traded be a security because it is an “evidence of an interest in” securities to the extent the entity holds securities as defined in section 475? The definition of a security includes an “evidence of an interest in” stocks, bonds, and widely held or publicly traded partnerships. To the extent that the partnership holds securities as defined in section 475, there are strong policy reasons to permit the partnership interest to be marked to market.

⁴⁰ 1997-2 C.B. 494.

16. Provide guidance on definition of a security and a commodity for purposes of sections 475(c)(2) and 475(e)(2). A securities dealer or electing trader must mark to market all of its securities as defined under section 475(c)(2) and treat the gain or loss as ordinary. A commodities dealer or trader electing under section 475(e) or section 475(f) must similarly mark to market all of its commodity positions described in section 475(e)(2). A number of issues have arisen as to what constitutes a security or a commodity for these purposes. For example:

- a) Characterization of regulated futures contracts with respect to securities as section 475(c)(2) securities. Under section 475(c)(2)(E), derivatives in stocks, bonds, and currencies are securities for purposes of section 475. However, regulated futures contracts that are marked to market under section 1256(a) are excluded from the definition of a security under section 475(c)(2)(E) and do not qualify as securities unless they qualify as hedges of securities under section 475(c)(2)(F). Under these rules, Treasury futures contracts that are marked to market under section 1256(a) are not securities unless they are identified as hedges under section 475(c)(2)(F).

In contrast, a securities futures contract (as defined in section 1234B(c)) is not a section 1256 contract, and can qualify as a security under section 475(c)(2)(E).⁴¹ Thus, a futures contract on a single stock or on a narrow-based stock index can qualify as a security subject to section 475 while other futures contracts for delivery of securities not described in section 1234B(c), such as Treasury futures contracts, do not qualify. We do not believe there should be disparate treatment of these futures contracts, because both types of futures contracts are with respect to section 475(c)(2) securities.

Moreover, the exclusion of section 1256 contracts from the definition of a security creates practical difficulties for traders in securities that have made an election under section 475(f). These traders often use section 1256 contracts (for example, Treasury futures) to hedge other trading securities, but also for speculative purposes. Importantly, it is often difficult to determine whether a specific section 1256 security is a hedge of a section 475 security, is a stand-alone speculative investment or is an investment that is being hedged by a section 475 security.

Securities traders often would like all of their traditional securities positions to receive the same treatment (*i.e.*, mark-to-market, ordinary); however, because the definition of security under section 475(c)(2) generally excludes section 1256 contracts (which result in 60% long-term, 40% short-term capital gain or loss), achieving uniformity of treatment under the current rules can be difficult. We believe regulatory consideration should be given to allowing section 475 taxpayers, on the date of acquisition, to elect to treat a section 1256 contract as a security for purposes of section 475 if, absent the section 1256 exclusion, the contract would be treated as a security under section 475(c)(2)(E). Alternatively,

⁴¹ I.R.C. § 1256(b)(2)(A).

regulatory consideration should be given to interpreting section 475(c)(2)(F)(ii) broadly to allow taxpayers to treat classes of investments that are used to both hedge other section 475 securities as well as for speculative purposes as qualifying under section 475(c)(2)(F)(ii).

- b) Characterization of regulated futures contracts with respect to securities as section 475(e)(2) commodities. Under section 475(e), an electing commodities dealer or trader must mark to market actively traded “commodities” held in connection with its commodities dealing or trading activities. The definition of a commodity includes futures contracts in actively traded commodities.⁴² Neither the statute nor the regulations define the term “commodity.”

The lack of guidance regarding the definition of the term commodity raises uncertainty regarding whether certain derivatives are commodities. In the absence of guidance, one could take a plain language approach to the definition of the term. On the other hand, one could look to the definition of commodity used by other Code sections. Further, there is no guidance under section 475 that prohibits a section 1256 contract in a security that is not identified as a hedge under section 475(c)(2)(F) from qualifying as a commodity under section 475(e)(2)(C).

For example, if a Treasury futures contract is held by a commodities dealer or trader that made an election under section 475(e) or (f)(2), a question arises as to whether the contract is considered a commodity position by virtue of being traded on a commodity futures exchange. If the Treasury futures contract is a commodity position for purposes of section 475(e)(2), Proposed Regulation section 1.475(f)-2(e)(2) would provide that the mark would be ordinary, rather than 60% long-term, 40% short-term capital gain or loss. The mere fact that a contract is traded on a commodities exchange should not make a contract with respect to securities a commodity.⁴³

Accordingly, we recommend that Treasury and the Service provide guidance regarding the definition of the term commodity.

- c) Section 1256 regulated futures contracts with respect to foreign currency. Unless a taxpayer elects out under section 988(c)(1)(D)(ii), a regulated futures contract for delivery of currency is governed by section 1256, providing mark-to-market treatment with 60% long-term, 40% short-term capital gain characterization. If a section 475(a) securities dealer or an electing commodities dealer or trader holds such a foreign currency futures contract, the issue again arises as to whether it is an interest in a security or commodity, in which the mark would be ordinary.
- 1) Characterization as a security. Given that the section 1256 regulated futures contract with respect to currency would be a contract to which section 1256(a)

⁴² I.R.C. § 475(e)(2)(C).

⁴³ *But see* Rev. Rul. 78-414, 1978-2 C.B. 213 (characterizing a T-Bill futures contract as a futures transaction in a commodity for purposes of section 1222).

applies, it appears to be excluded from the definition of security by the flush language of section 475(c)(2). Taxpayers wishing an ordinary mark under section 1256, however, can elect into section 988 treatment under section 988(c)(1)(D)(ii).

- 2) Characterization as a commodity. Foreign currency has been treated as a commodity for some tax purposes.⁴⁴ Guidance would be helpful as to whether foreign currency and foreign currency derivatives are commodities for purposes of section 475(e)(2). We note that section 475(e)(2), unlike section 475(c)(2), does not appear to have an exception for derivatives that are section 1256 contracts. Therefore, if foreign currency is a commodity, foreign currency derivatives could qualify as commodities under section 475(e)(2)(C). As noted above, even if a regulated futures contract for currency is not treated as a commodity position for purposes of section 475(e)(2), a commodity trader or dealer wishing an ordinary mark can elect section 988 treatment under section 988(c)(1)(D).

- d) Clarify whether direct ownership of foreign currency is a position in securities for purposes of section 475(c)(2)(E). As discussed above, foreign currency derivatives are securities described in section 475(c)(2)(E), subject to the exclusion for section 1256 contracts. In addition, foreign currency denominated debt receivables are securities described in section 475(c)(2)(C). We believe that where foreign currency has been deposited in a bank account, the depositor holds a debt obligation of the bank, which is a security within the meaning of section 475(c)(2)(C). Specific confirmation of this point in final regulations would be helpful.

Where the dealer instead holds actual foreign currency cash in its vault, it is less clear that the cash represents a security, though it seems clearer that it represents a commodity, as noted above. Confirmation that section 475(c)(2)(E) or section 475(e)(2)(A) applies to cash positions in foreign currency also would be helpful.

We believe that cash, debt, and derivative positions with respect to a currency should be treated symmetrically to a securities dealer, although, as noted above, there appears to be a technical issue with respect to qualifying section 1256(a) currency contracts as securities. We believe that if a taxpayer is otherwise a dealer or trader in foreign currency, it should be able to obtain ordinary treatment for its section 1256 contracts in foreign currency without having to make an election under section 988(c)(1)(D).

- e) Virtual Currencies. Similarly, are virtual currencies or interests in virtual currencies, such as Bitcoin, securities for purposes of section 475(c)(2) or commodities for purposes of section 475(e)(2)?⁴⁵

⁴⁴ See, e.g., PLR 8527041 (Apr. 8, 1985); *Gillin v. United States*, 423 F.2d 309 (Ct.Cl. 1970).

⁴⁵ See American Bar Association, Section of Taxation, *Comments on Notice 2014-21*, (March 24, 2015), available at

17. Address mark-to-market implications for a commodity that was, but ceases to be, actively traded under section 475(e)(2). “Commodity” is defined in section 475(e)(2)(A) simply as any commodity which is actively traded as defined in section 1092(d)(1). Sections 475(e)(2)(B) and (C), respectively, define commodities to include notional principal contracts or derivative instruments in or with respect to any commodity as described in subsection (A).

Pursuant to regulations issued under section 1092(d)(1), the actively traded standard requires that there be an established financial market, which can range from exchange trading at one end of the spectrum to the existence of an interdealer market at the other end of the spectrum.⁴⁶

As markets evolve, exchanges can commence and cease trading in certain commodities positions, and/or certain exchanges may terminate their trading operations entirely. In addition, the level of trading interest in certain commodities contracts or positions can vary over time, and trading volumes and/or pricing information may become thin or sporadic. As such, there is a potential for certain commodities positions to cease being actively traded.

Accordingly, we recommend that Treasury and the Service issue guidance regarding commodities that are initially classified by the taxpayer as actively traded and, thus, marked to market, but subsequently fail to satisfy the actively traded requirement of the section 1092 regulations. It would be helpful to have guidance confirming that, to the extent a taxpayer has made an election under either or both of section 475(e) or (f) and marks positions in a particular “commodity” to market, the taxpayer’s positions in that particular commodity continue to be subject to the mark-to-market method of accounting even if the commodity subsequently ceases to be actively traded.

18. Clarify the scope of Regulation section 1.475(b)-1(c)(1).⁴⁷ Regulation section 1.475(b)-1(c)(1) generally provides that section 475(b)(1)(A) (exempting from mark-to-market accounting certain securities that are held for investment) does not apply to a security if (i) the security is described in section 475(c)(2)(D) or (E) (describing certain notional principal contracts and derivative securities); and (ii) the taxpayer is a dealer in such securities.

We request guidance that clarifies the application of this rule. If a taxpayer is a dealer in only certain securities described in section 475(c)(2)(D) or (E), does Regulation section 1.475(b)-1(c)(1) apply only to those derivative securities that are of the type in which the taxpayer is a dealer or does it apply to all securities described in section 475(c)(2)(D) and (E) regardless of whether the taxpayer is a dealer in those types of

<http://www.americanbar.org/content/dam/aba/administrative/taxation/policy/032415comments.authcheckdam.pdf>, (commenting on the treatment of virtual currency transactions).

⁴⁶ Reg. § 1.1092(d)-1(c)(1).

⁴⁷ These comments also apply to a dealer in commodities. *See* Prop. Reg. § 1.475(e)-1(c)(1), 64 Fed. Reg. 4374 (1999).

derivative securities? If, as we believe is appropriate given the significant commercial and legal differences among types of derivatives, it applies only to those securities that are of a type in which the taxpayer is a dealer, we request guidance defining the scope of type.

19. Coordinate the treatment of hedges.⁴⁸ Regulation section 1.446-4(a)(2)(i) provides that the Regulation section 1.446-4 hedge timing rules do not apply to “any position to which section 475(a) applies.” But if the position is a hedge under section 475(c)(3), it can be subject to various timing (and character) rules within section 475.

If the hedge position is not itself a security under section 475(c)(2)(A)-(E), but is a section 475(c)(3) hedge of a security described within one of those five subparagraphs, then the choice of law becomes more complicated. If the hedged security is being marked under section 475(a), then the treatment of the hedge under section 475 (before any application of section 1221(a)(7) principles) would depend on whether the hedge was identified under section 475(c)(2)(F)(iii). If so, then it too would be marked under section 475(a) and Regulation section 1.446-4 would not change that result.

If, however, the hedged security is being marked under section 475 but the hedge was not identified under section 475(c)(2)(F)(iii), section 475(d)(2)(B) would mandate a higher-of-cost-or-market timing of recognition. In such a case, would the hedge be a position to which section 475(a) applies for purposes of exclusion from the section 1.446-4 rules, or is this alternative higher-of-cost-or-market regime in section 475 trumped by the general timing rule in Regulation section 1.446-4(a), which would match the timing of the hedge to the timing of the hedged item? The argument for “pure” hedge timing is that section 475(d)(2)(B) timing is not an application of section 475(a), so the exclusion from the regular hedge timing rules of Regulation section 1.446-4 does not apply. In that case and under the facts (the hedge is of a security that is itself being marked), the hedge timing rule would be mark-to-market timing, removing the section 475(d)(2) “penalty” timing.

What if the hedged security was itself not marked under section 475(a) because it was identified out of marking under section 475(b)(1)(A) or (B)? As with the prior example, Regulation section 1.446-4(a)(2)(i) would mandate section 475(d)(2) “penalty” timing only if that regime is viewed as an application of section 475(a).

Treasury and the Service should clarify that a hedge position that is subject to higher of cost or market under section 475(d)(2) is not subject to the hedge timing rules of Regulation section 1.446-4 if that was the intent or, alternatively, confirm that higher of cost or market is not an application of section 475(a) and therefore the hedge is accounted for under Regulation section 1.446-4.

There is also confusion about which character rules apply when a position is a hedge under both sections 475(c)(3) and 1221(a)(7). Would the character of gains and

⁴⁸ These comments also apply to commodities.

losses (including marks) be ordinary under section 1221(a)(7) despite the failure to identify out of section 475, which appears contrary to the rule of section 475(d)(3)(B)? (Under that rule, ordinary character is not provided under section 475(d)(3)(A), but apparently is provided by other rules, in this case section 1221(a)(7) and Regulation section 1.1221-2(a).) Does ordinary character of losses depend solely on identification under section 1221(a)(7) or the exceptions in Regulation section 1.1221-2(g)(2)? And is ordinary character of gains also mandated by Regulation section 1.1221-2(g)(2) and the exceptions thereunder?

20. Clarify applicability of exemption from mark to market under section 475(b)(1)(C) where a security hedges both marked and non-marked securities.⁴⁹ Under section 475(b)(1)(C), a taxpayer may exempt from mark-to-market accounting a security that is a “hedge” of a security that is not marked to market or a position that is not a security. The term “hedge” means a position that manages the dealer’s risk of interest rate or price changes or currency fluctuations.⁵⁰ Can a dealer in securities identify a security as exempt from mark-to-market accounting under section 475(b)(1)(C) if the security manages risk from both securities that are marked to market and securities (or positions) that are not marked to market? Does it matter whether the predominant reduction is with respect to risk from one or the other?
21. Expand the *per se* held for investment categories in Regulation section 1.475(b)-1(b)(1). Equity securities of related parties are *per se* held for investment under Regulation section 1.475(b)-1(b)(1)(i). The current rules apply only to corporate stock and to a “partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust.” They do not apply to debt or other non-equity securities.

In the corporate context, there can be uncertainty whether an interest is equity, on the one hand, or debt (or some other arrangement), on the other. With respect to partnership and trust instruments, there is both the uncertainty whether the interest is debt or equity, as well as uncertainty about whether the partnership or trust is widely held or publicly traded and thus qualifies as a security.⁵¹ A broad *per se* held for investment rule covering related party debt, partnership interests and trust interests would eliminate those uncertainties. Alternatively, expanding the *per se* rule to cover related party debt would eliminate a large part of the debt/equity type of uncertainty and avoid timing issues when the dealer marks the related party debt but the related party does not mark to market its own debt.

22. Modify the scope of the “*per se*” held for investment rules. As noted, current Regulation section 1.475(b)-1(b)(1)(i) requires that certain securities are *per se* “held for investment.” This provision has created significant problems for dealer taxpayers that acquire certain subordinated collateralized debt obligations (“CDOs”). Although

⁴⁹ These comments also apply to commodities.

⁵⁰ I.R.C. § 475(c)(3).

⁵¹ I.R.C. § 475(c)(2)(B)).

debt in form, the subordinated CDOs are treated as equity for U.S. federal income tax purposes. If the taxpayer acquires a sufficient amount of such subordinated CDOs of an issuer to become a related party, such investments are treated as held for investment under Regulation section 1.475(b)-1(b)(1)(i). However, many dealer taxpayers acquiring such instruments expect that the investments would be marked to market because the subordinated CDOs resemble traditional investment purchases rather than acquisitions of a closely-held interests, which are the types of securities generally governed by the Regulation section 1.475(b)-1(b)(1)(i) rule. Accordingly, we recommend modifying the regulation to provide that it applies only to in-form equity where the taxpayer has traditional shareholder control rights and not in-form debt that is characterized as equity for tax purposes.

23. Clarify the dealer-customer relationship in the case of related parties under Regulation section 1.475(c)-1(a)(3). The term “customer” is not defined for a dealer in securities under section 475(c)(1). Instead, the determination of whether a taxpayer is transacting business with a customer is based upon all the facts and circumstances, as stated in Regulation section 1.475(c)-1(a)(2)(ii). Chief Counsel Advice 201423019⁵² acknowledges that a “customer” definition has developed in case law, and that in determining whether a taxpayer has customers, the courts have looked to whether the taxpayer is compensated as a dealer by being paid for its services as an intermediary or market maker. CCA 201423019 also acknowledges that, in determining whether there is a dealer-customer relationship, it is relevant that a taxpayer “regularly” purchases or sells securities in the ordinary course of its trade or business, taking into account the amount, and the frequency of purchases and sales.

In the context of hedge centers that facilitate the management of currency or interest rate risk on behalf of non-consolidated related parties, these factual questions often lead to uncertainty as to whether or not the activities rise to the level of dealer activities. We recommend that Regulation section 1.475(c)-1(a)(3) be amended to make it clear that the required level of dealer activity must be regular and continuous. We also recommend that Treasury and the Service consider adopting an exception to dealer status for hedge centers whose customers are limited to related parties outside of its consolidated group (coupled with an election into section 475 similar to the intragroup customer election set forth in Regulation section 1.475(c)-1(a)(3)(iii)). In essence, we suggest expanding the current Regulation section 1.475(c)-1(a)(3)(ii) to include non-consolidated related parties. As an alternative to expanding Regulation section 1.475(c)-1(a)(3)(ii) for related party hedge centers, we recommend that Treasury and the Service consider adopting a *de minimis* threshold, in terms of number of actual transactions (similar to the negligible sales rule), that would provide a safe harbor for related party hedge center activities (and an election out for a taxpayer desiring to use the mark-to-market method).

24. Limit Regulation section 1.475(c)-2(a)(2) to debt denominated in the dealer’s functional currency. Regulation section 1.475(c)-2(a)(2) provides that the definition of “security” does not include “a debt instrument issued by the taxpayer” This

⁵² Jan. 22, 2014.

rule makes considerable sense in the case of functional currency non-contingent debt, because changes in the fair market value of debt liabilities attributable to interest rate or credit quality fluctuations will reverse out over time if the debt is paid in accordance with its terms. The same is not true with respect to changes in the fair market value of a debt liability due to foreign currency fluctuations where the liability is denominated in foreign currency. Such changes in value will not automatically reverse themselves as amounts owed are paid, but instead are permanent items.

The statutory language of section 475(c)(2)(E) can be read as including foreign currency denominated liabilities within the definition of security, in that it includes all “short positions” with respect to a foreign currency. A taxpayer’s liability under a foreign currency denominated debt instrument is a short position with respect to the currency in which the debt is denominated in both an economic sense and for purposes of the straddle rules.⁵³ Therefore, we recommend that Treasury and the Service clarify that foreign currency denominated liabilities are excluded from the operation of Regulation section 1.475(c)-2(a)(2) based on this statutory language.

Given that many section 475(a) securities dealers either have, or would like to have, foreign currency denominated debt liabilities on their balance sheets to balance loans receivable denominated in the same currencies, allowing such debt liabilities to be marked together with the offsetting loans receivable would more clearly reflect income than allowing only the loans receivable to be marked.

25. Consider excluding from Regulation section 1.475(c)-2(a)(2) contingent debt obligations with payments linked to the value of a security. Similar asymmetries arise in the context of structured notes issued by section 475(a) dealers. Like the case of foreign currency denominated liabilities, changes in the fair market value of contingent debt obligations with payments linked to the value of a security do not reverse on payment of principal, so the policy behind Regulation section 1.475(c)-2(a)(2) is arguably not applicable.

Section 475(a) dealers that issue structured notes would like to mark both the change in value of the notes and the change in value of the positions that economically hedge the contingency embedded in the notes to clearly reflect income. Serious timing issues can arise if the dealer is not able to mark its liability under a structured note but is required to mark the offsetting derivative positions. If regulations were to limit the mark to the change in value of the derivative position embedded in the contingent debt instrument, this approach would be consistent with our understanding of the financial accounting treatment. Further, marking to market the embedded security is consistent with Regulation section 1.1092(d)-1(d), which provides that an issuer’s obligation under a debt instrument with payments linked to the value of personal property is a position in personal property and may be part of a straddle.

We appreciate your attention to these Comments.

⁵³ See I.R.C. § 1092(d)(7).