

## **Notice of Proposed Rulemaking and Notice of Public Hearing**

### **Mark-to-Market for Dealers in Securities; Equity Interests in Related Parties and the Dealer-Customer Relationship**

**FI-32-95**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations that make mark-to-market accounting inapplicable to most equity interests in related entities. The regulations also relate to the definition of a dealer in securities for certain federal income tax purposes. To qualify as a dealer in securities, a taxpayer must engage in transactions with customers. The proposed regulations concern the existence of dealer-customer relationships. The Revenue Reconciliation Act of 1993 amended the applicable tax law. These regulations provide guidance for taxpayers that engage in securities transactions. This document also provides notice of a public hearing on these proposed regulations.

**DATES:** Written comments and outlines of oral comments to be presented at a public hearing scheduled for October 15, 1996, at 10 a.m., must be received by September 18, 1996.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:R (FI-32-95), room 5228, Internal Revenue Service, POB

7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (FI-32-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224. The public hearing will be held in the Commissioner's Conference Room, room 3313, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC 20224.

**FOR FURTHER INFORMATION CONTACT:** Concerning the regulations, Jo Lynn L. Ricks, (202) 622-3920, or Robert B. Williams, (202) 622-3960; concerning submissions and the hearing, Michael Slaughter, (202) 622-7190 (not toll-free numbers).

#### **SUPPLEMENTARY INFORMATION:**

##### *Paperwork Reduction Act*

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by August 19, 1996.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information is described in the Explanation of Provisions section of the Preamble (rather than being included in the text of the proposed regulations). The Preamble requests comments on whether the final regulations should permit taxpayers to elect to disregard certain inter-company transactions in determining status as a dealer in securities. The preamble also indicates that, if the election is allowed to be made, it is expected that taxpayers would make it by attaching a statement to a tax return. If the final regulations

allow taxpayers to make this election in this manner, the information will be required by the IRS to determine whether the election has been made, and will be used for that purpose. The likely respondents will be businesses that file consolidated tax returns. If taxpayers are allowed to make the election, responses to this collection of information will be required to obtain the benefit of having status as a dealer in securities determined without regard to certain inter-company transactions.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103. Estimated total annual reporting burden: 6,000 hours.

The estimated annual burden per respondent varies from .25 hour to 1 hour, depending on individual circumstances, with an estimated average of .5 hours.

Estimated number of respondents: 12,000.

Estimated annual frequency of responses: once in the existence of each respondent.

##### *Background*

This document contains proposed regulations under section 475 of the Internal Revenue Code, which requires mark-to-market accounting for certain dealers in securities. Section 475 was added by section 13223 of the Revenue Reconciliation Act of 1993, Pubic Law 103-66, 107 Stat. 481, and is effective for all taxable years ending on or after December 31, 1993.

Temporary and proposed regulations published on December 29, 1993, [58 FR 68798] provide that stock in a 50-percent-controlled subsidiary (and interests in 50-percent-controlled partnerships and trusts) are deemed properly identified as held for investment and thus are excluded from mark-to-market accounting. The IRS is reproping this rule with two changes. First, the IRS has concluded that the rationale for the rule applies equally to equity interests in most related persons and not just to persons controlled by the taxpayer. Second, after considering various comments received, the IRS determined that this rule prohibiting marking a security to market should not apply if two require-

ments are met: (1) the security is actively traded on a national securities exchange or through an interdealer quotation system; and (2) the taxpayer who marks owns less than 5 percent of all shares or interests of the same class. Comments are requested as to whether it is appropriate to allow any equity interests in related parties to be marked to market, and, if so, whether the proposed limitations are the most appropriate ones. The provisions in this document concerning these issues are referred to below in this preamble as the reproped regulations.

When commenting on the temporary and proposed regulations, taxpayers asked the IRS to provide guidance on whether certain transactions are entered into with customers for purposes of section 475. Whether transactions are entered into with customers can affect both whether a taxpayer is a dealer in securities subject to mark-to-market accounting (see section 475(c)(1)) and whether a dealer may exempt a security from mark-to-market treatment (see section 475(b)(1)(A) and (B) and § 1.475(b)-1T(a)).

In response to these comments, on January 4, 1995, the IRS published proposed regulations [(FI-42-94) (60 FR 397)] stating that whether a taxpayer is transacting business with customers is determined based on all of the facts and circumstances (see proposed § 1.475(c)-1(c), reproped as § 1.475(c)-1(a)). These proposed regulations also provide that the term dealer in securities includes a taxpayer that, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) (see proposed § 1.475(c)-1(c)(2), reproped as § 1.475(c)-1(a)(2)).

On March 4, 1996, the IRS published Notice 96-12 (1996-10 I.R.B. 29), stating that the IRS intended to publish additional proposed regulations concerning when transactions with related parties may be transactions with customers for purposes of section 475. Notice 96-12 also described the substance of rules that the proposed regulations were expected to contain. The rules were expected to be proposed to be effective for taxable years beginning on or after February 20, 1996. The proposed regulations in this document generally reflect the substance that was described in Notice 96-12.

## *Explanation of Provisions*

### *Prohibition against marking equity interests in related persons*

The repropounded regulations identify certain assets that are inherently investments and, thus, may not be marked to market under section 475. The new rules retain the provision in the temporary regulations that prevents marking certain insurance products to market, but they differ from the temporary regulations in the provisions that prevent the marking of certain equity interests. Under the temporary regulations, the prohibition against marking applies only if the dealer in securities controls the issuer of an equity interest (whether it is stock in a corporation or an interest in a widely held or publicly traded partnership or trust). The repropounded regulations expand the scope of this treatment so that mark-to-market accounting cannot be used for equity interests in many related issuers. (For these purposes, the repropounded regulations incorporate by reference the relevant relations described in sections 267(b) and 707(b)(1).) The repropounded regulations also narrow the scope of this prohibition against marking so that mark-to-market accounting can be used for certain actively-traded securities, regardless of the dealer's relation to the issuer of the security, if the dealer owns less than five percent of the securities. The IRS is particularly interested in receiving comments on the scope of the repropounded rules' exception to the general prohibition on marking to market equity interests in a related person.

These repropounded regulations also contain rules to cover situations where a security begins, or ceases, to be subject to this deemed-identification rule. First, if a security is being marked to market and then, as a result of a change in facts, the regulations prohibit the security from continuing to be marked to market, the regulations require that the security be marked as of the close of business on the last day before the day when the prohibition on marking first applies.

Second, the repropounded regulations also cover situations in which the regulations have prohibited a security from being marked to market and then the prohibition on marking ceases to apply. In these cases, the deadline for the taxpayer to identify the security under section 475(b)(2) as exempt from mark-to-market treatment is generally ex-

tended until the date the prohibition on marking ceases to apply. (If the taxpayer had identified the security by the original deadline, the extension, of course, is irrelevant.) If the identification is not made on or before the deadline (as so extended), new changes in value are taken into account under the mark-to-market method, but recognition of appreciation and depreciation that occurred while the security was not being marked is suspended. This is the approach adopted by section 475(b)(3) for securities that lose their exemption from mark-to-market treatment. The repropounded rule is to apply both when the prohibition on marking ceases because of a change in facts and when the prohibition on marking ceases because the rule covering certain actively-traded securities becomes effective.

In sum, under the repropounded regulations, the following assets held by a dealer in securities are deemed to be properly identified as held for investment: (1) stock in a corporation (or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust) to which the taxpayer is related (other than certain actively-traded stock or interests); and (2) an annuity, endowment, or life insurance contract. The provision concerning the second category of assets continues to be proposed to apply to all taxable years ending on or after December 31, 1993. The rules concerning the first category of assets, however, are proposed to prohibit only those marks to market that would have occurred on or after June 19, 1996. If the prohibition against marking begins to apply to a security solely because of this effective date rule, then (unlike the situation when the onset of the prohibition is caused by a change in facts) the security is not marked to market immediately before the prohibition begins.

In general, the provision allowing certain actively-traded securities to be marked to market even when the issuer of the security is related is proposed to be effective for marks to market on or after June 19, 1996. Thus, this effective date is the same as the effective date in the repropounded regulations for the general prohibition on marking to market securities issued by a related person. Until the repropounded regulations are finalized, however, all equity interests issued by controlled entities continue to be subject to the temporary regulations' prohibition against being marked to market, even if the dealer owns less

than 5 percent of interests of that class and even if the interests are actively traded.

Some commenters suggested there should be no per se rule treating certain securities as held for investment, but instead there should be a rebuttable presumption to this effect for these items. Other commenters proposed to add, or delete, a variety of items to or from those deemed to be per se held for investment. The repropounded regulations do not adopt these suggestions.

### *Consolidated Returns*

Under both the temporary and the repropounded regulations, there are situations in which the mark-to-market method may apply to a consolidated group member's stock held by another member of the group. This may result in the recognition of duplicate gain or loss. For instance, if a common parent marks to market stock in a subsidiary to reflect increases in the value of the subsidiary stock owned by the parent resulting from appreciation in the value of the subsidiary's assets, the parent will recognize gain on that stock under the mark-to-market method. The subsidiary's subsequent sale of the assets will replicate that gain at the subsidiary level. The gains will generate duplicate stock basis increases under section 475 and § 1.1502-32(b), creating the potential for an offsetting loss when the stock is subsequently marked down to fair market value under section 475. Section 1.1502-20, however, may disallow any such offsetting loss. Comments are invited regarding how to address the anomalies these rules may produce.

### *The dealer-customer relationship*

These proposed regulations clarify that a taxpayer's transactions with members of its consolidated group or other related persons may be transactions with customers for purposes of section 475. Thus, a taxpayer may be a dealer in securities for purposes of section 475 even if its only customer transactions are transactions with members of its consolidated group. In enacting section 475, Congress adopted a taxpayer-by-taxpayer approach to determining dealer status, rather than the single-entity approach embodied in § 1.1502-13.

An example in the proposed regulations clarifies that, for purposes of section 475, transactions do not fail to be transactions with customers solely because the parties enter into them with

other than arms-length pricing terms. Under section 482 and the regulations thereunder, however, the district director may make allocations between or among the members of the group if he or she determines that a member has not reported its true taxable income.

These proposed regulations generally reflect the substance of the rules set forth in Notice 96-12 (1996-10 I.R.B. 29). In response to taxpayer comments, however, certain language in Notice 96-12 has been clarified. Because of these changes, although the rules described in Notice 96-12 were expected to be proposed to be effective for taxable years beginning on or after February 20, 1996, these proposed regulations are to be effective for taxable years beginning on or after June 20, 1996. If there are any situations in which the proposed rules lead to a different result from that which would be reached under the rules described in the notice, a taxpayer may reasonably and consistently apply the rules described in the notice for any taxable year beginning on or after February 20, 1996, and before June 20, 1996.

Under these regulations, a taxpayer may be a dealer in securities based solely on transactions with other members of its consolidated group. The IRS requests comments on whether certain consolidated groups should be allowed to disregard inter-member transactions in determining a member's status as a dealer in securities. For instance, a group might be allowed to disregard inter-member transactions if the group, considered as a single corporation, would not be a dealer in securities for purposes of section 475. It is likely that the election, if permitted by the final regulations, would be made by attaching an appropriate statement to the taxpayer's return. (See the Paperwork Reduction Act section of this preamble, which requests comments on the burden that might be imposed by this requirement.) The IRS hereby requests comments on the desirability and potential terms and conditions of any such election. Comments could also address whether such an election should apply in determining whether a taxpayer had made more than negligible sales for purposes of re-proposed § 1.475(c)-1(c). Further, the IRS requests comments on whether the election should be available only to groups that have not made a separate-entity election under § 1.1221-2(d)(2).

#### Miscellaneous

Some of the 1993 and 1995 proposed regulations are reordered.

#### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 15, 1996, at 10 a.m. in the Commissioner's Conference Room, room 3313, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC 20224. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 18, 1996.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### Drafting Information

The principal authors of these regulations are Jo Lynn L. Ricks and Robert

B. Williams, Office of Assistant Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

#### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1, as proposed on January 4, 1995, at 60 FR 401, is further amended by revising the entries for "Section 1.475(b)-1", "Section 1.475(b)-2", and "Section 1.475(b)-4" to read as follows:

Authority: 26 U.S.C. 7805. \* \* \*

Section 1.475(b)-1 also issued under 26 U.S.C. 475(a) and 26 U.S.C. 475(e).

Section 1.475(b)-2 also issued under 26 U.S.C. 475(b)(2) and 26 U.S.C. 475(e). \* \* \*

Section 1.475(b)-4 also issued under 26 U.S.C. 475(b)(2), 26 U.S.C. 475(e), and 26 U.S.C. 6001. \* \* \*

Par. 2. Section 1.475-0, as proposed on January 4, 1995 (60 FR 401), is amended by:

1. Revising the heading and entries for §§ 1.475(b)-1, 1.475(b)-2, and 1.475(b)-4.

2. Revising the entries under §§ 1.475(c)-1 and 1.475(c)-2.

3. Removing the entries under § 1.475(e)-1.

The revisions read as follows:

§ 1.475-0 Table of contents.

\* \* \* \* \*

§ 1.475(b)-1 Scope of exemptions from mark-to-market requirement.

(a) Securities held for investment or not held for sale.

(b) Securities deemed identified as held for investment.

(1) In general.

(2) Relationships

(i) General rule

(ii) Attribution

(iii) Trusts treated as partnerships

(3) Securities traded on certain established financial markets.

(4) Changes in status.

(i) Onset of prohibition against marking.

(ii) Termination of prohibition against marking.

(iii) Examples

(c) Securities deemed not held for investment.

(1) General rule for dealers in notional principal contracts and derivatives.

(2) Exception for securities not acquired in dealer capacity.

(d) Special rules.

(1) Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts.

(i) In general.

(ii) Control defined.

(iii) Applicability.

(2) [Reserved]

§ 1.475(b)-2 Exemptions—Identification requirements.

(a) Identification of the basis for exemption.

(b) Time for identifying a security with a substituted basis.

(c) Securities involved in integrated transactions under § 1.1275-6.

(1) Definitions.

(2) Synthetic debt held by a taxpayer as a result of legging in.

(3) Securities held after legging out.

\* \* \* \* \*

§ 1.475(b)-4 Exemptions—Transitional issues.

(a) Transitional identification.

(1) Certain securities previously identified under section 1236.

(2) Consistency requirement for other securities.

(b) Corrections on or before January 31, 1994.

(1) Purpose.

(2) To conform to § 1.475(b)-1(a).

(i) Added identifications.

(ii) Limitations.

(3) To conform to § 1.475(b)-1(c).

(c) Effect of corrections.

§ 1.475(c)-1 Definitions—Dealer in securities.

(a) Dealer-customer relationship.

(1) [Reserved].

(2) Transactions described in section 475(c)(1)(B).

(i) In general.

(ii) Examples.

(3) Related parties.

(i) In general.

(ii) Example.

(b) Sellers of nonfinancial goods and services.

(c) Taxpayers that purchase securities but do not sell more than a negligible portion of the securities.

(1) Exemption from dealer status.

(2) Negligible portion.

(3) Special rules.

(d) Issuance of life insurance products.

§ 1.475(c)-2 Definitions—Security.

(a) In general.

(b) Synthetic debt held by a taxpayer as a result of an integrated transaction under § 1.1275-6.

(c) Negative value REMIC residuals.

(d) Special rules.

\* \* \* \* \*

§ 1.475(e)-1 Effective dates.

Par. 3. Section 1.475(b)-1 as proposed on December 29, 1993 (58 FR 68798), is amended by revising paragraph (b) and adding paragraph (d) to read as follows:

§ 1.475(b)-1 Scope of exemptions from mark-to-market requirement.

\* \* \* \* \*

(b) *Securities deemed identified as held for investment*—(1) *In general*. The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)-(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(i) Except as provided in paragraph (b)(3) of this section, stock in a corporation, or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship specified in paragraph (b)(2) of this section; or

(ii) A contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract (see sections 817 and 7702).

(2) *Relationships*—(i) *General rule*. The relationships specified in this paragraph (b)(2) are—

(A) those described in section 267(b)(2), (3), (10), (11), or (12); or

(B) those described in section 707(b)(1)(A) or (B).

(ii) *Attribution*. The relationships described in paragraph (b)(2)(i) of this section are determined taking into account sections 267(c) and 707(b)(3), as appropriate.

(iii) *Trusts treated as partnerships*. For purposes of this paragraph (b)(2), the phrase partnership or trust is substituted for the word partnership in sections 707(b)(1) and 707(b)(3), and a reference to beneficial ownership interest is added to each reference to capital interest or profits interest in those sections.

(3) *Securities traded on certain established financial markets*. Paragraph (b)(1)(i) of this section does not apply to a security if—

(i) The security is actively traded within the meaning of § 1.1092(d)-1(a) taking into account only established financial markets identified in § 1.1092(d)-1(b)(1)(i) or (ii) (describing national securities exchanges and interdealer quotation systems), and

(ii) The taxpayer owns less than 5 percent of all of the shares or interests in the same class.

(4) *Changes in status*—(i) *Onset of prohibition against marking*—(A) Once a security begins to be described in paragraph (b)(1) of this section and for so long as it continues to be so described, section 475(a) does not apply to the security in the hands of the taxpayer.

(B) If a security has not been timely identified under section 475(b)(2) and, after the last day on which such an identification would have been timely, the security begins to be described in paragraph (b)(1) of this section, then the dealer must recognize gain or loss on the security as if it were sold for its fair market value as of the close of business of the last day before the security begins to be described in paragraph (b)(1) of this section, and gain or loss is taken into account at that time.

(ii) *Termination of prohibition against marking*. If a taxpayer did not timely identify a security under section 475(b)(2) and paragraph (b)(1) of this section applies to the security on the last day on which such an identification would have been timely but it thereafter ceases to apply—

(A) An identification of the security under section 475(b)(2) is timely if made on or before the close of the day paragraph (b)(1) of this section ceases to apply; and

(B) Unless the taxpayer timely identifies the security under section 475(b)(2) (taking into account the additional time for identification that is provided by paragraph (b)(4)(ii)(A) of this section), section 475(a) applies to changes in value of the security after the cessation in the same manner as under section 475(b)(3).

(iii) *Examples*. These examples illustrate this paragraph (b)(4):

*Example 1. Onset of prohibition against marking*—(A) *Facts*. Corporation H owns 75 percent of the stock of corporation D, a dealer in securities within the meaning of section 475(c)(1). On December 1, 1995, D acquired less than half of the stock in corporation X. D did not identify the stock for purposes of section 475(b)(2). On July

17, 1996, *H* acquired from other persons 70 percent of the stock of *X*. As a result, *D* and *X* became related within the meaning of paragraph (b)(2)(i) of this section. The stock of *X* is not described in paragraph (b)(3) of this section (concerning securities traded on certain established financial markets).

(B) *Holding*. Under paragraph (b)(4)(i) of this section, *D* recognizes gain or loss on its *X* stock as if the stock were sold for its fair market value at the close of business on July 16, 1996, and the gain or loss is taken into account at that time. As with any application of section 475(a), proper adjustment is made in the amount of any gain or loss subsequently realized. After July 16, 1996, section 475(a) does not apply to *D*'s *X* stock while *D* and *X* continue to be related to each other.

*Example 2. Termination of prohibition against marking; retained securities identified as held for investment—(A) Facts.* On July 1, 1996, corporation *H* owned 60 percent of the stock of corporation *Y* and all of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). Thus, *D* and *Y* are related within the meaning of paragraph (b)(2)(i) of this section. Also on July 1, 1996, *D* acquired, as an investment, 10 percent of the stock of *Y*. The stock of *Y* is not described in paragraph (b)(3) of this section (concerning securities traded on certain established financial markets). When *D* acquired its shares of *Y* stock, it did not identify them for purposes of section 475(b)(2). On December 27, 1996, *D* identified its shares of *Y* stock as held for investment under section 475(b)(2). On December 30, 1996, *H* sold all of its shares of stock in *Y* to an unrelated party. As a result, *D* and *Y* cease to be related within the meaning of paragraph (b)(2)(i) of this section.

(B) *Holding*. Under paragraph (b)(4)(ii)(A) of this section, identification of the *Y* shares is timely if done on or before the close of December 30, 1996. Because *D* timely identified its *Y* shares under section 475(b)(2), it continues to refrain from marking to market its *Y* stock after December 30, 1996.

*Example 3. Termination of prohibition against marking; retained securities not identified as held for investment—(A) Facts.* The facts are the same as in *Example 2* above, except that *D* did not identify its stock in *Y* for purposes of section 475(b)(2) on or before December 30, 1996. Thus, *D* did not timely identify these securities under section 475(b)(2) (taking into account the additional time for identification provided in paragraph (b)(4)(ii)(A) of this section).

(B) *Holding*. Under paragraph (b)(4)(ii)(B) of this section, section 475(a) applies to changes in value of *D*'s *Y* stock after December 30, 1996, in the same manner as under section 475(b)(3). Thus, any appreciation or depreciation that occurred while the securities were prohibited from being marked to market is suspended. Further, section 475(a) applies only to those changes occurring after December 30, 1996.

\* \* \* \* \*

(d) *Special rules—(1) Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts—(i) In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(A) Stock in a corporation that the taxpayer controls (within the meaning of paragraph (d)(1)(ii) of this section); or

(B) A partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust that the taxpayer controls (within the meaning of paragraph (d)(1)(ii) of this section).

(ii) *Control defined.* Control means the ownership, directly or indirectly through persons described in section 267(b) (taking into account section 267(c)), of—

(A) 50 percent or more of the total combined voting power of all classes of stock entitled to vote; or

(B) 50 percent or more of the capital interest, the profits interest, or the beneficial ownership interest in the widely held or publicly traded partnership or trust.

(iii) *Applicability.* The rules of this paragraph (d)(1) apply only before the date 30 days after final regulations on this subject are published in the **Federal Register**.

(2) [Reserved].

Par. 4. Section 1.475(b)–2, as proposed on December 29, 1993 (58 FR 68798), is redesignated as § 1.475(b)–4.

Par. 5. Section 1.475(b)–4, as proposed on January 4, 1995 (60 FR 404), is redesignated as § 1.475(b)–2.

Par. 6. Section 1.475(c)–1, as proposed on December 29, 1993 (58 FR 68798), and amended on January 4, 1995 (60 FR 405), is amended as follows:

1. Paragraph (c) is removed.

2. Paragraphs (a) and (b) are redesignated as paragraphs (b) and (c), respectively.

3. New paragraph (a) is added to read as follows:

§ 1.475(c)–1 *Definitions—Dealer in securities.*

(a) *Dealer-customer relationship.* Whether a taxpayer is transacting business with customers is determined on the basis of all of the facts and circumstances.

(1) [Reserved].

(2) *Transactions described in section 475(c)(1)(B)—(i) In general.* For purposes of section 475(c)(1)(B), the term dealer in securities includes, but is not limited to, a taxpayer that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as being willing and able to enter into

either side of a transaction enumerated in section 475(c)(1)(B).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (a)(2). In the following examples, *B* is a bank:

*Example 1.* *B* regularly offers to enter into interest rate swaps with other persons in the ordinary course of its trade or business. *B* is willing to enter into interest rate swaps under which it either pays a fixed interest rate and receives a floating rate or pays a floating rate and receives a fixed rate. *B* is a dealer in securities under section 475(c)(1)(B), and the counterparties are its customers.

*Example 2.* *B*, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of positions in a foreign currency with other banks in the interbank market. *B*'s activities in the foreign currency make it a dealer in securities under section 475(c)(1)(B), and the other banks in the interbank market are its customers.

*Example 3.* *B* engages in frequent transactions in a foreign currency in the interbank market. Unlike the facts in *Example 2*, however, *B* does not regularly hold itself out as being willing and able to enter into either side of positions in the foreign currency, and all of *B*'s transactions are driven by its internal need to adjust its position in the currency. No other circumstances are present to suggest that *B* is a dealer in securities for purposes of section 475(c)(1)(B). *B*'s activity in the foreign currency does not qualify it as a dealer in securities for purposes of section 475(c)(1)(B), and its transactions in the interbank market are not transactions with customers.

(3) *Related parties—(i) In general.* A taxpayer's transactions with members of its consolidated group or with other related persons may be transactions with customers for purposes of section 475. For example, transactions enumerated in section 475(c)(1)(B) between members of a consolidated group are transactions with customers if, in the ordinary course of its business, the taxpayer holds itself out as being willing and able to engage in these transactions on a regular basis. A taxpayer may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are transactions with other members of its consolidated group.

(ii) *Example.* The following example illustrates this paragraph (a)(3):

*Example. Risk management transactions—(1) Facts.* *HC*, a hedging center, provides interest rate hedges to all of the members of its consolidated group. Because of the efficiencies created by having a centralized risk manager, group policy prohibits members other than *HC* from entering into derivative interest rate positions with outside parties. *HC* regularly holds itself out as being willing and able to, and in fact does, enter into either side of interest rate swaps with its fellow members. *HC* periodically computes its aggregate position and hedges the net risk with an unrelated party. *HC* does not otherwise enter into interest rate positions with persons that are not members of the consolidated group. Because *HC* attempts to operate at cost and the terms of its swaps do not

factor in any risk of default by the affiliate, *HC*'s affiliates receive somewhat more favorable terms than they would receive from an unrelated swaps dealer.

(2)  *Holding.* Because *HC* regularly holds itself out as being willing and able to enter into transactions enumerated in section 475(c)(1)(B), *HC* is a dealer in securities for purposes of section 475(c)(1)(B) and the other members are its customers.

\*- \*- \*- \*- \*

Par. 7. Section 1.475(c)-2, as proposed on December 29, 1993 (58 FR 68798), and amended on January 4, 1995 (60 FR 405), is amended as follows:

1. Paragraphs (b), (c), and (d) are redesignated as paragraphs (c), (d), and (b), respectively.

2. Paragraph (a) and newly designated paragraph (c) are revised by removing the phrase "paragraph (b)" each place it appears and replacing it with "paragraph (c)" each place it appeared.

3. Newly designated paragraph (d) is revised by removing the phrase "paragraphs (a)(3) and (b)" and replacing it with "paragraphs (a)(3) and (c)". Newly designated paragraph (d) is further revised by removing the phrase "this paragraph (c)(1)." and replacing it with the phrase "this paragraph (d)(1).".

4. Newly designated paragraph (b) is revised by removing the words "See § 1.475(b)-4(c)" and replacing them with the words "See § 1.475(b)-2(c)".

Par. 8. Section 1.475(e)-1, as proposed on December 29, 1993 (58 FR 68798), and amended on January 4, 1995 (60 FR 405), is revised to read as follows:

*§ 1.475(e)-1 Effective dates.*

(a) Section 1.475(a)-1 (concerning mark-to-market for debt instruments) applies to taxable years beginning on or after January 1, 1995.

(b) Section 1.475(a)-2 (concerning marking a security to market upon disposition) applies to dispositions or terminations of ownership occurring on or after January 4, 1995.

(c) Section 1.475(a)-3 (concerning acquisition by a dealer of a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(d) Section 1.475(b)-1 (concerning the scope of exemptions from the mark-to-market requirement) applies as follows:

(1) Section 1.475(b)-1(a) (concerning securities held for investment or not held for sale) applies to taxable years ending on or after December 31, 1993.

(2) Except as provided elsewhere in this paragraph (d)(2), § 1.475(b)-1(b)(1) (concerning securities deemed identified as held for investment) applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(b)-1(b)(1)(i) (concerning equity interests issued by a related person) applies on or after June 19, 1996. If, on June 18, 1996, a security is subject to mark-to-market accounting and, on June 19, 1996, § 1.475(b)-1(b)(1) begins to apply to the security solely because of the effective dates in this paragraph (d)(2) (rather than because of a change in facts), then the rules of § 1.475(b)-1(b)(4)(i)(A) (concerning the prohibition against marking) apply, but § 1.475(b)-1(b)(4)(i)(B) (imposing a mark to market on the day before the onset of the prohibition) does not apply.

(ii) Section 1.475(b)-1(b)(2) (concerning relevant relationships for purposes of determining whether equity interests in related persons are prohibited from being marked to market) applies on or after June 19, 1996.

(iii) Section 1.475(b)-1(b)(3) (concerning certain actively-traded securities) generally applies on or after June 19, 1996, to securities held on or after that date. In the case, however, of securities described in § 1.475(b)-1(d)(1)(i) (concerning equity interests issued by controlled entities), § 1.475(b)-1(b)(3) applies on or after the date thirty days after final regulations on this subject are published in the **Federal Register** to securities held on or after that date. If § 1.475(b)-1(b)(1) ceases to apply to a security by virtue of the operation of this paragraph (d)(2)(ii), the rules of § 1.475(b)-1(b)(4)(ii) apply to the cessation.

(iv) Except to the extent provided in paragraph (d)(2)(i) of this section, § 1.475(b)-1(b)(4) (concerning changes in status) applies on or after Jun 19, 1996.

(e) Section 1.475(b)-2 (concerning the identification requirements for obtaining an exemption from mark-to-market treatment) applies to identifications made on or after January 4, 1995.

(f) Section 1.475(b)-3 (concerning exemption of securities in certain securitization transactions) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(g) Section 1.475(b)-4 (concerning transitional issues relating to exemptions) applies to taxable years ending on or after December 31, 1993.

(h) Section 1.475(c)-1(a) (concerning the dealer-customer relationship), except for § 1.475(c)-1(a)(1), (a)(2)(ii), and (a)(3), applies to taxable years beginning on or after January 1, 1995. Section 1.475(c)-1(a)(2)(ii) and (a)(3) (concerning certain aspects of the dealer-customer relationship) apply to taxable years beginning on or after June 20, 1996.

(i) Section 1.475(c)-1(b) (concerning sellers of nonfinancial goods and services) and (c) (concerning taxpayers that purchase securities but do not sell more than a negligible portion of the securities) applies to taxable years ending on or after December 31, 1993.

(j) Section 1.475(c)-1(d) (concerning the issuance of life insurance products) applies to taxable years beginning on or after January 1, 1995.

(k) Section 1.475(c)-2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. Note, however, that, by its terms, § 1.475(c)-2(a)(3) applies only to interests or arrangements that are acquired on or after January 4, 1995, and that the integrated transactions to which § 1.475(c)-2(b) applies will exist only after the effective date of § 1.1275-6.

(l) Section 1.475(d)-1 (concerning the character of gain or loss) applies to taxable years ending on or after December 31, 1993.

Margaret Milner Richardson,  
*Commissioner of Internal Revenue.*

(Filed by the Office of the Federal Register on June 19, 1996, 8:45 a.m., and published in the issue of the Federal Register for June 20, 1996, 61 F.R. 31474)