Section 475.—Mark to Market Accounting Method for Dealers in Securities

26 CFR 1.475(c)–1: Definitions—dealers in securities.

T.D. 8700

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Mark to Market for Dealers in Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations providing guidance to enable taxpayers to comply with the mark-to-market requirements applicable to dealers in securities. The Revenue Reconciliation Act of 1993 amended the applicable tax law. These regulations provide guidance to dealers in securities.

DATES: These final regulations are effective December 24, 1996, except paragraph (a) of § 1.475(c)–1T is removed effective December 24, 1996, and the remainder of § 1.475(c)–1T is removed effective January 23, 1997.

For dates of applicability, see § 1.475(e)–1.

FOR FURTHER INFORMATION CONTACT: Robert B. Williams at (202) 622–3960 or Jo Lynn Ricks at (202) 622–3920 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1496. Responses to this collection of information are required for a taxpayer to obtain the benefit of an exemption from marking to market under section 475 for those securities (see § 1.475(b)–2) and for a consolidated group of taxpayers to obtain the benefit of treating inter-member transactions as customer transactions for purposes of the definition of dealer in securities (the intragroup-customer election, § 1.475-(c)–1(a)(3)(iii)).

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 estimated annual burden per recordkeeper regarding § 1.475(b)–2 varies from .25 to 3 hours, depending on individual circumstances, with an estimated average of 1 hour. Section 1.475(b)–4 (formerly § 1.475(b)–2T), which permitted a taxpayer to add or remove certain identifications on or before January 31, 1994, does not impose a recordkeeping burden into the future. The estimated burden per respondent in making the intragroup-customer election in §§ 1.475(c)–1(a)(3)(iii) varies from .25 to 1 hours, depending on individual circumstances, with an estimated average of .5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and 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.

Books or records relating to this 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.

Background

This document contains final regulations under section 475 (relating to mark-to-market accounting for dealers in securities). Section 475 was added by section 13223 of the Revenue Reconciliation Act of 1993, Public Law 103–66, 107 Stat. 481, and is effective for all taxable years ending on or after December 31, 1993.

On December 29, 1993, temporary regulations (T.D. 8505, [1994–1 C.B. 152] 58 FR 68747) (hereinafter sometimes referred to as the temporary regulations) and cross-referenced proposed regulations (FI–72–93, 58 FR 68798) (hereinafter sometimes referred to as the 1993 proposed regulations) were published to furnish guidance on several issues, including the scope of exemptions from the mark-to-market requirements, certain transitional issues relating to the scope of exemptions, and the meaning of the statutory terms *security*, *dealer in securities*, and *held for investment*. Various comments were received regarding those regulations, and a hearing was held on April 12, 1994.

Additional regulations were proposed on January 4, 1995 (60 FR 397) (hereinafter sometimes referred to as the 1995 proposed regulations), and on June 20, 1996 (61 FR 31474) (hereinafter sometimes referred to as the 1996 proposed regulations). The 1995 and 1996 proposed regulations supplemented, and in a few cases revised, the 1993 proposed regulations. Hearings on the 1995 and 1996 proposed regulations were held on May 3, 1995, and October 15, 1996, respectively.

The final regulations in this document generally adopt the 1993 proposed regulations, as revised by the 1995 and 1996 proposed regulations, with certain changes reflecting comments that were received. These final regulations also adopt additional portions of the 1995 proposed regulations. The sections that are not adopted at this time remain proposed.

The provisions governing mark to market of debt instruments, which were proposed in January 1995, attracted substantial comment. The IRS and Treasury intend to finalize those regulations in a substantially revised form in response to those taxpayer comments.

Explanation of Provisions

Acquisition by a dealer of a security with a substituted basis

The final regulations adopt without change the provisions in the 1995 proposed regulations that provide rules for situations where a dealer in securities receives a security with a basis in its hands that is determined, in whole or in part, either by reference to the basis of the security in the hands of the transferor or by reference to other property held at any time by the dealer. In these cases, section 475(a) applies only to post-acquisition gain and loss with respect to the security. That is, section 475(a) applies only to changes in value of the security occurring after its acquisition. See section 475(b)(3). The character of the mark-to-market gain or loss is determined as provided under section 475(d)(3). The character of pre-acquisition gain or loss (that is, the built-in gain or loss at the date the dealer acquires the security) and the time for taking that gain or loss into account are determined without regard to section 475. The fact that a security

has a substituted basis in the dealer's hands does not affect the security's date of acquisition for purposes of determining the timeliness of an identification under section 475(b).

Scope of Exemptions From Mark-To-Market Requirement

Section 475(b) exempts certain securities from mark-to-market accounting under section 475(a). Among the exempted securities are those held for investment and debt securities not held for sale. Section 1.475(b)–1(a) of the regulations, like the temporary rule that preceded it, provides that held for investment, as used in section 475(b)(1)(A), and not held for sale, as used in section 475(b)(1)(B), have the same meaning. The regulations provide that both terms refer to a security that is not held by a taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. By providing that a security is held for investment (or not held for sale) if it is not held primarily for sale to customers in the ordinary course of a trade or business, the regulations adopt the concept of held for investment in section 1236(a). Thus, under these regulations, a dealer in securities may identify as held for investment a security that it holds primarily for sale to non-customers (for example, a trading security). The IRS and the Treasury believe that providing a single standard for purposes of sections 475 and 1236 is consistent with the purpose of section 475. These rules apply to taxable years ending on or after December 31, 1993.

The final regulations require a taxpayer that identifies a security as exempt from being marked to market to state (on its books and records) whether the security is, on the one hand, exempt as held for investment or not held for sale or, on the other hand, exempt because it is a hedge of an item not subject to mark to market. This regulation applies to identifications made on or after July 1, 1997.

The temporary and 1993 proposed regulations 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 1996 proposed regulations reproposed this rule with two changes. First, the IRS believed 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 proposed that this rule prohibiting marking a security to market should not apply if two requirements 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 were 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.

After considering the comments received in response, the IRS and the Treasury have decided to adopt the provisions in the 1996 proposed regulations with certain modifications. First, the general threshold above which even actively traded stock in a related party may not be marked to market has been increased from 5% to 15%. The 15% limit, however, includes shares held both by the dealer and by certain related parties. Second, shares that a dealer acquires from a related party cannot be marked to market unless, after the time they were acquired, both one full business day has passed and there has been significant trading in the security involving persons who are not related to the taxpayer.

Section 475(b)(3) applies when a security has been exempt from marking to market and the exemption then ceases to apply. Thus, changes in a security's value that occur while section 475(a) does not apply are suspended. This rule has additional significance for certain members of consolidated groups because § 1.1502–13(f)(6) disallows certain losses recognized by members of consolidated groups on common parent stock if the loss is not taken into account pursuant to section 475(a).

The final regulations provide that, except as determined by the Commissioner, notional principal contracts and derivative securities described in section 475(c)(2)(D) or (E) that are held by a dealer in those securities are not eligible to be exempted from mark-to-market treatment as held for investment.

Under the temporary and 1993 proposed regulations, however, an analogous barrier to exemption from mark-to-market treatment did not apply if the taxpayer established unambiguously that the security was acquired other than in the taxpayer's capacity as a dealer in such securities. It was anticipated that this exception would apply only in rare instances. Commenters suggested an easing of the standard for establishing that a security was acquired other than in the taxpayer's capacity as a dealer in such securities.

These suggestions are specifically rejected in the final regulations set forth in § 1.475(b)–1(c). Instead, as described above, to avoid uncertainty and ambiguity, the rule barring exemption from mark-to-market treatment for certain notional principal contracts and derivative securities applies unless the Commissioner explicitly determines otherwise. For securities acquired or entered into before January 23, 1997, however, the final regulations continue the rule found in the temporary regulations.

Commenters suggested that changes are needed to allow taxpayers that are dealers in notional principal contracts and derivative securities (described in section 475(c)(2)(D) or (E)) to identify as exempt from mark-to-market treatment a notional principal contract or derivative that is held as a hedge of a position that is not marked to market.

No change was made to the temporary regulations to reflect these comments because none was necessary. Section 1.475(b)–1(c) limits exemptions only under section 475(b)(1)(A) (concerning securities held for investment). Section 1.475(b)–1(c) does not limit exemptions under section 475(b)(1)(C) (concerning securities that are hedges of non-mark-to-market positions). Although the flush language at the end of section 475(b)(1) authorizes analogous regulatory limitations on exemption under section 475(b)(1)(C), as of this time, no such regulation has been issued or proposed. Accordingly, if a dealer in notional principal contracts or derivatives enters into a notional principal contract or derivative as a hedge of a position that is not marked to market, the dealer may properly identify it under section 475(b)(1)(C) as exempt from mark-to-market treatment.

In response to comments, the final regulations expand the securities that a taxpayer may identify under section 475(b)(1)(C) as exempt from mark-to-market accounting. Under the final regulations, a taxpayer can identify as exempt from mark-to-market treatment under section 475(b)(1)(C) a security that hedges a position of another member of the taxpayer's consolidated group and meets the following three require-

ments: the security is a hedging transaction within the meaning of § 1.1221–2(b); the security is timely identified as a hedging transaction under § 1.1221–2(e) (including satisfaction of the requirement that the hedged item be identified); and the security hedges a position that is not marked to market under section 475(a). Although identification of the hedged item is not required under § 1.1221–2 until some time after the day the hedging transaction is entered into, the identification of the hedge under section 475(b)(2) must still be made no later than the close of the day on which the hedge is acquired, originated, or entered into.

Permitting taxpayers to identify these securities as exempt from mark-to-market accounting is consistent with the single-entity approach of the consolidated group hedging regulations under § 1.1221–2(d)(1). As a result of the identification, the timing of the gain or loss on the hedge is matched with the timing of the gain or loss on the hedged item without forcing taxpayers to use back-to-back hedges and the separate-entity election under § 1.1221–2(d)(2). This rule is effective for hedges entered into on or after January 23, 1997.

Exemptions—Transitional Issues

The final regulations adopt without substantive change a number of transitional rules relating to various exemption and identification issues. These transitional rules, now found in § 1.475(b)–4, were contained in § 1.475(b)–2T of the temporary regulations. A more complete description of these provisions may be found in the preamble of T.D. 8505 at 58 FR 68747 (1994–1 C.B. 152).

Dealer in Securities—the Dealer-Customer Relationship

The final regulations retain the rules in the 1995 proposed regulations concerning the dealer-customer relationship. Thus, the final regulations provide that determination of whether a transaction is with a customer is based on all of the facts and circumstances. Further, under section 475(c)(1)(B), 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).

The final regulations retain the general rule in the 1996 proposed regulations that transactions with related persons may be transactions with customers for purposes of section 475. In response to comments, however, in § 1.475(c)–1(a)(3) the final regulations provide both a special rule for members of a consolidated group and an election for the rule not to apply. If the special rule applies, then, solely for purposes of determining whether the taxpayer meets the definition of a dealer in securities, a taxpayer's transactions with other members of its consolidated group are not transactions with customers. Thus, a member whose only customers are other members of its consolidated group generally is not a dealer in securities. Treating intragroup transactions as noncustomer transactions is consistent with the single-entity approach of §§ 1.1221–2(d)(1) and 1.1502–13. (The IRS expects to provide additional guidance on whether there are any circumstances in which the special rule applies for other purposes, such as whether a security may be exempted from mark-to-market treatment because it is not held for sale to customers.)

A consolidated group may elect not to apply the special rule. If a group has made this intragroup customer election, a member of a group may be a dealer in securities even if its only customer transactions are with other members of its consolidated group. Once made, the election continues for all subsequent taxable years and may be revoked only with the consent of the Commissioner.

These final regulations significantly alter the proposed default rule for intragroup transactions. Under the proposed regulations, a taxpayer's intragroup transactions would have been customer transactions for purposes of section 475. Because the final regulations reverse this rule (making noncustomer status the default and requiring an affirmative election to consider intragroup transactions in applying the dealer definition), the rules for intragroup transactions are effective for taxable years beginning on or after December 24, 1996. (The general rule for related party transactions other than intragroup transactions is effective for taxable years beginning on or after June 20, 1996.) The IRS will soon publish guidance to assist taxpayers who may have to change their methods of accounting because their status as a dealer changes as a result of the application of § 1.475(c)–1(a)(3).

For prior years, the Service generally will not challenge a taxpayer's treatment of intragroup transactions as customer or noncustomer transactions, provided the taxpayer had a reasonable basis for its treatment of the transactions and consistently applied that basis from year to year. In this regard, a taxpayer does not fail this consistency requirement solely because it changed its treatment of its intragroup transactions in order: (1) to avail itself of the separate-entity election under the consolidated group hedging regulations, or (2) to coincide with the expected effective date of either Notice 96–12 (1996–10 I.R.B. 29) or the related party rules in the 1996 proposed regulations. (If a taxpayer wishes to change its treatment of prior open years to be consistent with its status during the first year that § 1.475(c)–1(a)(3) applies, see § 301.9100–1T(a).)

Dealer in Securities—Sellers of Nonfinancial Goods and Services

In general, the final regulations exclude from dealer status any taxpayer that would not be a dealer in securities but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer debt with respect to the taxpayer or another member of the taxpayer's consolidated group. A debt instrument is customer debt at a particular time with respect to a person if three conditions are met: (1) the person's principal activity is selling nonfinancial goods or providing nonfinancial services; (2) the debt instrument was issued by a purchaser of the goods or services at the time of purchase of those items in order to finance their purchase; and (3) at all times after the debt instrument was issued, it has been owned by the person who sold the goods or services or by a member of its consolidated group. If, however, a taxpayer is a dealer in securities despite this provision, customer debt remains a security in the taxpayer's hands and must be marked to market unless exempted by another rule.

The temporary regulations contain a narrower provision—that a seller of nonfinancial goods or services is not a dealer in securities for purposes of section 475 solely by virtue of extending credit to its nonfinancial customers (even if it sells the debt instruments so acquired). In response to comments, the final regulations extend this principle to accommodate consolidated groups that include both a seller of nonfinancial goods or services and a captive finance subsidiary.

The rule in the final regulations exempting from dealer status most captive finance subsidiaries of retailers and other sellers of nonfinancial goods and services applies to all taxable years ending on or after December 31, 1993, unless the taxpayer elects for the exemption not to apply. If the election is made, it continues for all subsequent taxable years and may be revoked only with the consent of the Commissioner.

Under the final regulations, there are two additional circumstances in which this exemption from dealer status does not apply. The first is when, for purposes of the inventory accounting rules under section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory. The second circumstance is when the taxpayer is not itself the seller of nonfinancial goods and services and the customer debt is accounted for by the taxpayer or by a member of its consolidated group under a method that permits either the recognition of unrealized gains or losses or deductions for additions to a reserve for bad debts. This rule does not affect the seller of nonfinancial goods and services itself but is designed to prevent groups from having one captive finance subsidiary that is treated as a nondealer and another member of the group that is a dealer or a financial institution that accounts for customer debt under a method that takes into account mark-to-market gains or losses or reserve deductions.

Dealer in Securities—the Negligible Sales Exemption

Under the final regulations, in general, if a taxpayer purchases securities from customers (including originating loans in the ordinary course of the taxpayer's trade or business of originating loans) but engages in no more than negligible sales of the securities so acquired, the purchases do not cause the taxpayer to be a dealer in securities. This negligible sales rule does not apply if the taxpayer so elects or accounts for any security as inventory for purposes of section 471. A taxpayer that would be a dealer in securities but for the negligible sales rule elects to be a dealer simply by filing a federal income tax return reflecting the application of section 475(a) in computing its taxable income. The final regulations differ from the proposed regulations by explicitly making the negligible sales rule elective.

In response to comments, the final regulations clarify the test for determining negligible sales of debt instruments acquired from customers. Under this rule, a taxpayer has engaged in no more than negligible sales of the debt instruments (or portions of the debt instruments) that it regularly purchases from customers in the ordinary course of its business if, and only if, during the year, either (1) it sells all or part of fewer than 60 debt instruments (regardless how acquired), or (2) the total adjusted basis of the debt instruments or portions of debt instruments (regardless how acquired) that it sells is less than 5 percent of the total basis, immediately after acquisition, of the debt instruments that it acquires during the year.

This special test replaces the examples in the temporary regulations illustrating the negligible sales provision. Some commenters noted that § 1.475(c)–1T(b)(2) *Example 1* of the temporary regulations is ambiguous because it refers to a taxpayer that both ''retains almost all of the loans that it acquires'' and ''sells fewer than 60 loans.'' The final regulations eliminate the ambiguity by making no reference to how many loans are retained.

In response to comments, the final regulations contain two special rules for applying the negligible sales test to members of a consolidated group. Under the first rule, if a taxpayer is a member of a consolidated group that has made the intragroup-customer election, described above, it must apply the negligible sales test for debt instruments by taking into account all of its sales of debt instruments to other group members. On the other hand, if the taxpayer is a member of a consolidated group that has not made the intragroup-customer election, the negligible sales test is satisfied if either of two criteria is met: first, if the taxpayer satisfies the negligible sales test, taking into account all sales of debt instruments including sales to other group members; or second, if the taxpayer's consolidated group would satisfy the test if it were a single corporation and the members of the group were divisions of that corporation. This group-wide approach to the negligible sales test is consistent with the single-entity approach of §§ 1.1221–2(d)(1) and 1.1502–13.

Under a new rule in the final regulations, if a debt instrument is qualitatively different from all of the debt instruments that the taxpayer purchases from customers, a sale of that debt instrument does not count as one of the 60 instruments sold, and that debt instrument is not included in either the numerator or the denominator under the 5% test. The regulations contain an example that illustrates this principle.

The rules regarding the negligible sales exemption are generally effective for taxable years ending on or after December 31, 1993. The special rules for members of a consolidated group, however, are effective for taxable years beginning on or after January 23, 1997. Further, a taxpayer may rely on the rules set out in § 1.475(c)–1T(b) (as contained in 26 CFR part 1 revised April 1, 1996) for taxable years beginning before January 23, 1997, provided the taxpayer applies that paragraph reasonably and consistently.

Dealer in Securities—Issuance of Life Insurance Products

The final regulations adopt without change a provision in the 1995 proposed regulations to clarify that a life insurance company does not become a dealer in securities solely by selling annuity, endowment, or life insurance contracts to its customers.

Under the final regulations and the December 28, 1993, proposed regulations, a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract is deemed to have been identified as held for investment, and is therefore not marked to market by the policy holder. This rule was necessary because variable life and annuity products fall within the literal language of section 475(c)(2)(E). Because many life insurance companies sell these insurance contracts to their customers, some commenters on the 1993 proposal had asked whether these life insurance companies were dealers in securities. There is no indication that Congress intended for a life insurance company that was not otherwise a dealer in securities to be characterized as a dealer merely because it sells life insurance policies to its customers.

Several commenters requested that certain activities not cause dealer status under section 475 because those activities, although described by section 475, traditionally had not been considered dealer activities. Those comments were generally rejected. Congress determined that section 475 would bestow dealer status on taxpayers who had not been thought of as dealers prior to the enact-

ment of section 475. Thus, the final regulations do not adopt proposals that making and selling policy loans should not cause an insurance company to be a dealer in securities and that sales of student loans or auto loans and sales of loan participations should not be taken into account in determining whether a taxpayer is a dealer in securities. Of course, if a lead bank never owns a particular portion of a loan for tax purposes (because some other participating lender always had the economic benefits and burdens of that portion), then the lead bank cannot sell that portion to that other participating lender. Thus, the lead bank is not a dealer in securities by reason of these participations.

Definition of Security

Under the final regulations, certain items are not securities within the meaning of section 475(c)(2). These items include both debt issued by the taxpayer and any security (determined without regard to this provision) if section 1032 bars recognition of gain or loss by the taxpayer with respect to that security.

The final regulations adopt without change the provisions in the 1995 proposed regulations that exclude from the definition of security all REMIC residual interests acquired on or after January 4, 1995. This rule was adopted because applying section 475 to residual interests would undermine the Congressional design for taxing REMIC income, including the intended operation of sections 860C and 860E (relating to excess inclusions).

Unlike the 1995 proposed regulations, the temporary regulations excluded only some residual interests from the definition of security. Specifically, the temporary regulations excluded only negative value residual interests (NVRIs) in a REMIC and other arrangements that are determined to have substantially the same economic effect as NVRIs. Under the final regulations, this exclusion continues to apply to NVRIs acquired before January 4, 1995.

One commenter acknowledged the tension between mark-to-market accounting and the excess inclusion rules, but proposed to address that problem in another way. Under the commenter's proposal, a dealer would be permitted to mark to market a residual interest, but any loss resulting from the mark would be taken into account only to the extent that the loss exceeded the amount of excess inclusion with respect to that residual interest for the taxable year.

The IRS and Treasury believe that this comment does not address the tension between mark-to-market accounting and section 860C. Apart from the excess inclusion rules, the REMIC provisions contemplate income inclusions (and corresponding basis increases) that are not necessarily associated with increases in the value of the residual interest. Under the commenter's proposal, a dealer could claim a loss by marking to market a residual interest where the increased basis in the interest resulted from an allocation of REMIC income that was unaccompanied by an increase in value. Thus, the dealer could avoid its allocable share of REMIC income and thereby frustrate the taxing regime contemplated for residual interests.

Moreover, adopting this comment would require additional, complex rules, and the burden of administering those rules would not be justified by the potential benefit. For example, under the proposal, a taxpayer would have one basis in a residual interest for purposes of section 475 and a different basis in the residual interest for purposes of section 860C(d). Also, adopting the proposal would require rules to coordinate losses that are limited under section 475 with losses that are limited under section 860C(e)(2).

Some commenters suggested that certain types of assets should not be marked to market because they may be difficult to value. Under section 475, however, ease of valuation is not relevant in determining whether a security is required to be marked to market.

Character of Gain or Loss

The regulations adopt without change the proposed provision to clarify that marking to market a security that is not held in connection with a taxpayer's activities as a dealer in securities does not affect the character of gain or loss from that security.

In addition, under a new provision in the final regulations that responds to comments from taxpayers, if a dealer in certain notional principal contracts or derivative securities (described in section 475(c)(2)(D) or (E)) marks those securities to market because it is precluded from identifying them as exempt from mark-to-market treatment on the grounds that they are held for investment, the dealer recognizes ordinary gain or loss with respect to those securities.

Effective Dates

These final regulations generally apply to taxable years ending on or after December 31, 1993, except as otherwise noted.

Miscellaneous

Some of the 1993 and 1995 proposed regulations are reordered.

Special Analyses

It has been determined that this Treasury decision 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) does not apply to these regulations. The collection of information required by § 1.475(b)–2 was contained in a notice of proposed rulemaking preceding these regulations that was issued prior to March 29, 1996. Moreover, it is hereby certified that the collection of information required by § 1.475(c)–1 of these regulations (regarding the intragroup customer election) does not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the election is generally attractive only to an affiliated group of taxpayers that files a consolidated return (generally large businesses), that has elected separate entity treatment under § 1.1221–2, and that has an in-house hedge center or securities dealer which deals solely with other group members and which uses mark-to-market accounting for book purposes. Thus, the election is likely to be made only by, and the collection of information applies only to, a very small number of large taxpayers. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Robert B. Williams and Jo Lynn Ricks, Office of Assistant Chief

Counsel (Financial Institutions and Products), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entries for §§ 1.475(b)–1T, 1.475(b)–2T, 1.475(c)–1T, 1.475(c)–2T, 1.475(d)–1T, and 1.475(e)–1T and adding entries in numerical order to read as follows:

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

Section 1.475(a)–3 also issued under 26 U.S.C. 475(e).

Section 1.475(b)–1 also issued under 26 U.S.C. 475(b)(4) 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.

Section 1.475(c)–1 also issued under 26 U.S.C. 475(e).

Section 1.475(c)–2 also issued under 26 U.S.C. 475(e) and 26 U.S.C. 860G(e).

Section 1.475(d)–1 also issued under 26 U.S.C. 475(e).

Section 1.475(e)–1 also issued under 26 U.S.C. 475(e). * * *

Sections 1.475(b)–1T, 1.475(b)–2T, 1.475(c)–1T, 1.475(c)–2T, 1.475(d)–1T, and 1.475(e)–1T [Removed]

Par. 2. Sections 1.475(b)–1T, 1.475(b)–2T, 1.475(c)–2T, 1.475(d)–1T, and 1.475(e)–1T are removed.

Par. 2a. Paragraph (a) of § 1.475(c)–1T is removed effective December 24, 1996, and the remainder of § 1.475(c)–1T is removed January 23, 1997.

Par. 3. Sections 1.475–0, 1.475(a)–3, 1.475(b)–1, 1.475(b)–(2), 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1, and 1.475(e)–1 are added to read as follows:

§ 1.475–0 Table of contents.

This section lists the major captions in §§ 1.475(a)–3, 1.475(b)–1, 1.475(b)–2, 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1, and 1.475(e)–1.

§ 1.475(a)–1 [Reserved]

§ 1.475(a)–2 [Reserved]

§ 1.475(a)–3 Acquisition by a dealer of a security with a substituted basis.

(a) Scope.
(b) Rules.

§ 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; dealers in notional principal contracts and derivatives.
(d) Special rule for hedges of another member's risk.
(e) Transitional rules.
(1) Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts before January 23, 1997.
(i) In general.
(ii) Control defined.
(iii) Applicability.
(2) Dealers in notional principal contracts and derivatives acquired before January 23, 1997.
(i) General rule.
(ii) Exception for securities not acquired in dealer capacity.
(iii) Applicability.

§ 1.475(b)–2 Exemptions—identification requirements.

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§ 1.475(a)–3 Acquisition by a dealer of a security with a substituted basis.

(a) *Scope*. This section applies if—

(1) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to the basis of that security in the hands of the person from whom the security was acquired; or

(2) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to other property held at any time by the dealer.

(b) *Rules*. If this section applies to a security—

(1) Section 475(a) applies only to changes in value of the security occurring after the acquisition; and

(2) Any built-in gain or loss with respect to the security (based on the difference between the fair market value of the security on the date the dealer acquired it and its basis to the dealer on that date) is taken into account at the time, and has the character, provided by the sections of the Internal Revenue Code that would apply to the built-in gain or loss if section 475(a) did not apply to the security.

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

(a) *Securities held for investment or not held for sale.* Except as otherwise provided by this section and subject to the identification requirements of section 475(b)(2), a security is held for investment (within the meaning of section 475(b)(1)(A)) or not held for sale (within the meaning of section 475(b)(1)(B)) if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(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 72, 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 (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);

(ii) Less than 15 percent of all of the outstanding shares or interests in the same class are held by the taxpayer and all persons having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section; and

(iii) If the security was acquired (e.g., on original issue) from a person having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section, then, after the time the security was acquired—

(A) At least one full business day has passed, and

(B) There has been significant trading involving persons not having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section.

(4) *Changes in status*—(i) *Onset of prohibition against marking*—(A) Once paragraph (b)(1) of this section begins to apply to the security and for so long as it continues to apply, 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, paragraph (b)(1) of this section begins to apply to the security, 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 paragraph (b)(1) of this section begins to apply to the security, 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 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 some 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 paragraph (b)(1)(i) of this section (concerning the relationship between *X* and *D*) continues to apply.

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 some 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 24, 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* ceased 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 after December 30, 1996, to refrain from marking to market its *Y* stock.

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.

Example 4. Acquisition of actively traded stock from related party—(A) *Facts.* Corporation *P* is the parent of a consolidated group whose taxable year is the calendar year, and corporation *M*, a member of that group, is a dealer in securities within the meaning of section 475(c)(1). Corporation *M* regularly acts as a market maker with respect to common and preferred stock of corporation *P*. Corporation *P* has outstanding 2,000,000 shares of series *X* preferred stock, which are traded on a national securities exchange. During the business day on December 29, 1997, corporation *P* sold 100,000 shares of series *X* preferred stock to corporation *M* for $100 per share. Subsequently, also on December 29, 1997, persons not related to corporation *M* engaged in significant trading of the series *X* preferred stock. At the close of business on December 30, 1997, the fair market value of series *X* stock was $99 per share. At the close of business on December 31, 1997, the fair market value of series *X* stock was $98.50 per share. Corporation *M* sold the series *X* stock on the exchange on January 2, 1998. At all relevant times, corporation *M* and all persons related to *M* owned less than 15% of the outstanding series *X* preferred stock.

(B) *Holding.* The 100,000 shares of series *X* preferred stock held by corporation *M* are not subject to mark-to-market treatment under section 475(a) on December 29, 1997, because at that time the stock was held for less than one full business day and is therefore treated as properly identified as held for investment. At the close of business on December 30, 1997, that prohibition on marking ceases to apply, and section 475(b)(3) begins to apply. The built-in loss is suspended, and subsequent appreciation and depreciation are subject to section 475(a). Accordingly, when corporation *M* marks the series *X* stock to market at the close of business on December 31, 1997, under section 475(a) it recognizes and takes into account a loss of $.50 per share. Under section 475(b)(3), when corporation *M* sells the series *X* stock on January 2, 1998, it takes into account the suspended loss, that is, the difference between the $100 per share it paid corporation *P* for that stock and the $99-per-share fair market value when section 475(b)(1) ceased to be apply to the stock. No deduction, however, is allowed for that loss. (See § 1.1502–13(f)(6), under which no deduction is allowed to a member of a consolidated group for a loss with respect to a share of stock of the parent of that consolidated group, if the member does not take the gain or loss into account pursuant to section 475(a).)

(c) *Securities deemed not held for investment; dealers in notional principal contracts and derivatives*—(1) Except as otherwise determined by the Commissioner in a revenue ruling, revenue procedure, or letter ruling, 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.

(2) See § 1.475(d)–1(b) for a rule concerning the character of gain or loss on securities described in this paragraph (c).

(d) *Special rule for hedges of another member's risk.* A taxpayer may identify under section 475(b)(1)(C) (exempting certain hedges from mark-to-market accounting) a security that hedges a position of another member of the taxpayer's consolidated group if the security meets the following requirements—

(1) The security is a hedging transaction within the meaning of § 1.1221–2(b);

(2) The security is timely identified as a hedging transaction under § 1.1221–2(e) (including identification of the hedged item); and

(3) The security hedges a position that is not marked to market under section 475(a).

(e) *Transitional rules*—(1) *Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts before January 23, 1997*— (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 (e)(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 (e)(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 (e)(1) apply only before January 23, 1997.

(2) *Dealers in notional principal contracts and derivatives acquired before January 23, 1997*—(i) *General rule.* Section 475(b)(1)(A) (exempting certain securities from mark-to-market accounting) does not apply to a security if—

(A) The security is described in section 475(c)(2)(D) or (E) (describing certain notional principal contracts and derivative securities); and

(B) The taxpayer is a dealer in such securities.

(ii) *Exception for securities not acquired in dealer capacity.* This paragraph (e)(2) does not apply if the taxpayer establishes unambiguously that the security was not acquired in the taxpayer's capacity as a dealer in such securities.

(iii) *Applicability*. The rules of paragraph (e)(2) apply only to securities acquired before January 23, 1997.

§ 1.475(b)–2 Exemptions—identification requirements.

(a) *Identification of the basis for exemption.* An identification of a security as exempt from mark to market does not satisfy section 475(b)(2) if it fails to state whether the security is described in—

(1) Either of the first two subparagraphs of section 475(b)(1) (identifying a security as held for investment or not held for sale); or

(2) The third subparagraph thereof (identifying a security as a hedge).

(b) *Time for identifying a security with a substituted basis.* For purposes of determining the timeliness of an identification under section 475(b)(2), the date that a dealer acquires a security is not affected by whether the dealer's basis in the security is determined, in whole or in part, either by reference to the basis of the security in the hands of the person from whom the security was acquired or by reference to other property held at any time by the dealer. See § 1.475(a)–3 for rules governing how the dealer accounts for such a security if this identification is not made.

(c) *Integrated transactions under § 1.1275–6*— (1) *Definitions.* The following terms are used in this paragraph (c) with the meanings that are given to them by § 1.1275–6: integrated transaction, legging into, legging out, qualifying debt instrument, § 1.1275–6 hedge, and synthetic debt instrument.

(2) *Synthetic debt held by a taxpayer as a result of legging in.* If a taxpayer is treated as the holder of a synthetic debt instrument as the result of legging into an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the synthetic debt instrument is treated as having the same acquisition date as the qualifying debt instrument. A pre-leg-in identification of the qualifying debt instrument under section 475(b)(2) applies to the integrated transaction as well.

(3) *Securities held after legging out.* If a taxpayer legs out of an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the qualifying debt instrument, or the § 1.1275–6 hedge, that remains in the taxpayer's hands is generally treated as having been acquired, originated, or entered into, as the case may be, immediately after the leg-out. If any loss or deduction determined under § 1.1275–6(d)(2)(ii)(B) is disallowed by § 1.1275–6(d)(2)(ii)(D) (which disallows deductions when a taxpayer legs out of an integrated transaction within 30 days of legging in), then, for purposes of this section and section 475(b)(2), the qualifying debt instrument that remains in the taxpayer's hands is treated as having been acquired on the same date that the synthetic debt instrument was treated as having been acquired.

§ 1.475(b)–4 Exemptions—transitional issues.

(a) *Transitional identification*—(1) *Certain securities previously identified under section 1236.* If, as of the close of the last taxable year ending before December 31, 1993, a security was identified under section 1236 as a security held for investment, the security is treated as being identified as held for investment for purposes of section 475(b).

(2) *Consistency requirement for other securities.* In the case of a security (including a security described in section 475(c)(2)(F)) that is not described in paragraph (a)(1) of this section and that was held by the taxpayer as of the close of the last taxable year ending before December 31, 1993, the security is treated as having been properly identified under section 475(b)(2) or 475(c)(2)(F)(iii) if the information contained in the dealer's books and records as of the close of that year supports the identification. If there is any ambiguity in those records, the taxpayer must, no later than January 31, 1994, place in its records a statement resolving this ambiguity and indicating unambiguously which securities are to be treated as properly identified. Any information that supports treating a security as having been properly identified under section 475(b)(2) or (c)(2)(F)(iii) must be applied consistently from one security to another.

(b) *Corrections on or before January 31, 1994*—(1) *Purpose.* This paragraph (b) allows a taxpayer to add or remove certain identifications covered by § 1.475(b)–1.

(2) *To conform to § 1.475(b)–1(a)*—(i) *Added identifications.* To the extent permitted by paragraph (b)(2)(ii) of this section, a taxpayer may identify as being described in section 475(b)(1)(A) or (B)—

(A) A security that was held for immediate sale but was not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business (for example, a trading security); or

(B) An evidence of indebtedness that was not held for sale to customers in the ordinary course of the taxpayer's trade or business and that the taxpayer intended to hold for less than one year.

(ii) *Limitations.* An identification described in paragraph (b)(2)(i) of this section is permitted only if—

(A) Prior to December 28, 1993, the taxpayer did not identify as being described in section 475(b)(1)(A) or (B) any of the securities described in paragraph (b)(2)(i) of this section;

(B) The taxpayer identifies every security described in paragraph (b)(2)(i) of this section for which a timely identification of the security under section 475(b)(2) cannot be made after the date on which the taxpayer makes these added identifications; and

(C) The identification is made on or before January 31, 1994.

(3) *To conform to § 1.475(b)–1(c).* On or before January 31, 1994, a taxpayer described in § 1.475(b)–1(e)(2)(i)(B) may remove an identification under section 475(b)(1)(A) of a security described in § 1.475(b)–1(e)(2)(i)(A).

(c) *Effect of corrections.* An identification added under paragraph (a)(2) or (b)(2) of this section is timely for purposes of section 475(b)(2) or (c)(2)(F)(iii). An identification removed under paragraph (a)(2) or (b)(3) of this section does not subject the taxpayer to the provisions of section 475(d)(2).

§ 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 and is not a member of a consolidated group:

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) *General rule.* Except as provided in paragraph (a)(3)(ii) of this section (concerning transactions between members of a consolidated group, as defined in § 1.1502–1(h)), a taxpayer's transactions with related persons may be transactions with customers for purposes of section 475. For example, if a taxpayer, in the ordinary course of the taxpayer's trade or business, regularly holds itself out to its foreign subsidiaries or other related persons as being willing and able to enter into either side of transactions enumerated in section 475(c)(1)(B), the taxpayer is a dealer in securities within the meaning of section 475(c)(1), even if it engages in no other transactions with customers.

(ii) *Special rule for members of a consolidated group.* Solely for purposes of paragraph (c)(1) of section 475 (concerning the definition of dealer in securities) and except as provided in paragraph (a)(3)(iii) of this section, a taxpayer's transactions with other members of its consolidated group are not with customers. Accordingly, notwithstanding paragraph (a)(2) of this section, the fact that a taxpayer regularly holds itself out to other members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause the taxpayer to be a dealer in securities within the meaning of section 475(c)(1)(B).

(iii) *The intragroup-customer election*—(A) *Effect of election.* If a consolidated group makes the intragroup-customer election, paragraph (a)(3)(ii) of this section (special rule for members of a consolidated group) does not apply to the members of the group. Thus, a member of a group that has made this election may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are with other members of its consolidated group.

(B) *Making and revoking the election.* Unless the Commissioner otherwise prescribes, the intragroup-customer election is made by filing a statement that says, ''[Insert name and employer identification number of common parent] hereby makes the Intragroup-Customer Election (as described in § 1.475(c)–1(a)(3)(iii) of the income tax regulations) for the taxable year ending [describe the last day of the year] and for subsequent taxable years.'' The statement must be signed by the common parent and attached to the timely filed federal income tax return for the consolidated group for that taxable year. The election applies for that year and continues in effect for subsequent years until revoked. The election may be revoked only with the consent of the Commissioner.

(iv) *Examples.* The following examples illustrate this paragraph (a)(3):

General Facts. HC, a hedging center, provides interest rate hedges to all of the members of its affiliated group (as defined in section 1504(a)(1)). 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 affiliated group. *HC* attempts to operate at cost, and the terms of its swaps do not factor in any risk of default by the affiliate. Thus, *HC*'s affiliates receive somewhat more favorable terms then they would receive from an unrelated swaps dealer (a fact that may subject *HC* and its fellow members to reallocation of income under section 482). No other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B).

Example 1. General rule for related persons. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has not elected under section 1501 to file a consolidated return. Under paragraph (a)(3)(i) of this section, *HC*'s transactions with its affiliates can be transactions with customers for purposes of section 475(c)(1). Thus, under paragraph (a)(2)(i) of this section, *HC* is a dealer in securities within the meaning of section 475(c)(1)(B), and the members of the group with which it does business are its customers.

Example 2. Special rule for members of a consolidated group. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file consolidated returns and has not made the intragroup-customer election. Under paragraph (a)(3)(ii) of this section, *HC*'s interest rate swap transactions with the members of its consolidated group are not transactions with customers for purposes of determining whether *HC* is a dealer in securities within the meaning of section 475(c)(1). Further, the fact that *HC* regularly holds itself out to members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause *HC* to be a dealer in securities within the meaning of section 475(c)(1)(B). Because no other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B), *HC* is not a dealer in securities.

Example 3. Intragroup-customer election. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file a consolidated return but has also made the intragroup-customer election under paragraph (a)(3)(iii) of this section. Thus, the analysis and result are the same as in *Example 1.*

(b) *Sellers of nonfinancial goods and services*— (1) *Purchases and sales of customer paper.* Except as provided in paragraph (b)(3) of this section, if a taxpayer would not be a dealer in securities within the meaning of section 475(c)(1) but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group (as defined in § 1.1502–1(h)) as the taxpayer, then for purposes of section 475 the taxpayer is not a dealer in securities.

(2) *Definition of customer paper.* A debt instrument is customer paper with respect to a person at a point in time if—

(i) The person's principal activity is selling nonfinancial goods or providing nonfinancial services;

(ii) The debt instrument was issued by a purchaser of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and

(iii) At all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a corporation that is a member of the same consolidated group as that person.

(3) *Exceptions.* Paragraph (b)(1) of this section does not apply if—

(i) For purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory;

(ii) The taxpayer is subject to an election under paragraph (b)(4) of this section; or

(iii) The taxpayer is not described in paragraph (b)(2)(i) of this section and one or more debt instruments that are customer paper with respect to a corporation that is a member of the same consolidated group as the taxpayer are accounted for by the taxpayer, or by a corporation that is a member of the same consolidated group as the taxpayer, in a manner that allows recognition of unrealized gains or losses or deductions for additions to a reserve for bad debts.

(4) *Election not to be governed by the exception for sellers of nonfinancial goods or services*—(i) *Method of making the election.* Unless the Commissioner otherwise prescribes, an election under this paragraph (b)(4) must be made in the manner, and at the time, prescribed in this paragraph (b)(4)(i). The taxpayer must file with the Internal Revenue Service a statement that says, ''[Insert name and taxpayer identification number of the taxpayer] hereby elects not to be governed by § 1.475(c)–1(b)(1) of the income tax regulations for the taxable year ending [describe the last day of the year] and for subsequent taxable years.''

(A) *Taxable years ending after December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends after December 24, 1996, the statement must be attached to a timely filed federal income tax return for that taxable year.

(B) *Taxable years ending on or before December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996, and the election changes the taxpayer's taxable income for any taxable year the federal income tax return for which was filed before February 24, 1997, the statement must be attached to an amended return for the earliest such year that is so affected, and that amended return (and an amended return for any other such year that is so affected) must be filed not later than June 23, 1997. If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996, but the taxpayer is not described in the preceding sentence, the statement must be attached to the first federal income tax return that is for a taxable year subject to the election and that is filed on or after February 24, 1997.

(ii) *Continued applicability of an election.* An election under this paragraph (b)(4) continues in effect for subsequent taxable years until revoked. The election may be revoked only with the consent of the Commissioner.

(c) *Taxpayers that purchase securities from customers but engage in no more than negligible sales of the securities*—(1) *Exemption from dealer status*—(i) *General rule.* A taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) but engages in no more than negligible sales of the securities so acquired is not a dealer in securities within the meaning of section 475(c)(1) unless the taxpayer elects to be so treated or, for purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory.

(ii) *Election to be treated as a dealer.* A taxpayer described in paragraph (c)(1)(i) of this section elects to be treated as a dealer in securities by filing a federal income tax return reflecting the application of section 475(a) in computing its taxable income.

(2) *Negligible sales.* Solely for purposes of paragraph (c)(1) of this section, a taxpayer engages in negligible sales of debt instruments that it regularly purchases from customers in the ordinary course of its business if, and only if, during the taxable year, either—

(i) The taxpayer sells all or part of fewer than 60 debt instruments, regardless how acquired; or

(ii) The total adjusted basis of the debt instruments (or parts of debt instruments), regardless how acquired, that the taxpayer sells is less than 5 percent of the total basis, immediately after acquisition, of the debt instruments that it acquires in that year.

(3) *Special rules for members of a consolidated group*— (i) *Intragroup-customer election in effect.* If a taxpayer is a member of a consolidated group that has made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the negligible sales test in paragraph (c)(2) of this section takes into account all of the taxpayer's sales of debt instruments to other group members.

(ii) *Intragroup-customer election not in effect.* If a taxpayer is a member of a consolidated group that has not made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the taxpayer satisfies the negligible sales test in paragraph (c)(2) of this section if either—

(A) The test is satisfied by the taxpayer, taking into account sales of debt instruments to other group members (as in paragraph (c)(3)(i) of this section); or

(B) The test is satisfied by the group, treating the members of the group as if they were divisions of a single corporation.

(4) *Special rules.* Whether sales of securities are negligible is determined without regard to—

(i) Sales of securities that are necessitated by exceptional circumstances and that are not undertaken as recurring business activities;

(ii) Sales of debt instruments that decline in quality while in the taxpayer's hands and that are sold pursuant to an established policy of the taxpayer to dispose of debt instruments below a certain quality; or

(iii) Acquisitions and sales of debt instruments that are qualitatively different from all debt instruments that the taxpayer purchases from customers in the ordinary course of its business.

(5) *Example.* The following example illustrates paragraph (c)(4)(iii) of this section:

Example. I, an insurance company, regularly makes policy loans to its customers but does not sell them. *I,* however, actively trades Treasury securities. No other circumstances are present to suggest that *I* is a dealer in securities for purposes of section 475(c)(1). Since the Treasuries are qualitatively different from the policy loans that *I* originates, under paragraph (c)(4)(iii) of this section, *I* disregards the purchases and sales of Treasuries in applying the negligible sales test in paragraph (c)(2) of this section.

(d) *Issuance of life insurance products.* A life insurance company that is not otherwise a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities solely because it regularly issues life insurance products to its customers in the ordinary course of a trade or business. For purposes of the preceding sentence, the term *life insurance product*

means a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract. See sections 72, 817, and 7702.

§ 1.475(c)–2 Definitions—security.

(a) *Items that are not securities.* The following items are not securities within the meaning of section 475(c)(2) with respect to a taxpayer and, therefore, are not subject to section 475—

(1) A security (determined without regard to this paragraph (a)) if section 1032 prevents the taxpayer from recognizing gain or loss with respect to that security;

(2) A debt instrument issued by the taxpayer (including a synthetic debt instrument, within the meaning of § 1.1275–6(b)(4), that § 1.1275–6(b) treats the taxpayer as having issued); or

(3) A REMIC residual interest, or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect, if the residual interest or the interest or arrangement is acquired on or after January 4, 1995.

(b) *Synthetic debt that § 1.1275–6(b) treats the taxpayer as holding.* If § 1.1275–6 treats a taxpayer as the holder of a synthetic debt instrument (within the meaning of § 1.1275–6(b)(4)), the synthetic debt instrument is a security held by the taxpayer within the meaning of section 475(c)(2)(C).

(c) *Negative value REMIC residuals acquired before January 4, 1995.* A REMIC residual interest that is described in paragraph (c)(1) of this section or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect is not a security within the meaning of section 475(c)(2).

(1) *Description.* A residual interest in a REMIC is described in this paragraph (c)(1) if, on the date the taxpayer acquires the residual interest, the present value of the anticipated tax liabilities associated with holding the interest exceeds the sum of—

(i) The present value of the expected future distributions on the interest; and

(ii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(2) *Special rules applicable to negative value REMIC residuals acquired before January 4, 1995.* Solely for purposes of this paragraph (c)—

(i) If a transferee taxpayer acquires a residual interest with a basis determined by reference to the transferor's basis, then the transferee is deemed to acquire the interest on the date the transferor acquired it (or is deemed to acquire it under this paragraph (c)(2)(i)).

(ii) Anticipated tax liabilities, expected future distributions, and anticipated tax savings are determined under the rules in § 1.860E–2(a)(3) and without regard to the operation of section 475.

(iii) Present values are determined under the rules in § 1.860E–2(a)(4).

§ 1.475(d)–1 Character of gain or loss.

(a) *Securities never held in connection with the taxpayer's activities as a dealer in securities.* If a security is never held in connection with the taxpayer's activities as a dealer in securities, section 475(d)(3)(A) does not affect the character of gain or loss from the security, even if the taxpayer fails to identify the security under section 475(b)(2).

(b) *Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.* Section 475(d)(3)(B)(ii) (concerning the character of gain or loss with respect to a security held by a person other than in connection with its activities as a dealer in securities) does not apply to a security if § 1.475(b)–1(c) and the absence of a determination by the Commissioner prevent section 475(b)(1)(A) from applying to the security.

§ 1.475(e)–1 Effective dates.

(a) and (b) [Reserved].

(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) Except as provided elsewhere in this paragraph (d), § 1.475(b)''1 (concerning the scope of exemptions from the mark-to-market requirement) applies to taxable years ending on or after December 31, 1993.

(1) Section 1.475(b)''1(b) applies as follows:

(i) Section 1.475(b)''1(b)(1)(i) (concerning equity interests issued by a related person) applies beginning 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) (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 beginning June 19, 1996.

(iii) Section 1.475(b)''1(b)(3) (concerning certain actively traded securities) applies beginning June 19, 1996, to securities held on or after that date, except for securities described in § 1.475(b)''1(e)(1)(i) (concerning equity interests issued by controlled entities). If a security is described in § 1.475(b)''1(e)(1)(i), § 1.475(b)-''1(b)(3) applies only on or after January 23, 1997, if the security is 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)(1)(iii), the rules of § 1.475(b)''1(b)-(4)(ii) apply to the cessation.

(iv) Except to the extent provided in paragraph (d)(1) of this section, § 1.475(b)''1(b)(4) (concerning changes in status) applies beginning June 19, 1996.

(2) Section 1.475(b)''1(c) (concerning securities deemed not held for investment by dealers in notional principal contracts and derivatives) applies to securities acquired on or after January 23, 1997.

(3) Section 1.475(b)–1(d) (concerning the special rule for hedges of another member's risk) is effective for securities acquired, originated, or entered into on or after January 23, 1997.

(e) Section 1.475(b)–2 (concerning identification of securities that are exempt from mark to market treatment) applies as follows:

(1) Section 1.475(b)–2(a) (concerning the general rules for identification of basis for exemption from mark to market treatment) applies to identifications made on or after July 1, 1997.

(2) Section 1.475(b)–2(b) (concerning time for identifying a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(3) Section 1.475(b)–2(c) (concerning identification in the context of integrated transactions under § 1.1275–6) applies

on and after August 13, 1996 (the effective date of § 1.1275–6).

(f) [Reserved].

(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 applies as follows:

(1) Except as otherwise provided in this paragraph (h)(1), § 1.475(c)–1(a) (concerning the dealer-customer relationship) applies to taxable years beginning on or after January 1, 1995.

(i) [Reserved].

(ii) Section 1.475(c)–1(a)(2)(ii) (illustrating rules concerning the dealer-customer relationship) applies to taxable years beginning on or after June 20, 1996.

(iii) (A) Section 1.475(c)–1(a)(3) applies to taxable years beginning on or after June 20, 1996, except for transactions between members of the same consolidated group.

(B) For transactions between members of the same consolidated group, paragraph § 1.475(c)–1(a)(3) applies to taxable years beginning on or after December 24, 1996.

(2) Section 1.475(c)–1(b) (concerning sellers of nonfinancial goods and services) applies to taxable years ending on or after December 31, 1993.

(3) Except as otherwise provided in this paragraph (h)(3), § 1.475(c)–1(c) (concerning taxpayers that purchase securities but engage in no more than negligible sales of the securities) applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(c)–1(c)(3) (special rules for members of a consolidated group) is effective for taxable years beginning on or after December 24, 1996.

(ii) A taxpayer may rely on the rules set out in § 1.475(c)–1T(b) (as contained in 26 CFR part 1 revised April 1, 1996) for taxable years beginning before January 23, 1997, provided the taxpayer applies that paragraph reasonably and consistently.

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

(i) Section 1.475(c)–2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. By its terms, however, § 1.475(c)–2(a)(3) applies only to residual interests or to interests or arrangements that are acquired on or after January 4, 1995; and the integrated transactions that are referred to in §§ 1.475(c)–2(a)(2) and 1.475(c)–2(b) exist only after August 13, 1996 (the effective date of § 1.1275–6).

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

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In § 602.101 paragraph (c) is amended by:

1. Removing the following entry from the table:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.475(b)–2T	1545–1422
* * * * *	

2. Adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.475(b)–4.	1545–1496
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 6, 1996.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 23, 1996, 8:45 a.m., and published in the issue of the Federal Register for December 24, 1996, 61 F.R. 67715)