REPORT #890

TAX SECTION

New York State Bar Association

Letter on Proposed Regulations on Mark-to-Market Accounting by Securities Dealers (FI-32-95)

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TAX SECTION

New York State Bar Association

December 10, 1996

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

Re: Proposed Regulations on Mark-to-Market Accounting by Securities Dealers (FI-32-95)

Dear Commissioner Richardson:

On June 20, 1996, the Internal Revenue Service issued proposed regulations under section 475 (the "Proposed Regulations") that would make mark-to-market accounting inapplicable to most equity interests in related persons and that would address in certain respects how transactions with related persons are treated for purposes of determining a particular taxpayer's status as a dealer in securities (hereafter, a "dealer") for purposes of section 475.[1] In the preamble to the Proposed Regulations (the "Preamble"), the Service solicited comments with respect to certain issues. In this letter we address those issues and add some additional comments.

A. Prohibition against marking equity interests in related persons.

1. Proposed Regulation section 1.475(b)-1(b)(3): Scope of exceptions.

1 All section references are to the Internal Revenue Code of 1986, as amended, and to the Treasury Regulations promulgated thereunder. Dickson Brown and Bruce Kayle participated substantially in the preparation of this letter.

Temporary and Proposed Regulations published on December 29, 1993 (the "Original Regulations"), provided that stock in a 50 percent controlled subsidiary and interests in 50 percent controlled partnerships and trusts are deemed to be properly identified as held for investment and thus are not subject to mark to market accounting. The Proposed Regulations would expand the types of interests that would be treated as per se investments that may not be marked to market to include equity interests in most related persons. However, the per se investment rule would not apply to any security that is actively traded on a national securities exchange or interdealer quotation system if the dealer owns less than five percent of all shares or interests of that class, regardless of the relationship between the dealer and the issuer of the securities.[2]

The IRS has requested comments on the propriety of the scope of the proposed exception to the expanded per se investment rule. In our February 28, 1994 report regarding the Original Regulations[3], we suggested that there are circumstances in which a dealer in securities could be acting as such with respect to stock in a related party, and that these circumstances could be determined on a case by case basis. Moreover, these circumstances are not necessarily negated by the dealer's ownership of more than five percent of the class of securities involved. Accordingly, we recommend a modification to the proposed exception to the per se investment rule to allow a dealer to mark to market securities issued by a related person provided (1) the securities are actively traded and (2) the dealer holds the securities in its capacity as a dealer. As a safeguard for both taxpayers and the Service against marking to market in inappropriate circumstances, we would also recommend requiring the dealer to apply for and receive a ruling from the Internal Revenue Service permitting it to do so. The ruling may impose limitations appropriate to the circumstances. For example, a ruling may limit the percentage of securities in a class that may be marked to market without limiting the percentage of the class that may be owned by the dealer and also may address other issues such as appropriate identification procedures.

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[2] Prop. Reg. § 1.475(b)-1(b)(3).

[3] See New York State Bar Association, Tax Section, Committee on Financial Instruments, "Report on Section 475 Mark to Market Regulations," reprinted in Highlights & Documents, March 4, 1994, p. 3920 et seq.

B. Consolidated returns.

The Preamble describes an unintended effect the Proposed Regulations have on consolidated groups, namely the potential for duplicative gain and the disallowance of any offsetting loss pursuant to Regulation Section 1.1502-20. The example given in the Preamble concerns a parent (X) who is a dealer in securities and a subsidiary (Y) where the parent subsidiary file consolidated tax returns. The value of Y’s assets appreciate, and the value of Y’s stock held by X appreciates accordingly. X recognizes gain on the appreciation of the stock when it is marked to market. When the subsidiary sells an appreciated asset, the gain recognized by X with respect to Y’s stock gain is replicated and will be reflected in a duplicate stock basis increase. The problem, as the Preamble accurately describes, is that the subsequent marking down to fair market value of Y’s stock creates the potential for an offsetting loss which may be disallowed under Regulation section 1.1502-20.

We note that the circumstances in which the issue could arise are limited to two cases. In one, X owns 100% of the common stock of Y and some of the non-voting non-participating preferred stock of Y while acting as a dealer with respect to the latter. In the other, X owns 100% of one class of common stock of Y and a small amount of another class of common, where the percentage of vote and value of the other class held by shareholders other than X is insufficient to prevent consolidation (e.g., the other class is non-voting and represents less than 20% of the value of Y). We recommend an exception to Regulation section 1.1502-20 that would allow loss recognition to the extent mark to market gains have previously been recognized. We do not see that doing so would lead to abuses of the sort Regulation section 1.1502-20 was designed to prevent. However, we recommend limiting any proposed exception to stock that substantially participates in corporate growth or earnings. The marking to market of stock that does not participate in corporate growth would not normally reflect asset appreciation of the issuing corporation. Non-participating preferred stock of a financially sound corporation will fluctuate in value with interest rates rather than asset values of the issuer. Thus, the marking to market of this type of stock does not present the, problem described in the Preamble.

C. Single entity election for dealer status.

In our letter to you dated May 14, 1996 (the “May Letter”),[4] we expressed our concern that the lack of coordination among section 475, the consolidated hedging regulations (Regulation section 1.1221-2) and the

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4 Letter to Hon. Leslie A. Samuels and Hon. Margaret M. Richardson, reprinted in Highlights Documents, May 17, 1996, pp. 2419 et seq.

intercompany transactions rules (Regulation section 1.1502-13) may overtax or undertax a consolidated group in which a member (the “hedging member”) subject to section 475 hedges the risk of another member. This problem arises because the hedging regulations generally apply on a single entity basis and do not apply to positions subject to section 475(a). On the other hand, while section 475(a) does not apply if a hedge is involved, the determination of whether a hedge exists under section 475 is made on a separate entity basis. Thus, it is possible to have a position that is a “hedge” under section 1221 (where the determination is made based on a single entity approach) but not a “hedge” under section 475 (where the determination is made based on a separate entity approach). In such a case, the mark to market rules of section 475 would apply and the hedging rules of sections 446 and 1221 would be unavailable.

In our May Letter, we recommend that regulations be issued under section 475 that would except a “hedging transaction” under Regulation section 1.1221-2 from the mark to market rules of section 475(a). We again urge that this suggestion be adopted. It provides the proper matching and avoids some of the complexity that necessarily arises from the separate entity approach required by the Proposed Regulations. We believe that adding our recommendation as an alternative to the Proposed Regulations provides the necessary flexibility to taxpayers while assuring that mismatches in timing or character are avoided.

In the May Letter we recognized that, provided the hedging member is certain that it is a dealer, a consolidated group can avoid the overtaxation or undertaxation described above by making the separate entity election provided by Regulation section 1.1221-2(d)(2) and consistently entering into “back-to-back” intercompany hedges.[5] However, the May Letter also points out that it is quite common that the hedging member may not be certain of its dealer status. If the hedging member were to make a separate company election but is then determined not to be a dealer, certain character mismatches would occur. As a result, we support the Proposed Regulations and the certainty they provide a hedging member in determining its dealer status.

Specifically, the Proposed Regulations provide that a taxpayer's transactions with members of its own consolidated group or other related persons can be transactions with customers for purposes of determining

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[5] Similarly, if the hedging member were certain that it was not a dealer, it would not mark its positions to market and overtaxation or undertaxation should not arise.

whether the taxpayer is a “dealer” under section 475.[6] Thus, under the Proposed Regulations, a taxpayer can be a dealer in securities under section 475 even if its only customer transactions are transactions with members of its own consolidated group. The IRS has requested comments on whether certain consolidated groups should be able notwithstanding the above-stated rule to elect to disregard inter-member transactions in determining whether a member is a dealer in securities under section 475. In addition, the IRS has also requested comments as to whether such an election should be limited to those consolidated groups that are treated as single entities under Regulation section 1.1221-2(d)(2). We believe that granting to a consolidated group the ability to disregard inter-member transactions in determining whether a member is a dealer in securities under section 475 is an extremely useful technique that, in addition to and not instead of the recommendation contained in the May Letter, can eliminate undesirable and unnecessary character and timing mismatches.

1. Consistency. A consolidated group can elect either to be treated as a single entity or to have its members treated as separate entities for purposes of applying the hedging rules under Regulation section 1.1221-2. Sections 475 and 1221 and the Proposed Regulations are interrelated because the final hedging regulations only allow an inter-member transaction to be treated as a “hedging transaction” under Regulation section 1.1221-2 if one of the members marks its position to market. Thus, as stated in Notice 96-12, “whether a member of a consolidated group is a dealer in securities under Section 475 can affect whether intercompany risk-shifting transactions may be hedging transactions.” In fact, Notice 96-12 stated that its guidance on whether inter-member transactions would be considered under section 475 “will assist consolidated groups in deciding whether or not to make a separate-entity election under Regulation Section 1.1221-2(d)(2) of the Income Tax Regulations.” As stated above, we agree that the general rule provided by Notice 96-12 and the Proposed Regulations is of great help to taxpayers that wish to be certain they are eligible to make a separate company election. At the same time, we believe that it is appropriate for taxpayers that do not wish to make such a separate entity election to be able to disregard inter-member transactions in determining dealer status in order to achieve equivalent certainty.

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[6] In this respect, the Proposed Regulations generally reflect guidance provided by the IRS in Notice 96-12 (February 20, 1996).

2. Need to limit ability to elect. Because section 475 generally uses a taxpayer-by-taxpayer approach to determining dealer status and the mark to market method of accounting results in a clear reflection of a taxpayer's true economic* position, we see little problem with permitting a consolidated group that is treated as a single entity under section 1221 to disregard inter-member transactions in determining a member's dealer status under section 475. However, there does not appear to be any compelling reason to allow an entity that has elected separate entity treatment under section 1221 to elect to disregard inter-member transactions in determining a member's dealer status under section 475. The main effect of allowing an entity for which a separate entity election is made under Regulation section 1.1221-2(d) to elect to disregard inter-member transactions in determining dealer status under section 475 would be to introduce or enhance the risk that the group would be determined to be ineligible for the separate company election, leading to the undesirable potential character mismatches described in the May Letter. As a result, we do not believe as a practical matter taxpayers electing separate entity treatment under Regulation section 1.1221-2(d) will wish to disregard inter-member transactions in determining dealer status under section 475.

3. Effect on timing and character. We recognize that by allowing a consolidated group to disregard inter-member transactions in determining dealer status under section 475, an entity that would have otherwise been a dealer (and thus subject to the mark to market method of accounting) might avoid dealer status. However, allowing a consolidated group to disregard inter-member transactions in determining dealer status under section 475 is consistent with the approach taken in the consolidated return intercompany transaction rules.[7] Although permitting a consolidated group to disregard inter-member transactions in determining a member's dealer status under section 475 may affect the timing of gain or loss recognition, we believe that these timing effects are an inherent consequence of treating a consolidated group as a single entity. Moreover, any potential timing differences may be minimized by the ability of the "dealer" entity to identify its contracts with unrelated parties as hedges and apply the rules of Regulation section 1.446-4.

With respect to the character of any such gain or loss, we believe that in most circumstances the ability to disregard inter-member transactions in determining a member's dealer status under section 475 will have a significant effect. In many cases, transactions with unrelated parties will not result in the hedging member being a dealer under section 475. In such cases, the character of any gain or loss will be the

[7] See Reg. § 1.1502-13.

same in determining its dealer status under section 475. In cases where a member of a consolidated group would be subject to the mark to market method solely because of its inter-member transactions, such member would presumably be able to avoid mark to market treatment of any transaction with a non-member (provided such transaction was not of the same type as its inter-member transactions) by identifying such transaction as a position held for investment. Thus, any gain or loss recognized by the member with respect to its transaction with the non-member would be capital gain or loss regardless of whether such member was considered a dealer under section 475.[8]

D. Disregarding inter-member transactions for purposes of the negligible sales exception.

The IRS has also requested comments as to whether a consolidated group should be able to elect to disregard inter-member transactions for purposes of determining whether a taxpayer had made more than negligible sales for purposes of (reproposed) Proposed Regulation section 1.475(c)-1(c).[9] We believe that the election to disregard inter-member transaction should be made available for purposes of the negligible sales exception without limitation. We believe that the general rule allowing the nonfinancial entity to avoid dealer status notwithstanding its regular activities in extending credit to customers is a sound one where the entity is not otherwise acting in a manner that causes it to resemble a more “traditional dealer.” In this regard, we do not believe that any number of sales of assets to a consolidated group member (which may be a dealer) should be viewed in the same manner as sales to unrelated parties.

E. Additional recommendation.

As a general matter, we would support liberalizing the ability of taxpayers to use a mark-to-market method of accounting where the property is actively traded. We believe the IRS has the authority under section 446 to sanction the elective use of such a method. We recognize that a non-dealer using mark-to-market accounting would not have the benefit of section 475(d)(3), treating mark-to-market, gains and losses as ordinary. However, we believe that even if mark-to-market losses were capital losses, taxpayers would find the certainty of being permitted to elect mark-to-market accounting attractive. Because mark-to-market accounting

[8] The character of its inter-member transactions should not matter because such transactions should offset each other.

[9] Under Proposed Regulation section 1.475(c)-1(c), a taxpayer will be exempted from dealer status if such taxpayer sells only a negligible amount of its securities.

more clearly reflects income and is less subject to manipulation than other methods, we see little reason why permitting mark-to-market accounting at least for reliably valued assets would present a problem from the IRS's point of view.

I or other representatives of the Tax Section would be pleased to discuss the foregoing with you or your designees at your convenience.

Very truly yours,

Richard L. Reinhold