DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, DISTRICT
ATTN:

FROM: Lon B. Smith
Acting Associate Chief Counsel (FIP)

SUBJECT: Mark-to-market accounting

This Field Service Advice responds to your memorandum dated April 27, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND

Taxpayer	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Date 1	=
$a	= $
$b	= $
$c	= $
$d	= $
e%	= %
f%	= %
g%	= %

h% = %

ISSUES

1. Whether Taxpayer is a "dealer in securities," and must therefore mark-to-market all or a portion of its home equity loan portfolio pursuant to I.R.C. § 475.

2. If so, whether Taxpayer is entitled to the spread of any § 481 adjustment that results from marking to market its home equity loan portfolio.

CONCLUSIONS

1. The determination of whether a taxpayer is a dealer in securities must be made on an entity-by-entity basis. Your submission, however, generally discusses the activities of Taxpayer's corporate family as a whole. Accordingly, we have set forth, infra, some facts that need to be clarified in order for us to determine whether Taxpayer and its subsidiaries are dealers in securities, or are eligible for any of the exceptions to the mark-to-market requirements.

2. If Taxpayer is required to mark-to-market its securities, whether Taxpayer is entitled to spread any resulting adjustment will depend upon whether the change of method is voluntary or involuntary. It is not clear whether the change of method at issue in this case is voluntary or involuntary. A taxpayer voluntarily requesting a change of method while under examination may use a four-year spread period if it meets certain exceptions set forth in Rev. Proc. 97-27, 1997-1 C.B. 680. If the Service initiates the change in method, the entire resulting adjustment is generally taken into account for the taxable year in which the change occurred, although the Service may agree to spread the adjustment over several years.

FACTS

The taxable years in issue are Years 2 through Date 1, Year 6. Taxpayer is the parent of a controlled group of subsidiaries, both foreign and domestic. Taxpayer and its subsidiaries are primarily engaged in the business of originating and acquiring consumer loans, including home equity loans.

During Years 2 through 5, Taxpayer securitized a portion of its home equity loan portfolio into Real Estate Mortgage Investment Conduits (REMICs).[1] See § 860D(a) (defining the term "REMIC"). Specifically, Taxpayer contributed to REMIC securitization trusts variable rate home equity lines of credit (HELOC) that had a loan balance above a certain threshold amount. In exchange, Taxpayer received from the trust regular and residual trust interests. Taxpayer sold the regular interests to third parties, and retained the residual interests. Taxpayer agreed to service the loans that it transferred to the REMICs, and received a fee.

Taxpayer entered into no more than two REMIC transactions during each of the years in issue. The total yearly amounts of the HELOCs that Taxpayer and its subsidiaries securitized are as follows:

Year	Amount
Year 2	$a
Year 3	$b
Year 4	$c
Year 5	$d

These amounts represent between e% and f% of Taxpayer's and its subsidiaries' total HELOC portfolio during each of Years 2 through 5, and between g% and h% of Taxpayer's and its subsidiaries' entire domestically-originated loan portfolio during each of Years 2 through 4. Taxpayer on its books and records has identified its entire loan portfolio, including the HELOCs, as held for investment.

Exam argues that Taxpayer, in transferring the HELOCs to the REMICs, sold securities to customers in the ordinary course of its trade or business. Accordingly, Exam has concluded that Taxpayer must mark-to-market all or a portion of its HELOC portfolio pursuant to I.R.C. § 475.

LAW AND ANALYSIS

1. Whether Taxpayer is a dealer in securities, and must therefore mark-to-market all or a portion of its home equity loan portfolio in accordance with section 475.

Section 475 generally requires a dealer in securities to account for its securities on a mark-to-market method of accounting. § 475(a). Section 475(c)(1)(A) and (B) defines a "dealer in securities" as a taxpayer who either: (A) regularly purchases securities from or sells securities to customers in the ordinary course of its trade or

[1] Taxpayer did not securitize any of its home equity loans during Year 6.

business; or (B) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. The term "security" includes a note, bond, debenture, or other evidence of indebtedness. § 475(c)(2)(C). Treasury Reg. § 1.475(c)-1(a)(2) provides that the term "dealer in securities" includes 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 described in section 475(c)(1)(B). Although not expressly stated in § 475, the legislative history reflects that dealer status is determined on an entity-by-entity basis. See H.R. Rep. No. 11, 103d Cong., 1st Sess. 224, n.37 (explaining that contracts between dealers and related parties are treated as contracts between unrelated parties).

Treasury Reg. § 1.475(c)-1(c) exempts from dealer status a taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business (including regularly making loans to customers) but engages in no more than negligible sales of the securities so acquired. Treasury Reg. § 1.475(c)-1(c)(2) provides that a taxpayer engages in negligible sales of debt instruments if, during the taxable year: (a) it sells all or part of fewer than 60 debt instruments, or (b) the total adjusted basis of the debt instruments 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.

With respect to taxpayers that qualify as dealers in securities, section 475(b)(1)(A), (B), and (C) provides that the mark-to-market requirements set forth in section 475(a) do not apply to: (A) any security held for investment; (B) a note, bond, debenture, or other evidence of indebtedness that is acquired or originated by the taxpayer and which is not held for sale; and (C) any security that is a hedge of an item that is not subject to the mark-to-market rules. Under section 475(b)(2), however, a dealer is not eligible to exempt a security from mark-to-market treatment pursuant to subparagraphs (A), (B), or (C) of section 475(b)(1) unless the dealer, before the close of the day on which the security was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe), clearly identifies the security in the dealer's records as being described in such subparagraph.

Taxpayer has raised several arguments in support of its position that it is not required to mark-to-market its home equity loan portfolio. Particularly, Taxpayer argues that: (1) the REMIC is not Taxpayer's customer, and thus, Taxpayer is not a dealer subject to the mark-to-market requirement because it does not hold any portion of its home equity loan portfolio for sale to customers; (2) it is not a dealer because it does not sell any portion of its home equity loan portfolio to REMICs; and (3) since securitization transactions are capital transactions conducted for corporate funding purposes, "tax policy fairness" principles should preclude Taxpayer from being subject to section 475 solely because it raised capital by using a REMIC in lieu of other transactions achieving the same result. Furthermore, Taxpayer has identified its entire loan portfolio as held for investment for purposes of section 475(b)(1)(A) or not held for sale for purposes of section 475(b)(1)(B). Thus, Taxpayer implicitly argues that even if it is a dealer in securities, none of its loan portfolio is subject to the mark-to-market requirements.

a. Taxpayer's first two arguments: Whether Taxpayer is a dealer in securities.

With respect to Taxpayer's first two arguments that it is not a dealer in securities, it appears that Taxpayer and some of its subsidiaries are in the business of making loans to customers in exchange for notes or other evidence of indebtedness. It is unclear whether all or some of Taxpayer's subsidiaries have engaged in this activity. To the extent that Taxpayer or any of its subsidiaries are in the business of originating loans to customers, Taxpayer and any such subsidiary are dealers in securities, and must mark-to-market its securities unless an exception applies.[2] See § 475(c)(1)(B). In this case, there are two relevant exceptions whereby Taxpayer or its subsidiaries may not be required to mark-to-market its securities: (1) Taxpayer or any one of its subsidiaries is not a dealer in securities if it engages in no more than a negligible amount of sales of its securities; and (2) even if it is a dealer in securities, Taxpayer or any one of its subsidiaries is not required to mark-to-market any security either held for investment or not held for sale.

(1) Whether Taxpayer or its subsidiaries are eligible for the negligible sales exception.

Since dealer status is determined on an entity-by-entity basis, we cannot tell from your submission whether any entity within Taxpayer's corporate group is subject to the negligible sales exception. It appears that during the years in issue, Taxpayer and its subsidiaries as a whole transferred to REMICs in excess of 60 loans, which represented 5% or greater of the total basis of the debt instruments acquired by Taxpayer and its subsidiaries during each of those taxable years. Nevertheless, a particular entity within Taxpayer's corporate group may qualify for the negligible sales exemption if transferred minimal amounts of HELOCs to the REMICs. Furthermore, despite the considerable volume of HELOCs transferred to the REMICs, Taxpayer and its subsidiaries would qualify for the negligible sales exception if it did not sell HELOCs to the REMICs. In this regard, Taxpayer argues that there is no "technical sale" of the HELOCs to the REMICs because section 860F(b)(1)(A) treats as nontaxable any transfer of property to a REMIC in exchange for a regular or residual interest. Taxpayer further contends that the true sale

[2] Since dealer status is separately decided for each entity, this determination must be made for each of Taxpayer's subsidiaries.

occurs when Taxpayer sells the regular interests in the REMIC to third party investors.

We disagree with Taxpayer's argument. Section 1001(c) provides that a taxpayer must recognize the entire amount of gain or loss resulting from the sale or exchange of property, except as otherwise provided. Therefore, a transaction may constitute a sale or exchange for tax purposes, although it is not a taxable transaction. The Service's position with respect to transfers to REMICs, as set forth in the proposed regulations, is consistent with this principle.[3] Particularly, Prop. Reg. § 1.475(b)-3(a) provides that a taxpayer that expects to contribute mortgages to a REMIC must treat such assets as held for sale unless the taxpayer expects that each of the interests it will receive from the REMIC in return for the mortgages will be either held for investment or not held for sale to customers in the ordinary course of the taxpayer's trade or business.

In addition, Taxpayer may argue that it entered into an exchange, rather than a sale, with respect to its transfer of the HELOCs to the REMICs. <u>See</u> <u>Guest v. Commissioner</u>, 77 T.C. 9, 24 (1981) (explaining that a sale is a transfer of property for money, while an exchange is a transfer of property for property). Although Treas. Reg. § 1.475(c)-1(c), provides an exception to dealer status for taxpayers who have <u>sold</u> no more than a negligible amount of securities, the term "sale" in this context contemplates exchanges, particularly in a case where the taxpayer immediately sells for cash the property received in the exchange. Otherwise, taxpayers could qualify for the negligible sales exception by entering into non-cash transactions with their customers. We also note that, under the Uniform Commercial Code, exchanges are treated as sales. <u>See</u> U.C.C. § 2-304 (providing that "price" paid pursuant to a sale under U.C.C. § 2-106(1) may be in money or otherwise). The Tax Court has cited the Uniform Commercial Code's definition of "sale" for the purpose of determining whether a taxpayer has held property primarily for sale to customers. <u>Guardian Industries Corp. v. Commissioner</u>, 97 T.C. 308, 318, 319 n.5 (1991).

Accordingly, we conclude that Taxpayer and its subsidiaries sold HELOCs to the REMICs. Taxpayer and any one of its subsidiaries, however, may be eligible for the negligible sales exception, depending upon the volume of HELOCs that each entity sold.

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[3] We reference the proposed regulations not as litigation authority but as both an interpretation of Congressional intent and a convenience to assist you in assessing the hazards of the case. The Tax Court has explained that although proposed regulations constitute a "body of informed judgment," they are accorded no more weight than a litigation position. <u>KTA-Tator, Inc. v. Commissioner</u>, 108 T.C. 100, 102-103 (1997) (quoting <u>Bolton v. Commissioner</u>, 694 F.2d 556, 560 n.10 (9th Cir. 1982)).

(2) Whether Taxpayer or its subsidiaries held the HELOCs for investment or did not hold the HELOCs for sale.

Section 475(b)(1)(A) and (B) provides that a dealer in securities is not required to mark-to-market any security held for investment or any security not held for sale. A taxpayer is generally required to treat as held for sale any securities that it expects to contribute to a REMIC.[4] Treasury Reg. § 1.475(b)-1 provides that a security is held for investment or not held for sale if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. As mentioned, Taxpayer has identified its entire HELOC portfolio as held for investment and not primarily for sale; and (2) since the REMICs were not Taxpayer's customers, Taxpayer did not hold the HELOCs for sale to customers. This determination must be made on an entity-by-entity basis.

We first address whether the activities of Taxpayer and its subsidiaries indicate an intent to hold the HELOCs primarily for sale. In determining whether a taxpayer held an asset primarily for sale to customers, the Supreme Court of the United States has explained that the term "primarily" means "of first importance" or "principally". Malat v. Riddell, 383 U.S. 569, 572 (1966). A taxpayer's purpose for holding property is based on a number of factors, including: (1) the frequency and regularity of sales; (2) the substantiality of the sales and the amounts of income derived by the taxpayer from its regular business relative to the sales at issue; (3) the length of time the assets are held; (4) the nature and extent of the taxpayer's business and the relationship of the assets to that business; (5) the purpose for which the assets were acquired and held prior to sale; (6) the extent of the taxpayer's efforts to sell the property by advertizing or otherwise; and (7) any improvements made by the taxpayer to the assets. Guardian Industries, 97 T.C. at 316-317. This determination is highly factual.

In Rev. Rul. 60-346, 1960-2 C.B. 217, the Service addressed whether a bank that originated mortgage loans, half of which it sold to financial institutions within three months after the loan origination, held the loans primarily for sale to customers within the meaning of section 1221. With respect to the loans that it sold, the bank agreed to service and collect the outstanding loan balance in return for a fee. Furthermore, the bank did not purchase any loans. The Service concluded that the taxpayer held the loans primarily for sale to customers in the ordinary course of its

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[4] Prop. Reg. § 1.475(b)-3(a) explains that a taxpayer is only required to treat as held for sale those securities that it expects to contribute to a REMIC. In this case, since Taxpayer and its subsidiaries securitized only a portion of their HELOC portfolio during the years in issue, it appears that they expected that only a portion or the HELOCs originated would ever be securitized . Consequently, Taxpayer and its subsidiaries are not required to mark-to-market their entire HELOC portfolio.

trade or business, reasoning that: (1) the taxpayer consistently engaged in the practice converting mortgages into liquid funds for the purpose of making additional loans; (2) the loans were made with the intention of selling the mortgages; and (3) selling mortgages in this fashion is a customary function of the taxpayer's banking business. The Service also noted that the bank sold the loans at or near par value.

In this case, Taxpayer argues that, unlike the taxpayer described in Rev. Rul. 60-346, it decided to securitize the HELOCs on an ad hoc basis, and chose the REMIC structure as one of several alternative sources of securitizing the HELOCs. Characterizing itself as an "opportunistic participant" in the securitization market, Taxpayer argues that the HELOCs were held primarily for investment and not for sale.

Taxpayer, in similar fashion to the taxpayer described in Rev. Rul. 60-346, consistently engaged in the practice of converting a portion of its mortgage portfolio into liquid funds. As discussed in Rev. Rul. 60-346, this is an integral part of the mortgage lending industry. Your submission also contains references to Taxpayer's Board of Directors' minutes, various correspondences, and financial statements which indicate that Taxpayer contemplated securitizing the HELOCs in advance. For example, Taxpayer's annual reports for Years 1 and 2 discuss anticipated REMIC securitizations for the following year. Furthermore, Taxpayer and its subsidiaries transferred to REMICs a significant portion of its HELOC portfolio at least once during each of Years, 2 through 5. Therefore, it appears that Taxpayer expected that a portion of its HELOC portfolio would be transferred to REMICs at the time that the loans were originated. You submission, however, does not contain sufficient facts from which we can conclude the Taxpayer held the HELOCs primarily for sale. In this regard, we have set forth infra, further areas of factual development.

We next address Taxpayer's argument that it did not hold the HELOCs for sale to customers because the REMICs were not Taxpayer's customers. Whether a taxpayer is transacting business with customers is determined on the basis of all relevant facts and circumstances. Treas. Reg. § 1.475(c)-1(a). A dealer in securities is analogous to a merchant, insofar as the dealer purchases securities with the expectation of making a profit not because of a rise in value during the time in which the dealer held the security, but because the dealer anticipates that a market of buyers will purchase the securities in excess of their cost. United States v. Wood, 943 F.2d 1048, 1051 (9th Cir. 1991) (quoting Kemon v. Commissioner, 16 T.C. 1026, 1032-1033 (1951)). The profit earned by a dealer, therefore, represents remuneration for the dealer's activities as a middle man that performs the usual services of a retailer. Thus, dealers are unlike other sellers of securities insofar as they perform merchandising functions, and have a source of supply that is significantly different from that of those to whom they sell. Kemon, 16 T.C. at 1033. The dealer's performance of services in creating this unique source of supply enables the dealer to mark-up the price of the securities. Id. In contrast, parties that do not have customers, such as traders or investors, depend upon circumstances such as an increase in value or an advantageous purchase in order to sell at a price in excess of cost. See Wood, 943 F.2d at 1051-1052.

In this case, Taxpayer and its subsidiaries created a source of supply by originating the loans that it sold. Furthermore, it appears that Taxpayer and its subsidiaries generated profits from the REMIC transactions from both the servicing fee and from the spread between the interest rate paid on the HELOCs and the interest rate paid to the purchasers of the REMIC interests. Your submission indicates that Taxpayer developed a reputation for service and credit quality, which allowed it to increase its profitability by issuing REMIC interests at reduced interest rates. Accordingly, it appears that Taxpayer and its subsidiaries generated profits from the REMIC transactions not by selling appreciated HELOCs, but by generating supply, servicing the loans, and marketing the quality of its product. Although further factual development is necessary, as set forth infra, it appears that Taxpayer's relationship with the REMIC is comparable to the relationship that the taxpayer in Rev. Rul. 60-346 had with its customers.

b. Taxpayer's third argument: Whether "tax policy fairness" principles should preclude Taxpayer from being subject to section 475.

Taxpayer argues that its objective in entering into the REMIC transactions was to mange its "funding base" and to provide a varied source of liquidity. Taxpayer also explains that these goals could have been achieved by using securitization structures other than REMICS that would have undoubtedly placed Taxpayer outside of the scope of section 475. Accordingly, Taxpayer argues that, as a tax policy matter, it should not be subject to section 475 by virtue of choosing the REMIC structure in lieu of other securitization transactions that would have accomplished the same business purpose.

The Supreme Court has observed that, although taxpayers are free to organize their affairs as they choose, once having done so, they must accept the tax consequences of that choice, whether contemplated or not. Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134, 149 (1974). If the taxability of a transaction were to depend upon whether there existed alternative forms that the applicable statute did not tax, uncertainty would result. Id. (quoting Founders General Corp. v. Hoey, 300 U.S. 268, 275 (1937)). Furthermore, if Taxpayer's argument in this case were accepted, then most, if not all taxpayers transferring securities to a REMIC could avoid the mark-to-market requirements. Therefore, we disagree with Taxpayer that notions of "tax policy fairness" should preclude Taxpayer from being subject to section 475.

2. <u>Whether Taxpayer is entitled to the spread of any § 481 adjustment that results from marking to market its home equity loan portfolio.</u>

Assuming that Taxpayer or any of its subsidiaries are required to mark-to-market a portion of its HELOC portfolio, we address the manner in which Taxpayer should account for any resulting adjustment.

Section 481(a) provides that if the taxpayer, in computing taxable income, uses a method of accounting different from the method under which the taxpayer computed income for the preceding taxable year, there shall be taken into account in the present year those adjustments which are necessary by reason of the change in method in order to prevent amounts from being duplicated or omitted.

Section 13223(c)(2) of the Omnibus Budget Reconciliation Act of 1993 ("1993 Act"), Pub. L. No. 103-66, 107 Stat. 312, 484 (1993), 1993-3 C.B. 1, 72, provides that a taxpayer: (1) who became a dealer for the taxable year that includes December 31, 1993, merely by virtue of passage of the 1993 Act, and (2) accounted for securities as a dealer under section 475 on its original tax return for that year, is treated as having changed its method of accounting with the consent of the Commissioner. <u>See</u> Holding 19 of Rev. Rul. 97-39, 1997-2 C.B. 62, 66. Accordingly, a taxpayer so affected is entitled to take into account any resulting section 481 adjustments ratably over a 5-year period. In this case, the Taxpayer would not be subject to section 475 until a taxable year subsequent to and not including December 31, 1993. Consequently, the five-year spread period provided under the 1993 Act is not available and the general rules regarding spread periods apply.

The general rules applicable to changes in method of accounting vary depending upon whether the changed in method is voluntary (i.e., initiated by the taxpayer), or involuntary. On the basis of the facts presented, it is unclear whether the change in method at issue was initiated by Taxpayer or the Service.

The rules for voluntary accounting method changes are found in Rev. Proc. 97-27, 1997-1 C.B. 680, which, under section 5.02(3)(a), generally provides for a four-year section 481(a) spread period for taxpayers that are not under examination. As further explained under section 6, a taxpayer that is under examination at the time it applies for a voluntary accounting change may also use the four-year spread period if it meets certain exceptions listed there. Although it is probable that none of the exceptions apply in the present case, this is not certain under the facts presented.

With respect to changes in method that are involuntary (i.e., not initiated by the taxpayer), Treas. Reg. § 1.481-1(c)(3) states that the entire amount of the adjustments required by section 481(a) is taken into account for the taxable year in which the change occurred. <u>See</u> Notice 98-31, § 2.05(3), 1998-1 C.B. 1165, 1169. Nevertheless, the adjustment required by 481(a) may also be spread over several years. See I.R.C. § 481(c); Treas. Reg. §§ 1.446-1(e)(3)(i) and 1.481-4. Taxpayers that are required to make a method change while under examination, however, normally receive a shorter spread period than taxpayers requesting method changes prior to being contacted for examination. Notice 98-31, § 1.02, 1998-1 C.B. 1165, 1167. Notice 98-31 generally sets forth rules for appeals and district counsel to resolve timing issues including allowing the taxpayer to have longer spread periods.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As explained, the Service determines whether a taxpayer is a dealer in securities on any entity-by-entity basis. Your submission, however, discusses the securities held by Taxpayer's corporate group as a whole. Although it appears that Taxpayer and some of its subsidiaries should be treated as dealers in securities because they are in the business of making loans to customers in exchange for notes or other evidence of indebtedness, it is unclear whether all or some of Taxpayer's subsidiaries have engaged in this activity. Additionally, particular entities within Taxpayer's corporate group may qualify for the negligible sales exemption. Moreover, particular entities with Taxpayer's corporate group may have held HELOCs for investment and not for sale. These determinations must be made on an entity-by-entity basis. If you were to provide us with specific information in this regard, we would be available assist you in making this determination.

[redacted]

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[redacted]

Please call if you have any further questions.

Lon B. Smith
Acting Associate Chief Counsel (FIP)

By: ______________________________
JOEL E. HELKE
Special Counsel to Associate Chief Counsel (FIP)