INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

November 29, 2007

Number: **200811018**
Release Date: 3/14/2008

Third Party Communication: None
Date of Communication: Not Applicable

Index (UIL) No.: 864.01-04, 864.02-00, 864.02-01
CASE-MIS No.: TAM-105539-06

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year(s) Involved:
Date of Conference:

LEGEND:

Taxpayer:
Country A:
Country B:
Management Desk:
City A:
City B:
Year 1:
Year 2:
Date A:
Date B:
Date C:
Date D:

ISSUE(S):

1. Whether Taxpayer's securities arbitrage activities conducted through the active conduct of Taxpayer's banking, financing, or similar business in its U.S. office in City B constitute a securities trading activity under U.S. tax principles; and

2. Whether income, gains and losses from such activity with respect to securities described in §1.864-4(c)(5)(ii)(b)(3) are allocable between effectively connected income ("ECI") and noneffectively connected income ("non-ECI") under the formulary rule of §1.864-4(c)(5)(ii) (the "10 Percent Rule"), or are treated as entirely effectively connected with Taxpayer's banking, financing, or similar business under §1.864-4(c)(5)(vi).

CONCLUSION(S):

1. The facts provided indicate that, under U.S. tax principles, the securities acquired in Taxpayer's securities arbitrage activity that are also described in §1.864-4(c)(5)(ii)(b)(3) ("(b)(3) securities") were held by Taxpayer for trading, and not for investment. Taxpayer's mark-to-market treatment under section 475 is not determinative of whether the securities were held for investment or trading for section 864 purposes. However, the fact that Taxpayer and Exam agree the securities in question had more than one year to maturity from date of acquisition and as such were "(b)(3) securities" as described, and that such securities were predominantly disposed from the accounts as of year end provides factual indication of regular securities turnover activity absent a clear and convincing proof that a material volume of the turnover observed in the accounts was otherwise with respect to disposition at maturity. Taxpayer maintained other financial accounts on its U.S. books for other investments that did not mark to market for financial or tax purposes, and such accounts were available but were not used to book the (b)(3) securities, is relevant for determining Taxpayer's factual intent to hold such securities in connection with trading rather than investment.

2. Taxpayer's income, gains and losses with respect to its (b)(3) securities that are traded for taxpayer's own account through Taxpayer's U.S. office in City B where Taxpayer's banking, financing, or similar business is carried on are treated as ECI under §1.864-4(c)(5)(vi) rather than allocable between ECI and non-ECI under the 10 Percent Rule of §1.864-4(c)(5)(ii). The 10 Percent Rule override in §1.864-4(c)(5)(vi) does not apply to non-ECI allocations made with respect to any other (b)(3) securities Exam and Taxpayer may determine were held for investment rather than for trading.

3. Taxpayer's (b)(3) securities acquired in its securities arbitrage activity are taken into account first to determine the overall percentage of all of its (b)(3) securities that are subject to allocation under the 10 Percent Rule formula.

> Consequently, even though the (b)(3) securities held for trading are treated entirely as effectively connected under §1.864-4(c)(5)(vi), they are included in the 10 Percent Rule formula to determine the allocation percentage of other (b)(3) securities that are held for investment rather than for trading.

FACTS:

Taxpayer is a corporation resident in Country A that conducts retail banking activities in Country A, and corporate and private banking, as well as other financial services, in Country A and throughout the world. Taxpayer has many subsidiaries and branches throughout the world, including in the United States where it is engaged in the active conduct of a banking, financing, or similar business within the United States as defined in §1.864-4(c)(5)(i). Taxpayer is also a dealer in securities for purposes of both section 864 and section 475.

Funding of Taxpayer's worldwide operations is overseen by its Management Desk located at its head office in City A. The responsibility for managing the day-to-day funding of the Bank's U.S. branch operations is delegated to the Management Desk located in the City B branch under the direction of the Country A Treasurer. Among the activities conducted in the United States was a securities arbitrage activity. This activity consisted of the ownership and management of five types of securities portfolios: REMICs, US government obligations, equity derivatives, US equity baskets and interest rate swaps. A senior vice president employed by the City B branch managed the Bank's securities arbitrage desk and its Management Desk in the United States.

The securities at issue in this memorandum are the securities acquired through the U.S. branch securities arbitrage activity. The issue concerns whether the income, gains and losses from such securities are eligible for allocation between ECI and non-ECI under the 10 Percent Rule in Regulations section 1.864-4(c)(5)(ii).

Taxpayer's banking, financing, or similar business within the United States included books maintained and managed under Country A GAAP financial accounting for Taxpayer's City B and Country B operations. The City B and Country B Books included accounts labeled "Trading", "Placement" and "Investing." As Taxpayer describes:

> Under [Country A] GAAP, securities held in a "Trading" account are subject to mark to market treatment. Securities held in a "Placement" account (also sometimes referred to as "available for sale") are accounted for using the lower of cost or market. Securities held in an "Investment" account are carried at cost. While the Bank may dispose of securities reflected in the Trading or Placement accounts prior to maturity, the accounting principle generally precludes the Bank from disposing of such securities reflected in the Investment account prior to maturity.

> The Bank had latitude as to the account in which securities were recorded for accounting purposes based on these category descriptions One of the factors influencing the booking decision was the natural preference for generating current accounting income as a result of the accounting mark to market treatment afforded the "Trading" classification. Thus there was a preference to booking the securities in the account entitled "Trading."

The (b)(3) securities were booked in Taxpayer's City B and Country B books in accounts designated by Taxpayer as "utilized for trading for their own account." Taxpayer represents that these accounts were labeled this way for Country A financial income reporting purposes. None of the securities held in connection with the U.S. branch securities arbitrage activity were identified by Taxpayer on its books as held for investment. Consequently, because Taxpayer is a dealer in securities, all such securities were marked to market for tax purposes under section 475. The accounts in which the (b)(3) securities were booked were also marked to market for financial accounting purposes.

Taxpayer's accounts labeled "investing" recorded primarily fixed income securities that were generally (but not exclusively) held to maturity or indexed to variable rate securities. These accounts were not marked to market for either financial or tax purposes. None of the securities from the securities arbitrage activity were held in any of the accounts labeled as investing.

Taxpayer argues that the designation of the accounts as "Trading" where the (b)(3) securities were booked, is merely a designation for Country A GAAP purposes, and that the designation of an account as a "trading," "investment," or "placement" account is irrelevant for determining whether the (b)(3) Securities were held for trading or investment. Taxpayer also argues that marking the (b)(3) Securities to market under section 475 is irrelevant for determining whether the such securities were held for trading or investment. Other than these statements of the applicable rules that permit or require mark-to-market treatment under section 475, Taxpayer has submitted no factual proof that the (b)(3) Securities acquired in the arbitrage activity were otherwise held for investment rather than for trading.

The international agent examined Taxpayer's U.S. books and records and observed the average balances of the accounts that held the (b)(3) Securities. By comparing Taxpayer's Date A and Date B aging reports for the securities arbitrage portfolios, the agent determined that the turnover rate for the securities was approximately 25% for the sampled period. In addition, by comparing the Taxpayer's Date C, and Date D aging reports, the agent determined that approximately 80% of the securities held by Taxpayer during the year were no longer held at the end of the year. However because the accounts in which the (b)(3) Securities were recorded were regularly marked to market for financial purposes, the agent did not determine with certainty the exact

volume of trading in these accounts, how often the portfolio turned over throughout the entire examination period, or the gains or losses from individual transactions. Exam and Taxpayer did agree that the securities in the accounts (other than Treasury securities and stocks) all had a term to maturity exceeding one year from Taxpayer's date of acquisition and recording in the accounts in question. Accordingly, the determination that the securities qualified as "(b)(3) securities" depends on this factual condition.

Taxpayer claims that the income, gains and losses from the (b)(3) Securities are eligible for allocation and subject to partial ECI treatment under the 10 Percent Rule in §1.864-4(c)(5)(ii). Taxpayer and Exam agree that all of the securities in question were capital assets not held in Taxpayer's capacity as a dealer in securities, and that all of the securities booked in Taxpayer's City B and Country B books that were designated as "utilized as trading for the Taxpayer's own account" were attributable to Taxpayer's U.S. branch office in City B under the material participation test of §1.864-4(c)(5)(iii).

LAW AND ANALYSIS

Treas. Reg. §1.864-4(c)(5)(i) provides that for purposes of determining U.S. source effectively connected income under all of §1.864-4, and for purposes of determining foreign source effectively connected income from dividends or interest, or gains or loss from stocks or securities under §1.864-5(b)(2), a nonresident alien or foreign corporation shall be considered to be engaged in the active conduct of a banking, financing, or similar business in the United States if at some time during the taxable year a nonresident alien or foreign corporation is engaged in business in the United States and the activities of such business consist of any one or more of the following activities with persons situated within or without the United States:

(a) Receiving deposits of funds from the public,

(b) Making personal, mortgage, industrial, or other loans to the public,

(c) Purchasing, selling, discounting, or negotiating for the public on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness,

(d) Issuing letters of credit to the public and negotiating drafts drawn thereunder;

(e) Providing trust services to the public, or

(f) Financing foreign exchange transactions for the public.

Taxpayer conducts one or more of the activities listed above on a regular and continuous basis through a U.S. branch office, and is considered to be engaged in the

active conduct of a banking, financing, or similar business within the United States. These activities are recorded on Taxpayer's City B and Country B books and records that are maintained in the U.S. branch office in City B.

Scope of effectively connected rules to taxpayers engaged in the active conduct of a banking, financing, or similar business. The determination of U.S. source effectively connected income is subject to the statutory provisions of sections 864(c)(2) and 864(c)(3). Section 864(c)(2) provides that effectively connected treatment of U.S. source periodical income of the types described in sections 871(a), 871(h), 881(a) and 881(c), and gain or loss from U.S. sources from the sale or exchange of capital assets, is determined by reference to whether "income, gain or loss is derived from assets used in or held for use in the conduct of such trade or business (the "asset-use test"), or the activities of such trade or business were a material factor in the realization of the income, gain or loss (the "business-activities test"). All other U.S. source income, gain or loss is treated as effectively connected under section 864(c)(3).

For purposes of determining U.S. source effectively connected income, §1.864-4 includes the statutory asset use and business activities tests of section 864(c)(2) in §1.864-4(c)(2) and (3), and the residual effectively connected income rule for all other U.S. source income is provided in §1.864-4(b). For purposes of determining foreign source effectively connected income of a banking, financing, or similar business, §1.864-5(b)(2) limits the scope of income to interest, dividends or gains or losses from the sale of stocks or securities. Section 865(e)(2) supersedes the regulation with respect to the source of income from the sale of stocks or securities attributable to a U.S. office. Dispositions of stocks and securities attributable to a U.S. office are treated under section 865(e)(2) as giving rise to U.S. source income, gain or loss, and are subject to the rules of §1.864-4 rather than §1.864-5(b)(2).

Treatment of income from stocks or securities in a banking, financing, or similar business. Nonresident aliens or foreign corporations that are engaged in the active conduct of a banking, financing, or similar business within the United States are subject to §1.864-4(c)(5)(ii) with respect to U.S. source dividends and interest, and with respect to gain or loss from stocks or securities that are capital assets and that are "attributable to the U.S. office through which such business is carried on." Securities are defined in §1.864-4(c)(5)(v) as "any bill, note, bond, debenture, or other evidence of indebtedness, or any evidence of an interest in, or right to subscribe to or purchase, any of the foregoing items." The same definition applies for securities that give rise to foreign source effectively connected income. §1.864-6(b)(2)(ii)(c).

Regulations section 1.864-4(c)(5)(iii) provides that, for purposes of §1.864-4(c)(5)(ii), a stock or security shall be deemed attributable to a U.S. office of a banking, financing, or similar business only if such office actively and materially participated in soliciting, negotiating, or performing other activities required to arrange the acquisition of the stock or security (the "material-participation test"). The U.S. office need not have been the

only active participant. See Rev. Rul. 86-154, 1986-2 C.B. 103. However, these provisions only apply if the stocks or securities giving rise to this income, gain or loss are described as either acquired for one of three purposes provided in §1.864-4(c)(5)(ii)(a)(1)-(3), or consist of securities having have one of three particular characteristics as provided in §1.864-4(c)(5)(ii)(b)(1)-(3).

The rules of §1.864-4(c)(5)(ii) take precedence over the asset use and business activities tests in §1.864-4(c)(2) and (3) to determine the effectively connected treatment of stocks or securities acquired in the active conduct of a banking, financing, or similar business. The rules provide that U.S. source dividends or interest from stocks or securities, or gain or loss from the sale or exchange of stocks or securities that are capital assets are treated as effectively connected income only if the stocks or securities giving rise to the income, gain or loss is attributable to a U.S. office and

(a) were acquired-

(1) As a result of, or in the course of making loans to the public,

(2) In the course of distributing such stocks or securities to the public, or

(3) For the purpose of being used to satisfy the reserve requirements, or other requirements similar to reserve requirements, established by a duly constituted banking authority in the United States, or

(b) Consist of securities (as defined) which are-

(1) Payable on demand or at a fixed maturity date not exceeding 1 year from the date of acquisition,

(2) Issued by the United States, or any agency or instrumentality thereof, or

(3) Not described in (a) or in (1) or (2) of this (b).

The same principles apply to determine whether dividends or interest from stocks or securities from sources without the United States are treated as effectively connected with a banking, financing, or similar business within the United States. §1.864-6(b)(2)(ii)(b).

The sixth type of security, provided for under §1.864-4(c)(5)(ii)(b)(3) is a default category for all securities that are attributable to a U.S. office by reason of the material participation test and do not otherwise fit within one of the categories listed under §§1.864-4(c)(5)(ii)(a) or (b)(1) and (2). This sixth category, the (b)(3) securities, includes the securities acquired in the securities arbitrage activity at issue in this technical advice memorandum.

Distinctions between the banking, financing, or similar business rules and the asset-use and business-activities tests. The banking, financing, or similar business rules are similar to the asset-use and business-activities tests in that all three rules apply to securities that are capital assets. The main distinctions, however, are that §1.864-4(c)(5) provides special ECI treatment to banking-related activities that may be non-ECI under the asset-use or business-activities tests, while also providing that certain volumes of investment activity may be treated as non-ECI notwithstanding that such activities could be treated as ECI under the asset-use or business-activities tests. The material-participation test in the banking, financing, or similar business rules provide a simpler relief provision for banks to obtain full effectively connected treatment with respect to U.S. source interest income from customer loans and other banking-related activities that might otherwise be subject to withholding on the gross income. If the material-participation test is met at the inception of a loan origination, the income will be treated as effectively connected under §1.864-4(c)(5)(ii) regardless of whether the loan is ever held in connection with taxpayer's trade or business within the United States or whether the trade or business continues to be a material factor in the realization of the income throughout the period the loan is held by the taxpayer. Similarly, a security that is not materially negotiated or solicited in a U.S. office of a banking, financing, or similar business will not give rise to ECI even if it is held in connection with a trade or business within the United States and meets the asset-use test during the entire period the security is held by the bank. The location where a security is booked and managed is not relevant to determining its ECI or non-ECI treatment. See §1.864-4(c)(5)(iii)(b).

While the banking, financing, or similar business rules enable broader ECI treatment for customer loans, the material-participation test may not be used to provide broad ECI treatment to excessive investing within the United States through the U.S. office. Section 1.864-4(c)(5)(ii) was issued in 1972 well before the 1984 repeal of withholding on U.S. source portfolio interest. Sections 871(h) and 881(c). The regulations, reflect a balance that provides ECI treatment to securities acquired in a banking–related activity actively conducted through a U.S. office. Non-banking related activities are initially treated under the regulations as investment activities that are subject to the 10 Percent Rule. See 1970 TM LEXIS 39 (Dec. 23, 1970). Accordingly, §1.864-4(c)(5)(ii) treats banking-related income, gain or loss from securities attributable to a taxpayer's U.S. office as income that is taxable ECI in the trade or business under sections 871(b) and 882(a), and excessive investing as income that should be treated as non-ECI and subject to tax under sections 871(a) and 881(a). Securities treated as banking-related are those described in §1.864-4(c)(5)(ii)(a)(1) – (3) and (b)(1) – (2). Securities described in §1.864-4(c)(5)(ii)(b)(3) are subject to a special allocation formula that determines whether income, gain or loss from such securities constitutes a volume of activity that would not generally be entered into in a banking business. This allocation formula is the 10 Percent Rule.

Application of the 10 Percent Rule to (b)(3) securities. Section §1.864-4(c)(5)(ii) limits the amount of income, gain or loss from (b)(3) securities that may be treated as ECI to a foreign resident taxpayer's banking, financing, or similar business within the United States. Section 1.864-4(c)(5)(ii)(b)(3) provides a non-elective formula that measures the volume of a foreign taxpayer's (b)(3) securities in relation to the total assets of the U.S. office to which the (b)(3) securities are attributable. When the volume of a taxpayer's (b)(3) securities is equal to or less than 10 percent of the total assets of the U.S. office, the formula treats all of the income, gain or loss as effectively connected to the trade or business within the United States. As the proportion of (b)(3) securities rises above 10 percent of the assets of the U.S. office, the formula allocates income, gain or loss in increasing proportions to non-ECI.

The income, gains and losses from the (b)(3) securities are multiplied by the following formula:

$$\frac{10\%}{\text{average book value of (b)(3) securities} \div \text{book value of total asset of U.S. office}}$$

The book value of the assets is averaged for the year and determined by the sum of the month end balances divided by 12. For example if a taxpayer's average (b)(3) securities are $1,000 and the total assets of the U.S. office where the banking, financing, or similar business is carried on is $4,000, then 40% (the ratio of 25% ($1,000 ÷ $4,000) divided into the fixed numerator of 10%) of the income, gain or loss with respect to the $1,000 of (b)(3) securities is treated as ECI and 60% is treated as non-ECI.

Generally, investing activities standing alone, regardless of the volume, do not constitute a "trade or business" under U.S. tax principles. Higgins v. Commissioner, 312 U.S. 217 (1941), reh'g denied, 313 U.S. 714 (1941). Regular and continuous trading of stocks, securities, or commodities generally constitutes a trade or business under U.S. tax principles. Adda v. Commissioner, 10 T.C. 273, aff'd, 171 F.2d 457 (4th Cir. 1948), cert. denied, 336 U.S. 952 (1949), citing Fuld v. Commissioner, 139 F.2d 465 (2nd Cir. 1943); Commissioner v. Nubar, 185 F.2d 584 (4th Cir. 1950); Connelly v. Commissioner, 45 T.C.M. (CCH) 49 (1982). Where, however, a foreign resident conducts a trade or business of trading stocks or securities for it's own account, it may be exempt from being treated as a "trade or business within the United States" under the trading "safe harbor" in section 864(b)(2)(A). The trading safe harbor is not available to foreign taxpayers that are dealers in securities and who trade for their own account within the United States directly. Section 864(b)(2)(A)(ii). Although such investing and trading activities standing alone within the United States do not necessarily constitute a "trade or business within the United States," such activities may

nevertheless be effectively connected with the active conduct of a banking, financing, or similar business a taxpayer otherwise has within the United States.

Relevance of investing vs. trading under the banking, financing, or similar business rules – the 10 Percent Rule override. The banking, financing, or similar business rules apply the material-participation test to all securities that are capital assets to determine if they are attributable to the U.S. office where the business is carried on. For this purpose, securities acquired for investment or for trading for a taxpayer's own account are "property held by the taxpayer" that does not qualify for any of the exceptions to capital asset classification under section 1221. See Bielfeldt v. Commissioner, T.C. Memo 1998-394. Once such securities are attributable to the U.S. office, the rules of §1.864-4(c)(5)(ii) apply to determine whether the income, gain or loss is treated entirely as ECI or is subject to allocation under the 10 Percent Rule with respect to any of the attributable (b)(3) securities. If any amount of income, gain or loss from (b)(3) securities is allocated and treated as non-ECI, the banking, financing, or similar business rules provide that such income will still be treated as ECI under the asset use or business activities test if the taxpayer is trading stocks or securities for its own account. Section §1.864-4(c)(5)(vi)(a) provides in relevant part-

> "Any dividends, interest, gain or loss from sources within the United States which by reason of the application of [§1.864-4(c)(5)](ii) of this paragraph is not effectively connected with the active conduct by a nonresident alien individual or a foreign corporation of a banking, financing, or similar business in the United States may be effectively connected for the taxable year under subparagraphs [§1.864-4(c)](2) or [§1.864-4(c)](3) of this paragraph with the conduct by such taxpayer of another trade or business in the United States, such as, for example, the business of selling or manufacturing goods or merchandise or of trading in stocks or securities for the taxpayer's own account." Emphasis added.

Section 1.864-4(c)(5)(vi) harmonizes the overall approach of the banking, financing, or similar business regulations taking into account that the rules were issued prior to the repeal of gross-basis taxation on portfolio interest. The rule preserved non-ECI treatment and gross basis taxation under the 10 Percent Rule with respect to excessive non-banking related investing in securities while preserving net basis taxation on trading activities that are not otherwise generally subject to tax under sections 871(a) or 881(a). The distinction between investing and trading under general U.S. tax principles is applicable in determining whether income that is non-ECI under the 10 Percent Rule is nevertheless treated as ECI under §1.864-4(c)(5)(vi). Although both investment and trading securities may be (b)(3) securities subject to allocation under the 10 Percent Rule, §1.864-4(c)(5)(vi) only seeks to retain ECI treatment with respect to the securities income from U.S. sources, the principal amount of which is derived from short-term gains and is not subject to tax under section 871(a) and 881(a). For this purpose the distinction between investing and trading under U.S. tax principles is relevant.

An investor may have gains or losses from the sale or disposition of securities from its investment account. The court in Liang v. Commissioner, 23 T.C. 1040, 1043 (1955), held that:

> The distinction between an investment account and a trading account is that in the former, securities are purchased to be held for capital appreciation and income, usually without regard to short-term developments that would influence the price of the securities on the daily market. In a trading account, securities are bought and sold with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short-term basis. Emphasis added.

Similarly, a trader may have fixed or other determinable or other periodic income ("FDAP") of a type described in section 871(a) or section 881(a) with respect to securities held in connection with a trading activity. Moller v. United States, 721 F.2d 810, 813 (1983) ("in order to be a trader, a taxpayer's activities must be directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than the dividends and interest paid on those securities." Emphasis added. By its terms, gains and losses from (b)(3) securities that are capital assets are subject to allocation under the 10 Percent Rule. Consequently, both investment and trader securities eligible classes of (b)(3) securities subject to allocation under the rule. Accordingly, the gains and losses from (b)(3) securities held in connection with an investing activity are subject to allocation between ECI and non-ECI under the 10 Percent Rule along with the FDAP income from such investments. The FDAP income earned in connection with a trading activity conducted in the Taxpayer's U.S. office where its banking, financing, or similar business is carried on is subject to the 10 Percent Rule override in §1.864-4(c)(5)(vi) and treated as ECI under the asset-use or business-activities tests along with the gains and losses from such (b)(3) securities.

In determining whether a taxpayer who manages its own investments is treated as an investor or a trader under U.S. principles, the relevant considerations are the taxpayer's investment intent, whether the taxpayer principally derives short-term gains or capital appreciation and income, and the frequency, extent, and regularity of the taxpayer's securities transactions. Moller at 813. See also Purvis v. Commissioner, 530 F.2d 1332, 1334 (9th Cir. 1976).

ANALYSIS

Taxpayer and Exam agree that Taxpayer is a dealer in stocks and securities, and that it entered into all of the (b)(3) securities transactions in a non-dealer capacity directly through the material participation of its U.S. branch office. The trading safe harbor for stocks and securities provided by section 864(b)(2)(A)(ii) does not apply when the taxpayer is a dealer in stocks or securities. Accordingly, Taxpayer's securities are not

eligible for the trading safe harbor. Apart from its investing or trading activities in (b)(3) securities, Taxpayer is engaged in trade or business within the United States through the active conduct of a banking, financing, or similar business as defined in §1.864-4(c)(5)(i). Because the (b)(3) securities were acquired in the same office where Taxpayer's banking, financing, or similar business is carried on, the potential ECI treatment of Taxpayer's (b)(3) securities is first determined by reference to whether the securities are attributable to Taxpayer's U.S. office the material-participation test of §1.864-4(c)(5)(iii) without regard to the asset-use and business-activities tests. Securities that are attributable to Taxpayer's U.S. office that are also (b)(3) securities are then subject to the 10 Percent Rule allocation formula to determine the percentage of income, gain or loss that is treated as effectively connected with Taxpayer's banking, financing, or similar business.

In determining whether any of the (b)(3) securities are held for investment or trading, Taxpayer's intent with respect to such securities may be observed by reference to the frequency in which such securities were traded, and absent clear information establishing such frequency, by reference to the intent established for financial purposes in the accounts in which they were booked. Taxpayer is a dealer in securities under section 475(a) and is subject to mark-to-market treatment on all of its (b)(3) securities except to the extent such securities are properly identified as held for investment. See section 475(b)(2). Since Taxpayer did not identify any of its (b)(3) securities as held for investment, and booked them in its accounts designated as "utilized for trading for their own account" for financial purposes, such securities were marked to market for both financial income and U.S. tax purposes. However, Taxpayer's mark-to-market treatment for tax purposes does not provide informative evidence of Taxpayer's intent because the (b)(3) securities could have been subject to mark-to-market treatment under section 475 regardless of whether they were booked in a financial trading, placement or investment account.

The requirements and restrictions for booking securities in Taxpayer's financial investment account under Country A GAAP does provide informative evidence of intent that may not be observed by reference to whether a security in fact marks to market under section 475. Securities that are in fact held with an intent to sell may not be booked in Taxpayer's financial investment accounts. However, this restriction, standing alone is not determinative of whether the use of another account constitutes a non-investment use of such other account. Absent any other proof, use of such other account that permits booking of trading securities is a factor to be considered in determining the status of particular securities booked in such account.

Further evidence of Taxpayer's intent to hold the (b)(3) securities in question for trading is observed from its actual turnover in the accounts used during the year ended Date D. A sampling of Taxpayer's aging reports indicate that over 25% of the securities were traded each month during year 1 and that over 80% of the total portfolio held on Date C within the taxable year ended Year 1 was disposed as of Date D at the end of Year 1.

Taxpayer did not provide any factual information supporting a finding of an intent to hold the (b)(3) securities for capital appreciation or for income, nor did it provide evidence demonstrating that the dispositions of securities no longer reflected on the aging reports were dispositions at maturity. By definition, in order for the securities in issue to qualify as (b)(3) securities, more than one year to maturity must remain from their date of acquisition. See section 1.864-4(c)(5)(ii)(b)(1). However, Exam established the 80% turnover of securities in the account within the same taxable year ending on Date D despite their longer terms to maturity from the date of acquisition. Absent specific information demonstrating that the securities were not otherwise generally disposed of at maturity, the turnover observed in the accounts used and the fact such accounts reflect gains and losses currently rather than solely at year end is presumptive of an intent to hold the securities for trading rather than investment. Moller at 812. While such financial accounting treatment is not determinative, the accounts used and the financial mark-to-market treatment voluntarily implemented are also relevant factors that may establish Taxpayer's intent to hold the securities for trading, absent a specific showing of holding periods for the securities typical of investors. The turnover of 80% of the portfolio as of the year end with respect to securities that by definition must have more than one year to maturity from their date of acquisition in order to qualify as (b)(3) securities, is a strong factor that support a factual conclusion that such securities were held for trading and not held for investment.

All (b)(3) securities are included in the determination of the allocation percentage regardless of whether they are held for investment or for trading for Taxpayer's own account. Under the override provision of §1.864-4(c)(5)(vi), the portion of the (b)(3) securities held for trading that allocated to non-ECI under the 10 Percent Rule is then evaluated under the asset-use and business-activities tests of §§1.864-4(c)(2) and (3). All of Taxpayer's (b)(3) securities were acquired, booked and managed through their holding period in the U.S. office to which the (b)(3) securities were attributable under the material-participation test. Such securities were held for use in connection with Taxpayer's trade or business within the United States, and the U.S. office where the trade or business is conducted was a material factor in the realization of all the income with respect to the securities. Consequently, all income, gain or loss with respect to any (b)(3) securities held for trading is treated as ECI to Taxpayer's trade or business within the United States. The income, gain or loss from any other (b)(3) securities that Exam determines were held for investment and that is allocable to non-ECI under the 10 Percent Rule is not subject to reallocation to ECI under the asset-use or business-activities tests.

SUMMARY

Taxpayer's acquisitions of securities in its U.S. branch office where its banking, financing, or similar business is carried on is subject to the material-participation test of §1.864-4(c)(5)(iii) to determine whether such securities are attributable to such U.S. office. The (b)(3) securities attributable to Taxpayer's U.S. office are included in the 10

Percent Rule formula of §1.864-4(c)(5)(ii) whether the securities are held for investment or trading. Section 1.864-4(c)(5)(vi) overrides the non-ECI allocation determined under the 10 Percent Rule of the income, gains and losses from the (b)(3) securities held for trading. Such income, gains and losses are treated as ECI to Taxpayer's trade or business within the United States under the asset-use and business-activities tests in §§1.864-4(c)(2) and (3). Based on the information provided, Taxpayer's (b)(3) securities acquired in its securities arbitrage activity were in fact held for trading and are all subject to the §1.864-4(c)(5)(vi) override of the 10 Percent Rule.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.