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to: Carol Schultz
Associate Area Counsel
(Large & Mid-Size Business)

from: Patrick White
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Financial Institutions & Products

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subject:

This Chief Counsel Advice responds to your request for assistance dated October 22, 2007. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Date 1 =

Year 1 =

Agency 1 =

Agency 2 =

Year 2 =

A =

Amount 1 =

Date 2 =

B =

C =

Year 3 =

D =

Date 3 =

Quote 1

Authority =

Executive 1 =

Date 4 =

Quote 2 =

Executive 2 =

Date 5 =

Quote 3 =

Pages a =

Quote 4 =

Page b =

Quote 5 =

Amount 2 =

Amount 3 =

E =

F =

Page c =

Quote 6 =

Report =

Year 4 =

ISSUE

Did the reclassified securities held by Taxpayer cease to be held for investment under section 475(b)(3), thereby becoming subject to mark-to-market treatment?

CONCLUSION

We do not disagree with your tentative conclusion that the reclassified securities continue to be held for investment and are not subject to mark-to-market accounting.

OVERVIEW

Taxpayer's primary business activity is purchasing and holding securities, and other investments in its investment portfolio. Its primary source of revenue is the net interest that it earns in excess of interest expense

incurred on debt that it issues. Taxpayer also and earns fees in connection therewith.

As a securities dealer under section 475, Taxpayer is required to mark-to-market all of its securities that are not excepted under section 475(b). Until Date 1, Taxpayer identified out of mark-to-market treatment securities held in its investment portfolio as held for investment under section 475(b)(1)(A). Taxpayer ceased identifying out securities acquired after Date 1 for its investment portfolio.

In Year 1, Taxpayer's by Agency 1 and Agency 2. Taxpayer , was forced to and substantially increase its regulatory capital. Taxpayer approached the Service in early Year 2 to obtain guidance regarding its plan to sell off some securities to enable it to meet required capital levels. Taxpayer advised the Service that it had determined that its liquidation of some of the securities would cause particular securities in its investment portfolio to no longer be held for investment. Taxpayer concluded, without seeking input from the Service, that securities that it reclassified as primarily held for sale would have to be marked-to-market for future changes in value in accordance with section 475(b)(3).[1] Instead, Taxpayer sought a letter ruling from the Service that its reclassification of certain specified securities (acquired before Date 1) would not cause securities that were not reclassified to be marked-to-market.

Taxpayer was well aware of the considerable potential tax benefits associated with marking its prepayable debt securities to market. Documents show that Taxpayer understood that

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Taxpayer in mid-Year 2 reclassified as primarily held for sale all or nearly all of its pre-Date 1 securities held in its investment portfolio in which it did not own A percent of the issue. Taxpayer had built-in tax gain of roughly Amount 1 in the reclassified securities that it is recognizing proportionately over the period . If Taxpayer had made a section 475(f) election, the built-in gain (or

[1] A Date 2 Taxpayer internal memorandum shows that Taxpayer knew that the existence of ongoing investment intent would preclude mark-to-market treatment. That memorandum and other documents recommended seeking Service approval of the reclassifications. Taxpayer never requested Service approval and did not even disclose that the reclassifications were being made for tax purposes. After Taxpayer adopted its return position, the National Office learned that the "reclassifications" (or "redesignations") were ostensibly made for tax, not financial accounting, purposes. Though not relevant here, section 1.475(b)-4(c) contains a limited transitional rule permitting an identification to be "removed." Nothing in section 475 discusses the need or possibility of reclassifying or redesignating securities, and Taxpayer never raised whether such a step was a possibility for income tax purposes.

loss) with respect to securities covered by that election would have been taken into income immediately as a section 481 adjustment. Rev. Proc. 99-17, 1999-1 C.B. 503.

Taxpayer sold substantial amounts of the reclassified securities, though as a percentage of its portfolio the amount of sales was relatively low, topping out at roughly B percent in Year 2 and C percent in Year 3. Taxpayer did not provide details on when the reclassified securities were sold, but it appears that most of the sales in Year 2 were immediately prior to the deadline for satisfying Agency 1's imposed capital requirement. Overall monthly sales dropped precipitously after that deadline. Taxpayer utilized its existing trading operations to sell its securities. Sales were generally made in large volume to the broker-dealers who were primary dealers in those securities. On average, the reclassified securities had been held for almost D years prior to reclassification.

As a result of its capital concerns and , Taxpayer has been precluded from pursuing its historically successful strategy of increasing profits by growing the size of its investment portfolio. Consequently, Taxpayer adopted an enhanced business strategy for its investment portfolio in which it considers opportunistically selling securities when interest rate spreads are tight and acquiring such assets when spreads are more attractive.[2] Accordingly, Taxpayer claims that some of its sales of reclassified securities were motivated by not only capital needs but also by the desire to take advantage of a richly priced market. However, documents provided indicate that Taxpayer did not view its enhanced business strategy to be a significant change. Taxpayer representatives informed the of its Board of Directors that " ." In addition, in a Date 3 investor/analyst call, Taxpayer described its enhanced business strategy as an investment strategy that focused on increasing returns incrementally and as Quote 1.

Throughout much of this period and through today, Taxpayer has been attempting to convince Agency 1 and Authority to allow it to . Agency 1 recently by roughly C percent.

Taxpayer asserts that its state of mind, at least as described by tax representatives, is controlling and that it clearly intended to hold the reclassified securities primarily for sale to customers starting in mid-Year 2. Taxpayer further claims that its enhanced business strategy of considering opportunistic sales when prices were attractive and its considerable sales substantiates this intent. Additionally, Taxpayer claims that its regular sales to primary dealers are sales to customers based on its reading of regulations under section 475.

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[2] Some evidence indicates that Taxpayer may have also been selling some reclassified securities in an effort to reconstitute the mix of its debt assets so as to maximize its risk adjusted spreads given its

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LAW AND ANALYSIS

Section 475(b)(3) provides that if a security held by a section 475 dealer ceases to be held for investment under section 475(b)(1) at any time after it was identified as such under section 475(b)(2), then it shall be subject to section 475(a) mark-to-market accounting with respect to any change in value occurring after the cessation. Section 1.475(b)-1(a) provides that a security is considered to be held for investment within the meaning of section 475(b)(1) if it is not held by the taxpayer "primarily for sale to customers in the ordinary course of the taxpayer's trade or business." Thus, the issue here is whether the reclassified securities ceased to be held for investment and became primarily held for sale to customers in Year 2, allowing Taxpayer to mark them to market.[3]

The primarily held for sale test is a highly factual inquiry on which the taxpayer bears the burden of proof. Van Suetendael v. Commissioner, 3 T.C.M. (CCH) 987, aff'd, 152 F.2d 654 (2nd Cir. 1945). The section 1.475(b)-1(a) test, adopted by the Service to conform with the language in section 1236, has been frequently applied by the courts in classifying sales of securities under section 1221, which also employs the same language.[4]

Primarily Held for Sale

In determining whether a taxpayer holds property "primarily for sale," the word "primarily" has been interpreted to mean "principally" or "of first importance." Malat v. Riddell, 383 U.S. 569 (1966). A mere statement by a taxpayer that securities were purchased or held primarily for resale to customers is insufficient. Vaughan v. Commissioner, 85 F.2d 497, 500 (2nd Cir. 1936). In deciding a taxpayer's holding purpose, more weight is given to objective evidence than to that taxpayer's own statements of intent. Guardian Industries Corp. v. Commissioner, 97 T.C. 308, 316 (1991); Stern Brothers v. Commissioner, 16 T.C. 295, 313 (1951); Pacific Securities v. Commissioner, 63 T.C.M. (CCH) 2060 (1992). Moreover, a taxpayer must produce significant objective evidence to prove a change of intended purpose. Goldberg v. Commissioner, 223 F.2d 709, 712 (5th Cir. 1955).

Tax representatives of Taxpayer claim that its intent changed upon reclassification of the securities.[5] Not only is this evidence not objective, it is contradicted by statements made by non-tax personnel (considerably more familiar with Taxpayer's business operations) to investors, non-tax agencies and even to Authority.

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[3] The "ordinary course of trade or business" requirement is not being addressed here.

[4] Pursuant to the memorandum of understanding between Taxpayer and the Service, Taxpayer was supposed to provide Exam with all relevant law and facts in order to facilitate Taxpayer's request for an expedited audit. Except for Malat v. Riddell, 383 U.S. 569 and Guardian Industries v. Commissioner, 97 T.C. 308, none of the relevant caselaw cited herein was brought to Exam's attention.

[5] Taxpayer agrees that the fashion in which securities are held (not the act of reclassification) controls whether the reclassified securities are no longer held for investment.

Consistent with its historic business model of issuing debt to capture interest rate spreads on , Taxpayer continues to characterize its assets as investments, at least for non-tax purposes. The public record is replete with ongoing instances where Taxpayer characterizes itself to investors, analysts, Authority, and regulators as an investor in . For example, Executive 1, explained in some detail to analysts in Date 3 and Date 4 conference calls how Taxpayer was managing its investment portfolio. Among other things, Executive 1 explained that Taxpayer had simply refined its analysis to take into account incremental economic returns of its investments over their life; he added that the process was the same as it had always undertaken and its focus on long-term investment spreads is the same type of analysis done by virtually all long-term investors in or other assets. In the Date 4 conference call, he succinctly added, Quote 2. Recently, Executive 2 of Taxpayer, addressed Authority regarding Taxpayer's need for

. In regard to its , he told Authority on Date 5, Quote 3. In its Year 2 Form 10K (at Pages a), Taxpayer stated that it has investment objectives similar to other investors: Quote 4

Taxpayer's Year 2 and Year 3 year-end balance sheets describe the securities as investments, consistent with Statement of Financial Accounting Standard No. 115 (the standard used by non-dealers to report investment securities) and consistent with Taxpayer's historic and ongoing business model.[6] Taxpayer's financials show it holding only a limited amount of trading assets that are considered, for financial reporting purposes, primarily held for sale. Moreover, Taxpayer's treatment of unrealized losses on impaired securities that are designated as available-for-sale for financial accounting purposes is extremely telling. On Page b of its Year 2 Form 10K, Taxpayer explains that it is able to avoid a write-down for the bulk of such securities that have unrealized losses (principally due to interest rate movement) because Quote 5. Such represented intent with regard to its reclassified securities is sharply at odds with Taxpayer's asserted state of mind for federal income tax purposes. Moreover, because these statements of investment intent are not self-serving and were made or approved by high ranking executives much more familiar with Taxpayer's operations, they should be afforded considerable weight A significantly less direct admission against interest (testimony that sales were made opportunistically) has precluded a taxpayer from being treated as a dealer holding debt primarily for sale to customers. Frankel v. Commissioner, 56 T.C.M. (CCH) 1156 (1989).

[6] The classification of a security under financial accounting principles is not dispositive of the treatment of the security for section 475 purposes. Rev. Rul. 97-39, 1997-2 C.B. 62 (Holding 4).

Even putting aside Taxpayer's acknowledged investment intent, objective facts demonstrate that Taxpayer was not holding the reclassified securities primarily for sale to customers. Securities are consistently treated by courts as held for investment and not primarily held for sale to customers where they are held primarily for their income yield. United States v. Chinook Inv. Co., 136 F.2d 984 (9th Cir. 1943); Brown v. United States, 426 F.2d 355 (Ct. Cl. 1970); United States v. Wood, 943 F.2d 1048 (9th Cir. 1991). As stated in Stephens, Inc. v. United States, 464 F.2d 53, 57 (8th Cir. 1972), "it is well established that 'investor' status attaches to anyone, including a recognized 'dealer,' who acquires securities with the primary intent to profit from their income yield." This is true even though the taxpayer has the status of "dealer" with respect to other similar securities that it properly holds in its inventory. Id at 58.

Taxpayer did not materially change its overall business model in Year 2. Rather, consistent with public documents, speeches of its executives and information on its website, Taxpayer's business model was still driven by two sources of revenue: (a) the income that it earns for and (b) as most relevant here, the net interest income spread that it generates from . That net interest income accounted for Amount 2 in Year 2 and Amount 3 in Year 3, or approximately E percent and F percent of total annual income respectively.[7] (See, e.g., Year 2 Taxpayer Form 10K (at Page c) stating that, Quote 6) Taxpayer's enhanced business (investment) strategy was consistent with Taxpayer's overall business model. At most, Taxpayer tweaked its investment strategy in consideration of capital limitations, pursuing maximum "good spreads" whenever possible to maximize total return on its investments. At the end of the day, however, Taxpayer's enhanced business strategy was all about maximizing its net interest spreads within the confines of its capital constraints. See Taxpayer Report. Updating an investment strategy to allow for more frequent sales activity to optimize returns remains primarily an investment strategy.[8] Nevertheless, Exam might want to give Taxpayer an opportunity to demonstrate the kind and extent of net returns generated, relative to and beyond net interest spreads, by its enhanced business strategy. Facts showing that the incremental returns generated by its enhanced business strategy were dwarfed by net interest spreads would even further solidify your tentative position.[9]

Courts have also generally been unwilling to find a change of investment intent with respect to assets that a taxpayer is forced to liquidate to meet business needs. Erfurth v. Commissioner, 53 T.C.M. (CCH) 767 (1987). Much of the record, including statements made to the Service and Agency 1, demonstrate that Taxpayer was in a

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[7] Most of the remaining income reported on Taxpayer's condensed consolidated income statements is income.

[8] Moreover, it seems evident from information supplied that a high percentage of sales, particularly those in Year 2, were foremost driven by capital requirements.

[9] As discussed below, the incremental returns would have to have been derived from earning a dealer spread and not from holding the securities as investments. To the contrary, however, Taxpayer's Report indicates that the Taxpayer was aiming to speculate on the movement of spreads in hopes of earning relatively minimal additional basis points to enhance its overall net interest spreads.

position where it had to sell investments to meet its capital needs or . Indeed, the incoming submission shows that a high percentage of sales were made near the time of Agency 1 imposed deadlines. It appears that Taxpayer hopes to rebuff that fact by arguing that it also made some of the sales to take advantage of attractive pricing. The factual strength of that assertion would be considerably undermined by evidence that shows that Taxpayer tended not to sell more assets than was necessary to satisfy capital requirements or to . Exam should consider undertaking that analysis, though it may be somewhat academic because courts view even frequent opportunistic sales to be evidence of holding such assets for investment. Farr v. Commissioner, 44 B.T.A. 683 (1941); Frankel v. Commissioner, T.C. Memo 1989-39.

Customer Requirement Under Caselaw

In addition to holding applicable securities primarily for sale, a taxpayer must be selling "to customers" in order for such securities to be considered not held for investment. Section 1.475(b)-1(a). In the securities context, courts have consistently equated the need for sales to customers with acting as a dealer. Van Suetendael, 3 T.C.M. (CCH) 987. Dealers have customers but investors and traders do not. Marrin v. Commissioner, 147 F.3rd 147, 151 (2nd Cir. 1998), aff'g, 73 T.C.M. (CCH) 1748; United States v. Wood, 943 F.2d at 1051-1052; Bielfeldt v. Commissioner, 76 T.C.M. (CCH) 776 (1998).

Courts apply a merchant analogy to determine whether a taxpayer sells securities "to customers." Bradford v. United States, 444 F.2d 1133 (Ct. Cl. 1971). The often-quoted court in Kemon v. Commissioner, 16 T.C. 1026 (1951) described the merchant function as follows:

> Those who sell "to customers" are comparable to a merchant in that they purchase their stock in trade, in this case securities, with the expectation of reselling at a profit, not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middle man bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods. Such sellers are known as "dealers."
>
> Contrasted to "dealers" are those sellers of securities who perform no such merchandizing functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable

> them to sell at a price in excess of cost. Such sellers are known as "traders."

Kemon, 16 T.C. at 1032-1033 (citations omitted). See also, Bradford, 444 F.2d at 1140; Currie v. Commissioner, 53 T.C. 185, 199 (1969); Frankel v. Commissioner, 56 T.C.M. (CCH) 1156 (1989).

Taxpayer has not supplied evidence that it acted as a dealer with respect to the reclassified securities, serving as a middleman or merchant for those securities.[10] Critically absent are any facts showing that Taxpayer hoped to earn a "commission" or dealer type spread or mark-up in connection with its purchases and sales. Taxpayer also failed to supply evidence that the readily tradable reclassified securities that it generally sold to primary dealers were not otherwise readily accessible to those primary dealers. Though we cannot speak authoritatively on the topic, we suspect that primary dealers in the reclassified securities were in fact regularly acting as merchants, providing quotes to Taxpayer and others requesting such and otherwise acting as merchants or middlemen. Exam might want to further explore the role of primary dealers with regard to Taxpayer and others, either with experts, regulators or the primary dealers themselves. See Bielfeldt v. Commissioner, 76 T.C.M. (CCH) 776 (1998)(describing function of primary dealers in government debt market).

Additionally, unlike a dealer, Taxpayer was not acquiring securities either before or after their reclassification as a source of supply for customers. Farr v. Commissioner, 44 B.T.A. at 689. Taxpayer indicated in an information document request response that it was more advantageous to make sales of older securities over more recently purchased securities.[11] Bielfeldt v. Commissioner, 76 T.C.M. (CCH) 776 (1998) (inability to immediately sell acquired securities at a mark-up is indicative of not being a dealer).

Though direct evidence of acting as a merchant was not provided, there is ample evidence that Taxpayer did not intend to act a dealer. As discussed above, Taxpayer's motivations for its sales were driven by its capital requirements, and perhaps, to some undefined extent, the favorable prices available for its reclassified securities. That evidence alone seems to preclude any suggestion that it was seeking to capture a dealer spread inherent in buying and selling the securities themselves. Other evidence indicates that Taxpayer was looking to optimize its net interest spreads, not bid/ask spreads. Vaughan v. Commissioner, 85 F.2d 497 (2nd Cir. 1936)(a taxpayer is not a dealer with respect to securities that it holds for investment); Stephens, Inc. v. United States, 464 F.2d 53 (1972) (a dealer's profit must accrue strictly from the sale of

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[10] We understand that Taxpayer regards itself to be a dealer with respect to because it acts as a merchant with regard to that are not otherwise readily tradable.

[11] Taxpayer claims that it sold older securities (purchased prior to Year 1) because market demand for such enabled it to obtain a better return. Information supplied by Taxpyer to Agency 1, however, indicates Taxpayer sought to sell older securities because the built-in gain in those assets gave Taxpayer improved regulatory capital results.

the security itself and cannot be planned to arise from the necessity of combining the investment income yielded by the security and the ultimate resale price). Van Suetendael v. Commissioner, 3 T.C.M. (CCH) 987. Taxpayer's repeated claims that its decisions on whether to sell were based on net interest spreads is consistent with its characterization of its increased opportunistic sales as a low turnover strategy, despite those securities being readily marketable.[12]

In evaluating the customer requirement, courts have also given particular attention to whether the taxpayers held themselves out or considered themselves to be dealers. Bielfeldt v. Commissioner, 76 T.C.M. (CCH) 776 (1998), aff'd, 231 F.3d 1035 (7th Cir. 2000); Pacific Securities v. Commissioner, 63 T.C.M. (CCH) 2060. Taxpayer has not indicated that it was registered with the SEC or anyone else as a primary or secondary dealer in reclassified securities. Taxpayer has not suggested that it was required to provide quotes or otherwise make a market in the reclassified securities. There is no indication that Taxpayer promoted itself as a dealer[13] or others viewed Taxpayer to be a dealer in the reclassified securities. Rather, the evidence demonstrates that Taxpayer holds itself out, as discussed in detail above, as a long term investor in and the press, regulators and even Authority share that view. Consistent therewith, Taxpayer reported on its Year 2 Form 10K that its competitors were other investors (not dealers) and it deployed Statement of Financial Accounting Standard No. 115 to account for its reclassified investment securities, a standard that does not apply to securities dealers. Exam may wish to consider contacting Agency 1 to determine, among other things, if Agency 1 approved or discussed with Taxpayer its acting as a dealer in reclassified securities.

Relaxed Customer Requirement Argument

Taxpayer argues that the regulations under section 475 interpret the customer requirement much less strictly than it has been construed in caselaw. In particular, it asserts that section 1.475(c)-1(a)(2), a provision defining a dealer in derivatives under section 475(c)(1)(B), should be read so that the customer requirement under section 1.475(b)-1(a) is satisfied if a taxpayer regularly buys or sells securities, without regard to whether the taxpayer performs a middleman or merchant function as specified by caselaw. In this case, Taxpayer contends that the customer requirement is satisfied because it regularly sold to primary dealers in those securities. Taxpayer's argument is meritless. Its reading of section 1.475(c)-1(a)(2) is inconsistent with the regulation

[12] Exam may wish to independently investigate whether it would have been even possible for Taxpayer to earn a dealer spread on newly acquired non-reclassed securities when selling to primary dealers. No evidence was provided in the incoming documents to show that the Taxpayer consistently, or ever, purchased older securities (having characteristics of those reclassified) for immediate resale to customers at a dealer profit (without regard to rate movements).

[13] Curiously, Taxpayer asserted that it promoted its new dealer activity in reclassified securities by describing the details of its enhanced business strategy to stock analysts in quarterly conference calls in Year 2. As such and consistent with its investment focus, we suspect that Taxpayer will be unable to provide any credible or meaningful evidence that it held itself out as a dealer.

language and intent, producing nonsensical results with respect to traders and certain other investors.[14]

In actuality, section 1.475(c)-1(a)(2) is consistent with caselaw interpreting the customer requirement. Under the regulation and caselaw, the focus is on whether a taxpayer is serving in the role of middleman or merchant. Section 1.475(c)-1(a)(2) describes what constitutes a dealer-customer relationship, particularly under section 475(c)(1)(B). Section 475(c)(1)(B) defines a "dealer in securities" as a taxpayer who 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. Section 1.475(c)-1(a)(2) generally provides that the determination of whether a taxpayer is transacting business with a customer is determined on the basis of all the facts and circumstances. The regulation is silent and reserved with respect to transactions described in section 475(c)(1)(A), where Taxpayer's reclassified securities sales fall. The particular regulation language relied upon by Taxpayer goes well beyond stating that regular sales are sufficient for a customer relationship. Rather, section 1.475(c)-1(a)(2) states that a section 475(c)(1)(B) dealer 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 described in section 475(c)(1)(B). The examples, dealing with interest rate swaps and foreign currency positions, describe how a taxpayer that regularly holds itself out as willing to enter into either side of those transactions would qualify as a dealer and its counterparties are its customers. Example 3 further indicates that transactions that a taxpayer undertakes based on its own internal needs do not constitute dealer transactions with customers. C.f., U.S. v. Diamond, 788 F.2d 1025 (4th Cir. 1986)(a taxpayer that sells for its "own account" is not selling to customers); Burnett v. Commissioner, 40 B.T.A. 605 (1939), aff'd, 118 F.2d 659 (5th Cir. 1941)(sales by a taxpayer for its "own account" are not to customers). Thus, the regulation language, just like caselaw dealing with securities sales, requires that a derivatives dealer willingly hold itself out as a middleman or merchant, earning a spread from serving that function.[15]

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[14] Ironically, if Taxpayer was looking for actual language to support its contention that regular transactions establish a customer relationship, it should have focused its efforts on the caselaw. Estate of Hall v. Commissioner, 29 B.T.A. 1255 (1934), contains some language indicating that regular or repeated transactions establish a customer relationship. Id at 1259. However, the opinion then goes on to clarify that a merchandizing function must be served, consistent with Kemon and its progeny. Id. at 1260. Further, the Second Circuit has recently said that merely engaging in many trades does not create a customer relationship. Marrin v. Commissioner, 147 F.3rd 147, 152. See also, Kelly v. Commissioner, 72 T.C.M. (CCH) 1389 (1996)(regular and substantial trading establishes the existence of a trade or business but does not satisfy the customer requirement for dealer status).

[15] Even assuming section 1.475(c)-1(a)(2) controls what is a customer in this case, Taxpayer has not shown that it regularly holds itself out as a dealer that willingly offers to enter into either side of a transaction involving reclassified securities. Rather, the information supplied shows that Taxpayer was willing to consider holding itself out as a seller of reclassified securities only where it suited its internal needs (capital requirements, or maximizing net interest spreads). There is no indication that Taxpayer acquired securities of the type reclassified to sell to customers and earn a dealer spread, as would be the case with a derivatives dealer taking offsetting positions.

Additionally, there is no indication in the section 475 regulations that the Service intended to upend the longstanding judicial interpretations of the customer requirement. Rather, in adopting the primarily held for sale to customer standard to determine whether a security is held for investment or not held for sale, the Service expressly recognized in the preamble to final section 475 regulations that it was adopting a standard identical to the standard used in section 1236 (which itself is also consistent with section 1221(a)(1)). Treasury Decision 8700. In administering section 475, the Service has also respected the historic distinction between securities trading and dealing, a task that would be virtually impossible if the customer requirement were considered satisfied by simply making regular sales. Unlike a dealer, a trader does not have customers. Kemon v. Commissioner, 16 T.C. at 1033; Marrin v. Commissioner, 147 F.3rd 147, 151. The preamble to Treasury Decision 8700 confirms that the Service believed that even trading securities held by a dealer should be permitted to be identified out as not primarily held for sale to customers. Section 1.475(b)-4(b)(2)(A). As under caselaw, the Service contemplated that a trader does not sell to customers. See also, Rev. Rul. 97-39; 1997-2 C.B. 62 (Holding 4). If as Taxpayer argues, a customer relationship was established by regular sales, then all or nearly all traders (as well as many investors including regulated investment companies) would be dealers under section 475 and would be unable to identify out securities from mark-to-market treatment. Consequently, neither common sense nor the Service's relevant administrative actions suggest that the Service was adopting in section 1.475(c)-1(a)(2) a relaxed definition of a customer that only required regular sales.[16]

We do not disagree with your tentative conclusion that Taxpayer has not demonstrated that its reclassified security sales, either pursuant to capital restoration needs or pursuant to its apparently somewhat modified opportunistic investment strategy, are inconsistent with its prior designation of those assets as held for investment. We would further add, however, that if Taxpayer were correct that its selective sale of investments and its regular sales to primary dealers caused those assets to be primarily held for sale to customers, there would be many taxpayers, including Taxpayer, that have improperly identified their assets as held for investment or not held for sale. We think such a result would be wholly unsupported and untenable.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

On examination, Taxpayer claimed that it relied on the National Office's informal statements and even silence during the letter ruling submission process. Even if Taxpayer's claims were accurate (which they are not), it would not have been entitled to

[16] The enactment of the mark-to-market election for traders under section 475(f) would have also been unnecessary if the customer requirement were satisfied by making regular sales. Traders do not act as merchants but do make regular sales. Thus, most if not all traders would qualify as dealers if regular sales were sufficient to establish a customer relationship. Moreover, if the customer requirement were satisfied by regular sales, the regulation would have been more aptly (though oddly) written to describe the customer requirement as a nullity as the statute itself (both section 475(c)(1)(A) and (B)) already requires "regular" transactions.

rely on informal remarks or silence by the Service. Rev. Proc. 2007-1, 2007-1 I.R.B. 1, sections 2.05 and 10.07(4).

Exam undertook review of this issue in accordance with a nonbinding memorandum of understanding providing for the accelerated examination of the section 475 issue alone. Among other things, the memorandum of understanding indicates that there will be honest and open communication and that Taxpayer will provide all relevant facts and law, including contrary authority. At the very minimum, Taxpayer has glaringly failed to provide Exam with relevant law and contrary authority. Failure of either party to adhere to the memorandum of understanding is grounds for termination, and it appears that the nonbinding arrangement can be terminated without cause by either party with written notice. [redacted]

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Please call if you have any further questions.

Stephen Larson
Associate Chief Counsel
(Financial Institutions & Products)

/S/

By: _____
Patrick White
Senior Counsel
Office of Associate Chief Counsel
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