**Office of Chief Counsel**
**Internal Revenue Service**
# memorandum

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to: Area Counsel (Heavy Manufacturing & Transportation)
(Large Business & International)
Attn: Philip Yarberough

from: Associate Chief Counsel
(Financial Institutions & Products)

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subject: Section 475 Dealer Status for Owner of Residual Interest Certificates

This Chief Counsel Advice responds to your request for assistance dated October 23, 2013. This advice may not be used or cited as precedent.

LEGEND

Taxpayer
Partnership X
Partnership Y
Partnership Z
Operating companies
DE Trusts
Depositor
Owner Trustee
Indenture Trustee
Subservicer
Year 1
Year 2
Year 3
Date 1
Date 2
Date 3
amount a

amount b
amount c
amount d
amount e
amount f
amount g
amount h
amount i
amount j
amount k
amount L
amount m
A % interest
B percent
C interest

## ISSUES

1. Whether Taxpayer is a dealer in securities under section 475 because of its interest in Partnership X?

2. Whether the Subservicer's activities of making loan modifications to some of the mortgage loans held as collateral for the Notes issued by the DE Trusts is a dealer activity under section 475 and attributable to Taxpayer, who holds Residual Interests in the DE Trusts?

3. Whether Taxpayer is treated as a trader in securities under section 475 and allowed to mark to market its securities.

## CONCLUSIONS

1. No, Taxpayer is not a dealer in securities because of its interest in Partnership X. Although Partnership X is a dealer in securities, and a flow through entity, it is not a disregarded entity. So the ordinary character of the marked securities flowed through to Taxpayer, but the dealer activities of Partnership X were not attributable to and do not flow through to Taxpayer.

2. None of the Subservicer's activities regarding loan modifications were attributable to Taxpayer as dealer activities. Although any gains and losses that occur as a result of the loan modifications may flow through to Taxpayer, the activities of the Subservicer do not. Subservicer is not a disregarded entity of Taxpayer, but rather it is a disregarded entity of a partnership in which Taxpayer has an interest. Furthermore, we support your position that the Subservicer did not act as an agent of Taxpayer.

3. Taxpayer did not make a timely section 475(f) election so Taxpayer is not entitled to use mark-to-market accounting for its securities. No further analysis of the trader versus investor issue is needed to make this determination.

FACTS

The year at issue in this audit is Year 3. In that year, Taxpayer used the mark-to-market method of accounting under section 475 for the first time, claiming it became a dealer in securities because of the Residual Interests it holds in the DE Trusts it purchased from Partnership X on Date 2. Specifically, Taxpayer claims that because of loan modifications made by the Subservicer on behalf of the DE Trusts, there is dealer activity that is attributable to Taxpayer. Taxpayer claims that it is entitled to mark all of the mortgage loans held in the DE Trusts as collateral for the Notes. The following facts are from your incoming request.

Taxpayer, a holding company for Partnership X and several other operating companies, was created in Year 2. Taxpayer had A % interest in Partnership X. Throughout Year 2, Partnership X engaged in the business of originating and purchasing mortgage loans on the open market. It also participated in mortgage-backed securitization activities. In general, Partnership X contributed the mortgage loans to the DE Trusts, and the Trusts issued Notes to third party investors as mortgage-backed securities. Specifically, Partnership X contributed the mortgage loans to Depositor, which in turn contributed the loans to the DE Trusts under a Trust Agreement. At the same time the Owner Trustees entered into an Indenture Agreement with the investment bank that acted as the Indenture Trustee. The Indenture Trustee's responsibilities included issuing the Notes, making payments with respect to the Notes and protecting the mortgage loans which served as collateral for the Notes. Partnership X had set up some of the Delaware statutory trusts as REMICs, but it also established the DE Trusts. Partnership X retained Residual Equity Interests in the securitizations. Partnership X used a mark-to-market method under section 475 for its securities. Partnership X identified about B percent of the mortgage loans as held for investment, and did not mark those mortgage loans.

The parties to the securitization entered into 3 servicing agreements concerning the mortgage loans. The Master Servicer agreed to supervise the servicing of the mortgage loans on behalf of the DE Trusts and the Indenture Trustee. On the same date that the Master Servicer agreement was signed, the DE Trusts entered into a servicing agreement with a second national bank, the Servicer, to perform certain loan servicing functions on behalf of the holders of the Notes and the Residual Interests. Using a subservicing agreement, the Servicer delegated servicing duties of underperforming loans to a Subservicer. The Subservicer could collect principal and interest payments for the mortgage loans, monitor property taxes and insurance and foreclose on securing properties. Generally, the Subservicer could not modify terms of the loans or extend additional principal amounts or defer payments or reduce or increase outstanding principal balances or extend the final maturity date. However, where default was

imminent, the Subservicer could modify the terms of the loan to avoid default. The loan modifications generally involved deferred interest payments, lowered interest rates and reduced penalties.

Starting in Year 1 and until Date 1, the Subservicer, a limited liability company, was a wholly owned disregarded subsidiary of Partnership X. One Date 1, Partnership X contributed its interest in the Subservicer to Partnership Z in exchange for a C % interest. On Date 2, Partnership X transferred its interest in Partnership Z to Taxpayer. Taxpayer held a C % interest in it. The remaining interests in the Subservicer were held by unrelated investors.

Under the Servicing Agreements, each identified the Master Servicer, the Servicer and the Subservicer as independent contractors. The language in Master Servicing Agreement specifically provided that it was the intent of the parties to have the Master Servicer act as an independent contractor, and not as a partner, joint venture or agent of the Indenture Trustee. The other two agreements for the Servicer and Subservicer followed along the lines of the agreement for the Master Servicer. They were also clear about them acting as an independent contractor, and not as a partner or joint venture among the DE Trust, the Master Servicer and the Servicer. Only the Master Servicing Agreement provided for the Master Servicer to act as agent for the Indenture Trustee to perfect the Indenture Trustee's security interest in foreclosure property. The Servicers were compensated through monthly servicing fees which the Servicers subtracted from the collected interest and principal that they remitted to the DE Trusts and the Noteholders.

Each DE Trust issued several classes of Notes, each class with a different priority of payment. In addition to the Notes, the DE Trusts also created a Residual Interests class, the certificates of which were not available to the public. The Residual Interests were issued to Partnership X, the Residual Owner. The Residual Owner was entitled to certain prepayments premiums or lockout fees collected from the mortgage loans. The Residual Owner was also entitled to any excess principal or interest from the mortgage loans that remained after the Note obligations were satisfied.

On Date 2, Partnership X sold its Residual interests in the DE trusts to Taxpayer. The parties framed the transaction for tax purposes as the sale of the mortgage loans underlying the DE Trusts and an assumption by Taxpayer of the nonrecourse liability associated with the Notes. The sale of the Residual Interests to Taxpayer did not affect the obligations or restrictions created by the Trust Agreement, Indenture or Servicing Agreements. For book purposes, the transaction was recorded as a transfer of the Residual Certificates from Partnership X to Taxpayer.

For tax purposes, Partnership X calculated the value of the total assets (including the mortgage loans, cash and other investments) in the DE Trusts at amount c, with amount d of that amount being attributable to the mortgage loans (amount h of the total assets). Partnership X calculated the amount of nonrecourse liabilities attributable to

the DE Trusts to be in amount e. Partnership X recognized gain on the sale of its Residual Interests in amount f (amount g for the liabilities assumed in excess of the transferred assets and cash paid by Taxpayer). When Taxpayer calculated its basis in the mortgage loans, it increased its basis by the value of the mortgage loans on the sale date plus by amount h of the excess liabilities and cash paid by it to Partnership X.

During Year 3, the Subservicer engaged in significant and ongoing loan workout activity on certain mortgage loans. Taxpayer provided transactional information for amount k loan modifications that took place during Year 3 (modified loans). Taxpayer claims that these modified loans were significantly modified, creating taxable exchanges under Treas. Reg.§ 1.1001-3. Taxpayer recognized gain on the modifications. [redacted] Taxpayer originally recognized gains for the modified loans in amount L on its Year 3 tax return. Taxpayer now claims that it should have recognized gains for Year 3 in amount m.

It is Taxpayer's position that in Year 3 the Subservicer was involved in making significant loan modifications to some of the mortgage loans held by the DE Trusts, and this resulted in new loans which constituted dealer activity for the Subservicer. Taxpayer asserts because it holds the Residual Interests in the DE Trusts, that the Subservicer's dealer activity is attributable to Taxpayer. Therefore it is Taxpayer's position that it is entitled to mark to market all the mortgage loans held at the end of Year 3. Taxpayer marked the mortgage loans as of Date 3 at amount i. Taxpayer claimed a loss in amount j on its Year 3 tax return.

## LAW AND ANALYSIS

### Dealer Status

Section 475(a) requires a dealer in securities to use a mark to market method of accounting for any securities it holds. Under section 475(a)(2), any security not held as inventory and which is held at the end of the year shall be treated as if it were sold at its fair market value on the last business day of the year, and any gain or loss shall be recognized. Proper adjustment shall then be made in the amount of any gain or loss previously taken into account under section 475(a)(2).

A dealer in securities is defined in section 475(c) (1) as a taxpayer who-
(A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or 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.

Under section 475(c)(1)(A), purchasing securities includes originating mortgages loans. The legislative history and regulations under section 475 clarify this point. See

H.R. Conf. Rept. 103-213, 1993-3 C.B. 393, 493: Treas. Reg. § 1.475(c)-1(c)(1)(i) (negligible sales exception). The regulations addressing the negligible sales exception to dealer status provide that originating loans is considered purchasing loans. Under section 475(c)(2)(C), a mortgage loan is a security.

Section 475 does not define the term customer for the dealer–customer relationship that is necessary under this section to be a dealer in securities. The regulations provide that the determination of whether a taxpayer is transacting business with a customer is based upon all the facts and circumstances. See Treas. Reg. §1.475(c)-1(a)(2)(ii). The regulations provide no examples of a dealer-customer relationship for a dealer as described in section 475(c)(1)(A). However, there is plenty of case law that has looked at the question of dealer and trader for purposes of section 1221, and discussed the customer requirement for a dealer in that context. See Kemon v. Commissioner, 16 T.C. 1026 (1951); Wood v. Commissioner, 16 T.C. 213, 219-220; Marrin v. Commissioner, 147 F.3d 147, 152 (2nd Cir., 1998), aff'g T.C. Memo 1997-24; United States v. Wood, 943 F.2d 1048, 1051 (9th Cir. 1991); King v. Commissioner, 89 T.C. 445, 458(1987). See also Bielfeldt v. Commissioner, T.C. Memo 1998-394.

In determining whether a taxpayer has customers, the courts have looked to how a taxpayer is compensated. The Courts in finding dealer status outside of section 475 have looked to whether a taxpayer is paid for its services as an intermediary- as a market-maker. The Courts have looked at whether Taxpayer was getting paid for making a market (dealer) and not profiting from earnings on return from the receipt of premiums from the positions it takes or from a rise in values of the underlying assets during the interval of time between a purchase and resale (investor or trader). The Courts have used a merchant analogy to distinguish dealers from traders. Dealers, like merchants, sell to customers and purchase the securities with the expectation of selling at a profit. This profit is not because of a rise in value during the period of time between purchase and sale, but because they 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 acting as a middle man, bringing together buyer and seller. See Kemon at 1032-1033. Although section 475 does not require that a dealer both purchase and sell, the analogy of providing a market and acting as a middle man still applies.

After it is determined whether there is a dealer- customer relationship, the next question to be addressed is whether Taxpayer "regularly" purchases or sells securities in the ordinary course of its trade or business. This requires looking at the amount of and the frequency of purchases and sales and determining whether it is sufficient to be considered dealer activity. Whether there is sufficient activity to be regular may be a difficult issue in this case. The grounds for dealer status for the Subservicer and Taxpayer is not based upon the initial origination of the mortgage loans held by the DE Trusts, but upon the loan modifications and whether they resulted in originating new loans and if so, in sufficient amounts and frequency to be considered regularly. Another

question is whether doing the loan modifications was in the ordinary course of the Subservicer's trade or business.

It is Taxpayer's position that it is a dealer in securities because of the Modified loans created in Year 3 by the Subservicer. For that position to be correct, it must be established that Taxpayer should be treated as making loans to customers and that it was regularly engaged in the trade or business of making loans, and that the modifications were within its ordinary course of business. That means the loan modifications made by the Subservicer would have to rise to the level of dealer activity and also be attributable to Taxpayer.

It is our position that the activities of the Subservicer are not attributable to Taxpayer simply because it holds Residual Interests in the disregarded entity DE Trusts. We also agree that the activities of Subservicer are not attributable to Taxpayer based upon Taxpayer's argument that the Subservicer acted as its agent. In either case, there are issues as to whether the Subservicer qualifies as a dealer in securities. Although the loan modifications may result in an exchange for section 1001 purposes, it is not clear that the loan modifications as they occurred in this case would rise to the level of dealer activities, or that they occurred with customers of the Subservicer or that they occurred regularly and in the ordinary course of the Subservicer's business or Taxpayer's business.

Partnership X's dealer status is not attributable to Taxpayer

Although Taxpayer holds Residual Interests in the DE Trusts, Taxpayer steps into those Interests in Year 3, when all the mortgage loans had already been originated by Partnership X, a dealer in securities. The DE Trusts are holding the mortgage loans as collateral for the Notes issued by the DE Trusts. None of the mortgage loans are with customers of Taxpayer. The loans are with customers of Partnership X. Although Taxpayer holds A % interest in Partnership X, Partnership X is not a disregarded entity, it is a flow through entity. So although the character of any gains and losses attributable to Partnership X will flow through to Taxpayer, any of the activities of Partnership X, a separate entity do not flow through to Taxpayer. Therefore none of the dealer activities of Partnership X, including customer status with the holders of the mortgage loans are attributable to Taxpayer.

Subservicer's Activities are not Attributable to Taxpayer

Taxpayer argues that because of the loan modifications made in Year 3 by the Subservicer, and because of the fact that it was the Residual Interests holder of the DE Trusts at year end, that it is a dealer in securities and is subject to marking under section 475. We disagree.

First, we do not think that the Subservicer's activities regarding the loan modifications are attributable to Taxpayer. The Subservicer is a disregarded entity, but

not a disregarded entity of Taxpayer. Rather it is a disregarded entity of Partnership Z, in which Taxpayer holds a majority interest. However, that partnership is not a disregarded entity and the activities of the Subservicer that may be attributable to Partnership Z do not get attributed to Taxpayer.

We also do not think that the Subservicer acted as an agent of Taxpayer. We think that we have good arguments that none of its activities regarding the loan modifications are attributable to Taxpayer because of an agency relationship. See further discussion below at pages 9-10. Furthermore, even if there were hazards as to the agency argument, Subservicer's activities do not meet the requirements for a dealer in securities under section 475.

Subservicer's Activities do not meet Dealer Requirements

While the changes to the modified loans in this case might be considered an exchange for section 1001 purposes, it is a different question as to whether the workout activity to achieve loan modifications in this case rises to the level of dealer activity under section 475, such as regularly purchasing (including originating) loans to customers in the ordinary course of the Subservicer's trade or business. It is our position that the Subservicer's loan modification activities do not rise to the level of dealer activities. First, there is an issue as to whether the loan modifications should be considered as originating loans for section 475 purposes. Second, there is an issue as to whether the Subservicer has customers in the loan modification transactions or whether the mortgage loan holders remain customers of Partnership X. Third, there is also an issue as to whether this loan modification activity falls within the requirement that it regularly occurs in the ordinary course of the Subservicer's trade or business.

Although some of these loan modifications may have been an exchange of debt for debt for section 1001 purposes, we think that the Service has an argument that the Subservicer in this case did not originate new loans for section 475 purposes. Under the terms of the Subservicer's servicing agreement, the Subservicer could collect principal and interest payments for the mortgage loans, monitor property taxes and insurance and foreclose on securing properties. Generally, the Subservicer could not modify terms of the loans or extend additional principal amounts or defer payments or reduce or increase outstanding principal balances or extend the final maturity date. However, if default was imminent, the Subservicer could modify the terms of the loan to avoid default. It is our understanding from the incoming facts that the loan modifications generally involved deferred interest payments, lowered interest rates and reduced penalties. When the Subservicer did a loan modification it was merely preserving the mortgage loans held as collateral for the Trusts. The Subservicer was in the business of servicing the loans, and although it could do loan modifications to stop default proceedings, there are questions as to whether it regularly engaged in loan modifications and whether loan modifications were in the ordinary course of its trade or business of servicing loans. The Subservicer was not in the business of being a

mortgage loan originator. The fact that it may occasionally do some loan modifications does not make it a mortgage loan originator.

The underlying purpose for the mortgage loans was to be collateral for the Notes issued by the DE Trusts. Although ownership of the Residual Interests transferred to Taxpayer, the purpose and restrictions of the DE Trusts remained the same. The mortgage loans could not be sold whenever the Trustee or the Residual Interests owner wanted to sell the mortgages. The mortgage loans could not be sold by the Trustee until the principal balance of the loans equals amount a of the initial principal balance of the loans. At that time, the Trustee is required to seek bids at a minimum price for the purchase of the mortgage loans and then the Trustee could pay off the outstanding notes. Taxpayer could make a bid then. Taxpayer, as the Residual Owner could also have the option to purchase the underlying loans once the collective principal of the mortgage loans was less than amount b of the initial balance, but it did not have that right before then.

There is also a question as to whether the Subservicer had customers for purposes of meeting the dealer requirement of purchasing or selling securities. It is more likely that the debtors remain the customers of Partnership X and not that of the Subservicer. Also depending upon when the loan modifications occurred in Year 3, there is even stronger support for the argument that these debtors remained customers of Partnership X. If the loan modifications occurred prior to Date 2, the Subservicer was the disregarded entity of Partnership X, the original originator of these mortgage loans. The Subservicer's purpose for the modification was not to generate a profit from a mark-up in price, but to preserve the underlying debt obligation. These loan modifications resulted in lowered interest rates, reduced penalties and deferred interest payments. The Subservicer is not selling, purchasing or making loans to customers. The Subservicer is preserving the collateral for the Notes issued by the DE Trusts and Taxpayer's investment in the loans through its Residual Interests.

In this case, Taxpayer did not directly originate loans or make loan modifications to customers. It cannot have dealer activity because of its actions. Also because the Subservicer's activities were not attributable to Taxpayer, and because Subservicer did not originate loans to customers, Taxpayer cannot claim dealer status based upon the Subservicer's activities regarding loan modifications.

Subservicer was not acting as the agent of Taxpayer

Taxpayer claims that it engaged in loan modifications activities through the Subservicer who acted as Taxpayer's agent in servicing the mortgage loans. Under the Servicing Agreement, the Subservicer is described as an independent contractor of the Indenture trustee of the DE Trusts or the Seller (Partnership X). Since Taxpayer acquired the Residual Interests, the Subservicer should likewise be viewed as an independent contractor of the DE Trusts and Taxpayer.

Under the express language in the Servicing Agreement, the Subservicer does not qualify as agent of taxpayer under the agency rules established in National Carbide Corp. v. Commissioner, 336 U.S. 422, 437 (1943). In National Carbide, the Supreme Court provided the following four factors and two indicia that are to be considered in determining whether an entity acts as an agent for another taxpayer:

> Whether the corporation (1) operates in the name and for the account of the principal, (2) binds the principal by its actions, (3) transmits money received to the principal, and (4) whether receipt of income is attributable to the services of the employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. (1) If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. (2) Its business purpose must be carrying on of the normal duties of an agent.

336 U.S. at 437 (National Carbide factors). The Court revised this issue in Commissioner v. Bollinger, 485 U.S. 340 (1988), in which it held that the ownership dependency indicator was not necessarily a controlling factor and explained that the following three factors, if present, are sufficient to create a corporate agency relationship:

> It seems to us that the genuiness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided when (1) the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, (2) the corporation functions as an agent and not principal with respect to the asset for all purposes, (3) and the corporation is held out as the agent and not principal in all dealings with third parties relating to the asset.

The facts in this case do not support Taxpayer's use of agency theory under the National Carbide factors. First, the Subservicer did not operate in the name of or for the account of Taxpayer. Partnership X (and Taxpayer as a successor in interest) were not parties to the Servicing Agreements and, for state law purposes, had no legal rights to the mortgage loans. The Subservicer was only entitled to act as agent for the DE Trusts in perfecting claims to foreclosure properties, but was considered independent contractor in every other respect.

Second, the Subservicer did not transmit money received to Taxpayer. For state law purposes, the Subservicer transmitted amounts collected from the mortgage loans to the noteholders on behalf of the DE Trusts and not Taxpayer.

Third, receipt of income by the Subservicer was not attributable to the services of the employees of Taxpayer or assets belonging to Taxpayer. According to the Trust

agreement, Taxpayer, as Residual Interests owner, did not hold legal title to any part of the mortgage loans. Taxpayer, a holding company, also did not have any employees. Therefore the Subservicer's compensation can not be attributed to taxpayer's employees or assets.

Fourth, the Servicers were not, in form or substance, agents of taxpayer for purposes of modifying the loans. The Subservicing agreement expressly provided that the Subservicer was to perform the servicing functions as an independent contractor. No provision of the Subservicing Agreement stated that the Subservicer was an agent of the DE Trusts or the security holders with respect to the collection or modification of the mortgage loans. The Subservicer in this case was contracted to manage the mortgage loans, which as described above, were indirectly owned by Taxpayer after Date 2 and were acquired for investment purposes.

Taxpayer did not make a Trader Election under Section 475(f)

Section 475(f) provides that a taxpayer engaged in a trade or business as a trader in securities may elect to apply the mark-to-market method of accounting to securities held in connection with such trade or business. *See* section 475(f)(1). Section 7805(d) provides that, except to the extent otherwise provided by the Code, any election shall be made at such time and in such manner as the Secretary shall prescribe.

On February 16, 1999, the Internal Revenue Service published Revenue Procedure 99-17, 1999-1 C.B. 503, (section 6 superseded by Rev. Proc. 99-49, 1999-2 C.B. 725, which was clarified, modified, amplified, and superseded by Rev. Proc. 2002-9, 2002-1 C.B. 327). Rev. Proc. 99-17 provides the exclusive procedure for traders in securities to make an election to use the mark-to-market method of accounting under section 475(f). This revenue procedure applies both to existing taxpayers who are changing to the mark-to-market method of accounting for securities and to new taxpayers who are adopting that method.

Section 5.03(1) of Rev. Proc. 99-17 provides, in relevant part, that for a taxpayer to make a section 475(f) election that is effective for a taxable year beginning on or after January 1, 1999, the taxpayer must file a statement that satisfies the requirements in section 5.04 of that revenue procedure. The statement must be filed not later than the due date ( without regard to extensions) of the original federal income tax return for the taxable year immediately preceding the election year and must be attached either to that return or, if applicable, to a request for an extension of time to file that return.

In this case, since Taxpayer was in existence prior to Year 3, to be able to make the election for Year 3, taxpayer had to have filed an election statement with its prior year return. Based upon the facts presented, there is no mention of this taxpayer ever

having made such an election. Therefore it can not use the mark-to-market method under section 475 for its securities. A taxpayer may not file a late election or retroactively file an election to mark under section 475(f). The courts have repeatedly upheld the Service's position regarding denial of marking for late elections. See Kantor v. Commissioner, T.C. Memo 2008-297; Knish v. Commissioner, T.C. Memo 2006-268; Acar v. United States, 2006 U.S. Dist. LEXIS 60859, 98 A.F.T.R.2d(RIA) 6296, 2006-2 USTC par. 50,529 (N.D. Cal. 2006), aff'd 545 F.3d 727 (9th Cir. 2008); Marandola v. United States, 76 Fed. Cl. 237 (2007); Lehrer v. Commissioner, T.C. Memo 2005-167, aff'd non published opinion, 278 Fed. Appx. 549 (9th Cir. 2008); Kohli v. Commissioner, T.C. Memo 2009-287. As such, there is no further need to discuss the trader versus investor issue as it relates to Taxpayer's ability to mark under section 475.

## CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

### Valuation and Mark Prior to Disposition Rule

We do want to point out that although Taxpayer can not use a mark-to-market method of accounting for its securities under section 475, it is possible that Partnership X chose to follow the mark immediately prior to disposition rule set out under the proposed regulations §1.475(a)-2. Because this is a proposed regulation, a taxpayer may chose to follow the proposed regulations, but we will not force taxpayer to follow a proposed regulation. Under that rule, if a dealer in securities ceases to be the owner of a security for federal income tax purposes and if the security would have been marked to market under section 475(a) if the dealer's taxable year had ended immediately before the dealer ceases to own it, then the dealer must recognize gain or loss on the security as if it were sold for its fair market value immediately before the dealer ceases to own it, and gain or loss is taken into account at that time. Because Partnership X was a dealer in securities when it sold the Residual Interests to Taxpayer, if it followed the mark before disposition rule, then Partnership X would have valued the loans as of Date 2 and recognized any gain or loss. Partnership X would then increase or decrease basis in accordance with the recognized gain or loss. On the sale to taxpayer there would be no gain or loss for Partnership X and Taxpayer would have a basis in the mortgage loans of that of Partnership X. Now if Partnership X had properly identified B percent of the loans as held for investment, those loans would not be marked prior to disposition. However, Partnership X would have realized a gain on the actual sale of those loans.

Because the mark prior to disposition occurs on Date 2, it may have the same valuation as the securities will have on Date 3 or very close to that valuation.

[redacted]

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call if you have any further questions.

HELEN HUBBARD
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