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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
DISTRICT COUNSEL,

FROM: Deborah A. Butler
Assistant Chief Counsel CC:DOM:FS

SUBJECT: Section 475 - Mark-to-Market

This Field Service Advice responds to your memorandum dated August 6, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

X =
Y =
z =
Year 1 =
Year 2 =
Years 3-5 =
Date 1 =
Date 2 =

ISSUE(S):

1. Whether X's retail and wholesale installment receivables are customer paper for purposes of Treas. Reg. §1.475(c)-1(b)(2)?

2. Whether X must obtain the consent of the Commissioner before it changes its method of accounting to comply with I.R.C. § 475, if that change is made after Year 2?

CONCLUSIONS:

1. Based upon the facts available, we believe X may be holding securities that are both customer paper and noncustomer paper for section 475 purposes. If additional facts support this conclusion, then X was not required to elect out of the exception for sellers of nonfinancial goods and services (customer paper exception) to be subject to section 475.

2. Additional facts need to be developed to determine whether X applied the section 475 mark-to-market method for Year 2. If X did so, it was entitled to an automatic consent to use that method for Year 2 and subsequent years. If, however, X did not use the mark-to-market method in Year 2, it is required to request the Commissioner's consent to change its method to comply with section 475 for Years 3-5 and subsequent years.

FACTS:

Corporation X is a financial services subsidiary of corporation Y. Y is in the business of manufacturing z. X has a portfolio of retail installment receivables and wholesale installment receivables. The retail installment receivables are installment loans to customers who purchased z from various dealers. The wholesale installment receivables are loans made by X to dealers to finance their purchase of z for sale to retail customers.

X's Year 2 return showed no evidence that X marked to market any of its securities. X, however, represents that it applied the section 475 mark to market principles for its Years 1 and 2 securities, but had no adjustment to income. In addition, on Date 1, X made a protective identification that identified all securities as held for investment and, thus, not subject to mark-to-market, other than the retail and wholesale installment receivables. Section 475(b)(2); Rev. Rul. 97-39, 1997-2 C.B. 62, Holding 6.

For its Years 3-5, X marked to market its portfolios of installment receivables. X filed no Form 3115. In response to an information document request, X claims that it was not required to file a Form 3115 since the legislative history of section 475 provides for an automatic consent to change to the mark-to-market method for a taxpayer who became a dealer of securities in 1993 for purposes of section 475. None of the returns filed for Years 2-5 attached a statement electing out of the mark to market exception for customer paper or negligible sales.

On Date 2, X filed an informal refund claim. The basis for the claim is a significant increase in the write downs to market for the Years 3-5.

LAW AND ANALYSIS

Section 475(a) generally requires a dealer in securities to account for its securities on a mark-to-market method of accounting. It provides that for any security which is not inventory in the hands of the dealer and which is held at the close of any taxable year, the dealer shall recognize gain or loss as if the security were sold for its fair market value on the last business day of the taxable year. Section 475(c)(1) defines a "dealer in securities" as a taxpayer who either: (1) regularly purchases securities from or sells securities to customers in the ordinary course of its trade or business; or (2) 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. Treas. Reg. § 1.475(c)-1(a) provides that whether a taxpayer is transacting business with customers is determined on the basis of all the facts and circumstances. Section 475(c)(2) defines the term security to include a note, bond, debenture, or other evidence of indebtedness.[1]

Assuming X is not subject to the exception of Treas. Reg. § 1.475(c)-1(b), discussed below, X qualifies as a dealer in securities under section 475. X regularly provides financing to either dealers for their entire floor plan of z or to customers who have purchased z from dealers.[2] X is transacting business with customers in the ordinary course of its business.

Treas. Reg. § 1.475(c)-(1)(b) generally excludes from the dealer definition a taxpayer who would not be a dealer in securities but for its purchase and sale of debt instruments that are customer paper. The regulations define a debt instrument as customer paper if:

> (1) the person's principal activity is selling nonfinancial goods or providing nonfinancial services;
>
> (2) the debt instrument was issued by a purchaser of goods or services at the time of the purchase of those goods or services in order to finance the purchase; and
>
> (3) at all times since the debt instrument was issued, it has been held either by the person selling those goods or services or by a member of the same consolidated group as that person.

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[1] Section 475(c)(4) was added for tax years ending on or after July 22, 1998, and it removes trade receivables from the definition of "security" for section 475 purposes.

[2] We are uncertain whether the purchaser of the z obtains financing directly from X or whether the dealer originally finances the purchase and then sells or assigns the loans to X.

Treas. Reg. § 1.475(c)-1(b)(2)(i),(ii), and(iii).

Under Treas. Reg. § 1.475(c) -1(b)(4)(i), a taxpayer may elect to waive the customer paper exception. The regulations provide that a taxpayer may file a statement, identifying itself by name and taxpayer number, stating that it is electing not to be governed by exception for sellers of nonfinancial goods and services for tax years ending on a certain date and for all subsequent years. The waiver may also be elected for a year ending on or before December 26, 1996, by attaching a statement to an amended return filed not later than October 31, 1997. See Rev. Rul. 97-39, Holding 13. An election under Treas. Reg. § 1.475(c)-1(b)(4)(i) also is deemed to be an election to waive the exemption from application of section 475(a) provided by Treas. Reg. § 1.475(c)-1(c) for taxpayers with negligible sales of securities. See Rev. Rul. 97-39, Holdings 17 and 18.

Rev. Proc. 97-43, 1997-2 C.B. 494, provides the procedures for a taxpayer to obtain the automatic consent of the Commissioner to change its method of accounting to reflect this application of section 475 as a result of making an election under Treas. Reg. § 1.475(c)-1(b)(4)(i).

The enabling statute of the Omnibus Reconciliation Act of 1993, section 13223(c)(2), provided for the automatic consent for a change in method of accounting for taxpayers who (1) became a dealer for the taxable year that includes Dec. 31, 1993, merely by virtue of the passage of the 1993 Act and (2) who accounted for securities as a dealer under section 475 on its original return for that year. Consent for any other changes of method to comply with section 475 must be obtained either on a taxpayer-by-taxpayer basis or as part of an automatic consent contained in published guidance. See Rev. Rul. 97-39, Holding 19.

The incoming request assumed that all of the receivables were customer paper and thus the customer paper exception in Treas. Reg. § 1.475(c) -1(b) would apply. We believe, however, the primary issue is whether in fact all of the receivables meet the definition of customer paper. Customer paper as defined in the regulations requires that X's principal activity be selling or providing nonfinancial goods or services. X is in the business of providing financial services (loans/financing) for the purchase of z. The wholesale installment receivables are more likely to be customer paper than the retail installment receivables because of the nature of the transaction. X provides the financing for the purchase of dealers' entire floor plans. X is a subsidiary of Y. Y is the manufacturer of the z. If the dealers purchase their floor plans from Y, X's principal activity can be deemed to be providing nonfinancial goods because X and Y are related parties. Thus X meets the first requirement for customer paper. X also meets the second requirement since the financing was issued to purchase the automobile floor plans. The third requirement is that the debt instrument was held at all times since it was issued by X or a member of the same consolidated group. If that requirement is met, then the wholesale

installment receivables are customer paper. Further factual development will determine whether X meets this requirement.

The retail installment receivables do not appear to be X's customer paper. X provides loans to purchasers of z. Unlike the wholesale receivables, the z can not be deemed purchased from X since the customer directly purchased the z from dealers. Therefore, the retail installment receivables apparently are not customer paper and are securities subject to section 475.

Section 475(b)(1)(A),(B), and (C) provide that the mark-to-market requirement of section 475(a) does not apply to: (1) any security held for investment; (2) certain securities that are not held for sale; and (3) any security that is a hedge of an item that is not subject to the mark-to-market rules. Further, under section 475(b)(2), a security is not treated as described in section 475(b)(1)(A), (B), or (C) unless it is clearly identified in the dealer's records as being described in such subparagraph before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe). An exception to this same day identification rule is contained in Holding 15 of Rev. Proc. 97-39.

Assuming not all of the receivables at issue are customer paper, the exception of Treas. Reg. § 1.475(c) -1(b) would not be available to X. Once a taxpayer is determined to be a dealer in securities, section 475 (a) requires that all securities must be marked to market, unless they had specifically been identified as not subject to section 475(a) under section 475(b). X had identified under section 475(b)(2) all of its securities on its Date 1 security identification except for the receivables at issue. Therefore, X is subject to section 475 without having to elect out of the customer paper exception.

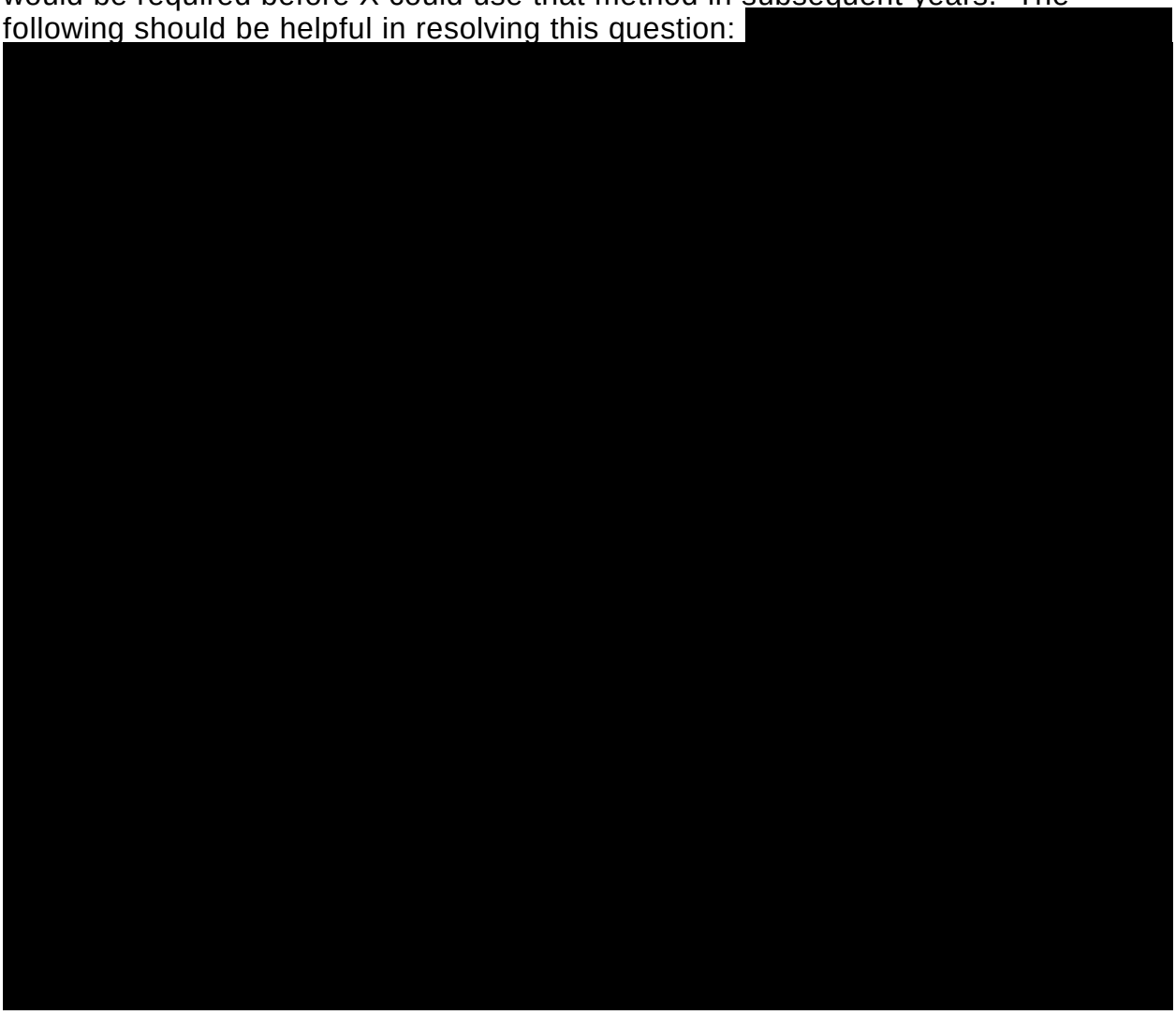
It is not clear whether X applied the section 475 mark-to-market method for Year 2. The Service has taken the position that if a taxpayer did not change its method to mark-to-market for the 1993 year under the automatic consent provided by the statute, any later changes would require the Commissioner's consent or be subject to other automatic consent requirements contained in published guidance. See Rev. Rul. 97-39 at 66, Holdings 19 and 20. If X did not apply the mark-to-market method for Year 2, it must obtain the Commissioner's consent before it can change to that method in later years. It is our understanding that no Form 3115 was filed for later years.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

This case needs additional factual development. We recommend that you confirm whether the wholesale installment receivables are solely for the financing of dealer floor plans and whether the dealers purchased the z from Y for those receivables. If the z are not purchased from Y, these receivables can not be customer paper. In

addition, you need to confirm that these receivables have been held by X at all times since their issuance. Our conclusion that X is a dealer under section 475 would not change if the wholesale installment receivables are not customer paper; X would still be buying securities under section 475. However, it could be important to know whether the customer paper requirements are met if the retail installments receivables are not as described. If further factual development established that the retail receivables were customer paper, then X might hold only customer paper, and X would have had to properly elect out of the customer paper exception before it could use the mark-to -market method of section 475. However, we do not believe that to be the situation based upon our discussions with you.

In addition, you should clarify whether X did use the mark-to-market method for Year 2. If so, automatic consent would be granted for Year 2 and subsequent years. If X did not use the mark-to-market method, the Commissioner's consent would be required before X could use that method in subsequent years. The following should be helpful in resolving this question:



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Please call if you have any further questions.

By: CAROL P. NACHMAN
Special Counsel
Financial Institutions & Products Branch

CC: