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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR EDWARD F. PEDUZZI, JR.
Associate District Counsel CC:NER:PEN:PIT

FROM: DEBORAH A. BUTLER
Assistant Chief Counsel CC:DOM:FS

SUBJECT: I.R.C. § 475 Election out of Customer Paper Exception

This Field Service Advice responds to your memorandum dated September 22, 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

taxpayer =
A =
B =
C =

D =
E =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =

Date 10 =
Date 11 =

Year 1 =
Year 2 =

ISSUES

1. Whether the taxpayer is precluded from electing dealer status pursuant to I.R.C. § 475 and regulations thereunder during the pendency of the merger agreements because of language in the Restated Agreement and Plan of Merger?

2. Does the language in the Restated Agreement and Plan of Merger cause all or certain transition securities to be identified pursuant to Holding 15, thus precluding the taxpayer from marking to market those identified securities?

CONCLUSIONS

1. The language in the Restated Agreement and Plan of Merger does not preclude the taxpayer from electing dealer status pursuant to Treas. Reg. § 1.475(c)-1(b)(4).

2. The language in the Restated Agreement and Plan of Merger does not cause any transition securities to be treated as identified as held for investment. Thus, the taxpayer is not precluded from marking to market certain transition securities.

FACTS

On Date 4, A and its newly-formed subsidiary, B, and C the taxpayer, entered into an Agreement and Plan of Merger (“Agreement”). On Date 6, A and the taxpayer entered into a Restated Agreement and Plan of Merger (“Restated Agreement”). Pursuant to the terms of the Restated Agreement, B was merged with and into the taxpayer by an exchange of the taxpayer’s stock for the stock in A. The merger was effective as of the close of business on Date 7. Both the taxpayer and A are under audit by two different audit teams for the pre-merger years. The tax years at issue are those that include the terms of the merger agreements, that is, Year 1 and the short taxable year ending on Date 7.

Section 5.01(b) of the Restated Agreement reads in part as follows:

> the Company [the taxpayer] will not, and will not permit any of its Subsidiaries to, merge, consolidate or enter into a share exchange with any other person or acquire any

> stock or any material amount of assets of any other Person, to sell, lease, license, mortgage, pledge or otherwise dispose of any material assets or property except (i) pursuant to existing contracts or commitments, (ii) in the ordinary course consistent with past practice, (iii) transfers between the Company [the taxpayer] and/ or its wholly-owned Subsidiaries, or (iv) such actions as may be necessary in order to consummate the transactions contemplated by this Agreement. . . .

Section 5.01(e) of the Restated Agreement reads in part as follows:

> except as otherwise expressly permitted hereby, the Company [taxpayer] will not and will not permit any of its Subsidiaries to make any commitment or enter into any contract or agreement material to the Company [the taxpayer] and its Subsidiaries taken as a whole except in the ordinary course of business consistent with past practice and shall consult with [A] before making or committing to make any capital expenditure of $100,000 or more.

Section 6.01(c) of the Restated Agreement reads in part as follows:

> [A] will not, and will not permit any of its Subsidiaries to sell, lease, license, mortgage, pledge or otherwise dispose of any material assets or property except (i) pursuant to existing contracts or commitments, (ii) in the ordinary course consistent with past practice, (iii) transfers between [A] and / or its wholly-owned Subsidiaries or (iv) such actions as may be necessary in order to consummate the transactions contemplated by this Agreement. . . .

The taxpayer is a seller of nonfinancial goods, and it is our understanding that the taxpayer originated accounts receivable from its customers in the ordinary course of its trade or business.

Examination has asked whether the language of Article 5 of the Agreement prevented the taxpayer from selling its accounts receivable during the pendency of the Agreement, that is, from Date 4, through the end of the short taxable year on Date 7, and whether this would prevent its marking to market its customer paper.

The language of Article 5 of the Agreement dated Date 4, is nearly identical to the language of Section 5 of the Restated Agreement; therefore, we shall consider the language of only the Restated Agreement for convenience.

In the taxpayer's Board of Directors Meeting minutes dated Date 2, at page 5, any two officers are authorized to "discount with the same [pre-approved] bank any bills or notes receivable held by this Corporation [the taxpayer] upon such terms as they may deem proper, with full authority to endorse the same in the name of this Corporation [the taxpayer]." We have presumed that the acts undertaken by the taxpayer's Board of Directors were valid and were not revoked or superseded until the taxpayer and A merged.

Also in the Board of Directors Meeting minutes, at page 7, the taxpayer's Chief Executive Officer is authorized, directly or by delegation, to dispose of property of the corporation with a value of up to $D for each item and up to $E in the aggregate without further action by the Board or any committee of the Board.

Accounts receivable represented a large percentage of both the taxpayer's and A's assets. We understand that the taxpayer did not sell its accounts receivable, but one small subsidiary of the taxpayer had sold a small amount of its accounts receivable. The taxpayer represented in a Memorandum dated Date 11, at 3-4 ("Memorandum") the following:

> a sale or factoring of its accounts receivables by the taxpayer would clearly have been "in the ordinary course of business." In addition, any sale or factoring of the taxpayer's accounts receivable would have been consistent with the taxpayer's overall method of accounts receivable collection. In that regard, a sale or factoring of accounts receivable merely accelerated the collection of cash. This would be consistent with past practice in that the taxpayer collects cash from its accounts receivables. This is true whether the taxpayer would have waited to collect its cash until the customer paid, or it decided to accelerate the process by selling or factoring the accounts receivables before the customer paid. More importantly, [the taxpayer]'s current or prior business practices is not a proper area of inquiry for the Revenue Agent.

It is our understanding that the taxpayer believes that A would have approved of the taxpayer's selling its accounts receivable during the time period at issue.

In Date 8 and Date 9, the taxpayer filed a claim for a refund by filing Amended Forms 1120X for its tax years ended Date 1, Date 3, and Date 5, and also for its short taxable year ended Date 7. In the refund claim for its tax year ended Date 1, the taxpayer elected out of the customer paper exception pursuant to Treas. Reg. § 1.475(c)-1(b)(3)(ii) and elected mark-to-market accounting for certain of its accounts receivable for 1993 and subsequent tax years.

The taxpayer filed a Form 3115, Application for Change in Accounting Method, for its tax year ended Date 1, dated Date 10. On an Attachment to the taxpayer's Form 3115, the taxpayer stated the following:

> According to Regulation Section 1.475(c)-1(b)(4), the election not to be governed by the exception for sellers of nonfinancial goods and services is a separate member (taxpayer) election. In accordance with Rev. Proc. 97-43, §4.02 and Reg. §1.475(c)-1(b)(4), the taxpayer hereby elects that it not be governed by §1.475(c)-1(b)(1) of the income tax regulations for the taxable year ending 1-2-94 and for subsequent taxable years.

The taxpayer stated in the Attachment to the Form 3115 that it had placed in its books and records a statement pursuant to Holding 15 of Rev. Rul. 97-39, 1997-2 C.B. 62, 65, serving to resolve any ambiguities existing with respect to its marking to market of its securities pursuant to § 475(a). The taxpayer stated the following:

> for securities in the nature of accounts receivable that were generated from the sale of goods or services to customers for periods prior to [Date 10], information contained in the company's books and records and entered substantially contemporaneously with the date of acquisition of securities in the nature of accounts receivable in no way supports a conclusion that such securities were intended to be or were in fact identified as being described by section 475(b)(1)(A), (B) or (C). To the contrary, such books and records support a conclusion . . . that mark-to-market accounting is required for such securities.

On the Attachment to the Form 3115, the taxpayer stated that, on Schedule A attached to the Form 3115, the taxpayer retroactively identified certain securities that it did not hold for sale to customers and which were transition securities subject to identification under Holding 15. These securities were intercompany accounts that the taxpayer believed would be paid.

We understand that the taxpayer identified the specific accounts receivable that it marked to market for its Year 1 and Year 2 tax years by account number in a market value analysis performed by its accountants, and this analysis constituted a part of the taxpayer's books and records. We do not know when the taxpayer acquired these accounts receivable or when the taxpayer performed this identification.

It is our understanding that A also elected out of the customer paper exception and elected to be treated as a dealer in securities for the tax year ended Date 5, and for all subsequent years.

LAW AND ANALYSIS

Issue 1

Generally, certain taxpayers are required to annually mark to market certain securities, that is, recognize any gain or loss as if such securities were sold for fair market value on the last business day of the taxable year, pursuant to I.R.C. § 475. A dealer in securities is required to mark to market a security which is not inventory in its hands pursuant to § 475(a)(2). A dealer in securities is defined in § 475(c)(1) as a taxpayer who either regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or 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. For purposes of § 475, the definition of a security includes a note, bond, debenture, or other evidence of indebtedness. I.R.C. § 475(c)(2)(C).[1]

A dealer in securities must mark to market all securities unless the security (1) is held for investment, or the security is a hedge with respect to a position that is not marked to market, and (2) meets an identification requirement. I.R.C. § 475(b)(1) and (2).

The regulations under § 475 limit the definition of a dealer in securities for sellers of nonfinancial goods or services. If a taxpayer would not be considered a dealer in securities for purposes of § 475 but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper of the taxpayer, then the taxpayer is not a dealer in securities. Treas. Reg. § 1.475(c)-1(b)(1). One exception to this rule is for a taxpayer who is subject to an election under Treas.

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[1] Nonfinancial customer paper is no longer included within the definition of a security under § 475(c)(2)(C), and a dealer in securities can no longer mark to market its nonfinancial customer paper because of the enactment of § 475(c)(4)(A) by Pub. L. No. 105-206, § 7003(a) (1998), effective for tax years ending after July 22, 1998.

Reg. § 1.475(c)-1(b)(4) not to be governed by this exception, pursuant to Treas. Reg. § 1.475(c)-1(b)(3)(ii). The election out of the exception for sellers of nonfinancial goods and services under Treas. Reg. § 1.475(c)-1(b)(4) must state the following:

> [the taxpayer] hereby elects not to be governed by § 1.475(c)-1(b)(1) of the income tax regulations for the taxable year ending [describe the last day of the year] and for subsequent taxable years.

Customer paper is defined as a debt instrument with respect to a person at a point in time if the person's principal activity is selling nonfinancial goods or providing nonfinancial services, if the debt instrument was issued by a purchaser of the goods or services at the time of the purchase to finance the purchase, and if the debt instrument has been held at all times since issuance by either the seller of the goods or services or by a corporation that is a member of the same consolidated group as the seller. Treas. Reg. § 1.475(c)-1(b)(2).

This taxpayer fits within the definition of a dealer in securities set forth in § 475(c)(1). The taxpayer regularly purchased securities (accounts receivable) from customers in the ordinary course of its trade or business. We presume that the taxpayer's debt instruments were issued to the taxpayer by the taxpayer's customers, and that the taxpayer has held the debt instruments at all times. It appears that the taxpayer held customer paper within the definition in Treas. Reg. § 1.475(c)-1(b)(2) when it purchased accounts receivable from its customers. Further, although the taxpayer falls within the exception, the taxpayer properly elected out of this exception from marking to market pursuant to Treas. Reg. § 1.475(c)-1(b)(4) in its Attachment to Form 3115. Because it is not required that the taxpayer sell its customer paper to be a dealer, any language in the Restated Agreement which may arguably preclude the taxpayer from selling its accounts receivable is irrelevant for the inquiry into whether this taxpayer is a dealer and properly elected out of the customer paper exception.

<u>Issue 2</u>

A taxpayer electing out of the exception from dealer status for customer paper under Treas. Reg. § 1.475(c)-1(b)(1) retroactively, for a date prior to the taxpayer's date of election, must identify its securities pursuant to a special identification regime set forth in Holding 15. Rev. Rul. 97-39, 1997-2 C.B. 62, 65. The special identification regime applies only to securities, called transition securities, for which identification would have been timely under the general rule set forth in § 475 and the regulations thereunder if the identification had been made on or before October

31, 1997. This special identification regime applies only to taxpayers electing out of either the customer paper exception pursuant to Treas. Reg. § 1.475(c)-1(b)(4), or the negligible sales exemption, and to taxpayers who were not treated as dealers in securities under Treas. Reg. § 1.475(c)-1T. This taxpayer elected out of the customer paper exception retroactively and held transition securities; therefore, Holding 15 applies to this taxpayer.

Holding 15 applies to securities for which an identification would have been timely under the general rule in Holding 14 only if made on or before October 31, 1997. The general rule in Holding 14 for identifying a security as excepted from mark-to-market accounting is that a taxpayer must timely identify the security as exempt pursuant to § 475(b)(2).

Under the special identification regime in Holding 15, a transition security will be considered to be properly identified as excepted from marking to market for purposes of § 475(b)(2) or (c)(2)(F)(iii) if:

> the information that is contained in the taxpayer's books and records and that was entered substantially contemporaneously with the date of acquisition of the transition security supports a conclusion that the transition security was described by section 475(b)(1)(A), (B) or (C) [securities identified as held for investment, generally not held for sale, or a security which is a hedge, and therefore, not marked to market]. This rule applies even if the information in the books and records does not meet the specificity that Holding 5 generally requires for identification. . . .
>
> The taxpayer must, by October 31, 1997, place in its books and records a statement resolving ambiguities, if any, concerning which transition securities are properly identified within the meaning of the preceding paragraph. Any information that supports treating a transition security as being described in § 475(b)(2) . . . must be applied consistently.

A taxpayer is not required to sell any of its accounts receivable to mark them to market pursuant to Holding 15.

Section 5.01(b) of the Restated Agreement provides that the taxpayer could not sell, lease, license, mortgage, pledge or otherwise dispose of any material assets or property except (among other exceptions) in the ordinary course consistent with past practice. The taxpayer's Board of Directors Meeting minutes dated Date 2, authorize any two of the taxpayer's officers to discount any bills or notes receivable held by this Corporation as described in the Minutes.

We understand that the taxpayer itself did not sell any of its accounts receivable; however, a subsidiary of this taxpayer previously sold a small amount of the subsidiary's accounts receivable. An officer of the taxpayer could have authorized a sale of its accounts receivable. We understand that A would not have disallowed a sale of the taxpayer's accounts receivable.

On its Schedule A attached to Form 3115, the taxpayer identified certain securities by general ledger and account number, all of which had a date of Date 10, as not held for sale to customers. The taxpayer stated that it "maintains information in its books and records that was entered contemporaneous with and prior to its acquisition of the security." These securities were almost entirely intercompany accounts which the taxpayer knew would be paid. It appears that the taxpayer resolved any ambiguity concerning whether the transition securities were properly identified under the special identification regime by placing a statement in its books and records stating that certain transition securities were identified as exempt under § 475(b)(1)(A) or (B), and, therefore, the taxpayer has met the identification requirements of Holding 15.

We have found no language in the Restated Agreement indicating that the taxpayer was precluded from selling its accounts receivable, or that a sale of the taxpayer's transition securities during the pendency of the Merger Agreement would have been inconsistent with the taxpayer's past practice and causing the taxpayer's transition securities to be treated as identified from marking to market pursuant to Holding 15.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

It is Service position that, under Holding 15, the taxpayer need not show that it had sold or held for sale its transition securities in order to mark to market the securities. Rather, the key to whether the taxpayer's accounts receivable may be marked to market is the taxpayer's entries in its books and records (e.g., account name), but not the taxpayer's actions or business practices. We have inquired into this taxpayer's actions or business practices, and have found no facts indicating that this taxpayer had a business practice or policy prohibiting the sale of its account receivables.

We did not review the taxpayer's identifications of its accounts receivable in its books and records, and have assumed the correctness of the identifications. We presume that the taxpayer's debt instruments were issued to the taxpayer by the taxpayer's customers, and that the taxpayer has held the debt instruments at all times. In addition, we have presumed that the taxpayer's Board of Directors Meeting minutes dated Date 2, were valid until the time of the merger of the two companies. If it is determined that the taxpayer failed to properly identify its securities, or that the accounts receivable do not fit within the definition of customer paper, please contact us for additional assistance. If you determine that the taxpayer had established a policy prohibiting the sale of its accounts receivable, and that the terms of the Board of Directors Meeting minutes were not valid, please contact us for additional assistance.

Holding 15 requires that the information that supports treating a transition security as being described in § 475(b)(2) or (c)(2)(F)(iii), identified as excepted from marking to market, must be applied consistently. We do not know whether the taxpayer treated the identified transition securities consistently. We recommend that you inquire into whether the taxpayer treated these accounts receivable consistently.

[redacted] In addition, taxpayers can no longer mark to market their accounts receivable because of the enactment of § 475(c)(4)(A) by Pub. L. No. 105-206, § 7003(a) (1998). Therefore, this issue is of diminishing administrative significance.

Please call if you have any further questions.

JOEL E. HELKE, Chief
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