Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: April 26, 2007

to: Associate Area Counsel LM:HMT
(Large & Mid-Size Business)
Attn:

from: Associate Chief Counsel
(Financial Institutions & Products)

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subject: – Section 475 Issues- Dealer Status & Indentification

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

LEGEND

Group A =

X =
Y =
Z =
Year 1 =
Year 2 =
Year 3 =
C =
D amount =
E amount =
F amount =

ISSUES

1. Whether the taxpayer, Group A, consisting of the parent holding company and its affiliates, are dealers in securities under section 475?

2. Whether Group A properly identified some of its securities as held for investment or not held for sale under section 475(b)(1)?

3. If the securities referenced in issue 2 above are not properly identified, what securities should be marked and what method should be used to value those securities?

4. Whether the sale of participation interests among the members of Group A prevent these securities from being subject to the exemption under section 475(b)(1) and subject to marking under section 475?

CONCLUSIONS

1. We agree with your conclusion that the members of Group A are dealers in securities under section 475.

2. We agree with your conclusion that taxpayer's section 475 identification statement in combination with its ledgers and software systems are sufficient for purposes of meeting the identification requirements of section 475(b)(2), and the exception to marking under section 475(b)(1) applies.

3. Because there is no improper identification, there is no need to determine which of the securities identified as held for investment or not held for sale should be marked and what valuation methodologies should be used.

4. The sale of participation interests among members of Group A (consolidated affiliates) does not invalidate the held for investment/not held for sale exception under section 475(b)(1). Because there was no intra-group election in effect, there were no sales to customers, and therefore, the securities remain exempt from marking under section 475.

FACTS

Dealer Status

During the tax year at issue, Year 3, Taxpayer, Group A, is a consolidated group. The relevant members of Group A for purposes of this request consist of the parent

holding company and the affiliated community banks.[1] Group A conducts the following banking activities: originating mortgage loans, participation in mortgage loans originated by other group members and renegotiating the terms of existing mortgage loans with borrowers resulting in a new debt instrument. Group A makes retail and commercial loans, including mortgage loans. Each bank holds its own inventory of loans. Each affiliate bank will close loans and put the loans into their inventory if a decision is made to hold the loans.

All of Group A's mortgage loans that are sold to the secondary market are closed in Y's name and transferred to X prior to sale outside of the affiliated group. X sold mortgage loans into the secondary market on an individual, whole loan basis. Not all of Group A's originated mortgage loans are sold into the secondary market. The decisions to hold or sell the loans were made at the time the mortgage loans were approved. Taxpayer entered into forward sales of the loans (commitments) with Z in advance of origination of the loans. The commitments with Z were for sale of the entire interest in the individual loans subject to customers closing on the transactions. Taxpayer retains the servicing rights on the loans sold. Only mortgage loans are sold into the secondary market. All other types of loans are retained by the bank affiliates. During year 3, D amount of loans were sold to Z, E amount of loans were sold to other purchasers, and F amount was the aggregate principal amount of the loans sold in year 3.

Loan Participation Sales

The Group A members have an arrangement among themselves for both large mortgage loans and other large loans. In the case of a large loan, the originating bank sells a portion of the loan to other consolidated group members. Prior to the loan closing, the participation amounts are determined and the affiliates fund their respective share of the loan at the closing. The participations are sold at par, with the originating bank receiving a defined portion of the interest charged as compensation for servicing the loan. Taxpayer has not made an intra-group customer election pursuant to Treas. Reg. § 1.475(c)-1(a)(3)(iii).

Section 475 Identification Statement

During Year 3, Group A used C, a software system, to help manage its mortgage banking operations. The software system helps to manage the loan pipeline and warehouse inventory of loans held pending sale. This system interfaced with Z's loan underwriting software.

At the time the mortgage loan application is taken, the loan officer inputs the loan information into C software system. This information is then transmitted to Z's software

[1] According to the incoming facts, the consolidated group also consists of three other non-banking companies which offer insurance, trust and financial planning services to customers, and which are presumably not dealers in securities.

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system. The feedback from Z's software system goes directly to the loan officer, who prepares an internal pipeline registration form that goes to X's mortgage division. X then uses the information from the registration form to enter into a forward sale of the loan with the investor, typically Z.

X records all its mortgage loans in a single general ledger account. This general ledger account combines the held for sale and not held for sale loans into a single account. Taxpayer's C software system will produce various reports. One of the reports is "closed loans" and is used by X to identify its held for sale loans. Loans are tracked in C until the loans are sold. Loans that are not held for sale, but are held by the originating affiliate banks, are not tracked in the C software system once the loans have closed. According to the incoming facts, Exam has found that taxpayer can immediately identify which loans are held for sale and which are not held for sale by using its C software. Exam was also able to reconcile the closed loan pipeline reports for years 2 and 3 with the held for sale loans reported by X and reported in its Call Reports filed with the FDIC for those years.

In Year 1 Taxpayer had attached a section 475 identification statement with its return for Group A members. The blanket statement provided that in accordance with section 475(b)(2) all loans and securities are exempt from marking except for mortgage loans identified in its books as held for sale.

LAW AND ANALYSIS

This request raises several issues in regards to the application of section 475. To determine whether any of these loans have been properly marked, it must be determined whether each member of Group A is a dealer in securities. For any Group A member that is a dealer in securities, it must be determined whether or not the loans held by that member have been properly excepted from marking. If the loans are not excepted or if they have been improperly identified, then issues have been raised as to which securities must be marked and what are the proper valuation methodologies to be used.

Issue 1.- Dealer Status

To determine whether the members of Group A are dealers, we must look at the status of each member of Group A, the parent holding company and its banking affiliates separately since dealer status under section 475 is determined on an entity by entity basis.

Under section 475(c)(1)(A), a dealer in securities is defined as a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business. The term security includes a note, bond, debenture, or other evidence of indebtedness. Section 475(c)(2)(C). The purchase of securities from

customers includes the origination of loans to customers. Members of Group A originate loans with customers. One of the affiliates, X, also sells mortgage loans into the secondary market. Therefore, based upon section 475(c)(1) (A), all members of Group A qualify as dealers in securities, unless excepted under the negligible sales rules.

Next, it must be determined whether any of the members of Group A are subject to the negligible sales exception in the regulations. Treas. Reg. § 1.1475(c)-1(c)(2) provides that a taxpayer that regularly purchases securities from customers in the ordinary course of a trade or business (including regularly making loans to customers in the ordinary course of a trade or business of making loans) but engages in no more than negligible sales of the securities so acquired is not a dealer in securities within the meaning of section 475 (c)(1), unless the taxpayer elects to be so treated.

The regulations provide that a taxpayer engages in negligible sales of debt instruments that it regularly purchases from customers in the ordinary course of its business if certain quantitative tests are met. One of the tests requires that the taxpayer sells 60 or fewer debt instruments, regardless of how acquired. The second test is a percentage test, requiring that the total adjusted basis of the debt instruments that are sold be less than 5 percent of the total basis, immediately after acquisition of the debt instruments acquired in that year. See Treas. Reg. § 1.475(c)-1(c)(2)(i) and (ii).

In the case of a consolidated group that does not have an intra-group customer election in effect, such as Group A, there is a two part test that must be looked at to determine whether the negligible sales exception excludes the entire group or any of the affiliates from dealer status. Under Treas. Reg. § 1.475.(c)-1(c)(3)(ii) a taxpayer satisfies the negligible sales test if either of these two tests are met. Under one of the tests the consolidated group is tested as a whole, treating members of the group as if they were divisions of a single corporation, and taking into account all of the taxpayer's sales of debt instruments. See § 1.475(c)-1(c)(3)(ii)(B). In this case, if Group A is treated as a single entity, the negligible sales test is not met because according to the incoming facts, more than 60 debt instruments are sold during the year by X and also by other members of Group A, and more than 5 percent of the total basis of acquired loans is sold during the year.

Because the consolidated group did not meet the negligible sales test as a single entity, we must also now look at each member of Group A separately to determine whether any of the members could qualify for the negligible sales test. In this test, all sales of debt instruments to other group members are taken into account. See Treas. Reg. § 1.475(c)-1(c)(3)(ii)(A). According to the facts provided in the incoming request, none of the members of Group A would qualify for this exception since each sold more than 60 loans, including loans sold among the other members of the consolidated group, and these loans exceeded 5 percent of the total basis of loans acquired or originated. Based upon the facts provided, Group A members engaged in the banking business are all dealers in securities under section 475.

Issue 2- Section 475 Identification Statement

Section 475(b)(1) provides that certain securities shall not be subject to marking under section 475 if they have been properly identified as held for investment, not held for sale or as hedges. Section 475(b)(2) provides that to be properly identified as such, the securities must be clearly identified in the dealer's records as falling within subparagraph (A),(B) or (C) of section 475(b)(1) by the close of the day it was acquired, originated or entered into (or such other time as set forth in regulations). Dealer's records are not specifically defined by the statute or regulations under section 475. Rev. Rul. 97-39, Issue 6, 1997-2 C.B. 63, provides that a dealer may comply with the identification requirements under section 475 using any reasonable method. The revenue ruling also provides some further guidance as to what is considered reasonable and it clearly indicates that the identification must be made on and retained as part of the dealer's books and records. The identification must clearly indicate the specific security, or accounts that contain specific securities covered by a particular exception, and that the identification is being made for section 475 purposes. The ruling also provides that blanket statements covering all securities as exempt, unless specifically identified as not exempt, are also acceptable.

In this case, Taxpayer had filed with its year 1 tax return, a blanket identification statement for all of Group A members. The statement provided that all loans are exempt under section 475(b)(1) other than mortgage loans designated in the taxpayers books as "RE loans-held for sale."

This statement is clear that the identification is being made for purposes of section 475 (b)(1). A question has arisen as to how these held for sale loans are identified in taxpayer's books and records. There is no account that is specific to or called "Re loans-held for sale" in taxpayer's general ledger.

Group A uses a combination of a software program know as the C software system and a general ledger account to keep track of its loans. Taxpayer records all its mortgage loans (held for sale and not held for sale) in one general ledger account. According to the facts provided, taxpayer can immediately identify which loans are held for sale and which are not held for sale by using its C software system and generating certain reports that produce numbers for sub-accounts not contained on the general ledger. According to the incoming facts, Exam was able to verify that reports generated from the C software system reconciled with the loans reported as held for sale as reported to the federal and state regulators. A question has arisen as to whether the identification statement is proper if taxpayer does not maintain two separate accounts on its general ledger.

We agree with your conclusion that the taxpayer has identified which loans are held for sale for year 3 and that the method used to identify those loans was reasonable. As noted above, neither the statute nor the regulations define what is

considered to be a dealer's books and records for purposes of section 475. The fact that the securities not held for sale could not be distinguished from the loans held for sale by looking only at the general ledger is not fatal. The taxpayer has an additional system it uses for its records, a software system that produces reports and sub-accounts that do identify the two classes of loans reported in the general ledger account. The use of this system falls within dealer's books and records. The only published guidance discussing what particular method is to be used in identifying securities exempt from section 475, provides only that the method be reasonable. This method seems reasonable. Therefore, there is no improper identification, and those securities identified as not held for sale are excepted from marking under section 475.

Issue 3- If an Improper Identification Exists - What Securities are Marked and What are Appropriate Valuation Methods

Since we determined in issue 2 above that the identification requirements for the exception for held for investment/not held for sale were met, and those securities so identified are exempt from marking, there is no need to discuss which of these securities should be marked under section 475 and what valuation methodologies are appropriate for those securities. In determining that there was not an improper identification, we have also taken into consideration the loan participation sales which are discussed in issue 4 below.

Issue 4- Sale of Loan Participations among Affiliates in a Consolidated Group

According to the incoming facts, the members of Group A have an arrangement among themselves for both large mortgage loans and other types of loans. The originating bank of a large loan sells a portion of the loan to other affiliated group members. Prior to the loan closing, the participation amounts are determined and the affiliates fund their respective shares of the loan at closing. The participations are sold at par, with the originating bank receiving a defined portion of the interest charges as compensation for servicing the loan. A question has arisen as to whether the sale of these loan participations among the affiliated group removes these securities from the held for investment exemption and subjects them to marking under section 475.

The regulations under § 1.475(b)-1(a) provide that a security meets the exemption from marking if it is held for investment or not held for sale. The regulations provide that a security qualifies for this exemption if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business. In these transactions, the loan participations are securities under section 475. The questions arise as to whether these securities were primarily held for sale to customers in the ordinary course of the taxpayer's trade or business. In this case the real question arises as to whether the loan participations were sold to customers. The loan participations were sold to members of the consolidated group, the bank affiliates. Whether a dealer is transacting business with customers is determined on the basis of all the facts and circumstances. See Section 1.475(c)-1(a). Solely for purposes of

section 475(c)(1) (concerning the definition of a dealer in securities) and except as provided in section 1.475(c)-(1)(a)(3)(iii) (the intra-group election), a taxpayer's transactions with other members of its consolidated group are not with customers. Treas. Reg. § 1.475(c)-1(a)(3)(ii). In this case, no intra-group customer election was made. Therefore, the sale of loan participations among members of Group A are not sales to customers. We agree with your conclusion that the sale of loan participations to other members of Group A does not take them out of the held for investment/not held for sale exception of section 475(b)(1) and they are not subject to marking under section 475.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The incoming facts did mention that occasionally some loan participations are sold outside the consolidated group and the terms of those transactions are slightly different from the terms of the intra-group sales. There was no mention as to whether these loans were marked to market. These loans are not covered by the analysis discussed in issue 4 relating to sales of loans among the consolidated group. The incoming request did not raise any issues to these loans.

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 at if you have any further questions.

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