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Section 475 mark to market

Tax essentials for the banking industry

Under section 475, Congress enacted rules that require dealers in securities to apply mark-to-market (MTM)accounting to their securities portfolio.[1] In many cases, a traditional lender qualifies as a dealer in securities, and the lender's loans will meet the definition of a security. Therefore, the lender may be required to carry its loan portfolio, as well as its other securities portfolios, at fair market value in its tax books. While this concept seems relatively straightforward, the application of the rules to banks continues to raise challenges for tax departments. The purpose of this article is to provide an introduction to the rules under section 475 and how those rules apply to banks. It will also address certain elections under section 475 that banks may consider to achieve their desired tax objectives.

Definition of dealer in securities

General rule

In general, a taxpayer is considered a dealer in securities if it (A) regularly purchases securities from *or* sells securities to customers in the ordinary course of its 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 its trade or business.[2]

Under section 475(c)(2), a security is defined as (1) stock in a corporation; (2) a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (3) a note, bond, debenture, or other evidence of indebtedness; (4) an interest rate, currency, or equity notional principal contract; (5) evidence of an interest in, or a derivative financial instrument in, any of the securities listed in 1–4 above, or in any currency;[3] and (6) a position that is not listed in 1–5 above as a security, but is a timely identified hedge with respect to such a security.[4] Of relevance for this discussion, the loan products regularly offered to a bank's customers (e.g., mortgage loans, HELOCs, commercial loans) qualify as securities under item 3 above, and for purposes of section 475, "buying" securities also includes originating loans.[5] Therefore, to the extent a bank regularly originates loan products to customers, the bank qualifies under the statutory definition of a dealer in securities. However, as discussed below, the bank must still consider whether it qualifies under the negligible sales exception provided in the Regulations under section 475.

[1] Unless otherwise stated, any "section" reference herein is to the Internal Revenue Code of 1986, as amended (the "Code"), or to the Treasury regulations (the "Regulations") promulgated thereunder.

[2] I.R.C. § 475(c)(1). The first definition generally applies to dealers in cash securities (e.g., loans, bonds, stock) and the second definition applies to dealers in derivatives that reference securities.

[3] However, section 1256 contracts are excluded from this category, even if the section 1256 contract references a security. A detailed discussion of the rules under section 1256 is outside the scope of this article.

[4] Section 1.475(c)-2 provides a list of items that do not qualify as securities, including debt issued by the taxpayer (i.e., a borrowing), REMIC residual interests, and a security if section 1032 prevents the taxpayer from recognizing gain or loss with respect to that security.

Negligible sales exception

Under the negligible sales exception, a taxpayer does not qualify as a dealer in securities if it regularly purchases debt securities from customers in the ordinary course of a trade or business (including regularly making loans to customers) but engages in no more than negligible sales of the securities so acquired.[6] A taxpayer engages in negligible sales of debt securities if during the tax year: (i) it sells all or part of fewer than 60 debt instruments, or (ii) the total adjusted basis of the debt instruments that the taxpayer sells is less than 5 percent of the total basis, immediately after acquisition, of the debt instruments that it acquires in that year.[7]

The regulations provide specific rules for taxpayers that are members of a consolidated group as well as requires certain sales to be excluded from these tests.[8] However, if a taxpayer that qualifies under the negligible sales exception still wishes to MTM its securities, it can elect out of the negligible sales exception.[9] Revenue Ruling 97–39 provides specific procedures to make an election out of the negligible sales exception.[10]

Many banks may struggle to qualify under the negligible sales exception given that mortgage lenders frequently sell originated mortgage loans to one of the government-sponsored entities (Fannie Mae, Freddie Mac, Ginnie Mae) or another financial institution that will securitize the loans. For a bank that does qualify under the negligible sales exception, the bank may consider electing out of the negligible sales exception to the extent MTM tax accounting aligns with the bank's tax objectives.

Mark to market—Timing and character

General rule

For any security that is held in inventory, the MTM rules require that the security be included in inventory at its fair market value.[11] For noninventory securities, the dealer recognizes gain or loss as if the security was sold for its fair market value on the last business day of the taxable year.[12] Generally, the MTM rules require gains or losses to be characterized as ordinary gains or losses.[13]

This treatment is in stark contrast to securities to which the MTM rules do not apply. Without the application of the MTM rules, unrealized gain or loss on securities are generally deferred until a realization event occurs. Furthermore, the character of the gain or loss on a disposition of a security to which the MTM rules do not apply defaults to general tax principles. This may result in capital gains and losses on the sale of securities to which the MTM rules do not apply.[14] Capital losses have certain limitations on their use, depending on the taxpayer.

Section 475(b) identification

Under section 475(b), dealers in securities may exempt certain securities from the MTM rules. More specifically, section 475(b)(1) provides that the following three categories of securities are not required to be marked to market by a dealer: (1) a security that is held for investment; (2) a debt security acquired (including originated) by the taxpayer in the ordinary

[5] *See e.g.,* Rev. Rul. 97-39, 1997-2 C.B. 62 ("A bank or an insurance company is subject to the mark-to-market rules if its activities bring it within the definition of a dealer in securities in [section] 475(c)(1). For example, many banks are dealers because they regularly originate and sell loans.").

[6] Reg. § 1.475(c)-1(c)(1). If the taxpayer meets the definition of a dealer in securities through other activity (e.g., entering into derivative contracts with customers), the taxpayer would qualify as a dealer in securities even if its lending activity satisfies the requirements to apply the negligible sales exception.

[7] Reg. § 1.475(c)-1(c)(2).

[8] *See* Reg. § 1.475(c)-1(c)(3). Under section 1.475(c)-1(c)(4), the following sales are excluded from the calculation: (1) sales of securities that are necessitated by exceptional circumstances and that are not undertaken as recurring business activities; (2) sales of debt instruments that decline in quality while in the taxpayer's hands and that are sold pursuant to an established policy of the taxpayer to dispose of debt instruments below a certain quality; and, (3) acquisitions and sales of debt instruments that are qualitatively different from all debt instruments that the taxpayer purchases from customers in the ordinary course of its business.

[9] Reg. § 1.475(c)-1(c)(1)(ii).

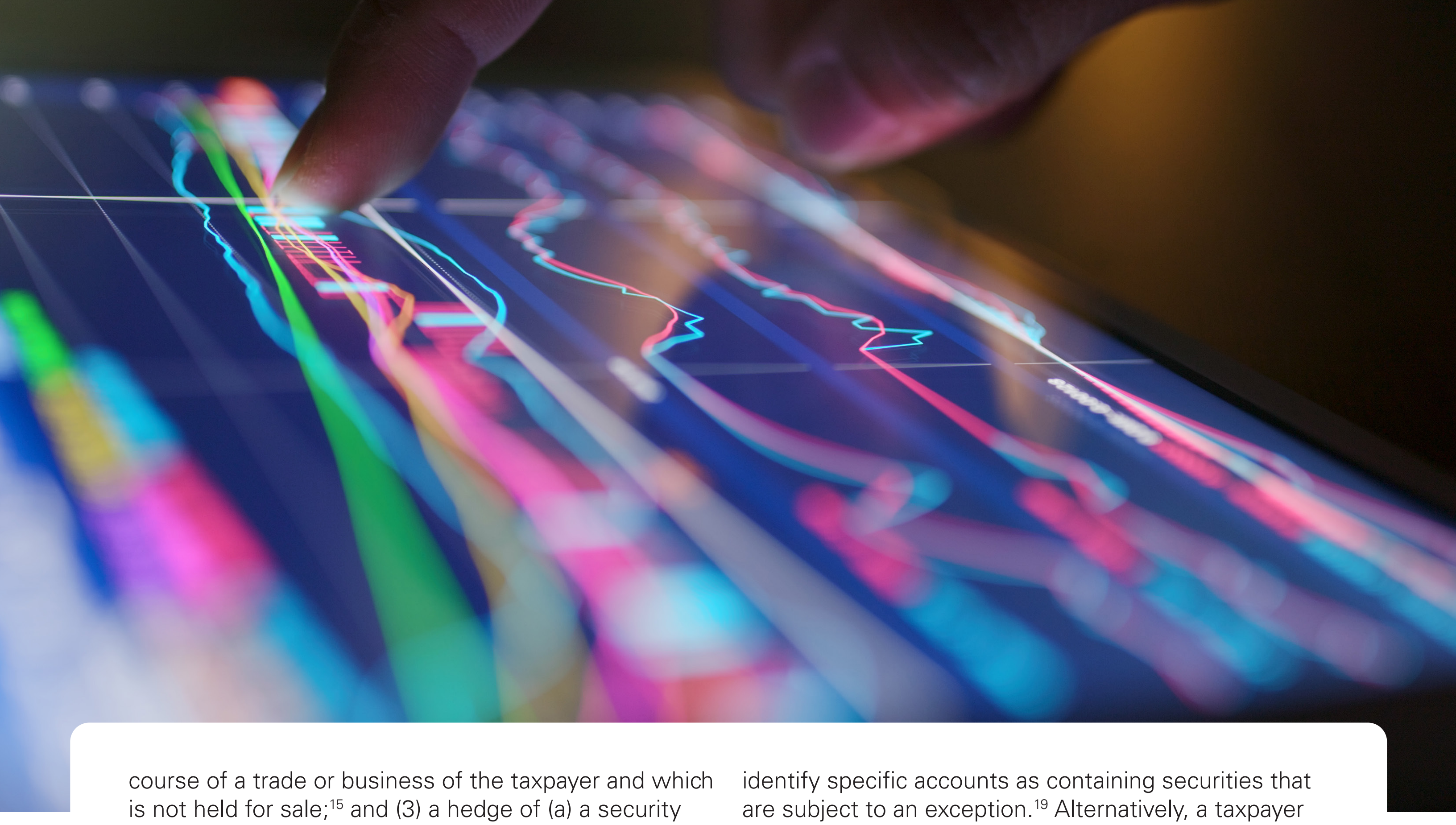
[10] 1997-2 C.B. 62.

[11] I.R.C. § 475(a)(1).

[12] I.R.C. § 475(a)(2). Adjustments are made to the amount of any gain or loss subsequently realized for gain or loss taken into account through the MTM adjustment at the end of the prior year(s).

[13] I.R.C. § 475(d)(3). Section 475(d)(3)(B) provides certain exceptions to the ordinary character rule, including (i) securities that hedge items that are not subject to MTM; (ii) securities held by a taxpayer other than in connection with its activities as a dealer in securities; (iii) a nonsecurity that is a hedge of a security but not properly identified under section 475(c)(2)(F)(iii); and (iv) a security identified under section 475(b)(2) but does not qualify under any of the categories described in section 475(b)(1).

[14] For banks, gain or loss upon the disposition of a debt security would generally be ordinary under section 582(c). In addition, debt securities may be ordinary assets for nonbank lenders under section 1221(a)(4). See Burbank Liquidating Corp. v. Commissioner, 39 T.C. 999 (1963), *aff'd in part, rev'd in part*, 335 F.2d 125 (9th Cir. 1964).



course of a trade or business of the taxpayer and which is not held for sale;[15] and (3) a hedge of (a) a security that is not subject to the MTM rules (e.g., a security identified under category 1 or 2 above) or (b) a hedge of a nonsecurity (e.g., a borrowing).

However, in order to be exempt from the MTM rules under section 475(b), the security must also be clearly identified in the dealer's books and records as qualifying under one of the three categories discussed above.[16] For most dealers, the identification must be made before the day on which the security is acquired, originated, or entered into. However, banks have 30 calendar days after the date of origination or acquisition to identify debt securities.[17]

The IRS has provided some flexibility with respect to how dealers can satisfy the identification requirements. A taxpayer can use any reasonable method as long as the identification is retained in the taxpayer's books and records and the identification indicates that it is being made for purposes of section 475.[18] A designation for financial accounting purposes is not adequate. One approach provided by the IRS is to identify specific accounts as containing securities that are subject to an exception.[19] Alternatively, a taxpayer can identify a specific account as not covered by an exception and identify all other securities or accounts as being covered by a particular exception.[20] While the IRS does provide flexibility with preparing the identification in the taxpayer's books and records, the rules unfortunately do not provide relief if the taxpayer fails to timely make the identification. Therefore, if a security is not timely identified, it must be marked to market.

For certain financial institutions, there may be questions with respect to whether the institution qualifies as a dealer in securities. In addition, a financial institution may not qualify as a dealer in securities today, but expects to qualify as a dealer in securities at a later date (e.g., will fail to qualify under the negligible sales exception at a later date). These institutions must still timely satisfy the identification requirements under section 475(b) if they do not want to MTM securities held at the time they become a dealer (i.e., identify a security under section 475(b) on the date it is acquired, originated, or entered into).[21]

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[15] An obligation to acquire a debt security that will not be held for sale can also be identified if the obligation is not held for sale.

[16] I.R.C. § 475(b)(2).

[17] Rev. Rul. 97-39, 1997-2 C.B. 62.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.* The revenue ruling provides that an identification of a security under section 475(b) does not result in the taxpayer becoming a dealer in securities or create an inference that the taxpayer is a dealer in securities.

Other considerations

Elective MTM provisions for commodities dealers and securities and commodities traders

Unlike securities dealers, commodities dealers are not required to MTM their commodities. However, commodities dealers can elect to apply the MTM rules.[22] When evaluating whether a taxpayer qualifies as a dealer in commodities, the taxpayer applies a test that is similar to the rules for determining whether a taxpayer is a dealer in securities.[23] Commodities are defined under section 475 as: (1) any commodity that is actively traded; (2) a notional principal contract related to any actively traded commodity; (3) evidence of interest in, or a derivative instrument in, any aforementioned commodities, including any option, forward contract, short position, and any similar instrument in such a commodity; and (4) a position that is not an aforementioned commodity, but is a timely identified hedge with respect to such a commodity.

Under section 475(f), traders in securities and commodities can also elect to apply the MTM rules. However, in order to make this election, the taxpayer must first apply existing case law and IRS guidance to determine whether it qualifies as a trader (as compared to an investor).

Revenue Procedure 99-17 provides specific procedures for commodities dealers, commodities traders, and securities traders that want to make an election to apply the MTM rules.[24]

Valuation

Section 475 does not provide guidance with respect to how a dealer or trader determines a security's fair market value. Consequently, the IRS and taxpayers previously spent considerable time focusing on the valuation of securities and commodities. In an attempt to reduce disagreements over valuation, the IRS issued regulations containing a valuation safe harbor for dealers subject to section 475.[25] Taxpayers that elect the safe harbor are generally permitted to use the fair market value recorded in their financial statements. The regulations provide a number of requirements that must be satisfied in order to apply the valuation safe harbor.

In order to address continuing challenges with valuing securities and commodities, in 2011 the IRS released an Industry Director Directive (IDD), which directed Large Business and International (LB&I) examiners not to challenge MTM valuations recorded on qualified financial statements.[26] The IDD defines qualified financial statements as those filed with the SEC. Upon examination, the taxpayer must also submit a "Certification Statement" that states (a) the financial statement valuations are consistent with section 475 values, (b) no adjustments were recorded for tax purposes, and (c) no deferred tax assets/liabilities or valuation allowances were reported regarding section 475 values. As evidenced by the IDD, the IRS has moved toward greater acceptance of financial statement valuations for purposes of applying section 475.

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[22] *See* I.R.C. § 475(e).
[23] Prop. Reg. § 1.475(e)-1.
[24] 1999-1 C.B. 503.
[25] Reg. § 1.475(a)-4.
[26] LB&I Control No: LB&I-4-1110-033, Field Directive related to Mark-to-Market Valuation, (Apr. 14, 2011).

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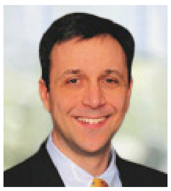

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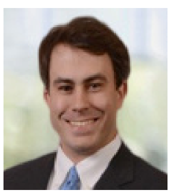

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