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## Section 475.—Mark-to-Market Accounting Method for Dealers in Securities

*26 CFR 1.475(b)-2: Exemptions—identification requirements. (Also §§ 446, 475, 7805; 1.446-1, 1.475(c)-1, 301.7805-1.)*

**Mark-to-market accounting method for dealers in securities.** This ruling provides guidance to enable taxpayers to comply with the mark-to-market requirements of section 475 of the Code. Rev. Ruls. 94-7 and 93-76 clarified, modified, partially obsoleted, and superseded.

### Rev. Rul. 97-39

#### PURPOSE

This revenue ruling provides guidance under § 475 of the Internal Revenue Code to enable taxpayers to comply with the mark-to-market requirements of § 475. Rev. Rul. 93-76, 1993-2 C.B. 235 (which was previously modified by Rev. Rul. 94-7, 1994-1 C.B. 151), is clarified, modified, partially obsoleted, and superseded.

#### LAW

Section 475 of the Code was enacted on August 10, 1993, in the Omnibus Budget Reconciliation Act of 1993 (the “1993 Act”), section 13223, 1993-3 C.B. 1, 69. It requires mark-to-market accounting treatment for certain securities

held by a “dealer in securities” as defined in § 475(c)(1). This requirement is effective for all taxable years ending on or after December 31, 1993. Section 475 was amended on August 5, 1997, in the Taxpayer Relief Act of 1997 (the “1997 Act”), section 1001(b) (redesignating old § 475(e) as § 475(g) and adding new § 475(e) and (f) to allow dealers in commodities and traders in securities and commodities to elect mark-to-market accounting, effective for taxable years ending after August 5, 1997). This revenue ruling is limited to issues arising under the 1993 Act and does not address issues arising under the 1997 Act.

Section 475(a) sets forth two mark-to-market rules. First, any security that is inventory in the hands of a dealer must be included in inventory at its fair market value. Second, any security that is not inventory in the hands of a dealer and that is held at the close of any taxable year is treated as sold by the dealer for its fair market value on the last business day of that taxable year, and any gain or loss is required to be taken into account for that taxable year.

Section 475(b)(1) provides that the mark-to-market rules do not apply to: (1) any security held for investment; (2) any evidence of indebtedness that is acquired (including originated), or any obligation to acquire an evidence of indebtedness that is entered into, by a dealer in the ordinary course of its trade or business, but only if the evidence of indebtedness or obligation to acquire an evidence of indebtedness is not held for sale; (3) any security that is a hedge with respect to a security that is not subject to the mark-to-market rules; and (4) any security that is a hedge of a position, right to income, or liability that is not a security in the hands of the taxpayer. Under § 475(b)(2), a security must be clearly identified in the dealer’s records as being covered by one of the exceptions described in § 475(b)(1) before the close of the day on which the dealer acquired, originated, or entered into the security.

In addition to the identification requirements in § 475(b), § 475(c)(2)(F)(iii) requires a dealer in securities to identify a position that is not a security described in § 475(c)(2)(A)–(E), but that is treated as a

security because it is a hedge with respect to such a security.

#### ISSUES AND HOLDINGS

**Issue 1:** If a taxpayer is not otherwise a dealer in securities within the meaning of § 475(c)(1) but, nevertheless, timely identifies all of its securities as being covered by one of the exceptions in § 475(b)(1), does that “protective identification” cause the taxpayer to be treated as a dealer?

**Holding 1:** No. A taxpayer that is not a dealer in securities within the meaning of § 475(c)(1) does not become a dealer in securities or create an inference that it is a dealer in securities by making a protective identification of its securities.

**Issue 2:** Is a bank or an insurance company excepted from the mark-to-market rules on the grounds that it is, per se, not a dealer in securities within the meaning of § 475(c)(1)?

**Holding 2:** No. 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 § 475(c)(1). For example, many banks are dealers because they regularly originate and sell loans. As another example, an insurance company that regularly makes and sells policyholder loans is a dealer for purposes of § 475.

**Issue 3:** If a taxpayer’s sole business consists of trading in securities (that is, the taxpayer does not purchase from, sell to, or otherwise enter into transactions with customers), is the taxpayer a dealer in securities within the meaning of § 475(c)?

**Holding 3:** No. A taxpayer whose sole business consists of trading in securities is not a dealer in securities within the meaning of § 475(c) because that taxpayer does not purchase from, sell to, or enter into transactions with, customers in the ordinary course of a trade or business.

**Issue 4:** Does the classification of a security under financial accounting principles, including FASB Statement No. 115 (Accounting for Certain Investments in Debt and Equity Securities), determine whether the security qualifies for one of the exceptions to the mark-to-market rules under § 475(b)(1)?

**Holding 4:** No. The classification of a security under financial accounting

principles is not dispositive of the treatment of the security for federal income tax purposes. For example, for purposes of § 475, a security may in certain cases qualify for the held-for-investment exception to the mark-to-market rules even though, under applicable financial accounting principles, the security is classified as available for sale.

Issue 5: Does an identification of a security as “held for investment” under § 1236 serve to identify that security as “held for investment” (within the meaning of § 475(b)(1)(A)) or as “not held for sale” (within the meaning of § 475(b)(1)(B))?

Holding 5: No. Taxpayers may choose not to identify under § 475(b)(2) some or all of the securities that they identify under § 1236(a)(1). (For a transitional rule applicable to securities held as of the close of the last taxable year ending before December 31, 1993, however, see § 1.475(b)-4(a) of the Income Tax Regulations.) Accordingly, even if a § 1236 identification has been made, an identification of a security or hedge is a valid identification for purposes of § 475(b)(2) only if it contains a specific reference to § 475; this specific reference, however, may be effected by any reasonable method. For instance, certain accounts may be identified in such a way that placing a security or hedge in the account identifies the security or hedge for purposes of both § 1236(a)(1) and § 475(b)(1)(A), (B), or (C). See Holding 6 below. See Holding 15 below for a transitional rule that requires less specificity for identification of securities held by certain taxpayers that were not dealers in securities under § 1.475(c)-1T (as contained in 26 CFR part 1 revised April 1, 1996).

Issue 6: Is a dealer in securities required to use a special procedure to comply with the identification requirements under § 475?

Holding 6: No. Unless the Commissioner otherwise prescribes, a dealer may comply with the identification requirements under § 475 using any reasonable method (see, for example, guidance concerning identification requirements under §§ 988(a)(1)(B), 1221, 1236(a)(1), and 1256(e)(2)(C)). The identification, however, must be made on, and retained as part of, the dealer’s books and records.

The dealer’s books and records must clearly indicate the specific security or hedge being identified, and the identification must clearly indicate that it is being made for purposes of § 475. Alternatively, the dealer may identify specific accounts as containing only securities or hedges that are covered by a particular exception, so that placing a security or hedge in the account identifies the security or hedge as being covered by that exception. Under § 1.475(b)-2(a), an identification need not distinguish between an exception under § 475(b)(1)(A) (concerning certain securities held for investment) and one under § 475(b)(1)(B) (concerning securities not held for sale). Exceptions under either of these provisions, however, must be distinguished from exceptions under § 475(b)(1)(C) (concerning securities held as hedges).

In addition, rather than identifying specific securities or accounts as being covered by an exception described in § 475(b)(1), a dealer may comply with the identification requirement under § 475(b) by clearly indicating the specific securities or accounts that are not covered by a particular exception (that is, indicating that they are covered by some other exception or that they are not exempt) and identifying all other securities or accounts as being covered by a particular exception.

For example, a dealer may place on its books and records a statement that, unless otherwise identified, all of its securities for which an identification is still timely (including securities yet to be acquired) are identified as exempt under either § 475(b)(1)(A) or (B). This statement is effective to identify under § 475(b)(1)(A) or (B) each security covered by its terms unless, before the expiration of the period during which the security may be timely identified, the dealer identifies it as not exempt or as exempt under § 475(b)(1)(C).

Analogously, under Rev. Rul. 64-160, 1964-1 (Part I) C.B. 306, modified by Rev. Rul. 76-489, 1976-2 C.B. 250, dealers can identify specified accounts as containing only securities held for investment for purposes of § 1236(a)(1). Accordingly, dealers can satisfy the identification requirements of § 475(b)(2) by unambiguously indicating that all of the securities in one or more of these ac-

counts are also described, for example, in § 475(b)(1)(A) or (B). Once such an identification of an account is made, placing a security in the account identifies the security not only as being “held for investment” for purposes of § 1236 but also as being described in the applicable subparagraph of § 475(b)(1).

Issue 7 in Rev. Rul. 93-76 concerned transitional identification issues for securities acquired, originated, or entered into between August 10, 1993, and October 31, 1993. As the transition period has now ended, Issue 7 is obsolete and is not reprinted in this revenue ruling.

Issue 8: If a dealer in securities originates or acquires an evidence of indebtedness in the ordinary course of a trade or business, are there any exceptions to the requirement that the dealer make an identification under § 475(b)(2) before the close of the day on which it originates or acquires the security?

Holding 8: Yes. Pending further guidance, if a financial institution (as defined in § 265(b)(5)) originates or acquires an evidence of indebtedness in the ordinary course of a trade or business, an identification of the evidence of indebtedness is timely if it is made in accordance with the dealer’s accounting practice, but no later than 30 calendar days after the date of origination, or acquisition, by the financial institution. The preceding sentence applies to any dealer in securities for evidences of indebtedness that are mortgage loans.

Also, pending further guidance, a dealer in securities that enters into commitments to acquire mortgage loans may identify those commitments as being held for investment if the dealer acquires the mortgage loans and holds the mortgages as investments. This identification of commitments to acquire mortgage loans must be made in accordance with the dealer’s accounting practice, but no later than 30 calendar days after the date of acquisition of the mortgage loans.

Issues 9, 10, and 11 discussed transitional issues concerning proper identification, computation of adjustments, and the period over which to spread any adjustments, for taxable years that included December 31, 1993. As the transition period has now passed, Issues 9, 10, and 11 are obsolete and are not reprinted in this revenue ruling.

Issue 12: May a taxpayer use an amended return to make an election under § 1.475(c)–1(c)(1)(ii) (which concerns taxpayers that purchase securities from customers but make no more than negligible sales of securities)?

Holding 12: For any taxable year for which an original federal income tax return is filed after October 31, 1997, an election under § 1.475(c)–1(c)(1)(ii) must be made on an original federal income tax return that is filed on or before the due date (including any extensions of time) for that return. For any taxable year for which an original federal income tax return was filed on or before October 31, 1997, an election under § 1.475(c)–1(c)(1)(ii) also may be made on an amended return filed not later than October 31, 1997. Not later than December 15, 1997, compliance with § 475 must be reflected on an original or amended return for every other taxable year which is subject to the election and the original return for which is due on or before October 31, 1997. Note that amended returns must be filed before the expiration of the statute of limitations on assessment under § 6501(a).

As is noted in Holding 17 below, a taxpayer subject to more than one exemption must affirmatively elect out of all applicable exemptions to be treated as a dealer in securities.

Issue 13: If a taxpayer wishes to use an amended return to make an election out of the customer paper exemption under § 1.475(c)–1(b)(4)(i)(B), by what date must the taxpayer file the amended return?

Holding 13: Section 1.475(c)–1(b)(4)(i)(B) provides a June 23, 1997, deadline to make the customer paper election on an amended return. Notice 97–37, 1997–27 I.R.B. 8, provides that additional guidance will extend that deadline. Accordingly, that deadline to file an amended return is extended to October 31, 1997. Not later than December 15, 1997, compliance with § 475 must be reflected on an original or amended return for every other taxable year which is subject to the election and the original return for which is due on or before October 31, 1997. Note that amended returns must be filed before the expiration of the statute of limitations on assessment under § 6501(a).

Issue 14: What is the general rule for identifying a security as excepted from mark-to-market accounting?

Holding 14: For a security to be exempt from mark-to-market accounting, the taxpayer must make an identification that is timely under § 475(b)(2), which generally requires a security to be identified before the close of the day on which it is acquired. For the only current exceptions to this rule, see Holding 8 above (identifications of securities by financial institutions and dealers in mortgages), § 1.475(b)–1(b)(4)(ii)(A) (identification of securities to which § 1.475(b)–1(b)(1) ceases to apply), and Holding 15 below (special identification rules for taxpayers not treated as dealers under § 1.475(c)–1T). For information about the required specificity of the identification, see Holding 5 above.

Issue 15: If a taxpayer makes an election out of either § 1.475(c)–1(b)(1) (customer paper exemption) or § 1.475(c)–1(c)(1) (negligible sales exemption) and the election has the effect of causing the taxpayer to be treated as a dealer in securities for a taxable year starting before the date the taxpayer filed the documentation effecting the election (date of the election), how does the taxpayer identify securities that were acquired before the date of the election?

Holding 15: A special identification regime applies to taxpayers that satisfy the following criteria:

First, the taxpayer is making an election out of the customer paper exemption, the negligible sales exemption, or both.

Second, the taxpayer was not treated as a dealer in securities under § 1.475(c)–1T (as contained in 26 CFR part 1 revised April 1, 1996).

The special identification regime applies only to securities (“transition securities”) for which an identification would have been timely under the general rule (described in Holding 14 above) only if made on or before October 31, 1997. In applying the preceding sentence, a taxpayer may choose to substitute any earlier date that is on or after December 24, 1996. To make this substitution, the taxpayer must place in its books and records no later than October 31, 1997, an unambiguous statement that the taxpayer chooses to apply the general identification rule described in Holding 14 for all securities acquired on or after the specific date selected by the taxpayer.

Under the special identification regime, a transition security was properly identified as exempt for the 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 § 475(b)(1)(A), (B), or (C). 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 status of a transition security that was acquired before the first day of the taxable year for which the election is being made is determined by examining the books and records as of the last day of the preceding taxable year.

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) or (c)(2)(F)(iii) must be applied consistently.

A taxpayer, in determining whether a transition security must be identified, must apply the following principles: if the transition security was identified under § 1.1221–2 or § 1256(e) and the item being hedged is described in § 475(b)(1)(C)(i) or (ii), the § 1.1221–2 or § 1256(e) identification constitutes an identification for purposes of § 475(b)(2); and, if the item being hedged was ordinary property, as defined in § 1.1221–2, and the taxpayer did not identify the transition security as a hedging transaction, the transition security cannot be identified under § 475(b)(1)(C).

If a taxpayer made a protective identification (as described in Issue 1 above) of a transition security, and subsequent to the protective identification the taxpayer makes an election that causes the taxpayer to be a dealer in securities for purposes of § 475, the protective identification is recognized and the taxpayer is subject to the general rules governing identifications for all transition securities that were eligible to be timely identified after the date that the taxpayer began making protective identifications. Thus, if a transition security was properly and timely identified as exempt from being marked to market and remains eligible for the exemption claimed, that transition security is not marked to market even though § 475 applies to the taxpayer. If a transition secu-

urity was properly and timely identified and thereafter ceases to be held for investment or as a hedge, see § 475(b)(3). If a transition security was not eligible to be identified as exempt, see § 475(d)(2).

Issue 16: If an issuer of an evidence of indebtedness has the right to prepay at any time without a penalty (for example, a revolving credit card balance), does that right preclude that indebtedness from having a fair market value that is greater than the face value of the obligation?

Holding 16: No. Securities must be marked to fair market value based on all the facts and circumstances. For example, in light of contractual interest rates and general payment history on customer obligations, the fair market value of a customer obligation may be greater than the face amount, even if the customer has the right to repay the debt at its face amount at any time.

Issue 17: If a taxpayer would meet the definition of a dealer in securities under § 475 but otherwise satisfies more than one exemption from dealer status, must the taxpayer elect out of all applicable exemptions to be a dealer in securities for the purpose of § 475?

Holding 17: Generally, a taxpayer must make an election out of all applicable exemptions in order to be treated as a dealer under § 475. A taxpayer subject to multiple exemptions from § 475 must file all the documentation required to elect out of each applicable exemption. Sometimes, the documentation required for one election satisfies all of the filing requirements for another election. For example, if a taxpayer is subject to both the customer paper exemption under § 1.475(c)-1(b) and the negligible sales exemption under § 1.475(c)-1(c), the taxpayer may make an election under § 1.475(c)-1(b)(4) that is effective as of January 1, 1993, and timely file an amended 1993 federal income tax return using mark-to-market accounting for securities. The amended 1993 return itself represents an election out of the negligible sales exemption.

Issue 18: How does a taxpayer that is in its first year of existence elect out of an exemption from dealer status under § 475?

Holding 18: If a taxpayer decides for its first year of existence to make an election out of the negligible sales exemption to account for securities on a mark-to-market basis, the taxpayer should attach to its orig-

inal return for that first year the following statement: “[Insert name and taxpayer identification number of the taxpayer] hereby elects not to be governed by § 1.475(c)-1(c)(1)(i) of the income tax regulations for the taxable year ending [describe the last day of the year] and for subsequent taxable years.” If a taxpayer decides for its first year of existence to make an election out of the customer paper exemption or to make the intragroup-customer election, the taxpayer must meet the requirements of § 1.475(c)-1.

Issue 19: Which changes of accounting method are covered by the consent provisions of § 13223(c)(2) of the 1993 Act?

Holding 19: Under § 13223(c)(2) of the 1993 Act, certain changes of accounting method are treated as made with the consent of the Commissioner. This treatment extends only to a change in method that was effected by a taxpayer who (1) became a dealer for the taxable year that includes December 31, 1993, merely by virtue of the passage of the 1993 Act, and (2) who accounted for securities as a dealer under § 475 on its original federal income tax return for that year. Consent for other changes of method to comply with § 475 must be obtained either on a taxpayer-by-taxpayer basis or as part of automatic consent contained in published guidance. See Rev. Proc. 97-43, page 12, this Bulletin.

Issue 20: If a taxpayer is accounting for securities by marking them to market under § 475(a), may the taxpayer, without the consent of the Commissioner, file a federal income tax return for a later taxable year that does not account for securities on a mark-to-market basis?

Holding 20: No. Once a taxpayer has used the § 475 mark-to-market method as its method of accounting for securities, the taxpayer may not change that method of accounting without obtaining the consent of the Commissioner. See § 446(e). Unless the Commissioner otherwise prescribes, to request consent the taxpayer must comply with the requirements of Rev. Proc. 97-27, 1997-21 I.R.B. 10. For example, if a taxpayer accounts for securities by marking them to market because the taxpayer made more than negligible sales of securities and in a later year makes only negligible sales of securities, the taxpayer must obtain the consent of the Commissioner to change its method of accounting for securities. If a taxpayer

made no more than negligible sales of securities but, pursuant to § 1.475(c)-1(c)(1)(ii), accounted for securities on a mark-to-market basis and the taxpayer makes no more than negligible sales of securities in a subsequent year, the taxpayer must obtain the consent of the Commissioner to change its method of accounting for securities. Especially in the latter example, consent for the change will be granted only in unusual circumstances.

## EFFECT ON OTHER DOCUMENTS

Rev. Rul. 93-76 as modified by Rev. Rul. 94-7, is clarified, modified, partially obsolete, and superseded. Notice 97-37, 1997-27 I.R.B. 8, is obsolete.

## PROSPECTIVE APPLICATION

Pursuant to § 7805(b), if an identification is made on or before June 30, 1997, and the identification complies with the requirements set forth in the third paragraph of Holding 6 of Rev. Rul. 93-76, the identification will not be treated as failing to satisfy the requirements of § 475(b)(2) solely on the grounds that it failed to identify the operative subparagraph of that provision.

## PAPERWORK REDUCTION ACT

The collections of information contained in this revenue ruling have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1558.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collections of information in this revenue ruling are in sections 26 CFR 1.475(b)-2, 26 CFR 1.475(b)-4, and 26 CFR 1.475(c)-1. This information is required to facilitate the administration of § 475 of the Internal Revenue Code. This information will be used to facilitate audits of taxpayers that elect to not be governed by certain exemptions under § 475 of the Code. The collections of information are required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The recordkeeping burden described in Holding 6 was reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1496.

The estimated total annual recordkeeping burden described in Holding 15 is 450,000 hours.

The estimated annual burden per recordkeeper varies from 15 hours to 45 hours, depending on individual circumstances, with an estimated average of 22.5 hours. The estimated number of recordkeepers is 20,000.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

## DRAFTING INFORMATION

The principal authors of this revenue ruling are Pamela Lew and Robert B. Williams of the Office of the Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue ruling contact Ms. Lew at (202) 622-3950 or Mr. Williams at (202) 622-3960 (not toll-free calls)

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