26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 475; 1.446–1, 1.475(c)–1.)

Rev. Proc. 97–43

SEC. 1. PURPOSE

This revenue procedure tells taxpayers how to request consent to change methods of accounting to comply with elections out of certain exemptions from dealer status for purposes of § 475 of the Internal Revenue Code. *See* § 1.475(c)–1(a)(3) of the Income Tax Regulations (concerning taxpayers buying securities from or selling securities to members of the same consolidated group); § 1.475(c)–1(b) (concerning sellers of nonfinancial goods and services); and § 1.475(c)–1(c) (concerning taxpayers that engage in no more than negligible sales of securities).

SEC. 2. BACKGROUND

.01 Under § 475(a), dealers in securities must use a mark-to-market accounting method for securities other than certain securities timely identified as exempt under § 475(b)(2). Section 475(c)(1) defines dealer in securities for purposes of § 475.

.02 One component of the definition of dealer in securities in § 475(c)(1) is entering into transactions in securities with customers. Members of the same consolidated group are ordinarily not each other's customers for purposes of § 475(c)(1). Section 1.475(c)–1(a)(3)(ii). A consolidated group may, however, elect to treat its members as potential customers of one another for purposes of § 475(c)(1) (the intragroup-customer election). Unless the Commissioner otherwise prescribes, the election is made by filing a specified statement with a timely filed consolidated federal income tax return. Section 1.475(c)–1(a)(3)(iii)(B).

.03 A taxpayer is ordinarily exempt from treatment as a dealer in securities if the taxpayer would not be a dealer in securities but for its purchases and sales of debt instruments that are customer paper as defined in § 1.475(c)–1(b)(2) with respect to the taxpayer or another member of its consolidated group (the customer paper exemption). Section 1.475(c)–1(b)(1). Taxpayers may elect not to be governed by the customer paper exemption. Section 1.475(c)–1(b)(4). Unless the Commissioner otherwise prescribes, the election generally is made by filing a specified statement with a timely filed federal income tax return (or, in limited cases, an amended return). Section 1.475(c)–1(b)(4)(i); *see also* Rev. Rul. 97–39, page 4, this Bulletin, Holding 13.

.04 A taxpayer's purchases of securities from customers do not make the taxpayer a dealer in securities if the taxpayer engages in no more than negligible sales of securities as defined in § 1.475(c)–1(c)(2) (the negligible sales exemption). Section 1.475(c)–1(c)(1)(i). Taxpayers may elect not to be governed by the negligible sales exemption. This is done on a timely filed original federal income tax return (or, in limited cases, on an amended return). Section 1.475(c)–1(c)(1)(ii); *see also* Rev. Rul. 97–39, Holding 12.

.05 In general, making one of these elections results in the taxpayer being required to change its method of accounting to reflect the application of § 475(a). *But see* Rev. Rul. 97-39, Holding 17 (discussing circumstances in which more than one election must be made for § 475(a) to apply). A taxpayer must obtain the consent of the Commissioner to change an accounting method. Section 446(e).

.06 A taxpayer that accounts for securities under § 475(a) may change that method only with the consent of the Commissioner. Section 446(e). *See* Rev. Rul. 97–39, Holding 20; *see also* Rev. Proc. 97–27, 1997–21 I.R.B. 10, or its successor on how to request consent to change.

SEC. 3. SCOPE

This revenue procedure applies to taxpayers required to change methods of accounting as a result of elections under § 1.475(c)–1(a)(3)(iii), –1(b)(4), or –1(c)(1)(ii) (including taxpayers that made those elections prior to September 10, 1997).

SEC. 4. PROCEDURE

.01 If a taxpayer elects to be governed by the intragroup-customer election and the election results in the taxpayer being required to change its method of accounting, then the taxpayer must attach both the statement described in § 1.475(c)–1(a)(3)(iii)(B) and the additional documents required by section 4.07 of this revenue procedure to the taxpayer's timely filed original federal income tax return for the first year subject to the election. If that return is filed on or before October 31, 1997, however, the additional documents may be filed at a later date in accordance with section 4.04. In addition, a copy of those documents must be filed as required by section 4.05 and, if applicable, section 4.06.

.02 If a taxpayer elects not to be governed by the customer paper exemption and the election results in the taxpayer being required to change its method of accounting, then the taxpayer must attach both the statement described in § 1.475(c)–1(b)(4)(i) and the additional documents required by section 4.07 of this revenue procedure to a timely filed federal income tax return or to an amended return, as appropriate under § 1.475(c)–1(b)(4)(i)(A) or (B) or Holding 13 of Rev. Rul. 97-39. If that return is filed on or before October 31, 1997, however, the additional documents may be filed at a later date in accordance with section 4.04. In addition, a copy of those documents must be filed as required by section 4.05 and, if applicable, section 4.06.

.03 If a taxpayer elects not to be governed by the negligible sales exemption and the election results in the taxpayer being required to change its method of accounting, then the taxpayer must attach the documents required by section 4.07 of this revenue procedure to the timely filed original federal income tax return described in § 1.475(c)–1(c)(1)(ii) or the amended return described in Rev. Rul. 97–39, Holding 12 (discussing when the election not to be governed by the negligible sales exemption may be made by filing an amended return). If that return is filed on or before October 31, 1997, however, the additional documents may be filed at a later date in accordance with section 4.04. In addition, a copy of those documents must be filed as required by section 4.05 and, if applicable, section 4.06.

.04 A taxpayer that files the return described in section 4.01, 4.02, or 4.03 of this revenue procedure on or before October 31, 1997, need not attach the docu-

ber 31, 1997, need not attach the documents required by section 4.07 to that return if the taxpayer instead attaches these documents to the first federal income tax return or amended return filed by the taxpayer after October 31, 1997, that is for a taxable year subject to the election.

.05 The taxpayer must file a copy of the documents required by section 4.07 of this revenue procedure with the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, P.O. Box 7604, Benjamin Franklin Station, Washington, DC 20044 (or, in the case of a designated private delivery service: Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224). This filing must occur on or before the later of October 31, 1997, and the time the taxpayer files the return described in section 4.01, 4.02, or 4.03. The documents must contain the name and telephone number of the examining agent, appeals office, or counsel of record for the government, if any, described in section 4.06.

.06 If a taxpayer files an amended return on which the taxpayer elects not to be governed by the customer paper exemption or the negligible sales exemption and, at the time of filing, the taxable year to which the amended return applies or any subsequent taxable year is before the Service or before a federal court, then the taxpayer must provide a copy of the documents required by section 4.07 of this revenue procedure to the persons provided below.

(1) If a taxable year in question is before the Service, a copy of the documents required by section 4.07 of this revenue procedure must be provided to the taxpayer's examining agent or, instead, if the taxable year has been assigned to an appeals office, to such appeals office. The taxpayer must provide the copy by the later of October 31, 1997, and the day that is 30 days after the date the taxable year in question first came before the Service. For purposes of this section, a taxable year shall be considered before the Service from the time the taxpayer (or any member of a consolidated group of which taxpayer was a member during the taxable year) has been contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of its federal income tax return for that year until the receipt of a no-change letter for that year, the execution of a waiver of restrictions on assessment and collection of deficiency in tax and acceptance of overassessment, the expiration of the period for filing a petition with the Tax Court for that year, or the filing of a petition with the Tax Court.

(2) If a taxable year in question is before a federal court, a copy of the documents required by section 4.07 of this revenue procedure must be provided to counsel of record for the government. The taxpayer must provide the copy by the later of October 31, 1997, and the day which is 30 days after the date the taxable year in question first came before a federal court. For purposes of this section, a taxable year will be considered before a federal court if the treatment of any item (whether or not involving a method of accounting) for such taxable year would be considered before a federal court for the purpose of Rev. Proc. 97–27, 1997–21 I.R.B. 10, section 3.08(3).

.07 The taxpayer must properly complete and execute a Form 3115. A legend must be typed on the top of the first page of the Form 3115 that identifies the applicable parts of section 4 of this revenue procedure (other than section 4.04 and section 4.07). The legend should read substantially as follows: "Filed under section[s] 4.** [and 4.**] of Rev. Proc. 97–43."

(1) Form 3115 requires an explanation of the legal basis of the proposed change in method of accounting. That explanation must state specifically which election(s) the taxpayer made under § 1.475(c)–1. *See also* Rev. Rul. 97–39, Holding 17 (discussing the need for multiple elections).

(2) The taxpayer must attach to the Form 3115 a statement describing all identifications, if any, that are or were effective for the purposes of § 475(b)(2) of securities acquired prior to the date of executing the Form 3115 (or the date of filing if filed more than 30 days after executing). For identifications that are not subject to Holding 15 of Rev. Rul. 97–39, the statement must describe the procedures or systems used to make each identification, the date on which the identifications were made, and the content and location of the identifications in the taxpayer's books and records. *See* Rev. Rul. 97–39, Holding 14 (discussing when an identification under § 475(b)(2) is timely made). If the taxpayer holds, or held, transition securities, which are subject to identification under Holding 15 of Rev. Rul. 97–39, the statement must describe the basis for concluding that the securities were or were not described in § 475(b)(1)(A), (B), or (C), including the date, content, and location of documents in the taxpayer's books and records that support such conclusions. If there were no identifications, or if none of the taxpayer's securities were transition securities, then the statement should convey this information.

SEC. 5. CONSENT

.01 If a taxpayer described in section 3 of this revenue procedure complies with the requirements set forth in section 4, then the Commissioner hereby grants consent for the taxpayer to change its method of accounting for securities to reflect the application of § 475(a).

.02 Pending further guidance, in the case of any taxpayer granted automatic consent to change an accounting method by this revenue procedure, § 475(a) applies only to changes in value of securities occurring after the start of the year of change, and any built-in gain or loss as of the beginning of the year of change must be taken into account under rules similar to § 1.475(a)–3(b)(2).

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective September 10, 1997, the date this revenue procedure was made available to the public.

SEC. 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure 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 procedure are in sections 2.02, 2.03, 2.04, and 4.07(2). This information is required by the Service in order to facil-

itate monitoring taxpayers changing accounting methods resulting from making the elections provided by § 1.475(c)–1(a)(3)(iii), –1(b)(4), or –1(c)(1)(ii). The information collected will be used if a taxpayer making the change is audited. The collection of information is required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The collection of information contained in sections 2.02, 2.03, and 2.04 were 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 reporting burden described in section 4.07(2) is 100,000 hours.

The estimated annual burden per respondent varies from .25 hours to 50 hours, depending on individual circumstances, with an estimated average of 5 hours. The estimated number of respondents is 20,000.

The estimated annual frequency of responses is once in the existence of each respondent.

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 author of this revenue procedure is Kenneth P. Christman of the Office of Assistant Chief Counsel (Financial Institutions and Products). For further information regarding this revenue procedure, contact Mr. Christman at 202-622-3950 (not a toll-free call).

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

Questions and answers about the application of section 475 and the regulations thereunder. See Rev. Rul. 97–39, page 4.

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26 CFR 1.446–1: General rule for methods of accounting.

What information must a taxpayer provide in order to obtain automatic consent to change accounting method when section 475(a) becomes applicable as a result of the taxpayer making an election (i) to treat transactions within a consolidated group as transactions with customers as provided by section 1.475(c)–1(a), or (ii) not to be governed by the exemptions from the status of a dealer in securities provided by section 1.475(c)–1(b) or –1(c)? See Rev. Proc. 97–43, page 12.

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 accounts 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-

rity 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 original 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 obsoleted, and superseded. Notice 97–37, 1997–27 I.R.B. 8, is obsoleted.

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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26 CFR 1.475(c)–1: Exemptions—identification requirements.

Questions and answers about the application of section 475 and the regulations thereunder. See Rev. Rul. 97–39, page 4.

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26 CFR 1.475(c)–1; Definitions—dealer in securities.

What information must a taxpayer provide in order to obtain automatic consent to change accounting method when section 475(a) becomes applicable as a result of the taxpayer making an election (i) to treat transactions within a consolidated group as transactions with customers as provided by section 1.475(c)–1(a), or (ii) not to be governed by the exemptions from the status of a dealer in securities provided by section 1.475(c)–1(b) or –1(c)? See Rev. Proc. 97–43, page 12.

Section 6621.— Determination of Interest Rate

26 CFR 301.6621–1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 1997, will be 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 is 6.5 percent.

Rev. Rul. 97–40

Section 6621 of the Internal Revenue Code establishes different rates for interest on tax overpayments and interest on tax underpayments. Under § 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points, except the rate for the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under § 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See § 6621(c) and § 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable rate. Section 6621(c) and § 301.6621–3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under § 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(3) provides that t federal short-term rate for any month the federal short-term rate determin during such month by the Secretary in a cordance with § 1274(d), rounded to t nearest full percent (or, if a multiple 1/2 of 1 percent, the rate is increased the next highest full percent).

Notice 88–59, 1988–1 C.B. 546, a nounced that in determining the qua terly interest rates to be used for ove payments and underpayments of ta under § 6621, the Internal Revenue Se vice will use the federal short-term ra based on daily compounding becau that rate is most consistent with § 662 which, pursuant to § 6622, is subject t daily compounding.

Rounded to the nearest full percent, th federal short-term rate based on daily com pounding determined during the month c July 1997 is 6 percent. Accordingly, a overpayment rate of 8 percent and an ur derpayment rate of 9 percent are estat lished for the calendar quarter beginnin October 1, 1997. The overpayment rat for the portion of corporate overpayment exceeding $10,000 for the calendar quarte beginning October 1, 1997, is 6.5 percen The underpayment rate for large corporat underpayments for the calendar quarter be ginning October 1, 1997, is 11 percent These rates apply to amounts bearing inter est during that calendar quarter.

Interest factors for daily compound in terest for annual rates of 6.5 percent, 8 percent, 9 percent, and 11 percent are published in Tables 18, 21, 23, and 27 o Rev. Proc. 95–17, 1995–1 C.B. 556, 572 575, 577, and 581.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the accompanying tables.

DRAFTING INFORMATION

The principal author of this revenue ruling is Marcia Rachy of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Ms. Rachy on (202) 622-4940 (not a toll-free call)

"(I) a taxpayer (or any predecessor) used the last-in first-out (LIFO) method of accounting with respect to any qualified securities for the 5-taxable year period ending with its last taxable year ending before December 31, 1993, and

"(ii) any portion of the net amount described in paragraph (2)(C) is attributable to the use of such method of accounting,

then paragraph (2)(C) shall be applied by taking such portion into account ratably over the 15-taxable year period beginning with the first taxable year ending on or after December 31, 1993.

"(B) Qualified security.—For purposes of this paragraph, the term 'qualified security' means any security acquired—

"(i) by a floor specialist (as defined in section 1236(d)(2) of the Internal Revenue Code of 1986) in connection with the specialist's duties as a specialist on an exchange, but only if the security is one in which the specialist is registered with the exchange, or

"(ii) by a taxpayer who is a market maker in connection with the taxpayer's duties as a market maker, but only if—

"(I) the security is included on the National Association of Security Dealers Automated Quotation System,

"(II) the taxpayer is registered as a market maker in such security with the National Association of Security Dealers, and

"(III) as of the last day of the taxable year preceding the taxpayer's first taxable year ending on or after December 31, 1993, the taxpayer (or any predecessor) has been actively and regularly engaged as a market maker in such security for the 2-year period ending on such date (or, if shorter, the period beginning 61 days after the security was listed in such quotation system and ending on such date)."

PART III.—ADJUSTMENTS.

Sec.

In '64, P.L. 88-272, added item 483.

In '60, P.L. 86-459, added Dealer Reserve Income Adjustment. See Note to Code Sec. 451.

Sec. 481. Adjustments required by changes in method of accounting.

(a) General rule.

In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

(b) Limitation on tax where adjustments are substantial.

(1) Three year allocation. If—

(A) the method of accounting from which the change is made was used by the taxpayer in computing his taxable income for the 2 taxable years preceding the year of the change, and

(B) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2) exceeds $3,000,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if one-third of such increase in taxable income were included in taxable income for the year of the change and one-third of such increase were included in each of the 2 preceding taxable years.

(2) Allocation under new method of accounting.

(A) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2) exceeds $3,000,

(B) the taxpayer establishes his taxable income (under the new method of accounting) for one or more taxable years consecutively preceding the taxable year of the change for which the taxpayer in computing taxable income used the method of accounting from which the change is made,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if the adjustments required by subsection (a)(2) were allocated to the taxable year or years specified in subparagraph (B) to which they are properly allocable under the new method of accounting and the balance of the adjustments required by subsection (a)(2) was allocated to the taxable year of the change.

(3) Special rules for computations under paragraphs (1) and (2). For purposes of this subsection—

(A) There shall be taken into account the increase or decrease in tax for any taxable year preceding the year of the change to which no adjustment is allocated under paragraph (1) or (2) but which is affected by a net operating loss (as defined in section 172) or by a capital loss carryback or carryover (as defined in section 1212), determined with reference to taxable years with respect to which adjustments under paragraph (1) or (2) are allocated.

(B) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning of section 1314(a)) for such year.

(C) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(c) Adjustments under regulations.

In the case of any change described in subsection (a), the taxpayer may, in such manner and subject to such conditions as the Secretary may by regulations prescribe, take the adjustments required by subsection (a)(2) into account in computing the tax imposed by this chapter for the taxable year or years permitted under such regulations.

In '81, P.L. 97-34, Sec. 203(c)(2), provides:

"(2) Change in method of accounting. Sections 446 and 481 of the Internal Revenue Code of 1954 shall not apply to the change in the method of depreciation [i.e., as defined in Code Sec. 168(g)(6)] to comply with the provisions of this subsection [i.e., Sec. 203(c)(1)]."

In '80, P.L. 96-471, Sec. 2(b)(3), repealed subsec. (d), effective for dispositions made after 10/19/80 in tax yrs. end. after 10/19/80. Prior to repeal, subsec. (d) read as follows:

"(d) Exception for change to installment basis.

"This section shall not apply to a change to which section 453 (relating to change to installment method) applies."

In '76, P.L. 94-455, Sec. 1901(a)(70)(A), deleted paras. (b)(4), (5) and (6) . . . Sec. 1901(a)(70)(B), deleted ", other than the amount of such adjustments to which paragraph (4) or (5) applies,", after "subsection (a)(2)", each place it appeared in paras. (b)(1) and (2), effective for tax. yrs. begin. after 12/31/76.

"(I) a taxpayer (or any predecessor) used the last-in first-out (LIFO) method of accounting with respect to any qualified securities for the 5-taxable year period ending with its last taxable year ending before December 31, 1993, and

"(ii) any portion of the net amount described in paragraph (2)(C) is attributable to the use of such method of accounting,

then paragraph (2)(C) shall be applied by taking such portion into account ratably over the 15-taxable year period beginning with the first taxable year ending on or after December 31, 1993.

"(B) Qualified security.—For purposes of this paragraph, the term 'qualified security' means any security acquired—

"(i) by a floor specialist (as defined in section 1236(d)(2) of the Internal Revenue Code of 1986) in connection with the specialist's duties as a specialist on an exchange, but only if the security is one in which the specialist is registered with the exchange, or

"(ii) by a taxpayer who is a market maker in connection with the taxpayer's duties as a market maker, but only if—

"(I) the security is included on the National Association of Security Dealers Automated Quotation System,

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"(III) as of the last day of the taxable year preceding the taxpayer's first taxable year ending on or after December 31, 1993, the taxpayer (or any predecessor) has been actively and regularly engaged as a market maker in such security for the 2-year period ending on such date (or, if shorter, the period beginning 61 days after the security was listed in such quotation system and ending on such date)."

PART III.—ADJUSTMENTS

Sec.

481. Adjustments required by changes in method of accounting.

482. Allocation of income and deductions among taxpayers.

483. Interest on certain deferred payments.

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In computing the taxpayer's taxable income for any taxable year (referred to in this section as the "year of the change")—

(1) if such computation is under a method of accounting different from the method under which the taxpayer's taxable income for the preceding taxable year was computed, then

(2) there shall be taken into account those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted, except there shall not be taken into account any adjustment in respect of any taxable year to which this section does not apply unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer.

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(A) the method of accounting from which the change is made was used by the taxpayer in computing his taxable income for the 2 taxable years preceding the year of the change, and

(B) the increase in taxable income for the year of the change which results solely by reason of the adjustments required by subsection (a)(2) exceeds $3,000,

then the tax under this chapter attributable to such increase in taxable income shall not be greater than the aggregate increase in the taxes under this chapter (or under the corresponding provisions of prior revenue laws) which would result if one-third of such increase in taxable income were included in taxable income for the year of change and one-third of such increase were included each of the 2 preceding taxable years.

(2) Allocation under new method of accounting.

(A) the increase in taxable income for the year of change which results solely by reason of the adjustments required by subsection (a)(2) exceeds $3,000,

(B) the taxpayer establishes his taxable income (under the new method of accounting) for one or more taxable years consecutively preceding the taxable year of the change for which the taxpayer in computing taxable income used the method of accounting from which the change is made,

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(3) Special rules for computations under paragraphs (1) and (2). For purposes of this subsection—

(A) There shall be taken into account the increase or decrease in tax for any taxable year preceding the year of the change to which no adjustment is allocated under paragraph (1) or (2) but which is affected by a net operating loss (as defined in section 172) or by a capital loss carryback or carryover (as defined in section 1212), determined with reference to taxable years with respect to which adjustments under paragraph (1) or (2) are allocated.

(B) The increase or decrease in the tax for any taxable year for which an assessment of any deficiency, or a credit or refund of any overpayment, is prevented by any law or rule of law, shall be determined by reference to the tax previously determined (within the meaning of section 1314(a)) for such year.

(C) In applying section 7807(b)(1), the provisions of chapter 1 (other than subchapter E, relating to self-employment income) and chapter 2 of the Internal Revenue Code of 1939 shall be treated as the corresponding provisions of the Internal Revenue Code of 1939.

(c) Adjustments under regulations.

In the case of any change described in subsection (a), the taxpayer may, in such manner and subject to such conditions as the Secretary may by regulations prescribe, take the adjustments required by subsection (a)(2) into account in computing the tax imposed by this chapter for the taxable year or years permitted under such regulations.

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hanges

ncrements

Dec. 31, 1958	Dec. 31, 1959	Dec. 31, 1960
$ 500	...	$1,000
550	...	1,200
930	$ 465	...
1,100	575	...
$1,430	$ 465	$1,000
1,650	575	1,200
115.38	123.66	120.00

atio of total current-year cost to total base-year cost Percent	Dec. 31, 1960, inventory at LIFO value
100.00	$ 7,000
105.00	1,050
107.86	4,050
115.38	1,650
123.66	575
120.00	1,200
...	$15,525

nts of subparagraph (2) of set. Also, for such year, if a using only a method of pool- nis section, or a method of be authorized by this section ere included in the pool, and atural business unit method, has not inventoried all items ventory investment for such t on the LIFO method, he tural business unit method if provisions of § 1.472-3 to ex- on to all items entering into investment for such natural led the requirements of sub- is paragraph are met. The dopted shall be used for the for all subsequent taxable is required by the Commis- arly reflect income, or unless is granted by the Commis- paragraph (e) of § 1.446-1.

ts. A statement shall be at- e tax return for the year of in subparagraph (1) of this rth, in summary form, the

on of the new pool or pools, for selection of the new pool

Final Regs.

See p. 20,601 for regulations not amended to reflect law changes

(iii) a schedule showing the computation of the LIFO value of the former pool or pools, and

(iv) a schedule showing the transition from the former pool or pools to the new pool or pools.

In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D.C. The taxpayer shall submit such other information with respect to the change in method of pooling as may be requested. [Reg. § 1.472-8.]

☐ [*T.D.* 6539, 1-19-61. *Amended by T.D.* 7814, 3-15-82.]

[Reg. § 1.475-0]

§ 1.475-0. Table of contents.—This section lists the major captions in §§ 1.475(a)-3, 1.475(b)-1, 1.475(b)-2, 1.475(b)-4, 1.475(c)-1, 1.475(c)-2, 1.475(d)-1, and 1.475(e)-1.

(B) Taxable years ending on or before December 24, 1996.

(ii) Continued applicability of an election.

(c) Taxpayers that purchase securities from customers but engage in no more than negligible sales of the securities.

(1) Exemption from dealer status.

(i) General rule.

(ii) Election to be treated as a dealer.

(2) Negligible sales.

(3) Special rules for members of a consolidated group.

(i) Intragroup-customer election in effect.

(ii) Intragroup-customer election not in effect.

(4) Special rules.

(5) Example.

(d) Issuance of life insurance products.

§ 1.475(c)-2 Definitions—security.

(a) Items that are not securities.

(b) Synthetic debt that § 1.1275-6(b) treats the taxpayer as holding.

(c) Negative value REMIC residuals acquired before January 4, 1995.

(1) Description.

(2) Special rules applicable to negative value REMIC residuals acquired before January 4, 1995.

§ 1.475(d)-1 Character of gain or loss.

(a) Securities never held in connection with the taxpayer's activities as a dealer in securities.

(b) Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.

§ 1.475(e)-1 Effective dates.

[Reg. § 1.475-0.]

☐ [*T.D.* 8700, 12-23-96.]

[Reg. § 1.475(a)-3]

§ 1.475(a)-3. Acquisition by a dealer of a security with a substituted basis.—(a) *Scope.* This section applies if—

(1) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to the basis of that security in the hands of the person from whom the security was acquired; or

(2) A dealer in securities acquires a security that is subject to section 475(a) and the dealer's basis in the security is determined, in whole or in part, by reference to other property held at any time by the dealer.

(b) *Rules.* If this section applies to a security—

(1) Section 475(a) applies only to changes in value of the security occurring after the acquisition; and

(2) Any built-in gain or loss with respect to the security (based on the difference between the fair market value of the security on the date the dealer acquired it and its basis to the dealer on that date) is taken into account at the time, and has the character, provided by the sections of the Internal Revenue Code that would apply to the built-in gain or loss if section 475(a) did not apply to the security. [Reg. § 1.475(a)-3.]

☐ [*T.D.* 8700, 12-23-96.]

[Reg. § 1.475(b)-1]

§ 1.475(b)-1. Scope of exemptions from mark-to-market requirement.—(a) *Securities held for investment or not held for sale.* Except as otherwise provided by this section and subject to the identification requirements of section 475(b)(2), a security is held for investment (within the meaning of section 475(b)(1)(A)) or not held for sale (within the meaning of section 475(b)(1)(B)) if it is not held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business.

(b) *Securities deemed identified as held for investment*—(1) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(i) Except as provided in paragraph (b)(3) of this section, stock in a corporation, or a partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust, to which the taxpayer has a relationship specified in paragraph (b)(2) of this section; or

(ii) A contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract (see sections 72, 817, and 7702).

(2) *Relationships*—(i) *General rule.* The relationships specified in this paragraph (b)(2) are—

(A) Those described in section 267(b)(2), (3), (10), (11), or (12); or

(B) Those described in section 707(b)(1)(A) or (B).

(ii) *Attribution.* The relationships described in paragraph (b)(2)(i) of this section are determined taking into account sections 267(c) and 707(b)(3), as appropriate.

(iii) *Trusts treated as partnerships.* For purposes of this paragraph (b)(2), the phrase *partnership or trust* is substituted for the word *partnership* in sections 707(b)(1) and (3), and a reference to beneficial ownership interest is added to each reference to capital interest or profits interest in those sections.

(3) *Securities traded on certain established financial markets.* Paragraph (b)(1)(i) of this section does not apply to a security if—

(i) The security is actively traded within the meaning of § 1.1092(d)-1(a) taking into account only established financial markets identified in § 1.1092(d)-1(b)(1)(i) or (ii) (describing national securities exchanges and interdealer quotation systems);

(ii) Less than 15 percent of all of the outstanding shares or interests in the same class are held by the taxpayer and all persons having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section; and

(iii) If the security was acquired (e.g., on original issue) from a person having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section, then, after the time the security was acquired—

(A) At least one full business day has passed, and

(B) There has been significant trading involving persons not having a relationship to the taxpayer that is specified in paragraph (b)(2) of this section.

(4) *Changes in status*—(i) *Onset of prohibition against marking*—(A) Once paragraph (b)(1) of this section begins to apply to the security and for so long as it continues to apply, section 475(a) does not apply to the security in the hands of the taxpayer.

(B) If a security has not been timely identified under section 475(b)(2) and, after the last day on which such an identification would have been timely, paragraph (b)(1) of this section begins to apply to the security, then the dealer must recognize gain or loss on the security as if it were sold for its fair market value as of the close of business of the last day before paragraph (b)(1) of this section begins to apply to the security, and gain or loss is taken into account at that time.

(ii) *Termination of prohibition against marking.* If a taxpayer did not timely identify a security under section 475(b)(2), and paragraph (b)(1) of this section applies to the security on the last day on which such an identification would have been timely but thereafter ceases to apply—

(A) An identification of the security under section 475(b)(2) is timely if made on or before the close of the day paragraph (b)(1) of this section ceases to apply; and

(B) Unless the taxpayer timely identifies the security under section 475(b)(2) (taking into account the additional time for identification that is provided by paragraph (b)(4)(ii)(A) of this section), section 475(a) applies to changes in value of the security after the cessation in the same manner as under section 475(b)(3).

(iii) *Examples.* These examples illustrate this paragraph (b)(4):

Example 1. Onset of prohibition against marking—(A) *Facts.* Corporation *H* owns 75 percent of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). On December 1, 1995, *D* acquired less than half of the stock in corporation *X*. *D* did not identify the stock for purposes of section 475(b)(2). On July 17, 1996, *H* acquired from other persons 70 percent of the stock of *X*. As a result, *D* and *X* became related within the meaning of paragraph (b)(2)(i) of this section. The stock of *X* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets).

(B) *Holding.* Under paragraph (b)(4)(i) of this section, *D* recognizes gain or loss on its *X* stock as if the stock were sold for its fair market value at the close of business on July 16, 1996, and the gain or loss is taken into account at that time. As with any application of section 475(a), proper adjustment is made in the amount of any gain or loss subsequently realized. After July 16, 1996, section 475(a) does not apply to *D*'s *X* stock while paragraph (b)(1)(i) of this section (concerning the relationship between *X* and *D*) continues to apply.

Example 2. Termination of prohibition against marking; retained securities identified as held for investment—(A) *Facts.* On July 1, 1996, corporation *H* owned 60 percent of the stock of corporation *Y* and all of the stock of corporation *D*, a dealer in securities within the meaning of section 475(c)(1). Thus, *D* and *Y* are related within the meaning of paragraph (b)(2)(i) of this section. Also on July 1, 1996, *D* acquired, as an investment, 10 percent of the stock of *Y*. The stock of *Y* is not described in paragraph (b)(3) of this section (concerning some securities traded on certain established financial markets). When *D* acquired its shares of *Y* stock, it did not identify them for purposes of section 475(b)(2). On December 24, 1996, *D* identified its shares of *Y* stock as held for investment under section 475(b)(2). On December 30, 1996, *H* sold all of its shares of stock in *Y* to an unrelated party. As a result, *D*

and *Y* ceased to be related within the meaning of paragraph (b)(2)(i) of this section.

(B) *Holding.* Under paragraph (b)(4)(ii)(A) of this section, identification of the *Y* shares is timely if done on or before the close of December 30, 1996. Because *D* timely identified its *Y* shares under section 475(b)(2), it continues after December 30, 1996, to refrain from marking to market its *Y* stock.

Example 3. Termination of prohibition against marking; retained securities not identified as held for investment—(A) *Facts.* The facts are the same as in *Example 2* above, except that *D* did not identify its stock in *Y* for purposes of section 475(b)(2) on or before December 30, 1996. Thus, *D* did not timely identify these securities under section 475(b)(2) (taking into account the additional time for identification provided in paragraph (b)(4)(ii)(A) of this section).

(B) *Holding.* Under paragraph (b)(4)(ii)(B) of this section, section 475(a) applies to changes in value of *D*'s *Y* stock after December 30, 1996, in the same manner as under section 475(b)(3). Thus, any appreciation or depreciation that occurred while the securities were prohibited from being marked to market is suspended. Further, section 475(a) applies only to those changes occurring after December 30, 1996.

Example 4. Acquisition of actively traded stock from related party—(A) *Facts.* Corporation *P* is the parent of a consolidated group whose taxable year is the calendar year, and corporation *M*, a member of that group, is a dealer in securities within the meaning of section 475(c)(1). Corporation *M* regularly acts as a market maker with respect to common and preferred stock of corporation *P*. Corporation *P* has outstanding 2,000,000 shares of series *X* preferred stock, which are traded on a national securities exchange. During the business day on December 29, 1997, corporation *P* sold 100,000 shares of series *X* preferred stock to corporation *M* for $100 per share. Subsequently, also on December 29, 1997, persons not related to corporation *M* engaged in significant trading of the series *X* preferred stock. At the close of business on December 30, 1997, the fair market value of series *X* stock was $99 per share. At the close of business on December 31, 1997, the fair market value of series *X* stock was $98.50 per share. Corporation *M* sold the series *X* stock on the exchange on January 2, 1998. At all relevant times, corporation *M* and all persons related to *M* owned less than 15% of the outstanding series *X* preferred stock.

(B) *Holding.* The 100,000 shares of series *X* preferred stock held by corporation *M* are not subject to mark-to-market treatment under section 475(a) on December 29, 1997, because at that time the stock was held for less than one full business day and is therefore treated as properly identified as held for investment. At the close of business on December 30, 1997, that prohibition on marking ceases to apply, and section 475(b)(3) begins to apply. The built-in loss is suspended, and subsequent appreciation and depreciation are subject to section 475(a). Accordingly, when corporation *M* marks the series *X* stock to market at the close of business on December 31, 1997, under section 475(a) it recognizes and takes into account a loss of $.50 per share. Under section 475(b)(3), when corporation *M* sells the series *X* stock on January 2, 1998, it takes into account the suspended loss, that is, the difference between the $100 per share it paid corporation *P* for that stock and the $99-per-share fair market value when section 475(b)(1) ceased to be apply to the stock. No deduction, however, is allowed for that loss. (See § 1.1502-13(f)(6), under which no deduction is allowed to a member of a consolidated group for a loss with respect to a share of stock of the parent of that consolidated group, if the member does not take the gain or loss into account pursuant to section 475(a).)

(c) *Securities deemed not held for investment; dealers in notional principal contracts and derivatives*—(1) Except as otherwise determined by the Commissioner in a revenue ruling, revenue procedure, or letter ruling, section 475(b)(1)(A) (exempting from mark-to-market accounting certain securities that are held for investment) does not apply to a security if—

(i) The security is described in section 475(c)(2)(D) or (E) (describing certain notional principal contracts and derivative securities); and

(ii) The taxpayer is a dealer in such securities.

(2) See § 1.475(d)-1(b) for a rule concerning the character of gain or loss on securities described in this paragraph (c).

(d) *Special rule for hedges of another member's risk.* A taxpayer may identify under section 475(b)(1)(C) (exempting certain hedges from mark-to-market accounting) a security that hedges a position of another member of the taxpayer's consolidated group if the security meets the following requirements—

(1) The security is a hedging transaction within the meaning of § 1.1221-2(b);

(2) The security is timely identified as a hedging transaction under § 1.1221-2(e) (including identification of the hedged item); and

(3) The security hedges a position that is not marked to market under section 475(a).

(e) *Transitional rules*—(1) *Stock, partnership, and beneficial ownership interests in certain controlled corporations, partnerships, and trusts before January 23, 1997*—(i) *In general.* The following items held by a dealer in securities are per se held for investment within the meaning of section 475(b)(1)(A) and are deemed to be properly identified as such for purposes of section 475(b)(2)—

(A) Stock in a corporation that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section); or

(B) A partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust that the taxpayer controls (within the meaning of paragraph (e)(1)(ii) of this section).

(ii) *Control defined.* Control means the ownership, directly or indirectly through persons described in section 267(b) (taking into account section 267(c)), of—

(A) 50 percent or more of the total combined voting power of all classes of stock entitled to vote; or

(B) 50 percent or more of the capital interest, the profits interest, or the beneficial ownership interest in the widely held or publicly traded partnership or trust.

(iii) *Applicability.* The rules of this paragraph (e)(1) apply only before January 23, 1997.

(2) *Dealers in notional principal contracts and derivatives acquired before January 23, 1997*—(i) *General rule.* Section 475(b)(1)(A) (exempting certain securities from mark-to-market accounting) does not apply to a security if—

(A) The security is described in section 475(c)(2)(D) or (E) (describing certain notional principal contracts and derivative securities); and

(B) The taxpayer is a dealer in such securities.

(ii) *Exception for securities not acquired in dealer capacity.* This paragraph (e)(2) does not apply if the taxpayer establishes unambiguously that the security was not acquired in the taxpayer's capacity as a dealer in such securities.

(iii) *Applicability.* The rules of paragraph (e)(2) apply only to securities acquired before January 23, 1997. [Reg. § 1.475(b)-1.]

☐ [*T.D.* 8700, 12-23-96.]

[Reg. § 1.475(b)-2]

§ 1.475(b)-2. Exemptions—Identification requirements.—(a) *Identification of the basis for exemption.* An identification of a security as exempt from mark to market does not satisfy section 475(b)(2) if it fails to state whether the security is described in—

(1) Either of the first two subparagraphs of section 475(b)(1) (identifying a security as held for investment or not held for sale); or

(2) The third subparagraph thereof (identifying a security as a hedge).

(b) *Time for identifying a security with a substituted basis.* For purposes of determining the timeliness of an identification under section 475(b)(2), the date that a dealer acquires a security is not affected by whether the dealer's basis in the security is determined, in whole or in part, either by reference to the basis of the security in the hands of the person from whom the security was acquired or by reference to other property held at any time by the dealer. See § 1.475(a)-3 for rules governing how the dealer accounts for such a security if this identification is not made.

(c) *Integrated transactions under § 1.1275-6*—(1) *Definitions.* The following terms are used in this paragraph (c) with the meanings that are given to them by § 1.1275-6: integrated transaction, legging into, legging out, qualifying debt instrument, § 1.1275-6 hedge, and synthetic debt instrument.

(2) *Synthetic debt held by a taxpayer as a result of legging in.* If a taxpayer is treated as the holder of a synthetic debt instrument as the result of legging into an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the synthetic debt instrument is treated as having the same acquisition date as the qualifying debt instrument. A pre-legin identification of the qualifying debt instrument under section 475(b)(2) applies to the integrated transaction as well.

(3) *Securities held after legging out.* If a taxpayer legs out of an integrated transaction, then, for purposes of the timeliness of an identification under section 475(b)(2), the qualifying debt instrument, or the § 1.1275-6 hedge, that remains in the taxpayer's hands is generally treated as having been acquired, originated, or entered into, as the case may be, immediately after the leg-out. If any loss or deduction determined under § 1.1275-6(d)(2)(ii)(B) is disallowed by § 1.1275-6(d)(2)(ii)(D) (which disallows deductions when a taxpayer legs out of an integrated transaction within 30 days of legging in), then, for purposes of this section and section 475(b)(2), the qualifying debt instrument that remains in the taxpayer's hands is treated as having been acquired on the same date that the synthetic debt instrument was treated as having been acquired. [Reg. § 1.475(b)-2.]

☐ [*T.D.* 8700, 12-23-96.]

[Reg. § 1.475(b)-4]

§ 1.475(b)-4. Exemptions—Transitional issues.—(a) *Transitional identification*—(1) *Certain securities previously identified under section 1236.* If, as of the close of the last taxable year ending before December 31, 1993, a security was identified under section 1236 as a security held for investment, the security is treated as being identified as held for investment for purposes of section 475(b).

(2) *Consistency requirement for other securities.* In the case of a security (including a security described in section 475(c)(2)(F)) that is not described in paragraph (a)(1) of this section and that was held by the taxpayer as of the close of the last taxable year ending before December 31, 1993, the security is treated as having been properly identified under section 475(b)(2) or 475(c)(2)(F)(iii) if the information contained in the dealer's books and records as of the close of that year supports the identification. If there is any ambiguity in those records, the taxpayer must, no later than January 31, 1994, place in its records a statement resolving this ambiguity and indicating unambiguously which securities are to be treated as properly identified. Any information that supports treating a security as having been properly identified under section 475(b)(2) or (c)(2)(F)(iii) must be applied consistently from one security to another.

(b) *Corrections on or before January 31, 1994*—(1) *Purpose.* This paragraph (b) allows a taxpayer to add or remove certain identifications covered by § 1.475(b)-1.

(2) *To conform to § 1.475(b)-1(a)*—(i) *Added identifications.* To the extent permitted by paragraph (b)(2)(ii) of this section, a taxpayer may identify as being described in section 475(b)(1)(A) or (B)—

(A) A security that was held for immediate sale but was not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business (for example, a trading security); or

(B) An evidence of indebtedness that was not held for sale to customers in the ordinary course of the taxpayer's trade or business and that the taxpayer intended to hold for less than one year.

(ii) *Limitations.* An identification described in paragraph (b)(2)(i) of this section is permitted only if—

(A) Prior to December 28, 1993, the taxpayer did not identify as being described in section 475(b)(1)(A) or (B) any of the securities described in paragraph (b)(2)(i) of this section;

(B) The taxpayer identifies every security described in paragraph (b)(2)(i) of this section for which a timely identification of the security under section 475(b)(2) cannot be made after the date on which the taxpayer makes these added identifications; and

(C) The identification is made on or before January 31, 1994.

(3) *To conform to § 1.475(b)-1(c).* On or before January 31, 1994, a taxpayer described in § 1.475(b)-1(e)(2)(i)(B) may remove an identification under section 475(b)(1)(A) of a security described in § 1.475(b)-1(e)(2)(i)(A).

(c) *Effect of corrections.* An identification added under paragraph (a)(2) or (b)(2) of this section is timely for purposes of section 475(b)(2) or (c)(2)(F)(iii). An identification removed under paragraph (a)(2) or (b)(3) of this section does not subject the taxpayer to the provisions of section 475(d)(2). [Reg. § 1.475(b)-4.]

☐ [*T.D.* 8700, 12-23-96.]

[Reg. § 1.475(c)-1]

§ 1.475(c)-1. Definitions—Dealer in securities.—(a) *Dealer-customer relationship.* Whether a taxpayer is transacting business with customers is determined on the basis of all of the facts and circumstances.

(1) [Reserved].

(2) *Transactions described in section 475(c)(1)(B)*—(i) *In general.* For purposes of section 475(c)(1)(B), the term *dealer in securities* includes, but is not limited to, a taxpayer that, in the ordinary course of the taxpayer's trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (a)(2). In the following examples, *B* is a bank and is not a member of a consolidated group:

Example 1. *B* regularly offers to enter into interest rate swaps with other persons in the ordinary course of its trade or business. *B* is willing to enter into interest rate swaps under which it either pays a fixed interest rate and receives a floating rate or pays a floating rate and receives a fixed rate. *B* is a dealer in securities under section 475(c)(1)(B), and the counterparties are its customers.

Example 2. *B*, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of positions in a foreign currency with other banks in the interbank market. *B*'s activities in the foreign currency make it a dealer in securities under

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Example 3. *B* engages in frequent transactions in a foreign currency in the interbank market. Unlike the facts in *Example 2*, however, *B* does not regularly hold itself out as being willing and able to enter into either side of positions in the foreign currency, and all of *B*'s transactions are driven by its internal need to adjust its position in the currency. No other circumstances are present to suggest that *B* is a dealer in securities for purposes of section 475(c)(1)(B). *B*'s activity in the foreign currency does not qualify it as a dealer in securities for purposes of section 475(c)(1)(B), and its transactions in the interbank market are not transactions with customers.

(3) *Related parties*—(i) *General rule.* Except as provided in paragraph (a)(3)(ii) of this section (concerning transactions between members of a consolidated group, as defined in § 1.1502-1(h)), a taxpayer's transactions with related persons may be transactions with customers for purposes of section 475. For example, if a taxpayer, in the ordinary course of the taxpayer's trade or business, regularly holds itself out to its foreign subsidiaries or other related persons as being willing and able to enter into either side of transactions enumerated in section 475(c)(1)(B), the taxpayer is a dealer in securities within the meaning of section 475(c)(1), even if it engages in no other transactions with customers.

(ii) *Special rule for members of a consolidated group.* Solely for purposes of paragraph (c)(1) of section 475 (concerning the definition of dealer in securities) and except as provided in paragraph (a)(3)(iii) of this section, a taxpayer's transactions with other members of its consolidated group are not with customers. Accordingly, notwithstanding paragraph (a)(2) of this section, the fact that a taxpayer regularly holds itself out to other members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause the taxpayer to be a dealer in securities within the meaning of section 475(c)(1)(B).

(iii) *The intragroup-customer election*—(A) *Effect of election.* If a consolidated group makes the intragroup-customer election, paragraph (a)(3)(ii) of this section (special rule for members of a consolidated group) does not apply to the members of the group. Thus, a member of a group that has made this election may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are with other members of its consolidated group.

(B) *Making and revoking the election.* Unless the Commissioner otherwise prescribes, the intragroup-customer election is made by filing a statement that says, "[Insert name and employer identification number of common parent] hereby makes the Intragroup-Customer Election (as described in § 1.475(c)-1(a)(3)(iii) of the income tax regulations) for the taxable year ending [describe the last day of the year] and for subsequent taxable years." The statement must be signed by the common parent and attached to the timely filed federal income tax return for the consolidated group for that taxable year. The election applies for that year and continues in effect for subsequent years until revoked. The election may be revoked only with the consent of the Commissioner.

(iv) *Examples.* The following examples illustrate this paragraph (a)(3):

General Facts. HC, a hedging center, provides interest rate hedges to all of the members of its affiliated group (as defined in section 1504(a)(1)). Because of the efficiencies created by having a centralized risk manager, group policy prohibits members other than *HC* from entering into derivative interest rate positions with outside parties. *HC* regularly holds itself out as being willing and able to, and in fact does, enter into either side of interest rate swaps with its fellow members. *HC* periodically computes its aggregate position and hedges the net risk with an unrelated party. *HC* does not otherwise enter into interest rate positions with persons that are not members of the affiliated group. *HC* attempts to operate at cost, and the terms of its swaps do not factor in any risk of default by the affiliate. Thus, *HC*'s affiliates receive somewhat more favorable terms then they would receive from an unrelated swaps dealer (a fact that may subject *HC* and its fellow members to reallocation of income under section 482). No other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B).

Example 1. General rule for related persons. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has not elected under section 1501 to file a consolidated return. Under paragraph (a)(3)(i) of this section, *HC*'s transactions with its affiliates can be transactions with customers for purposes of section 475(c)(1). Thus, under paragraph (a)(2)(i) of this section, *HC* is a dealer in securities within the meaning of section 475(c)(1)(B), and the members of the group with which it does business are its customers.

Example 2. Special rule for members of a consolidated group. In addition to the *General*

Facts stated above, assume that *HC*'s affiliated group has elected to file consolidated returns and has not made the intragroup-customer election. Under paragraph (a)(3)(ii) of this section, *HC*'s interest rate swap transactions with the members of its consolidated group are not transactions with customers for purposes of determining whether *HC* is a dealer in securities within the meaning of section 475(c)(1). Further, the fact that *HC* regularly holds itself out to members of its consolidated group as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) does not cause *HC* to be a dealer in securities within the meaning of section 475(c)(1)(B). Because no other circumstances are present to suggest that *HC* is a dealer in securities for purposes of section 475(c)(1)(B), *HC* is not a dealer in securities.

Example 3. Intragroup-customer election. In addition to the *General Facts* stated above, assume that *HC*'s affiliated group has elected to file a consolidated return but has also made the intragroup-customer election under paragraph (a)(3)(iii) of this section. Thus, the analysis and result are the same as in *Example 1.*

(b) *Sellers of nonfinancial goods and services*—(1) *Purchases and sales of customer paper.* Except as provided in paragraph (b)(3) of this section, if a taxpayer would not be a dealer in securities within the meaning of section 475(c)(1) but for its purchases and sales of debt instruments that, at the time of purchase or sale, are customer paper with respect to either the taxpayer or a corporation that is a member of the same consolidated group (as defined in § 1.1502-1(h)) as the taxpayer, then for purposes of section 475 the taxpayer is not a dealer in securities.

(2) *Definition of customer paper.* A debt instrument is customer paper with respect to a person at a point in time if—

(i) The person's principal activity is selling nonfinancial goods or providing nonfinancial services;

(ii) The debt instrument was issued by a purchaser of the goods or services at the time of the purchase of those goods or services in order to finance the purchase; and

(iii) 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 corporation that is a member of the same consolidated group as that person.

(3) *Exceptions.* Paragraph (b)(1) of this section does not apply if—

(i) For purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory;

(ii) The taxpayer is subject to an election under paragraph (b)(4) of this section; or

(iii) The taxpayer is not described in paragraph (b)(2)(i) of this section and one or more debt instruments that are customer paper with respect to a corporation that is a member of the same consolidated group as the taxpayer are accounted for by the taxpayer, or by a corporation that is a member of the same consolidated group as the taxpayer, in a manner that allows recognition of unrealized gains or losses or deductions for additions to a reserve for bad debts.

(4) *Election not to be governed by the exception for sellers of nonfinancial goods or services*—(i) *Method of making the election.* Unless the Commissioner otherwise prescribes, an election under this paragraph (b)(4) must be made in the manner, and at the time, prescribed in this paragraph (b)(4)(i). The taxpayer must file with the Internal Revenue Service a statement that says, "[Insert name and taxpayer identification number of 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."

(A) *Taxable years ending after December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends after December 24, 1996, the statement must be attached to a timely filed federal income tax return for that taxable year.

(B) *Taxable years ending on or before December 24, 1996.* If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996, and the election changes the taxpayer's taxable income for any taxable year the federal income tax return for which was filed before February 24, 1997, the statement must be attached to an amended return for the earliest such year that is so affected, and that amended return (and an amended return for any other such year that is so affected) must be filed not later than June 23, 1997. If the first taxable year subject to an election under this paragraph (b)(4) ends on or before December 24, 1996, but the taxpayer is not described in the preceding sentence, the statement must be attached to the first federal income tax return that is for a taxable year subject to the election and that is filed on or after February 24, 1997.

(ii) *Continued applicability of an election.* An election under this paragraph (b)(4) continues in effect for subsequent taxable years until re-

voked. The election may be revoked only with the consent of the Commissioner.

(c) *Taxpayers that purchase securities from customers but engage in no more than negligible sales of the securities*—(1) *Exemption from dealer status*—(i) *General rule.* 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 or, for purposes of section 471, the taxpayer accounts for any security (as defined in section 475(c)(2)) as inventory.

(ii) *Election to be treated as a dealer.* A taxpayer described in paragraph (c)(1)(i) of this section elects to be treated as a dealer in securities by filing a federal income tax return reflecting the application of section 475(a) in computing its taxable income.

(2) *Negligible sales.* Solely for purposes of paragraph (c)(1) of this section, a taxpayer engages in negligible sales of debt instruments that it regularly purchases from customers in the ordinary course of its business if, and only if, during the taxable year, either—

(i) The taxpayer sells all or part of fewer than 60 debt instruments, regardless how acquired; or

(ii) The total adjusted basis of the debt instruments (or parts of debt instruments), regardless how acquired, 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.

(3) *Special rules for members of a consolidated group*—(i) *Intragroup-customer election in effect.* If a taxpayer is a member of a consolidated group that has made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the negligible sales test in paragraph (c)(2) of this section takes into account all of the taxpayer's sales of debt instruments to other group members.

(ii) *Intragroup-customer election not in effect.* If a taxpayer is a member of a consolidated group that has not made the intragroup-customer election (described in paragraph (a)(3)(iii) of this section), the taxpayer satisfies the negligible sales test in paragraph (c)(2) of this section if either—

(A) The test is satisfied by the taxpayer, taking into account sales of debt instruments to other group members (as in paragraph (c)(3)(i) of this section); or

(B) The test is satisfied by the group, treating the members of the group as if they were divisions of a single corporation.

(4) *Special rules.* Whether sales of securities are negligible is determined without regard to—

(i) Sales of securities that are necessitated by exceptional circumstances and that are not undertaken as recurring business activities;

(ii) 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; or

(iii) 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.

(5) *Example.* The following example illustrates paragraph (c)(4)(iii) of this section:

Example. I, an insurance company, regularly makes policy loans to its customers but does not sell them. *I*, however, actively trades Treasury securities. No other circumstances are present to suggest that *I* is a dealer in securities for purposes of section 475(c)(1). Since the Treasuries are qualitatively different from the policy loans that *I* originates, under paragraph (c)(4)(iii) of this section, *I* disregards the purchases and sales of Treasuries in applying the negligible sales test in paragraph (c)(2) of this section.

(d) *Issuance of life insurance products.* A life insurance company that is not otherwise a dealer in securities within the meaning of section 475(c)(1) does not become a dealer in securities solely because it regularly issues life insurance products to its customers in the ordinary course of a trade or business. For purposes of the preceding sentence, the term *life insurance product* means a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract. See sections 72, 817, and 7702. [Reg. § 1.475(c)-1.]

☐ [*T.D.* 8700, 12-23-96.]

→ Caution: Temporary Reg. § 1.475(c)-1T(a), below, was removed by T.D. 8700, effective December 24, 1996.←

[Reg. § 1.475(c)-1T]

§ 1.475(c)-1T. Definitions—Dealers in securities (temporary).—(a) *Sellers of nonfinancial goods and services.* If the principal activity of a taxpayer is selling nonfinancial goods or providing nonfinancial services, the fact that the taxpayer extends credit to the purchasers of its nonfinancial goods or services does not make the taxpayer a dealer in securities within the meaning of section 475(c)(1), even if the taxpayer sells the evidences of indebtedness so acquired. The preceding sentence does not apply if, for purposes of section 471, the taxpayer claims to be a dealer in those evidences of indebtedness.

→ Caution: Temporary Reg. § 1.475(c)-1T(b), below, was removed by T.D. 8700, effective January 23, 1997.←

(b) *Taxpayers that purchase securities but do not sell more than a negligible portion of the securities*—(1) *Exemption from dealer status.* 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) is not thereby a dealer in securities for purposes of section 475(c)(1) if the taxpayer does not sell more than a negligible portion of the securities so acquired. The preceding sentence does not apply if, for purposes of section 471, the taxpayer claims to be a dealer in those securities.

(2) *Negligible portion.* The meaning of negligible portion is illustrated by the following examples:

(i) *Example 1. A* regularly acquires loans (both by making loans to customers and by otherwise purchasing loans) in the ordinary course of its business. *A* retains almost all of the loans that it acquires. In 1993, *A* sells fewer than 60 loans. Accordingly, in 1993 *A* does not sell more than a negligible portion of the securities it acquired.

(ii) *Example 2. B* regularly acquires loans (both by making loans to customers and by otherwise purchasing loans) in the ordinary course of its business. In 1993, *B* sells more than 60 loans, but the total adjusted basis of the loans that *B* sells in 1993 is less than 5% of the total basis, immediately after acquisition, of the loans that it acquires in that year. Accordingly, in 1993 *B* does not sell more than a negligible portion of the securities it acquired.

(3) *Special rules.* Whether the portion of securities sold is negligible is determined without regard to—

(i) Sales of evidences of indebtedness 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 evidences of indebtedness below a certain quality; or

(ii) Sales that are necessitated by exceptional circumstances and that are not undertaken as recurring business activities. [Temporary Reg. § 1.475(c)-1T.]

☐ [*T.D.* 8505, 12-28-93. *Removed by T.D.* 8700, 12-23-96.]

[Reg. § 1.475(c)-2]

§ 1.475(c)-2. **Definitions—Security.**—(a) *Items that are not securities.* The following items are not securities within the meaning of section 475(c)(2) with respect to a taxpayer and, therefore, are not subject to section 475—

(1) A security (determined without regard to this paragraph (a)) if section 1032 prevents the taxpayer from recognizing gain or loss with respect to that security;

(2) A debt instrument issued by the taxpayer (including a synthetic debt instrument, within the meaning of § 1.1275-6(b)(4), that § 1.1275-6(b) treats the taxpayer as having issued); or

(3) A REMIC residual interest, or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect, if the residual interest or the interest or arrangement is acquired on or after January 4, 1995.

(b) *Synthetic debt that § 1.1275-6(b) treats the taxpayer as holding.* If § 1.1275-6 treats a taxpayer as the holder of a synthetic debt instrument (within the meaning of § 1.1275-6(b)(4)), the synthetic debt instrument is a security held by the taxpayer within the meaning of section 475(c)(2)(C).

(c) *Negative value REMIC residuals acquired before January 4, 1995.* A REMIC residual interest that is described in paragraph (c)(1) of this section or an interest or arrangement that is determined by the Commissioner to have substantially the same economic effect is not a security within the meaning of section 475(c)(2).

(1) *Description.* A residual interest in a REMIC is described in this paragraph (c)(1) if, on

the date the taxpayer acquires the residual interest, the present value of the anticipated tax liabilities associated with holding the interest exceeds the sum of—

(i) The present value of the expected future distributions on the interest; and

(ii) The present value of the anticipated tax savings associated with holding the interest as the REMIC generates losses.

(2) *Special rules applicable to negative value REMIC residuals acquired before January 4, 1995.* Solely for purposes of this paragraph (c)—

(i) If a transferee taxpayer acquires a residual interest with a basis determined by reference to the transferor's basis, then the transferee is deemed to acquire the interest on the date the transferor acquired it (or is deemed to acquire it under this paragraph (c)(2)(i)).

(ii) Anticipated tax liabilities, expected future distributions, and anticipated tax savings are determined under the rules in § 1.860E-2(a)(3) and without regard to the operation of section 475.

(iii) Present values are determined under the rules in § 1.860E-2(a)(4). [Reg. § 1.475(c)-2.]

☐ [*T.D.* 8700, 12-23-96.]

[Reg. § 1.475(d)-1]

§ 1.475(d)-1. Character of gain or loss.—(a) *Securities never held in connection with the taxpayer's activities as a dealer in securities.* If a security is never held in connection with the taxpayer's activities as a dealer in securities, section 475(d)(3)(A) does not affect the character of gain or loss from the security, even if the taxpayer fails to identify the security under section 475(b)(2).

(b) *Ordinary treatment for notional principal contracts and derivatives held by dealers in notional principal contracts and derivatives.* Section 475(d)(3)(B)(ii) (concerning the character of gain or loss with respect to a security held by a person other than in connection with its activities as a dealer in securities) does not apply to a security if § 1.475(b)-1(c) and the absence of a determination by the Commissioner prevent section 475(b)(1)(A) from applying to the security. [Reg. § 1.475(d)-1.]

☐ [*T.D.* 8700, 12-23-96.]

[Reg. § 1.475(e)-1]

§ 1.475(e)-1. Effective dates.—(a) and (b) [Reserved].

(c) Section 1.475(a)-3 (concerning acquisition by a dealer of a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(d) Except as provided elsewhere in this paragraph (d), § 1.475(b)-1 (concerning the scope of exemptions from the mark-to-market requirement) applies to taxable years ending on or after December 31, 1993.

(1) Section 1.475(b)-1(b) applies as follows:

(i) Section 1.475(b)-1(b)(1)(i) (concerning equity interests issued by a related person) applies beginning June 19, 1996. If, on June 18, 1996, a security is subject to mark-to-market accounting and, on June 19, 1996, § 1.475(b)-1(b)(1) begins to apply to the security solely because of the effective dates in this paragraph (d) (rather than because of a change in facts), then the rules of § 1.475(b)-1(b)(4)(i)(A) (concerning the prohibition against marking) apply, but § 1.475(b)-1(b)(4)(i)(B) (imposing a mark to market on the day before the onset of the prohibition) does not apply.

(ii) Section 1.475(b)-1(b)(2) (concerning relevant relationships for purposes of determining whether equity interests in related persons are prohibited from being marked to market) applies beginning June 19, 1996.

(iii) Section 1.475(b)-1(b)(3) (concerning certain actively traded securities) applies beginning June 19, 1996, to securities held on or after that date, except for securities described in § 1.475(b)-1(e)(1)(i) (concerning equity interests issued by controlled entities). If a security is described in § 1.475(b)-1(e)(1)(i), § 1.475(b)-1(b)(3) applies only on or after January 23, 1997, if the security is held on or after that date. If § 1.475(b)-1(b)(1) ceases to apply to a security by virtue of the operation of this paragraph (d)(1)(iii), the rules of § 1.475(b)-1(b)(4)(ii) apply to the cessation.

(iv) Except to the extent provided in paragraph (d)(1) of this section, § 1.475(b)-1(b)(4) (concerning changes in status) applies beginning June 19, 1996.

(2) Section 1.475(b)-1(c) (concerning securities deemed not held for investment by dealers in notional principal contracts and derivatives) applies to securities acquired on or after January 23, 1997.

(3) Section 1.475(b)-1(d) (concerning the special rule for hedges of another member's risk) is effective for securities acquired, originated, or entered into on or after January 23, 1997.

(e) Section 1.475(b)-2 (concerning identification of securities that are exempt from mark to market treatment) applies as follows:

(1) Section 1.475(b)-2(a) (concerning the general rules for identification of basis for exemption

from mark to market treatment) applies to identifications made on or after July 1, 1997.

(2) Section 1.475(b)-2(b) (concerning time for identifying a security with a substituted basis) applies to securities acquired, originated, or entered into on or after January 4, 1995.

(3) Section 1.475(b)-2(c) (concerning identification in the context of integrated transactions under § 1.1275-6) applies on and after August 13, 1996 (the effective date of § 1.1275-6).

(f) [Reserved].

(g) Section 1.475(b)-4 (concerning transitional issues relating to exemptions) applies to taxable years ending on or after December 31, 1993.

(h) Section 1.475(c)-1 applies as follows:

(1) Except as otherwise provided in this paragraph (h)(1), § 1.475(c)-1(a) (concerning the dealer-customer relationship) applies to taxable years beginning on or after January 1, 1995.

(i) [Reserved].

(ii) Section 1.475(c)-1(a)(2)(ii) (illustrating rules concerning the dealer-customer relationship) applies to taxable years beginning on or after June 20, 1996.

(iii) (A) Section 1.475(c)-1(a)(3) applies to taxable years beginning on or after June 20, 1996, except for transactions between members of the same consolidated group.

(B) For transactions between members of the same consolidated group, paragraph § 1.475(c)-1(a)(3) applies to taxable years beginning on or after December 24, 1996.

(2) Section 1.475(c)-1(b) (concerning sellers of nonfinancial goods and services) applies to taxable years ending on or after December 31, 1993.

(3) Except as otherwise provided in this paragraph (h)(3), § 1.475(c)-1(c) (concerning taxpayers that purchase securities but engage in no more than negligible sales of the securities) applies to taxable years ending on or after December 31, 1993.

(i) Section 1.475(c)-1(c)(3) (special rules for members of a consolidated group) is effective for taxable years beginning on or after December 24, 1996.

(ii) A taxpayer may rely on the rules set out in § 1.475(c)-1T(b) (as contained in 26 CFR part 1 revised April 1, 1996) for taxable years beginning before January 23, 1997, provided the taxpayer applies that paragraph reasonably and consistently.

(4) Section 1.475(c)-1(d) (concerning the issuance of life insurance products) applies to taxable years beginning on or after January 1, 1995.

(i) Section 1.475(c)-2 (concerning the definition of security) applies to taxable years ending on or after December 31, 1993. By its terms, however, § 1.475(c)-2(a)(3) applies only to residual interests or to interests or arrangements that are acquired on or after January 4, 1995; and the integrated transactions that are referred to in §§ 1.475(c)-2(a)(2) and 1.475(c)-2(b) exist only after August 13, 1996 (the effective date of § 1.1275-6).

(j) Section 1.475(d)-1 (concerning the character of gain or loss) applies to taxable years ending on or after December 31, 1993. [Reg. § 1.475(e)-1.]

☐ [*T.D.* 8700, 12-23-96.]

Adjustments

[Reg. § 1.481-1]

§ 1.481-1. Adjustments in general.—(a) (1) Section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a method of accounting different from that under which the taxable income was previously computed. A change in method of accounting to which section 481 applies includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item. For rules relating to changes in methods of accounting, see section 446(e) and paragraph (e) of § 1.446-1. In computing taxable income for the taxable year of the change, there shall be taken into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent amounts from being duplicated or omitted. The "year of the change" is the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year.

(2) Unless the adjustments are attributable to a change in method of accounting initiated by the taxpayer, no part of the adjustments required by subparagraph (1) of this paragraph shall be based on amounts which were taken into account in computing income (or which should have been taken into account had the new method of accounting been used) for taxable years beginning before January 1, 1954, or ending before August 17, 1954 (hereinafter referred to as pre-1954 years).

(b) The adjustments specified in section 481(a) and this section shall take into account inventories, accounts rece
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