

Frequency and Volume Requirements for Code Sec. 475 Securities Dealer Classification? Insights from Chief Counsel Advice 201423019

By William R. Pomierski

William Pomierski examines the recently released CCA in which the IRS considered whether a taxpayer's activities were sufficient to cause it to be a dealer in securities.



Wolters Kluwer
CCH

Code Sec. 475 requires a dealer in securities to account for its securities transactions on the mark to market method of tax accounting.¹ If a taxpayer is classified as a dealer in securities, the general rule is that *all* securities held or entered into by the taxpayer must be marked-to-market, except for those securities that are eligible for one of the exemptions set out in Code Sec. 475(b). Dealers in commodities and commodities derivatives are not automatically subject to Code Sec. 475, but can elect to apply the mark to market rules to their commodities dealer activities.²

Code Sec. 475(c)(1)(A) defines a dealer in securities as a taxpayer that regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business. Code Sec. 475(c)(1)(B) further defines a securities dealer as a taxpayer that regularly offers to enter into, assume, offset, assign or otherwise terminate (derivative) positions in securities with customers in the ordinary course of a trade or business.

WILLIAM R. POMIERSKI is a Partner in the international law firm of McDermott Will & Emery LLP, resident in the Chicago office. He is a former editor-in-chief of the JOURNAL OF TAXATION OF FINANCIAL PRODUCTS. Mr. Pomierski may be contacted at wpomierski@mwe.com.

The critical components of the definition of a securities dealer are that the taxpayer (1) *regularly* engage in securities transactions (2) with *customers*. Although Code Sec. 475 has been part of the Code for over 20 years, there is surprisingly little authority specifically addressing either of these requirements. As a result, taxpayers—and the IRS—have turned to older case law defining a dealer for other purposes, including authorities addressing the tax character of gains and losses under Code Sec. 1221 (and its predecessor), for assistance in defining a securities dealer.³

Code Sec. 475(f) permits traders in securities and commodities to elect mark-to-market tax accounting for their trading activities. For these purposes, a taxpayer is permitted to make a securities and/or commodities trader election if the taxpayer is engaged in the trade or business of trading. Unlike the securities dealer rules, however, there are a handful of authorities addressing the specific question of whether and when a taxpayer may be considered engaged in a trade or business of trading for purposes of Code Sec. 475(f) (in contrast to an investor whose activities do not arise to the level of a trade or business). The oft-cited standard adopted by the Code Sec. 475(f) authorities is that a taxpayer must engage in “frequent, regular and continuous” activities to be considered a trader in securities or commodities.⁴

In the absence of clear guidance regarding the required level of dealer activities, there continues to be uncertainty in various situations regarding the potential application of Code Sec. 475(a), or the availability of an election under Code Sec. 475(e). Recently issued Chief Counsel Advice 201423019 (the CCA), however, offers a peek at the IRS’s thinking on the dealer issue.⁵ The CCA considers the application of Code Sec. 475(a) to certain activities relating to outstanding mortgage loans and concludes that, for a number of reasons, the activities at issue were not sufficient to result in the taxpayer being considered a securities dealer. Of particular importance to the dealer classification issue, the CCA notes that in determining whether a taxpayer “regularly” purchases or sells securities in the ordinary course of its trade or business, it is necessary to look at the amount and the frequency of purchases and sales.

Code Sec. 475—In General

As indicated above, Code Sec. 475(a) requires a dealer in securities to use the mark-to-market method of tax accounting for the securities it holds or enters into. Under Code Sec. 475(a), if a taxpayer is a dealer in securities,

all securities held or entered into by the taxpayer must be marked to market. Code Sec. 475(b) then provides that the mark-to-market requirements do not apply to an exempt security (as defined below) held or entered into by a securities dealer, provided the security is properly and timely identified as an exempt security.

A. Critical Definitions

To be classified as a dealer in securities within the meaning of Code Sec. 475, a taxpayer has to engage in transactions involving securities with customers. Each of these principal terms is discussed below.

Dealers. For purposes of Code Sec. 475, there are two categories of dealers: inventory dealers and noninventory dealers. An inventory dealer is defined in Code Sec. 475(c)(1)(A) as a taxpayer that regularly purchases securities from *or* sells securities to customers in the ordinary course of a trade or business. This definition is aimed at transactions in traditional securities that can be purchased, originated, held in inventory, and sold, such as equity securities and debt instruments.⁶

Code Sec. 475 also applies to dealers in nontraditional securities, such as over-the-counter derivative contract positions (options, forward contracts, and notional principal contracts) that generally cannot be purchased and sold, or otherwise held in inventory. This second dealer category applies to any taxpayer that regularly offers to enter into, assume, offset, assign or otherwise terminate derivative positions in securities with customers in the ordinary course of a trade or business.⁷

Note that dealer status is determined on a taxpayer-by-taxpayer basis. Thus, if a member of a consolidated federal income tax group is considered a dealer for purposes of Code Sec. 475, other members of the group will not be considered dealers unless they engage in securities dealer activities in their own right. Under Reg. §1.1502-13, however, transactions between a Code Sec. 475 dealer and a non-dealer member of the consolidated federal income tax group must be accounted for under the matching rules relating to the timing and character of income. This often requires the non-dealer member to account for its side of an intercompany transaction with a dealer on a mark-to-market basis, but will not extend beyond the non-dealer member’s transactions with the dealer.⁸

Finally, as described in the CCA, Code Sec. 475 dealer status does not extend to a tax partner of a regarded tax partnership that is engaged in securities dealer activities.

Securities. For purposes of Code Sec. 475, a security is broadly defined to include the following:⁹

- shares of stock
- interests in widely held or publicly traded partnerships or trusts
- notes, bonds, debentures, or other evidences of indebtedness (excluding “customer paper”)¹⁰
- interest rate, currency and equity notional principal contracts
- an evidence of an interest in, or a derivative financial instrument in any security described in subparagraphs (A) through (D) of Code Sec. 475(c)(2) or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency
- a position which is not a security described in subparagraphs (A) through (E) of Code Sec. 475(c)(2), and which is a hedge with respect to such a security, and is clearly and timely identified in the dealer’s records as being described as a hedging transaction

Customers. Merely engaging in transactions in securities of the type described in Code Sec. 475 will not, by itself, be sufficient to cause a taxpayer to be considered a dealer in securities. To be classified as a dealer, a taxpayer must regularly engage in securities transactions with customers.

Whether a taxpayer is engaging in transactions with customers is determined on the basis of all of the facts and circumstances.¹¹ Note that for purposes of Code Sec. 475, a customer may include a related taxpayer that is outside of the dealer’s U.S. consolidated federal income tax group.¹² In fact, a taxpayer can be a dealer for purposes of Code Sec. 475 even if all of its customers are related parties outside of its consolidated federal income tax group.

Under Reg. §1.475(c)-1(a)(3)(ii), if a taxpayer’s *only* customers are members of its consolidated federal income tax group, absent an election to the contrary, the taxpayer will *not* be considered a Code Sec. 475 dealer. This election is referred to as the “intragroup-customer election.”¹³ However, if the taxpayer is otherwise considered a dealer in securities for purposes of Code Sec. 475, members of the taxpayer’s consolidated federal income tax group may be considered customers for these purposes without regard to the intragroup-customer election.

Unfortunately, beyond the rules for related parties and consolidated group members, neither Code Sec. 475 nor the regulations thereunder provide any guidance as to the meaning of the term “customer” in this context. Given the lack of statutory or regulatory guidance, authorities defining a customer outside of Code Sec. 475 must be considered. For example, in *Bielfeldt*, the Tax Court analyzed whether an individual was acting as a dealer because of his extensive buying and selling of Treasury securities.¹⁴ The

Tax Court reviewed a long line of case law and determined that the taxpayer’s pool of purchasers—primary dealers in Treasury securities—was not indicative of dealer status. Citing *Wood*,¹⁵ the Tax Court indicated that:

A dealer is a person who purchases the securities or commodities with the expectation of realizing a profit not because of a rise in value during the interval of time between purchase and resale, but merely because they have or hope to find a market of buyers who will purchase from them at a price in excess of their cost. This excess or mark-up represents remuneration for their labors as a middleman bringing together buyer and seller, and performing the usual services of retailer or wholesaler of goods.

The Tax Court refused to reach a conclusion that a “customer” includes any person with whom the taxpayer had established business relationships and with whom the taxpayer had dealt with regularly. Accordingly, the Tax Court upheld the IRS’s position that the taxpayer was not a dealer, and that the taxpayer’s losses from its trading activities involving Treasury securities were capital.¹⁶

One of the more frequently-quoted cases in this area is *Kemon*, where the Tax Court distinguished dealers from traders (who do not perform a merchandising function) as follows¹⁷:

Contrasted to “dealers” are those sellers of securities who perform no such merchandizing functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. The sellers depend upon such circumstances as a rise in value or an advantageous purchase to enable them to sell at a price in excess of cost. Such sellers are known as “traders.”

In the absence of a merchandising function, courts have consistently treated securities as held for investment and not primarily held for sale to customers where they are held by the taxpayer primarily for their income yield.¹⁸

B. Exempt Securities

As indicated above, the starting point under Code Sec. 475(a) is that *all* securities held or entered into by a securities dealer must be marked to market. Code Sec. 475(b) then provides that the mark-to-market rules do not apply

to an *exempt security* held or entered into by a securities dealer if the security is properly and timely identified as an exempt security.

Under Code Sec. 475(b), an exempt security is a security that satisfies one of three exceptions: (1) a security that is held for investment; (2) a note, bond, debenture, or other evidence of indebtedness that is acquired or originated in the ordinary course of the taxpayer's business but is not held for sale to customers; or (3) a "qualifying hedge."¹⁹ Qualification as an exempt security is not, by itself, sufficient to avoid mark-to-market treatment. In addition to meeting one of the exceptions, an exempt security must also be timely identified as an exempt security to avoid being marked to market.²⁰

CCA 201423019

In the CCA, the taxpayer (referred to as "Taxpayer"), took the position that it was a Code Sec. 475 securities dealer by reason of certain servicing activities relating to mortgage loans the Taxpayer acquired from a related entity (referred to as Partnership X), where the mortgages were originated by Partnership X rather than by the Taxpayer itself.²¹ Specifically, the Taxpayer took that the position that (1) the Subservicer, as described below, caused significant modifications to the mortgage loans held by the Taxpayer (through securitization trusts), resulting in deemed exchanges under Reg. §1.1001-3, (2) the Subservicer's activities relating to the new loans resulting from these deemed exchanges arose to the level of a securities dealer, and (3) the Subservicer's dealer activities could be attributed to Taxpayer.

A. The Facts

Taxpayer is described as a holding company for several operating companies, including a regarded tax partnership (referred to as Partnership X) that was engaged in the business of originating and purchasing mortgage loans in the open market. The CCA indicates that Partnership X accounted for its securities transactions on the mark-to-market method under Code Sec. 475, except for a portion of its mortgage loans that were identified as exempt (held for investment) securities.

Partnership X participated in mortgage-backed securitization activities pursuant to which it contributed the mortgage loans it originated to trusts (referred to in the CCA as the "DE Trusts"). The DE Trusts, in turn, issued notes to third party investors as mortgage-backed securities. Partnership X also set up some of the trusts as real estate mortgage investment conduits (REMICs). Partnership X

retained the residual interests in the securitization trusts (representing tax ownership of the mortgage loans). It subsequently sold the residual interests in the trusts to Taxpayer. The CCA indicates that the parties treated that transaction as a sale of the mortgage loans underlying the trusts from Partnership X to Taxpayer.

According to the facts described in the CCA, the parties to the securitizations entered into three servicing agreements relating to the mortgage loans involving (1) a Master Servicer, (2) a Servicer, and (3) a Subservicer. Pursuant to the relevant servicing agreement, the Subservicer, whose activities become the focus of the Taxpayer's Code Sec. 475 position, was authorized to collect principal and interest payments on the mortgage loans, monitor property taxes and insurance and foreclose on securing properties. The Subservicer was not, however, authorized to modify mortgage loan terms unless a default was imminent.

The Subservicer is described as a limited liability company that was initially a wholly-owned tax disregarded subsidiary of Partnership X. Partnership X later contributed its equity interest in the Subservicer to Partnership Z, a regarded tax partnership, in exchange for a portion of Partnership Z's outstanding equity. Partnership X then transferred its equity interest in Partnership Z to Taxpayer, resulting in Taxpayer owning an interest in the Subservicer through Partnership Z (a regarded tax partnership).

B. Regularity of Dealer Activities

Before considering the specific activities that the Taxpayer asserted resulted in it being classified as a securities dealer under Code Sec. 475, the IRS first considered the appropriate standard for determining dealer status. According to the IRS, after determining that a dealer-customer relationship exists, the next critical question is whether a taxpayer "regularly" purchases or sells securities in the ordinary course of its trade or business.

The IRS indicated that the "regularly" standard in Code Sec. 475 "requires looking at the amount of and the frequency of purchases and sales and determining whether it is sufficient to be considered dealer activity." The IRS then considered this standard in light of the activities at issue in the CCA. As described below, the Taxpayer's principal position was that the loan modifications resulting from the Subservicer's activities on behalf of the DE Trusts were dealer activities that could be attributed to Taxpayer. Unfortunately, beyond stating that the "amount of and frequency of" securities transactions has to be considered in determining whether there is a sufficient level of activity to constitute a securities dealer, the CCA offers little in terms of practical guidance on this point.

C. Loan Modifications as Loan Originations

As noted above, the Taxpayer took that the position that the mortgage loan modification activities of the Subservicer were dealer activities that could be attributed to the Taxpayer.²² According to the CCA, the “grounds” for dealer status for the Subservicer—and thus the Taxpayer—was based on the loan modifications and whether they resulted in “originating new loans” with customers.

Keeping in mind that the basic definition of a securities dealer is a taxpayer that regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, the IRS questioned “whether workout activity to achieve loan modifications in this case rises to the level of dealer activity” under Code Sec. 475. The IRS then set out several alternative arguments it could make in support of its view that the Subservicer did not regularly engage in loan modifications and that the loan modifications were not in the ordinary course of its trade or business of servicing loans.

Of particular interest both for purposes of Code Sec. 475 and for other Code sections, including but not limited to Code Sec. 864, is the IRS view that while the loan modifications at issue may have resulted in deemed exchanges under Reg. §1.1001-3, that such deemed exchanges did not constitute loan *originations*.²³ The IRS noted that the Subservicer’s authority under the related servicing agreement to modify the terms of the mortgage loans was limited and available only where default was imminent. It believed that this loan modification activity was intended to preserve the mortgage loans held as collateral for the DE Trusts. It concluded that the Subservicer was in the business of servicing the loans, and “although it could do loan modifications to stop default proceedings, there are questions as to whether it regularly engaged in loan modifications and whether loan modifications were in the ordinary course of its trade or business of servicing loans.” The IRS ultimately determined that the Subservicer “was not in the business of being a mortgage loan originator. The fact that it may occasionally do some loan modifications does not make it a mortgage loan originator.”

The CCA also considered whether the Subservicer’s activities involved customers for purposes of Code Sec. 475. Based on its view that the Subservicer’s purpose for engaging in loan modifications was to preserve the collateral (mortgages) underlying the debt obligations issued by the DE Trusts, as opposed to generating a profit from a markup in price, the IRS concluded that the Subservicer’s activities resulting in the loan modifications did not involve selling, purchasing or making loans to or from its customers.

D. Attribution of Subservicer’s Activities to the Taxpayer—Agency and Partnership Considerations

The IRS also addressed the question of whether, assuming the Subservicer’s activities arose to the level of a securities dealer, those activities could be attributed to the Taxpayer. In considering this issue, the IRS first noted that while the Subservicer was a disregarded tax entity, it was disregarded into Partnership Z, in which the Taxpayer held a majority equity interest, rather than directly into the Taxpayer. As such, the Subservicer’s activities could not be attributed directly to the Taxpayer.

The IRS then considered whether the Subservicer’s activities could be attributed to the Taxpayer as its agent. On this issue, the IRS focused on the terms of the related servicing agreement, which described the Subservicer as an independent contractor of the DE Trusts. The IRS concluded, after a lengthy analysis, that under the express language in the servicing agreement, the Subservicer did not qualify as the Taxpayer’s agent under the agency rules established in the leading cases of *National Carbide Corp.* and *Bollinger*.²⁴

Finally, while it is not clear from the CCA whether or to what extent the Taxpayer asserted that it should be considered a dealer in securities based on Partnership X’s mortgage lending activities, the IRS also addressed this potential attribution issue. The IRS pointed out that the mortgage loans represented by the residual interests in the DE Trusts were originated by Partnership X, which was a dealer in securities. It viewed the mortgage loans as having been entered into with customers of Partnership X, who were not customers of the Taxpayer. The IRS concluded that in light of the fact that Partnership X was not a disregarded entity, while the character (and timing) of any gains and losses attributable to Partnership X’s securities dealer activities flowed through to Taxpayer, as a partner, the dealer activities of Partnership X did not. In other words, the Taxpayer could not treat itself as a dealer in securities by reason of its equity interest in a regarded partnership engaged in securities dealer activities.

Conclusions

At first glance, the CCA may not be viewed as particularly noteworthy in light of the factual scenario under consideration. The facts described in the CCA may be somewhat unique in light of the relationships among the various parties and the transfer and modification of the securities at issue.

The CCA should be of general interest, however, in light of the questions considered by the IRS in its analysis of the situation. In particular, the CCA is important in that it calls into question the required level of activities that may be necessary to result in a securities (or commodities) dealer classification. This is an issue that often arises in the context of hedge center arrangements pursuant to which a taxpayer enters into, for example, foreign currency derivative hedging activities with related parties. Specifically, hedge centers often take on currency risk from related parties and manage some or all of that aggregate risk by entering into third party hedging transactions. Similarly, cash pooling arrangements can involve a designated entity that accepts deposits from related entities and makes (originates) loans to other related entities. These activities often raise questions as to whether the level and frequency of transactions between the hedge center and its affiliates are sufficient to rise to the level of a securities dealer.

Although a definitive dealer-customer standard did not come out of the CCA, the IRS has at least acknowledged that securities dealer activities need to be engaged in *regularly*, and that this requires an evaluation of “the amount of and the frequency of purchases and sales and determining whether it is sufficient to be considered dealer activity.” This analysis suggests, for example, that the mere existence of a hedge center arrangement may not result in a per se securities dealer activity, and that the critical issue is whether the particular hedge center’s activities are substantial and sufficiently frequent to arise to the level of a dealer.

In the absence of definitive guidance, taxpayer’s engaging in activities that could potentially be viewed as securities dealer activities should consider the impact of Code Sec. 475 on their activities, and should further consider, if appropriate, establishing procedures for identifying exempt securities (where available), on a protective basis or otherwise.²⁵

ENDNOTES

- ¹ Unless otherwise indicated, all references to “Code Sec.” and “§” are to the Internal Revenue Code of 1986, as amended (the “Code”), or the Treasury Regulations promulgated thereunder.
- ² See Code Sec. 475(e). If a dealer in commodities makes an election under Code Sec. 475(e), commodities (as defined) held or entered into by such dealer are accounted for in the same manner as Code Sec. 475 applies to a dealer in securities. See Proposed Reg. §1.475(e)-1(b) (“Except as otherwise provided in this section or in other guidance prescribed by the Commissioner, the rules and administrative interpretations under section 475 for dealers in securities apply to dealers in commodities that make an election under section 475(e)(1).”).
- ³ The Chief Counsel Advice itself acknowledges the absence of guidance on the determination of dealer status: “Section 475 does not define the term customer for the dealer–customer relationship that is necessary under this section to be a dealer in securities. The regulations provide that the determination of whether a taxpayer is transacting business with a customer is based upon all the facts and circumstances. See Treas. Reg. §1.475(c)-1(a)(2)

- (ii). The regulations provide no examples of a dealer–customer relationship for a dealer as described in section 475(c)(1)(A). However, there is plenty of case law that has looked at the question of dealer and trader for purposes of section 1221, and discussed the customer requirement for a dealer in that context.” See also CCA 201132021, released August 12, 2011 (“When applying this case law under section 475, we need to make sure that we do not get caught up on the purchase and resale requirement that is not part of section 475. We think your analysis may have done so. However, we do need to use this case law to help in making the customer determination.”).
- ⁴ See *F. Chen*, 87 TCM 1388, Dec. 55,653(M), TC Memo. 2004-132 (“For a taxpayer to be considered a trader, the taxpayer’s trading activity must be ‘substantial’, and it must be ‘frequent, regular, and continuous to be considered part of a trade or business. *** Sporadic trading does not constitute a trade or business.’ *N. Boatner*, 74 TCM 342, Dec. 52,211, TC Memo. 1997-379, *aff’d*, CA-8, 98-2 ustrc ¶150,785, 164 F3d 629; see also *R. Groetzing*, SCT, 85-2 ustrc ¶9622, 480 US 23, 35, 107 Sct 980 (1987) (“We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity ***. A sporadic activity *** does not qualify.”). See also *R. Kay, Jr.*, 102 TCM 19, Dec. 58,691(M), TC Memo 2011-159.
- ⁵ The Chief Counsel Advice, which was publicly released on June 6, 2014, is a memorandum prepared by the Office of Chief Counsel of the IRS. It is intended to provide written advice or instructions from Chief Counsel to field examiners and/or service center employees. See Code Sec. 6110(i); see also Dale S. Collinson, Current Federal Tax Developments, *Generic Legal Advice—A New Form of Nonprecedential Legal Advice*, J.TAX’N FIN’L PRODUCTS, Vol. 6, No. 3 (2007). Pursuant to Code Sec. 6110(k)(3), these determination letters cannot be used or cited as precedent.
- ⁶ See Reg. §1.475(c)-1(c)(1)(i). Under the Treasury regulations, however, if a taxpayer’s only “dealer” activities are those of regularly purchasing (or originating) loans from customers in the ordinary course, the taxpayer will *not* be treated as a dealer in securities under Code Sec. 475 to the extent the taxpayer satisfies the “negligible sales” exception. Note that the regulations provide for an election out of the negligible sales exception for lenders that want to be subjected to the mark-to-market rules. See Reg. §1.475(c)-1(c)(1)(ii). Alternatively, a taxpayer can be considered to have elected out of the negligible sales exception if it accounts for its securities (loans) as “inventory” for purposes of Code Sec. 471.
- ⁷ Code Sec. 475(c)(1)(B).
- ⁸ See, e.g., Reg. §1.1502-13(c)(7)(ii), Example 11. See also the intercompany obligation rules under Reg. §1.1502-13(g).
- ⁹ See Code Sec. 475(c)(2)(A) – (F).
- ¹⁰ “Customer paper” is defined in Code Sec. 475(c)(4) as any receivable which (1) is a note, bond, debenture or other evidence of indebtedness; (2) arises out of the sale of nonfinancial goods or services by a person the principal activity of which is the selling or providing of nonfinancial goods or services; and (3) is held by such person (or related person) at all times since issuance.
- ¹¹ Reg. §1.475(c)-1(a).
- ¹² Reg. §1.475(c)-1(a)(3).
- ¹³ See Reg. §1.475(c)-1(a)(3)(iii).
- ¹⁴ *G.K. Bielfeldt*, 76 TCM 776, Dec. 52,943(M), TC Memo. 1998-394, *aff’d*, CA-7, 2000-2 ustrc ¶150,829, 231 F3d 1035.
- ¹⁵ *S.M. Wood*, CA-9, 91-2 ustrc ¶150,432, 943 F2d 1048, 1051-52.
- ¹⁶ See also *R. Frankel*, 56 TCM 1156, Dec. 45,447, TC Memo. 1989-39 (the Tax Court declined to adopt the definition of a “customer” as any person who buys an asset from another person and concluded that the taxpayer was not a dealer because the taxpayer sold to brokers and market makers, and not to customers. The Tax Court effectively ruled in favor of the IRS’s position that the taxpayer was a trader by virtue of its activities of attempting to profit from price movements in the underlying securities. Hence taxpayer’s losses were capital, not ordinary.)
- ¹⁷ *G.R. Kemon*, 16 TC 1026, 1032-33, Dec. 18,271 (1951).
- ¹⁸ See, e.g., *Chinook Inv. Co.*, CA-9, 43-2 ustrc ¶9538, 136 F2d 984; *R. Brown*, CtClS, 70-1 ustrc ¶9407, 426 F2d 355; and *S.M. Wood*, CA-9, 91-2 ustrc ¶150,432, 943 F2d 1048. See also *Stephens, Inc.*, CA-8, 72-2 ustrc ¶9547, 464 F2d 53 (a dealer’s profit must accrue strictly from the sale of the security

itself and cannot be planned to arise from the necessity of combining the investment income yielded by the security and the ultimate resale price). See also *S. Marrin*, CA-2, 98-2 ustrc ¶50,490, 147 F3d 147, *aff'g*, 73 TCM 1748, Dec. 51,826, TC Memo. 1997-24; and *M. King*, 89 TC 445, 458, Dec. 44,174. In Chief Counsel Advice 200817035 (Apr. 25, 2008), in the context of considering the exemption under Code Sec. 475(b)(1)(B) (not held for sale to customers), the IRS, in addressing the case law distinguishing between dealers and traders, focused heavily on the manner in which the taxpayer at issue was compensated for engaging in certain securities transactions, suggesting that compensation for serving as a middle man or merchant in a securities transaction is a critical dealer classification consideration.

¹⁹ A "qualifying hedge" is defined in Code Sec. 475(b)(1)(C) as any security which is a hedge with respect to (1) another security that is not subjected to the mandatory mark-to-market rules, or (2) with respect to any other position, right to income, or liability that is not a security in and of itself.

²⁰ A securities dealer can essentially elect whether or not to mark its exempt securities to market by making—or refraining from making—timely identifications of its exempt securities. A securities dealer seeking to take advantage of an available exemption must identify a qualifying security as exempt *before the close of the day* on which the security is acquired, originated or entered into. Code Sec. 475(b)(2). In addition, the taxpayer must identify the particular subparagraph of Code Sec. 475(b)(1) under which the security is exempt. *Id.* For example, a security that is eligible for the "held for investment exemption" must be identified as exempt under Code Sec. 475(b)(1)(A). Neither Code Sec. 475 nor the regulations thereunder specify the manner in which an exempt security is to be identified. The current procedures are set out in Holding 6 of Rev. Rul. 97-39, 1997-2 CB 69. Exemption identifications are not filed with the IRS but are, rather, simply made and retained as part of the taxpayer's books and records.

²¹ Without discussing whether the Taxpayer in the CCA was eligible to make a securities trader election under Code Sec. 475(f), the IRS simply noted that no such election was timely made for the years under examination.

²² For a detailed discussion of the debt modification rules set out in Reg. §1.1001-3 and the resulting deemed exchange considerations, see William R. Pomierski and Jeffrey K. Ekeberg, *Final Actively Traded Debt Regulations: Implications for Debt Modifications and Exchanges*, TAX EXECUTIVES, Feb.–Mar. 2013.

²³ For a discussion of the issues relating to the application of Code Sec. 864 to loan originations by non-U.S. persons, see David H. Shapiro and Jeff Maddrey, *The Importance of a 'Customer Relationship' in Loan Origination*, 126 TAX NOTES 659 (Feb. 1, 2010).

²⁴ See *National Carbide Corp.*, SCt, 49-1 ustrc ¶9223, 336 US 422, 437, 69 SCt 726, and *J. Bollinger*, SCt, 88-1 ustrc ¶9233, 485 US 340, 108 SCt 1173.

²⁵ As noted above, the current procedures for identifying an exempt security are set out in Holding 6 of Rev. Rul. 97-39, 1997-2 CB 69.

It is important to note that if a taxpayer acquires or enters into Code Sec. 475 securities prior to becoming a dealer, there is no transitional relief from the requirement that exempt securities must be identified as exempt on or before the end of the day on which such securities are acquired or entered into. As a result, if a taxpayer becomes a dealer in securities, any previously acquired securities that do not qualify for the per se held for investment rule described in Reg. §1.475(b)-1(b) will be subject to market accounting if such existing securities were not timely identified as exempt even though the taxpayer may not have been a dealer in securities at such securities were acquired or entered into. A taxpayer that is concerned about the possibility of becoming a dealer in securities in the future, however, may make protective exemption identifications without creating an adverse implication as to its status as a dealer. See Holding 1 of Rev. Rul. 97-39.

This article is reprinted with the publisher's permission from the JOURNAL OF TAXATION OF FINANCIAL PRODUCTS, a quarterly journal published by CCH, a part of Wolters Kluwer. Copying or distribution without the publisher's permission is prohibited. To subscribe to the JOURNAL OF TAXATION OF FINANCIAL PRODUCTS or other CCH, a part of Wolters Kluwer Journals please call 800 449 8114 or visit CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH, a part of Wolters Kluwer.