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Memorandum

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to: Associate Area Counsel
(Manhattan Group 5)
(Large Business & International)
Attn: David Lee

from: Stephen Larson
(Associate Office of Chief Counsel (Financial Institutions & Products))

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subject: Whether Taxpayer is a Dealer in Securities

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

LEGEND

Taxpayer =
Group A =
Company B =
foreign subsidiary =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Securities X =
A amount =
B amount =
C amount =
D amount =
E =
F amount =
G Amount =
H amount =

I amount =
J amount =

ISSUES

1. Whether Taxpayer qualifies as a dealer in securities?

2. Did Taxpayer make an unauthorized change in its method of accounting for Years 3 and 4 to use the mark-to-market method under section 475? If not, and if Taxpayer no longer qualifies as a dealer in securities in Year 4, can it use the mark-to-market method of accounting under section 475?

CONCLUSIONS

1. Yes, based upon the information provided, it is our view that Taxpayer qualifies as a dealer in securities. We think this Taxpayer regularly purchased and also sold securities to customers in the ordinary course of its trade or business. We also think that the lack of purchases or sales during a year in which the markets were highly distressed should not disqualify Taxpayer from dealer status.

2. Based upon the information provided to date, we can not say for certain that Taxpayer made an unauthorized change in its method of accounting. The fact that no mark-to-market gain or loss was reported for Years 1 and 2 does suggest that possibility. But it is also possible that Taxpayer has been marking since Year 1, but that it had no gain or loss in those earlier years. One way to verify whether Taxpayer adopted a mark to market method in Year 1 for tax purposes is to look to the valuations reported for the same securities for financial statement purposes. If Taxpayer had no gains or losses reported for these securities, then this is strong support that they just had no gains or losses to report for section 475 purposes.

FACTS

Taxpayer is the parent company for Group A. Taxpayer is the holding company for four subsidiaries. The overall business of Group A is that of an investment bank. One of the subsidiaries, Company B, is a registered broker/dealer entity. Taxpayer and Company B are involved with the securitization activity discussed in this memo. These particular securitizations are part of the Taxpayer's larger securitization business.

In Year 1, Taxpayer began purchasing trust preferred securities (TruPs) from various regional banks. According to the incoming facts, the TruPs were treated as debt for tax purposes.[1] Taxpayer would hold and warehouse these TruPs until there

[1] TruPs are able to be treated as debt for tax purposes, depending upon the specific facts and circumstances. See Notice 94-47, 94-1 C.B. 357, which describes factors IRS will look at in determining whether a transaction that is treated as debt for tax purposes, but equity for regulatory purposes is actually debt for tax purposes.

was a sufficient number and dollar amount of these securities to form a securitization vehicle. Company B worked with outside advisors to form Trusts that would hold the TruPs and issue Securities X to an investor base. Securities X is a brand name given to the type of collateralized debt obligation (CDOs) created by the Company B.[2] Securities X was made up of the repackaged TruPs and other debt sold by insurance companies and REITs. Once Company B and outside advisors had arranged enough buyers for Securities X, Taxpayer sold the TruPs to the Trusts. According to the incoming request, these trusts are Cayman Island third parties and not disregarded entities of the Taxpayer.[3] The repackaged TruPs and other securities were then sold as Securities X to third party investors. Company B was a co-issuer of these securities.

Taxpayer claims that it purchased and sold the TruPs at their fair market value which equaled par value at the time of purchase and sale. Taxpayer asserted that they did not expect to have any gain or loss on the sale of the TruPs. Taxpayer was compensated for its services by receiving a warehousing fee from the co-issuers of Securities X**.** This warehouse fee was A amount of the par amount of the TruPs. Taxpayer reported this warehouse fee as service income. Taxpayer claims that this fee was in lieu of and akin to a bid/ask spread. Although the percentage Taxpayer received as a warehousing fee remained the same for Years 1-4, the total amount that Taxpayer collected in warehousing fees decreased as the securitization market dried up. This fee was Taxpayer's only source of income from the sale of the TruPs. In Year 2, 3 and 4, Taxpayer also received interest income from TruPs securities it was holding. The total amount of interest income received over the financial crisis years from these TruPs increased as the TruPs were held longer after it became more difficult to sell them.

For Years 1 and 2, Taxpayer did not report any mark-to-market gain or loss attributable to the purchase or sale of TruPs. For the years under audit, Years 3 and 4, Taxpayer reported mark-to-market losses in B amount and C amount, respectively. Taxpayer asserts that for financial reporting purposes it always marked to market all of its warehoused TruPs. As the financial crisis hit and lack of liquidity in the market spread, Taxpayer did have mark-to-market losses. The securitization market dried up, the credit quality of the issuing banks deteriorated and Taxpayer and Company B were unable to sell Securities X, so Taxpayer was forced to retain a pool of TruPs on its books. In Year 4, the value of the TruPs plummeted. Also in Year 4, Taxpayer was approached by some of the TruPs issuing regional banks wanting to reacquire their TruPs because they had an interest rate significantly higher than current market rate. Taxpayer realized a loss on the sale of those TruPs in the D amount.

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[2] Your incoming request states in one place that Taxpayer created Securities X and in another place that Company B repackaged and created Securities X. We are assuming it is Company B that created Securities X based upon the overall description of the securitization process.

[3] [redacted]

LAW AND ANALYSIS

There are several issues that must be determined for purposes of evaluating Taxpayer's refund claim. First it must be determined whether Taxpayer ever qualified to be a dealer in securities, and if so, did it cease to be a dealer in Year 4. Then it must be determined whether Taxpayer was entitled to use the mark-to-market method of accounting in Years 3 and 4 or whether it made an unauthorized change in its method of accounting. It is Taxpayer's use of that method that allowed large losses for Years 3 and 4, contributed to the NOL carrybacks to prior years, and generated the refund claims.

Dealer in Securities Issue

In making the determination as to whether Taxpayer qualifies as a dealer in securities under section 475, we must look at the different dealer type activities that are going on in this securitization, and any other activities in which Taxpayer may be involved. We view this securitization process as having two parts. The first part consists of the purchase of the TruPs from the regional banks, the warehousing of them, and then the sales of the TruPs to the Trusts. The second part of the securitization process is the repackaging of the debt into Securities X and the actual sale of Securities X to third party investors by Company B.[4] There are different possible dealer activities that Taxpayer is involved in for the first part of this particular securitization transaction. We need to look at each of those activities to see whether Taxpayer acted as a dealer in securities.

Section 475(c)(1)(A) provides that a dealer in securities is a taxpayer who regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business. In this case, it appears that Taxpayer is purchasing debt from the regional banks. Debt is a security under section 475(c)(2)(C). Therefore, Taxpayer is purchasing section 475 securities, unless there are other facts that would support a finding that the TruPs are not debt. The taxpayer is also selling debt to the Trusts. So Taxpayer is meeting the requirement of section 475(c)(1)(A) that it either purchase or sell securities. Taxpayer appears to be doing both.

The next question is whether Taxpayer is regularly purchasing this debt from customers or selling it to customers. Section 475 does not define who is a customer, but we can look at case law prior to the enactment of section 475 to help in making that determination. In determining whether a taxpayer has customers, the courts have looked to how a taxpayer is compensated. The courts in finding dealer status outside of section 475 have looked to whether a taxpayer is paid for its services as an intermediary- as a market-maker. We note that section 475 departs from the old case law in that it does not require that a dealer both buy and sell securities. Instead, section 475 only requires a buy or sell test. The result of that change is that the middleman

[4] It is our understanding that the repackaging and selling of Securities X by Company B is a different dealer activity, in which Taxpayer is not involved.

function described in many of the cases discussing dealer status is no longer required under section 475. That said, many section 475 dealers do both buy and sell and serve that middleman function.

We need to see whether Taxpayer was getting paid for making a market (dealer) and not profiting from a rise in values of the underlying assets during the interval of time between a purchase and resale (investor or trader). Several pre-section 475 cases have used a merchant analogy to distinguish dealers from traders. Dealers, like merchants, sell to customers and purchase the securities with the expectation of selling at a profit. This profit is not because of a rise in value during the period of time between purchase and sale, but because they 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 acting as a middle man, bringing together buyer and seller. See Kemon v. Commissioner, 16 T.C. 1026, 1032-1033. We think that Taxpayer did both buy and sell securities and served that middleman function, even though it was not required to do so under section 475.

In this transaction, although the matter is not entirely free from doubt, we think the regional banks from which the debt is purchased are the Taxpayer's customers. Dealers regularly transact with other dealers. Sometimes one acts as the customer of the other in different transactions. Since Taxpayer is in the securitization business and it holds itself out as a market-maker looking to buy TruPs from regional banks so that securitization vehicles can be created, we think there is a fairly strong argument that the regional banks are customers of Taxpayer.

We think the Trusts are customers of Taxpayer. Taxpayer sells debt to these Trusts.[5] It appears that Taxpayer is acting as a middleman between the regional banks and Company B and Trusts by buying the TruPs, warehousing them until Company B is ready to repackage them as a new type of debt and then making sure that the debt is available when needed. Taxpayer also provides liquidity to the regional banks by buying the TruPs before the TruPs are repackaged and the new debt is sold to investors by Company B. Taxpayer is being paid A amount by the co-issuers of the Trusts as warehousing fee for the TruPs. It can be argued that this warehousing fee is consistent with a fee for being a market-maker for the first part of this securitization transaction. This warehouse fee is remuneration for acting as a middle man, bringing together buyers and sellers, and performing the usual services of a retailer or wholesaler of goods.

The next question to be addressed is whether Taxpayer "regularly" purchases or sells securities. Whether there is sufficient activity to be regular may be one of the more difficult issues in this case. This requires looking at the amount of and the frequency of

[5] If it is discovered that these Trusts are related to Taxpayer, we would want to reevaluate our position. We also suggest that it might be worthwhile to look at the owners of these trusts to see if they are related to the foreign subsidiary of Taxpayer or to Taxpayer. If so, you may want to talk to an International Examiner to see if there are any international issues, perhaps a section 482 issue.

purchases and sales and determining whether it is sufficient to be considered dealer activity. We think that it is also important in making that determination to consider the type of dealer business. Many dealers engage in several kinds of dealer activities, such as a derivatives business, physical securities, loan origination and securitizations. In those type of dealer businesses there will be large amounts and continuous purchase and sales activity and other dealer activity, usually on a daily basis. If the only dealer activity is securitizations, as appear to be the case for Taxpayer, it is only natural that the amount and frequency of the dealer activity will be less. Prior to the most recent financial crisis, it was probably common for securitizations to take about 30 days or so to be completed, during the financial crisis securitizations stopped or slowed down dramatically. During and after that crisis it was probably more common for securitizations to take at least 60-90-120 days, in part to meet stricter due diligence requirements.

In this case, it is not clear to us whether Taxpayer is engaged in any active dealer business other than securitizations. We understand that Group A is in the investment bank business, but to what extent Taxpayer is involved in those activities on the entity level is not clear. We do know that Taxpayer is involved in the TruPs securitization transactions business along with Company B. To the extent that you develop other facts that may establish other dealer activity either with other subsidiaries, or on its own (or other business with Company B), those activities are also considered in determining whether Taxpayer is a dealer. Because section 475 dealer status is determined on an entity by entity approach, we do not attribute the dealer activity of Company B to Taxpayer. Therefore we do not look at the sale of the Securities X to third party investors as part of Taxpayer's dealer activity, unless Company B was acting as an agent of Taxpayer in making those sales.

It has been represented that over the period from Year 1, when this Taxpayer started this type of securitization transaction until Year 4, it has purchased over E issuances of TruPs, with a par value in excess of F amount. For the years under audit, Years 3 and 4, the amount of sales of TruPs into the securitization market had declined due to the effects of the financial crisis. In Year 3, Taxpayer sold G Amount of TruPs to the Trusts. In Year 4, no TruPs were sold to the Trusts. Taxpayer did however sell back D amount of the TruPs to the issuing regional banks. We think that the amount of TruPs purchased by this Taxpayer and the frequency of the sales to the Trusts falls within a range that would constitute dealer activity. We also think that because of the financial crisis, it is very probable that the securitizations decreased or even ceased to happen for certain years. The Service should not take the position that a taxpayer no longer qualifies as a dealer because it held securities rather then sold them at severely distressed market prices during this time.

Exam raised the issue that during Year 3 and 4 Taxpayer may have held these securities as "long investment to corporate bonds" rather than as inventory. It was asserted that this should support a finding that Taxpayer is not a dealer in these years and thus is not entitled to mark its losses under section 475. We disagree. Taxpayer, if

properly on section 475, would still have to mark these securities because they would not met the timeliness requirements for identifying these securities as held for investment or as not held for sale.

Other factors mentioned in old case law looking at dealer/trader status, (such as whether the taxpayer has a regular place of business, whether it is licensed as a dealer, advertises itself as a dealer, transacts a large volume of business and subscribes to certain services used by brokers and dealers), on balance support treating this Taxpayer as a dealer. Although Taxpayer was not a registered broker dealer with the SEC, taxpayer was conducting business with other regional banks and basically holding itself out as a dealer in that it purchased from several different regional banks. Both the text of the statute and the legislative history make it clear in enacting section 475 Congress intended to extend "dealer in securities" well beyond broker/dealer.

Issue 2 – Was there an Unauthorized Change in Method of Accounting

A question is raised as to whether Taxpayer made an unauthorized change in its method of accounting since it did not appear to mark under section 475 prior to Year 3 and did not file a Form 3115 requesting permission from the Commissioner to change its method of accounting. Based upon the facts that are presented so far, we can not definitively say whether or not there has been an unauthorized change in Taxpayer's method of accounting. The fact that no mark-to-market gain or loss was reported for Years 1 and 2 raises that question, but we also think that there is a possibility that taxpayer was marking under section 475 since its inception in Year 1, but that it just had no gain or loss to report in those years. Taxpayer claims to have had no gain or loss under section 475 until Year 3 because it always bought and sold at par value and that par equaled fair market value.[6] Taxpayer claims that it only intended to profit from the warehouse fee that it earned upon the sale of the securities to the Trusts, and not from the increasing prices of the securities. If Taxpayer had no gain or loss to report because it bought and sold the securities at par, and that par was equal to fair market value at all relevant dates, then there would be no section 475 gain or loss to report for those years. Once the financial crisis hit and Taxpayer was not able to sell the securities at par because their value had decreased, then there were section 475 losses to report.

Taxpayer started this securitization business in Year 1 and claims to have always marked for financial and tax reporting purposes. It is probably worthwhile to ask taxpayer to show whether or not there is any gain or loss reported on the financial statements for Year 1 and 2 for these securities. It is our understanding that there may be some IDR responses in which Taxpayer represented that they had no gain or loss for these securities in Year 2, but you may not have any information as to Year 1, other than Taxpayer's assertion that it used mark to market since its inception in Year 1.

6 [redacted]

For tax purposes Year 1 is the relevant year to determine whether Taxpayer adopted a mark-to-market method. We believe it qualifies as a dealer in securities and it should have been using a mark-to-market method. To determine definitively whether any unauthorized change was made, we need to know what method it was using at its inception. Based upon all of the facts presented, including its business model, its reporting for financial statement purposes and taxpayer's position that it is a dealer in securities and our agreement that it is a dealer in securities, we think that it is unlikely that Taxpayer made an unauthorized change in its method of accounting for Years 3 and 4. However, that issue is not free from doubt.

Finally, we note that if even Taxpayer did not qualify as a dealer in securities for Year 4,[7] it would still be required to use the mark-to-market method of accounting under section 475 for its tax return until it requested consent to change that method. This assumes Taxpayer had adopted the mark-to-market method in Year 1. The general tax rule on method changes is that once a Taxpayer has adopted an **impermissible** method and used it for 2 years, it must request consent to change from that method, even if it is an improper method.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

It is our understanding that this Taxpayer has signed a certification statement for the Industry Director's Directive (IDD) for Valuation under Section 475 for Years 2 through 4. Under that IDD, if the certification requirements are met, the Service will accept the valuations used for securities for financial reporting purposes as the value of the securities subject to section 475 for tax purposes. Thus, we will not discuss the issue of whether the fair market value of the TruPs securities can equal par value, and that Taxpayer bought and sold the TruPs at par value resulting in no gain or loss. We will note that it is possible for that situation to exist in some type of securities, such as the Dutch Auction type of securities. It may also be possible that the market can be very stable for certain type of fixed-income securities, and that there may be little fluctuation in interest rates over certain periods of time so that no gain or loss is incurred.

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

[7] As we have noted above, we do think Taxpayer was a dealer in Year 4.

Please call (202) 622-7794 if you have any further questions.

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