New Mark to Market Rule for "Securities Dealers"

The Revenue Reconciliation Tax Act of 1993 ("the Act") enacted on August 10, 1993 includes a new provision (Internal Revenue Code Section 475) requiring mark to market tax accounting for all dealers in securities. This provision is effective for tax years ending on or after December 31, 1993.

The new provision will require that inventories of securities, which are not investments, be valued at fair market value. If the security is not inventory, the dealer must recognize gain/loss as if the security was sold for its fair market value on the last business day of the taxable year. A hedge may or may not fall under these rules depending on the hedging instrument and the type of transaction. For subsequent dispositions, taxpayers must adjust the basis in securities to reflect the gain or loss previously recognized under the mark to market rules. Certain statutory exceptions are available for non-inventory dealer securities.

Taxpayers Affected by Section 475

The mark to market rules apply to "securities" held by a "dealer":

(1)<u>Dealer</u>- a dealer in securities is any taxpayer who:

- ☐ Regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business or
- ☐ Regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.

(2)<u>Security</u>- the term security means any:

- ☐ Share of stock in a corporation.
- ☐ Partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust.
- ☐ Note, bond, debenture, or other evidence of indebtedness.
- ☐ Interest rate, currency, or equity notional principal contract.
- ☐ Evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security or currency. (Non-hedge section 1256(a) contracts are specifically <u>excluded)</u>.

- A position which is a hedge to an above mentioned security if **clearly identified** as a hedge to a security on the acquisition date (or such other time as the Treasury may prescribe).

Exceptions to Mark to Market

The following securities are exempt from mark to market treatment if the identification requirements are met:

- Any security held for **investment** (dealers in notional principal contracts and derivative instruments cannot use this exception <u>for such</u> instruments).
- Any note or bond acquired or **originated** in the ordinary course of business and <u>**not held for sale**</u> or any obligation to acquire such a security.
- Any security which is a **hedge** for an exempt security or which is a hedge for a non-security (this exception is not available to a taxpayer holding the hedge in its capacity as dealer).

Identification Requirements

All securities acquired after the date of enactment and eligible for one of the above exceptions must be specifically identified as **held for investment** by the close of business on the acquisition date. If taxpayers properly identify loans and securities as being excepted from the mark to market provisions, these loans and securities may be carried at cost. Taxpayers either may identify the loans and securities that are excepted or may identify all loans and securities as being excepted unless the taxpayer affirmatively indicates that a loan or security is subject to mark-to-market.

It is anticipated that Treasury regulations will permit a dealer that originates <u>indebtedness</u> in the ordinary course of business to identify it through its accounting practices as not held for sale no later than 30 days after the debt was originated. However, as discussed later, the accounting rules for identification differ in some respects from the tax mark to market provisions and thus further guidance through regulations will be necessary.

There is no prescribed method of identification in the Code or in the legislative history. However, based on informal discussions with Treasury officials, the identification process may be met through a general ledger procedure or any good faith effort such as an internal memorandum detailing those accounts held for sale or held for investment. There is <u>no formal filing</u> required to be made with the IRS with respect to the identification.

Penalty Provisions

The Code provides a penalty in two circumstances: if a dealer **identifies a security as qualifying for an exception** to the mark to market rules and the security does not qualify, or if the dealer **fails to identify a hedge of a security** as such. In either case, the mark to market rules apply to such positions. However, if a loss is to be recognized under the mark to market rules prior to the disposition of the security, then the loss is recognized only to the extent of the gain previously recognized under the mark to market rules. Any deferred loss may only be recognized upon disposition.

Character of the Gain Recognized

The gain or loss recognized as a result of mark to market accounting generally is treated as **ordinary**. Thus, both inventory and non-inventory securities will be afforded ordinary treatment unless eligible for one of the exceptions and properly identified. However, this character rule does not apply to 1) a hedge for the period in which it is a "hedge" of a position that is not subject to the mark to market rules, 2) a security held by a taxpayer that is not related to its dealer activities, and 3) improperly or untimely identified securities which are not subject to the mark to market rules.

Ordinary treatment also applies to securities subject to the mark to market rules that are sold before the end of the taxable year.

The issue of the character of gains and losses with respect to hedging activities has therefore been clarified with respect to hedges subject to IRC section 475 (i.e. ordinary gain or loss treatment). With respect to hedges which do not fall within the mark to market provisions, Congress recognizes the business significance of these hedging transactions and has requested the Executive and Legislative branches to provide guidance on how to proceed with such positions in order to clarify the uncertainty after Arkansas Best Co. v. Commissioner, 485 U.S. 212 (1988) and the latest case on the issue, FNMA v. Commissioner, 100 T.C. 36 (1993).

Summary

These new mark to market provisions are extremely complex and can be affected by a number of other provisions in the Code. Further complicating present planning considerations, is the fact that the IRS has not yet issued any regulations or further guidance. The Code specifically left a number of issues open to IRS interpretation.