Mark to Market for Securities Dealers: The Dealer-Customer Relationship

Notice 96–12

This notice provides immediate guidance, pending the issuance of proposed regulations, concerning whether a taxpayer's transactions with related persons, including members of the taxpayer's consolidated group, may be transactions with customers for purposes of § 475 of the Internal Revenue Code. This guidance will assist consolidated groups in deciding whether or not to make a separate-entity election under § 1.1221–2(d)(2) of the Income Tax Regulations. One result of making this election is that a group takes a separate-entity perspective in determining whether a transaction reduces risk for purposes of the definition of *hedging transaction* in § 1.1221–2(b).

Even when a group makes the separate-entity election, however, an intercompany transaction can be a hedging transaction only if it is entered into with a member that accounts for its position in the intercompany transaction by marking the position to market. *See* § 1.1221–2(d)(2)(ii)(B). Section 475 of the Code requires dealers in securities generally to use mark-to-market accounting for the securities that they hold. Thus, whether a member of a consolidated group is a dealer in securities under section 475 can affect whether intercompany risk-shifting transactions may be hedging transactions.

Whether a taxpayer is a dealer in securities depends on whether certain of its transactions are entered into with customers. Section 475(c)(1) defines a dealer in securities as a taxpayer who: (1) regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business (§ 475(c)(1)(A)); or (2) 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 (§ 475(c)-(1)(B)).

Under existing proposed regulations, whether a taxpayer is transacting business with customers is based on all of the facts and circumstances. *See* § 1.475(c)–1(c) of the proposed Income Tax Regulations, published in the Federal Register on January 4, 1995 (60 Fed. Reg. 397). Under § 1.475(c)–1(c)-(2) of the proposed regulations, the term dealer in securities includes a taxpayer that, in the ordinary course of its trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in § 475(c)(1)(B).

EXPECTED ADDITIONAL PROPOSED REGULATIONS

The Service expects to publish additional proposed regulations that address the issue of whether a taxpayer is transacting business with customers. The proposed regulations are expected to contain, in substance, the following rules.

Transactions with related parties

A taxpayer's transactions with members of its consolidated group or with other related persons may be transactions with customers for purposes of § 475. Thus, a sale of a security to another member of a consolidated group is a sale to a customer if the relationship between the parties is consistent with that of a dealer in securities transacting business with an unrelated customer. Similarly, transactions enumerated in § 475(c)(1)(B) between members of a consolidated group are transactions with customers if, in the ordinary course of its business, the taxpayer holds itself out as being willing and able to engage in these transactions on a regular basis and the relationship between the parties is consistent with that of a dealer in securities transacting business with an unrelated customer. A taxpayer may be a dealer in securities within the meaning of section 475(c)(1) even if its only customer transactions are transactions with other members of its consolidated group.

The following example illustrates the foregoing.

Facts: *HC*, a hedging center, provides interest rate hedges to all of the members of its consolidated group. 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 consolidated group. The terms of the transactions between *HC* and its fellow members are consistent with the terms the members would obtain if they entered into the transactions with an unrelated swaps dealer.

Holding: Because the relationship between *HC* and its fellow members is consistent with that of a dealer in securities transacting business with unrelated customers (*see* § 1.475(c)–1(c)-(2) of the proposed Income Tax Regulations), *HC* is a dealer in securities for purposes of section 475(c)(1)(B), and the other members are its customers.

The preceding rules are expected to be proposed to be effective for taxable years beginning on or after February 20, 1996.

DRAFTING INFORMATION

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