under the criteria of the Regulatory Flexibility Act.

List of Subjects in 14 CFR Part 71

Airspace, Incorporation by reference, Navigation (Air).

The Proposed Amendment

In consideration of the foregoing, the Federal Aviation Administration proposes to amend 14 CFR part 71 as follows:

PART 71—[AMENDED]

1. The authority citation for 14 CFR part 71 continues to read as follows:

Authority: 49 U.S.C. app. 1348(a), 1354(a), 1510; E.O. 10854, 24 FR 9565, 3 CFR, 1959–1963 Comp., p. 389; 49 U.S.C. 106(g): 14 CFR 11.69.

§ 71.1 [Amended]

2. The incorporation by reference in 14 CFR 71.1 of the Federal Aviation Administration Order 7400.9B, Airspace Designations and Reporting Points, dated July 18, 1994 and effective September 16, 1994, is amended as follows:

Paragraph 6005 Class E airspace areas extending upward from 700 feet above the surface of the earth.

* * * * *

ASO GA E5 Hampton, GA [New]

Clayton County—Tara Field Airport, GA
(Lat. 33°23′21″ N, long. 84°19′55″ W)

That airspace extending upward from 700 feet above the surface within a 6.8-mile radius of Clayton County—Tara Field Airport; excluding that airspace within the Atlanta, GA, Peachtree City, GA, and Griffin, GA, Class E airspace areas.

* * * * *

Issued in College Park, Georgia, on December 16, 1994.

Walter E. Denley,

Acting Manager, Air Traffic Division, Southern Region.

[FR Doc. 95–00077 Filed 1–3–95; 8:45 am]

BILLING CODE 4910–13–M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[FI–42–94]

RIN 1545–AS85

Mark to Market for Dealers in Securities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the mark-to-market method of accounting for securities that is required to be used by a dealer in securities. The proposed regulations address the relationship between mark-to-market accounting and the accrual of stated interest and discount and the amortization of premium and between mark-to-market accounting and the tax treatment of bad debts. They also provide rules relating to certain dispositions and acquisitions of securities required to be marked to market, the exemption from mark-to-market treatment of securities in certain securitization transactions, and the identification requirements for obtaining exemption from mark-to-market treatment. Finally, these proposed regulations provide guidance relating to the exclusion of REMIC residual interests from the definition of security and to the relationship between the mark-to-market provisions and the integrated transaction rules in the proposed regulations on debt instruments with contingent payments. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by April 4, 1995. Outlines of oral comments to be presented at a public hearing scheduled for May 3, 1995, at 10 a.m. must be received by April 4, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (FI–42–94), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (FI–42–94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

The public hearing will be held in the Internal Revenue Auditorium, 7400 Corridor, Internal Revenue Building, 1111 Constitution Ave., NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning § 1.475(c)–2(a)(4), Carol A. Schwartz, (202) 622–3920; concerning other sections of the regulations, Robert B. Williams, (202) 622–3960, or JoLynn Ricks, (202) 622–3920; concerning submissions and the hearing, Michael Slaughter, (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224.

The collection of information is in § 1.475(b)–4. The information required to be recorded under § 1.475(b)–4 is required by the IRS to determine whether exemption from mark-to-market treatment is properly claimed. This information will be used to make that determination upon audit of taxpayers' books and records. The likely recordkeepers are businesses or other for-profit institutions.

Estimated total annual recordkeeping burden: 2,500 hours.

The estimated annual burden per recordkeeper varies from 15 minutes to 3 hours, depending on individual circumstances, with an estimated average of 1 hour.

Estimated number of recordkeepers: 2,500.

Background

Section 475 of the Internal Revenue Code requires mark-to-market accounting for dealers in securities, broadly defined. Section 475 was added by section 13223 of the Revenue Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 481), and is effective for all taxable years ending on or after December 31, 1993.

On December 29, 1993, temporary regulations (T.D. 8505, 58 FR 68747) and cross-reference proposed regulations (FI–72–93, 58 FR 68798) were published to furnish guidance on several issues, including the scope of exemptions from the mark-to-market requirements, certain transitional issues relating to the scope of exemptions, and the meaning of the statutory terms ''dealer in securities'' and ''held for investment.'' This notice contains proposed regulations that supplement, and in a few cases revise, the proposed regulations that were published last December.

Explanation of Provisions

Stated Interest, Discount, and Premium

The proposed regulations contained in this notice provide rules for taking into account interest (including original issue discount (OID) and market discount), premium, and certain gains

and losses on securities that are debt instruments. In general, immediately before a debt instrument is marked to market, Code provisions related to calculating interest must be applied, and basis must be correspondingly adjusted. The mark-to-market computations do not affect either the amount treated as interest earned from a debt instrument or the taxable years in which that interest is taken into account.

For example, immediately before a debt instrument is marked to market, accruals of unpaid qualified stated interest (QSI) must be taken into account, and basis must be correspondingly increased. This is true regardless of the taxpayer's regular method of accounting. Marking a debt instrument to market under section 475(a) precludes the deferral that a cash-basis taxpayer might have experienced in the absence of the statutory provision, and the current accrual under the proposed regulations is needed in order to preserve the interest character of the QSI.

For debt instruments acquired with original issue discount or market discount, the proposed regulations require that, immediately before the mark-to-market gain or loss is computed under section 475(a), any OID or market discount accrued through the date of computation must be taken into account, and basis must be correspondingly increased. The amount of discount attributable to a particular period of time is computed under sections 1272 through 1275 (in the case of OID) and sections 1276 through 1278 (in the case of market discount). Thus, for example, the computation of OID attributable to a particular period takes into account any reduction for acquisition premium under section 1272(a)(7).

As indicated in the preceding paragraph, the proposed regulations provide that, in the case of a market discount bond to which section 475(a) applies, the holder must take market discount into account as it accrues, regardless of whether the holder elected under section 1278(b) to do so for all of its bonds. This rule is necessary to prevent market discount from producing gain on the mark instead of interest income. This provision, however, does not impose a section 1278(b) election on the taxpayer, because it does not apply to bonds that are not marked to market under section 475.

For taxable debt instruments acquired with amortizable bond premium, the proposed regulations provide that, if a dealer has made an election to amortize premium under section 171, any amortization for the taxable year (or for the portion of the taxable year during which the instrument is held by the dealer) must be taken into account (and basis must be appropriately reduced) before the mark-to-market gain or loss is computed under section 475. Because section 171 applies only to instruments not held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, this proposed regulatory provision is applicable only to premium instruments described in section 475(b)(1) for which the taxpayer has not made the identification described in section 475(b)(2).

In the case of tax-exempt bonds, the proposed regulations require basis to be reduced as required by section 1016(a)(5) or (6) before mark-to-market gain or loss is computed.

If a dealer acquires a bond with premium and a section 171 election first applies to the bond in a taxable year after the year of acquisition, the proposed regulations require the dealer to amortize premium based on the original basis, without regard to any mark-to-market adjustments that may have been taken into account before the section 171 election became effective, but with regard to the adjustments required under section 171(b)(1). Thus, for example, if a dealer acquires in year 1 an instrument that is subject to section 475(a) and that has $10 of amortizable premium and if the dealer makes an election to amortize premium that is first effective in year 4 (when unamortized premium attributable to years 1 through 3 is $4), the dealer takes into account the appropriate portion of the remaining $6 of amortizable bond premium (as required under section 171(b)(3)) each taxable year before computing the mark-to-market adjustment on the instrument. Any mark-to-market basis adjustments in taxable years 1 through 3 are ignored in determining the amount of amortizable bond premium to which the election applies.

Under section 475(a)(2), a dealer in securities recognizes mark-to-market gain or loss on a security, other than inventory, as if the security were sold on the last business day of the taxable year. Although there may be circumstances under which marking a security to market produces results similar to the actual sale of the security, the statutory reference to the deemed sale prescribes the amount of gain or loss to be taken into account and does not trigger all of the consequences of a sale and reacquisition under the Code. For example, when a dealer in securities marks a bond (or other security) to market and takes recognized gain or loss into account, the dealer has not actually sold and reacquired the bond. Thus, under the proposed regulations, marking a debt instrument does not create, increase, or reduce market discount, acquisition premium, or bond premium.

The proposed regulations also contain a special rule to provide the proper character for mark-to-market gains or losses on a market discount instrument that was originally identified as held for investment by the dealer. This rule is necessary to ensure that all market discount is ultimately characterized as interest income and not as gain from the sale of a security.

Worthless Debts

The proposed regulations provide rules for marking a partially or wholly worthless debt to market. These rules coordinate the mark-to-market rules with the bad debt rules under the Code. The amount of gain or loss recognized under section 475(a)(2) when a debt instrument is marked to market generally is the difference between the adjusted basis and the fair market value of the debt. Under the proposed regulations, if a debt becomes partially or wholly worthless during a taxable year, the amount of any gain or loss required to be taken into account under section 475(a) is determined using a basis that reflects the worthlessness. The basis of the mark-to-market debt is treated as having been reduced by the amount of any book or regulatory charge-off (including the establishment of a specific allowance for a loan loss) for which a deduction could have been taken, without regard to whether any portion of the charge-off is, in fact, deducted or charged to a tax reserve for bad debts. The difference between this adjusted basis and the fair market value of the debt is the amount of gain or loss to be taken into account under section 475(a)(2). Thus, if the debt is wholly worthless, its basis would be reduced to zero and no gain or loss would be taken into account under section 475(a)(2).

This proposed treatment preserves the longstanding distinctions between losses due to the worthlessness of debts and other losses on debt instruments held by a taxpayer. See § 1.166–1(a), which requires bad debts to be taken into account either as a specific deduction in respect of debts or as a deduction for a reasonable addition to a reserve for bad debts. See also §§ 1.585–3 and 1.593–7(c), which require a reserve-method taxpayer to charge bad debts to the reserve for bad debts. In addition, computing the mark-to-market adjustment as if the debt's basis had been adjusted to reflect worthlessness

preserves a taxpayer's ability to postpone claiming a deduction for partial worthlessness until the debt becomes wholly worthless. To the extent that a debt has been previously charged off, mark-to-market gain is treated as a recovery.

The rules that are provided for bad debts in the proposed regulations do not apply to debts accounted for by a dealer as inventory under section 475(a)(1). Although it is possible for a debt that is in inventory to become partially worthless prior to sale, the likelihood or frequency of such an occurrence is difficult to ascertain given the speed with which inventory is sold. Comments are requested, however, concerning whether similar rules are necessary for partially worthless debt that is accounted for as inventory of the dealer.

Dispositions

Section 475(a) states that regulations may provide for securities held by a dealer to be marked to market at times other than the end of the dealer's taxable year. In general, the proposed regulations provide that, if a dealer in securities ceases to be the owner of a security for tax purposes, and if the security would have been marked to market under section 475(a) if the dealer's taxable year had ended immediately before the dealer ceases to own it, then (whether or not the security is inventory in the hands of the dealer) the dealer must recognize gain or loss as if the security had been sold for its fair market value immediately before the dealer ceases to own it. Any gain or loss so recognized is taken into account at that time.

In the absence of a mark upon disposition, a gain on a security held by a dealer could be deferred by transferring the security before the end of the taxable year to a related non-dealer in an intercompany transaction or in a non-recognition, carry-over-basis transaction. This potential for abuse is avoided if marking to market is required in every case in which a dealer ceases to be the owner of a security for tax purposes. The proposed requirement is analogous to the requirement that applies to dispositions of securities that are required to be marked to market under section 1256.

Transfers to which the proposed rule applies include the following: (a) Transfers to a controlled corporation under section 351; (b) Transfers to a trust (other than a grantor trust); (c) Transfers by gift to a charitable or non-charitable donee; (d) Transfers to other members of the same controlled group; (e) Transfers to a partnership under section 721; and (f) Transfers of mortgages to a REMIC under section 860F(b).

In the case of a transfer by a dealer to a partnership, the basis of a security transferred is generally its fair market value, because the security is marked to market immediately before the transfer. Thus, no special allocation issues arise. If there is any difference between a transferred security's basis after the mark and its fair market value (because, for example, the security transferred had been properly identified as held for investment but ceased to be so held at some time prior to the date of transfer), any special allocation of built-in gain or loss with respect to that security in the hands of the partnership will be made under section 704 and the regulations thereunder.

The mark to market immediately before disposition is separate and distinct from the disposition transaction. Thus, for example, the gain or loss from the mark is not gain or loss from a deferred intercompany transaction under § 1.1502–13.

Securities Acquired With Substituted Basis

The proposed regulations provide rules for situations where a dealer in securities receives a security with a basis in its hands that is determined, in whole or in part, either by reference to the basis of the security in the hands of the transferor or by reference to other property held at any time by the dealer. In these cases, section 475(a) applies only to post-acquisition gain and loss with respect to the security. That is, section 475(a) applies only to changes in value of the security occurring after its acquisition. See section 475(b)(3). The character of the mark-to-market gain or loss is determined as provided under section 475(d)(3). The character of pre-acquisition gain or loss (that is, the built-in gain or loss at the date the dealer acquires the security) and the time for taking that gain or loss into account are determined without regard to section 475. The fact that a security has a substituted basis in the dealer's hands does not affect the security's date of acquisition for purposes of determining the timeliness of an identification under section 475(b).

The proposed regulations provide rules for the identification of securities contributed and received in securitization transactions. Under the proposed regulations, a taxpayer that expects to contribute securities to a trust or other entity in exchange for interests therein may identify the contributed securities as 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)) only if it expects each of the interests received (whether or not a security within the meaning of section 475(c)(2)) to be either held for investment or not held for sale to customers in the ordinary course of the taxpayer's business. Thus, for example, if a mortgage banker securitizes its loans and does not intend to hold for investment (or for other than sale to customers) all of the interests received in the securitization transaction, the mortgage banker will be required to account for its inventory of mortgages at fair market value under section 475(a)(1), regardless of whether the mortgages are to be sold to a trust or contributed to a REMIC.

Under the proposed regulations, if a dealer engages in a securitization transaction that results in dispositions of only partial interests in the contributed securities, the dealer is not permitted to identify the contributed securities as exempt under section 475(b)(1)(A) or (B). As a result, all of the contributed securities must be accounted for under section 475(a). Moreover, under the mark-on-disposition rule of these proposed regulations, the dealer is required to mark the securities to market immediately before the securitization transaction. The Service invites comments on whether there are other administrable approaches that reflect the fact that only a partial disposition of the securities has occurred.

In other securitization transactions, a taxpayer transfers securities to a trust (or other entity) in a transaction that is not a disposition of the securities for tax purposes. The trust issues certificates (or other forms of interest) that represent secured debt of the taxpayer rather than debt of the trust or ownership of the underlying securities. In these cases, if the taxpayer retains the full ownership of the contributed securities for tax purposes and if the contributed securities otherwise qualify to be identified as held for investment or not held for sale, then the taxpayer may identify the securities as held for investment or not held for sale notwithstanding the transfer.

Further, if a transfer of securities is a disposition, a taxpayer may identify the interests received in a securitization transaction as exempt from mark-to-market if the interests are described in section 475(b)(1) and are not treated for tax purposes as continuing ownership of the securities transferred. This identification is permitted even if the securitized assets were marked to market under section 475. For example, a taxpayer may identify some of the

REMIC regular interests received on the transfer of mortgage securities to a REMIC, even if the mortgages were subject to section 475(a). Conversely, a taxpayer that has marked mortgages to market but subsequently contributes those mortgages to a grantor trust and receives beneficial interests therein may not identify the beneficial interests as exempt from mark-to-market treatment, because the beneficial interests represent continued ownership of the contributed securities, whose eligibility for exemption was determined when they were acquired.

The proposed regulations clarify that an identification of a security as exempt must specify the subparagraph of section 475(b)(1) under which the exemption is claimed and that the time by which a dealer must identify a security as exempt is not affected by whether the dealer has a substituted basis in the security. The proposed regulations also provide rules for determining whether an identification of a security as exempt is timely where a dealer engages in certain integrated transactions described in § 1.1275–6 as proposed on December 16, 1994 (FI–59–91, 59 FR 64884, 64905).

Definition of Dealer in Securities

Section 475(c)(1) defines a dealer in securities as a taxpayer who regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business or who 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.

The proposed regulations provide that whether a taxpayer is transacting business with customers is determined based on all of the facts and circumstances.

Under section 475(c)(1)(B) and 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 section 475(c)(1)(B). For instance, if a taxpayer regularly holds itself out as being willing to enter a swap in which it is either the fixed or the floating payor, the taxpayer is a swaps dealer.

The proposed regulations clarify that a life insurance company does not become a dealer in securities solely by selling annuity, endowment, or life insurance policies to its customers. Under the temporary regulations published on December 29, 1993 (T.D. 8505), a contract that is treated for federal income tax purposes as an annuity, endowment, or life insurance contract is deemed to have been identified as held for investment, and is therefore not marked to market by the policy holder. This was necessary because variable life and annuity products fall within the literal language of section 475(c)(2)(E). Because many life insurance companies sell these insurance contracts to their customers, some commentators asked whether these life insurance companies were dealers in securities. There is no indication that Congress intended for a life insurance company that was not otherwise a dealer in securities to be characterized as a dealer merely because it sells life insurance policies to its customers. These proposed regulations provide the appropriate clarification.

Definition of Security

The temporary regulations that were published on December 29, 1993 (T.D. 8505), exclude certain items from the definition of security. Among the excluded items are liabilities of the taxpayer and negative value residual interests (NVRIs) in a REMIC and other arrangements that are determined to have substantially the same economic effect as NVRIs (for example, a widely held partnership that holds noneconomic REMIC residual interests). Those rules are needed to carry out the purposes of section 475 and other Code provisions, including section 860E.

These proposed regulations clarify that a liability of the taxpayer means a debt issued by the taxpayer. Also, for the reasons given below, these proposed regulations exclude all REMIC residual interests from the definition of security.

A typical REMIC holds a pool of long-term, real estate mortgages originated at a ''blended'' interest rate. These mortgages are used to support the issuance of regular interests, which are treated as debt, with varied maturities and interest rates. The REMIC takes cash flows on the mortgages and redirects them to holders of the regular interests. As a result, there is generally a mismatch in the recognition of interest income from the mortgages and the interest expense attributable to the regular interests. This mismatch of interest income and interest deductions results in taxable income or loss that does not represent economic gain or loss. Some commentators refer to this as ''phantom'' income or loss.

Phantom income or loss is allocated to the holders of the residual interests in a REMIC even though that income or loss does not represent any economic benefit or detriment to those holders. Further, sections 860C and 860E require a residual interest holder to pay taxes on a portion of phantom income (called ''excess inclusion'') and to increase the basis of the residual interest by the amount of phantom income. Because this basis increase does not represent economic value, a subsequent mark to market is likely to result in a loss. Permitting taxpayers to take this loss into account currently under the mark-to-market provisions effectively undermines the Congressional mandate embodied in section 860E to require current taxation of phantom income.

Although the adverse effect of section 475 on section 860E is most apparent when the residual interests being considered are NVRIs, residual interests with positive value present the same issue. Many residual interests with positive value, in spite of being entitled to REMIC distributions, have substantially the same economic effect as NVRIs and thus are already excluded by the temporary regulations from the definition of ''security.'' The IRS is concerned, however, that residual interests may be structured in a way that avoids embodying substantially the same economic effects as an NVRI but that still undermines the purposes of section 860E. The proposed regulations, therefore, contain a rule that would remove from the category of securities subject to section 475 all residual interests that are acquired after January 4, 1995. Also removed are arrangements that are acquired after that date and are determined to have substantially the same economic effect as a REMIC residual interest (for instance, an interest in a widely held partnership holding residual interests). The temporary regulations continue to apply to all residual interests described therein for all taxable years ending on or after December 31, 1993.

In addition, the Commissioner has determined that, if a residual interest, or an interest or arrangement that has substantially the same economic effect, is not a security within the meaning of section 475, it should not be treated as inventory under other provisions. Additional guidance on this matter will be issued.

Comments are requested concerning whether there are any residual interests that do not undermine section 860E upon being marked to market. If comments are received that describe any such interests, subsequent guidance may provide that they are included in the mark-to-market regime. In this regard, it is important that any mechanism for identifying these interests not impose an undue burden on either taxpayers or the IRS.

Additional Comments Requested

The provisions of section 475 generally apply in determining the taxable income of a dealer that may also be subject to various international provisions of the Code. The Service is considering the possibility of using the definitions contained in section 475 and the regulations thereunder for purposes of various international provisions, except where a modification of the provisions is necessary to carry out the purposes of those international provisions. Comments on this issue also are welcome.

Finally, the Service is considering whether there are additional situations in which securities should not be accounted for under section 475(a). (The temporary and proposed regulations that were published on December 29, 1993, listed some such situations.) For example, a dealer in securities may acquire at original issue and in exchange for property certain non-interest-bearing debt instruments that are not subject to the interest imputation provisions of section 1274 or 483. Because these instruments will seldom appreciate in value, it may be inappropriate to subject them to the mark-to-market regime.

Dates of Applicability

The proposed regulations will apply to identifications made, securities acquired, or events occurring, on or after January 4, 1995, or to taxable years beginning on or after January 1, 1995, as appropriate.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, May 3, 1995 at 10 a.m. The public hearing will be held in the Internal Revenue Auditorium, 7400 corridor, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC 20224. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by April 4, 1995 and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 4, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Robert B. Williams and JoLynn Ricks, Office of Assistant Chief Counsel (Financial Institutions & Products). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.475(a)–1 also issued under 26 U.S.C. 475(e).

Section 1.475(a)–2 also issued under 26 U.S.C. 475(a) and 26 U.S.C. 475(e).

Section 1.475(a)–3 also issued under 26 U.S.C. 475(e).

* * * * *

Section 1.475(b)–3 also issued under 26 U.S.C. 475(e).

Section 1.475(b)–4 also issued under 26 U.S.C. 475(b)(2) and 26 U.S.C. 475(e).

Section 1.475(c)–1 also issued under 26 U.S.C. 475(e).

* * * * *

Section 1.475(c)–2 also issued under 26 U.S.C. 475(e) and 26 U.S.C. 860G(e).

* * * * *

Section 1.475(e)–1 also issued under 26 U.S.C. 475(e).

* * * * *

Par. 2. Section 1.475–0 is added to read as follows:

§ 1.475–0 Table of contents.

This section lists headings contained in §§ 1.475–0, 1.475(a)–1, 1.475(a)–2, 1.475(a)–3, 1.475(b)–1, 1.475(b)–2, 1.475(b)–3, 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1, and 1.475(e)–1.

§ 1.475–0 Table of contents.

Par. 3. Section 1.475(a)–1 is added to read as follows:

§ 1.475(a)–1 Mark to market of debt instruments.

(a) *Overview.* This section provides rules for taking into account interest accruals and gain and loss on a debt instrument to which section 475(a) applies. Paragraph (b) of this section clarifies that the mark-to-market computation affects neither the amount treated as interest earned from a debt instrument nor the taxable year in which that interest is taken into account. Paragraph (c) of this section prescribes general rules. Paragraph (d) of this section prescribes additional rules for instruments acquired with market discount. Paragraph (e) of this section provides rules for taking into account market discount that accrued on a bond before the bond became subject to the mark-to-market requirements. Paragraph (f) of this section prescribes rules for computing the mark-to-market gain or loss on partially or wholly worthless debts, and paragraph (g) provides rules for dealers accounting for bad debts using a reserve method of accounting.

(b) *No effect on amount of market discount, acquisition premium, or bond premium.* Marking a debt instrument to market does not create, increase, or reduce market discount, acquisition premium, or bond premium, nor does it affect the adjusted issue price of, or accruals of original issue discount (OID) on, a bond issued with OID.

(c) *Accrual of interest, discount, and premium.* In general, the amount of gain or loss from marking a debt instrument to market is computed after adjustments to basis for accruals of stated interest, discount, and premium.

(1) *Qualified stated interest.* Immediately before a debt instrument is marked to market under section 475(a), the holder of the instrument must take any unpaid accrued qualified stated interest into account and must correspondingly increase the basis of the instrument. The holder must later decrease the basis of the instrument when accrued qualified stated interest is actually received. (See § 1.1273–1(c) for the definition of qualified stated interest and § 1.446–2(b) for the rule governing its accrual.)

(2) *General rule regarding accrual of discount.* If a bond that was acquired with OID or market discount is marked to market under section 475(a), then, immediately before the bond is marked to market, the discount accrued through that date (determined under section 1272, 1275(d), or 1276, as applicable) is included in gross income, to the extent not previously included, and the bond's basis is correspondingly increased for amounts so included. (Because accrued OID is determined under all of the rules of section 1272 and the regulations thereunder, it is computed taking into account the reduction for acquisition premium that is required by section 1272(a)(7).) See paragraph (d) of this section, which requires the current inclusion in income of market discount on bonds marked to market. See paragraph (e) of this section for exceptions, and additional rules, for market discount bonds that become subject to section 475(a) after acquisition.

(3) *Bond premium.* If a debt instrument that is subject to the basis adjustment required by section 1016(a)(5) or (6) is marked to market under section 475(a), then, immediately before the debt instrument is marked to market, the required basis adjustment must be made. Accordingly, the mark-to-market adjustment is computed after the basis of the debt instrument has been adjusted under section 1016(a)(5) or (6) for disallowed amortizable bond premium (in the case of tax-exempt bonds) or deductible bond premium (in the case of taxable bonds). If an election under section 171(c) is made after the first taxable year in which section 475(a) applies to the bond, the amount of bond premium is determined under section 171(b)(1) without regard to any basis adjustments that may have been required as a result of the bond being marked to market in prior taxable years. See paragraph (b) of this section for the rule that marking a debt instrument to market does not affect bond premium.

(d) *Mandatory current inclusion of market discount*—(1) *General rule.* If section 475(a) applies to a bond during any portion of a taxable year, gross income for that taxable year includes the market discount attributable to the portion of the year to which section 475(a) applies (as determined under section 1276(b)). Section 1276 does not apply to the bond except with respect to market discount, if any, that accrued before the bond became subject to section 475(a). Similarly, section 1277 does not apply to the bond except with respect to any net direct interest expense (as defined in section 1277(c)) that accrued before the bond became subject to section 475(a). See paragraph (e) of this section for additional rules governing this situation. For purposes of the Code other than the purposes described in the last sentence of section 1278(b)(1), any amount included in gross income under this paragraph (d)(1) is treated as interest. The bond's basis is correspondingly increased for any amount so included in gross income.

(2) *Interaction with section 1278(b).* Paragraph (d)(1) of this section applies to a dealer, even if the dealer has not elected under section 1278(b) to include market discount currently. If the dealer has not made that election, however, this paragraph (d) does not require current inclusion of market discount on any bond to which section 475(a) does not apply.

(e) *Recognition of market discount that accrued before section 475(a) applies to a market discount bond*—(1) *General rule.* In the case of a debt instrument that is acquired with market discount, that is not subject to an election under section 1278(b), and that first becomes subject to section 475(a) in the taxpayer's hands on a date after its acquisition, this paragraph (e) governs the recognition of market discount that is attributable (as determined under section 1276(b)) to any period before section 475(a) applies to the debt instrument. To the extent that the market discount described in the preceding sentence is greater than the excess, if any, of the fair market value of the debt instrument at the time it became subject to section 475(a) over its adjusted basis at that time, section 1276(a)(1) applies to any gain recognized under section 475(a). To the extent of any remaining market discount that had accrued before section 475(a) became applicable, section 1276(a) applies no later than it would have applied if section 475(a) did not apply to the bond. For example, section 1276(a) applies to the previously accrued market discount as partial principal payments are made. Except as provided in the preceding sentences, gain recognized under section 475(a) is not recharacterized as interest by section 1276(a).

(2) *Examples.* The rules of paragraphs (d) and (e) of this section are illustrated by the following examples:

Example 1.

(i) *Facts.* Bond *X* was issued on January 1, 1996, for $1,000. Bond *X* matures on December 31, 2005, provides for a principal payment of $1,000 on the maturity date, and provides for interest payments at a rate of 8%, compounded annually, on December 31 of each year. *D* is a dealer in securities within the meaning of section 475(c)(1). On January 1, 1997, *D* purchased bond *X* for $955. *D* had not elected under section 1278(b) to include market discount in gross income currently. Under section 475(b), section 475(a) did not apply to bond *X* until January 1, 1999, at which time bond *X* had a fair market value of $961. On December 31, 1999, bond *X* had a fair market value of $980.

(ii) *Holdings.* In the absence of an election under section 1276(b)(2), market discount on bond *X* accrues under section 1276(b)(1) at the rate of $5 per year. On January 1, 1999, when bond *X* became subject to section 475(a), $10 of market discount had accrued, but the excess of the bond's fair market value on January 1, 1999, over its adjusted basis on that date (the built-in gain) was only $6 ($961—$955). During 1999, *D* is required to include as interest income the $5 of market discount that accrues during that year, and *D* increases by that amount its basis in the bond and the amount to be used in computing mark-to-market gain or loss. On December 31, 1999, *B* must mark bond *X* to market and recognize a gain of $14 ($980—[$961 + $5]). Under section 1276(a)(1) and (4) and paragraph (e)(1) of this section, $4 of that $14 gain is treated as interest income. The $4 is the amount by which the market discount of $10 that had accrued on January 1, 1999, exceeded the $6 built-in gain on that date.

Example 2.

(i) *Facts.* The facts are the same as in *Example 1*, except that, in addition, *D* sells bond *X* for its fair market value of $1,000 on June 30, 2000.

(ii) *Holdings.* Immediately before the sale, *D* is required to include as interest income the $2.50 of market discount that accrued during the portion of the year through June 30, and *D* increases by that amount its basis in the bond and the amount to be used in computing mark-to-market gain or loss. Also, under § 1.475(a)–2, immediately before the sale, *D* recognizes $17.50 of mark-to-market gain (the increase in value since the preceding mark to market, less the basis increase of $2.50 from the market discount accrual. See § 1.475(a)–2). On the sale, *D* also recognizes the $6 of built-in gain, all of which is recharacterized as ordinary interest income under section 1276(a)(4).

Example 3.

(i) *Facts.* The facts are the same as in *Example 1*, except that, during 2001, the issuer of bond *X* made a partial principal payment in the amount of $20.

(ii) *Holdings.* Under paragraph (e)(1) of this section and section 1276(a)(4), $6 of the partial principal payment is included in *D*'s 2001 income as interest income. The $6 is the portion of the $10 of market discount that had accrued at the time bond *X* became subject to section 475(a) and that had not previously caused gain or a partial principal payment to be treated as interest income.

(f) *Worthless debts*—(1) *Computation of mark-to-market gain or loss.* This paragraph (f) applies to any dealer that, under section 475(a)(2), marks to market either a debt that was charged off during the year because it became partially worthless or a debt that became wholly worthless during the taxable year (without regard to whether the debt was charged off). Any gain or loss attributable to marking a debt to market is determined by deeming the debt's adjusted basis to be the debt's adjusted basis under § 1.1011–1, less the amount charged off during the taxable year or during any prior taxable year, to the extent that amount has not previously reduced tax basis. A debt that becomes wholly worthless is deemed to have an adjusted basis of zero. The deemed adjusted basis, however, is used solely for this paragraph (f). Thus, any portion of a loss attributable to a bad debt continues to be accounted for under the bad debt provisions of the Code, and the basis of the debt continues to be adjusted as otherwise required under the Code.

(2) *Treatment of mark-to-market gain or loss.* To the extent that a debt has been previously charged off, mark-to-market gain is treated as a recovery. Thus, for example, a dealer using the section 585 reserve method of accounting for bad debts must credit to the reserve any portion of mark-to-market gain that is treated as a recovery of a bad debt previously charged to the reserve account, and the dealer must include any excess in gross income as required by § 1.585–3(a). Similarly, if a dealer is a large bank that changed to the specific charge-off method of accounting for bad debts using the elective cut-off procedures described in § 1.585–7, the dealer must charge to the reserve for pre-disqualification loans all losses recognized as a result of marking to market a debt that is a pre-disqualification loan within the meaning of § 1.585–7(b)(2). Marking a pre-disqualification loan to market, however, is not a disposition of that loan under § 1.585–7(d).

(g) *Additional rules applicable to reserve-method taxpayers.* If a dealer accounts for bad debts using the reserve method of accounting under section 585 or 593, the following additional rules apply in computing a reasonable addition to a reserve—

(1) To determine the amount of total loans outstanding, the outstanding balance on a debt that is marked to market is increased or decreased by the amount of any mark-to-market gain or loss recognized, except that the outstanding balance of the debt may never exceed the actual balance currently due; and

(2) If the reasonable addition to the reserve is computed based on a percentage of taxable income, any gain or loss attributable to marking a debt to market must be taken into account in computing taxable income.

(h) *Example.* This example illustrates paragraphs (f) and (g) of this section.

Example.

(i) *B*, a calendar year taxpayer, is a dealer that marks some of its debts to market under section 475(a)(2). Additionally, *B* is a bank that accounts for bad debts using the section 585 reserve method of accounting. *B* has not made an election to use the conformity method of accounting described in § 1.166–2(d)(3).

(ii) On December 31, 1995, *B* has total loans outstanding of $1,000,000 and a bad debt reserve balance of $1000. Among the loans that *B* marks to market is loan *X*. On January 1, 1995, loan *X* had a book and tax basis of $100. During the taxable year, loan taxable became partially worthless, and *B* charged off the loan by $5. Thus, loan *X* had a book basis of $95 and a tax basis of $100. The fair market value of loan *X* was $94 on December 31, 1995.

(iii) *B* computes the amount of gain or loss to be taken into account under section

475(a)(2) with respect to loan *X* using the rules of paragraph (f) of this section. Under paragraph (f)(1) of this section, *B* treats the adjusted tax basis of loan *X* as having been reduced by the $5 charge-off. Thus, *B* determines that it is required to take into account a $1 mark-to-market loss based on the difference between *B*'s adjusted basis in loan *X* of $95, as determined under paragraph (f)(1) of this section, and loan *X*'s fair market value of $94.

(iv) Further, *B* decides to claim a bad debt deduction with respect to loan *X* in 1995, rather than waiting until loan *X* becomes totally worthless. Thus, *B* charges the $5 of partial worthlessness to its reserve for bad debts. In computing a reasonable addition to the reserve under section 585(b), *B* reduces the amount of its total loans outstanding by $6 ($5 charged to the reserve for bad debts, plus $1 mark-to-market loss).

(v) On December 31, 1997, loan *X* has a fair market value of $93 and an adjusted basis (and outstanding principal balance) of $90. No additional worthlessness occurred with respect to loan *X* in 1996 or 1997. *B* determines that it is required to recognize a $3 mark-to-market gain with respect to loan *X*. Because *B* previously charged $5 to the bad debt reserve with respect to loan *X*, the entire $3 is a recovery item and must be credited to the bad debt reserve. See paragraph (f)(2) of this section. In computing a reasonable addition to the reserve for 1997, *B* does not increase the balance of its total loans outstanding by the $3 mark-to-market gain, because that adjustment would increase the balance to an amount in excess of the actual outstanding principal balance of $90. See paragraph (g)(1) of this section.

Par. 4. Section 1.475(a)–2 is added to read as follows:

§ 1.475(a)–2 Mark to market upon disposition of security by a dealer.

(a) *General rule.* If a dealer in securities ceases to be the owner of a security for federal income tax purposes and if the security would have been marked to market under section 475(a) if the dealer's taxable year had ended immediately before the dealer ceases to own it, then (whether or not the security is inventory in the hands of the dealer) the dealer must recognize gain or loss on the security as if it were sold for its fair market value immediately before the dealer ceases to own it, and gain or loss is taken into account at that time. The amount of any gain or loss subsequently realized must be properly adjusted, in the form of a basis adjustment or otherwise, for gain or loss taken into account under this paragraph (a). See § 1.475(b)–4(b) for the rule governing when a security with substituted basis must be identified if it is to be exempted from the application of section 475(a).

(b) *Example.* The rule of paragraph (a) of this section is illustrated by the following example.

Example.

(i) *Facts. D* is a dealer in securities within the meaning of section 475(c)(1) and is a member of a consolidated group that uses the calendar year as its taxable year. On February 1, 1995, *D* acquired for $100 a debt instrument issued by an unrelated party. On June 1, 1995, *D* sold the debt instrument to another member of the group, *M1*, for $110, which was the fair market value of the security on that date. *D* would have been required to mark the debt instrument to market under section 475(a) if its taxable year had ended immediately before it sold the debt instrument to *M1*.

(ii) *Holding.* Under paragraph (a) of this section, *D* marks the debt instrument to market immediately before the sale to *M1* and takes into account $10 of gain. The gain is not deferred intercompany gain. As a result, *D*'s basis in the debt instrument increases to $110 immediately before the sale. Accordingly, there is no gain or loss on the sale, and *M1*'s basis in the debt instrument is $110.

Par. 5. Section 1.475(a)–3 is added to read as follows:

§ 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 Code that would apply to the built-in gain or loss if section 475(a) did not apply to the security.

Par. 6. Section 1.475(b)–3 is added to read as follows:

§ 1.475(b)–3 Exemption of securities in certain securitization transactions.

(a) *Exemption of contributed assets.* If a taxpayer expects to contribute securities (for example, mortgages) to a trust or other entity, including a REMIC, in exchange for interests therein (including ownership interests or debt issued by the trust or other entity), the contributed securities qualify as 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)) only if the taxpayer expects each of the interests received (whether or not a security within the meaning of section 475(c)(2)) to be either held for investment or not held for sale to customers in the ordinary course of the taxpayer's trade or business.

(b) *Exemption of resulting interests*—(1) *General rule.* If a taxpayer contributes securities to a trust or other entity in exchange for interests therein (including ownership interests or debt issued by the trust or other entity) and if, for federal income tax purposes, the ownership of the interests received is not treated as ownership of the securities contributed, the interests received may be identified as being described in section 475(b)(1), even if some or all of the contributed securities were not so described and could not have been so identified. For purposes of determining the timeliness of an identification of an interest received, the interest is treated as acquired on the day of its receipt.

(2) *Examples.* The following examples illustrate the principles of paragraph (b)(1) of this section.

Example 1. Identification of REMIC regular interests. If a taxpayer holds mortgages that are marked to market under section 475 and the taxpayer contributes the mortgages to a REMIC in exchange for REMIC regular interests that are described in section 475(b)(1), the taxpayer may identify the regular interests as exempt from mark-to-market treatment. This is permissible because REMIC regular interests are debt securities issued by the REMIC and do not represent continued ownership of the contributed mortgages.

Example 2. Identification of interests in a grantor trust. If a taxpayer contributes securities to a grantor trust and receives beneficial interests therein and if the taxpayer marked the contributed securities to market under section 475, the taxpayer cannot identify the beneficial interests in the grantor trust as exempt from mark-to-market treatment. Because ownership of a beneficial interest in a grantor trust represents continued ownership of an undivided interest in the contributed assets, no new security has been acquired.

Par. 7. Section 1.475(b)1–4 is added to read as follows:

§ 1.475(b)–4 Exemptions—Identification requirements.

(a) *Identification of the basis for exemption.* An identification of a security as exempt does not satisfy section 475(b)(2) if it fails to identify the subparagraph of section 475(b)(1) in which the security is described.

(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) *Securities involved in 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 becomes 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-leg-in identification of the qualifying debt instrument under section 475(b)(2) applies to the synthetic debt instrument 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.

Par. 8. Section 1.475(c)–1, as proposed on December 29, 1993 (58 FR 68798), is amended as follows:

1. The heading of the section is revised.

2. Paragraphs (c) and (d) are added.

3. The revision and additions read as follows:

§ 1.475(c)–1 Definitions—Dealer in securities.

* * * * *

(c) *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).* 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). An example of a taxpayer willing to enter into either side of a transaction is a taxpayer willing to enter into an interest rate swap and either pay a fixed interest rate and receive a floating rate or pay a floating rate and receive a fixed rate.

(d) *Issuance of life insurance products.* A life insurance company that is not otherwise a dealer in securities under section 475(c)(1) does not become a dealer 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 817 and 7702.

Par. 9. Section 1.475(c)–2, as proposed on December 29, 1993 (58 FR 68798), is amended as follows:

1. The heading of the section is revised.

2. Paragraph (a)(2) is revised.

3. Paragraph (a)(3) is amended by adding ''; or'' in lieu of the period at the end of that paragraph.

4. Paragraph (a)(4) and paragraph (d) are added.

5. The revisions and additions read as follows:

§ 1.475(c)–2 Definitions—Security.

(a) * * *

(2) A debt issued by the taxpayer (including a synthetic debt instrument, within the meaning of § 1275–6(b), that the taxpayer is treated as having issued as a result of an integrated transaction under § 1.1275–(6);

(3) * * * ; or

(4) 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.

* * * * *

(d) *Synthetic debt held by a taxpayer as a result of an integrated transaction under § 1.1275–6.* If, as the result of an integrated transaction under § 1.1275–6, a taxpayer is treated as the holder of a synthetic debt instrument (within the meaning of § 1.1275–6(b)), the synthetic debt instrument is a security held by the taxpayer within the meaning of section 475(c)(2)(C). See § 1.475(b)–4(c) for rules governing identification of such a synthetic debt instrument for purposes of section 475(b).

Par. 10. Section 1.475(e)–1, as proposed on December 29, 1993 (58 FR 68798), is revised to read as follows:

§ 1.475(e)–1. Effective dates.

(a) *Taxable years ending on or after December 31, 1993.* The following sections apply to taxable years ending on or after December 31, 1993: §§ 1.475(b)–1 (concerning the scope of exemptions from mark-to-market requirement), 1.475(b)–2 (concerning transitional issues relating to exemptions), 1.475(c)–1(a) (concerning sellers of nonfinancial goods and services) and (b) (concerning taxpayers that purchase securities but do not sell more than a negligible portion of the securities), 1.475(c)–2 (concerning the definition of security), and 1.475(d)–1 (concerning the character of gain or loss). Note, however, that, by its terms, § 1.475(c)–2(a)(4) applies only to interests or arrangements that are acquired on or after January 4, 1995, and the integrated transactions to which § 1.475(c)–2(d) applies will exist only after the effective date of § 1.1275–6.

(b) *Taxable years beginning on or after January 1, 1995.* The following sections apply to taxable years beginning on or after January 1, 1995: §§ 1.475(a)–1 (concerning mark to market accounting for debt instruments) and 1.475(c)–1(c) (concerning the dealer-customer relationship) and (d) (concerning the issuance of life insurance products).

(c) *Securities acquired on or after January 4, 1995.* The following sections apply to securities acquired, originated, or entered into on or after January 4, 1995: §§ 1.475(a)–3 (concerning acquisition by a dealer of a security with a substituted basis), 1.475(b)–3(a) (concerning securities the taxpayer expects to contribute to a trust or other entity in a securitization transaction), and 1.475(b)–3(b) (concerning securities received in a securitization transaction).

(d) *Events occurring on or after January 4, 1995.*

(1) Section 1.475(a)–2 (concerning marking a security to market upon disposition) applies to dispositions occurring on or after January 4, 1995.

(2) Section 1.475(b)–4 (concerning the identification requirements for obtaining an exemption from mark-to-market treatment) applies to identifications made on or after January 4, 1995.

Margaret Milner Richardson,

Commissioner of Internal Revenue.

[FR Doc. 95–13 Filed 01–03–95; 8:45 am]

BILLING CODE 4830–01–U

26 CFR Part 1

[IA–55–94]

RIN 1545–AT13

Accuracy-related Penalty

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations which provide guidance as to when a taxpayer may rely upon the advice of others as evidence of reasonable cause and good faith within the meaning of section 6664(c) of the Internal Revenue Code of 1986 for purposes of avoiding the accuracy-related penalty of section 6662, and what constitutes reasonable cause and good faith within the meaning of section 6664(c) as it applies to the substantial understatement penalty of section 6662(b)(2) with respect to tax shelter items of a corporation. The proposed regulations implement changes to the accuracy-related penalty under section 6662 that were made by Title VII of the Uruguay Round Agreements Act (the Act) implementing the Uruguay Round of the General Agreement on Tariffs and Trade. Finally, this document provides notice of a public hearing on the proposed amendments to the regulations.

DATES: Written comments must be received by April 7, 1995. The IRS intends to hold a public hearing on these proposed regulations on April 28, 1995, beginning at 10 a.m. Persons wishing to speak at the hearing must submit outlines of their comments by April 7, 1995.

ADDRESSES: Send submissions to: Internal Revenue Service, Attn: CC:DOM:CORP:T:R (IA–55–94), room 5228, POB 7604, Ben Franklin Station, Washington, DC 20044. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, David L. Meyer, 202–622–6232; concerning submissions, Christina Vasquez, 202–622–6803. (These are not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 6662 of the Internal Revenue Code (Code) imposes an accuracy-related penalty on certain underpayments of tax. Section 6664(c) provides that no accuracy-related penalty is imposed with respect to any portion of an underpayment if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion.

Under current regulations interpreting sections 6662 and 6664, a taxpayer's good faith reliance on the advice (including an opinion) of a professional tax advisor may be taken into account for purposes of determining whether the taxpayer will be subject to an accuracy-related penalty. See, e.g., §§ 1.6662–4(g)(4)(ii) and 1.6664–4(b).

Section 6662(b)(2) of the Code imposes a penalty for a substantial understatement of income tax. An understatement is substantial if it exceeds the greater of 10 percent of the tax required to be shown on the taxpayer's return for the taxable year, or $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). An understatement is defined as the excess of (1) the amount of tax required to be shown on the taxpayer's return, over (2) the amount of tax imposed which is shown on the return, reduced by any rebate.

The Code provides that the amount of an understatement is reduced to the extent that certain conditions are met. For example, section 6662(d)(2), prior to amendment by the Act (Pub. L. 103–465), provided that an understatement is reduced by the portion of the understatement attributable to a tax shelter item of the taxpayer (the *section 6662 tax shelter rule*) if: (1) there is substantial authority for the taxpayer's treatment of the tax shelter item; and (2) the taxpayer reasonably believed (at the time its return was filed) that its treatment of such item was more likely than not the proper treatment.

The substantial understatement penalty was first adopted in section 323 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97–248. At that time, Congress believed that the new standards would ''assure that taxpayers who take highly aggressive filing positions are penalized while those who endeavor in good faith to self-assess are not penalized'' and that, with respect to tax shelters, ''if the principal purpose of a transaction is the reduction of tax, it is not unreasonable to hold participants to a higher standard than ordinary taxpayers.'' H.R. Conf. Rep. No. 97th Cong., 2d Sess. 575–76 (1982), 1982–2 C.B.650. More recently, Congress has been concerned that the substantial understatement penalty has not been effectively deterring corporate tax shelter transactions and thus, in Section 744 of the Act, eliminated the section 6662 tax shelter rule as it applies to corporations. As a result of this change, ''the standards applicable to corporate tax shetlers are tightened'' and ''in no instance [will] this modification result in a penalty not being imposed where a penalty would have been imposed under prior law.'' S. Rep. No. 412, 103d Cong., 2d Sess. 165 (1994); H.R. Rep. No. 826, 103d Cong., 2d Sess. 198–99 (1994). The change is effective for transactions occurring after December 8, 1994.

The proposed regulations set forth in this document address issues related to the section 6662 tax shelter rule and the reasonable cause exception of section 6664. This guidance includes, but is not limited to, rules that reflect the amendment of section 6662 by the Act.

Explanation of Provisions

Reliance on Tax Advisor

The proposed regulations set forth general rules clarifying when a taxpayer may be considered to have reasonably relied in good faith upon advice (including an opinion provided by a professional tax advisor). These rules apply to all taxpayers and to both tax shelter items and non-tax shelter items. In particular, the rules apply in determining whether reasonable cause and good faith exist for purposes of section 6664(c) and also apply in determining whether a taxpayer other than a corporation is considered to have reasonably relied in good faith on an opinion in order to satisfy the ''reasonable belief'' requirement of the section 6662 tax shelter rule.

In general, the proposed regulations require advice to be based on all material facts (including, for example, the taxpayer's purposes for entering into a transaction) and to relate applicable law to such facts in reaching its conclusion. The advice must not be based upon unreasonable factual or legal assumptions (including assumptions as to future events), nor