Office of Chief Counsel
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Memorandum

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date: June 30, 2014

to: Associate Area Counsel,
(Large Business & International)

from: Chief, Branch 1
(Passthroughs & Special Industries)

subject: Application of § 7701(g) to § 475

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

LEGEND

Partnership X	=
Partnership Y	=
Partnership Z	=
Year 1	=
Year 2	=
x	=

ISSUES

1. Does section 7701(g) apply to the determination of gain or loss under section 475(a)(2), such that a dealer in securities determining year-end mark-to-market gain or loss on securities must treat the fair market value of the securities as being not less than the amount of nonrecourse indebtedness to which the securities are subject?

2. If section 7701(g) does not apply to section 475, do the principles established in Commissioner v. Tufts, 461 U.S. 300 (1983) and Crane v. Commissioner, 331 U.S. 1 (1947) require a dealer in securities determining year-end mark-to-market gain or loss on securities to include in the amount realized the amount of nonrecourse indebtedness to which the securities are subject?

CONCLUSIONS

1. Yes, section 7701(g) applies to section 475(a)(2), and a dealer in securities determining year-end mark-to-market gain or loss on securities must treat the fair market value of securities as being not less than the amount of nonrecourse indebtedness to which the securities are subject.

2. Yes, even if section 7701(g) does not apply to section 475, the principles in the Crane and Tufts cases do apply, and a dealer in securities determining year-end mark-to-market gain or loss on securities must include in the amount realized the amount of nonrecourse indebtedness to which the securities are subject.

FACTS

Partnership X, Partnership Y, and Partnership Z (collectively, the "Partnerships") are commonly controlled entities that were treated as partnerships for federal income tax purposes during the years at issue. Originally created in Year1, Partnership X served as a traditional holding company for Partnership Y and held a majority interest in Partnership Z. Historically, Partnership Y and Partnership Z engaged in the business of originating and purchasing mortgage loans on the open market and issuing notes to third-party investors as mortgage backed securities in exchange for cash.[1] Partnership Y and Partnership Z treat the receipt of the cash as non-taxable loan proceeds. The transactional documents reflect that the Partnerships are not personally liable for the payment of the notes, and the Partnerships concede that the notes are nonrecourse liabilities to which the mortgage securities were subject. Therefore, no issue is being raised as to the whether the notes are nonrecourse indebtedness to which the mortgage securities were subject.

[1] The Partnerships generally conducted this business through grantor trusts or other disregarded entities. For federal tax purposes, the Partnerships treated the mortgage securities as their own assets.

In Year 2, Partnership Y sold some of its mortgage securities subject to nonrecourse liabilities to Partnership X. Partnership Y included the amount of the nonrecourse liabilities in calculating its amount realized on the sale, and Partnership X included the amount of the nonrecourse liabilities in calculating its basis in the purchased mortgage securities.

The Partnerships treated themselves as dealers subject to mark-to-market accounting under section 475, and treated the mortgage securities as subject to section 475(a)(2).[2] In calculating the section 475 mark-to-market gain or loss at the end of each year, the Partnerships did not include the nonrecourse liabilities to which the securities were subject in the determination of the fair market value of the mortgage securities. Thus, to calculate the year-end section 475(a) gain or loss, the Partnerships first compared the basis of each mortgage security to its respective fair market value (without regard to the nonrecourse indebtedness), which in many cases resulted in a loss amount (the "Current Loss"). The Partnerships then compared the cumulative section 475(a) gains and losses attributable to the mortgage security with the Current Loss and reported the difference as gain or loss on its tax return. For example, assume one of the Partnerships acquired a mortgage security for $100 and later the same year incurred nonrecourse indebtedness of $100 secured by the mortgage security. If the value of the mortgage security dropped to $90 at the end of that year, the Partnership would report a $10 mark-to-market loss during that year. In the next year, if the fair market value of the mortgage security dropped to $85, with the nonrecourse debt remaining at $100, the Partnership would calculate a $15 Current Loss, but only report a $5 loss deduction (the difference between the $10 cumulative loss and $15 Current Loss) on its tax return so as to not "double count" the loss. As a result of this treatment, the Partnerships claimed over $x in mark-to-market loss deductions.

LAW AND ANALYSIS

Issue 1: Application of Section 7701(g) to Section 475

Section 475(a) requires a dealer in securities to use a mark-to-market method of accounting for any securities that it holds. In the case of inventory, section 475(a)(1) applies and requires that the security be included in inventory at its fair market value. Under section 475(a)(2), any security not held as inventory and which is held at the end of the year shall be treated as if it were sold at its fair market value on the last business day of the year, and any gain or loss shall be recognized. Proper adjustment shall then be made in the amount of any gain or loss previously taken into account under section 475(a)(2).

[2] In a CCA dated Jan. 22, 2014, we determined that Partnership X was not a dealer in securities in Year 2. Therefore, the analysis in this CCA regarding section 7701(g) and Crane/Tufts is an alternative argument with respect to Partnership X in Year 2.

Section 7701(g), “Clarification of Fair Market Value in the Case of Nonrecourse Indebtedness,” provides that for purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.

Section 7701(g) was enacted in 1984 to reflect the rationale in Tufts regarding the amount realized for property subject to nonrecourse debt. The Joint Committee on Taxation explained that section 7701(g) was "to be limited in application to those Code provisions which expressly refer to the fair market value of property in determining the amount of gain or loss with respect to certain transfers of property.”[3] For example, the Joint Committee referenced section 338, which creates a deemed sale of corporate assets that are subject to a qualified stock purchase, as a Code section that is subject to the fair market value definition in section 7701(g).

Section 475 was enacted in 1993, nine years after section 7701(g), and does not contain any language precluding the application of section 7701(g). In contrast, several Code sections enacted after section 7701(g) expressly preclude section 7701(g) from applying to the respective definitions of "fair market value" used therein. See Sections 357(d) ("... nonrecourse liability ... reduced by the lesser of ... the fair market value of such other assets (determined without regard to section 7701(g))") and 362(d) ("In no event shall the basis of property be increased ... above the fair market value of such property (determined without regard to section 7701(g)) ..."). As previously discussed, section 475 contains a provision that dealers "shall recognize gain or loss as if such security were sold for its fair market value on the last business day of such taxable year ....." Section 475(a)(2) (emphasis added). Unlike sections 357(d) and 362(d), section 475 does not preclude the application of section 7701(g). It is generally assumed that "Congress is aware of existing law when it passes legislation." Miles v. Apex Marine Corp., 498 U.S. 19, 32 (1990). Because section 475 was enacted nine years after section 7701(g), it should be assumed that Congress intended section 7701(g) to apply to the term "fair market value" in determining the deemed gain or loss under section 475.

Therefore, section 7701(g) applies to section 475(a)(2), and in determining their year-end mark-to-market gain or loss on the mortgage securities, the Partnerships must treat the fair market value of the securities as being not less than the amount of nonrecourse indebtedness to which the securities are subject.

[3] Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the fax Reform Act of 1984, at 239 (1985).

Issue 2: Application of Tufts and Crane to Section 475

In Crane v. Commissioner, the Supreme Court dealt with the proper calculation of adjusted basis and amount realized for the disposition of property subject to nonrecourse debt. The Court first determined that the basis of such property included the amount of nonrecourse mortgage used to purchase the property. In determining the amount realized upon sale of the property, the Court, likewise, included in the amount realized the remaining nonrecourse debt assumed by the purchaser. The Court recognized that to do otherwise would have permitted the taxpayer "to recognize a tax loss unconnected with any actual economic loss." Tufts, 461 U.S. at 307 (explaining the rationale of Crane). In dicta, the Court in Crane observed:

> Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

Crane, 331 US 1, at 14, n. 37.

In Tufts, the Supreme Court addressed the situation discussed in the Crane dicta: nonrecourse indebtedness exceeding the sale price. In Tufts, real estate developers who financed an apartment complex with nonrecourse debt included such debt in their basis for calculating depreciation deductions. As the real estate market declined, the developers sold the property for less than the adjusted basis of the property and less than the amount of outstanding debt. The developers claimed a loss on the sale based on the difference between the adjusted basis and the sale price. The Supreme Court rejected the taxpayers' position and held that the buyer's assumption of the nonrecourse debt should have been treated as part of the selling price in determining the amount realized by the selling taxpayers:

> Crane teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended and will have received an unwarranted increase in the basis of his property. The Commissioner's interpretation of § 1001(b) in this fashion cannot be said to be unreasonable ... .

Tufts, 461 U.S. at 309-310.

The Court's rationale was thus essentially one of symmetry. That is, if a tax benefit is claimed and allowed from debts incurred under nonrecourse obligations, the taxpayer must treat the transfer of these obligations as part of the consideration for a sale of the property. See Herrick v. Commissioner, 85 T.C. 237, 262 (1985). Odend'hal v. Commissioner, 748 F.2d 908 (4th Cir. 1984), affg 80 T.C. 588 (1983).

Here, Partnership X received the tax benefit of including the amount of the nonrecourse liabilities in calculating its basis in the mortgage securities it purchased from Partnership Y. Partnership Y and Partnership Z received the tax benefit of treating cash received in exchange for issuance of the mortgage backed securities as non-taxable loan proceeds. Therefore, even if section 7701(g) did not apply to section 475, the Partnerships' omission of the nonrecourse indebtedness in determining the amount realized under section 475(a)(2), fails to follow the symmetrical approach endorsed by the Supreme Court in Crane and Tufts. This asymmetrical treatment resulted in the Partnerships inappropriately claiming to recognize a tax loss unconnected with any actual economic loss.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

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Please call Benjamin Weaver at (202-317-[redacted] or Marsha Sabin at (202) 317-[redacted] if you have any further questions.

Sincerely,

David R. Haglund
Chief, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)