

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, *MI*, 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 *MI*.

(ii) *Holding.* Under paragraph (a) of this section, *D* marks the debt instrument to market immediately before the sale to *MI* 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 *MI*'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.