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 nondealer 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 noncharitable 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 preacquisition 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-ondisposition 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