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 longterm, 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.