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Internal Revenue Service

Department of the Treasury

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Person to Contact:

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LEGEND:

Company =

Market =
Function =
Account 1 =
Account 2 =
Fees =
Year 1 =
Year 2 =
Status 1 =
Status 2 =
Insurer =
Regulation 1 =
X =

This is in response to a letter dated June 1, 1999, and subsequent correspondence requesting rulings that the Company should treat positions held in Account 1 as being sold at fair market value on the last business day of the taxable year under section 1256 of the Internal Revenue Code but should not treat positions held in Account 2 as being sold at fair market value on the last business day of the taxable year under section 1256.

FACTS

The Company has submitted the following information and representations:

The Company is a registered broker-dealer with the Securities Exchange Commission (SEC) that performs the Function for certain equity options. The Company operates in a number of equity options markets, but most of its transactions occur on the Market. The

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Company represents that all of its activities are on qualified boards or exchanges. The Company's entire business consists of the Function, and the Company does not execute trades in equity options for the general public.

The Company records transactions in one of two accounts, Account 1 or Account 2. If a Company employee executes an equity option transaction directly on the floor of an equity option market, the transaction is recorded in Account 1. If the transaction is entered into by telephoning a non-employee broker physically present on the market trading floor, the transaction is recorded in Account 2. The volume of transactions recorded in Accounts 1 and 2 are approximately equal. Almost all of the profits of the Company are earned in Account 2, and a large portion of this profit is unrealized.

The Company represents that the decisions to conduct business directly through Company employees on a market floor or through a non-employee broker are made based upon factors including trading volume, trading costs, and an evaluation of which method presents better opportunities for the Company. There have been situations where equity option transactions were accomplished through Company employees but are now accomplished through non-employee brokers.

Prior to Year 1, Account 1 and Account 2 were treated differently by the Market, and the Company was required to pay Fees for Account 2. Beginning in Year 1, the Market will treat the Company as having Status 1 for both Accounts 1 and 2 and no Fees will be paid to the Market for either Account 1 or Account 2. Also, neither Account 1 nor Account 2 is subject to Regulation 1, and neither Account 1 nor Account 2 has insurance coverage by the Insurer. Further, the SEC treats the Company as having Status 2 and requires the Company to use mark-to-market accounting for both Account 1 and Account 2.

For federal tax purposes, the Company represents that in Year 2 it made a timely mixed straddle election under section 1092(b)(2)(A)(i)(II) of the Code. Currently, the Company uses mark-to-market accounting for federal tax purposes for Account 1, while Account 2 is not marked to market. At the end of Year 2, the Company had an unrealized gain of $_X in Account 2.

The Company has requested two rulings: 1) Account 1 must be marked to market under section 1256, and 2) Account 2 is not marked to market under section 1256.

LAW AND ANALYSIS

Request #1

Section 1256(a) of the Code generally requires a taxpayer to mark to market any 1256 contract held on the last day of a taxable year by treating the contract as if it had been sold for its fair market value on the last business day of that taxable year.

Section 1256(b) defines "1256 contract" to include any dealer equity option.

Under 1256(g)(4), a dealer equity options is, with respect to an options dealer, any listed

option which is 1) an equity option, 2) purchased or granted by such options dealer in the normal course of his activity of dealing in options, and 3) is listed on the qualified board or exchange on which such options dealer is registered.

Section 1256(g)(5) provides that a "listed option" is any option (other than a right to acquire stock from an issuer) which is traded on (or subject to the rules of) a qualified board or exchange.

Under section 1256(g)(6)(A), an equity option is generally any option to buy or sell stock or any option the value of which is determined directly or indirectly by reference to any stock, group of stocks, or stock index.

A qualified board or exchange is defined in section 1256(g)(7) to include a national securities exchange which is registered with the SEC.

Section 1256(g)(8) provides that an "options dealer" is any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.

Based upon the information provided, the Company engages in transactions involving equity options that are listed options. Further, the company is an options dealer within the meaning of section 1256(g)(8). The only activity that the Company engages in is the Function; the Company does not accept or execute orders from the general public. We therefore conclude that the equity options accounted for in Account 1 are purchased or granted by the Company in the normal course of its activity in dealing in options. We further conclude that section 1256(a) applies to the equity options accounted for in Account 1 and that the Company must therefore mark to market all equity options held in Account 1 on the last taxable day of the year.

Request #2

The Company has requested a ruling that Account 2 is not subject to the mark-to-market requirements of section 1256, which is different than the request made for Account 1. The Company argues that the transactions recorded in Account 1 are, and that transactions recorded in Account 2 are not, entered into "in the normal course of [its] activity of dealing in options" under section 1256(g)(4)(B). In order to justify treating Account 2 differently than Account 1, there must be a factual basis for treating the accounts differently.

You have represented that, beginning in Year 1, the Market will treat the Company as having Status 1 for both Accounts 1 and 2 and no Fees will be paid to the Market for either Account 1 or Account 2. Also, neither Account 1 nor Account 2 is subject to Regulation 1, and neither Account 1 nor Account 2 has insurance coverage by the Insurer. Further, the SEC treats the Company as having Status 2 and requires the Company to use mark-to-market accounting for both Account 1 and Account 2. You have not informed us of any objective, verifiable standards that determine whether a transaction will be completed through a Company employee (and thus recorded in Account 1) or completed through a non-employee broker (and thus recorded in Account 2) other than a determination that completing a transaction by one method or the other presents a "better business opportunity." Taking into account the fact that

the Market, the Regulator and the Insurer each treat Account 2 in the same manner as they treat Account 1, and the fact that neither Account is subject to the restrictions of Regulation 1, you have not presented sufficient facts for us to conclude that you may treat Account 2 differently than Account 1.

CONCLUSIONS

Based upon all of the information and representations submitted, we hold as follows:

1. The Company must mark the Financial Products recorded in Account 1 to market as required under section 1256(a)(1) of the Code.

2. The facts submitted are not sufficient for us to conclude that you may treat Account 2 differently than Account 1.

The above holdings are based solely upon the information and representations submitted to us for consideration. Upon examination, an examining agent may ascertain whether the representations on which this ruling was based reflect a complete and accurate statement of the material facts. If it is determined that additional material facts exist that would justify differing treatment under section 1256 for Accounts 1 and 2, it is possible that an examining agent may conclude that Account 2 should be treated differently than Account 1.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Furthermore, we do not express any opinion about the applicability of other Code sections to the Company or Accounts 1 and 2. In particular, no ruling was requested, and we accordingly do not rule upon, the applicability of sections 475 and 1256(f)(4) of the Code to the Company and Accounts 1 and 2. However, we do note that section 475(c)(2)(E) does not apply to any contract to which section 1256(a) is applicable.

A copy of this letter must be attached to any income tax return to which it is relevant.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Assistant Chief Counsel
(Financial Institutions and Products)

By: Robert B Williams
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