OFFICE OF
CHIEF COUNSEL

**DEPARTMENT OF THE TREASURY**
**INTERNAL REVENUE SERVICE**
**WASHINGTON, D.C. 20224**
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Jeffrey Dorfman
Chief, Branch 5 CC:INTL:BR5

SUBJECT:

This Field Service Advice responds to your memorandum dated May 5, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

| | |
|---|---|
| Taxpayer | = |
| S Corp. | = |
| $x | = |
| Years 1-7 | = |
| product z | = |
| y | = |
| w | = |
| City A | = |

ISSUE(S):

1. Are Taxpayer's foreign currency losses characterized as ordinary or capital losses?

2. Did Taxpayer's trading activities rise to the level of a trade or business?

CONCLUSION:

Given the limited facts submitted for review, we are unable to provide conclusions to the issues presented. However, in accordance with your request, we are providing you with a discussion of the law regarding these questions to assist in your analysis.

FACTS:

During the years 1-6, Taxpayer incurred losses in excess of $ x in trading foreign currency futures contracts, forward contracts, options and swaps. In his tax returns as originally filed, the losses were characterized as capital losses, and the expenses incurred in connection with the foreign currency trading were treated as investment expenses. As a result, Taxpayer realized no tax benefit from the majority of his losses, and investment expenses (which apparently were only deductible to the extent of investment income).

Now, Taxpayer claims that the foreign exchange losses should be characterized as ordinary, rather than capital, losses under section 988. Accordingly, Taxpayer's foreign exchange losses would result in net operating losses ("nols") in the years 1-6. These nols (or a portion thereof) would then be carried forward to taxable year 7, when Taxpayer had income before the nol carryforwards. As a result, Taxpayer is claiming a large refund in year 7.

Taxpayer also claims that expenses that he incurred in connection with his foreign currency trading activity should be fully deductible. First, Taxpayer argues that he was a trader, rather than an investor, in connection with his foreign currency trading activities. In addition, Taxpayer asserts that the foreign currency transactions were in part entered into in order to hedge his foreign currency product z liabilities incurred in his y business.

Although it appears that the losses were realized, we have no meaningful information as to the types of contracts which Taxpayer traded, or the amount of losses which Taxpayer incurred in trading the specific products. Taxpayer merely states that Taxpayer incurred losses in trading "options, forwards, futures, and swap contracts." We assume, however, that Taxpayer did not engage in any notional principal contracts. In addition, we were not provided sufficient information as to the amount or frequency of Taxpayer's trading activity. Taxpayer states that "[he] consummated w individual trades each year." We also have no information regarding the amount of time in which Taxpayer's foreign currency positions remained open, or whether any of the positions were part of a straddle under section 1092. For purposes of this FSA we assume that in fact none of Taxpayer's positions were part of a straddle.

In Year 1, Taxpayer formed S Corp., a subchapter S corporation, and acquired all of its stock in order to lower Taxpayer's transaction costs of his foreign currency trading activity. To that end S Corp. acquired a seat on the City A Stock Exchange, and engaged in the same type of foreign currency trading as Taxpayer. At this point we have no information as to how many of Taxpayer's trades were actually entered into each year by Taxpayer and how many were entered into by S Corp. Similarly, we do not know how much of the trading losses and related expenses were incurred by Taxpayer and how much were incurred by S Corp.

We address in this memo whether and to what extent, Taxpayer's losses on its foreign currency trading activities would be characterized as ordinary losses. In addition we address whether Taxpayer's trading activity rises to the level of a trade or business. Lastly, we address whether S Corp. should be treated as an independent entity, or merely as Taxpayer's agent. As explained in more detail below, we do not have enough information to answer these questions. However, we will explain what information is needed for a complete analysis, and provide general guidance.

LAW AND ANALYSIS

I. Rules regarding Characterization of Gain/Loss on Foreign Currency Products

In this part of the FSA we set out the rules as to the characterization of the losses on different types of foreign currency products, in the different years.

Preliminarily, although Taxpayer asserts that he entered into the foreign currency transactions in part to hedge his foreign currency denominated product z liabilities, we assume that Taxpayer did not treat the foreign currency products as part of hedging transactions under section 988(d) ("qualified hedging transactions"). In general, section 988(d) and the regulations thereon, apply when a taxpayer eliminates or reduces its foreign currency risk in connection with a debt instrument denominated in a nonfunctional currency ("qualifying debt instrument") which it either holds or is an obligor on, with a foreign currency product ("the hedge"). § 1.988-5(a). Section 988(d) and the regulations allow the taxpayer to integrate the federal tax treatment of owning a qualifying debt instrument with the hedge, so that the taxpayer is treated as owning or being an obligor on a synthetic debt instrument. Id. If section 988(d) and regulations apply, Taxpayer would not recognize any foreign currency loss on the foreign currency products serving as a hedge to his foreign currency denominated product z liabilities. Rather, the foreign currency loss would be absorbed in the tax treatment of its synthetic product z liabilities. However, in order to treat the foreign currency products as part of qualified hedging transactions, Taxpayer must have identified the hedge on or before the date the acquisition of the financial instrument constituting the hedge is settled or closed. § 1.988-5(a)(5)(ii). In addition, the legging in and legging out rules of § 1.988-5(a)(6) apply if Taxpayer

did not hold the hedge for the complete time that he was an obligor on the product z liabilities. If Taxpayer legged out of integrated treatment of a product z liability, i.e., if Taxpayer disposed of the hedge while remaining an obligor on the product z liability, that product z liability may not be part of a qualified hedging transaction for any period subsequent to the leg out date. § 1.988-5(a)(6)(D). We have no information that Taxpayer in fact treated the acquisition of any of its foreign currency products as a section 988(d) hedge for its foreign currency denominated product z liabilities. Therefore, the remainder of this FSA assumes that the foreign currency products were not part of a qualified hedging transaction.

We further assume for purposes of this FSA that Taxpayer did not acquire or enter into the foreign currency products as hedging transactions under section 1256(e). A hedging transaction under section 1256(e) is a transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to reduce various types of risk, including risk of currency fluctuations with respect to borrowing made or obligations incurred by the taxpayer, provided all income, gain or loss on the underlying borrowing would be characterized as ordinary income, gain or loss. Section 1256(e)(2)(A)(ii). In order for the foreign currency products to be treated as hedging transactions under section 1256(e), Taxpayer, on the day he entered into the transactions would have had to clearly identify such transactions as being hedging transactions. Section 1256(e)(2)(C). If the transactions are characterized as hedging transactions, the financial products would not be subject to the mark to market provisions of section 1256(a), and the loss on the products would not be characterized as capital losses. Section 1256(f)(1),(2), and (3). Since we have no information that Taxpayer in fact treated the acquisition of any of its foreign currency products as a hedging transaction under section 1256(e) with respect to its foreign currency denominated product z liabilities, we assume for purposes of this FSA that the foreign currency products were not acquired of entered into as a hedging transaction under section 1256(e). We also need to assume that the § 1.1221-2 regulations do not apply. These regulations are retroactive.

Section 988(a)(1)(A) generally treats foreign currency gain or loss from a section 988 transaction as ordinary income or loss, notwithstanding that another provision of the Code may provide for a different characterization. A section 988 transaction is defined as a transaction described in section 988(c)(1)(B) if the amount which the taxpayer is entitled to receive or is required to pay by reason of such transaction is denominated in terms of a nonfunctional currency or is determined by reference to the value of one or more nonfunctional currencies. Section 988(c)(1)(B) includes entering into or acquiring any forward contract, futures contract, option, or similar financial instrument. Section 988(c)(1)(B)(iii).

Nonetheless, as we explain below, the rules for characterizing the losses on the different types of foreign currency products vary since certain of the products are

currently, or in previous taxable years were, excluded from the definition of section 988 transaction, and consequently, their characterization would not be determined under section 988.

A. Regulated Futures Contracts and Nonequity Options

Regulated futures contracts are defined in section 1256(g)(1) as a contract with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and which is traded on or subject to the rules of a qualified board or exchange. Nonequity options generally include options to purchase or sell foreign currency. Specifically, nonequity options are defined as options which are traded on or subject to a qualified board of trade, and which are not options to buy or sell stock, and the value of which is not determined directly or indirectly by reference to any stock or stock index. See section 1256(g)(3),(5) and (6).

Regulated futures contracts are included in the definition of a section 1256 contract. Accordingly, under section 1256(a)(1) the contracts must be marketed to market at the end of each taxable year. In addition, gain or loss on the contracts, whether the gain or loss is recognized as a result of the contracts being marketed to market, or recognized upon a disposition of the contracts, is treated as capital gain or loss. Section 1256(a)(1) and (3) and (f)(3)(A). Forty percent of the gain or loss is treated as short term gain or loss, and the remaining sixty percent is treated as long term gain or loss. Section 1256(a)(3).

Section 988(c)(1)(D)(i), as in effect for transactions entered into, or contracts acquired, after October 21, 1988, in effect removes regulated futures contracts and nonequity options from the definition of a section 988 transaction. Consequently, unless Taxpayer elected under section 988(c)(1)(D)(ii) to treat these transactions as section 988 transactions, as described below, Taxpayer will recognize capital loss under section 1256(a)(3) on the regulated futures contracts and nonequity options entered into or contracts acquired after October 21, 1988. Of course, if Taxpayer elected in the manner prescribed under section 988(c)(1)(D)(ii) and § 1.988-1(a)(7)(iii) to treat these transactions as section 988 transactions, Taxpayer will receive ordinary losses on those regulated futures contracts and nonequity options. We have no information as to whether the election was made.

In addition, for years prior to 1988, and for taxable year 1988, for transactions entered into prior to October 22, 1988, regulated futures contracts and nonequity options were excluded from the definition of section 988 transaction since they would be marked to market under section 1256. See section 988(c)(1)(B)(iii) (as enacted in the Tax Reform Act of 1986, P.L. 99-514 § 1261(a). Consequently, Taxpayer will recognize capital loss under section 1256(a)(3) on the regulated

futures contracts and nonequity options entered into, or contracts acquired, prior to October 22, 1988.

One may argue that for taxable years prior to 1988, and in taxable year 1988, for transactions entered into prior to October 22, 1988, the regulated futures contracts and nonequity options were not excluded from the definition of section 988 transactions unless they were held on December 31, of the taxable year at issue. However, this argument was put to rest when Congress enacted the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA"). Congress clarified in TAMRA § 1012(v)(6) that "taxpayers who acquire [section] 1256 contracts cannot elect [section] 988 rules for characterizing . . . such contracts simply by disposing of the contracts prior to the last day of the taxable year." Joint Committee on Taxation, Staff Description of the Technical Corrections Act of 1988, at 316.

Therefore, for all the taxable years in issue, losses on regulated futures contracts and nonequity options are characterized as capital losses under section 1256, notwithstanding section 988. Losses on foreign currency futures contracts that do not qualify as regulated futures contracts under section 1256(g)(1) (because, for example, they are not traded on or subject to the rules of a qualified board or exchange as defined in section 1256(g)(7)) or on foreign currency options that do not qualify as nonequity options under section 1256(g)(3) (because, for example, the options are not "listed" options as defined in section 1256(g)(5)) will be characterized as ordinary losses since the transactions will be subject to section 988.

B. Foreign Currency Contracts

Foreign currency contracts generally refer to forward contracts on exchange traded foreign currency. Specifically, foreign currency contracts are defined in section 1256(g)(2) as contracts which require delivery of, or the settlement of which depends on the value of, a foreign currency. The underlying foreign currency must be a currency in which positions are also traded through regulated futures contracts. In addition, the foreign currency contracts must be traded in the interbank market, and must be entered into at arm's length at a price determined by reference to the price in the interbank market.

Foreign currency contracts are included in the definition of a section 1256 contract. Accordingly, as we explained above regarding regulated futures contracts, under section 1256(a)(1) the contracts must be marked to market at the end of each taxable year. In addition, losses on the contracts are characterized as forty percent short term capital losses, and sixty percent long term capital losses. Section 1256(a)(1) and (3) and (f)(3)(A).

Nevertheless, for taxable years 1989 onwards, and for foreign currency contracts acquired or entered into after October 21, 1988, under section 988 the losses on the contracts are generally characterized as ordinary losses. However, if Taxpayer elected under section 988(a)(1)(B) and § 1.988-3(b) to treat any gain or loss on the foreign currency contracts as capital gain or loss, the losses would then be characterized as capital losses. Any election made under section 988(a)(1)(B) must be verified by the taxpayer by attaching a statement to its return describing each transaction for which an election was made, among other things. § 1.988-3(b)(4).

C. Other Forward Contracts

Forward contracts which are not foreign currency contracts as defined in section 1256(g)(2), i.e., forward contracts in which the underlying foreign currency is not traded on or subject to a qualified board or exchange, or that the forward contracts are not traded in the interbank market, are not section 1256 contracts. Accordingly, for all the taxable years at issue, losses incurred on these contracts are characterized as ordinary losses under section 988(a)(1)(A), unless Taxpayer elected under section 988(a)(1)(B) and § 1.988-3(b) to treat any gain or loss on the forward contracts as capital gain or loss. If Taxpayer made the above election, the losses are characterized as capital losses. Again, in order for the election to be valid, a verification statement must be attached to the return.

II. Deductibility of Taxpayer's Trading Activity Expenses

Taxpayer asserts that expenses, such as interest on his margin account and commissions, that he incurred in connection with his trading activity, should be characterized as ordinary trade or business expenses, rather than as investment expenses. It is unclear if Taxpayer is referring to expenses other than interest and commissions.

Preliminarily, commissions on the purchase and sale of the currency products are not deductible regardless of whether Taxpayer was a trader in the currency products. Rather, the purchase commissions increase the basis of the contracts; unless Taxpayer was a dealer in the currency products, sales commissions reduce the selling price of the contracts. See Covington v. Commissioner, 120 F.2d 768 (5th Cir. 1941), cert. denied, 315 U.S. 822 (1942); cf. § 1.263(a)-2(e) (commissions on the purchase and sale of securities).

Generally, if expenses Taxpayer incurred in trading currency products are characterized as ordinary trade or business expenses, they may be deductible under section 162(a). In addition, to the extent Taxpayer's expenses exceeded his gross income in any year, the net operating loss ("nol") (for the taxable years in issue) would be carried back three years and forward fifteen years. See generally section

172(a), (b), and (c). If the expenses are characterized as investment expenses, the expenses generally may be deductible under section 212 (ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income) in the year in which they are incurred. However, for purposes of calculating the amount of Taxpayer's nol to be carried back or forward, nonbusiness deductions are only included in the nol to the extent of the amount which is the sum of the nonbusiness gross income and the excess of the nonbusiness capital gains over nonbusiness capital losses. Section 172(c) and (d); § 1.172-3(a)(3)(i). Therefore, if Taxpayer's trading activity does not rise to the level of a trade or business, the related expenses may only be carried back or carried forward as part of a nol subject to the limitation of section 172(d)(4).

In addition, if Taxpayer's trading activity does not rise to the level of a trade or business, the interest expense incurred in connection with the trading activity may only be deducted to the extent of investment income. Section 163(d). If the trading activity constitutes a trade or business, the interest expense would not be limited by section 163(d). King v. Commissioner, 89 T.C. 445 (1987). Lastly, if Taxpayer's trading activity rises to the level of a trade or business, under certain circumstances taxpayer may be allowed a home office deduction. See section 280A(c)(1).

Generally, an investor in securities or commodities is not considered to be engaged in a trade or business no matter how much time or resources the taxpayer expends on the activity, Higgins v. Commissioner, 312 U.S. 212, 218 (1941) ("no matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to [determine that a taxpayer is engaged in a trade or business]"); Estate of Yaeger v. Commissioner, 889 F.2d 29 (2d Cir. 1989) (taxpayer was not engaged in a trade or business although he devoted his full time to his investment activities); Moller v. United States, 721 F.2d 810 (Fed. Cir. 1983), cert. denied, 467 U.S. 1251 (1984) (same) ; Steffler v. Commissioner, T.C. Memo. 1995-271 (1995) (same regarding investing in commodities), or the amount of trades the taxpayer engaged in during the year. Estate of Yaeger v. Commissioner, 889 F.2d 29 (2d Cir. 1989) (taxpayer was not engaged in trade or business although he entered into over 1,100 transactions in each taxable year in issue); Mayer v. Commissioner, T.C. Mem. 1994-209 (1994) (same). In contrast, a trader's activity may rise to the level of a trade or business if it is pursued with sufficient frequency, continuity and regularity. Commissioner v. Groetzinger, 480 U.S. 23 (1987); King v. Commissioner, 89 T.C. 445 (1987); Steffler v. Commissioner, T.C. Memo. 1995-271 (1995). An investor is one that is generally interested in the long term growth potential of his investment, and derives his profit from interest, dividends, and capital appreciation of the securities, or commodities while a trader buys and sells securities with reasonable frequency in an endeavor to catch the swings in the daily market movements and profits thereby on a short term basis. Estate of Yaeger v. Commissioner, 889 F.2d 29, 33 (2d Cir.

1989); King v. Commissioner, 89 T.C. 445, 458-59 (1987).[1] Whether Taxpayer acted in the role of an investor or a trader is a factual issue, as is the further issue as to whether a trader's trading activity was pursued with sufficient continuity and regularity to constitute a trade or business.

Generally, a major factor the courts look to in determining whether the taxpayer is a trader or investor is the length of the holding period for the stocks or commodities taxpayer held, since the length of time taxpayer held the stocks or commodities will reflect on whether the taxpayer intended to profit through short term swings in the market, or whether Taxpayer intended to profit through the stock's or commodity's long term appreciation. Estate of Yaeger v. Commissioner, 889 F.2d 29 (2d Cir. 1989); Mayer v. Commissioner, T.C. Mem. 1994-209 (1994); Paoli v. Commissioner, T.C. Mem. 1991-351 (1991). The cases do not state a bright line as to how short an average holding period one must have to be characterized as a trader. However, generally an average holding period of one year or longer probably indicates that the taxpayer is an investor. See, e.g., Mayer v. Commissioner, T.C. Mem. 1994-209 (1994), at 2949-5, in which the taxpayer was held to be an investor when the weighted average holding periods of stock sold were 317 days, 439 days, and 415 days in 1986, 1987, and 1988 respectively, and approximately two thirds or more of the stocks sold during the years in issue were held more than six months.

Furthermore, even if Taxpayer traded the foreign currency products intending to profit through the short term swings in the market, Taxpayer's trading activity will only rise to the level of a trade or business if Taxpayer's activities were frequent, regular and continuous. It is difficult to state how many trades must be entered into. In Mayer the court found that the taxpayer's trading was sufficiently substantial in both dollar amounts and number of trades, when he entered into 1,140 transactions, 1,569 transactions and 1,136 transactions, in 1986, 1987, and 1988 respectively, and the dollar amount of gross proceeds was $16.6 million, $18.5 million, and $14.5 million in 1986, 1987, and 1988 respectively. Mayer v. Commissioner, T.C. Mem. 1994-209 (1994), at 2949-4 and 2949-5. (In Mayer the taxpayer was still not engaged in a trade or business since the taxpayer was found to be an investor based on his goal of long term appreciation, the long weighted average holding

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[1] But see, Levin v. United States, 597 F.2d 760 (Ct. Cl. 1979) (taxpayer was held to be a trader when he engaged in 332 transactions in a given year since he was an "active investor" ; no mention is made as to whether taxpayer intended to profit from long term capital appreciation, or whether he intended to profit from the short term swings in the market). To the extent that Levin implies that one may be a trader engaged in a trade or business merely by deriving one's entire income from one's investments, and devoting one's entire workday to stock transactions, the weight of authority is otherwise.

period for his stock and that his profits primarily consisted of dividends, interest and long term capital gains.)

In Commissioner v. Nubar, 185 F.2d 584 (4th Cir. 1950), cert. denied, 341 U.S. 925 (1951), the taxpayer was found to be engaged in a trade or business during the taxable years 1941-1944 when he entered into 137 trades, 303 trades, 296 trades, and 222 trades in 1941, 1942, 1943, and 1944 respectively. It must be noted however, that the issues in Nubar were whether the taxpayer was a nonresident alien, and if so, whether the taxpayer was engaged in a trade or business, so as to subject the taxpayer to tax in the United States. The finding that the taxpayer was engaged in a trade or business served to subject the taxpayer to tax. Accordingly, we do not believe that merely entering into 300 trades a year is sufficient to cause one's trading activities to rise to the level of a trade or business in the context of a case like the one at hand. But see Levin v. United States, 597 F.2d 760 (Ct. Cl. 1979) (the taxpayer was found to be a trader when he entered into 332 transactions in a given year; nonetheless, the taxpayer lost in that the loan was held not to be a business loan).[2]

Besides entering into a sufficient amount of transactions, in order to be considered in a trade or business the trading must also be regular and continuous, i.e., the taxpayer must be engaged in the trading activity for a substantial period of time. In Paoli v. Commissioner, T.C. Mem. 1991-351 (1991), the taxpayer's trading activity was held not to rise to the level of a trade or business although the taxpayer consummated 326 securities sales during the year at issue involving approximately $9 million worth of stock or options, since the trading activity did not have the requisite continuity and regularity. The court found that the activity lacked the necessary continuity and regularity since nearly 40% of the taxpayer's trades occurred in a one month period, and the vast majority of the trades occurred from January through May. During the remainder of the year the pace of the trading tapered off considerably, and in fact the taxpayer entered into only one or no trades during the final three months of the year. Paoli v. Commissioner, T.C. Mem. 1991-351 (1991), at 281-282.

Subchapter S Corporation

Taxpayer states that in Year 1 it formed S Corp., a subchapter S corporation, in order to reduce Taxpayer's transaction costs related to his trading activity. At all relevant times Taxpayer owned 100% of S Corp.'s shares. S Corp. acquired a seat on the City A stock exchange so that it could trade foreign currency products. S Corp., solely under Taxpayer's direction, engaged in the same type of foreign currency trading that Taxpayer engaged in.

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[2] See also our discussion of Levin in note 1.

S Corp.'s existence raises issues as to whether its trades should be considered when analyzing whether Taxpayer's trading activity was sufficiently regular and continuous so that Taxpayer would be considered to be a trader. If S Corp.'s activity is not considered when analyzing whether Taxpayer is a trader or investor, one would also have to analyze whether S Corp. was a trader or investor.

Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943), held that generally a corporation must be recognized as a separate entity apart from its shareholder if it was formed or operated for business purposes. See also National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949). Generally, the courts have held that the quantum of business activity required for the corporation to be recognized may be rather minimal. Hospital Corp. of America, 81 T.C. 520, 579 (1983). In this manner, in Moline Properties the Court held that the corporation had to be respected when the it was formed so that its shares would provide the corporation's creditor security for a loan in addition to the mortgage on the property. Accordingly, forming S Corp. in order to lower Taxpayer's transaction costs is likely a significant enough business purpose so that unless S Corp. was acting as an agent for Taxpayer, S Corp.'s activities must be viewed separately from Taxpayer. Furthermore, the fact that S Corp. is a subchapter S corporation does not change the above analysis. See, e.g., Crook v. Commissioner, 80 T.C. 27, 33 (1983), aff'd in unpublished opinion, 747 F.2d 1463 (5th Cir. 1984) (for the taxable years in issue, dividends from subchapter S corporation were included in investment income for purposes of section 163(d); "[t]he separate existence of corporations is firmly established under the tax law, and [the Tax Court] has recognized that the business of a subchapter S corporation is separate and distinct from that of its shareholders." (citations omitted)) Howell v. Commissioner, 57 T.C. 546, 553 (1972) (acq.) (the Tax Court preliminarily held that under Moline Properties the subchapter S corporation was to be respected).

Finally, we discuss whether S Corp. was merely an agent of Taxpayer, so that its currency transactions may be aggregated with Taxpayer's transactions, and its expenses may be treated by Taxpayer in the same manner as Taxpayer's expenses. Generally, the courts have narrowly restricted the instances in which a corporation has been found to act as an agent to its sole shareholder to situations where the corporation's role as an agent has been made clear. See Northern Indiana Public Service Co. v. Commissioner, 105 T.C. 341, 348 (1995), aff'd, 115 F.3d 506 (7th Cir. 1997); see also Commissioner v. Bollinger, 485 U.S. 340, 349 (1988) (". . . we agree that it is reasonable for the [Service] to demand unequivocal evidence of genuineness in the corporation-shareholder context . . ."). To determine whether a corporation is a true agent of an owner-principal, National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949) looked to the following four indicia of an agency relationship:

1. Whether the corporation operates in the name and for the account of the principal.
2. Whether the corporation binds the principal by its actions.
3. Whether the corporation transmits money received to the principal.
4. Whether the receipt of income is attributable to the services of the principal's employees and to the assets of the principal.

National Carbide Corp. v. Commissioner, 336 U.S. 422, 437 (1949). National Carbide Corp. also required that the corporation's business purpose must be the carrying on of the normal duties of an agent in order for an agency relationship to be recognized for tax purposes between a corporation and its owners. [3] Id. Commissioner v. Bollinger, 485 U.S. 340, 349-50 (1988) held that the genuineness of the agency relationship is adequately assured when the agency relationship is set forth in a written agreement, the corporation functions as an agent, and the corporation is held out as an agent in all dealings with third parties related to the transaction. See also Northern Indiana Public Service Co. v. Commissioner, 105 T.C. 341, 348 (1995) aff'd, 115 F.3d 506 (7th Cir. 1997).

In this case, in order to find that S Corp. was the agent of Taxpayer in a specific transaction or type of transaction, e.g., entering into regulated futures contracts on the City A Stock Exchange, it must be shown that in S Corp.'s contractual dealings with third parties involving that transaction or type of transaction, the third parties realized that S Corp. was contracting as an agent for Taxpayer. Therefore, when S Corp. purchased currency products on the City A Stock Exchange or otherwise, the other side to the transaction or the exchange must have understood that S Corp. was merely acting as a nominee for Taxpayer. In addition, when S Corp. maintained bank accounts used for purposes of its trading activity, the banks must have realized that they were contracting with S Corp. as an agent or nominee for Taxpayer.

If upon investigation the facts show that S Corp. was merely an agent for Taxpayer, then S Corp.'s and Taxpayer's trades may be aggregated in determining whether Taxpayer was a trader. In addition, if Taxpayer is found to be a trader, then

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[3] National Carbide Corp. also required that the corporation's relations with its principal must not be dependent upon the fact that it is owned by the principal. National Carbide, 336 U.S. 422, 437 (1949). The Court in Bollinger explained that the meaning of the second requirement is not entirely clear, but was apparently a generalized statement of the concern that the separate entity doctrine of Moline Properties not be subverted. Commissioner v. Bollinger, 485 U.S. 340, 349 (1988). This concern is satisfied where unequivocal evidence of the genuineness of the agency relationship exists. Bollinger, 485 U.S. at 349-350; First Chicago Corp. v. Commissioner, 96 T.C. 421, 445 (1991), aff'd, 135 F.3d 457 (7th Cir. 1998) .

all of S Corp.'s interest expense would be deductible in the same manner as Taxpayer's interest expense. If S Corp. is not found to be an agent for Taxpayer, then one will have to separately determine whether either Taxpayer's and/or S Corp.'s trades rise to a level of a trade or business. If either Taxpayer's or S Corp.'s trades rise to a level of a trade or business, then that person will be able totally deduct its interest expense and trading related expenses.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

If you have any further questions, please call the branch telephone number.

JEFFREY DORFMAN
Chief, Branch 5