

By hand delivery and electronic mail

September 28, 2007

CC:PA:LPD:PR (Notice 2007-58)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20044

Dear Sir/Madam:

On behalf of the Securities Industry and Financial Markets Association (SIFMA),¹ I am pleased to submit the attached comments in response to Notice 2007-58, which requests comments regarding financial services income under section 904(d) of the Internal Revenue Code.

Thank you for your consideration of our views. Please do not hesitate to contact me (at 202-216-2031 or pmcclanahan@sifma.org) if SIFMA can be helpful in any way as you proceed with your work in this area.

Sincerely,

Patricia McClanahan
Managing Director, SIFMA

Cc: Mike Mundaca
John Harrington
Steve Musher
Barbara Felker
Jeffrey Parry

¹ The Securities Industry Association merged with The Bond Market Association in November 2006 to become the Securities Industry and Financial Markets Association ("SIFMA"). SIFMA brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

SIFMA Response to Notice 2007-58
Comments on Treasury Regulation Section 1.904-4(e)
Categories of Active Financing Income

Introduction

Like so many other industries over the past twenty years, the financial services industry has been greatly affected by developments in technology, communications and globalization -- both directly and indirectly. Directly, in that these developments have helped the financial services industry to innovate and offer new products and services that would not have been feasible in less-global capital markets. Indirectly, in that they have led to the industry's customers demanding new products and services to help take advantage of their own opportunities, and manage the risks, presented by these trends. As was noted long ago, "The only constant is change".²

Many of these developments have also led to changes to the regulation of securities, banking and financial services firms. Today, most financial services firms are subject to global, group-wide supervision by a regulator that is recognized by regulators in other jurisdictions. For instance, the larger U.S.-based broker-dealers are Consolidated Supervised Entities ("CSEs") subject to group-wide supervision by the Securities and Exchange Commission ("SEC"). Likewise, under the Bank Holding Company Act, most large commercial banks are treated as financial holding companies and are subject to group-wide supervision by the Federal Reserve Bank.

As a result of these developments, it is not surprising that many activities that are now core to the financial services industry, and critical components of the global credit and liquidity markets, are nevertheless not explicitly mentioned on the list of activities giving rise to active financing income that is part of Treasury regulation section 1.904-4(e)(2)(i), which was issued almost twenty

² Attributed to Heraclitus of Ephesus (c.535 BC - 475 BC).

years ago. We appreciate the opportunity to provide comments on the scope of activities in the list. This list is critical to the proper “basketing” of income for the financial services industry, because many types of income that normally have a passive character in the hands of the general investing public or the non-financial services corporate sector, are of course earned by financial services companies as part of their core business.

While our businesses require substantial capital, at their heart our firms are service businesses. Like other services businesses, we have to go to our customers to provide the services they require. Because securities firms, banks and similar financial services businesses are engaged primarily in the delivery of sophisticated services to customers in major financial centers, and are subject to prudential regulation in the jurisdictions in which they operate, we have relatively little flexibility in where we locate our international operations. We appreciate that it is difficult to design appropriate tax rules for financial services firms, because so much of our business involves the application of capital to provide customer services, and income from capital has differing tax consequences depending on who earns it. Interest income, for example, is passive investment income when earned by an individual investor, or even by a mutual fund. However, in the hands of a securities firm or bank, interest income arising from a loan to a customer, or from a bond held in inventory for sale to customers, is active business income attributable to the firm’s core customer services of market making and financial and credit intermediation. As a result, income from capital has different economic and tax consequences depending on the context in which it is earned.

In creating a list of this nature, we recognize there is some degree of tension between trying to comprehensively capture the wide range of activities in which financial services firms engage in connection with their core customer driven businesses, and the risk of over-inclusively capturing certain types of activities that in the hands of certain taxpayers are really more passive in nature. Furthermore, we believe experience shows that any static list of this nature is

subject to the risk that it will shortly be in need of updating, as both the financial services industry and its customers continue to evolve and develop.

Approach One – Consolidated Supervision

We believe that there is an appropriate approach to properly allow activities that are part of a changing and dynamic financial services business to be characterized as such for foreign tax credit purposes while at the same time excluding income earned by those who are not engaged in an active financial services business. That is, we recommend that section 1.904-4(e) be amended to include in its list of categories of “active financing income” a lead category for all income earned by any entity that is subject to comprehensive, prudential regulation by a recognized financial services authority at the holding company level. For entities that do not fall under this lead category, the list should be revised and updated as discussed in Approach Two, below.

This approach has the virtue of being both narrowly tailored, because financial regulators by necessity only regulate those companies whose core business is offering financial services to customers, as well as dynamic, because it will capture whatever new products or services financial regulators approve to be engaged in by these entities.³ It also has the virtue of simplicity for most of the taxpayers who earn active financing income. For these purposes, financial regulators should include national (and regional) regulators, including banking regulators and securities regulators, and those imposing consolidated supervision regimes.

As mentioned above, most financial services firms are subject to global, group-wide supervision by a regulator that is recognized by other global regulators. The large U.S.-based broker-dealers are Consolidated Supervised Entities (“CSEs”) and are subject to group-wide supervision by the Securities and Exchange Commission (“SEC”). The CSE program is intended to provide

³ We note that the Internal Revenue Code and Treasury regulations, in several instances, already similarly refer to financial-services regulatory regimes in order to determine how income should be categorized or treated. Examples are the “eligible CFC” test of section 954(h) and certain foreign tax credit rules applicable to licensed or registered broker dealers under section 901(k)(4).

consolidated supervision to investment bank holding companies that is broadly consistent with Federal Reserve oversight of Bank Holding Companies.⁴ The CSE regime is intended to allow the SEC to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities, including U.S.- and foreign-registered banks and broker-dealers, or the broader financial system at risk. The CSE regime (similar to the Federal Reserve requirement for Bank Holding Companies) requires, in addition to many examination and reporting requirements, monthly and quarterly meetings between the SEC and the CSE firms, and is clearly not something an entity or group that is not a core financial services group would submit itself to merely to get a better result for section 904 basketing purposes.

Similar to the Federal Reserve requirement for U.S. Bank Holding Companies, the SEC requires that CSE holding companies maintain regulatory capital commensurate with the risk of their activities, inventory positions and principal investments, as reflected *inter alia* by capital adequacy measures computed under the internationally recognized Basel standards. These Basel standards are the standards followed by most of the non-U.S.-based financial services firms in their home jurisdiction. In addition, many non-U.S.-based financial services firms are also regulated in the U.S. by the Federal Reserve as financial holding companies.⁵

All U.S. bank holding companies are subject to comprehensive consolidated supervision under applicable Federal law. Since 1956, almost all companies that own insured banks are supervised at the holding company level by the Board of Governors of the Federal Reserve System (the Federal Reserve Board). In 1999, when Congress authorized bank holding companies to acquire and hold insurance companies and securities firms, the Federal Reserve Board

⁴ For more information on Consolidated Supervision, see SEC website at: <http://www.sec.gov/divisions/marketreg/hcsupervision.htm>

⁵ For more information on firms treated as financial holding companies by the Federal Reserve, see Federal Reserve website at: <http://www.federalreserve.gov/generalinfo/fhc/>

authority was reiterated when Congress named this agency the “Umbrella Supervisor” for financial holding companies. In this role the Federal Reserve sets capital requirements for the consolidated entity and supervises the consolidated entity through regular examinations and the exercise of its plenary enforcement authority. For financial holding companies, Congress requires the Federal Reserve to rely, to the greatest extent possible, on the examination and supervisory authority of the functional regulator for any insurance and securities subsidiaries. But if necessary, the Federal Reserve can examine, require reports from, and take enforcement actions against these functionally regulated entities in appropriate circumstances to prevent harm to the insured bank.

Approach Two – List Expansion

Regardless of whether a lead category for CSE entities is included in the list, the list of activities giving rise to active financing income should be expanded in a number of ways. It is important to first note, though, that even in its current form the list is drafted broadly. We therefore believe that virtually all of the core activities engaged in by financial services firms, including those mentioned below as not currently explicitly enumerated, are still within the scope of the existing regulation, either because they are similar to the other activities as provided in paragraph (e)(2)(i)(Y), or because they are incidental to such activities as provided in (e)(4). To bring a greater degree of clarity and certainty to the matter, however, we suggest below certain ways that the list should be amended to explicitly include certain additional activities.

First, as a broad matter, the list should include a category for any income earned by a dealer in securities or commodities in the ordinary course of its trade or business as a dealer in securities or commodities, as such terms are defined in section 475. The section 475 definition of a dealer is at once both narrowly tailored to those who engage in securities or commodities transactions with customers in the ordinary course of business, yet helpfully includes a broad definition of security which should serve, appropriately for these purposes, to capture the broad range of transactions that broker-dealers in fact enter into in

the ordinary course of that business. This approach would also exclude transactions, if any, that are not part of that business.

A category for ordinary course income of section 475 dealers would also allow several of the existing categories on the current list to be subsumed, and therefore eliminated as separate categories. Specifically, existing categories (I), (J) and (L), which each deal with different sub-categories of income that securities and commodities broker-dealers can earn in the ordinary course of business, could be eliminated. If this approach is not adopted, however, then, as detailed below, each of existing categories (I), (J), and (L) would need to be expanded to clarify the inclusion of transaction types that have grown in importance in the past two decades.

The more specific ways in which the list of activities should be amended are as follows.

1. Paragraph (C), dealing with income from investing deposits of money where the taxpayer holds itself out as providing a financial service by taking deposits, should be amended to clearly indicate that the amount of the taxpayer's income from investing deposits can be determined using a reasonable method.⁶
2. Paragraph (D), dealing with income from loans, should be amended to clearly also include loans of non-cash financial assets (*e.g.*, securities), as well as loans made pursuant to reverse-repurchase ("repo") agreements.
3. Paragraph (E), dealing with income from purchasing and selling evidences of indebtedness, should be amended to clearly also include income from transactions in receivables, and income from facilitating

⁶ Absent a taxpayer being able to directly trace investment income attributable to deposits received (which is generally unlikely due to deposited cash being a fungible asset of the taxpayer) the taxpayer should be able to determine income using a reasonable method. For example, potential methods could include allocating a portion of the taxpayer's total income by (1) multiplying the taxpayer's total income by the ratio of the taxpayer's deposits to total liabilities, or (2) multiplying the amount of deposits by the taxpayer's average earnings rate on its income-earning assets. The concern is not that the income from investing deposits does not constitute active financing income, but rather measuring the amount of such income.

transactions to repackage and securitize those listed assets, or other financial assets, as well as income from factoring receivables.

4. Paragraph (F), dealing with income from issuing letters of credit, should be amended to clearly also include income from other forms of loan commitments, and from issuing financial guarantees (such as guarantees of third party debt).
5. Paragraph (G), dealing with income from trust services, should be amended to clearly also include depository services.
6. Paragraphs (I), (J) and (L), as mentioned above, would be best subsumed in a category for a broker-dealer acting in the ordinary course of business. Each deals with different types of income that broker-dealers earn in the ordinary course of business. Paragraph (I) lists activities related to the distribution of securities which, by their nature, are generally performed by broker-dealers. Paragraph (J) is explicitly limited to broker-dealers, and attempts to list the different types of financial instruments that a broker-dealer earns income from, and the different types of income that it can earn. Paragraph (L) references certain sub-categories of derivative income. The potential shortcomings of static lists of activities is illustrated here, as none of these existing categories explicitly mentions, for example: dealer transactions in options, equity derivatives, stock borrowing and lending, or repos -- and the various different types of income that can be earned from these transactions that are not necessarily interest or dividends. These are activities which are all now critical sources of market liquidity and major parts of many dealers' core business. For these reasons, rather than attempting to specifically enumerate here all the different possible types of broker-dealer transactions and income sources, these categories (I), (J) and (L) should be effectively combined and captured as "Any item of income from any transaction (including hedging transactions and transactions involving physical

settlement) entered into the ordinary course by a dealer in securities or commodities (within the meaning of section 475) as such a dealer in securities or commodities.”

Since, however, some groups with active broker-dealers nevertheless maintain separate sales affiliates for regulatory or legal reasons (particularly in countries outside the broker-dealer’s home country) which can also earn customer commissions or distribution fees, this category should also include any commissions or distributions fees earned by an affiliate of a dealer in securities or commodities (within the meaning of section 475).

If this approach is not adopted, however, then at a minimum each of the existing categories should be clarified as follows.

- Paragraph (I) should be amended to clearly include income from purchasing and offering or selling commodities, futures, forwards, options, swaps, derivative financial products (including notional principal contracts), and to include income from private placement transactions.
- Paragraph (J) should be amended to clearly include income earned by broker-dealers from: principal transactions; transactions in commodities; purchasing, offering or selling futures, forwards, options, swaps, and other derivative financial products (including notional principal contracts); private placement transactions; transactions in connection with purchasing and repackaging financial assets, and selling the resulting securities; and borrowing or lending stock or securities for or to customers, or engaging in securities repurchase or reverse repurchase transactions with customers.
- Paragraph (L) should be amended to clearly include income from equity swaps, and from futures, options and other derivative transactions.

7. Paragraph (K), dealing with service fee income from investment and correspondent banking, should be amended to clearly also include advisory fees for mergers and acquisitions.
8. Paragraph (N), dealing with income from the management of funds, should be amended to clearly also include promote interests earned in connection with such management, income from management of other non-cash investments, and income earned on seed investments in funds for which the taxpayer is entitled to receive investment management fees or promote interests.
9. Paragraph (O), dealing with bank-to-bank participation income, should be amended to clearly also include other lender-to-lender participation income.
10. Paragraph (U), dealing with income from servicing mortgages, should be amended to clearly also include income from servicing other financial assets described in this section (including the accrual of interest incidental to such activities).
11. Paragraph (V), dealing with income from a finance lease, should be amended to include income from an operating lease.
12. Paragraph (X), dealing with income from, among other things, custodial services and stock transfer agency services, should be amended to clearly also include clearing services.

Once again, we think the most efficient approach is Approach One - to include a broad a category for income of regulated entities. It is simple, dynamic, and appropriate in what it would capture.