

April 13, 2000

Mr. Jonathan Talisman
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Mr. Eric Solomon
Deputy Assistant Secretary
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Dear Assistant Secretary Talisman
and Deputy Secretary Solomon:

We are writing in support of our view that the Treasury Department has the authority to issue guidance permitting, or even requiring, taxpayers to use financial accounting book values for purposes of mark-to-market accounting under Section 475 of the Internal Revenue Code (the "Code").^{1/}

Section 475(g) of the Code gives the Treasury authority to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of" Section 475. Likewise, the legislative history of Section 475 expresses

^{1/} Section 475 of the Code generally requires a securities dealer to include the securities in its inventory at their fair market values and, for other securities held at the close of a taxable year, to recognize gain or loss as if each security were sold at the end of the year for its fair market value.

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Congress' intention that the Treasury Department issue guidance with respect to valuation for purposes of mark-to-market accounting.^{2/}

Moreover, the Secretary has an affirmative duty, under section 7805(a) of the Code, to "prescribe all needful rules and regulations for the enforcement of" the Internal Revenue Code. Such rules and regulations are valid "so long as they are reasonable."^{3/}

The conference report accompanying the enactment of Section 475 states that "the conferees expect that the Treasury Department will authorize the use of valuation methods that will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for Federal income tax purposes."^{4/} For the reasons set out below, valuation by reference to the books that a securities dealer maintains for financial accounting purposes is the only valuation method that would clearly reflect the dealer's income for Federal income tax purposes with reasonable accuracy. Moreover, this is the only method that would avoid severe compliance burdens and administrative difficulties and thus be consistent with Congressional intent.

A dealer's valuation of its securities for financial accounting purposes clearly reflects income because a dealer uses these valuations in reports to investors and to regulators, such as the Securities and Exchange Commission, for internal risk management purposes and generally to determine employee compensation. A dealer's use of inaccurate valuations for these purposes would impose significant costs on the dealer, such as overpayment or underpayment of employees, loss of key employees, potential liability to investors, penalties for

^{2/} H. Rep. 103-213, at 616 (1993).

^{3/} Cottage Savings Association v. Commissioner, 499 U.S. 554, 560-61 (1991).

^{4/} H. Rep. 103-213, at 616 (1993).

regulatory noncompliance, involvement in unprofitable transactions, inadequate hedging of portfolios and general exposure to risk. For these reasons, securities dealers devote great attention, focus and expense to these valuations, and they are as accurate as possible.

By contrast, it is unlikely that an alternative "artificial" valuation would clearly reflect income. Given the importance of the non-tax issues at stake, if there were an alternative method of valuation that more clearly reflected income, the dealer in question would have adopted it. Such an alternative valuation would in any case be exceedingly difficult to review. As noted above, and as we have discussed with the IRS numerous times in the past, valuation of securities is exceedingly difficult and complex, and it is based on numerous factors and analytic models that vary over time. It cannot be reperformed years later by anyone, including experts, and hindsight valuations of securities do not reflect their true values for the relevant periods of time.

Likewise, requiring an alternative artificial valuation would impose a substantial and unnecessary compliance burden. As the Supreme Court has recognized, valuing assets in the absence of the evidence of value provided by sales requires both the taxpayer and the Commissioner to engage in a "cumbersome, abrasive, and unpredictable administrative task."^{5/}

In any case, it seems clear that Congress did not expect dealers to value their securities twice, once in the regular course of business, and separately for tax purposes. Rather, Congress concluded that complying with Section 475 would not be unduly burdensome to securities dealers because dealers would have already marked their securities to market for financial accounting purposes in the ordinary course of business. In describing the reasons for enacting Section

^{5/} Cottage Savings, 499 U.S. at 559 (internal quotation marks omitted).

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475, for example, the House Ways and Means Committee Report for the Revenue Reconciliation Act of 1993 contains the following language: "Inventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement purposes and in adjusting their inventory using the LCM [lower of cost or market] method for Federal income tax purposes."^{6/}

Regulations authorizing the use of financial accounting valuations for purposes of Section 475 might of course limit the use of book values to dealers who consistently use those values for significant non-tax purposes. Such regulations might also be designed to ascertain that the book values presented to the IRS are the same as those that are used for all other non-tax purposes. Apart from this, however, we think that Treasury not only has authority to permit securities dealers to use their book values for tax purposes, but a Congressional directive and duty to do so.

We hope you find this letter helpful, and we would be happy to assist you in any way with regard to this matter.

Very truly yours,

Saul Rosen
Chairman, Committee on the
Federal Taxation of the
Securities Industry

^{6/} H. Rep. 103-11, at 223 (1993).