

August 4, 2004

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: REG-128572-03; Application of Sections 265(a)(2) and 246A
in Multi-Party Financing Arrangements

Dear Sir or Madam:

The above notice of proposed rulemaking ("Notice") requests comments regarding various matters relative to the application of section 7701(f)¹ to link borrowings and investments by related parties for the purpose of applying sections 265(a)(2) and 246A. This letter responds to the request for comments regarding a two-part rule that would (1) permit taxpayers to trace proceeds of borrowings to specific taxable investments, or other specific uses, and (2) apply a pro rata approach to determine the use of proceeds of borrowings that are not traceable to a specific use (the "tracing/allocation approach").

Without commenting on the merits of the tracing/allocation approach as it might apply in the section 265(a)(2) setting, the Securities Industry Association ("SIA")² believes the use of that approach in respect of section 246A would not be authorized under the current statute.

Section 246A(a) provides for reduction of a dividends received deduction otherwise permitted to be claimed in circumstances involving "debt financed portfolio stock." "Portfolio stock" is considered debt financed if "portfolio indebtedness" exists with respect to the stock.³ "[P]ortfolio indebtedness" is defined as "any indebtedness directly attributable to an investment in the portfolio stock."⁴

The legislative history of section 246A articulates a narrow and specific meaning of the "directly attributable" standard:

The bill contemplates that the directly attributable requirement will be satisfied if there is a direct relationship between the debt and an investment in

stock. The bill does not contemplate the use of any allocation or apportionment formula or fungibility concept. Thus, for example the bill does not apply merely as a result of (i) the existence of outstanding commercial paper that is issued by a corporation as part of an ongoing cash management program or (ii) deposits received by a depository institution as a part of the ordinary course of its business. However, if indebtedness is clearly incurred for the purpose of acquiring dividend-paying stock *** [or] otherwise is directly traceable to such an acquisition, the indebtedness would constitute portfolio indebtedness. Thus, if stock is held in a margin account with a securities broker, the margin borrowing constitutes portfolio indebtedness. The same result would follow with respect to any non-recourse loan secured, in whole or in part, by dividend-paying stock.⁵

The direct tracing standard of section 246A, and rejection of any allocation or apportionment formula or fungibility concept, stands in stark contrast to the approach taken under section 265(a)(2), which has long employed a fungibility approach in identifying circumstances in which indebtedness is linked to holdings of tax-exempt debt.⁶

Thus, the legislative history of section 246A is absolutely clear that the measure was intended to have a narrow and well-defined scope that — unlike the approach taken under section 265(a)(2) — would link borrowings with portfolio stock investments only in situations involving a direct tracing of loan proceeds to the investment, or a security interest in the portfolio stock to secure borrowings.⁷ During the 20 years since the enactment of section 246A, the measure has been administered by the Internal Revenue Service and interpreted by the courts to reflect the direct tracing approach.⁸ As the decision in H Enterprises, *supra*, demonstrates, the application of section 246A is not undermined in situations in which a borrowing that is directly attributable to portfolio stock is effected by an affiliate of the investing party. In all cases, however, the requirement of the statute will be satisfied only if the borrowing and portfolio stock investment meet the directly attributable standard of section 246A(c)(1).

The tracing/allocation approach, by contrast, would allocate proceeds of borrowings on a pro rata basis, aside from proceeds traceable to specific uses. While the manner in which the pro rata allocation might be implemented is unspecified, it would not seem to matter, since, as discussed, section 246A may

not be applied by reference to any allocation or apportionment formulae, or fungibility approach.

As demonstrated above, any regulation implementing section 246A must utilize the “directly attributable” standard to link borrowings with portfolio stock investments, and may not employ any allocation or apportionment formula or fungibility approach. For that reason, the tracing/allocation approach would not be authorized under section 246A and its application in that setting should be rejected.

Thank you for your consideration of our views. Please do not hesitate to call me (at 202-216-2031) or Rick Reinhold of Willkie Farr & Gallagher, LLP (at 212-728-8000) if you would find it useful to discuss this matter.

Sincerely,

Patti McClanahan
Vice President and Director, Tax Policy
Securities Industry Association

cc: Gregory Jenner
Helen Hubbard
Michael Novey
Lon Smith

¹ “Section” references herein are to the Internal Revenue Code of 1996, as amended.

² The Securities Industry Association, established in 1972 through the merger of the Association of Stock Exchange Firms and the Investment Banker’s Association, brings together the shared interests of nearly 600 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs 780,000 individuals. Industry personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2003, the industry generated an estimated \$209 billion in domestic revenue and \$278 billion in global revenues. (More information about SIA is available on its home page: .)

³ Section 246A(c)(1).

⁴ Section 246A(d)(3)(A) (emphasis added).

⁵ H.R. Rep. No. 432, 98th Cong., 2d. Sess., 1984-3 C.B. (Vol. 2) 118; H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess., 1984-3 C.B. (Vol. 2) ____.

⁶ See, e.g., Commissioner v. Leslie, 413 F.2d 636 (2d Cir. 1969), cert. denied, 396 U.S. 1007 (1970); Rev. Proc. 72-18, 1972-1 C.B. 740.

⁷ Section 246A(f) authorizes the issuance of regulations providing for a carve-back of interest deductions rather than the dividends received deduction, but does not contemplate any broader linkage of borrowing with a portfolio stock investment.

⁸ See Rev. Rul. 88-66, 1988-2 C.B. 34 (situation 3) (bank deposits not portfolio indebtedness where proceeds loaned to affiliate to fund investment in portfolio stocks); H Enterprises International v. Commissioner, 105 T.C. 71 (1995); H Enterprises International v. Commissioner, 75 T.C.M. 1948 (1998); aff’d per curiam, 183 F.3d 907 (8th Cir. 1999) (proceeds of subsidiary borrowing from an institutional lender distributed to parent and promptly invested in portfolio stock; held, borrowing represents portfolio indebtedness subject to section 246A).