



Securities Industry Association

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To everyone on the Tax Policy Dividends Exclusion Team:

Thank you for meeting with us yesterday to discuss the proper treatment of dividends received by securities firms with respect to securities that are inventory under the President's dividends exclusion proposal. We very much appreciate the efforts you are devoting to consideration of the unique issues that arise for securities firms under the President's proposal, and we look forward to continuing to work with you to devise workable approaches to these issues.

One of the primary objectives of yesterday's meeting was to explore the holding period requirements of Sections 246(c) and 1059 that are designed to prevent taxpayers from purchasing stock shortly before an excludable dividend date, receiving excludable dividend income, and later selling the stock at a loss. These rules would effectively disallow the loss by reducing the basis of the stock.

We discussed a limited exception from the application of these rules for otherwise excludable dividends (or increases in basis) received in respect of inventory (*i.e.*, stock that is purchased from, or sold to, customers in the ordinary course of business) to the extent not in excess of a cap. The purpose of this exception would be to give dealers credit for taxable gains arising from their ownership and disposition of such stock prior to the relevant excludable dividend payment dates (for purposes of determining how much their basis in such stock must be reduced, on the grounds that their receipt of excludable dividends, or increases in basis, would otherwise give rise to net losses).

For example, if a dealer owned stocks for 89 days of a 90-day dividend period, sold them on the 89th day at a gain, but also bought an equivalent amount of stocks on the 89th day and sold them on the 90th day at a loss, the dealer's basis should not be decreased by the amount of any excludable dividends, because the dealer would not have any net loss. The gain from the stocks sold on the 89th day would equal the loss from the stocks sold on the 90th day, and the amount of the excludable dividends received by the dealer would be in proportion to the dealer's stock holdings throughout the dividend period.

As we discussed, the amount of stock that a dealer holds as inventory generally does not spike around a dividend date, because the amount of such stock is driven by

market forces (e.g., a seller wants to sell), rather than by tax-related concerns. The cap approach would generally ensure, however, that dealers could not obtain losses by increasing their inventory of stocks shortly before dividend dates.

The cap would equal the aggregate amount of excludable dividends or increases in basis accrued, under an accrual method of accounting for such items, for the taxable year on stocks that are inventory. As a technical matter, the cap might be determined by treating all stocks that are inventory as debt instruments issued and purchased at par, and by treating all excludable dividends or increases in basis as payments of “qualified stated interest” within the meaning of the regulations under Section 1273 of the Code. The cap would then equal the amount of qualified stated interest deemed accrued by an accrual-basis taxpayer under these assumptions. For example, if a dealer held stock for 2 days out of 90 during a quarter and the stock paid an excludable dividend of \$90,000 at the end of the quarter, the taxpayer would treat the \$90,000 as “qualified stated interest” and therefore accrue \$2,000 of “interest income” ($2/90 \times \$90,000$) for purposes of the cap.

The cap would presumably be applied at the level of each securities dealer, but it could be applied in the aggregate, under consolidated return regulations, to all members of a group that held stock as inventory. As we discussed, the rules of Sections 246(c) and 1059 would apply to any excludable dividends (or increases in basis) in excess of the cap that are received on such inventory, regardless of whether the relevant holding period requirements would otherwise apply.

For example, suppose that a dealer holds 1,000 different stocks as inventory over the course of the year, and the average aggregate value of these stocks is \$1 billion. Suppose that the aggregate amount of “qualified stated interest” accrued on these stocks in respect of excludable dividends and increases in basis is \$30 million. The dealer would not be required to apply the rules of Sections 246(c) and 1059 to up to \$30 million of otherwise excludable dividends or increases in basis received in respect of these stocks. These rules would automatically apply, however, to any excludable dividends or increases in basis in excess of \$30 million that are received in respect of these stocks, regardless of whether they would otherwise apply.

As we discussed, until the precise details of this approach are worked out, it might be appropriate to provide in the statute that “the Secretary is authorized to provide appropriate exceptions from the application of Sections 246(c) and 1059 of the Code for dividends and increases in basis received in respect of stock held as inventory.”

We believe that yesterday’s meeting was very useful, and we look forward to discussing further the proper treatment of dividends (and basis increases) received with respect to securities that are inventory. Please do not hesitate to contact me (202-326-5324; pmcclanahan@sia.com) or David Hariton (212-558-4248;

haritond@sullcrom.com) at any time on this or any other aspect of the President's dividends exclusion proposal.

Sincerely,

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