



Securities Industry Association

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April 25, 2001

The Honorable Mark A. Weinberger
Assistant Secretary (Tax Policy)
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Mark:

On behalf of the Securities Industry Association (SIA)¹, I urge you to give priority to the issuance of guidance concerning the valuation of securities under the mark-to-market rules of Internal Revenue Code section 475. We strongly believe there is a need for guidance to implement Congressional intent regarding the elimination of unnecessary compliance burdens for securities dealers who are required to use mark-to-market accounting under section 475. In order to aid in the efficient development of the necessary rules, we respectfully submit a draft regulation reflecting proposed rules that our industry believes would accomplish the purposes of the statute while minimizing taxpayer and IRS administrative costs.

As you know, the section 475 mark-to-market accounting rules for securities dealers were enacted as part of the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act"). They generally require a securities dealer to include securities in inventory at fair market value. For other securities held at the close of the taxable year, section 475 generally requires securities dealers to recognize gain or loss as if each security were sold at year end for its fair market value.

The 1993 Act did not specify rules for valuing securities for purposes of the section 475 requirement. Instead, Congress directed the Treasury Department to

¹ The Securities Industry Association brings together the shared interests of more than 740 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. The U.S. securities industry manages the accounts of approximately 50-million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans. The industry generates in excess of \$300 billion of revenues yearly in the U.S. economy and employs approximately 700,000 individuals. (More information about the SIA is available on its home page: <http://www.sia.com>.)

authorize the use of valuation methods that would alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for federal income tax purposes.²

A number of interested parties have previously written to the Treasury Department urging that taxpayers be authorized to value their securities for purposes of section 475 by reference to their financial statements. The attached draft regulation provides a valuation safe harbor along those lines, but adds an additional requirement that the valuation must be of significant use in the management of the taxpayer's dealer business.

The draft regulation establishes a fixed priority rule for determining which financial statement, if there are multiple financial statements, is the financial statement to be used for section 475 purposes (the "applicable financial statement"). The priorities in the draft regulation are based on similar priorities assigned to applicable financial statements under Treas. Reg. Sec. 1.56-1(c) (relating to the prior-law book-tax adjustment under the alternative minimum tax). Because there can be only one applicable financial statement for a dealer, both the taxpayer and the IRS need look to only one statement, and there is no potential for selecting among financial statements to achieve a desired result. We believe the prioritization order that we have outlined would be most easily administrable. In virtually all cases, we believe the same valuations will be used for all financial statements.

The draft regulation gives the highest priority to a statement that must be filed by the dealer in securities with a government regulatory authority (e.g., the Securities and Exchange Commission or a State or foreign regulatory agency maintaining comparable standards) that has primary responsibility for supervision of the dealer business of the dealer, or with an examining authority designated by that government regulatory agency (e.g., the National Association of Securities Dealers). Because significant consequences would arise if an inaccurate filing were made with a securities regulatory agency, we believe that the Treasury Department should view such regulatory filings as the most reliable. Only if no such regulatory financial statement exists would it be necessary to consider another financial statement. In that case, priority is assigned, in descending order to certified audited financial statements that are used for credit purposes, for disclosure to shareholders, or for any substantial non-tax purpose.

The requirement that the dealer make significant use of the same values in the management of its dealer business establishes the commercial importance of the assigned valuations. To satisfy this requirement, the dealer must make significant use of those valuations in the financial or commercial oversight of its business. For example, if a dealer uses those same valuations as the basis of its hedging decisions, or alternatively as part of the process of determining the compensation for a group of its employees, it is clear that the valuations are directly employed in operating the dealer's business.

We believe there is a compelling case for guidance along the lines we propose. First, the legislative history of the 1993 Act specifically references use of financial

² H.R. Rep. No. 103-213 at 616 (1993).

accounting valuations in discussing the section 475 issue. The House Ways and Means Committee Report, in its description of “Reasons for Change” for the section 475 provision, states:

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 method for Federal income tax purposes.³

Second, valuation by reference to the financial statements of a securities dealer is the only method that would avoid the type of compliance burdens that Congress expressly wished to avoid. It is clear that Congress did not expect for securities dealers to have to value their securities twice, once for financial statement purposes, and once for section 475 purposes. Rather, as the legislative history cited above indicates, Congress envisioned that complying with the section 475 valuation requirements would not be burdensome precisely because these valuations are already in existence.

Third, and most important, the proposed regulation contemplates the use of valuations that are directly employed by dealers in making important commercial and financial decisions, such as the compensation of key employees, or as the basis of the dealer's hedging decisions. These valuations are also used in reports to regulators and investors. Securities dealers and their financial auditors focus significant time and attention to ensuring the accuracy of these valuations. Inaccurate valuations would invite penalties for regulatory noncompliance and investor backlash, and also could result in overpayment or underpayment of employees or inaccurate hedging of portfolios. Valuations that drive important commercial and financial decisions, and that satisfy expert regulators, surely must clearly reflect income.

We believe that the approach taken in the draft regulations we are submitting is the correct approach. There is no reason to believe that any alternative method of valuation would be more accurate, or that it would more clearly reflect income. Moreover, any alternative method could lead to needless and costly future disputes (involving hindsight valuations and the use of experts) between taxpayers and the IRS over these matters.

We appreciate your consideration of this issue and would be pleased to meet with you at your convenience to discuss it. If you have any questions, please do not hesitate to contact me or Patricia McClanahan, SIA's Vice President and Director of Tax Policy (202-326-5324). With best wishes, I am

Sincerely yours,

Marc E. Lackritz
President

³ H.R. Rep. No. 103-11 at 223 (1993).