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OFFICE OF THE CHIEF COUNSEL

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The Honorable Charles E. Schumer  
United States Senate  
Washington, DC 20510

Dear Senator Schumer:

I am responding to your inquiry dated March 28, 2012, requesting clarification on the proper federal income tax treatment of income and expenses from certain "soft dollar" commissions that broker-dealers receive under Section 28(e) of the Securities Exchange Act of 1934. Specifically, you asked whether it is Service position that a broker-dealer must report income from soft dollar commissions when received, but may deduct expenses only when payments are made to the soft dollar service providers. Your letter notes that such a position could result in a discrepancy between the manner in which such commissions are reported for book and for tax reporting purposes.

In general, under Section 28(e), money managers can use their clients' funds to pay a commission to broker-dealers for the basic execution of a trade and an additional commission for qualifying brokerage and research services. The additional commission is referred to as a "soft dollar" commission. To comply with Section 28(e), the broker-dealer must pay for brokerage and research services with the soft dollar commissions when the broker-dealer or a third party provides the services.

We have not issued any specific published guidance on the proper federal income tax treatment of income and expenses from soft dollar commissions. Thus, the general rules on the reporting of income and expenses in the Internal Revenue Code (the Code) and underlying regulations apply in determining how a broker-dealer must report income and expenses from soft dollar commissions.

Section 61 of the Code, which provides that gross income includes all income from whatever source derived, applies in determining whether a taxpayer has received gross income. Section 451 provides general rules that govern the taxable year of inclusion in gross income of an amount an accrual method taxpayer receives, and section 461 provides general rules that govern the taxable year of deductions. In addition to the specific requirements under sections 61, 451, and 461 of the Code and the underlying regulations, the taxpayer must consider all relevant facts and circumstances, including any underlying contracts between the parties, to determine the proper tax reporting of income and expenses from soft dollar commissions.

Thus, for example, if a broker-dealer receives income from a soft dollar commission in tax year 1, the broker-dealer may not be entitled to a deduction for the amount paid to the soft dollar service provider until tax year 2 when the services are provided. While this treatment could result in a difference between the amounts that the broker-dealer reports for book and tax purposes, the requirements for properly reporting income and expenses under the Code and the underlying regulations may diverge from the financial accounting standards for reporting these items. A taxpayer's treatment of income and expenses for financial or regulatory purposes is not controlling for tax accounting purposes. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 542-43 (1979).

I hope this information is helpful. If you have any questions, please contact me at \_\_\_\_\_ or \_\_\_\_\_ of my office at \_\_\_\_\_.

Sincerely,

Andrew J. Keyso  
Associate Chief Counsel  
(Income Tax & Accounting)