United States

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Evolution of Safe Harbour Rules under Section 475

On 12 June 2007, the IRS published long-anticipated final safe harbour rules for the valuation of securities and commodities for Sec. 475 mark-to-market accounting purposes. This article explores the rule-making process by examining the original stated objectives of the IRS and the Treasury Department, and considers industry input regarding the business and accounting practices of the taxpayers involved. The final regulations implementing the original objectives, as refined by public comments, are discussed as well.

1. Introduction

On 12 June 2007, the Internal Revenue Service (IRS) published long-anticipated final safe harbour rules for the valuation of securities and commodities for Sec. 475[1] mark-to-market accounting purposes. The final regulations are a culmination of a process that formally began in 2003 and involved significant industry participation.

This article explores the rule-making process by examining the original stated objectives of the IRS and the Treasury Department. This article will also examine industry input regarding the business and accounting practices of the taxpayers involved. The final regulations implementing the original objectives, as refined by public comments, are discussed as well.

Prior to the enactment of Sec. 475, a securities dealer was allowed to value its inventory of securities based on the cost of the securities, the lower of cost or market (LCM) value of the securities, or the market value of the securities.[2] According to the legislative history of Sec. 475, mark-to-market treatment was required for dealers in securities because "[t]he committee believes that the cost method and the LCM method generally understate the income of securities dealers and that the mark-to-market method most clearly reflects their income".[3] Additionally, the House Report states that inventories of securities are easily valued at year-end and are currently valued at market by securities dealers in determining their income for financial statement purposes.[4]

Sec. 475(a) requires dealers in securities to mark their securities to market. Sec. 475(e) and (f) allow dealers in commodities and traders in securities or commodities to elect similar treatment for their securities or commodities. If the security or commodity is held as inventory, it must be included in inventory at its fair market value. If it is not inventory and is held at the end of the taxable year, gain or loss is recognized as if the security or commodity had been sold at its fair market value on the last business day of the taxable year.

When Code Sec. 475 was enacted in 1993, the House-Senate Conference Report stated that:

> The conference agreement does not provide any explicit rules mandating valuation methods that are required to be used for purposes of applying the mark-to-market rules. However, 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 tax purposes.[5]

As many in the securities industry have argued, a simplified method of valuation was anticipated that would serve as guidance for valuation of securities and commodities that would reduce the administrative burdens on those marking to market.

While such guidance may have been anticipated, it was not immediately forthcoming. In 1995 the IRS announced that it had undertaken a project in conjunction with the Los Alamos National Laboratory to create software models capable of calculating values for over-the-counter derivatives positions. In 1997 the IRS indicated that its project was put on hold, and the valuation model was never completed. Concerned by the continuing lack of valuation guidance, major players in the securities industry urged the IRS and Treasury to issue guidance under Sec. 475 to permit securities dealers to value derivatives the same way for both accounting and tax purposes. For example a 1999 ISDA submission stated:

> ISDA believes that rules permitting reasonable methods of valuing derivatives are necessary to effect Congressional intent, as expressed in the legislative history of Sec. 475. As Congress recognized, the absence of guidance will result (and already has resulted) in unnecessary compliance burdens for taxpayers and the IRS; these burdens include disputes on audit about the values of particular positions or the propriety of particular approaches to valuation.[6]

Similar sentiments were expressed by the Securities Industry Association (SIA), urging the Treasury to give priority to the issuance of guidance concerning the valu-

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1. All references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended, and all Reg. references are to the Treasury Regulations promulgated thereunder.
2. H.R. Rep. 103-213, 103rd Cong., 1st Sess. 611 (4 August 1993).
3. H.R. Rep. 103-111, 103rd Cong., 1st Sess. 661 (25 May 1993).
4. Id.
5. H.R. Rep. 103-213, 103rd Cong., 1st Sess., 616 (4 August 1993).
6. Id. at 15.

ation of securities under the mark-to-market rules of Sec. 475.[7] Organizations like the American Bar Association (ABA), as well as individuals from major accounting firms and academia, also submitted letters to the IRS urging regulations allowing for book-tax conformity under Sec. 475.[8]

On the judicial front, the first major case to focus on the proper valuation of a derivative dealer's portfolio was *Bank One Corp. v. Commissioner*.[9] At issue in *Bank One* was whether the bank properly valued its derivatives portfolio for purposes of mark-to-market accounting. The developments in *Bank One* were closely watched by members of the securities industry, and most major players were involved in the submission of an amicus curiae brief to the court hearing the *Bank One* case.[10] While the outcome of the case is still being parsed by commentators, it appears that the Tax Court relied heavily on its own witnesses and prescribed its own method of accounting that does not comport with that of the IRS or of the defendant.[11]

In light of the increasing uncertainty regarding the definition of fair value, exacerbated by judicial involvement, the IRS indicated its intent to address the issue directly. On 5 May 2003, the same day the Tax Court issued its opinion in *Bank One*, the IRS issued an Advance Notice of Proposed Rulemaking (ANPRM). The IRS provided the Tax Court with advance knowledge of the planned notice.[12] In this Notice, the IRS and the Treasury Department expressed their intent to publish a Notice of Proposed Rulemaking (NPRM) for valuing securities and commodities. The stated intent of the NPRM was to reduce the administrative burdens on both taxpayers and the IRS of determining fair market value under Sec. 475. To that end, the IRS and the Treasury Department were considering proposed rules that would permit values used in financial statements to be used on a tax return, and would provide an elective safe harbour for valuing securities and commodities.[13]

2. Advance Notice of Proposed Rulemaking

According to the ANPRM, three broad principles guide eligibility for the safe harbour. The mark-to-market methodology used must be sufficiently consistent with the mark-to-market methodology used under Sec. 475. The financial statement must be one that gives the taxpayer a strong incentive to report values fairly. Finally, the taxpayer, if requested, must provide information necessary to verify the relationship between the values reported on the financial statement and the values used for purposes of Sec. 475.[14] Each of these requirements is discussed in more detail below.

2.1. Consistency requirements

As a general matter, any mark-to-market methodology used on a financial statement submitted for financial purposes would have to be sufficiently consistent with the requirements of the mark-to-market methodology used for Sec. 475. This consistency requirement was defined to mean that securities and commodities must be valued as of the last day of the taxable year, gains and losses arising from changes in value must be recognized into income each year, and gain or loss on disposition must be computed by reference to the value at the end of the prior year.[15]

The IRS solicited comments regarding differences between mark-to-market for financial reporting and Sec. 475 and how those differences should affect the safe harbour. The IRS was also interested in whether generally accepted accounting principles (GAAP) should be used as a proxy for fair market value for tax purposes. Other areas that the Notice was specifically concerned with were the valuation of securities at the bid price and downward adjustments from mid-market values for future expenses, as well as redundant downward adjustments for credit risk. The IRS sought information on the types of adjustments currently used for financial statement purposes, and explanations of these adjustments. The authors of the Notice were also concerned with the consideration by the Financial Accounting Standard Board (FASB) of fair value reporting of derivatives, the valuation of the projected cash flows and any impact that this has on how taxpayers are reporting valuation adjustments for fair value purposes.[16]

2.2. Financial statements and business use

The ANPRM states that a taxpayer has strong incentive to report the values of securities and commodities if such values are reported on a financial statement and there is significant use of those reported values in the taxpayer's business.[17] According to the ANPRM, there are three classes of financial statements under consideration for the safe harbour, namely:[18]

- a financial statement required to be filed with the SEC (10K or annual statement to shareholders);

7. SIA letter, submitted by Marc Lackritz (25 April 2001), reprinted in 2001 TNT 96-27. This submission was accompanied by draft regulations for consideration by the Treasury.
8. ABA Recommendations for Treasury – IRS Guidance Priority List 2002-2003 (30 April 2002); letter submitted by Kenneth Kies of PricewaterhouseCoopers, LLP (11 September 2000), reprinted in 2000 TNT 184-23; letter submitted by Cornelius C Shields (24 October 2002), reprinted in 2002 TNT 220-27.
9. 120 T.C. 11 (2003), aff'd in part, vacated in part, and remanded; *JP Morgan Chase & Co. v. Commissioner*, 458 F.3d 564 (7th Cir. 2006).
10. Amici Curiae briefs by American Bankers Association, Institute of International Bankers, International Swaps and Derivatives Association, Inc, The New York Clearing House Association, LLC, Security Industry Association, Wall Street Tax Association (12 October 2000).
11. Paul Carman and Melanie Gnazzo, "FMV, Mark-to-Market, and Clear Reflection of Income: The Tax Court Takes a Middle Road in *Bank One*", 99 *Journal of Taxation* (August 2003); Lee Sheppard, "*Bank One*: Judge Laro's Third Way Accounting Method", 2003 TNT 92-11 (13 May 2003).
12. Bob Williams, Special Counsel to the Associate Chief Counsel (financial institutions and products), speaking to the DC Bar Tax Section's Financial Instruments and Products Committee (28 May 2003), as quoted by 2003 TNT 102-2.
13. Ann. 2003-35, 2003-1 C.B. 956 (5 May 2003).
14. Id. at 9.
15. Id. at 10.
16. Id. at 11 and 12.
17. Id. at 13.
18. Id. at 14.

- a financial statement required to be provided to the federal government or any of its agencies (other than the SEC or IRS); and
- a certified audited financial statement not required to be filed with the SEC or another federal agency.

With regard to financial statements, issues that the IRS was looking into were whether financial statements required to be filed with a state government or any of its agencies, a political subdivision of a state, or possibly a foreign regulatory authority should be considered. Comments were requested regarding the extent to which any of these categories of financial statements are appropriate for a safe harbour, and if any other classes of financial instruments may be appropriate, as well. The issue of related-party transactions is also raised, indicating a concern that financial consolidation between related parties may cause certain transactions to be eliminated or incompletely reported on financial statements.[19]

2.3. Recordkeeping and record production

Under the safe harbour, dealers would have to show that:
- the same value used on the financial statement was used on the tax return;
- no security subject to Sec. 475 and reported under the required methodology on the financial statement was excluded in the application of the safe harbour; and
- only securities or commodities subject to Sec. 475 had been carried out on the tax return under the safe harbour.[20]

The Notice states that:

> given the complexity of the business operations of many taxpayers, comparing a single line on the financial statement to a single line on the tax return will not suffice to verify that the same line used on the financial statement was used on the tax return. Therefore, a safe harbour will impose specific verification and reconciliation requirements.[21]

Area of expressed concern included the following.

Valuation issues arising from the pooling of securities and commodities. This would include how such items are pooled for financial reporting, how they are pooled for tax and how the basis of a single position contained in the pool can be determined if that position is sold in the year following the mark and the other positions are not sold. The IRS was also concerned about the impact of consolidation and de-consolidation, and the determination of whether the same securities and commodities will be reflected on both the financial statement and the tax return.[22]

Taxpayers making a safe harbour election would be required to maintain the following records, which would have to be provided at the Commissioner's request:
- books and records clearly establishing that the same values were used for Sec. 475(a) and the financial statement;
- for taxpayers filing a Form 1120, a reconciliation of the amount of net income on the financial statement to the amount reported on line 1 of the M-1 on the Form 1120; and
- for other taxpayers, a similar reconciliation schedule.[23]

The documents to be provided for reconciliation purposes include supporting schedules, exhibits, computer programs used in producing the values and schedules and documentation of the rules and procedures governing determination of the values.[24] The IRS requested comments on whether less burdensome recordkeeping requirements could be developed, and indicated that the IRS was considering entering into agreements with specific taxpayers establishing which particular records would have to be maintained and for how long they would need to be retained.[25]

Eligible taxpayers. The safe harbour was under consideration for dealers in securities under Sec. 475(c)(1). Extension to securities traders, dealers in commodities and commodities traders would depend on whether the extension would comport with the general principles described.[26]

Eligible securities and commodities. The need for a safe harbour was deemed most pressing with regard to positions for which pricing information is not readily available, including more complex notional principle contracts and derivative instruments and hedges described in Sec. 475(c)(2)(D)-(F).[27] Similar problems were raised with regard to commodities for which pricing information is not readily available. Therefore, comments regarding application of a safe harbour for commodities were requested as well.[28]

3. Response to ANPRM

As a general matter, the ANPRM was universally welcomed. Specific comments regarding the following issues were addressed by various organizations, including the New York state Bar Association (NYSBA), the SIA[29] and the International Securities Dealers Association[30] (ISDA). These are discussed below.[31]

19. Id. at 15-19.
20. Id. at 20.
21. Id. at 21.
22. Id. at 22, 23.
23. Id. at 24.
24. Id.
25. Id. at 25.
26. Id. at 26.
27. Id. at 27.
28. Id. at 28.
29. According to its submission, the SIA represents the interests of more than 600 securities firms. SIA member firms include investment banks, broker-dealers and mutual fund companies, and are active in all US and foreign markets and in all phases of corporate and public finance. In 2006, the SIA and the Bond Market Association merged to create the Securities Industry and Financial Markets Association (SIMFA).
30. According to its submission, the ISDA is an international organization with over 600 members in 46 countries. Members include the world's leading dealers in over-the-counter swaps and other private bilateral derivatives contracts.
31. Additional comments, including those by Leon Metzger, a hedge fund executive and academic, were also submitted. A discussion of his submissions (which pose an alternate approach to the safe harbour) is beyond the scope of this article.

3.1. Use of GAAP as a valuation safe harbour

There was general consensus among commentators favouring the use of GAAP to establish fair market value. According to the NYSBA, GAAP fair value may be used as a proxy for fair market value. The NYSBA suggested that the IRS evaluate the US GAAP methodology for valuing derivatives and other securities, and determine which are materially consistent with Sec. 475 principles and which are not. If any aspect of GAAP used by a taxpayer were materially inconsistent, a taxpayer would have to make a valuation adjustment in order to satisfy the consistency principle of the safe harbour.[32]

According to the SIA, the use of GAAP valuations provides a reliable measure of value because securities dealers use the values on their financial statements for other significant business purposes. In its support of GAAP, the SIA states:

> We believe that the book-tax conformity principle set forth in the notice will lead to reliable valuations, because those valuations are used for a wide variety of day-to-day core business functions, and thus are subject to rigorous checks and balances by different influential stakeholders. Those functions include internal business management, compensation, risk measurement and regulatory supervision.[33]

Therefore, because of the inherent checks and balances in business functions, there would be no danger of undervaluing positions.

The ISDA goes a step further in its support of GAAP valuation, and asserts that there is no practical alternative to the use of GAAP financial reporting values for over the counter (OTC) derivatives contracts to comply with Sec. 475.[34] The comments go on to say that:

> To ISDA's knowledge, all dealers now use the adjusted mid-market method for both financial reporting under GAAP and complying with Sec. 475. There is thus no difference between the mark-to-market methodologies used by dealers for these two purposes. The same method, the adjusted middle market method is used for both.[35]

According to the ISDA, no difference exists between marking to market (to mid-market) for both financial reporting under GAAP and complying with Sec. 475.

3.2. Description of GAAP mark-to-market in practice

Industry members attempted to clarify and illustrate actual accounting practices to support the appropriateness of the use of GAAP for mark-to-market valuation.

The ISDA asserted that all dealers use the adjusted mid-market method to value their OTC derivatives contracts under GAAP, and goes on to explain the basic theory and approach of the adjusted middle market method.[36] Mid-market valuation values a derivatives portfolio at the middle of the current market (the average of bid and offer prices), less specific adjustments. Once mid-market values have been determined, future cash flows are generated based on implied forward curves and prices. These cash flows are then discounted back using a zero coupon curve, which is generated from the mid-market value of the portfolio. The net present value of the cash flow represents the mid-market value of the portfolio. Once the mid-market value of the portfolio is determined, dealers make adjustments to these mid-market values in order to determine the actual value of their OTC derivatives under GAAP. Possible adjustments to these values include mid-market and model adjustments, as well as portfolio adjustments. Portfolio adjustments include adjustments for market risk and credit adjustments, as well as administrative and other portfolio adjustments.[37]

The ISDA points out that dealers use different names and categories when making these adjustments, but they are all intended to determine fair market value accurately. All adjustments reflect factors that participants in derivatives markets must take into account in determining fair market value.

> These differences in nomenclature and technique are all compatible with GAAP and should be irrelevant under a safe harbour based on book-tax conformity, particularly where, as is proposed here, the safe harbour will require non-tax business uses. [...], that requirement, together with competitive pressures, will ensure dealers have incentives to determine and report values accurately.[38]

The SIA also discusses the adjusted mid-market method for valuing derivatives, "as it is currently employed by all derivatives dealers of which we are aware".[39] OTC derivatives are valued using pricing models that determine the present value of estimated future gross cash flows. The values produced by these pricing models are intended to reflect the price for a derivative that is at the mid-point between the prevailing bid and ask prices. These mid-market valuations effectively value the anticipated future gross from a position. It is then necessary to make additional adjustments to the mid-market values in order to arrive at the adjusted mid-market value of a dealer's portfolio of OTC derivatives.[40]

As described, a derivatives dealer creates a synthetic annuity, and the mark-to-market value is the net present value of the of the annuity that dealer created. Projected gross income is calculated, and then discounted at the mid-market rate. Then the revenue stream is adjusted to reflect future expenses. As a result, the mark-to-market valuation of an OTC derivatives dealer's books of derivatives positions is universally calculated for all purposes (including tax) on a portfolio-wide basis.[41] The SIA

32. New York State Bar Association, Tax Section, "Report on Announcement 2003-35, Safe Harbor for Valuation under Sec. 475" (9 October 2003), at 11 (NYSBA October 2003).
33. Securities Industry Association, Submission in Response to Advance Notice Regarding Proposed Safe Harbor Under Sec. 475 (30 July 2003) (SIA July, 2003).
34. ISDA Comment Letter to the Internal Revenue Service, Re: Proposed Sec. 475 Book Tax Conformity Safe Harbor (4 August 2003), at 8 (ISDA August, 2003).
35. Id. at 21.
36. Id. at 10-20.
37. Id. at 12-13.
38. Id. at 18.
39. SIA July 2003, at 37.
40. Id. at 37-38.
41. Id. at 27.

makes it clear that derivatives held by a dealer are unlike physical securities held by a dealer.

> In valuing a dealer's portfolio of OTC derivatives, the dealer thus focuses not on the derivatives themselves, as if they were inventory from which the dealer will profit through their prompt resale, but rather on the future net income streams expected to be generated through retaining and tending to those derivatives.[42]

Therefore, the SIA contends that a derivative-by-derivative approach to calculating adjusted mid-market value is inappropriate. The SIA submission also includes an Appendix that provides an overview of commonly accepted adjustments to mid-market values. Categories included are model adjustments, portfolio adjustments, market risk adjustments, credit adjustments and administrative and other portfolio adjustments.[43]

3.3. Financial statements and business use

As a general matter, the NYSBA agrees with the categories of financial statements listed by the IRS, but would expand the listed categories to include financials filed with regulatory agencies of foreign and state governments. The report therefore recommends that the regulations include a list of such approved regulatory authorities. Further, as valuations not submitted to approved regulatory authorities are less reliable than those submitted to approved regulatory authorities, taxpayers should be granted a rebuttable (but not a conclusive) presumption that the values reported on other certified financials represent the fair market value for purposes of Sec. 475 if the taxpayer can demonstrate a significant non-tax business purpose that helps to ensure the accuracy of the valuations.[44]

Similarly, the ISDA's comments seek a broadening of acceptable financial statements, and contend that an audited financial statement that is provided to the SEC, to any regulatory body or to shareholders or creditors should qualify for the safe harbour. According to the ISDA submission, the IRS requirement of significant non-tax business use should be deemed to be fulfilled if the dealer takes the profit and loss effects of the mid-market accounts into consideration when making a determination regarding one of the following:

- managing market and credit risk;
- compensating key personnel; evaluating lines of business; or
- determining which transactions to enter into (hold) and which transactions to avoid (or terminate), and the prices at which transactions are to be entered into or terminated.[45]

The ISDA also argues that when mid-market valuations of non-US entities are incorporated into the financials of a non-US parent which are not prepared according to GAAP, such valuations should be respected, as well.

The SIA indicates that all reports supplied by its members to federal agencies, as well as to public investors, are prepared in accordance with GAAP, and therefore all employ the same mark-to-market valuation process. The SIA also suggest that in the interest of administrability, the IRS should provide a hierarchy of different types of reports that are considered acceptable for purposes of the safe harbour so that dealers will have a clear understanding of what documentation will be required of them in an audit process.[46]

3.4. Related-party transactions

The ISDA asserts that the safe harbour can and should apply to related-party transactions. According to the ISDA, with regard to OTC derivatives contracts between related parties, dealers generally value such contracts in the same way they value third-party contracts under the adjusted mid-market method, absent credit adjustments. According to the submission, there is no evidence that related-party transactions receive less regulatory scrutiny than third-party transactions. The ISDA suggests that if the IRS concludes that Sec. 482 is not adequate to prevent potential abuse in related-party transactions, it could require that that related-party contracts generally be valued under the same methodology as third-party contracts, but disregarding certain adjustments such as credit adjustments, which will generally have the effect of increasing values.[47]

As an initial matter, the SIA recommends that Sec. 482 be used when a taxpayer's methodology for valuing transactions with related parties is different to that used for transactions with unrelated parties. The submission indicates that valuation methods will not change merely because the transaction valued is eliminated under GAAP consolidation rules. Requiring consistent valuation methodologies for eliminated and non-eliminated positions would be appropriate and completely consistent with current practice.[48]

3.5. Record keeping

The ISDA is concerned that the scope of records to be retained under the safe harbour is overly broad. According to the ISDA, the IRS' "verification should be limited to confirming book tax conformity and the presence of the required non-tax business use".[49] The IRS would be able to accomplish this by tracing to the ledger entries and making sure that values are properly reflected in financial statements. Verification should not require an examination of the specific techniques by which the financial statement values were determined in accordance with GAAP.

The SIA supports the three requirements for verification enumerated by the ANPRM. They strongly recommend that the IRS enter into specific information agreements with individual dealers to account for differences in

42. Id. at 28.
43. Id. Appendix A at 60-65.
44. NYSBA October 2003, at 12.
45. ISDA August 2003, at 30-31.
46. SIA July 2003, at 52-53.
47. ISDA August 2003, at 32.
48. SIA July 2003, at 53-54.
49. ISDA August 2003, at 32.

operational and accounting systems of different dealers. The SIA further suggests that the Accelerated Issue Resolution (AIR) programme will be helpful in identifying appropriate procedures and identifying areas of difficulty.[50]

The submissions also addressed concerns raised by the IRS and the Treasury Department regarding pooling and deconsolidation.

3.6. Pooling

According to the SIA's submission, the unadjusted mid-market value is calculated for each individual security and derivatives position, and is posted to a security sub-ledger. If a security is disposed of in the following year, it would not appear in the sub-ledger and would be verifiable. Adjustments to the initial values would be made on a portfolio basis in the securities sub-ledger. The securities sub-ledger then calculates the adjusted profit and loss and trial balances for all derivative positions, which are posted to the firm's general ledger. The numbers are then used for all purposes, including financial reporting, risk management and compensation, as well as tax reporting. The IRS should be able to verify that the procedures used take into account positions that are disposed of during the year. The IRS can also verify that the adjustments are posted to the general ledger and that no M-1 adjustments are made to these values in calculating taxable income. As each taxpayer's operations and accounting systems are unique, the SIA suggests agreements with dealers regarding the relevant records that need to be maintained and the scope of the verification process.[51]

The ISDA makes parallel arguments, and takes the position that each element of adjusted mid-market value can be verified. The IRS need not verify the computation of gain or loss on a position-by-position basis in order to administer the safe harbour. If conformity is absent, it will be reflected in a Schedule M adjustment.[52]

3.7. Deconsolidation

Similarly, with regard to deconsolidation, the ISDA does not believe that the IRS will encounter verification difficulties. Under GAAP, fair value is still determined for transactions between entities that are consolidated for financial reporting purposes, and those values are reflected in the appropriate sub-ledgers and other supporting documentation. Using the appropriate sub-ledgers and the supporting documentation, the IRS can identify the fair market value that should be used in order to comply with Sec. 475.[53]

The SIA submission makes the same argument, and provides additional technical detail. It explains that under FAS 133, fair value is determined for each mark-to-market position held by a dealer and is entered into a sub-ledger regardless of whether one or more of those positions will later be eliminated under the consolidation rules. The fair values of eliminated transactions are subsequently entered into a special elimination account. Therefore, the SIA asserts, it will be possible through inspection of the relevant sub-ledgers to determine a GAAP fair value that may then serve as "fair market value" for tax purposes.[54] Further, the SIA does not object to specific agreements between individual dealers and the IRS, but anticipates that they be used in special cases, and the IRS should provide a set of reasonable record retention requirements.

3.8. Eligible taxpayers

The NYSBA recommends that all taxpayers (including securities traders, commodities dealers and traders), including taxpayers required to mark-to-market under Secs. 1256, 1259, 1260 and 1296, qualify for the safe harbour.[55] The submissions of both the ISDA and the SIA refer to dealers only, and do not appear to attempt to extend the application of the safe harbour to anyone other than themselves.

3.9. Eligible positions

According to the SIA, the safe harbour should apply to all securities that are subject to the mark-to-market regime under Sec. 475. Further, because commodities are similarly valued in accordance with GAAP for financial accounting purposes, and those values are used for significant, non-tax business purposes, the principles applicable to the valuation of securities are applicable to commodities, as well.[56]

4. Proposed Regulations

On 24 May 2005, the IRS published Proposed Regulations on the safe harbour for valuation under Sec. 475.[57] According to the overview of these regulations, the safe harbour is based on the principle that if the mark-to-market method used for financial reporting is sufficiently consistent with the mark-to-market method required by Sec. 475, the values used for financial reporting should be acceptable values for purposes of Sec. 475.

4.1. Scope of the safe harbour

The proposed safe harbour is available to any taxpayer subject to the mark-to-market regime under Sec. 475, including securities and commodities dealers and traders.[58] Eligible securities and commodities positions will be listed in a Revenue Procedure which is expected to apply to every security position and every commodity position subject to mark-to-market under Sec. 475.[59]

50. SIA July 2003, at 56.
51. SIA July 2003, at 55.
52. ISDA August 2003, at 33-34.
53. Id.
54. SIA July 2003, at 56.
55. NYSBA October 2003, at 13.
56. SIA July 2003, at 57-58.
57. Prop. Treas. Reg. Sec. 1.475-4; Notice of Proposed Rulemaking, REG-100420-03 (24 May 2005).
58. Prop. Treas. Reg. Sec. 1.475(a)-4(c).
59. REG-100420-03 (25 May 2005), Explanation of Provisions (70 Fed. Reg. 99, at 29664).

A taxpayer election would be required and would continue indefinitely, unless revoked by the Commissioner.[60]

4.2. Valuation requirements

The three general requirements for valuation are reiterated, and a new one is introduced requiring that fair value be determined using GAAP:

- *frequency*. Taxpayers must mark eligible positions to market through valuation on the last business day of the taxable year;[61]
- *recognition at the mark*. Taxpayers must recognize any gain or loss from mark on income statement;[62]
- *recognition on disposition*. Taxpayer must recognize into income on the income statement any gain or loss on disposition of an eligible position as if year end mark occurred immediately before disposition;[63] and
- *fair value standard*. Fair value must be determined in accordance with US GAAP.[64]

4.3. Additional valuation limitations

The Proposed Regulations impose the following additional limitations to ensure minimal divergence from fair market value:

- except for eligible positions that are traded on a qualified board or exchange as defined in Sec. 1256(g)(7), a taxpayer may not use valuation standards that result in values at or near the bid/ask value;[65]
- the valuation method used may not take into account any cash flows (income or expense) attributable to a period of time prior to the valuation date;[66] and
- in a determination of fair value, appropriate costs and risks may be taken into account, but no cost or risk may be accounted for more than once, either directly or indirectly.[67]

Taking into consideration submissions regarding how dealers profit from bid/ask spreads, the IRS recognizes that as a general matter, dealers attempt to enter into positions that, in the aggregate, offset each other. The Proposed Regulations incorporate the description used by commentators characterizing the typical dealer's balanced portfolio as "creating a synthetic annuity". As a result, use of the bid/ask value does not cause recognition of the present value of the synthetic annuity in the taxable year the annuity is created. Thus, the regulations require that values used must be closer to mid-market to be respected and may not be at or near bid/ask values.

The Proposed Regulations provide an exception for eligible positions that are traded on a qualified board or exchange as defined in Sec. 1256(g)(7), which may be valued at bid/ask. Recognizing the business model supplied by the industry comments, an exception is made for dealers in "physicals", as distinct from dealers in derivatives. As explained in the submissions, a dealer in physicals does not create a synthetic annuity, resulting in deferral of income. Rather, a dealer in physicals turns over its securities inventory rapidly which precludes significant deferral of income.

If the valuation method is based on the present value of projected cash flows from an eligible position or positions, the method must not take into account any cash flows of income or expense that are attributable to a period or time before the valuation date. This provision is intended to prevent items of income or expense from being double counted, i.e. through current realization and then at the mark.

No cost or risk may be accounted for more than once, either directly or indirectly. For example, if computation of the present value of cash flows uses a discount rate that already takes into account credit risk, a special adjustment which accounts for credit risk may not then be applied. The IRS appears to be particularly concerned with redundant credit adjustments.

4.4. Financial statements and business use

An eligible taxpayer's applicable financial statement for a taxable year is the taxpayer's primary financial statement.[68] In order to assist taxpayers in determining which financial statements qualify for the safe harbour, three categories of acceptable financial statements are listed, in order of priority:[69]

(1) financial statements that must be filed with the SEC;[70]
(2) financial statements that must be filed with the US government or any of its agencies other than the IRS. This includes statements filed by foreign-controlled financial institutions engaged in a US trade or business, which report their mark-to-market results to the Federal Reserve or the Office of the Comptroller of the Currency;[71] and
(3) certified audited financial statements provided for substantial non-tax purposes.[72]

For a financial statement in any of the above categories to qualify as an applicable financial statement, it must be prepared in accordance with US GAAP.

The preamble indicates that statements filed with the SEC provide a high degree of confidence that the values used in those statements reflect reasonable approximations of fair value. Therefore, there are no additional business use requirements for such financials. However, for categories (2) and (3), the additional requirement of significant non-tax use in the taxpayer's business is

60. Prop. Treas. Reg. Secs. 1.475(f)(1)-(2).
61. Prop. Treas. Reg. Sec. 1.475(a)-4(d)(i).
62. Prop. Treas. Reg. Sec. 1.475(a)-4(d)(ii).
63. Prop. Treas. Reg. Sec. 1.475(a)-4(d)(iii).
64. Prop. Treas. Reg. Sec. 1.475(a)-4(d)(iv).
65. Prop. Treas. Reg. Sec. 1.475(a)-4(d)(3)(i).
66. Prop. Treas. Reg. Sec. 1.475(a)-4(d)(3)(ii).
67. Prop. Treas. Reg. Sec. 1.475(a)-4(d)(3)(iii).
68. Prop. Treas. Reg. Sec. 1.475(a)-4(h)(1).
69. Prop. Treas. Reg. Sec. 1.475(a)-4(h)(2).
70. Prop. Treas. Reg. Sec. 1.475(a)-4(h)(2)(i).
71. Prop. Treas. Reg. Sec. 1.475(a)-4(h)(2)(ii).
72. Prop. Treas. Reg. Sec. 1.475(a)-4(h)(2)(iii).

imposed.[73] The requirement of significant business use is fulfilled if:

- the financial statement contains values for eligible positions;
- the eligible taxpayer makes significant use of financial statement values in most of the significant management functions of the business; and
- such use is related to the management of all or substantially all of the eligible taxpayer's business.[74]

4.5. Record keeping and retention

With regard to records, the Explanation of Provisions provides that a taxpayer must clearly show that:

- the same value used for financial reporting was used on the return;
- no eligible position subject to Sec. 475 is excluded from the application of the safe harbour; and
- only eligible positions are carried over to the Federal return under the safe harbour.[75]

All necessary records must be retained as long as their contents may become material in the administration of any internal revenue law. Taxpayers must provide reconciliation schedules between the financial statement for a particular year and the Federal income tax return for that year. This includes all computer programs, schedules, exhibits and detailed explanation of any adjustments.[76]

With regard to pooling, books and records must state the value used for each eligible position separately from the value used for any other eligible position. However, an eligible taxpayer may make adjustments to values on a pooled basis, if the taxpayer demonstrates that it can compute gain or loss attributable to the sale or other disposition of an individual eligible position.[77]

4.6. Consolidation

The taxpayer must provide records showing consolidation and deconsolidation used to prepare the financial statements and any subordinate schedules. The schedule must provide information that addresses the differences for consolidation between the applicable financial statement and the federal income tax return.[78]

There is a 30-day timeframe within which taxpayers must produce records after a request is made by the Commissioner.[79] The Proposed Regulations provide that the Commissioner may enter into advance agreements with individual taxpayers to determine what records must be maintained and for how long.[80]

5. Comments on Proposed Regulations

The SIA prepared the most extensive industry submissions, providing detailed comments and recommended changes to the Proposed Regulations. In all major areas, the ISDA concurred with the recommendations of the SIA, and added some independent comments for consideration by the IRS and the Treasury Department. Comments submitted by the Institute of International Bankers (IIB) and the ABA are discussed, as well. The positions presented are primarily those of SIA, supported by the ISDA, unless otherwise noted.

5.1. Income statement requirement

Many commentators objected to the requirement that a taxpayer recognize into income on the income statement the mark-to-market gain or loss for each taxable year.[81] The SIA submission[82] emphasizes that there are other places where reliable, audited valuations, prepared in accordance with US GAAP, appear other than the income statement. For example banks record certain changes in mark-to-market valuations as "other comprehensive income" (OCI) on the balance sheet which do not appear on the income statement. Items included in this category are "available for sale" securities (which are marketable equity securities that a bank may sell prior to maturity), as well as certain hedges of such securities (e.g. cash flow hedges and certain currency hedges). Procedures at banks are no less rigorous for calculating OCI, even though amounts do not appear on the income statement. Positions contained within OCI and available for sale are usually straightforward instruments that are readily valued. As valuations in these areas are among a taxpayer's least complicated and least controversial, there is no reason they should be excluded from the safe harbour merely because they are not reflected on the income statement.[83]

Call reports filed by US branches of foreign banks with the Federal Reserve or Office of the Comptroller of the Currency should also be accepted, as they are filed in accordance with GAAP and audited by outside accountants. According to the SIA, a US branch of a foreign bank will produce a US GAAP income statement for purposes of preparing its stand-alone balance sheet presented in the call report; the call reports themselves do not contain any income statement. The SIA would like IRS to amend the Proposed Regulations to clarify that call reports filed with the Federal Reserve or the Office of the Comptroller of the Currency should qualify as "applicable financial statements" under the safe harbour.[84] The ISDA agrees with the position taken by the SIA with regard to OCI and call reports.[85]

The IIB was also extremely concerned about the income statement limitation, specifically with regard to the call

73. Prop. Treas. Reg. Sec. 1.475(a)-4(h)(1).
74. Prop. Treas. Reg. Sec. 1.475(a)-4(j)(i)-(iii).
75. 70 Fed. Reg. 00 (24 May 2005), at 29666.
76. Prop. Treas. Reg. Sec. 1.475(a)-4(k)(2)(A).
77. Prop. Treas. Reg. Sec. 1.475(a)-4(k)(2)(B).
78. Prop. Treas. Reg. Sec. 1.475(a)-4(k)(2)(C).
79. Prop. Treas. Reg. Sec. 1.475(a)-4(k)(3).
80. Prop. Treas. Reg. Sec. 1.475(a)-4(k)(5).
81. Prop. Treas. Reg. Sec. 1.475(a)-4(d)(2)(ii).
82. SIA Submission regarding Proposed Regulations Establishing Book/Tax Conformity Safe Harbour Under Sec. 475 (SIA August 2005).
83. SIA August 2005, at 12-14.
84. Id. at 15.
85. ISDA Comments regarding Proposed Book-Tax Conformity Safe Harbour (7 March 2006), at 2-3 (ISDA March 2006).

reports of US branches of foreign banks.[86] A call report is prepared in accordance with US GAAP, but does not contain an income statement. Despite the fact that a call report does not contain an income statement or a complete balance sheet, the IIB contends that the call report qualifies as an "applicable financial statement", and that the method under which mark-to-market values shown on the call report were computed, qualifies as an eligible method.

Arguments discussed in the IIB submission include the following: The preamble to the Proposed Regulations specifically acknowledges that call reports are included in the second category of the definition of applicable financial statement. Further, the IIB asserts that mark-to-market fair values for securities and derivatives that are prepared in accordance with GAAP for the purposes of the call report of a US branch will almost invariably be the same values that are used by the bank to prepare its worldwide financial statements with regard to those securities and derivatives that must be marked to market under its applicable financial reporting standards. There is no reason to believe balance sheets are any less reliable than income statements. The Federal Reserve, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation require only call reports (absent income statements) to monitor the safety and soundness of a branch.[87] Like the SIA, the IIB would like the IRS to clarify that a call report qualifies as an applicable financial statement, and that the method under which the mark-to-market values shown on the call report were computed qualifies as an eligible method.

The issue of OCI valuations was also addressed during the hearing on Proposed Regulations[88] in comments made by Edward Kleinbard, on behalf of the SIA. Mr Kleinbard argued that the OCI valuations are supported by regulatory authorities who already police these values, as well as by the internal tension that tends to favour higher valuations due to compensation concerns. The IRS response was that based on "anecdotal evidence", OCI does not provide the same kind of healthy tension provided by the income statement. Mr Kleinbard then argued that it is easy to demonstrate that the exact methodologies are applied to a security on a trading book or in OCI, and that the location (in the trading book or OCI) depends on the bank's intention with regard to the security. Therefore, as long as the same valuation engine is being used, the values derived should be respected.[89]

Similarly, according to the ABA, the definition of an eligible method should not limit the application of the safe harbour to those mark-to-market adjustments which are recognized through the income statement. GAAP often prohibits the recognition of a mark-to-market adjustment through the income statement until a future event has occurred. Upon occurrence of the future event, the prior mark-to-market adjustments are transferred from the balance sheet to the income statement. There would be readily auditable information available to support the taxpayer's mark.

5.2. Bid/ask limitation

The Proposed Regulations require that except for eligible positions traded on a qualified board or exchange as defined in Sec. 1256(g)(7), the valuation method may not result in values that are "at or near" the bid or ask price.[90]

5.2.1. Issue 1

One major objection to this requirement is that it is too broadly applied, in that it does not provide an adequate exception for dealer positions in physical securities. The submissions describe the widespread practice with regard to physical securities in which long positions are marked to bid and shorts to ask.[91] A distinction is drawn between a dealer holding a derivative and one holding a physical security. A derivative dealer intends to hold the derivative indefinitely, while a physical is held for resale to customers. Because of the rapid turnover of dealer inventory in physical securities, the practice of marking long positions to the bid side of the market and short positions to the ask side, does not lead to significant deferrals of income or loss. The submission also asserts that marking longs to bid and shorts to ask is consistent with inventory valuation under Sec. 471 and consistent with the manner in which the majority of dealers value physical securities for financial accounting purposes.

As a result, the SIA takes the position that many physical securities, including most debt instruments such as US Treasury securities, are traded exclusively (or predominantly) through OTC markets and should be included in the exception for mid-market valuation. The SIA suggests that the exception utilize the broader language of "established financial market" incorporated in the Treas. Reg. Sec. 1.1092(d)-1(b) definition, rather than the language of Sec. 1256(g)(7), which limits the exception to securities traded "on a qualified board or exchange".

5.2.2. Issue 2

The Proposed Regulations require that the valuation come out nearer mid-market than bid/ask in order to be eligible for the safe harbour. As a general matter, the SIA submission questions the assumption that adjustments bringing the value nearer to bid/ask than mid-market are inappropriate. The SIA argues that disallowing bid/ask valuation is arbitrary. For example the SIA points out that especially in the case of exotic, illiquid derivatives, a dealer would justifiably mark an unhedged position very

86. The Institute of International Bankers represents internationally headquartered financial institutions from over 30 countries. IIB Comments on the Application of the Valuation Safe Harbour Under Proposed Regulation Sec. 1.475(a)-4 to Foreign Based Financial Institutions (13 September 2005) (IIB 2005).
87. IIB 2005, at 3.
88. US Department of the Treasury, Internal Revenue Service, Hearing on Proposed Regulations (REG-100420-03), Safe Harbour for Valuation Under Sec. 475, 26 CFR Part 1, Washington, DC (15 September 2005) (2005 Hearings).
89. Id. at 6-10.
90. Prop. Reg. Sec. 1.475(a)-4(d)(3)(i).
91. SIA July 2003, at 19 and 22.

near the bid or ask price. Further, the basic premise of the safe harbour is to achieve an administrable audit process by accepting a taxpayer's valuation, if such values are reported consistently for both tax and important, non-tax purposes. If the methodology produces values closer to bid/ask than unadjusted mid-market value, the inquiry should be whether these values are being used by the taxpayer for important, non-tax purposes. If they are, the presumption of the safe harbour is that the value is trustworthy.[92]

The SIA also contends that monitoring compliance with the "nearer to mid" requirement would be difficult. First, a net value for each component of a dealer's portfolio would have to be determined on a position-by-position basis. This would be problematic because dealers make value determinations and adjustments on a portfolio basis. Further, dealers do not retain records of bid/ask spreads for any meaningful period of time. Therefore, dealers' internal data retention systems would have to be revised.[93]

The ABA's submission states that the safe harbour should allow the use of bid/ask as long as they are consistently applied. Dealers should be allowed to mark securities subject to Prop. Reg. 1.475(a)-4, to either bid, ask, or mid-market value, while requiring that the dealer mark all instruments subject to the regulation consistently. As long as all instruments are marked consistently, regardless of whether the dealer is the buyer or the seller of the swap , the value of all income attributable to the "synthetic annuity" is effectively brought into taxable income currently.[94]

5.3. Requirement of GAAP

There were a number of submissions that criticized the safe harbour's limitation to financial reports prepared in accordance with US GAAP, as opposed to the GAAP of a non-US jurisdiction. The SIA asserts that insistence on a US GAAP requirement is flawed because it makes the safe harbour unavailable to foreign financial institutions which are required to pay taxes on US dealer operations, but which file their financials under the GAAP of another non-US jurisdiction. The SIA suggests that the IRS identify non-US jurisdictions with mark-to-market financial accounting that would be considered acceptable for purposes of the safe harbour. However, the SIA does not want to delay final regulations on the safe harbour, and recommends that the IRS reserve the right to identify non-US GAAP jurisdictions that employ mark-to-market financial accounting and identify those that are considered acceptable for purposes of the safe harbour. The ISDA concurs, and contends that the regulations should allow the IRS to permit non-US GAAP methods that are sufficiently consistent with US GAAP.

The IIB submissions advocate drafting the regulations to eliminate the disparate treatment of US and internationally headquartered financial institutions. Mark-to-market valuations under International Financial Reporting Standards (IFRS) and other non-US GAAP financial reporting standards that have been reconciled to US GAAP in SEC filings, should be acceptable financials for purposes of the safe harbour.

The IIB contends that the safe harbour should be qualified with regard to US branches of foreign banks, as well as foreign-based financial institutions that conduct trading activities in securities and commodities which are eligible to a mark-to-market election under Sec. 475(f) through unregulated US subsidiaries that do not prepare US GAAP financial statements. The IIB argues that several financial institutions currently file annual reports with the SEC based on non-US GAAP. Such reports require a footnote reconciliation statement. According to the IIB, the IIB is not aware of any situation in which an adjustment to conform the fair value of the marked- to-market securities and derivatives position to US GAAP, was deemed necessary by accountants or the SEC. Therefore, the IIB argues that no reconciliation is required for securities and derivatives that are marked to market because the accounting is consistent and no adjustments need be made.

Many of the IIB's arguments were reiterated in the Treasury Department Hearing. Because of the complexity of the issues involved, Treasury officials were reluctant to be put in the position of determining "whether a particular country's 'foreign GAAP' is similar to US GAAP and whether the implementation is similar".[95] It was suggested that proponents of the acceptance of the use of non-US GAAP for purposes of the safe harbour, do research and comparisons and provide information to the Treasury regarding differences in the mark-to-market methodology of the various GAAP systems.[96] The idea of having a Big Four accounting firm provide a certification or attestation that foreign GAAP is the same as US GAAP for fair value reporting was also raised.[97]

5.4. Scope of information required

According the SIA, the scope of information to be provided is too broad. The SIA suggests that the audit not extend to a review of a taxpayer's valuation methodology, but instead should be limited to information needed to establish book/tax conformity and to establish that a taxpayer's valuations meet the requirements of the safe harbour. Therefore, a taxpayer should be able to satisfy the requirements of the safe harbour by providing information demonstrating how values are used, rather than how they are produced.[98]

In a hearing on the Proposed Regulations, SIA representative Mr Edward Kleinbard also argued that it is not

92. SIA Submission regarding Book/Tax Conformity Safe Harbour Under Sec. 475, 17 August 2005), at 9-10 (SIA August 2005).
93. Id. at 10-11.
94. ABA Tax Section Comments on Possible Securities and Commodities Safe Harbour (7 December 2005), at 5-8.
95. 2005 Hearings, at 17.
96. Id. at 18-19.
97. Id. at 20.
98. SIA July 2005, at 7.

practical to require that dealers retain a five-year old valuation engine, as valuation engines are constantly being refined and adjusted. In response, the IRS contended that it would not be an unreasonable burden to save a computer program and run it a few years later. The IRS wants a valuation engine retained so that if an issue comes up later, it will be available to prove that valuations were appropriate.[99]

The SIA also takes issue with the requirement that taxpayers demonstrate that they could compute gain and loss with regard to each individual position. The intention of the IRS is to ensure that portfolio valuation adjustments relate to the specific terms and characteristics of the individual positions of the portfolio, and do not constitute some sort of general reserve account that could be arbitrarily applied to any collection of positions or could give rise to double counting of risks or other factors affecting the value of the portfolio.[100] However, dealers routinely make portfolio valuation adjustments in order to take account of synergies or negative synergies that arise from a combination of positions and risks held within a given portfolio. As a result, any allocation of these adjustments to particular positions within the portfolio is arbitrary and artificial.[101] Therefore, the SIA advocates allowing a taxpayer to document various individual elements of the portfolio that give rise to a portfolio valuation adjustment. As a result, a dealer would be required to maintain documentation establishing the economic justification of a portfolio valuation adjustment, and would not force a taxpayer to demonstrate that it can compute gain or loss attributable to the sale or other disposition of an eligible position.[102]

5.5. Timeframe

The SIA requests that the 30-day period for providing information to the Commissioner be increased to 60 days. The SIA argues that much of the information requested will be too complex, and will place too great a burden on the taxpayer's internal systems, for the taxpayers and the IRS to be assured that such information will be available within the 30-day period.[103] The ISDA agrees with this position, as well.[104]

6. Final Regulations

The final safe harbour regulations were reported in the Federal Register on 12 June 2007.[105] The preamble indicates that the underlying principles of the safe harbour are based on the business model for derivatives based on comments received in response to the ANPRM and NPRM. Echoing the submission of the SIA, the preamble to the Final Regulations goes on to describe the business model of derivatives dealers. The model describes dealers seeking to enter into balanced portfolios for their derivatives, carrying offsetting positions which remain on the dealers' books over the term of the positions. The difference between the bid and ask prices creates a synthetic annuity which is appropriately taxed in the year it is created.[106] With regard to physical securities, except for those acquired at the end of the year, the acquisition of a physical security EDITOR: change ok? occurs in the same taxable year, such that the effect of capturing a bid/ask spread also occurs entirely within that year. As a result, for securities traded on a qualified board or exchange as defined by Sec. 1256(g)(7), there is little difference between the results of realization and mark-to-market accounting, and little opportunity for manipulation.[107]

6.1. Eligible taxpayers

The safe harbour applies only to dealers in securities[108] and dealers in commodities.[109] As the Treasury Department and the IRS did not receive information regarding the business model for traders and how the limitations set forth in the NPRM would apply to traders, the Treasury Department and the IRS determined that it would be unwise to include traders in the safe harbour at this time.[110]

6.2. Eligible positions

In order to keep the Final Regulations flexible and dynamic in the future, a list of eligible securities will be issued concurrently with the final regulations. Rev. Proc. 2007-41 provides that the definition of securities includes those securities defined in Sec. 475(c)(2), and the definition of commodities is contained in Sec. 475(e)(2).

6.3. Eligible method

The four core requirements of a financial accounting method are retained. (e.g. mark-to-market as of the last day of the taxable year, recognize into income any gain or loss from marking eligible positions to market, recognize into income on the income statement any gain or loss on disposition of an eligible position as if a year end mark occurred immediately before the disposition, and values must be determined using US GAAP.) In addition, the three limitations imposed by the NPRM are retained as well (method may not result in values at or near bid or ask values, method may not take into account items of income or expense attributable to a period occurring on or before the valuation date, no cost or expense may be accounted for more than once, either directly or indirectly).

According to the IRS and the Treasury, the majority of the comments received concerned the core requirements and the limitations for eligible methods.

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99. 2005 Hearings, at 11-13.
100. SIA July 2005, at 8.
101. Id. at 9.
102. Id. at 11.
103. SIA July 2005, at 8.
104. ISDA Submission on Proposed Book-Tax Conformity Safe Harbour (7 March 2006), at 2.
105. TD 9328; 72 Fed. Reg. 32172-32181.
106. Id. at 32173
107. Id.
108. Treas. Reg. Sec. 1.475(a)-4(c)(1).
109. Treas. Reg. Sec. 1.475(a)-4(c)(2).
110. Id at 32174.

6.3.1. *Income statement requirement: Treas. Reg. Sec. 1.475(a)-4(d)(2)(ii)*

Submissions suggested that the requirement that taxpayers be allowed to report changes in value on their income statement, be expanded to allow values to be reported on their balance sheets because both are rigorously reviewed. The submissions also argued that because certain categories of comprehensive income do not generally appear on the balance sheet, the methodology used by many taxpayers for financial reporting would fail to be an eligible method and would not satisfy the safe harbour.

The Treasury Department and the IRS declined to allow values reported on a balance sheet to be used to satisfy the safe harbour. According to the IRS, values reported on an income statement sheet are inherently reliable because changes in value reported on an income statement also appear in retained earnings and in earnings per share. Therefore, the tension created between the benefits of higher earnings for financial reporting and the benefit of lower income for tax reporting, ensures reliability for tax purposes. As balance sheet items lack this tension, they are not as reliable as balance sheet items and are therefore not included in the safe harbour.

6.3.2. *Bid/ask limitation*

Comments suggested that the bid/ask limit be eliminated in order to make it easier for taxpayers to qualify for the safe harbour. It was argued that taxpayers do not retain records of spreads for meaningful periods of time and that it would be burdensome to monitor the spreads. With regard to comments regarding burdensome record keeping requirements, the IRS and Treasury responded that the Final Regulations do not impose an additional recordkeeping burden that is not already required by other sections of the Code.

Comments also reflected a concern with whether one position running afoul of the bid/ask method, disqualifies the entire financial accounting method, or whether failing for a particular position would require the taxpayer to prove that the method consistently produces values nearer to mid-market than to bid or ask. In response, the preamble explains that the Final Regulations clearly indicate that a method may occasionally produce a value that is nearer to bid / ask than mid-market, and that this will not preclude the use of the safe harbour.

Commentators also sought a broader definition of exchange-traded positions that would encompass exchange-traded positions defined by reference to Treas. Reg. Sec. 1.1092(d)-1(b), rather than using the definition provided in Sec. 1256(g)(7). The IRS response is that the definition contained in Treas. Reg. Sec. 1.1092(d)-1(b) was part of an anti-abuse provision and was therefore intentionally broad. As a result, the IRS does not want to use the definition contained because it might "inappropriately except too many positions from the general bid-ask limitation".[111]

With regard to the inclusion of debt instruments within the exception to mid-market valuation, the argument was made by commentators that debt instruments should be excepted from the bid/ask limitation as well. A dealer's business model generally is to turn over debt securities very rapidly, and dealers have a strong economic incentive to do so because holding debt securities consumes balance sheet resources and poses risk management issues. The Treasury and IRS argue that they do not posses sufficient information to conclude that spreads in the OTC debt markets are de minimis. The Treasury is also concerned with debt instruments being used to lock in spreads involving other derivative instruments which may run contrary to the tenets of the dealer business model for derivatives. In addition, there may be tax-motivated distortion in the marketplace with taxpayers seeking to lock in spreads with tax-advantaged instruments, rather than with instruments selected on the basis of their non-tax economic attributes.

6.3.3. *Applicable financial statements*

The main concern of commentators was that US GAAP is too narrow, and that if financial statements were prepared which were substantially similar to US GAAP, they should be accepted for purposes of the safe harbour.

The US GAAP requirement is retained, as it has been determined that the limitations of the safe harbour ensure sufficient consistency when applied to financial statements that are prepared in accordance with US GAAP. It is not clear that one would arrive at the same conclusion when looking at statements prepared under other regimes.

The IRS acknowledges the importance of making it practical for foreign banks to use the Sec. 475 safe harbour for their US branches. Therefore, the IRS and Treasury intend to revisit this matter and seeks help from the industry with regard to the following issues.

First, should the safe harbour require that the values reported in the call report of the foreign bank be the same values that are reported in the income statement filed in the foreign bank's home country? If so should the foreign bank, together with its certified independent registered public accountant, file with the US tax return, subject to penalties of perjury, a statement to that effect? Further, must the foreign country have formally adopted International Financial Reporting Standards as published by the International Accounting Standards Board?

Second, should the valuation standards used in a foreign bank's home country be identical to the valuation standards under US GAAP, and if not identical, in what ways may they differ? Should the foreign bank and its certified independent registered public accountant file a statement with the US tax return describing the differences?

Third, should the income statement filed by the foreign bank be filed with the foreign bank's home country bank

111. Final Reg. 32175.

regulatory authority (as distinct from a market regulatory authority like the SEC)?

Fourth, for purposes of these questions, should the term "home country" mean the country in which the foreign bank is chartered or incorporated?

The Treasury appears to have heeded the industry submissions arguing that the safe harbour should be extended to cover foreign banks, without delaying the finalization of the safe harbour regulations while the issue is further studied. This extensive list of questions appears to indicate a willingness by the Treasury and the IRS to revisit the safe harbour so as to broaden its application, at least to some extent, to include foreign banks, as well.

6.3.4. *Record retention and production*

Commentators expressed concern that language requiring all schedules, exhibits, computer programs, and other information used to produce values was too broad, making it difficult to know what materials must be retained and produced. The Treasury retained these requirements, asserting that other sections of the Code already require taxpayers to maintain sufficient records to support the accuracy of items reported on their federal tax returns. Except for a possible increase in the retention period in some instances, the Final Regulations impose no additional burden.

The IRS has indicated that it had conducted a test programme where it was demonstrated that 30 days was generally a sufficient period of time to produce the records. The Commissioner may also excuse failures to provide information within the 30-day period where there has been a good faith effort to comply. Additionally, a taxpayer may also enter into an agreement with the Commissioner regarding the types of records that are required and the length of time they are to be retained.