

# **Safe Harbor for Satisfying Statutory Requirements for Valuation Under Section 475 for Certain Securities and Commodities**

## **Announcement 2003-35**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Advance notice of proposed rule-making.

**SUMMARY:** This document describes and explains a possible framework for a safe harbor (including recordkeeping and record retention requirements) that would satisfy the statutory requirement to value certain securities and commodities under section 475 of the Internal Revenue Code. This document also invites comments from the public on this safe harbor and other alternative valuation methodologies. All materials submitted will be available for public inspection and copying.

**DATES:** Written or electronic comments must be submitted by August 4, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG-100420-03), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG-100420-03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may send electronic comments directly to the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs).

FOR FURTHER INFORMATION CONTACT: Concerning submissions, LaNita Van Dyke, (202) 622-7180; concerning the proposals, Marsha Sabin or John W. Rogers III, (202) 622-3950 (not toll-free numbers).

## SUPPLEMENTARY INFORMATION:

### A. Overview

Section 475(a) requires dealers in securities to mark their securities to market. If a security is inventory, it must be included in inventory at its fair market value. If a security is not inventory and is held at the end of the taxable year, it must be treated as if it were sold for its fair market value on the last business day of the taxable year. Mark-to-market treatment is available on an elective basis to commodities dealers and to traders in securities or commodities. See sections 475(e) and (f).

Although the meaning of the term "fair market value" has long been established, it has been difficult for both taxpayers and the IRS to determine fair market value in certain situations. To reduce the administrative burden on taxpayers and the IRS of determining fair market value under section 475, the IRS and the Treasury Department are considering the publication of a notice of proposed rulemaking that, by allowing values used on a financial statement to be used on the tax return, would provide an elective safe harbor for satisfying the statutory requirement to value securities and commodities.

Three broad principles guide eligibility for the safe harbor. First, any mark-to-market methodology used on a financial statement submitted for financial reporting purposes would have to be sufficiently consistent with the mark-to-market methodology used under section 475. Second,

the financial statement would have to be one for which the taxpayer has a strong incentive to report values fairly. Third, if requested, the taxpayer would have to timely provide the IRS with the information and documents necessary to verify the relationship between the values reported on the financial statement and the values used for purposes of section 475.

### B. Principle One: Mark-to-Market Methodology for Financial Reporting

To qualify for the safe harbor, a mark-to-market methodology used for financial reporting should be sufficiently consistent with the requirements of a mark-to-market methodology used for section 475. Under section 475, a mark-to-market methodology must (i) value securities and commodities as of the last business day of each taxable year, (ii) recognize into income the gains and losses arising from changes in value each year, and (iii) compute gain or loss on disposition by reference to the value at the end of the prior year. To the extent that mark-to-market methodologies for financial reporting and section 475 differ, the IRS and the Treasury Department request comments identifying the differences and addressing whether and how the differences should affect the safe harbor.

The valuation standard under section 475 is fair market value, the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. The IRS and the Treasury Department are considering whether to use the fair value standard under U.S. Generally Accepted Accounting Principles ("GAAP") as a proxy for the fair market value standard required for tax purposes. In particular, the IRS and the Treasury Department seek comments on whether GAAP permits (i) valuation of securities at the bid price, (ii) downward adjustments from mid-market values for future administrative, hedging, or financing expenses, or (iii) one or more redundant downward adjustments from mid-market values for credit risk. (In other words, if future cash flows are discounted to present value using a rate, such as LIBOR (London Interbank Offered Rate), that corresponds to the credit quality of the counterparty, is there a need for any additional credit adjustment?)

The IRS and the Treasury Department are interested in receiving information on

the types of adjustments that are currently used for financial statement purposes and an explanation of these adjustments. Comments are requested on the Financial Accounting Standards Board's consideration of fair value reporting of derivatives and the valuation of projected cash flows and any impact that has on how taxpayers are reporting any valuation adjustments for fair value purposes.

### C. Principle Two: Financial Statements and Business Use

Two factors are relevant in establishing that the taxpayer has a strong incentive to report values of the securities and commodities fairly on the financial statement: (i) reporting of values on a financial statement; and (ii) significant use of those reported values in the taxpayer's business.

As to the reporting of values, the IRS and the Treasury Department are considering various types of financial statements for the safe harbor. Three classes of financial statements under consideration are:

(1) A financial statement required to be filed with the Securities and Exchange Commission ("SEC") (the 10-K or the Annual Statement to Shareholders);

(2) A financial statement required to be provided to the federal government or any of its agencies (other than the SEC or the IRS); and

(3) A certified audited financial statement not required to be filed with the SEC or another federal agency.

In certain limited circumstances, it may also be appropriate to consider 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 regulator.

It may also be relevant whether a statement is provided to equity holders or creditors.

Comments are requested on the extent to which each of these various classes of financial statements is appropriate for the safe harbor and whether any other classes of financial statements may be as well.

As to significant use of reported values in the taxpayer's business, potentially significant uses include guiding the taxpayer's pricing and risk management decisions and determining employee compensation.

Special considerations arise if securities or commodities are held by a party re-

lated to the issuer or if derivatives in securities or commodities (including forward contracts in cash markets) exist between related parties. Financial consolidation can cause these securities or commodities (including derivatives) to be either eliminated (because of netting) or incompletely reported on financial statements. Additionally, in certain circumstances, these related party transactions may not receive the same level of regulatory scrutiny. It is not clear, therefore, whether the safe harbor would be appropriate for securities or commodities held by a party related to the issuer or for derivatives in securities or commodities that exist between related parties.

#### *D. Principle Three: Recordkeeping and Record Production*

Under the safe harbor, examinations of returns would focus on how the values used in the financial statements relate to gain and loss on the tax returns. Consequently, records would have to clearly show: (1) that the same value used on the financial statement was used on the tax return; (2) that no security subject to section 475 and reported under the required methodology on the financial statement was excluded in the application of the safe harbor; and (3) that only securities or commodities subject to section 475 had been carried over to the tax return under the safe harbor.

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 value used for the financial statement was used on the tax return. Therefore, a safe harbor will impose specific verification and reconciliation requirements.

The IRS and the Treasury Department are concerned about valuation issues that may arise from pooling of securities and commodities. Comments are requested on how securities and commodities are pooled for purposes of financial reporting, how they are pooled for tax reporting, and how the Commissioner can verify the basis determination of a single position contained in the pool if that position is sold or settled in the year following the mark and other positions in the pool are not sold.

The IRS and the Treasury Department are similarly concerned about the consolidation and de-consolidation of the business structure. Comments are requested on the impact of the consolidation and de-consolidation on determining whether the same securities and commodities will be reflected on both the financial statement and the tax return.

The IRS and the Treasury Department are considering rules that would require electing taxpayers to maintain and, if requested, provide to the Commissioner in a timely manner the following records: (1) books and records clearly establishing that the values used in determining gain or loss under section 475(a) for eligible securities or commodities were the values used in the financial statement; (2) for taxpayers filing a Form 1120, a reconciliation of the amount of net income reported on the financial statement to the amount reported on line 1 of the Schedule M-1 on the Form 1120, *Corporate Income Tax Return*; and (3) for other taxpayers, a similar reconciliation schedule. The documents for reconciliation purposes include supporting schedules, exhibits, computer programs used in producing the values and schedules, and documentation of rules and procedures governing determination of the values. Books and records would include all those that are required to be maintained for financial or regulatory reporting purposes, even if those books and records are not specifically covered by section 6001. Comments are requested on whether less burdensome recordkeeping requirements could be developed that would still allow for effective verification of conformity.

The IRS and the Treasury Department are considering situations in which the Commissioner should enter into agreements with specific taxpayers establishing which records would have to be maintained, how the records would have to be maintained, and how long the records would have to be retained. Because an agreement would be tailored to a particular taxpayer's operations and environment, it is expected that an agreement would arise only after individual negotiations. Although no taxpayer would be entitled to an agreement, an agreement based on an early understanding of a taxpayer's operations

would be in the best interests of tax administration and, therefore, would be encouraged.

#### *E. Eligible Taxpayers*

The safe harbor is being considered for dealers in securities under section 475(c)(1). Whether the safe harbor would also be extended to securities traders, dealers in commodities, and commodities traders would largely depend on whether the extension would comport with the principles described in the Overview.

#### *F. Eligible Securities and Commodities*

Section 475 applies to a wide variety of securities and commodities. It is relatively easy for both taxpayers and the IRS to determine the fair market value of positions for which pricing information is readily available, such as most actively traded personal property. The need for a safe harbor is most pressing for positions for which pricing information is not readily available, including more complex notional principal contracts and derivative instruments, and hedges described in sections 475(c)(2)(D), (E), and (F). Comments are requested on what securities should be included in the safe harbor.

Commodities raise problems similar to those for securities, so the need for a safe harbor is similarly pressing for commodities (including commodities derivatives) for which pricing information is not readily available. Comments are requested addressing application of a safe harbor for commodities.

#### *G. Comments on Other Valuation Methodologies and Safe Harbors*

Comments are requested on whether there are other methodologies for determining fair market values under section 475. Comments are also requested on whether other safe harbors could act as proxies for fair market value under section 475.

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