New York State Bar Association Tax Section

Report on IRS Announcement 2003-35
(Safe Harbor for Valuation Under Section 475)

October 9, 2003

Report No. 1040

New York State Bar Association

Tax Section

Report on IRS Announcement 2003-35

(Safe Harbor for Valuation Under Section 475)[*]

I. **Introduction**

Section 475 requires securities dealers, and electing commodities dealers and securities and commodities traders, to recognize gain or loss as if all of their securities (or commodities) were sold for their "fair market value" on the last day of each taxable year.

Section 475 contains no methodology for determining fair market value. Both the Committee Report and the Conference Agreement to section 475 contemplate that the Treasury Department "will authorize the use of valuation methods that will alleviate unnecessary compliance burdens for taxpayers."[1] The Conference Agreement also anticipates that any

---

[*] The principal draftsperson of this report was David S. Miller with substantial assistance from Susan Liu, Erika Nijenhuis, David Schizer, and Diana Wollman. Helpful comments were received from Sam Dimon, David M. Schiffman, Andrew Solomon, Michael Schler and Jay H. Zimbler.

[1] H.R. Conf. Rep. No. 103-213, 103rd Cong., 1st Sess., at 613 (August 14, 1993) ("It is expected that the Treasury Department will authorize the use of appropriate valuation methods that will alleviate unnecessary compliance burdens of taxpayers under the bill."); H.R. Conf. Rep. No. 103-213, at 616 ("*Valuation of securities*. 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 Federal income tax purposes."). See also Department of the Treasury, General Explanation of the President's Budget Proposals Affecting Receipts 89-90 (January 30, 1992) ("The mark-to-market method represents the best accounting practice in the trade or business of dealing in securities and is the method that most clearly reflects the income of a securities dealer",

valuation method will "clearly reflect income for federal income tax purposes."[2] The only other guidance is the historic definition of "fair market value" for federal income tax purposes.[3]

Most derivatives dealers value their over-the-counter derivatives for tax purposes under the same methodology that they use for financial accounting purposes.[4] First, a "mid-market

---

proposing that dealers be required to use mark-to-market accounting for their inventories "as they already do when preparing financial statements").

[2] H.R. Conf. Rep. 103-213, at 616.

The Committee Report provides that fair market value will be determined by valuing each security on an individual security basis without taking into account blockage discounts. H.R. Conf. Rep. No. 103-213, at 613 ("For purposes of the House bill, fair market value is generally determined by valuing each security on an individual security basis. Thus, if a taxpayer holds a large block of securities of the same type, the securities should be valued without taking any blockage discount into account.")

[3] See Treas. Reg. § 1.170A-1(c)(2) ("the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."); see also Treas. Reg. § 1.704-4(a)(3) (similar); Rev. Rul. 59-60, section 2.02; 1959-1 C.B. 237; T.B.R. 57, 1 C.B. 40 (1919) ("[a] fair market value that both a buyer and a seller, who are acting freely and not under compulsion and who are reasonably knowledgeable about all material facts, would agree to in a market of potential buyers at a fair and reasonable price"); Hudson River Woolen Mills v. Commissioner, 9 B.T.A. 862, 868 (1927) (same); Announcement 2003-35, 2003-21 I.R.B. 956 ("the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts").

The Tax Court has summarized the standards for fair market value as:

> (1) The buyer and the seller are a willing buyer and a willing seller; (2) neither the willing buyer nor the willing seller is under a compulsion to buy or sell the item in question; (3) the willing buyer and the willing seller are both hypothetical persons; (4) the hypothetical willing buyer and the hypothetical willing seller are both reasonably aware of all relevant facts involving the item in question; (5) the item in question is valued at its highest and best use; and (6) the item in question is valued without regard to events occurring after the valuation date to the extent that those subsequent events were not reasonably foreseeable on the date of valuation.

Bank One Corp. v. Commissioner, Nos. 5759-95, 5956-97, 2003 U.S. Tax Ct. LEXIS 13, at *260 (May 2, 2003).

interest rate curve" is constructed as of the last business day of the year. The mid-market curve is drawn from the averages of the bid and ask prices for swaps of standard maturities quoted in the interdealer market.[5] The curve is then used to discount all future cash flows to be made or received on each derivative in the dealers' portfolio in order to arrive at an aggregate net present value.[6] This net present value calculation is referred to as the "mid-market valuation."

The mid-market valuation for the entire portfolio is finally adjusted for (i) imperfections in the dealer's mid-market valuation model, (ii) the costs of maintaining positions that are not fully hedged (which include "bid/offer adjustments" for the market risk inherent in a position that is not fully reflected in the mid-market valuation, "liquidity adjustments," for the cost to close out a particular position, and "concentration adjustments," for the additional cost to close out a particularly large position), (iii) the risk of credit losses (i.e., the anticipated and unanticipated losses attributable to a default by the taxpayer's counterparties), (iv) future marginal administrative costs attributable to the portfolio (including the costs of maintaining systems, operational costs (including salaries), due diligence costs, documentary costs, legal costs, and the costs of servicing particular contracts (e.g., the costs of monitoring compliance and processing payments)), and (v) investing (or "cash management") to fund cash flow mismatches in the portfolio.

---

4 See Edward D. Kleinbard, "Some Thoughts on Market Valuation of Derivatives" (letter to the editor), 91 Tax Notes 1173 (May 14, 2001); Bank One, 2003 U.S. Tax Ct. LEXIS at *72-73.

5 See Bank One, 2003 U.S. Tax Ct. LEXIS at *58.

6 See Bank One, 2003 U.S. Tax Ct. LEXIS at *59 ("The mid-market value of a swap is calculated using a mathematical model that extracts the market's forecasts for future interest rates (implied forward interest rates) from the current mid-market swap curve to determine the floating-rate payments that will be due or payable under the swap agreement") (citation omitted).

In contrast, most securities dealers treat their "physical" long and short positions as if they were inventory and value their long positions at the "bid" price and their short positions at the "ask" price.[7] However, some dealers treat their physical positions consistently with their derivative positions and value all of them at adjusted mid-market.[8]

The absence of any guidance on valuation under section 475 has led to disputes between the Internal Revenue Service ("IRS") and taxpayers. Derivatives dealers anecdotally report that the IRS on audit routinely challenges their adjustments to the mid-market valuation.

---

7 See Securities Industry Association, "Submission In Response to Advance Notice Regarding Proposed Safe Harbor Under Section 475", 19 (July 30, 2003).

The authority for this position is regulations section 1.471-4(a) ("Under ordinary circumstances and for normal goods in an inventory, market means the aggregate of the current bid prices prevailing at the date of the inventory of the basic elements of cost reflected in inventories of goods purchased and on hand, goods in process of manufacture, and finished manufactured goods on hand."). See also D. Loveman & Sons Export Corp. v. Commissioner, 34 T.C. 776, 796 (1960) ("[T]he term 'market' in the phrase 'lower of cost or market' means the price which petitioners would have had to pay to replace items in their inventories on the applicable inventory dates. Conversely it does not mean the price at which such merchandise is resold or offered for resale."), aff'd per curiam, 296 F.2d 732 (6th Cir. 1962).

As discussed below, valuing physical securities at bid or ask is an inventory method of accounting and reflects the historic treatment of dealers as merchants maintaining inventory. This method is theoretically defensible for those physical securities that are in fact maintained as inventory. However, dealers sometimes maintain physical securities as hedges of their derivative positions rather than as inventory (and vice versa), and do not segregate that portion of their physical securities that serve as inventory from that portion that serves as hedges. Valuing physical securities at bid or ask where they are held as hedges for derivatives that are valued at adjusted mid-market is less defensible.

8 The generally accepted accounting principles of the United States ("GAAP") permits valuation of physical securities under any of the following methods, so long as it is consistently applied: (i) an average of bid and ask prices, (ii) bid prices for long positions and ask prices for short positions, (iii) some average of price quotations of a representative selection of market makers quoting on a particular financial investment, or (iv) a range of bid and ask prices considered best to represent value in its circumstances. AICPA, "Brokers and Dealers in Securities," section 7.08.

These disagreements culminated in litigation. In May, 2003, in Bank One v. Commissioner,[9] the Tax Court held that Bank One failed to properly value its derivatives under section 475. However, the Bank One case offers little guidance to taxpayers because Bank One lost largely because it failed to value its derivatives on the last day of each taxable year as section 475 clearly provides,[10] its valuation methodology was significantly flawed,[11] and it did not consistently use the same valuations for its financial accounting and regulatory reporting purposes as it used for tax purposes.[12]

Nevertheless, the Tax Court did endorse use of the mid-market valuation as the starting point for section 475 valuations, and further held that the mid-market valuation should be adjusted (i) for both parties' credit rating,[13] (iii) on a swap-by-swap (rather than a portfolio)

---

9 See Bank One Corp. v. Commissioner, Nos. 5759-95, 5956-97, 2003 U.S. Tax Ct. LEXIS 13 (May 2, 2003). Bank One was the successor to First National Bank of Chicago. To avoid confusion, this report consistently refers to the taxpayer in the Bank One case as "Bank One."

10 See Bank One, 2003 U.S. Tax Ct. LEXIS at *281 ("The mid-market values which FNBC computed . . . were not last business day values. Such an early valuation date is inconsistent with section 475, especially when one considers that the values of at least some of FNBC's swaps changed significantly from the early closing date to the date of the last business day.").

11 For example, Bank One (i) valued nonperforming swaps at lower of cost or market rather than at market, 2003 U.S. Tax Ct. LEXIS at *281-82, (ii) delayed its credit adjustments for one month, 2003 U.S. Tax Ct. LEXIS at *288-89, (iii) used a "static" method to adjust for credit risk, rather than a "dynamic" method based on actual credit risk values, 2003 U.S. Tax Ct. LEXIS at *298-300, (iv) adjusted its valuations for swaps that were no longer in existence, 2003 U.S. Tax Ct. LEXIS at *310, and (v) subtracted a portion of its fixed (rather than merely its marginal) administrative costs from the mid-market valuation. 2003 U.S. Tax Ct. LEXIS at *304-05.

12 See 2003 U.S. Tax Ct. LEXIS at *282.

13 See 2003 U.S. Tax Ct. LEXIS at *289 ("Respondent argues that the fair market value of interest rate swaps takes into account both parties' creditworthiness. We agree with respondent.").

basis,[14] (iii) for the taxpayer's actual incremental (but not fixed) costs of administering the derivatives, and (iv) for funding and other costs of capital.[15]

As discussed below, two aspects of the decision are controversial. First, many derivatives dealers adjust the mid-market valuation on account of their counterparty's creditworthiness, but not their own, as the Tax Court would require. Second, while dealers determine a mid-market value for each position, adjustments are calculated on a portfolio basis and not on a position-by-position basis.

After the Bank One litigation commenced, the Securities Industry Association petitioned the Treasury Department for regulations that would grant dealers a conclusive presumption that the values they assign to their derivatives constitute "fair market value" for section 475 purposes so long as (i) the values are the same as those used in their "applicable financial statement" and (ii) the dealer makes "significant use of these values in the management of its dealer business."[16]

---

14 See 2003 U.S. Tax Ct. LEXIS at *303. ("We agree . . . that the adjustments must be computed on a swap-by-swap basis.").

15 See 2003 U.S. Tax Ct. LEXIS at *306-07.

16 See Letter from Marc E. Lackritz to Hon. Mark A. Weinberger (April 25, 2001), 2001 TNT 96-27; Letter from Saul M. Rosen and Patti McClanahan to Hon. Mark Weinberger and Hon. B. John Williams (April 23, 2002), 2002 TNT 78-18.

The applicable financial statement is a statement complying with certain criteria. In the case that a dealer produces more than financial statement, the Securities Industry Association suggested a hierarchy based on similar priorities in Treas. Reg. § 1.56-1(c) (relating to the prior-law book-tax adjustment under the alternative minimum tax), to arrive at the "applicable" financial statement.

The Securities Industry Association proposed that "management of a dealer business" is the financial and commercial oversight of the securities dealer's business including (but not limited to) senior management review of business and profitability, market risk measurement or management, credit risk measurement or management, internal allocation of capital, and compensation of personnel. Management of a dealer's business would not include the dealer's tax accounting or its reporting of financial results to shareholders.

This approach may be characterized as an "incentive-based approach" because it relies on non-tax incentives to assure accuracy rather than mandating any particular methodology. The derivative dealers prefer this approach because it does not require them to undertake one valuation for financial accounting purposes and another for tax purposes.[17] In contrast, in Bank One, the Tax Court adopted a "normative" or "legal standard" approach which mandates a specific methodology (mid-market valuation, subject to certain specified adjustments) to determine fair market value under section 475.

On the same date that Bank One was decided, the IRS issued Announcement 2003-35,[18] which indicates that the IRS and the Treasury Department are considering proposed regulations that would permit taxpayers to use the valuations they report on their financial statements for section 475 purposes if certain conditions are satisfied. Announcement 2003-35 lays down three "principles" that together suggest some normative parameters that would bound the incentive-based approach proposed by the Securities Industry Association.

Under the first principle, any mark-to-market methodology used on a financial statement would have to be "sufficiently consistent" with the mark-to-market methodology used under section 475. We refer to this as the "consistency principle." More specifically, the consistency principle requires that the 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.

---

17 See Letter from Marc E. Lackritz to Hon. Mark A. Weinberger (April 25, 2001), 2001 TNT 96-27.

18 2003-21 I.R.B. 956.

Under the second principle, the financial statement would have to be one for which the taxpayer has a "strong incentive" to report values fairly. We refer to this as the "incentive principle." The incentive principle, in turn, incorporates two requirements: (i) reporting of values on a financial statement and (ii) "significant use" of these reported values in the taxpayer's business.

Announcement 2003-35 contemplates three classes of financial statement that might satisfy the financial statement requirement: (i) a financial statement required to be filed with the Securities and Exchange Commission ("SEC") (the 10-K or the Annual Statement to Shareholders), (ii) a financial statement required to be provided to the federal government or any of its agencies (other than the SEC or the IRS), and (iii) a certified audited financial statement not required to be filed with the SEC or another federal agency.[19]

Significant uses of reported values would include use of valuations for purposes of making decisions regarding pricing, risk management, and employee compensation.

Under the third principle, 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. We refer to this as the "verification principle."

The verification principle would require dealers to maintain records that clearly show: (i) that the same value used on the financial statement was used on the tax return, (ii) that no security subject to section 475 and reported under the required methodology on the financial

[19] The Announcement also indicates that 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, and to consider statements provided to equity holders or creditors.

statement was excluded in the application of the safe harbor, and (iii) that only securities or commodities subject to section 475 had been carried over to the tax return under the safe harbor.

The Announcement also lists some special topics of concern for the IRS. First, if a dealer has entered into derivatives with related parties, use of financial statements may be problematic because the derivatives may be eliminated or incompletely reported on the financial statements, or may receive insufficient scrutiny by regulators to ensure accuracy.[20] For example, if a taxpayer enters into a derivative with a related foreign counterparty that is consolidated with the taxpayer for financial accounting but not tax purposes, the derivative will not appear on the taxpayer's financial statements. Similarly, the IRS is concerned about the impact of consolidation and deconsolidation on a tax methodology that is based on GAAP reporting.[21]

Finally, the IRS is concerned that financial statements generally require valuation of a dealer's entire portfolio rather than each position on a position-by-position basis, as the legislative history to section 475 suggests and the Tax Court in Bank One required.[22]

---

[20] "Special considerations arise if securities or commodities are held by a party related 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."

[21] "Comments are requested on the impact of the consolidation and deconsolidation on determining whether the same securities and commodities will be reflected on both the financial statement and the tax return."

[22] "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

The Announcement also requests comments on two other topics. First, should the IRS enter into agreements with specific taxpayers?[23] Second, should a safe harbor (if adopted) be available to commodities dealers, and securities and commodities traders and, if so, what types of securities should be included?[24]

The balance of Announcement 2003-35 lists a number of questions relating to GAAP methodology for valuing derivatives. Some of the questions suggest a normative approach based on adjusted mid-market valuations.[25]

---

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."

23 "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."

24 "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."

25 For example, the IRS asked 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?)"

II. Summary of Recommendations

1. We believe that guidance for valuations under section 475 is important and we agree with the IRS that a safe harbor that permits taxpayers to use financial statement valuations for section 475 purposes would significantly reduce administrative burdens for taxpayers and the IRS alike, and reduce controversy. We also agree with the IRS that the three principles expressed in Announcement 2003-35 are appropriate.

2. We agree with the IRS that in order for a mark-to-market valuation that is reflected on a financial statement to serve as the basis for section 475 valuation, the methodology underlying the valuation must be "sufficiently consistent" with the principles of section 475. We believe that a valuation that is materially consistent with section 475 principles (including the definition of fair market value) should be sufficiently consistent.

   We suggest that the IRS evaluate U.S. GAAP's methodology for valuing derivatives and other securities, including all of the variants that GAAP permits, and determine which aspects or variants are materially consistent with section 475 principles and which, if any, are not. (We do not have sufficient expertise in GAAP valuation methodology to make this determination.) If the IRS were to determine that GAAP is generally materially consistent with section 475 principles, but one or more aspects or variants of GAAP are materially inconsistent with section 475 principles, then taxpayers using the impermissible aspects or variants for financial accounting purposes would be required to adjust their GAAP valuations with respect to these aspects in order to satisfy the consistency principle for the safe harbor. Taxpayers that report valuations consistent with GAAP (as so adjusted) would satisfy the consistency principle (but would also be required to satisfy the incentive and verification principles).

3. We agree with the IRS that in order for a taxpayer to be entitled to a conclusive presumption that a valuation reflected on a financial statement is accurate for section 475 purposes, in addition to the valuation satisfying the consistency principle, the taxpayer must have a strong incentive to report the values fairly.

   We believe that this incentive should exist if a taxpayer reports valuations for a meaningful amount of its securities on any financial statement that is filed with the Securities and Exchange Commission (i.e., a 10-K or the Annual Statement to Shareholders) or submitted to another agency of the federal government if the agency has enforcement powers authorizing it to impose significant economic or other penalties in case of any false or inaccurate disclosure or deceptive practices. We also believe that this incentive should exist for analogous reports filed with the regulatory agencies of foreign and state governments that are reasonably comparable to U.S. agencies and provide for analogous sanctions. We recommend that the regulations contain a list of these "approved regulators." We believe that a taxpayer may use valuations reported on financial statements submitted to the approved regulators for section 475 purposes without demonstrating another nontax use for the values.

4. We are concerned that valuations that are not submitted to approved regulators may be more susceptible to manipulation or inaccuracy. Therefore, we would grant taxpayers a

rebuttable (but not a conclusive) presumption that the values reported on other certified financials represent fair market value for purposes of section 475 if the taxpayer can demonstrate a significant nontax business purpose that helps to assure the accuracy of the valuations. Submitting the values to a regulatory agency other than an approved regulator will generally suffice if inaccuracy could give rise to significant civil or criminal sanctions and the filing is indeed subject to meaningful regulatory supervision. We agree with the IRS that use of the values for meaningful price determinations and risk management are significant nontax business purposes. Meaningful compensation decisions and reports to equityholders and creditors also should qualify as significant nontax business purposes if the taxpayer can establish a meaningful incentive to report values fairly. However, we recognize that in certain circumstances taxpayers may not have a meaningful incentive to report values fairly to equityholders and employees, especially if the persons receiving the reports would benefit from undervaluations by deferring tax liability.

If a taxpayer is entitled to a rebuttable presumption, the IRS would have the burden of proof to demonstrate that the values are materially inconsistent with section 475 principles.

5. It may be appropriate to exclude certain illiquid securities or securities denominated in or reflecting hyperinflationary currencies from even a rebuttable presumption if valuations of those securities are not included in financial statements filed with approved regulators, although we have not reached a consensus on this issue. We do believe that the valuations of all securities (including even illiquid securities and securities reflecting hyperinflationary currencies) that are reflected in financial reports filed with approved regulators should be entitled to a conclusive presumption.

6. If a taxpayer submits financials to more than one approved regulator and the financials reflect different valuations, we believe that the taxpayer should use the valuations that are most consistent with section 475 principles. However, we believe that the IRS should have the burden of proof to demonstrate that the valuations used by the taxpayer are materially inconsistent with section 475 principles.

   If a taxpayer prepares more than one set of certified financials, each of which reflect different valuations, and uses each of them for significant nontax business purposes but does not submit them to approved regulators, the taxpayer should also use the valuation that are most consistent with section 475 principles. The taxpayer would have the burden of proof to demonstrate that its valuations were materially consistent with section 475 principles.

7. If a taxpayer reports valuations on financials that entitle the taxpayer to a conclusive or rebuttable presumption, and the valuations so reported constitute a "meaningful amount" of the taxpayer's derivatives, the taxpayer should also be entitled to the same conclusive or rebuttable presumption for derivatives valued under the same methodology, but not reported due to consolidation or some other reasons. We have not formulated the threshold for a meaningful amount, but we do believe that an anti-abuse rule would be appropriate to prevent taxpayers from reporting valuations on a de minimis amount of

derivatives and then inappropriately claiming the safe harbor for valuations of derivatives entered into with consolidated parties or which otherwise are not reflected in the financials.

8. As a general matter, despite the legislative history to section 475 that securities should be valued on a security-by-security basis, we believe that the safe harbor will be useful only if it permits valuation on a portfolio basis (which is what GAAP requires). However, to the extent that a particular security is sold, terminated or offset during the year and the particular security has not been individually reported on a relevant financial statement, although the taxpayer may be entitled to a presumption regarding the value of the pool, the taxpayer should not be entitled to any presumptions regarding the proper basis and sales price or termination value of the security.

9. Although we support a safe harbor based on valuations reported on financial statements, we also believe that the regulations should provide some normative guidance on acceptable methods of valuing derivatives for those taxpayers that do not qualify for the safe harbor. We suggest that it would be appropriate for a taxpayer to value its derivatives based on the mid-market value with adjustments for (i) imperfections in the dealer's mid-market valuation model, (ii) "bid/offer," "liquidity," and "concentration" adjustments, (iii) credit losses attributable to the taxpayer's counterparties (but not reflecting the taxpayer's credit quality), (iv) future marginal administrative expenses, and (v) the funding cost of managing cash flow mismatches. However, because other methodologies may be appropriate, and advances in technology and theory may permit more accurate valuations, approval of any particular methodology should not preclude taxpayers from using others. Accordingly, the IRS should retain significant flexibility to approve of other methodologies or modify the approved methodology.

10. We believe that all taxpayers, including securities traders, commodities dealers and traders, and taxpayers required to mark-to-market securities under sections 1256, 1259, 1260 and 1296 should be entitled to the benefit of the presumptions and normative section 475 guidance.

11. On balance, we endorse use of the IRS's "Accelerated Issue Resolution" program (the "AIR program") for section 475 valuation issues. We recognize that as a practical matter private IRS/taxpayer agreements (such as those that result from the AIR program) may be available only to taxpayers with sufficient resources to hire sophisticated advisors, but we believe that private IRS/taxpayer agreements have served as a useful tool for the IRS to gain important industry knowledge, and they allow taxpayers to develop stable and workable procedures. For example, the advance pricing agreement ("APA") process has been successful. One possible model for taxpayer-specific agreements are qualified intermediary ("QI") agreements where there is a basic list of standard rules and the taxpayer and IRS negotiate specific provisions pertaining to the taxpayer. We are, however, concerned about how the agreement process will be implemented so as to be efficient, equitable and speedy.

III. **Discussion**

A. Importance of Section 475 Guidance; Desirability of a Section 475 Safe Harbor Based on Financial Statement Valuations

We believe that guidance for valuations under section 475 is important and we agree with the IRS that a safe harbor that permits taxpayers to use financial statement valuations for section 475 purposes would significantly reduce administrative burdens for taxpayers and the IRS alike, and would reduce controversy. We agree with the IRS that the three principles expressed in Announcement 2003-35 are appropriate.

B. The Consistency Principle

We agree with the IRS that in order for a mark-to-market valuation that is reflected on a financial statement to serve as the basis for section 475 valuation, the methodology underlying the valuation must be "sufficiently consistent" with the principles of section 475.[26] We suggest that the methodology that is "materially consistent" with section 475 principles should be acceptable (even if the methodology does not precisely measure fair market value as the tax law defines it). A materiality standard appropriately balances the two policy objectives expressed in the legislative history to section 475: reasonable compliance burdens and clear reflection of income.[27]

---

26 This is a necessary but not a sufficient condition for the safe harbor: The taxpayer must also satisfy the incentive and verification principles described below.

27 Clear reflection of income principles do not mandate exacting precision. See, e.g., E. W. Bliss Co. v. United States, 224 F. Supp. 374 (N.D. Ohio, 1963), aff'd, 351 F.2d 449 (6th Cir. 1965) ("The tax law and generally accepted principles of accounting recognize that substantial accuracy is the objective to be achieved and that in many situations exact determinations are neither practicable nor necessary."); Kentucky Color & Chemical Co. v. Glenn, 87 F. Supp. 618 (W.D. Ky. 1949), aff'd, 186 F.2d 975 (6th Cir. 1951) (clearly reflecting income means "'plainly, honestly, straightforwardly and frankly', but does not mean 'accurately', which in its ordinary use means precisely, exactly, correctly, without error or defect"); S. Weisbart & Co. v. Commissioner, T.C. Memo 1964-130 ("It is not

We agree with the IRS that, in order for a methodology reflected in the taxpayer's financial statements to be materially consistent with section 475 principles, the 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) complete gain or loss on disposition by reference to the value at the end of the prior year. Section 475 requires as much, and a methodology that failed any these three fundamental tests would not be materially consistent with section 475 principles.[28]

We also agree with the IRS that the valuation methodology must be materially consistent with the methodology for determining fair market value for federal income tax purposes. The Tax Court in Bank One held that "fair value" for GAAP purposes is not identical to "fair market value" for tax purposes for three reasons.[29] We also recognize that GAAP by its nature reflects a

---

necessary that petitioner's inventories be absolutely accurate or correct. As used in the pertinent Code sections, 'clearly' to reflect income means plainly, honestly, straightforwardly and frankly, not accurately, precisely, exactly, correctly, or without error or defect."); cf. Caldwell v. Commissioner, 202 F.2d 112 (2d Cir. 1953) ("clearly reflect the income" means that "income should be reflected with as much accuracy as standard methods of accounting practice permit.").

28 See section 475(a).

The Tax Court in Bank One held that section 475 requires valuation as of the last business day of each taxable year, and that Bank One's methodology failed this requirement. See Bank One, 2003 U.S. Tax Ct. LEXIS at *273.

29 First, fair market value requires that the willing buyer and willing seller be reasonably aware of all facts relating to the property to be valued; however, fair value requires no such knowledge. Second, fair market value requires that neither the willing buyer nor the willing seller be under a compulsion to buy or to sell the property in question. Although fair value requires that the property not be the subject of a forced sale or liquidation, a taxpayer could be under a compulsion to buy or sell in the absence of a forced liquidation. Finally, the buyer and seller for fair market value are hypothetical rather than actual persons, and the property is valued in its highest and best use. Fair market requires neither. See Bank One, 2003 U.S. Tax Ct. LEXIS at *265-66.

conservatism that could lead to systematic undervaluations.[30] We are not sufficiently expert in the fair value standard under U.S. GAAP to determine whether it is materially consistent with fair market value. Nevertheless, we believe that regulations could provide that GAAP's fair value may be used as a proxy for fair market value for section 475 purposes so long as the two are not materially different.[31]

We suggest that the IRS evaluate U.S. GAAP's methodology for valuing derivatives and other securities, including all of the variants that GAAP permits,[32] and determine which aspects

---

[30] See, e.g., Thor Power Tool v. Commissioner, 439 U.S. 522, 542 (1979) ("The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." AICPA Accounting Principles Board, Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises para. 171 (1970), reprinted in 2 APB, "Accounting Principles" 9089 (1973). See Sterling, "Conservatism: The Fundamental Principle of Valuation in Traditional Accounting," 3 Abacus 109-113 (1967).").

[31] The legislative history to section 475 anticipated that the valuation methods to section 475 will both alleviate unnecessary compliance burdens and clearly reflect income for federal income tax purposes. The legislative history indicates that Congress was aware that securities dealers valued their securities at year end for financial accounting purposes and contemplated conformity for tax purposes. See H.R Rep. 103-111, 103rd Cong., 1st Sess., at 661 (May 25, 1993) ("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"); see also Department of the Treasury, General Explanation of the President's Budget Proposals Affecting Receipts 89-90 (January 30, 1992) ("The mark-to-market method represents the best accounting practice in the trade or business of dealing in securities and is the method that most clearly reflects the income of a securities dealer"; proposing that dealers be required to use mark-to-market accounting for their inventories "as they already do when preparing financial statements").

[32] We understand that GAAP's valuation methodology is not rigid. For example, GAAP permits dealers to adjust the mid-market valuation for changes in the dealer's credit rating. See Securities Industry Association, "Submission In Response to Advance Notice Regarding

or variants are materially consistent with section 475 principles, and which, if any, are not. (We do not have sufficient expertise in GAAP valuation methodology to make this determination.) If the IRS were to determine that GAAP is generally materially consistent with section 475 principles, but one or more aspects or variants of GAAP are materially inconsistent with section 475 principles, then taxpayers using the impermissible aspects or variants for financial accounting purposes would be required to adjust their valuations with respect to these aspects or variants in order to satisfy the consistency principle for the safe harbor. Taxpayers that report valuations consistent with GAAP (as so adjusted) would satisfy the consistency principle (but would also be required to satisfy the incentive and verification principles).[33]

We have considered whether a taxpayer that uses GAAP valuations (adjusted as described above) for federal income tax purposes would satisfy the incentive principle if, after the taxpayer files its return, the taxpayer's valuations are restated for GAAP purposes so that, now, GAAP as restated does not match the taxpayer's valuations for tax purposes. In general, if the taxpayer is not required by its accountants (or legal counsel) to amend the financial statement

---

Proposed Safe Harbor Under Section 475," 29 (July 30, 2003) ("either approach [taking into account or disregarding changes in the dealer's own credit rating] today is considered appropriate under GAAP"). In addition, GAAP permits valuation of physical securities under any of the following methods, so long as it is consistently applied: (i) an average of bid and ask prices, (ii) bid prices for long positions and ask prices for short positions, (iii) some average of price quotations of a representative selection of market makers quoting on a particular financial investment, or (iv) a range of bid and ask prices considered best to represent value in its circumstances. AICPA, "Brokers and Dealers in Securities," section 7.08.

33 We would not permit a taxpayer whose methodology is materially inconsistent with GAAP to satisfy the consistency principle by demonstrating that the taxpayer's valuations resulted in materially the same result as would valuations based on section 475 principles. We believe that the safe harbor would fail its purpose of administrative convenience if it resulted in disputes over actual results under different methodologies.

that is used to satisfy the incentive principle (described below), we believe that the taxpayer should be treated as continuing to satisfy the consistency principle. However, if the taxpayer's accountants (or legal counsel) require an amendment to the financial statement that is used to satisfy the incentive principle, the taxpayer would not satisfy the incentive principle (and would not qualify for the safe harbor), unless the taxpayer amends its tax return to reflect the restated valuations.

C. The Incentive Principle

We agree with the IRS that in order for a taxpayer to be entitled to a conclusive presumption that a valuation reflected on a financial statement is accurate for section 475 purposes, in addition to the methodology being materially consistent with section 475 principles and thereby satisfying the incentive principle, the taxpayer must have a strong incentive to report the values fairly.

We believe that this incentive should exist for any financial statement that is filed with the Securities and Exchange Commission (i.e., a 10-K or the Annual Statement to Shareholders) or submitted to another agency of the federal government if the agency has enforcement powers authorizing it to impose significant economic or other penalties in case of any false or inaccurate disclosure or deceptive practices, to actively investigate violations, and actually enforces its sanctioning powers. We also believe that this incentive should exist for analogous reports filed with the regulatory agencies of foreign and state governments that are reasonably comparable to U.S. agencies and provide for analogous sanctions, and we recommend that the regulations contain a list of these "approved regulators." We believe that taxpayers have a sufficiently great incentive to report accurate valuations to these agencies so that the valuations should be entitled to a conclusive presumption of accuracy for section 475 purposes without the taxpayer being required to demonstrate another nontax business use for the values.

We are concerned that valuations that are not submitted to approved regulators may be more susceptible to manipulation or inaccuracy. Therefore, we would grant taxpayers a rebuttable (but not a conclusive) presumption that the values reported on other certified financials represent fair market value for purposes of section 475 if the taxpayer can demonstrate a significant nontax business use for the valuations that helps to assure their accuracy. Merely submitting the values to a federal, state or foreign regulatory agency other than an approved regulator will generally suffice to demonstrate a significant nontax business use if inaccuracy could give rise to significant civil or criminal sanctions and the filing is indeed subject to meaningful regulatory supervision. Thus, if financial statements are submitted to such a regulatory agency that does not qualify as an approved regulator, the taxpayer would be entitled to a rebuttable presumption of accuracy. It would be helpful if the regulations listed some regulatory agencies that satisfy this standard but do not qualify as approved regulators.

We agree with the IRS that use of the values for meaningful price determinations and risk management are significant nontax business purposes. Meaningful compensation decisions and reports to equityholders and creditors also should qualify as significant nontax business purposes if the taxpayer can establish a meaningful incentive to report values fairly. For example, if a hedge fund provides for periodic redemptions at net asset value, the hedge fund would have a significant non-tax business purpose to report value fairly.[34] However, we recognize that in

[34] In our report on PFICs, we suggested that the following factors tend to indicate that financial statements delivered to shareholders and creditors are reliable, and we believe these factors would also be appropriate for section 475 purposes:

> (i) the statement has been delivered to the company's shareholders and at least a specified number, perhaps 10, of the shareholders (counting any group of shareholders acting in concert as a single shareholder) are not related persons (within the meaning of section 267) to the company or to other shareholders; (ii) the statement was prepared or verified by an independent auditor or administrator; (iii) the company is subject to supervision or

certain circumstances taxpayers may not have a meaningful incentive to report values fairly to equityholders and employees, especially if the persons receiving the reports would benefit from undervaluations by deferring their tax liability.

If a taxpayer is entitled to a rebuttable presumption, the IRS would have the burden of proof to demonstrate that the values are materially inconsistent with section 475 principles.

It may be appropriate to exclude certain illiquid securities or securities denominated in or reflecting hyperinflationary currencies from even a rebuttable presumption if valuations of those securities are not included in financial statements filed with approved regulators, although we have not reached a consensus on this issue. We do believe, however, that the values of all securities (including even illiquid securities and securities reflecting hyperinflationary currencies) that are reflected in financial reports filed with approved regulators should be entitled to a conclusive presumption.

If a taxpayer submits financials to more than one approved regulator and the financials reflect different valuations, we believe that the taxpayer should use the valuations that are most consistent with section 475 principles.[35] However, the taxpayer's choice should be respected if it

---

regulation by a U.S. or foreign government, agency or instrumentality that requires the company to submit a profit and loss statement annually and has enforcement powers authorizing it to impose significant economic or other penalties in case of any false or inaccurate disclosure or deceptive practices, and the profit and loss statement is in fact submitted to or filed with that agency; and (iv) the statement is presented to any creditor that is not related (within the meaning of section 267) to the company or any significant (say, 5 percent) shareholder and that has extended credit to the company in excess of a set dollar amount, say $50 million, or a specified percentage, say 10 percent, of its paid-in capital contributions. New York State Bar Association Tax Section Report on Proposals for Guidance with Respect to Passive Foreign Investment Companies, 2001 WTD 109-41 (June 11, 2001).

35 We understand, however, that there are no significant mark-to-market valuation differences among the various regulatory and financial accounting regimes.

is consistently used for tax purposes and the valuations are not materially inconsistent with valuation for section 475 purposes. The IRS should have the burden of proof to demonstrate that the valuations used by the taxpayer are materially inconsistent with section 475 principles. (All that would be at stake is whether the valuations reflected in the other set of financials should have been used.)

If a taxpayer prepares more than one set of certified financials, each of which reflect different valuations, and uses each of them for significant nontax business purposes but does not submit them to approved regulators, the taxpayer should also use the valuations that are most consistent with section 475 principles. The taxpayer's choice should be respected if it is consistently used for tax purposes and the valuations are materially consistent with valuations for section 475 purposes. However, in this case, the taxpayer would have the burden of proof to demonstrate that the valuations it used were materially consistent with section 475 principles.

As a general matter, despite the statement in the legislative history to section 475 that securities should be valued on an individual basis, we believe that financials reflecting the value of the taxpayer's entire portfolio of securities and derivatives (i.e., "pooling valuation") could be used for section 475 purposes.[36] However, to the extent that a particular security is sold, terminated or offset during the year and the particular security has not been individually reported on a relevant financial statement, although the taxpayer may be entitled to a conclusive or

[36] We understand that the unadjusted mid-market value of each security is calculated on a position-by-position basis, but adjustments to these values are made on a portfolio basis. See Securities Industry Association, "Submission In Response to Advance Notice Regarding Proposed Safe Harbor Under Section 475," 55 (July 30, 2003); International Swaps and Derivatives Association, "Comment Letter Regarding Section 475 Book-Tax Conformity Safe Harbor," 33-34 (August 4, 2003).

rebuttable presumption regarding the value of the pool, the taxpayer should not be entitled to any presumptions regarding the proper basis and sales price (or termination value) of the security.[37]

We recognize that taxpayers will have to make adjustments to their financial statement valuations to account for derivatives that are entered into with related parties that are consolidated for financial reporting purposes because the value of these derivatives will not be reflected on their financials, and for consolidations and deconsolidations within the taxable year.

If a taxpayer reports valuations on financials that entitle the taxpayer to a conclusive or rebuttable presumption, and the valuations so reported constitute a "meaningful amount" of the taxpayer's derivatives, the taxpayer should also be entitled to the same conclusive or rebuttable presumption for derivatives valued under the same methodology, but not reported due to consolidation, or other factors.[38] We have not formulated the threshold for a meaningful amount, but we do believe that an anti-abuse rule would be appropriate to prevent taxpayers from reporting valuations on a de minimis amount of derivatives and then inappropriately claiming the

---

[37] We understand that GAAP requires sub-ledger entries that account for gains and losses of specific positions that are sold, exchanged or terminated during the year. See Securities Industry Association, "Submission In Response to Advance Notice Regarding Proposed Safe Harbor Under Section 475," 55 (July 30, 2003); International Swaps and Derivatives Association, "Comment Letter Regarding Section 475 Book-Tax Conformity Safe Harbor," 34 (August 4, 2003).

[38] We understand that dealers generally determine values for those derivatives entered into with related parties under the same methodology they use for transactions with unrelated parties. See Securities Industry Association, "Submission In Response to Advance Notice Regarding Proposed Safe Harbor Under Section 475," 55 (July 30, 2003); International Swaps and Derivatives Association, "Comment Letter Regarding Section 475 Book-Tax Conformity Safe Harbor," 31 (August 4, 2003) (same methodology used for transactions with unrelated parties, except no credit taken).

As mentioned above, if a taxpayer restates valuations reflected in the financials used to satisfy the incentive principle, and the financials are amended, the taxpayer will not be entitled to the safe harbor unless the taxpayer amends its tax return so that the valuations reported for tax purposes conform to those of the amended financials.

safe harbor for valuations of other derivatives with consolidated parties or that otherwise are not reflected in the financials.

D. Normative Section 475 Valuation Rules

A number of taxpayers will not qualify for the conclusive or rebuttable presumption. We believe that it would be helpful for guidance (such as a Revenue Procedure) to describe an acceptable methodology for valuing derivatives securities under section 475. This guidance will also provide a benchmark under which the consistency principle may be applied. We would recommend, however, that the methodology described in the regulations not be the exclusive methodology, and that the IRS retain significant flexibility to approve of other methodologies or modify the approved methodology.

1. Derivatives.

We suggest that adjusted mid-market values constitute an acceptable methodology for valuing taxpayer's portfolios of derivative positions.[39] More specifically, it would be acceptable

[39] See Bank One, 2003 U.S. Tax Ct. LEXIS at *311-12 ("The parties should determine the fair market value of each of FNBC's swaps and other like derivative products by valuing the derivative at its midmarket value as properly adjusted on a dynamic basis for credit risk and administrative costs."); See also Lee A. Sheppard, "News Analysis — The Bank One Case: Marking to No Market, 2001 TNT 63-4 (March 30, 2001) ("No one disagrees that the mid-market valuation method, which averages bid and asked prices so that pricing can be accomplished using a single yield curve, is an acceptable valuation model.").

In July 1993, The Group of Thirty (the "G-30"), a private, nonprofit, international body made up of representatives from various financial institutions and academia, issued a report, "Derivatives: Practice and Principles," which recommended that derivatives be valued based on the mid-market valuation with adjustments for (i) the credit quality of the dealer's counterparty, (ii) close-out costs, (iii) investing and funding costs, and (iv) administrative costs. See Group of Thirty, "Derivatives Practice and Principles," at Appendix I, 7 (1993). Similar recommendations were made by the Office of the Comptroller of the Currency (the "OCC") in 1993. See Banking Circular 277 (October 27, 1993) ("The best approach is to value derivatives portfolios on mid-market levels less adjustments. Adjustments should reflect expected future costs such as unearned credit spreads, close-out costs, investing and funding costs and administrative costs." The G-30 report and Banking Circular 277 were for a taxpayer to start with the mid-market value of the taxpayer's portfolio of derivative positions determined as of the last business day of each taxable year, and adjust it for (i) imperfections in the taxpayer's mid-market valuation model, (ii) the costs of maintaining positions that are not fully hedged (which include "bid/offer adjustments" for the market risk inherent in a position that is not fully reflected in the mid-market valuation, "liquidity adjustments," for the cost to close out a particular position, "concentration adjustments," for the additional cost to close out a particularly large position),[40] (iii) anticipated and unanticipated losses attributable to a decline in the credit quality of the taxpayer's counterparty (but not the taxpayer's credit quality), (iv) future marginal administrative costs attributable to the portfolio (including the costs of maintaining systems, operational costs (including salaries), due diligence costs, documentary costs, legal costs and the costs of servicing particular contracts (by monitoring compliance and processing payments)), and (v) investing and funding (or "cash management") costs representing the cost of cash flow mismatches in the portfolio.[41]

This methodology is largely consistent with the methodology established by the Tax Court in Bank One. For example, we agree with the Tax Court that adjustments for a

---

cited favorably in the Bank One opinion. See Bank One Corp. v. Commissioner, Nos. 5759-95, 5956-97, 2003 U.S. Tax Ct. LEXIS 13, *99-184 (May 2, 2003).

[40] This adjustment was recommended in the G-30 report. See Group of Thirty, "Derivatives Practice and Principles," at Appendix I, 7 (1993).

[41] If a position is not fully hedged, the securities dealer will be required to invest or borrow cash to manage cash flow mismatches. Mid-market valuation models generally assume that cash positions are loaned or funded at LIBOR flat. However, this simplying assumption should be adjusted for the particular securities dealer's cost of funds. The adjustment should be "dynamic," reflecting changes in the magnitude of the expedited investing/funding requirements and the dealer's costs of funds. See Group of Thirty, "Derivatives Practice and Principles," at Appendix I, 7 (1993), discussed in footnote 33.

counterparty's credit quality should take into account credit enhancements, such as collateral.[42] We also agree that credit adjustments must be made at the end of each year (i.e., adjustments must be "dynamic" rather than "static"). And we agree that the mid-market valuation should be adjusted for the taxpayer's actual marginal administrative costs, and not the taxpayer's fixed costs, and that administrative cost adjustments should reflect the taxpayer's actual marginal administrative costs (rather than hypothetical costs) or the average costs of other taxpayers.

However, we would not adjust the mid-market valuation for changes in the taxpayer's credit quality (as the Tax Court required in Bank One). Although this adjustment may be justifiable as a theoretical matter,[43] current federal income tax law does not generally require (or permit) a taxpayer to mark-to-market its outstanding indebtedness on account of the taxpayer's credit quality (or otherwise). Adjusting derivatives value based on changes in a taxpayer's credit quality would have similar effect and, if required, could cause mismatches of income and expense. We do not believe that the Tax Court's decision requires the IRS to mandate adjustments for changes in a taxpayer's credit quality.[44]

---

42 Bank One, 2003 U.S. Tax Ct. LEXIS at *167-68 ("FNBC's VEP system overstated FNBC's credit exposure in that the system did not consider collateral and other security or the offsetting losses with the same counterparties based on legally enforceable termination and netting rights.")

43 As a matter of theory, the question is whether the "value" of a dealer's portfolio of derivatives is the price that other dealers would pay or the replacement cost to the taxpayer. The price other dealers would pay for the taxpayer's portfolio would not take into account the taxpayer's credit quality. However, replacement cost would. See generally Edward D. Kleinbard, Letter to Dale S. Collinson (October 9, 2002); Edward D. Kleinbard, "Some Thoughts on Market Valuations of Derivatives," 91 Tax Notes 1173 (May 14, 2001); Edward D. Kleinbard, "A Short Course in Valuing Derivatives," 94 Tax Notes 2 (January 21, 2002).

44 We understand that GAAP permits a dealer to take into account its own credit rating in valuing its derivatives, but does not require a dealer to do so. We would not disqualify a

2. Physical Securities.

Some securities dealers value their physical securities based on adjusted mid-market values, but we understand that most major securities dealers treat their physical positions as if they were inventory and value the long positions at the "bid" price and their short positions at the "ask" price.[45]

Valuing physical long positions to bid and physical short positions to ask equates market value with replacement cost and is consistent with a view of dealers as wholesalers.[46]

If a dealer holds a physical security as inventory, valuing the security at bid or ask is consistent with inventory accounting and is justifiable.[47] Although valuing long physical securities at bid and shorts at physical securities at ask tends to defer the dealer's profit until the long position is sold or the short closed out, if the dealer's inventory turns over rapidly, the difference is not material. However, if a dealer holds a physical security as a hedge against a derivative position that is valued at mid-market, valuation of the physical security at bid (for longs) and ask (for shorts) is not justifiable and may result in significant deferral.[48]

---

dealer from the safe harbor if the dealer did take into account its own credit rating in valuing its derivative portfolio.

45 See Securities Industry Association, "Submission In Response to Advance Notice Regarding Proposed Safe Harbor Under Section 475", 22 (July 30, 2003). .

46 In contrast, valuing long and short positions to adjusted mid-market equates market value with retail cost and is more consistent with a dealer's valuation of its derivatives portfolio.

47 Assume that the bid price for a security is and remains $999 and the asking price is $1,000. If a dealer purchased a security for $999, was unable to sell it at year end, bid valuation would not result in the dealer recognizing income.

48 Assume that a dealer enters into a total return swap with respect to an equity security under which the dealer receives a LIBOR-based rate, pays any distributions made on the security and, at maturity, pays any appreciation in excess of the initial ask price of $1,000 and receives any depreciation below the initial ask price of $1,000. The securities dealer hedges its risk under this swap by actually purchasing the security at a bid price of $999. Economically, the dealer has "earned" the $1 difference between ask and bid upon execution

We believe that using the bid price for physical long positions and the ask price for physical short positions is appropriate only for those physical securities that are held as inventory and are not hedged by derivatives. Otherwise, the adjusted mid-market valuation should be used for a dealer's physical securities as well as derivatives.

There is no justification for traders to value their physical positions at bid (for long positions) and ask (for short positions), and therefore we recommend that traders value their physical securities either at "ask" for long securities or "bid" for short securities, or consistently at adjusted mid-market.

E. Scope of Guidance: Application to Securities Trader; Commodities Dealers and Traders, and Other Mark-to-Market Taxpayers

We believe that all taxpayers, including securities traders, commodities dealers and traders, and taxpayers required to mark-to-market securities under sections 1256, 1259, 1260 and 1296, should be entitled to the benefit of the presumptions and the normative guidance. We see no basis to deny the benefit of the safe harbor or any substantive guidance to any particular class of taxpayers.

F. Use of Accelerated Issue Resolution Program and Other Private IRS/Taxpayer Agreements to Resolve Section 475 Valuation Issues

On balance, we endorse use of the IRS's "Accelerated Issue Resolution" program to resolve section 475 valuation issues. We recognize that as a practical matter private IRS/taxpayer agreements (such as those that result from the AIR program) may be available only

---

of the total return swap and purchase of the security but, if the dealer values the physical security at bid and the derivative at mid-market, this spread will be deferred for the entire term of the swap.

to taxpayers with sufficient resources to hire sophisticated advisors, but we believe that private IRS/taxpayer agreements have served as a useful tool for the IRS to gain important industry knowledge, and they allow taxpayers to develop stable and workable procedures. For example, the APA process has been successful. One possible model for taxpayer-specific agreements is "qualified intermediary" ("QI") agreement under which the IRS lists basic rules and the taxpayer and IRS negotiate specific provisions pertaining to the taxpayer.[49] We are, however, concerned about how the agreement process will be implemented so as to be efficient, equitable and speedy. We would anticipate that the knowledge that the IRS gains from the process would be used to refine the section 475 safe harbors and normative rules.

[49] See Rev. Proc. 2003-64; 2003-32 I.R.B. 1.