

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 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.

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