Part III - Administrative, Procedural, and Miscellaneous

Sec. 475 Valuation Safe Harbor

Notice 2008-71

SECTION 1. PURPOSE

This notice requests comments with respect to possible expansion of §1.475(a)-4 of the Income Tax Regulations (safe harbor valuation regulations) so that financial institutions headquartered outside the United States can qualify to make the election described in Treas. Reg. § 1.475(a)-4(b).

SECTION 2. BACKGROUND

On June 12, 2007, the Treasury Department and the Internal Revenue Service (Service) published the safe harbor valuation regulations in the Federal Register (TD 9328; 72 FR 32172; 2007–27 I.R.B. 1). For dealers in securities and for dealers in commodities that elect to mark to market under section 475(e), those regulations provide an elective safe harbor for valuations under section 475. Specifically, if an eligible taxpayer makes the safe harbor election, the values of certain positions that the taxpayer reports on an eligible financial statement in a manner consistent with the requirements of the safe harbor valuation regulations are treated as those positions' fair market values for purposes of section 475. See Treas. Reg. § 1.475(a)-4(b).

Any tax regulatory regime that permits use of values from a financial statement for tax purposes must ensure that the financial accounting regime's standards that are used by taxpayers are consistent with the requirements of applicable sections of the Internal Revenue Code (Code) (in this case section 475). The safe harbor valuation regulations are based on the conclusion that use of financial statement values for tax purposes is justified to the extent that the taxpayer satisfies certain basic criteria:

1. The financial accounting method used in the taxpayer's financial statement must be sufficiently consistent with what section 475 requires for tax purposes (and therefore is an "eligible method," see Treas. Reg. § 1.475(a)-4(d)).

2. The taxpayer's financial statement must have sufficient indicia of reliability to ensure that the taxpayer carefully and consistently follows the financial accounting method being used in the statement (and therefore is an "applicable financial statement," see Treas. Reg. § 1.475(a)-4(h)).

3. The taxpayer's record keeping and record production must enable the Service to verify that the values used for tax purposes were the same as the values

reported on the financial statement; and, when the values to be reported on the tax return are required to incorporate adjustments to the raw values in the financial statement, the taxpayer's record keeping and record production must enable the Service to reconcile the two sets of values.

See generally the preamble to TD 9328 (discussing the broad policies underlying the particular requirements in the safe harbor valuation regulations).

Internationally Headquartered Financial Institutions

Some financial institutions that are chartered outside of the United States and are engaged in a trade or business within the United States (internationally headquartered financial institutions) have commented that certain of the requirements set forth in the safe harbor valuation regulations prevent them from using the safe harbor. The Treasury Department and the Service are considering expanding the regulatory safe harbor if the basic criteria above are satisfied and are requesting comments regarding that expansion.

Two definitions in the current regulations would need to be amended in order to expand the safe harbor valuation regime potentially to include internationally headquartered financial institutions.

Internationally headquartered financial institutions generally prepare financial statements in accordance with the International Financial Reporting Standards ("IFRS"). The definition of "eligible method" (see Treas. Reg. § 1.475(a)-4(d)) excludes non-U.S. GAAP accounting systems by including only accounting methods that determine value in accordance with U.S. GAAP. Therefore, in order for internationally headquartered financial institutions generally to be eligible to use the safe harbor, the definition of eligible method would have to be amended to include IFRS (or more specifically the version of IFRS the U.S. Securities and Exchange Commission (SEC) is considering for adoption).

Second, internationally headquartered financial institutions generally do not prepare financial statements that satisfy the current regulatory requirements for being an "applicable financial statement" (within the meaning of Treas. Reg. § 1.475(a)-4(h)). The definition of "applicable financial statement" requires preparation of the statement in accordance with U.S. GAAP and use of the statement in filings with the SEC or with any agency of the Federal government other than the Service. Internationally headquartered financial institutions generally file complete, non-U.S.-GAAP-based financial statements with a home country supervisor or market regulator, not with a Federal agency other than the Service as required by the safe harbor valuation regulations. Thus, the home country financial statement is not an "applicable financial statement." Therefore, in order for internationally headquartered financial institutions generally to be eligible to use the safe harbor, the definition of applicable financial statement would have to be amended to include non-U.S.-GAAP financial statements

filed with the institution's home country regulator or some other financial statement that is filed by that taxpayer with other appropriate regulatory authorities.

Expansion of the Safe Harbor Valuation Regulations to Include IFRS

The decision whether to expand the definition of "eligible method" to include IFRS (or, more specifically, the version of IFRS ultimately adopted by the SEC) will be based on the criteria identified above that justify use of financial statement values for tax purposes. The current regulatory definition of "eligible method" attempts to ensure that a financial statement may serve as the basis of valuation for tax purposes only if the accounting method used in that statement is sufficiently consistent with the accounting method that section 475 requires for tax purposes. The definition of "eligible method," which requires that an eligible method be a mark-to-mark method, recognizes that the central difference between a mark-to-market and a realization accounting method is that, under the former but not under the latter, the taxpayer's income statement currently accounts for unrealized changes in value. Moreover, in crafting the current safe harbor the Treasury Department and the Service "concluded that the requirements and limitations of the safe harbor ensure sufficient consistency when applied to financial statements prepared according to U.S. GAAP. This conclusion is less clear when the requirements and limitations are applied to financial statements prepared under other accounting regimes." T.D. 9328, 72 FR 32172, 32176; 2007–27 I.R.B. 1, 5.

The Treasury Department and the Service continue to evaluate the issue of whether to expand the definition of "eligible method" to include IFRS and are therefore interested in comments on the differences between U.S. GAAP valuation standards and those in IFRS, especially differences between mark-to-market valuation under IFRS and under U.S. GAAP (including whether IFRS permits voluntary adoption of alternative valuation standards).

Understanding these differences is necessary in evaluating whether any IFRS standards are sufficiently consistent both with the three criteria described above that underlie the safe harbor and with the policies of other sections of the Code and the Regulations (e.g., section 861 and Treas. Reg. § 1.882-5) that rely on asset values determined under section 475. For example, if a financial accounting method arrives at a value by including funding costs (including any management allocation of expenses) or permits those costs to be taken into account pursuant to a voluntary convention, allowing that method might significantly erode the policies of other sections of the Code and the Regulations.

Expansion of "Applicable Financial Statement"

The decision whether to expand the definition of "applicable financial statement" likewise will be based on the criteria identified above that justify the use of financial statement values for tax purposes. Many internationally headquartered financial institutions file a U.S. GAAP-based balance sheet (a "call report") with a United States bank regulator. Some commentators have urged that this financial statement be

permitted to be an “applicable financial statement’ to the extent that the other requirements of the regulations are satisfied. This partial financial statement does not satisfy the current regulatory requirements of the safe harbor. In particular, this partial financial statement does not contain an income statement and, as a result, changes in the values of the taxpayer’s positions are not currently reflected in income. The partial financial statement, therefore, does not employ an “eligible method,” and so the values reported on that partial statement are not eligible to be used in the safe harbor. It has been suggested, however, that when a taxpayer files a U.S. GAAP-based call report with a U.S. bank regulator and the values on the call report correspond to the values on the taxpayer’s home country IFRS-based financial statements that include an income statement, these circumstances should nevertheless satisfy the definition of an “applicable financial statement” to the extent that the other requirements of the regulations are satisfied.

This suggestion raises the question whether the basic criteria described above would be satisfied by the combination of a call report filed with a U.S. regulator and the reporting party’s home country income statement. In order for this to be the case, the mark-to-market method in the home country income statement would have to be an eligible method and the filing with a U.S. regulator would have to give the statement sufficient indicia of reliability that the financial accounting method is being carefully and consistently followed. In expressing uncertainty whether non-U.S.-GAAP financial statements satisfy the criteria underlying the regulations, the preamble to the final regulations asked a number of questions to solicit public comment. TD 9328, 72 FR at 32176; 2007–27 at 5. The Treasury Department and the Service continue to welcome answers to those questions.

SECTION 3. REQUEST FOR COMMENTS

In particular, to aid in the consideration of whether to expand the safe harbor valuation regulations so that internationally headquartered financial institutions can make the safe harbor valuation election, the Treasury Department and the Service request answers to the following questions:

1. If the existing regulatory requirements discussed above were expanded to permit internationally headquartered financial institutions to make the election described in Treas. Reg. § 1.475(a)-4(b), are a significant number of these institutions likely to make the election?

2. If the safe harbor were expanded to include circumstances where the values reported in the U.S. call report of a foreign bank are the same values that are reported in a mark-to-market income statement filed in the bank's home country, how will the Service be able to match the values used for tax purposes with those on the home country income statement?

3. What is the relationship between the call report and the home-country income statement? Are there foreign currency translation considerations between the

two? How might those be resolved so that the Service can effectively and efficiently audit the records?

4. If the definition of "applicable financial statement" is expanded, should the applicable financial statement be the one filed by the foreign bank with its home country bank regulator rather than with a home country market regulator (like the SEC)?

5. How, if at all, does mark-to-market valuation under IFRS take expenses into account, including funding costs or any similar amount (e.g., cost of carry)?

    a. Does IFRS allow these amounts to be taken into account pursuant to a voluntary accounting convention under any circumstances?

    b. What regulatory amendments, if any, should be considered if those costs are taken into account, keeping in mind the interaction of section 475 with other sections of the Code and Income Tax Regulations (e.g., section 861 and Treas. Reg. § 1.882-5)?

6. In what circumstances is section 475 relevant for other purposes of the Code and in what circumstances do the policies of other sections of the Code and the Regulations that rely on asset values determined under section 475 (including those determined pursuant to an election under Treas. Reg. § 1.475(a)-4(b)) require special adjustment to the amount determined under section 475?

7. Should the definition of "eligible method" go beyond the accounting methods that the SEC has accepted? If so, what is an appropriate (and administrable) framework for evaluating whether such a method complies with the basic criteria outlined above?

SECTION 4. INSTRUCTIONS

Comments should be submitted on or before November 1, 2008, and should include a reference to Notice 2008-71. Send submissions to CC:PA:LPD:PR (Notice 2008-71), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8:00 a.m. and 4:00 p.m. to CC:PA:LPD:PR (Notice 2008-71), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224, or sent electronically via the following email address: Notice.Comments@irscounsel.treas.gov. Please include the notice number 2008-71 in the subject line of any electronic communication. All materials submitted will be available for public inspection and copying.

DRAFTING INFORMATION

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