



Securities Industry Association

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**SUBMISSION REGARDING RECORD RETENTION AND PRODUCTION
REQUIREMENTS IN PROPOSED REGULATIONS ESTABLISHING BOOK/TAX
CONFORMITY SAFE HARBOR UNDER SECTION 475**

The Securities Industry Association's (the "SIA's")¹ Committee on the Federal Taxation of the Securities Industry appreciates the opportunity to comment on the proposed regulations recently issued by the Internal Revenue Service (the "IRS") under section 475 of the Internal Revenue Code of 1986, as amended (the "Code").²²

¹ The Securities Industry Association brings together the shared interests of more than 550 securities firms to accomplish common goals. SIA's primary mission is to build and maintain public trust and confidence in the securities markets. SIA members (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance. According to the Bureau of Labor Statistics, the U.S. securities industry employs nearly 800,000 individuals, and its personnel manage the accounts of nearly 93-million investors directly and indirectly through corporate, thrift, and pension plans. In 2004, the industry generated an estimated \$227.5 billion in domestic revenue and \$305 billion in global revenues. (More information about SIA is available at: www.sia.com.)

² Unless indicated otherwise, all section references in this letter are to the Code, or to Treasury regulations promulgated thereunder.

³ Specifically, proposed Treasury regulation section 1.475-4(c), provides that "eligible taxpayers" (i.e., taxpayers eligible to avail themselves of the safe harbor) include securities dealers, OTC derivatives dealers, commodities dealers, and traders electing mark-to-market treatment under section 475(f). The comments contained in this letter, however, relate primarily to the treatment of securities dealers and OTC derivatives dealers, who constitute the membership of the SIA.

The proposed regulations would, if finalized, provide an elective “book/tax conformity safe harbor” for dealers in securities and over-the-counter (“OTC”) derivatives,³ pursuant to which such dealers would be allowed to mark their open positions to market for U.S. federal income tax purposes using the same values that the dealers use when marking the positions to market on an “applicable financial statement” for financial accounting, regulatory, and other core business purposes. For SIA member firms that are public companies in the United States, the terms of the safe harbor effectively require consistency between values reflected on the dealer’s U.S. federal income tax returns and the dealer’s financial statements filed with the U.S. Securities and Exchange Commission (the “SEC”).⁴

As an initial matter, we would like to commend the IRS for issuing the proposed regulations, and for its sustained commitment to the development of a workable book/tax conformity safe harbor. As discussed in previous SIA submissions, we believe that a book/tax conformity safe harbor is a necessary means of providing a streamlined, effective and accurate process for auditing compliance with section 475,⁵ and the proposed regulations, which represent the fruits of an ongoing dialogue between the IRS and the dealer community over many years, are a very welcome development. Accordingly, although we believe that certain aspects of the proposed regulations need to be changed, our comments are offered in the context of our overall agreement with the approach taken in the proposed regulations, our appreciation of the

⁴ See proposed Treasury regulation section 1.475-4(h) (requiring consistency between tax values and values reported on financial statements filed with the SEC where such financial statements exist).

⁵ See, e.g., “Submission in Response to Advance Notice Regarding Safe Harbor Under Section 475,” submitted by the SIA to the IRS on July 30, 2003 pursuant to the IRS “Advance Notice of Proposed Rulemaking: Safe Harbor for Satisfying Statutory Requirements for Valuation under Section 475 for Certain Securities and Commodities,” 68 Federal Register 23,632 (May 5, 2003).

effort required to produce the proposed regulations, and our desire for a workable book/tax conformity safe harbor to be implemented as soon as practicable.

This submission comments on certain administrative requirements in the proposed regulations relating to the retention and production of documents by taxpayers. Specifically, our comments fall generally into three categories: (i) the scope of information required to be presented by taxpayers to the IRS in order to demonstrate compliance with the book/tax conformity safe harbor, (ii) the time frame for providing such information to the IRS, and (iii) issues relating to value adjustments that are made on a portfolio basis (as opposed to a position-by-position basis). In addition to this submission, the SIA intends to make a second submission to the IRS commenting on certain substantive requirements contained in the proposed regulations, (e.g., requirements regarding which types of valuation methods are acceptable for purposes of the safe harbor and which types of financial statements are acceptable).

Our comments are set forth under the three headings immediately below:

1. Scope of Information Required.

In setting forth the scope of information that a taxpayer must provide to the IRS in order to demonstrate compliance with the book/tax conformity safe harbor, proposed Treasury regulation section 1.475-4(k)(2)(A) provides the following general rules:

“An eligible taxpayer [*i.e.*, a taxpayer eligible to use the book/tax conformity safe harbor] must provide reconciliation schedules between the applicable financial statement for the taxable year and Federal income tax return for that year. The required reconciliation schedules include all supporting schedules, exhibits, computer programs and any other information used in producing the values and schedules, documentation of rules and procedures governing determination of the values.”

The above-quoted formulation has caused two basic concerns for SIA member firms. First, by requiring *any* information that was used in determining the relevant values, the formulation is open-ended to the point where taxpayers may have difficulty determining the scope of their obligations.

As a general matter, many of our members expect that they will need to effect significant institutional changes to their internal systems and procedures for capturing and compiling data in order to ensure compliance with the safe harbor's record-keeping requirements, and it will be difficult to conduct such a project productively without a clearer definition of the project's parameters. In this regard, we acknowledge that proposed Treasury regulation section 1.475-4(k)(5) provides that a taxpayer may enter into a written agreement with the IRS to define the scope of the taxpayer's record-keeping obligations more precisely, and we expect that many taxpayers will attempt to take advantage of this provision. As discussed in more detail below, however, we nonetheless believe that a taxpayer's obligations in the absence of such a written agreement need to be defined more specifically.

Second, the references to "computer programs," "information used in producing the values" and "documentation of rules and procedures governing determination of the values" appear to indicate an intention on the part of the IRS to conduct substantive audits of the appropriateness of a taxpayer's valuation models — as opposed to audits designed to resolve the narrower questions of: (i) whether the values used in the preparation of the taxpayer's tax returns are consistent with the values used in the preparation of the relevant applicable financial statements and (ii) whether those values comply with the other requirements of the safe harbor (e.g., the

requirements that the values be calculated at least annually, and that changes in the values give rise to a recognition of income or loss).⁶

Such an intention to conduct audits on the substance of a taxpayer's valuation methodology— if that in fact is the IRS's intention — would undermine the overarching purpose of the book/tax conformity safe harbor. The purpose of the book/tax conformity safe harbor, as we understand it, is to achieve an administrable audit process under section 475 by *accepting* a taxpayer's valuations, but only on the condition that the taxpayer demonstrate the trustworthiness of the valuations by showing that the valuations are reported consistently for both tax and significant non-tax purposes. We are therefore concerned that an attempt to expand the scope of the audit process to include a substantive review of a taxpayer's valuation methodology will result ultimately in an abandonment of the principles underpinning the book/tax conformity safe harbor and lead to exactly the kinds of disputes that necessitated the creation of the safe harbor in the first place.

In addition, if the reference to “computer programs” in the above-quoted language is intended to refer to a taxpayer's valuation models, there is a significant logistical constraint that could prevent taxpayers from being able to comply with an audit request to produce the specific valuation models used to prepare a specific tax return. Dealers in securities and OTC derivatives spend millions of dollars each year developing and refining their valuation models, and such models are accordingly in an almost-continual state of evolution. As a result, the model used by a dealer in a given year (or, for that matter, month) may *not* be identical to the model used by the dealer in

⁶ See proposed Treasury regulation section 1.475-4(d)(2).

any other year (or month). Given the complexity of the models and the costs of maintaining them, however, many OTC derivatives dealers simply do not save or maintain out-of-date versions of their valuation models. Therefore, if, in an audit, the IRS were to request an OTC derivatives dealer to provide a copy of the valuation model used to produce numbers for a previous year's tax return (or, even worse, an earlier tax return), the dealer effectively may be required to *recreate* an out-of-date version of its model in order to comply. Such a process would be costly and burdensome, and is not a practical option.

For all of the reasons set forth above, we believe that the proposed regulations should be amended to clarify that the scope of information required from taxpayers upon an audit of compliance with the book/tax conformity safe harbor does *not* extend to an extensive substantive review of a taxpayer's valuation methodology. Rather, the information required from taxpayers should be limited to that information necessary to establish book/tax conformity, and to establish that the taxpayer's valuations meet the requirements of the safe harbor (such as the requirement that values be determined at least annually). In attempting to determine the precise information that taxpayers should be required to produce upon audit, we believe that it is instructive to consider the experience of the "Accelerated Issue Resolution" program (the "AIR Program") that the IRS conducted with volunteer firms in order to determine the feasibility of auditing compliance with a book/tax conformity safe harbor.

In the AIR Program, the participating firms were required to provide documentation to the IRS describing the information flows through which values generated by the relevant valuation models were fed into various intermediate reports

and subjected to various levels of review and systems controls before ultimately appearing on a firm's financial statements and tax returns. The participating firms also demonstrated that it is possible to "tie" values appearing on a financial statement to the values appearing on the tax return (and vice versa) in such a manner that the IRS could determine whether the values were being reported consistently.

We believe that information of this type — *i.e.*, information demonstrating how values are *used* rather than how they are *produced* — would be more useful for determining compliance with the book/tax conformity safe harbor and more consistent with the scope of audits envisioned under the AIR Program than would detailed information regarding the substance of the relevant taxpayer's valuation model. In addition, taxpayers should be able to provide information concerning the use of their values to the IRS on audit within a reasonable time frame. We therefore suggest that the above-quoted formulation be amended to read as follows:

"An eligible taxpayer must provide reconciliation schedules between the applicable financial statement for the taxable year and Federal income tax return for that year. The required reconciliation schedules include all supporting schedules, exhibits, information regarding the flows of information within a taxpayer's reporting systems and any other information necessary to establish that the values reflected on the applicable financial statement are consistent with the values appearing on the Federal income tax return, and that such values meet the requirements set forth in paragraph (d)(2) of this section."

We believe that this alternative formulation would address the issue discussed above concerning the open-endedness of the current formulation, and would be consistent with the goal of using book/tax conformity as a means of avoiding the complications and difficulties inherent in a substantive audit of specific valuation models.

2. *Time Frame For Responding to Information Requests.*

The proposed regulations currently require that taxpayers produce documents for the IRS within 30 days of a request, unless the IRS grants a written extension. Although we recognize that a 30-day period is typical for IRS audit requests, we believe that such a period may prove to be insufficient for purposes of an audit of compliance with the book/tax conformity safe harbor. Specifically, many of our members believe that much of the information likely to be requested by an audit agent (such as the specific flow of a given valuation from the model to the financial statement and tax return) will be too complex, and place too great a burden on a taxpayer's internal systems, for taxpayers and the IRS to be assured that such information will be available within the 30-day period. Based on the time periods that were required for participants in the AIR Program to generate similar information for the IRS, we believe that a 60-day period would generally be sufficient.

3. *Requirement of Values for Individual Positions.*

Proposed Treasury regulation section 1.475(a)-4(k)(2)(B) requires that a taxpayer's "book and records must state the value used for each eligible position separately from the value used for any other eligible position," but then provides that "an eligible taxpayer may make adjustments to values on a pooled basis, if the taxpayer demonstrates that it can compute gain or loss attributable to the sale or other disposition of an individual eligible position." We understand the purpose of this requirement to be to ensure that valuation adjustments made by taxpayers on a pooled basis (so-called "portfolio valuation adjustments") in fact relate to the specific terms and characteristics of the individual positions of the portfolio, and do not constitute some sort of "general reserve" account that could be applied arbitrarily to any collection of

positions or that could give rise to a double-counting of risks or of other factors affecting the value of a portfolio. Although we have no quarrel with such a purpose, we believe that the above-quoted language is not the most effective means of achieving that purpose.

The requirement that taxpayers be able to demonstrate that they could compute gain or loss with respect to each individual position poses several difficulties, which ultimately result from the fact that the requirement does *not* relate to the question of book/tax conformity, but instead relates the substantive content of taxpayer valuation models and thus raises all of the difficulties inherent in an audit of a valuation model. As an initial matter, we wish to note that dealers of OTC derivatives and securities dealers routinely make portfolio valuation adjustments in order to take account of the synergies (or negative synergies) arising from a *combination* of positions and risks held within a given portfolio (e.g., increased exposures to various types of risk resulting from a combination of different positions). For this reason, if the proposed regulations are intended to require that taxpayers allocate a portfolio valuation adjustment among individual positions on some sort of *pro rata* basis, such an allocation — although technically feasible — would be artificial and arbitrary.

For example, a position requiring a taxpayer to take exposure to a certain kind of risk may be more or less valuable to the taxpayer, depending on the taxpayer's current levels of exposure to the risk in question through other positions in a portfolio. In other words, the value of one position is affected by the characteristics of the *other positions* in the portfolio. If, as a result of adding a new position to the portfolio, the taxpayer were to cause the portfolio's total exposure to the risk in question to increase

over a certain threshold and thus give rise to a portfolio valuation adjustment, it would be arbitrary to allocate this portfolio valuation adjustment among the individual risk positions. The combination of positions in this example produced the increased risk exposure, but no single position on a stand-alone basis would have required a special risk adjustment. Similarly, if yet another position were added to the portfolio that served as a partial hedge to the risk in question (and thus caused a decrease in the previous portfolio valuation adjustment), we see no principled method for determining whether the net reduction in risk should be added to the new position's value (reflecting the new position's contribution to the value of the portfolio as a whole) or to the value of the other hedged positions (reflecting the fact that they no longer create risk for the taxpayer at the same levels).

Because an allocation of certain types of portfolio valuation adjustments among various individual positions would be arbitrary to a large degree, such an allocation would *not* further the purpose of demonstrating that portfolio valuation adjustments in fact relate to the specific characteristics of the individual positions in a portfolio. The arbitrary allocation of an adjustment among individual positions in a portfolio could be performed in the case of the "general reserve" account referred to above just as easily as in the case of a legitimate portfolio valuation adjustment.⁷

⁷ As a theoretical matter, the proper method of showing the impact of an individual position on the overall value of a portfolio would be to calculate the portfolio's value, and then to recalculate the portfolio's value plus or minus the position. On a practical level, however, such an approach would be unworkable. Dealer portfolios typically consist of many thousands of positions, which are constantly changing, and portfolio valuation adjustments are often made much less frequently than on a daily basis (e.g., on a monthly basis). It would therefore be extremely burdensome as a practical matter to require a dealer to recreate a portfolio as of a specific date (perhaps many years in the past) and then to isolate the impact of one specific position on that portfolio's value. The burden would be exacerbated by the fact that, as discussed above, valuation models are in a state of almost-constant revision, and many dealers do not maintain out-of-date versions of the models. Therefore, a dealer might not be able to perform such a comparison using the exact model that gave rise to the original valuation.

An alternative to requiring taxpayers to allocate portfolio valuation adjustments among individual positions — and the alternative that we believe would be the most administrable means of effectively ensuring the legitimacy of portfolio valuation adjustments — would be for the IRS to require taxpayers simply to document the various individual elements in a portfolio that gave rise to a portfolio valuation adjustment. For example, a taxpayer making a portfolio valuation adjustment in respect of a certain type of risk could be required to document the various specific risk exposures within the portfolio that gave rise to the adjustment. Similarly, if a position that was taken account of in determining a portfolio valuation adjustment were later removed from the relevant portfolio, the taxpayer could be expected to be able to demonstrate through its records that the removed position ceased to be included in the portfolio valuation adjustment calculations following the position's removal.

Records of the type described immediately above were provided to the IRS as part of the AIR program, and we believe the IRS was satisfied that such records could serve as a basis for establishing the legitimacy of portfolio valuation adjustments. Furthermore, because such records are routinely provided by OTC derivatives dealers and securities dealers to their auditors, we believe that our member firms generally would be able to maintain and produce records supporting the portfolio valuation adjustments without undergoing an unreasonable burden. Such a requirement, however, would merely be a requirement to maintain documentation establishing the economic justification of a portfolio valuation adjustment, and would not force a taxpayer to demonstrate that it “can compute gain or loss attributable to the sale or other disposition of an individual eligible position.” As a result, if the IRS were to adopt this

approach, we believe that the current language of the proposed regulations would need to be amended. One possible alternative formulation would be for the taxpayer to “demonstrate that such adjustments made on a pooled basis are in fact attributable to the characteristics of the individual positions making up the pool at the time the adjustment is made.”

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Thank you for your consideration of our views. Please do not hesitate to contact Patti McClanahan, Vice President and Director for Tax Policy at the SIA (202-216-2031), or Edward Kleinbard of Cleary, Gottlieb, Steen & Hamilton, SIA's outside counsel on this matter (212-225-2480), if we can be of assistance with respect to any aspect of your ongoing work.