



Section 475 update

Bank & Capital Markets Tax Institute

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Statutory scheme of valuation requirement

- ▶ Any security that is inventory in the hands of a dealer shall be included in inventory at its fair market value (section 475(a)(1)).
- ▶ Other securities for which the election is in effect and held by a dealer at the end of the year and result in gain or loss as if such a security were sold for its fair market value at the end of the year (section 475(a)(2)).
- ▶ The term “fair market value” is not defined in the statute.
- ▶ Valuation requirement generally results in ordinary income or loss.

Legislative history

▶ Language from the Conference Report:

The conference agreement does not provide any explicit rules mandating the valuation methods that must be used for purposes of applying the mark-to-market rules. However, the conferees expect that the United States Department of the Treasury will authorize the use of valuation methods that will alleviate an unnecessary compliance burden for taxpayers and clearly reflect income for federal income tax purposes.

Impact of Bank One litigation

- ▶ The Tax Court concluded that section 446 principles apply to section 475 valuation methodologies
- ▶ The Seventh Circuit further held:

The method of determining “fair market value” under section 475 falls within the definition of “method” of accounting (as that term is used in section 446).

- ▶ Burden on taxpayers to establish clear reflection of income
- ▶ Potential method-change requirements

Development of safe harbor regulations

- ▶ 5 May 2003: Advance Notice of Proposed Rulemaking
- ▶ 2003: Accelerated Issue Resolution Program initiated
- ▶ 24 May 2005: Notice of Proposed Rulemaking
- ▶ 15 September 2005: public hearing
- ▶ 2 July 2007: final regulations published

Valuation safe harbor (section 1.475(a)-4)

- ▶ Where applicable, a dealer may elect to use the value of positions reported on its applicable financial statement as the fair market value of those positions for purposes of section 475.
- ▶ The safe harbor is based on the principle that if the mark-to-market method used for financial statement purposes is sufficiently consistent with the mark-to-market method required by section 475, then the values used for financial reporting purposes should be acceptable values for purposes of section 475.

Eligible method requirements

- ▶ The method must mark positions to market through year-end valuations.
- ▶ The method must cause gains/losses to be recognized into income on the income statement (for example, not through OCI).
- ▶ The method must cause built-in gain or loss at disposition to be recognized into income on the income statement.
- ▶ The method must use a valuation method in accordance with US GAAP.

Limitations on safe harbor applicability

- ▶ Bid-ask method: except for exchange-traded positions, the valuation method must not generally permit values at or near the bid or ask values; an acceptable method consistently produces values that are closer to the mid-market values than they are to the bid or ask values.
- ▶ Valuations based on present values of projected cash flows: must not take into account cash flows attributable to time on or before the valuation date.
- ▶ Accounting for costs and risks: no cost or risk may be accounted for more than once.
- ▶ Other examples of book-tax nonconformity

Transfers within consolidated group

- ▶ Treas. Reg. Sec. 1.1502-13(c)(7)(ii) Ex. 11
- ▶ Transfer of security from dealer to non-dealer
 - ▶ Non-dealer continues with mark-to-market method.
 - ▶ Character can differ under section 475(d)(3).
- ▶ Transfer of security from non-dealer to dealer
 - ▶ Mark-to-market requirement applies only to changes in value after transfer.
 - ▶ Non-dealer's gain or loss is triggered upon a disposition by dealer.
 - ▶ Again, the character can differ under section 475(d)(3).

SIFMA/IRS education session and follow-up

- ▶ Held on 22 April 2010
- ▶ Subsequent discussions between SIFMA members and Walter Harris' staff
- ▶ Subsequent educational session with Walter Harris (IRS Director Financial Services) and his staff
- ▶ Subsequent meetings with IRS Chief Counsel (Financial Institutions and Products) staff

Section 475 IDD-related to MTM valuation

- ▶ LB&I examiners “should not challenge” tax values that follow values used on a “qualified financial statement.”
- ▶ A qualified financial statement is a financial statement “required to be filed with the SEC.”
- ▶ Certification statement required upon request indicating tax values equal book values, no schedule M regarding value and no DTAs, DTLs or valuation allowances regarding value.
- ▶ Record retention: taxpayers should retain the underlying valuation documentation to allow IRS to reconcile book values with tax values.

Frequently asked questions for section 475 IDD

- ▶ FAQ (1) clarifies that schedule Ms are ok if they are “not related to any inconsistencies in value... .”
- ▶ FAQ (2) clarifies that the IDD applies to a taxpayer that has securities subject to section 475 for tax purposes but not reflected anywhere on the qualified financial statements at fair value. These securities are subject to normal examination procedures, but the taxpayer is otherwise eligible for the IDD.
- ▶ FAQ (3) clarifies that a taxpayer that fails to have tax values must follow book values for any securities is ineligible for the IDD for all of its securities.

Statutory scheme of section 475(e)

- ▶ In the case of a dealer in commodities who elects the application of section 475(e), section 475 applies to commodities held by such dealer in the same manner as this section applies to securities held by a dealer in securities.
- ▶ The term “commodity” includes any commodity actively traded the meaning of section 1092(d)(1); any NPC with respect to any commodity; any evidence of an interest in, or a derivative instrument in, any commodity; and any position that is not a otherwise a commodity but is a properly identified hedge with respect to such a commodity.

CCA 201132021 regarding dealers in commodities under 475(e)

- ▶ Confirms certain aspects of election
 - ▶ Entity-by-entity scope
 - ▶ Either buying *or* selling activities can be sufficient to be a dealer
 - ▶ Active trading need not be on an exchange
- ▶ Discusses natural gas, electricity and water (and contractual interests therein) as commodities
- ▶ Concludes that agreement to sell electricity based on cost of services is not a “commodity”

Statutory scheme of section 475(f)

- ▶ A trader in securities who elects section 475(f) recognizes gain or loss on any security held in connection with such trade or business at the close of any taxable year as if such security were sold for its fair market value on the last business day of such taxable year.
- ▶ Rules similar to the rules of subsections (b)(4) and (d) shall apply to securities held by a trader in securities with respect to which a section 475(f) election is in effect.

Elections for traders under 475(f)

- ▶ Eligibility for election
 - ▶ Engaged in “a trade or business as a trader”
 - ▶ Securities or commodities “held in connection with such trade or business”
- ▶ Making the election
 - ▶ Rev. Proc. 2008-52 – statement filed by due date for original return for preceding year
 - ▶ Late election possible, depending on the circumstances
- ▶ Changing the election
 - ▶ Consent to change in method of accounting possible, depending on the circumstances