or more (adjusted annually for inflation) in any one year.'' The current threshold after adjustment for inflation is $122 million, using the most current (2005) Implicit Price deflator for the Gross Domestic Product. FDA does not expect this final rule to result in any 1-year expenditure that would meet or exceed this amount.

VII. Federalism

FDA has analyzed this final rule in accordance with the principles set forth in Executive Order 13132. FDA has determined that the rule does not contain policies that have substantial direct effects on the States, on the relationship between the National Government and the States, or on the distribution of power and responsibilities among the various levels of government. Accordingly, the agency has concluded that the rule does not contain policies that have federalism implications as defined in the order and, consequently, a federalism summary impact statement is not required.

VIII. Paperwork Reduction Act of 1995

This final rule contains no collections of information. Therefore, clearance by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1995 (PRA) is not required. Elsewhere in this issue of the **Federal Register**, FDA is publishing a notice of availability of the guidance document entitled ''Class II Special Controls Guidance Document: Intervertebral Body Fusion Devices.'' The notice contains the PRA analysis for the guidance.

IX. References

The following reference has been placed on display in the division of Dockets Management (see **ADDRESSES**) and may be seen by interested persons between 9 a.m. and 4 p.m., Monday through Friday.

1. Orthopedic and Rehabilitation Devices Panel Meeting Transcript, pp. 1–141, December 11, 2003.

List of Subjects in 21 CFR Part 888

Medical devices.

■ Therefore, under the Federal Food, Drug, and Cosmetic Act, and under authority delegated to the Commissioner of Food and Drugs, 21 CFR part 888 is amended as follows:

PART 888—ORTHOPEDIC DEVICES

■ 1. The authority citation for 21 CFR part 888 continues to read asfollows:

Authority: 21 U.S.C. 351, 360, 360c, 360e, 360j, 371.

■ 2. Section 888.3080 is added to subpart D to read as follows:

§ 888.3080 Intervertebral body fusion device.

(a) *Identification.* An intervertebral body fusion device is an implanted single or multiple component spinal device made from a variety of materials, including titanium and polymers. The device is inserted into the intervertebral body space of the cervical or lumbosacral spine, and is intended for intervertebral body fusion.

(b) *Classification.* (1) Class II (special controls) for intervertebral body fusion devices that contain bone grafting material. The special control is the FDA guidance document entitled ''Class II Special Controls Guidance Document: Intervertebral Body Fusion Device.'' See § 888.1(e) for the availability of this guidance document.

(2) Class III (premarket approval) for intervertebral body fusion devices that include any therapeutic biologic (e.g., bone morphogenic protein). Intervertebral body fusion devices that contain any therapeutic biologic require premarket approval.

(c) *Date premarket approval application (PMA) or notice of product development protocol (PDP) is required.* Devices described in paragraph (b)(2) of this section shall have an approved PMA or a declared completed PDP in effect before being placed in commercial distribution.

Dated: May 31, 2007.

Linda S. Kahan,

Deputy Director, Center for Devices and Radiological Health.

[FR Doc. E7–11240 Filed 6–11–07; 8:45 am]

BILLING CODE 4160–01–S

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9328]

RIN 1545–BB90

Safe Harbor for Valuation Under Section 475.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document sets forth an elective safe harbor that permits dealers in securities and dealers in commodities to elect to use the values of positions reported on certain financial statements as the fair market values of those positions for purposes of section 475 of the Internal Revenue Code (Code). This safe harbor is intended to reduce the compliance burden on taxpayers and to improve the administrability of the valuation requirement of section 475 for the IRS.

DATES: *Effective Date:* These regulations are effective on June 12, 2007.

Applicability Dates: Section 1.475(a)–4, concerning a safe harbor to use applicable financial statement values for purposes of section 475, applies to taxable years ending on or after June 12, 2007.

FOR FURTHER INFORMATION CONTACT: Marsha A. Sabin or John W. Rogers III (202) 622–3950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1945. Comments on the accuracy of the estimated burden and suggestions for reducing the burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224.

The collection of information in these regulations is in § 1.475(a)–4(f)(1) and § 1.475(a)–4(k). This information is required by the IRS to avoid any uncertainty about whether a taxpayer has made an election and to verify compliance with section 475 and the safe harbor method of accounting described in § 1.475(a)–4(d). This information will be used to facilitate examination of returns and to determine whether the amount of tax has been calculated correctly. The collection of the information is required to properly determine the amount of income or deduction to be taken into account. The taxpayers providing this information are sophisticated dealers in securities or commodities.

Estimated total annual recordkeeping burden: 49,232 hours.

Estimated average annual burden per recordkeeper: 4–6 hours.

Estimated number of recordkeepers: 12,308.

Estimated frequency of recordkeeping: Annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

Books and records relating to the collection of information must be

retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to 26 CFR Part 1 under section 475 of the Internal Revenue Code (Code). Section 475 was added to the Code by section 13223(a) of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 312). Section 475(a) generally provides that the securities held by dealers in securities must be valued as of the last business day of the year at fair market value. Section 475(e) allows dealers in commodities to elect similar treatment for their commodities. Under section 475(f), if a person is engaged in a trade or business as a trader in securities or a trader in commodities, the person may elect for the section 475 mark-to-market regime to apply to their trade or business.

Section 475(g) directs the Secretary to prescribe regulations that may be necessary or appropriate to carry out the purposes of section 475. The legislative history of section 475 indicates that, under this authority, the Secretary may issue regulations to permit the use of valuation methodologies that reduce the administrative burden of compliance on the taxpayer but clearly reflect income for Federal income tax purposes. On May 5, 2003, the Treasury Department and the IRS published in the **Federal Register** an advance notice of proposed rulemaking (Safe Harbor for Satisfying Certain Statutory Requirements for Valuation under Section 475 for Certain Securities and Commodities) (REG–100420–03) [68 FR 23632] (the ANPRM); Announcement 2003–35, 2003–1 CB 956 (see § 601.601(d)(2)). The ANPRM solicited comments on whether a safe harbor approach using values reported on an applicable financial statement for certain securities may be used for purposes of section 475. On May 24, 2005, the Treasury Department and the IRS published in the **Federal Register** a notice of proposed rulemaking (Safe Harbor for Valuation under Section 475) (REG–100420–03) [70 FR 29663] (the NPRM). The NPRM set forth a possible safe harbor for valuing these securities and asked for comments on various aspects of the safe harbor. A public hearing was held on September 15, 2005. The IRS received written and electronic comments responding to the NPRM. After consideration of all comments, the proposed regulations are adopted as amended by this Treasury decision. The amendments are discussed in this preamble.

Explanation of Provisions and Summary of Contents

Overview

Section 475(a) requires dealers in securities to mark their securities to market. Section 475(e) allows dealers in commodities to elect similar treatment for their commodities. If the security or commodity is inventory, it must be included in inventory at its fair market value. If it is not inventory and is held at the end of the taxable year, gain or loss is recognized as if the security or commodity had been sold for its fair market value on the last business day of the taxable year.

Although the term ''fair market value'' has a long-standing and well-established meaning within the tax law, it is sometimes difficult to determine the fair market value of certain securities and commodities. This has impeded the efficient administration of the mark-to-market system under section 475. Consequently, with a view to improving the administrability of the valuation requirements of section 475, the Treasury Department and the IRS issued the NPRM, which set forth a safe harbor for valuing securities and commodities under section 475.

These final regulations adopt the approach of the NPRM with the modifications discussed in this preamble.

Underlying Principles of the Safe Harbor

The safe harbor generally permits eligible taxpayers to elect to have the values that are reported for eligible positions on certain financial statements treated as the fair market values of those eligible positions for purposes of section 475, if certain conditions are met. The safe harbor is based upon the principle that if the mark-to-market method used for financial reporting is sufficiently consistent with the mark-to-market method required by section 475, then the values used for financial reporting should be acceptable values for purposes of section 475. To ensure minimal divergence from fair market value under tax principles, these regulations impose certain restrictions on the financial accounting methods and financial statements that are eligible for the safe harbor and also require certain adjustments to the values of the eligible positions on those financial statements that may be used under the safe harbor.

The safe harbor and its various requirements and limitations are based upon the business model for derivatives dealers that was described in comments received in response to the ANPRM and the NPRM. According to these comments, dealers seek to capture and profit from bid-ask spreads in the marketplace by entering into balanced portfolios for their derivatives, that is, positions that offset each other, either individually or in the aggregate. Although dealers may have some open positions, they seek to have balanced portfolios with a majority of positions offsetting each other. Those offsetting positions generally remain on dealers' books over the terms of the positions.

The spread between bid and ask values contains the dealer's profit, which compensates the dealer for all risks and expenses. The creation of a balanced portfolio may be seen as giving rise to a synthetic annuity, with a value that is largely immune from market-related changes in the values of the component positions. At the time the dealer has entered into the offsetting positions and created the synthetic annuity, all steps required to earn the income from the synthetic annuity have been completed. Recognizing the present value of the income attributable to the bid-ask spread is appropriate in the taxable year the synthetic annuity is created. For a matched book of eligible positions, such as a dealer's portfolio of interest rate swap contracts, use of bid or ask values approximates realization accounting and fails to recognize in income the present value of the synthetic annuity in the taxable year that the synthetic annuity is created. The final regulations are to be applied in a manner consistent with the premise that the present value of the synthetic annuity should be recognized in income not later than the taxable year in which the synthetic annuity is created.

Commentators described a different business model for securities that are not derivatives, commonly known as physicals. Under this model, dealers plan on rapid turnover of the physicals that are traded on qualified boards or exchanges or on liquid over-the-counter markets. Except for those acquired at the end of the taxable year, the acquisition and disposition of a physical occurs within a single taxable year, so that the effect of capturing a bid-ask spread also occurs entirely within that year. Consequently, for securities traded on a qualified board or exchange, as defined under section 1256(g)(7), there is little difference between the results of realization and mark-to-market accounting, and little opportunity for manipulation.

Eligible Taxpayers

The NPRM provided that traders could elect to use the safe harbor. In both the ANPRM and the NPRM, the Treasury Department and IRS asked for comments addressing whether traders in securities and commodities should be able to elect the safe harbor and whether the business model for traders differs from the business model for dealers. The commentators that recommended that the safe harbor apply to traders did so without providing information about the business model for traders and without suggesting how the limitations set forth in the NPRM would apply to traders. Without a full understanding of the business model for traders, the Treasury Department and the IRS have determined that it would be unwise to include traders in the safe harbor at this time. Accordingly, the final regulations provide that the safe harbor is available only to taxpayers who are dealers in securities under section 475(a) or who are dealers in commodities and are subject to the election described in section 475(e)(1).

Eligible Positions

Because financial markets and products evolve rapidly, listing the securities and commodities in the regulations would make the regulations less flexible and dynamic in the future. To ensure that the safe harbor will be adaptable and administrable in a changing environment, the Commissioner will issue concurrently with these final regulations a revenue procedure that will list the types of securities and commodities that are subject to the safe harbor. This revenue procedure may be updated as necessary.

It is important to note, however, that the valuation methodology under the safe harbor applies only for positions that, taking into account any elections and identifications that are in effect, are required to be marked to market under section 475. That is, the safe harbor only addresses valuation and does not expand or contract the scope or application of section 475. For example, if a security is not marked to market under section 475 because it has been properly identified as held for investment, then it may not be marked to market for Federal income tax purposes even though the safe harbor election is in effect and the security is properly marked to market on the financial statement in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). Similarly, if a security is not marked to market on the applicable financial statement because, for example, it is a hedge for financial statement purposes but section 475(a) applies because the security is not a hedging transaction for tax purposes, then the security must nevertheless be marked to market under section 475.

Eligible Method

The NPRM set forth four core requirements that a financial accounting method must satisfy in order to be eligible for the safe harbor. First, the method must mark eligible positions to market through valuations made as of the last business day of each taxable year. Second, it must recognize into income on the income statement any gain or loss from marking eligible positions to market. Third, it must recognize into income on the income statement any gain or loss on disposition of an eligible position as if a year-end mark occurred immediately before the disposition. Fourth, it must arrive at fair value in accordance with U.S. GAAP.

In addition to these core requirements, the NPRM imposed certain limitations to ensure minimal divergence from fair market value. Under the first limitation, the financial accounting method must not result in values at or near the bid or ask values, even if the use of bid or ask values is permissible under U.S. GAAP. This limitation applies to all eligible positions except those that are traded on a qualified board or exchange, as defined in section 1256(g)(7). This limitation ensures that a sufficient portion of the synthetic annuity captured by a dealer is reported in the correct accounting period of that dealer.

Under the second limitation in the NPRM, if a method of valuation is based on the present value of projected cash flows from an eligible position or positions, that method must not take into account any income or expense attributable to a period or time on or before the valuation date. This limitation ensures that items of income or expense will not be accounted for twice, first through current recognition and then again in the mark.

Under the third limitation in the NPRM, no cost or risk may be accounted for more than once, either directly or indirectly. For example, a financial accounting method may allow a special adjustment for credit risk. If, however, a method computes the present value of projected cash flows using a discount rate that takes credit risk into account and the method employs a special adjustment that takes some or all of the credit risk into account, then the method does not satisfy this limitation. This limitation ensures that items of income or expense will not be accounted for twice.

Most of the comments received on the NPRM focused on the core requirements and limitations for eligible methods. As explained in this preamble, the final regulations address those comments, rejecting some suggestions and modifying the regulations in response to others. The majority of the comments focused on (1) requiring changes in value to be reported on the income statement, (2) limiting the use of bid and ask values, and (3) excepting certain types of physical securities from the bid-ask limitation.

Income Statement Requirement—§ 1.475(a)–4(d)(2)(ii)

Some commentators suggested that eligible taxpayers be allowed to report changes in value on either the balance sheet or the income statement, because both are rigorously reviewed. They also expressed concern that, because certain items of other comprehensive income generally appear on the balance sheet and not on the income statement, the methodology used by many taxpayers for financial reporting would fail to be an eligible method and, therefore, would not satisfy the safe harbor.

When changes in value appear on the income statement, they also appear in retained earnings and in earnings-per-share. This creates a tension between the benefits of higher earnings for financial reporting and the benefit of lower income for tax reporting. This tension helps to ensure the reliability of values for tax purposes, a fundamental concept underlying the safe harbor. Balance sheet items, such as other comprehensive income, do not have the same tension. Therefore, the final regulations retain the income statement requirement of the NPRM.

Bid-Ask Limitation

Some commentators suggested that the bid-ask limitation be eliminated to make it easier for taxpayers to qualify for the safe harbor. These commentators indicated that dealers generally do not retain records of individual positions' bid-ask spreads for any meaningful period of time, and it would be burdensome to monitor the spreads of those positions for which records do exist.

The safe harbor set forth in the NPRM does not add to taxpayers' existing recordkeeping burden. Without the safe harbor, other sections of the Code would require taxpayers to keep records to prove the values of individual positions or to keep records of spreads if taxpayers account for their income and loss based on those spreads. The safe

harbor simply allows taxpayers to use those same records to prepare both the applicable financial statement and their tax return. Accordingly, the bid-ask limitation has been retained in the final regulations.

Additionally, according to some commentators, the requirement in the NPRM that values should be nearer to the mid-market value than to the bid or ask value could be interpreted in two ways. First, it could be a requirement that, if not met for a particular position, would disqualify an entire financial accounting method as an eligible method. Second, it could be a safe harbor that, if not met for a particular position, would not disqualify the method but would require the taxpayer to prove that the method consistently produces values nearer to mid-market than to bid or ask. The final regulations make it clear that this provision is a safe harbor and that a method that may occasionally produce a value that is not nearer to mid-market than to bid or ask will not preclude use of the safe harbor.

The Treasury Department and the IRS also received suggestions from commentators seeking expansion of the exceptions to the bid-ask limitations. Some commentators noted that the exception for exchange-traded positions in the NPRM was too narrow because it did not cover those equities and debt securities, such as Treasury obligations, that are traded in very liquid, over-the-counter markets and have easily determinable values. These commentators suggested that, rather than limit the exception to positions on qualified boards or exchanges as defined in section 1256(g)(7), the regulations should include within the exception all positions for which there is an established financial market within the meaning of § 1.1092(d)–1(b).

The exception for positions that are traded on a qualified board or exchange described in section 1256(g)(7) was included in the NPRM to except those positions with spreads so small that applying the bid-ask limitation would have little effect on the determination of fair market value. Because section 1092 is an anti-abuse provision that Congress intended to be broad in scope, the definition of established financial market in § 1.1092(d)–1(b) reflects a corresponding breadth. Thus, expansion of the exception for exchange-traded positions by reference to § 1.1092(d)–1(b) might inappropriately except too many positions from the general bid-ask limitation. For example, many derivative contracts for which dealers lock in spreads are positions for which there is an established financial market. See § 1.1092(d)–1(b), (c). Consequently, the reference to section 1256(g)(7) has been retained.

Some of the comments about the bid-ask exception were prompted by the view that debt instruments should be excepted from the bid-ask limitation for some of the same reasons as positions traded on a 1256(g)(7) board or exchange.

The Treasury Department and the IRS, however, decline at this time to adopt the suggestion that debt instruments be generally excepted from the bid-ask limitation. The Treasury Department and the IRS recognize that dealers' business model for debt instruments generally is to turn over debt securities very rapidly and that dealers have a strong economic incentive to do so because holding debt securities consumes balance sheet resources and poses risk management issues. Nevertheless, based on comments received, the Treasury Department and the IRS do not possess sufficient information to conclude that spreads in the over-the-counter debt markets are *de minimis*. Additionally, debt instruments may be used to lock in spreads with respect to open positions in other instruments, such as derivatives. Therefore, excepting over-the-counter debt instruments from the bid-ask limitation may be contrary to the tenets of the dealer business model for derivatives. Moreover, excepting debt instruments from the bid-ask limitation might introduce a tax-motivated distortion into the marketplace, as taxpayers may decide to lock in spreads with tax-advantaged instruments rather than with instruments that are selected on the basis of their non-tax economic attributes. The Commissioner may, however, designate additional positions as being exempt from the bid-ask limitation.

Understanding the need for a limitation on the use of bid and ask values, one commentator suggested an open position exception to the bid-ask limitation. Under this alternative, offsetting positions in the balanced portion of a portfolio would not be valued at or near the bid or ask values. Open positions, however, would not be subject to this limitation. Instead, they could be valued at any value between and including the bid and ask values. According to this commentator, the bid-ask limitation ensures that the present value of the income attributable to the bid-ask spread is recognized in the taxable year the synthetic annuity is created. Open positions, it was noted, do not create a synthetic annuity so the bid-ask limitation need not apply to them.

The Treasury Department and the IRS decline to adopt the rule suggested by this commentator. Under a mark-to-market system, when a dealer enters into an open position with a customer, that dealer has captured the spread inherent in that customer position, even if the customer position is not offset by another position. Although it can be argued that a dealer may be forced to pay a spread to obtain a position offsetting the open customer position, to assume a dealer would do so across the board would be to ascribe customer status (which is paying spreads) to the dealer, a result inconsistent with the dealer business model (which is charging spreads). Additionally, in the event a dealer actually pays a spread to offset the open customer position, the disadvantageous terms of the offsetting position will be reflected in the mark-to-market valuation of that position. Administrability is also a concern. Before accepting the suggestion that a dealer should recognize no mark-to-market income from any open position until the position is offset by one or more other positions, the Treasury Department and the IRS would need more information regarding the manner in which to verify the process for determining the proper amounts of adjustments taxpayers will use to achieve this result.

Eligible Methods, Eligible Positions and the Safe Harbor Election

The final regulations modify the NPRM by providing that the election to use the safe harbor is made by filing a statement with the taxpayer's return declaring that the taxpayer makes the safe harbor election for all eligible positions for which it has an eligible method. An example elaborating on this concept has been added to the final regulations.

Applicable Financial Statements

Not all financial statements qualify under the safe harbor. Consequently, these regulations set forth a system that enables a taxpayer to determine which one of its financial statements, if any, may be used when applying the safe harbor. The final regulations adopt the provisions of the NPRM on applicable financial statements.

Some commentators expressed concern that U.S. branches of foreign banks would not be eligible to use the safe harbor because they do not prepare financial statements in accordance with U.S. GAAP. The comments suggested that many of these branches prepare their financial statements in accordance with rules that are substantially similar to U.S. GAAP and, therefore, should be

permitted to use those non-U.S. GAAP financial statements for purposes of the safe harbor. The commentators also suggested that call reports submitted to U.S. bank regulators by foreign banks have sufficient indicia of reliability to merit use in the safe harbor, even though changes over time in the values in those reports may not be directly reflected in income statements prepared according to U.S. GAAP.

As noted in this preamble, the safe harbor is based on the concept that, with appropriate limitations, mark-to-market values used on certain financial statements can be sufficiently consistent with fair market values under section 475. The IRS and Treasury Department have 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. Consequently, the final regulations retain the requirement that applicable financial statements be prepared in accordance with U.S. GAAP. The final regulations retain the requirement in the NPRM that, to be an eligible method, a financial statement method of accounting must cause changes in value to be recognized into income on the income statement.

Nevertheless, making it practical for foreign banks to use the safe harbor for their U.S. branches could be valuable not only to the foreign banks but also to the IRS in its administration and application of section 475. Therefore, the IRS and Treasury Department are interested in expanding the scope of these regulations so that they may apply in the future to foreign banks. Answers to the following questions would facilitate efforts to achieve that expansion. First, should the safe harbor require that the values reported in the call report of the foreign bank be the same values that are reported in the income statement filed in the foreign bank's home country? If so, should the foreign bank, together with its certified independent registered public accountant, file with the U.S. tax return, subject to penalties of perjury, a statement to that effect?

Second, should the valuation standards used in the foreign bank's home country be identical to the valuation standards under U.S. GAAP, and if not identical, in what ways may they differ? If so, should the foreign bank, together with its certified independent registered public accountant, file a statement with the U.S. tax return, subject to penalties of perjury, describing the differences, if any, between the foreign country valuation standards and those under U.S. GAAP? Further, should the foreign valuation standards be fully consistent with, and should the foreign country have formally adopted, International Financial Reporting Standards as published by the International Accounting Standards Board?

Third, should the income statement filed by the foreign bank be filed with the foreign bank's home country bank regulator (as distinct from a market regulator like the SEC)?

Fourth, for purposes of these questions, should the term ''home country'' mean the country in which the foreign bank is chartered or incorporated?

Record Retention and Production

The safe harbor will be administrable only if the IRS can readily verify that the financial statements at issue are taxpayers' applicable financial statements, that the accounting methods used are eligible methods, and that the values used on the applicable financial statements are also used on the Federal income tax return. Consequently, recordkeeping and record production are critical to the effective administration of the safe harbor.

These final regulations retain the provisions of the NPRM regarding record retention and production. They provide specific requirements for the types of records that must be maintained and provided, to enable ready verification. In general, electing taxpayers must clearly show: (1) That the same value used for financial reporting was used on the Federal income tax return; (2) that no eligible position subject to section 475 is excluded from the application of the safe harbor; and (3) that only eligible positions subject to section 475 are carried over to the Federal income tax return under the safe harbor.

Commentators expressed concern that the language of the NPRM requiring all schedules, exhibits, computer programs, and other information used to produce values was too broad, making it difficult to know what materials must be retained and produced. They also expressed concern that a requirement to keep computer programs and information used in producing values not only would require taxpayers to keep information about models that are changed frequently but also would encourage IRS employees to examine valuation models not just for compliance with the definition of ''eligible method'' but also for examining the accuracy of the underlying valuations.

The final regulations retain the record retention and production requirements set forth in the NPRM. Other sections of the Code already require taxpayers to maintain records sufficient to support the accuracy of items reported on their Federal tax returns. Except for a possible increase in the retention period in some instances, therefore, the final regulations create no additional burden. To avoid confusion or undue burden, the final regulations permit a taxpayer to enter into an agreement with the IRS specifying which records must be maintained, how they must be maintained, and for how long they must be maintained. These agreements may include terms covering the maintenance of computer programs and information used in producing values.

The maintenance and production requirements of the regulations preclude undue delay in producing records. One commentator suggested that the 30-day deadline provided too little time to produce records. During the development of these regulations, the IRS conducted a test program to determine not only whether values could be traced from financial statements to the tax return but also how long it would take for taxpayers to produce the necessary records. This test program demonstrated that 30 days was generally a sufficient period of time. For specific cases, the Commissioner may excuse failures to provide records within 30 days if the taxpayer shows reasonable cause for the failure and has made a good faith effort to comply. As noted above, the taxpayer may also enter into an agreement with the Commissioner that sets forth a different time period. Accordingly, the final regulations retain the general 30-day requirement.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the expectation that the safe harbor will be used primarily by dealers in securities that are financial institutions with a sophisticated understanding of the capital markets. Because section 475 is

elective for dealers in commodities, some small businesses could qualify for the safe harbor if they make two voluntary elections: (1) An election to mark to market commodities under section 475 and (2) an election to apply the safe harbor. Because both elections are voluntary, it is unlikely any small business taxpayer who thinks the reporting and recordkeeping requirements are too burdensome will make these elections. Furthermore, the total average estimated burden per taxpayer is small, as reported earlier in the preamble. This is because most of the recordkeeping requirements do not require taxpayers to generate new records, but instead require records used for financial reporting purposes to be kept for tax reporting purposes. For all of these reasons, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal authors of these regulations are Marsha A. Sabin and John W. Rogers III, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

■ Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.475(a)–4 also issued under 26 U.S.C. 475(g). * * *

■ **Par. 2.** Section 1.475–0 is amended by:

■ 1. Revising the introductory text.

■ 2. Adding entries to the table for § 1.475(a)–4.

■ 3. Redesignating the entry for § 1.475(e)–1 as § 1.475(g)–1.

The revision and addition reads as follows:

§ 1.475–0 Table of contents.

This section lists the major captions in §§ 1.475(a)–3, 1.475(a)–4, 1.475(b)–1, 1.475(b)–2, 1.475(b)–4, 1.475(c)–1, 1.475(c)–2, 1.475(d)–1 and 1.475(g)–1.

* * * * *

§ 1.475(a)–4 Safe Harbor for Valuation Under Section 475.

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(2) Dealer business model.
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(1) General rule.
(2) Example. Use of eligible and non-eligible methods.
(3) Scope of the safe harbor.
(c) Eligible taxpayer.
(d) Eligible method.
(1) Sufficient consistency.
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(f) Election.
(1) Making the election.
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(h) Applicable financial statement.
(1) Definition.
(2) Primary financial statement.
(i) Statement required to be filed with Securities and Exchange Commission (SEC).
(ii) Statement filed with a Federal agency other than the IRS.
(iii) Certified audited financial statement.
(3) Example. Primary financial statement.
(4) Financial statements of equal priority.
(5) Consolidated groups.
(6) Supplement or amendment to a financial statement.
(7) Certified audited financial statement.
(i) [Reserved.]
(j) Significant business use.
(1) In general.
(2) Financial statement value.
(3) Management of a business as a dealer.
(4) Significant use.
(k) Retention and production of records.
(1) In general.
(2) Specific requirements.
(i) Reconciliation.
(A) In general.
(B) Values on books and records with supporting schedules.
(C) Consolidation schedules.
(ii) Instructions provided by the Commissioner.
(3) Time for producing records.
(4) Retention period for records.
(5) Agreements with the Commissioner.
(l) [Reserved.]
(m) Use of different values.

* * * * *

§ 1.475(g)–1 Effective dates.

■ **Par. 3.** Section 1.475(a)–4 is added to read as follows:

§ 1.475(a)–4 Valuation safe harbor.

(a) *Overview*—(1) *Purpose.* This section sets forth a safe harbor that, under certain circumstances, permits taxpayers to elect to use the values of positions reported on certain financial statements as the fair market values of those positions for purposes of section 475. This safe harbor is based on the principle that, if a mark-to-market method used for financial reporting is sufficiently consistent with the requirements of section 475 and if the financial statement employing that method has certain indicia of reliability, then the values used on that financial statement may be used for purposes of section 475. If other provisions of the Internal Revenue Code or regulations require adjustments to fair market value, use of the safe harbor does not eliminate the need for those adjustments. See paragraph (e) of this section.

(2) *Dealer business model.* The safe harbor is based on the business model for a derivatives dealer. Under this model, the dealer seeks to capture and profit from bid-ask spreads in the marketplace by entering into substantially offsetting positions with customers that will remain on the derivatives dealer's books over their terms. Because the positions in the aggregate tend to offset each other, the dealer has achieved a predictable net cash flow (for example, a synthetic annuity) that reflects the captured bid-ask spread. This net cash flow is generally impervious to market fluctuations in the values on which the component derivatives are based. Section 475 requires current recognition of the present value of the net cash flow attributable to the capture of these spreads.

(3) *Summary of paragraphs.* Paragraph (b) of this section sets forth the safe harbor. To determine who may use the safe harbor, paragraph (c) of this section defines the term ''eligible taxpayer.'' Paragraph (d) of this section sets forth the basic requirements for determining whether the method used for financial reporting is sufficiently consistent with the requirements of

section 475. Paragraph (e) of this section describes adjustments to the financial statement values that may be required for purposes of applying this safe harbor. Paragraph (f) of this section describes the procedure for making the safe harbor election and the conditions under which the election may be revoked. Paragraph (g) of this section provides that the Commissioner will issue a revenue procedure that lists the types of securities and commodities that are eligible positions for purposes of the safe harbor. Using rules for determining priorities among financial statements, paragraph (h) of this section defines the term ''applicable financial statement'' and so describes the financial statement, if any, whose values may be used in the safe harbor. In some cases, as required by paragraph (j) of this section, the safe harbor is available only if the taxpayer's operations make significant business use of financial statement values. Paragraph (k) of this section sets forth requirements for record retention and record production. Paragraph (m) of this section provides that the Commissioner may use fair market values that clearly reflect income, but which differ from values used on the applicable financial statement, if an electing taxpayer fails to comply with the recordkeeping and record production requirements of paragraph (k) of this section.

(b) *Safe harbor*—(1) *General rule.* Subject to any adjustment required by paragraph (e) of this section, if an eligible taxpayer uses an eligible method for the valuation of an eligible position on its applicable financial statement and the eligible taxpayer is subject to the election described in paragraph (f) of this section, the value that the eligible taxpayer assigns to that eligible position on its applicable financial statement is the fair market value of the eligible position for purposes of section 475 and must be used for purposes of section 475, even if that value is not the fair market value of the position for any other purpose of the internal revenue laws. Notwithstanding the rule set forth in this paragraph, the Commissioner may, in certain circumstances, use fair market values that clearly reflect income but differ from the values used on the applicable financial statement. See paragraph (m) of this section.

(2) Example. Use of eligible and non-eligible methods. X uses eligible methods on its applicable financial statement for some, but not all, securities and commodities that are eligible positions. When X elects into the safe harbor, the election applies to all eligible positions for which X has an eligible method. Therefore, once the election is in effect, the financial statement values for eligible positions for which X has an eligible method are the fair market values of those eligible positions for purposes of section 475. Since X, however, does not have an eligible method for all eligible positions, those eligible positions for which X does not have an eligible method remain subject to the fair market value requirements of section 475 as set out in case law and otherwise.

(3) *Scope of the safe harbor.* The safe harbor may be used only to determine values for eligible positions that are properly marked to market under section 475. It does not determine whether any positions may or may not be subject to mark-to-market accounting under section 475.

(c) *Eligible taxpayer.* An eligible taxpayer is—

(1) A dealer in securities, as defined in section 475(c)(1); or

(2) A dealer in commodities, as defined in section 475(e), that is subject to an election under section 475(e).

(d) *Eligible method*—(1) *Sufficient consistency.* An eligible method is a mark-to-market method that is sufficiently consistent with the requirements of a mark-to-market method under section 475. To be sufficiently consistent with the requirements of a mark-to-market method under section 475, the eligible method must satisfy all of the requirements of paragraph (d)(2) and paragraph (d)(3) of this section.

(2) *General requirements.* The method—

(i) *Frequency.* Must require a valuation of the eligible position no less frequently than annually, including a valuation as of the last business day of the taxable year;

(ii) *Recognition at the mark.* Must recognize into income on the income statement for each taxable year mark-to-market gain or loss based upon the valuation or valuations described in paragraph (d)(2)(i) of this section;

(iii) *Recognition on disposition.* Must require, on disposition of the eligible position, recognition into income (on the income statement for the taxable year of disposition) as if a year-end mark occurred immediately before such disposition; and

(iv) *Fair value standard.* Must require use of a valuation standard that arrives at fair value in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP).

(3) *Limitations*—(i) *Bid-ask method*—(A) *General rule.* Except for eligible positions that are traded on a qualified board or exchange, as defined in section 1256(g)(7), or eligible positions that the Commissioner designates in a revenue procedure or other published guidance, the valuation standard used must not, other than on a *de minimis* portion of a taxpayer's positions, permit values at or near the bid or ask value. Consequently, the valuation method described in § 1.471–4(a)(1) fails to satisfy this paragraph (d)(3)(i)(A).

(B) *Safe harbor.* The restriction in paragraph (d)(3)(i)(A) of this section is satisfied if the method consistently produces values that are closer to the mid-market values than they are to the bid or ask values.

(ii) *Valuations based on present values of projected cash flows.* If the method of valuation consists of projecting cash flows from an eligible position or positions and determining the present value of those cash flows, the method must not take into account any cash flows attributable to a period or time on or before the valuation date. In addition, adjustment of the gain or loss recognized on the mark may be required with respect to payments that will be made after the valuation date to the extent that portions of the payments have been recognized for tax purposes before the valuation and appropriate adjustment has not been made for purposes of determining financial statement value.

(iii) *Accounting for costs and risks.* Valuations may account for appropriate costs and risks, but no cost or risk may be accounted for more than once, either directly or indirectly. Further, no valuation adjustment for any cost or risk may be made for purposes of this safe harbor if that valuation adjustment is not also permitted by, and taken for, U.S. GAAP purposes on the taxpayer's applicable financial statement. If appropriate, the costs and risks that may be accounted for include, but are not limited to, credit risk (appropriately adjusted for any credit enhancement), future administrative costs, and model risk. An adjustment for credit risk is implicit in computing the present value of cash flows using a discount rate greater than a risk-free rate. Accordingly, a determination of whether any further downward adjustment to value for credit risk is warranted, or whether an upward adjustment is required, must take that implicit adjustment into consideration.

(4) *Examples.* The following examples illustrate this paragraph (d):

Example 1. (i) X, a calendar year taxpayer, is a dealer in securities within the meaning of section 475(c)(1). X generally maintains a balanced portfolio of interest rate swaps and other interest rate derivatives, capturing bid-ask spreads and keeping its market exposure within desired limits (using, if necessary, additional derivatives for this purpose). X uses a mark-to-market method on a statement that it is required to file with the United

States Securities and Exchange Commission (SEC) and that satisfies paragraph (d)(2) of this section with respect to both the contracts with customers and the additional derivatives. When determining the amount of any gain or loss realized on a sale, exchange, or termination of a position, X makes a proper adjustment for amounts taken into account respecting payments or receipts. All of X's counterparties on the derivatives have credit ratings of AA/aa, according to standard credit ratings obtained from private credit rating agencies.

(ii) Under X's valuation method, as of each valuation date, X determines a mid-market probability distribution of future cash flows under the derivatives and computes the present values of these cash flows. In computing these present values, X uses an industry standard yield curve that is appropriate for obligations by persons with credit ratings of AA/aa. In addition, based on information that includes its own knowledge about the counterparties, X adjusts some of these present values either upward or downward to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from AA/aa.

(iii) X's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

Example 2. (i) The facts are the same as in *Example 1,* except that X uses a AAA/aaa rate to discount the payments to be received under the derivatives. Based on information that includes its own knowledge about the counterparties, X adjusts these present values to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from a AAA/aaa obligation.

(ii) X's methodology does not violate the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once.

Example 3. (i) The facts are the same as in *Example 1,* except that, after computing present values using the discount rates that are appropriate for obligors with credit ratings of AA/aa, and based on information that includes X's own knowledge about the counterparties, X adjusts some of these present values either upward or downward to reflect X's reasonable judgment about the extent to which the true credit status of each counterparty's obligation, taking credit enhancements into account, differs from AAA/aaa.

(ii) X's methodology violates the requirement in paragraph (d)(3)(iii) of this section that the same cost or risk not be taken into account, directly or indirectly, more than once. By using a AA/aa discount rate, X's method takes into account the difference between risk-free obligations and AA/aa obligations. This difference includes the difference between a rating of AAA/aaa and one of AA/aa. By adjusting values for the difference between a rating of AAA/aaa and one of AA/aa, X takes into account risks that it had already accounted for through the discount rates that it used. The same result would occur if X judged some of its counterparties' obligations to be of AAA/aaa quality but X failed to adjust the values of those obligations to reflect the difference between a rating of AAA/aaa and one of AA/aa.

Example 4. (i) The facts are the same as in *Example 1,* except that X determines the mid-market value for each derivative and then subtracts the corresponding part of the bid-ask spread.

(ii) X's methodology violates the rule in paragraph (d)(3)(i) of this section that forbids valuing positions at or near the bid or ask value.

Example 5. (i) The facts are the same as in *Example 1,* and, in addition, X's adjustments for all risks and costs, including credit risk, future administrative costs and model risk, may occasionally cause the adjusted value of an eligible position to be at or near the bid value or ask value.

(ii) X's methodology does not violate the rule in paragraph (d)(3)(i)(A) of this section that forbids valuing eligible positions at or near the bid or ask value.

(e) *Compliance with other rules.* Notwithstanding any other provisions of this section, the fair market values for purposes of the safe harbor must be consistent with section 482, or rules that adopt section 482 principles, when applicable. For example, if a notional principal contract is subject to section 482 or section 482 principles, the values of future cash flows taken into account in determining the value of the contract for purposes of section 475 must be consistent with section 482.

(f) *Election*—(1) *Making the election.* Unless the Commissioner prescribes otherwise, an eligible taxpayer elects under this section by filing with the Commissioner a statement declaring that the taxpayer makes the safe harbor election in this section for all eligible positions for which it has an eligible method. In addition to any other information that the Commissioner may require, the statement must describe the taxpayer's applicable financial statement for the first taxable year for which the election is effective and must state that the taxpayer agrees to provide upon the request of the Commissioner all information, records, and schedules in the manner required by paragraph (k) of this section. The statement must be attached to a timely filed Federal income tax return (including extensions) for the taxable year for which the election is first effective.

(2) *Duration of the election.* Once made, the election continues in effect for all subsequent taxable years unless revoked.

(3) *Revocation*—(i) *By the taxpayer.* An eligible taxpayer that is subject to an election under this section may revoke the election only with the consent of the Commissioner.

(ii) *By the Commissioner.* The Commissioner, after consideration of the relevant facts and circumstances, may revoke an election under this section, effective beginning with the first open year for which the election is effective or with any subsequent year, if—

(A) The taxpayer fails to comply with paragraph (k) of this section (concerning record retention and production) and the taxpayer does not show reasonable cause for this failure;

(B) The taxpayer ceases to have an applicable financial statement or ceases to use an eligible method; or

(C) For any other reason, no more than a de minimis number of eligible positions, or no more than a de minimis fraction of the taxpayer's eligible positions, are covered by the safe harbor in paragraph (b) of this section.

(4) *Re-election.* If an election is revoked, either by the Commissioner or by the taxpayer, the taxpayer (or any successor in interest of the taxpayer) may not make the election without the consent of the Commissioner for any taxable year that begins before the date that is six years after the first day of the earliest taxable year affected by the revocation.

(g) *Eligible positions.* For any taxpayer, an eligible position is any security or commodity that the Commissioner in a revenue procedure or other published guidance designates as an eligible position with respect to that taxpayer for purposes of this safe harbor.

(h) *Applicable financial statement*—(1) *Definition.* An eligible taxpayer's applicable financial statement for a taxable year is the taxpayer's primary financial statement for that year if that primary financial statement is described in paragraph (h)(2)(i) of this section (concerning statements required to be filed with the SEC) or if that primary financial statement both meets the requirements of paragraph (j) of this section (concerning significant business use) and is described in either paragraph (h)(2)(ii) or (iii) of this section. Otherwise, or if the taxpayer does not have a primary financial statement for the taxable year, the taxpayer does not have an applicable financial statement for the taxable year.

(2) *Primary financial statement.* For any taxable year, an eligible taxpayer's primary financial statement is the financial statement, if any, described in one or more of paragraphs (h)(2)(i), (ii), and (iii) of this section. If more than one financial statement of the taxpayer for the year is so described, the primary financial statement is the one first

described in paragraphs (h)(2)(i), (ii), and (iii) of this section. A taxpayer has only one primary financial statement for any taxable year.

(i) *Statement required to be filed with the Securities and Exchange Commission (SEC).* A financial statement that is prepared in accordance with U.S. GAAP and that is required to be filed with the SEC, such as the 10–-K or the Annual Statement to Shareholders.

(ii) *Statement filed with a Federal agency other than the Internal Revenue Service.* A financial statement that is prepared in accordance with U.S. GAAP and that is required to be provided to the Federal government or any of its agencies other than the Internal Revenue Service (IRS).

(iii) Certified audited financial statement. A certified audited financial statement that is prepared in accordance with U.S. GAAP; that is given to creditors for purposes of making lending decisions, given to equity holders for purposes of evaluating their investment in the eligible taxpayer, or provided for other substantial non-tax purposes; and that the taxpayer reasonably anticipates will be directly relied on for the purposes for which it was given or provided.

(3) Example. Primary financial statement. X prepares financial statement FS1, which is required to be filed with a Federal government agency other than the SEC or the IRS. FS1 is thus described in paragraph (h)(2)(ii) of this section. X also prepares financial statement FS2, which is a certified audited financial statement that is given to creditors and that X reasonably anticipates will be relied on for purposes of making lending decisions. FS2 is thus described in paragraph (h)(2)(iii) of this section. Because FS1, which is described in paragraph (h)(2)(ii) of this section, is described before FS2, which is described in paragraph (h)(2)(iii) of this section, FS1 is X's primary financial statement.

(4) *Financial statements of equal priority.* If the rules of paragraph (h)(2) of this section cause two or more financial statements to be of equal priority, then the statement that results in the highest aggregate valuation of eligible positions being marked to market under section 475 is the primary financial statement.

(5) *Consolidated groups.* If the taxpayer is a member of an affiliated group that files a consolidated return, the primary financial statement of the taxpayer is the primary financial statement, if any, of the common parent (within the meaning of section 1504(a)(1)) of the consolidated group.

(6) *Supplement or amendment to a financial statement.* A financial statement includes any supplement or amendment to the financial statement.

(7) *Certified audited financial statement.* For purposes of this paragraph (h), a financial statement is a certified audited financial statement if it is certified by an independent certified public accountant from a Registered Public Accounting firm, as defined in section 2(a)(12) of the Sarbanes-Oxley Act of 2002, Public Law 107–204, 116 Stat. 746 (July 30, 2002), 15 U.S.C. § 7201(a)(12), and rules promulgated under that Act, and is—

(i) Certified to be fairly presented (a ''clean'' opinion);

(ii) Certified to be fairly presented subject to a concern about a contingency, other than a contingency relating to the value of eligible positions (a qualified ''subject to'' opinion); or

(iii) Certified to be fairly presented except for a method of accounting with which the Certified Public Accountant disagrees and which is not a method used to determine the value of an eligible position held by the eligible taxpayer (a qualified ''except for'' opinion).

(i) [Reserved].

(j) *Significant business use*—(1) *In general.* A financial statement is described in this paragraph (j) if—

(i) The financial statement contains values for eligible positions;

(ii) The eligible taxpayer makes significant use of financial statement values in most of the significant management functions of its business; and

(iii) That use is related to the management of all or substantially all of the eligible taxpayer's business.

(2) *Financial statement value.* For purposes of this paragraph (j), the term *financial statement value* means—

(i) A value that is taken from the financial statement; or

(ii) A value that is produced by a process that is in all respects identical to the process that produces the values that appear on the financial statement but that is not taken from the statement because either—

(A) The value was determined as of a date for which the financial statement does not value eligible positions; or

(B) The value is used in the management of the business before the financial statement has been prepared.

(3) *Management functions of a business.* For purposes of this paragraph (j), the term *management functions of a business* refers to the financial and commercial oversight of the business. Oversight includes, but is not limited to, senior management review of business-unit profitability, market risk measurement or management, credit risk measurement or management, internal allocation of capital, and compensation of personnel. Management functions of a business do not include either tax accounting or reporting the results of operations to persons other than directors or employees.

(4) *Significant use.* If an eligible taxpayer uses financial statement values for some significant management functions and uses values that are not financial statement values for other significant management functions, then the determination of whether the taxpayer has made significant use of the financial statement values is made on the basis of all the facts and circumstances. This determination must particularly take into account whether the taxpayer's reliance on the financial statement values exposes the taxpayer to material adverse economic consequences if the values are incorrect.

(k) *Retention and production of records*—(1) *In general.* In addition to all records that section 6001 otherwise requires to be retained, an eligible taxpayer subject to the election provided by this section must keep, and timely provide to the Commissioner upon request, records and books of account that are sufficient to establish that the financial statement to which the income tax return conforms is the taxpayer's applicable financial statement, that the method used on that statement is an eligible method, and that the values used for eligible positions for purposes of section 475 are the values used in the applicable financial statement. This obligation extends to all records and books that are required to be maintained for any period for financial or regulatory reporting purposes, even if these records or books may not otherwise be specifically covered by section 6001. All records and books described in this paragraph (k) must be maintained for the period described in paragraph (k)(4) of this section, even if a lesser period of retention applies for financial statement or regulatory purposes.

(2) *Specific requirements*—(i) *Verification and reconciliation.* Unless the Commissioner otherwise provides—

(A) *In general.* An eligible taxpayer must provide books and records to verify the appropriate use of the safe harbor and reconciliation schedules between the applicable financial statement for the taxable year and the Federal income tax return for that year. The required verification materials and reconciliation schedules include all supporting schedules, exhibits, computer programs, and any other information used in producing the

values and schedules, including the documentation of rules and procedures governing determination of the values. The required reconciliation schedules must also include a detailed explanation of any adjustments necessitated by the imperfect overlap between the eligible positions that the taxpayer marks to market under section 475 and the eligible positions for which the applicable financial statement uses an eligible method. In the time and manner provided by the Commissioner, a corporate taxpayer subject to this paragraph (k) must reconcile the net income amount reported on its applicable financial statement to the amount reported on the applicable forms and schedules on its Federal income tax return (such as the Schedule M–1, ''Net Income(Loss) Reconciliation for Corporations With Total Assets of $10 Million or More''; Schedule M–3, ''Net Income(Loss) Reconciliation for Corporations With Total Assets of $10 Million or More''; and Form 1120F, ''U.S. Income Tax Return of a Foreign Corporation''). Eligible taxpayers that are not otherwise required to file a Schedule M–1 or Schedule M–3 must reconcile net income using substitute schedules similar to Schedule M–1 and Schedule M–3, and these substitute schedules must be attached to the return.

(B) *Values on books and records with supporting schedules.* The books and records must state the value used for each eligible position separately from the value used for any other eligible position. However, 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.

(C) *Consolidation schedules.* An eligible taxpayer must provide a schedule showing the consolidation and de-consolidation that is used in preparing the applicable financial statement, along with exhibits and subordinate schedules. This schedule must provide information that addresses the differences for consolidation and de-consolidation between the applicable financial statement and the Federal income tax return.

(ii) *Instructions provided by the Commissioner.* The Commissioner may provide an alternative time or manner in which an eligible taxpayer subject to this paragraph (k) must establish that the same values used for eligible positions on the applicable financial statement are also the values used for purposes of section 475 on the Federal income tax return.

(3) *Time for producing records.* All documents described in this paragraph (k) must be produced within 30 days of a request by the Commissioner, unless the Commissioner grants a written extension. Generally, the Commissioner will exercise his discretion to excuse a minor or inadvertent failure to provide requested documents if the taxpayer shows reasonable cause for the failure, has made a good faith effort to comply with the requirement to produce records, and promptly remedies the failure. For failures to maintain, or timely produce, records, see paragraph (f)(3)(ii) of this section (allowing the Commissioner to revoke the election), and see paragraph (m) of this section (allowing the Commissioner, but not the taxpayer, to use for eligible positions that otherwise might be subject to the safe harbor fair market values that clearly reflect income but that are different from the values used on the applicable financial statement).

(4) *Retention period for records.* All materials required by this paragraph (k) and section 6001 must be retained as long as their contents may become material in the administration of any internal revenue law.

(5) *Agreements with the Commissioner.* The Commissioner and an eligible taxpayer may enter into a written agreement that establishes, for purposes of this paragraph (k), which records must be maintained, how they must be maintained, and for how long they must be maintained.

(l) [Reserved].

(m) *Use of different values.* If, with respect to the records that relate to certain eligible positions for a taxable year, the taxpayer fails to satisfy paragraph (k) of this section (concerning record retention and record production), then, for those eligible positions for that year, the Commissioner may use values that the Commissioner determines to be fair market values that are appropriate to clearly reflect income, even if the values so determined are different from the values reported for those positions on the applicable financial statement. See also paragraph (f)(3)(ii) of this section (concerning revocation of the election by the Commissioner when a taxpayer does not produce required records and fails to demonstrate reasonable cause for the failure).

§ 1.475(e)–1 [Redesignated as § 1.475(g)–1]

■ **Par. 4.** Section 1.475(e)–1 is redesignated as § 1.475(g)–1.

■ **Par. 5.** Newly designated § 1.475(g)–1 is amended by redesignating paragraphs (d) through (j) as paragraphs (e) through (k), respectively, and adding a new paragraph (d) to read as follows:

§ 1.475(g)–1 Effective dates.

* * * * *

(d) Section 1.475(a)–4 (concerning a safe harbor to use applicable financial statement values for purposes of section 475) applies to taxable years ending on or after June 12, 2007.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER PAPERWORK REDUCTION ACT

■ **Par. 6.** The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

■ **Par. 7.** In § 602.101, paragraph (b) is amended by adding the entry for 1.475(a)–4 to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control no.
* * * *	*
1.475(a)–4	1545–1945
* * * *	*

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

Approved: May 30, 2007.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. E7–11146 Filed 6–11–07; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 165

[CGD09–07–005]

RIN 1625–AA00

Safety Zones; Annual Events Requiring Safety Zones in the Captain of the Port Lake Michigan Zone

AGENCY: Coast Guard, DHS.

ACTION: Final rule.

SUMMARY: The Coast Guard has established permanent safety zones for