

Safe Harbor or No Safe Harbor: A First Look at the Mark-to-Market Safe Harbor Regulations

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Richard Larkins, Kyle Klein and Jasper Nzedu describe the shortcomings of the final mark-to-market safe harbor regulations under Code Sec. 475 and discuss the need for clearer guidance and a broader application of the safe harbor.

Internal Revenue Code (“the Code”) Sec. 475 requires securities dealers, and electing commodities dealers and securities and commodities traders, to recognize gain or loss as if all of their securities (or commodities) were sold for their “fair market value” on the last business day of each tax year. Code Sec. 475, however, contains no methodology for determining fair market value, and until recently, the Treasury and the IRS did not provide guidance to taxpayers on the matter.¹ As a result, taxpayers could rely only on the historic definition of “fair market value” for federal income tax purposes² in developing valuation methodologies, and on the Conference Agreement on Code Sec. 475 that anticipated that any valuation method will “clearly reflect income for federal income tax purposes.”³ Inevitably, the absence of clarity on valuation methods has fostered a contentious environment resulting in many disputes between taxpayers and the IRS regarding the appropriate valuation methodology and, hence, a wasting of administrative resources for both taxpayers and the government.⁴

On June 11, 2007, the Treasury released final Reg. §1.475(a)-4, providing 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 Code Sec. 475. Coming after requests by taxpayers for guidance on valuation methods, the IRS Announcement 2003-35 (in which the IRS solicited comments and submissions on possible safe harbors for valuation methods under Code Sec. 475), and the proposed regulations released on May 20, 2005, the safe harbor is intended to reduce the compliance burden on taxpayers and to improve the administrability of the valuation requirement of Code Sec. 475 for the IRS. For many taxpayers, however, the safe harbor does not substantially, if at all, address the need for clarity of valuation methods under Code Sec. 475. Specifically, the final regulations unduly limit the type of taxpayer for whom the safe harbor would be available and the kinds of valuation methods and securities for which a taxpayer can apply the safe harbor. These taxpayers will find no haven in the safe harbor, and because the final regulations fail to provide clear guidance on valuation methods outside of the safe harbor, disputes on valuation methods between taxpayers and the IRS will likely continue. Therefore, it is improbable that the intended goals of the safe harbor will be achieved.

This article discusses the need for clear guidance and for making the safe harbor as broad as possible

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if the Treasury is to achieve the stated goals of the safe harbor—reducing the compliance burdens on taxpayers and improving the administrability of the valuation requirement of Code Sec. 475 for the IRS—and reduce unnecessary controversy and disputes between taxpayers and the IRS. The first part of the article discusses the events leading up to the regulations. Specifically, it addresses the issues and concerns faced by taxpayers and the IRS in complying with and administering Code Sec. 475 and the policy goals underlying the regulations. The second part discusses the scope and limitations of the final regulations and argues that (i) the final regulations fail to provide a substantial safe harbor to taxpayers given that dealers of securities and commodities may not use valuations that are near bid or ask prices for securities that are not exchange traded; (ii) the safe harbor is not available for valuations that do not flow through the income statement; (iii) the safe harbor only applies to financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles (GAAP); and (iv) the safe harbor is not available to securities and commodities traders, even if their valuation methodologies are consistent with Code Sec. 475. Finally, the article discusses the *Bank One* case and argues that the failure of the final regulations to provide substantial guidance to taxpayers makes the case more important than practitioners and the courts originally assumed.

Background

Code Sec. 475 was added to the Code by Section 13223(a) of the Omnibus Budget Reconciliation Act of 1993⁵; Code Sec. 475(g) provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of Code Sec. 475. The legislative history of Code Sec. 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. Despite this authority, the IRS and the Treasury did not provide any guidance to

taxpayers on valuation methods for more than 10 years. In the absence of any guidance, taxpayers and the IRS frequently disagreed on the appropriate valuation methodology for marking securities to market at the end of the year for federal income tax purposes.⁶ The disagreements culminated in litigation in 2001 in the *Bank One* case.⁷

After the *Bank One* litigation commenced, the Securities Industry Association (SIA) petitioned the Treasury for regulations that would grant dealers a

The proposed regulations' safe harbor was to be available only if (and to the extent that) "an eligible taxpayer uses an eligible method for the valuation of an eligible position on its applicable financial statement" and elects to apply the safe harbor.

conclusive presumption that the values they assign to their derivatives constitute "fair market value" for Code Sec. 475 purposes so long as: (i) the values are the same as those used in their "applicable financial statement" and (ii) the dealer makes "significant use of these values in the management of its dealer business."⁸

The SIA submitted a draft regulation to the Treasury and contended that there can be only one applicable financial statement for a dealer so that both the taxpayer and the IRS need look to only one statement, and that there is no potential for selecting among financial statements to achieve a desired result.⁹ In determining what should constitute an applicable financial statement, the draft regulation gave the highest priority to a statement that must be filed by the dealer in securities with a government regulatory authority (e.g., the Securities and Exchange Commission or a State or foreign regulatory agency maintaining comparable standards) that has primary responsibility for supervision of the dealer, or with an examining authority designated by that government regulatory agency (e.g., the National Association of Securities Dealers, which is now the Financial Industry Regulatory Authority). The SIA argued that such regulatory filings should be viewed as most reliable because significant consequences would arise if an inaccurate filing were made with a securities regulatory agency.¹⁰

The SIA further contended that the commercial importance of an assigned valuation is established by the requirement that the dealer make significant use of the same values in the management of its dealer business.¹¹ The SIA asserted that to satisfy this requirement, the dealer must make significant use of those valua-

tions in the financial or commercial oversight of its business. Thus, if a dealer uses those same valuations as the basis of its hedging decisions, or alternatively as part of the process of determining the compensation for a group of its employees, the SIA draft regulation would deem the valuations to be directly employed in operating the dealer's business.¹²

Accordingly, the SIA's approach relied on nontax incentives to assure accuracy rather than mandating any particular methodology. Not surprisingly, derivative dealers prefer this approach because it does not require them to undertake one valuation for financial accounting purposes and another for tax purposes.¹³ But the Treasury and the IRS did not immediately respond to the SIA's petition for guidance on valuation methodology and the SIA, on March 28, 2002, again urged them to issue clear regulations on Code Sec. 475.¹⁴

In May 2003, the Tax Court filed its initial opinion in the *Bank One* case and adopted a legal standard mandating a specific methodology (mid-market valuation, subject to certain specified adjustments) to determine fair market value under Code Sec. 475. The court's normative approach contrasted with the incentive-based approach recommended by the SIA two years earlier.

On the same day that the *Bank One* court filed its opinion, the IRS issued Announcement 2003-35 in response to the SIA and taxpayers' requests.¹⁵ Announcement 2003-35 indicated that the IRS and the Treasury were considering proposed regulations that would permit taxpayers to use the valuations they report on their financial statements for Code Sec. 475 purposes upon satisfying certain conditions. The Announcement contemplated that eligibility for a safe harbor under the valuation requirement of Code Sec. 475 would be guided by three broad "principles." First, any mark-to-market methodology used on a financial statement submitted for financial reporting purposes would have to be "sufficiently consistent" with the mark-to-market methodology used under Code Sec. 475. Second, the financial statement would have to be one for which the taxpayer has a strong incentive to report values fairly. Third, if requested, the taxpayer would have to timely provide

the IRS with the information and documents necessary to verify the relationship between the values reported on the financial statement and the values used for purposes of Code Sec. 475.

Under the first principle (the "consistency principle"), in order for a methodology reflected in the taxpayer's financial statements to be sufficiently consistent with Code Sec. 475 principles, the methodology must (i) value securities and com-

However, the long-standing practice among securities dealers is to mark long positions in physical securities to the bid side of the market and short positions to the ask side of the market and this practice complies with U.S. GAAP.

modities as of the last business day of each tax year, (ii) recognize into income the gains and losses arising from changes in value each year, and (iii) compute gain or loss on disposition by reference to the value at the end of the prior year. Announcement 2003-35 also contemplated

that the valuation standard under the safe harbor would be consistent with the valuation standard under Code Sec. 475, which is fair market value—the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. However, the Announcement left open the question whether the fair value standard under U.S. GAAP should be used as a proxy for the fair market value standard required for tax purposes.

Under the second principle (the "incentive principle"), the Announcement stated that two factors are relevant in establishing that the taxpayer has a strong incentive to report values of the securities and commodities fairly on the financial statement: (i) reporting of values on a financial statement; and (ii) significant use of those reported values in the taxpayer's business. Announcement 2003-35 contemplated three classes of financial statements that might satisfy the financial statement requirement: (i) a financial statement required to be filed with the Securities and Exchange Commission (SEC) (e.g., the 10-K or the Annual Statement to Shareholders); (ii) a financial statement required to be provided to the federal government or any of its agencies (other than the SEC or the IRS); and (iii) a certified audited financial statement not required to be filed with the SEC or another federal agency.¹⁶ According to the Announcement, significant uses of reported values

would include the use of valuations for purposes of making decisions regarding pricing, risk management and employee compensation.

Under the third principle (the “verification principle”), for purposes of the safe harbor, examinations of returns would focus on how the values used in the financial statements relate to gain and loss on the tax returns. Accordingly, taxpayers’ records would have to clearly show that (i) the same value used on the financial statement was used on the tax return; (ii) no security subject to Code Sec. 475 and reported under the required methodology on the financial statement was excluded in the application of the safe harbor; and (iii) only securities or commodities subject to Code Sec. 475 had been carried over to the tax return under the safe harbor.

Thus, Announcement 2003-35 adopted the incentive based approach earlier recommended by the SIA. However, the incentive principle was bounded by the consistency and verification principles.

After receiving submissions on the Advanced Notice of Proposed Rulemaking (ANPRM), the IRS and the Treasury released proposed regulations on May 20, 2005, Notice of Proposed Rulemaking (NPRM), providing for an elective safe harbor for valuation under Code Sec. 475.¹⁷ The proposed regulations’ safe harbor was to be available only if (and to the extent that) “an eligible taxpayer uses an eligible method for the valuation of an eligible position on its applicable financial statement” and elects to apply the safe harbor.¹⁸ Notably, an eligible taxpayer was proposed to be any taxpayer subject to the mark-to-market regime under Code Sec. 475, whether the taxpayer is a dealer in securities under Code Sec. 475(a), a dealer in commodities under Code Sec. 475(e), or a trader in either securities or commodities under Code Sec. 475(f).¹⁹

In order to constitute an “applicable financial statement,” it was proposed that the financial statement must be prepared in accordance with U.S. GAAP and either be:

- (i) required to be filed with the SEC;
- (ii) required to be provided to the federal government or any of its agencies other than the IRS;

- (iii) certified by an independent certified public accountant;
 - (iv) given to creditors for purposes of making lending decisions;
 - (v) given to equity holders for purposes of evaluating their investments in the taxpayer; or
 - (vi) provided for other substantial non-tax purposes.
- The taxpayer must reasonably anticipate that it will be directly relied on for the purposes for which it was created.²⁰

In addition, in the case of a financial statement described in the second or third category, the values for eligible positions contained in the financial statement must be used by the taxpayer in most of the significant management functions of all or substantially all of its business. According to the proposed regulations, “[t]his use includes activities such as 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, but does not include either tax accounting or reporting of the results of operations to other persons.”²¹ However, in determining use, consideration must be given to whether the taxpayer’s reliance on the values exposes the taxpayer to material adverse consequences if the values are incorrect.²²

In order to qualify as an “eligible method,” the method was proposed to be a “mark-to-market method that is sufficiently consistent with the requirements of a mark-to-market method under section 475,” which requires that it satisfy certain requirements set forth in the proposed regulations. First, it must mark eligible positions to market through valuations made as of the last business day of each tax 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.²³

Conditioning the inclusion of a security in the safe harbor on whether or not the value is reflected in the income statement abandons the underlying premise of the safe harbor might potentially make inclusion in the safe harbor elective and can only lead to more controversy.

The proposed regulations explain that “[t]his safe harbor is based on the principle that, if a market-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 should be appropriate values for purposes of section 475.”²⁴ Thus, the proposed regulations clarified that fair value under U.S. GAAP could be used as a proxy for fair market value for federal income tax purposes.

The proposed regulations, however, did place certain limitations on the ability of taxpayers to rely on their financial statement values. According to the preamble to the proposed regulations, these limitations were to ensure minimal divergence from fair market value.²⁵ Under the first limitation, which applied only to securities and commodities dealers, except for eligible positions that are traded on a qualified board or exchange (as defined in Code Sec. 1256(g)(7)), 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 in accordance with U.S. GAAP. Under the second limitation, if the method of valuation consists of determining the present value of projected cash flows from an eligible position or positions, then the method must not take into account any cash flows of income or expense that are attributable to a period or time before the valuation date. This limitation was aimed at ensuring that items of income or expense would not be accounted for twice, first through current realization and then again in the mark. Under the third limitation, no cost or risk may be accounted for more than once, either directly or indirectly. For example, a financial accounting method that allows a special adjustment for credit risk would generally satisfy this limitation. But, it would not satisfy the limitation if it computed the present value of projected cash flows using a discount rate that takes into account any amount of credit risk that is also taken into account by the special adjustment.²⁶

Finally, the proposed regulations imposed certain verification and record retention requirements in

keeping with the verification principle of Announcement 2003-35. Under the proposed regulations, electing taxpayers must clearly show that (i) the same value used for financial reporting was used on the federal income tax return; (ii) no eligible position subject to Code Sec. 475 is excluded from the application of the safe harbor; and (iii) the fair values of only eligible positions subject to Code Sec. 475 are carried over to the federal income tax return under the safe harbor.²⁷

Because they represented efforts by the IRS and the Treasury to provide clarity on the nettlesome problem of valuation under Code

Sec. 475, both Announcement 2003-35 and the proposed regulations were welcomed by taxpayers even though taxpayers were concerned with certain requirements in the proposed regulations for eligibility under the safe harbor.²⁸

Scope and Limitations of the Final Regulations

On June 11, 2007, the IRS and the Treasury released final Reg. §1.475(a)-4.²⁹ To the dismay of many taxpayers, the final regulations adopted the proposed regulations with some modifications that further limited the utility of the safe harbor. Specifically, the final regulations adopted the bid-ask limitations of the proposed regulations (with the exception for valuations that are at or near the bid-ask values for securities that are listed on a qualified board or exchange), the requirement that changes in the values of marked-to-market securities be reflected on the income statement (which excludes from the safe harbor the partial financial statements of U.S.-based subsidiaries of foreign banks that are generally filed with U.S. regulatory agencies, even though the financial statements generally are prepared in accordance with U.S. GAAP and almost invariably use valuation methodologies that are consistent with valuation standards under Code Sec. 475), the requirement that financial statements be prepared in accordance with U.S. GAAP and the verification—recordkeeping and retention—requirements of the proposed regulations. Under the final regulations, the safe harbor is available only to dealers in securities and dealers in

Given that many foreign financial institutions that are required to pay taxes on U.S. dealer operations file their primary financial statements under the GAAP of a non-U.S. jurisdiction, the requirement makes the safe harbor unavailable to these taxpayers.

commodities, notwithstanding that Announcement 2003-35 and the proposed regulations had contemplated the inclusion of traders in the safe harbor.

The preamble to the final regulations appropriately recognizes that it is “sometimes difficult to determine the fair market value of certain securities and commodities,” and that “[t]his has impeded the efficient administration of the mark-to-market system under section 475.”³⁰ The preamble, therefore, states that the regulations are issued “with a view to improving the administrability of the valuation requirements of section 475.”³¹ But the final regulations are unnecessarily restrictive and appear to abandon the three broad guiding principles for a safe harbor under Code Sec. 475 set out in Announcement 2003-35.

Unless its application is broadened, it is doubtful that the safe harbor will operate to reduce the controversy and contentious environment between the IRS and taxpayers with regard to valuation issues in connection with Code Sec. 475. This section discusses the reasons given by the IRS and the Treasury for limiting the availability of the safe harbor and why certain of the restrictions may not serve the best interests of taxpayers or the IRS.

Bid-Ask Limitation

Reg. §1.475(a)-4(d)(3) requires that in order to be eligible for the safe harbor, a dealer’s valuation methodology may not permit values for positions that are “at or near” the bid or ask prices of the market. Specifically, Reg. §1.475(a)-4(d)(3)(i) provides as follows:

- 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.

However, the long-standing practice among securities dealers is to mark long positions in physical securities to the bid side of the market and short positions to the ask side of the market and this practice complies with

U.S. GAAP. In fact, U.S. GAAP’s definition of “fair value” appears to be closer to bid and ask prices³² and permits using mid-market prices only as a “practical expedient.”³³ The safe harbor makes an exception for positions that are “traded on a qualified board or exchange.” But many physical securities, such as regularly traded equity and debt securities, are not traded on a qualified board or exchange and instead are traded on the over the counter (OTC) market.³⁴ Therefore, taxpayers electing to use bid-ask prices permitted by U.S. GAAP for valuing positions, would not be in compliance with the safe harbor, at least with respect to their positions in physical securities. The failure to include physical securities within the exception to the bid-ask limitation will operate to increase, rather than reduce controversy between taxpayers and the IRS.

The safe harbor lumps together, and thus fails to distinguish between physical securities that are traded on the OTC market and OTC-traded derivatives. But the business model of OTC derivatives dealers that is described in the preamble to the final regulations indicates that for purposes of income recognition by dealers, the bid-ask spreads of OTC derivatives are very different from the bid-ask spreads of physical securities traded in the OTC market.³⁵ As the preamble points out, dealers seek to capture and profit from bid-ask spreads in the marketplace by entering into balanced portfolios for their derivatives, *i.e.*, 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. The offsetting positions generally remain on dealers’ books over the terms of the positions. The spread between bid and ask values compensates the dealer for his risks and expenses and, therefore, contains the dealer’s profit. Therefore, the creation of a balanced portfolio gives rise to a synthetic annuity that has a value that is largely immune from market-related changes in the values of the component positions.

When a dealer enters into an offsetting position and creates a synthetic annuity, all steps required to earn the income from the synthetic annuity have been completed. Therefore, it is appropriate to recognize the present value of the income attributable to the bid-ask spread in the tax year the synthetic annuity is created. Nonetheless, using bid or ask values only approximates (it does not accurately represent) realization accounting for a matched book of eligible positions, such as a dealer’s portfolio of interest rate swap contracts. Therefore, the bid or ask values of

derivatives would not recognize in income the present value of a synthetic annuity in the tax year that the synthetic annuity is created.

By contrast, as one commentator has pointed out, for physical securities, dealers rapidly turn over the securities that are traded on qualified boards or exchanges or on liquid over-the-counter markets. Therefore, except for those acquired at the end of the tax year, the acquisition and disposition of a physical security occurs within a single tax year, so that the effect of capturing a bid-ask spread also occurs entirely within that year.³⁶

Accordingly, a dealer enters into a derivative position with a view to retaining that position on its books indefinitely, but buys physical securities into inventory for the purpose of near-term resale to customers.

The amount of income is easily determined regardless of the valuation methodology if the turnover is rapid; therefore, the values of physical securities can be easily determined, given that the spread between the bid and ask values almost invariably is captured in income in the same year that the dealer purchases the physical securities. Hence, it would appear that requiring physical securities to be marked closer to mid-market will not make their values any more reliable.

Nevertheless, the IRS and the Treasury assert the following: (i) they do not possess sufficient information, based on the comments received, to conclude that spreads in the over-the-counter debt markets are *de minimis*; (ii) debt instruments may be used to lock in spreads with respect to open positions in other instruments, such as derivatives; and (iii) 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.³⁷ Thus, the IRS and the Treasury appear to be focused on not compromising the clear reflection of income.

However, if the intention in fact is to allow dealers to benefit from the safe harbor without compromising the clear reflection of income, the concerns expressed by the IRS and the Treasury could easily have been addressed by a rule that permits within the safe harbor all debt instruments except for debt instruments with embedded derivatives and debt instruments that are part of a derivative position. Rather than enhancing the

clear reflection of income, the limitation may have unwittingly introduced a potential distortion into the marketplace. Because the limitation requires a dealer to recognize in income on a current basis dealer spreads in connection with the purchase of a physical security into inventory, a dealer can capture the credit from mark-to-market income merely by bulking up a position in physical securities at year-end. By contrast, in those situations where a dealer in fact captures a spread in respect of a physical security without actually selling the security (for example, by using the security as a hedge of an offsetting derivatives position), the rule suggested above will require the dealer to recognize in income the net present value of that spread on a current basis.

In addition, the bid-ask limitation undermines the underlying premise of the safe harbor. The fundamental premise underlying the safe harbor is that the IRS will accept taxpayer valuations, provided that the taxpayer can demonstrate the trustworthiness of its valuations by showing that it uses the same values for tax purposes as it does for important nontax purposes. That is why Announcement 2003-35 articulated three guiding principles—the consistency, incentive and verification principles—that would provide a framework for the safe harbor. The final regulations presume that a position's actual value could not in fact be closer to the bid or ask side of the market than to an unadjusted mid-market value. However, in the case of illiquid "exotic" derivatives, for example, it is entirely possible that a dealer could incur various risks in connection with an OTC derivatives position that are either very difficult or very expensive to hedge, so that the dealer quite appropriately could mark the unhedged position, for all relevant commercial and financial accounting purposes, very near the bid or ask price.

The limitation makes the safe harbor unavailable to a taxpayer having values that are at or near bid or ask values, even if the taxpayer can demonstrate that the same values are used for both tax and financial statement purposes. Given the underlying principles of the safe harbor, the appropriate inquiry should be whether a taxpayer is employing the values in question for financial accounting purposes (and, in appropriate cases, satisfying the significant business use standard of the regulations). The final regulations' approach of regulating adjustments to mid-market values at a substantive level abandons the underlying premise of the safe

harbor, and values removed from the safe harbor will potentially give rise to the same controversy and litigation that necessitated the safe harbor in the first place.

Recognition of Changes in Value into the Income Statement

Reg. §1.475(a)-4(d)(2)(ii) requires that, in order for a valuation method to be eligible for the benefits of the safe harbor, changes in the value of a given position recorded under the method must be reflected specifically on the taxpayer's income statement (as opposed to its audited balance sheet or other reliable financial reports). This requirement reflects the view that income statement values are more reliable than balance sheet and other financial statement values. Hence, the preamble to the final regulations contends as follows:

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.³⁸

Undoubtedly, the tension between maximizing income for financial reporting purposes and reducing income for income tax purposes might encourage a taxpayer to more accurately value its securities positions. But this tension is not the only, or indeed the most important, source of reliability for valuations. Depending on a particular taxpayer's situation, the two opposing interests may not always offset one another, and a taxpayer, determined to achieve a particular result, may not be deterred by the tension.

There is no reason to believe that the balance sheet is fundamentally less reliable than the income statement. The balance sheet statement is rigorously reviewed by both internal and external stakeholders so that taxpayers have no less need to demonstrate that they are using valuations in the balance sheet consistently both for financial statement and tax purposes. More importantly, taxpayers have a strong incentive to report values accurately if their financial statements are filed with the SEC or other regulatory agencies.

The balance sheet is used for very critical and significant nontax purposes. In the case of financial institutions, for example, the systems under which the financial statements are prepared as well as the items reported on those financial statements are scrutinized by internal audit departments, independent outside accountants and bank and securities regulators. For example, banking and securities dealer regulatory standards provide for minimum capital requirements that must be satisfied by banks and securities dealers and the balance sheets of these institutions are scrutinized to know whether the institutions satisfy the minimum capital requirements.³⁹ In addition, regulators, creditors, shareholders and the capital markets rely on the accuracy of the balance sheets. Therefore, a financial institution having irregularities in its financial statements would expect that there would be very serious consequences.

The reliability of the balance sheet is further buttressed by the fact that the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation require U.S. branches of foreign banks to file only a statement of their assets and liabilities on their call reports. These banks are not required to show their income statements on the call reports, even though the purpose of the call reports is to enable the federal bank regulators to monitor the safety and soundness of U.S. branches of foreign banks.

The call reports only show the assets and liabilities of the banks in accordance with U.S. GAAP, and do not contain income statements. In fact, a call report does not even contain a complete balance sheet because it does not include an equity capital section (given that the U.S. branch of a foreign bank is not completely separate from its parent). Instead, to equalize total assets and total liabilities, the call reports rely on the "net due to/due from head office and other related depository institutions" entries.⁴⁰ That the Federal Reserve and other government agencies place confidence in the values that are reported in the balance sheet indicates that the balance sheet is a reliable financial statement.

Additionally, it is not as though the income statement can stand independent of the balance sheet. On the contrary, the income statement and the balance sheet are interrelated. The net profit and loss on the income statement is derived by comparing the opening and closing balance sheets and adjusting for asset purchases and disposals and changes in liabilities and equity. Thus, the changes in fair value

of marked-to-market securities and derivatives (*i.e.*, the net gain or loss in respect of such instruments) that are reported on the income statement are derived from the balance sheet.⁴¹

The changes in value of securities reflected in the balance sheet that do not flow through the income statement are generally recorded in “other comprehensive income” (OCI) and include “available for sale” securities,⁴² cash flow hedges⁴³ and derivatives contracts entered into to hedge exposure to equity investments in non-U.S. subsidiaries (*e.g.*, certain currency hedges).⁴⁴ These are relatively straightforward and uncomplicated instruments and their market prices are readily available.⁴⁵ Given that they are the least likely to cause controversy in valuation between the IRS and taxpayers, there is no benefit to the IRS and taxpayers in not including them in the safe harbor.

Furthermore, there is no theoretical or practical reason for excluding a security from the safe harbor on the basis that its value is not recognized in income into the income statement when securities of the same class receive the benefit of the safe harbor. As noted previously, the safe harbor does not apply to available for sale securities because their values do not flow through the income statement but rather through OCI, while the safe harbor applies to trading securities because their values are reflected in the income statement. This creates the situation in which securities in the same class may be distinguished solely by reason of where they are reflected in a taxpayer’s financial statement and not because they are valued using different valuation methodologies. This will be the result if a taxpayer classifies some securities as “available for sale” and others in the same class as “trading” securities. It would appear that, at least in such a case, a taxpayer should be able to use the safe harbor if the taxpayer can demonstrate that the valuation methodology is used consistently (for both securities whose values are reflected in the income statement and those whose values are reflected only in the balance sheet) and the taxpayer has the records to verify the values.

Presumably, the IRS would prefer that the safe harbor applied to both to prevent “game-playing.” Therefore, arguably, a taxpayer has no need to be concerned if the taxpayer is using a single valuation methodology for the same class of securities, because IRS agents are not likely to challenge such methodology if the taxpayer can demonstrate that the methodology used for valuing “available for sale” securities is also used for valuing securities

in the safe harbor. Nevertheless, the premise of the safe harbor is that if a taxpayer uses the same valuation methodology consistently for both financial statement and tax purposes and there are strong incentives for the taxpayer to report values accurately, then the values should be accepted as fair market values for tax purposes. Accordingly, it is only proper that where a taxpayer employs the same valuation methodology for securities whose values are reflected in the income statement and securities of the same class whose values are reflected only in the balance sheet, the taxpayer should have the benefit of the safe harbor. Conditioning the inclusion of a security in the safe harbor on whether or not the value is reflected in the income statement abandons the underlying premise of the safe harbor, might potentially make inclusion in the safe harbor elective and can only lead to more controversy.

Moreover, the requirement that changes in the values of securities be specifically recognized in the income statement effectively makes the safe harbor unavailable to U.S. subsidiaries of foreign banks. As noted, these U.S. subsidiaries of foreign banks are required to file “call reports” on a quarterly basis with the Federal Reserve or the Office of the Comptroller of the Currency. The reports are prepared in accordance with U.S. GAAP, are audited by outside accountants, and effectively are standalone balance sheets for the U.S. subsidiaries. But the reports are not complete financial statements given that they do not contain statements of income or earnings. Therefore, in the view of the IRS and the Treasury, the call reports lack the “tension” necessary to make a financial statement reliable and the valuations appearing on the call reports do not qualify for the safe harbor.

The safe harbor is unavailable to U.S. subsidiaries of foreign banks filing call reports, even though Announcement 2003-35 and the proposed regulations had contemplated that call reports would be applicable financial statements. Under the preamble to the proposed regulations, the second category of financial statements—*i.e.*, those required to be provided to the federal government or any of its agencies other than the IRS—included “statements filed by foreign-controlled financial institutions engaged in trade or business within the United States who report their mark-to-market results to the Federal Reserve or the Office of the Comptroller of the Currency.”⁴⁶ These statements are the call reports discussed above.

The notion that a U.S. subsidiary of a foreign bank would understate the value of its portfolio to the

Federal Reserve or the Comptroller of the Currency in order to reduce tax income is not credible. Valuations by these banks are used for significant nontax purposes. These companies also face significant penalty risks if they misstate the values in their call reports. Therefore, call reports should be as trustworthy as financial statements that include an income statement and not including them as “applicable financial statements” will not serve to enhance the administrability of valuation under Code Sec. 475.

Recognizing the utility of including call reports as applicable financial statements, the final regulations leave open the possibility that the reports could later be included within the safe harbor. Therefore, the final regulations solicit responses to several issues that the IRS and the Treasury view as important in deciding whether to extend the safe harbor to call reports. The issues include (1) whether the safe harbor should 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; (2) whether the valuation standards used in the foreign bank’s home country should be identical to the valuation standards under U.S. GAAP; (3) whether the income statement filed by the foreign bank should be filed with the foreign bank’s home country bank regulator (as distinct from a market regulator like the SEC); and (4) whether the term “home country” should mean the country in which the foreign bank is chartered or incorporated.⁴⁷

Requirement of U.S. GAAP

The final regulations also limit the availability of the safe harbor by requiring that financial statements be prepared in accordance with U.S. GAAP.⁴⁸ Under Reg. §1.475(a)-4(h), a taxpayer’s “applicable financial statement” for a tax year is the taxpayer’s “primary financial statement” for that year and there are three categories of primary financial statements: (i) 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) 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 IRS; and (iii) 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 nontax purposes) and that the taxpayer reasonably anticipates will be directly relied on for the purposes for which it was given or provided.⁴⁹ Thus, only financial statements prepared in accordance with U.S. GAAP are eligible for the safe harbor.

Given that many foreign financial institutions that are required to pay taxes on U.S. dealer operations file their primary financial statements under the GAAP of a non-U.S. jurisdiction, the requirement makes the safe harbor unavailable to these taxpayers. As noted previously, the call reports filed by the U.S. subsidiaries of foreign banks are generally prepared in accordance with U.S. GAAP. However, the call reports do not contain income statements, and even though the valuations of securities shown on the call reports are reflected in the income statements filed by their parent banks using valuation standards that are essentially the same as U.S. GAAP, the income statements filed by their parent banks as part of their overall financial statements generally are prepared in accordance with the GAAP of the home countries. Accordingly, the final regulations fail to include U.S. subsidiaries of foreign banks in the safe harbor by requiring that changes in values of securities be shown on the income statement, and by requiring that the income statement be prepared in accordance with U.S. GAAP.

No doubt the IRS and the Treasury have a legitimate interest in ensuring that financial statements used for the safe harbor are prepared under a sound set of accounting principles. However, rather than requiring that financial statements be prepared in accordance with U.S. GAAP, it would appear that the relevant inquiry should be whether the accounting standard (or the valuation standard) under which a taxpayer’s financial statement is prepared is consistent with U.S. GAAP, if the goal is in fact to reduce the compliance burdens of taxpayers and minimize controversy. The utility of the limitation becomes even more questionable when one considers that U.S. GAAP is converging with International Financial Reporting Standards (IFRS), promulgated by the International Accounting Standards Board (IASB).

There is an ongoing project by the SEC and IASB to achieve convergence between U.S. GAAP and the IFRS.⁵⁰ Indeed, the SEC recently voted unanimously to publish a Concept Release to allow U.S. issuers that file on Form 10-K the option of preparing their financial statements in accordance with IFRS.⁵¹ The SEC has also proposed to eliminate the U.S. GAAP

reconciliation requirement for foreign private issuers who file financial statements prepared in accordance with IFRS.⁵² Therefore, at a time when the SEC is acknowledging the reliability and equivalence of the IFRS to U.S. GAAP, the IRS and the Treasury have decided to distinguish between the two standards for preparing financial statements.

More importantly, IFRS, as promulgated by the IASB (although not necessarily as adopted by all jurisdictions),⁵³ contains rules for marking securities and OTC derivatives to market that are essentially the same as fair value accounting under U.S. GAAP. The U.S. GAAP definition of "fair value" for a financial instrument is materially the same as that under the IFRS and there is no reasonable basis for not including valuations of financial instruments reported under the IFRS under the safe harbor. In fact, until the Financial Accounting Standards Board (FASB), the body responsible for promulgating U.S. GAAP standards, adopted Financial Accounting Standard (FAS) 157 (which defines fair value), the IFRS definition of fair value was considerably stricter than the U.S. GAAP standards.

International Accounting Standard (IAS) 39, the relevant section of the IFRS dealing with financial instruments, defines "fair value" as the "amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."⁵⁴ On the other hand, FAS 157 defines "fair value" as the "price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."⁵⁵

Under FAS 157, an orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).⁵⁶ Also, under FAS 157, market participants are buyers and sellers in the principal (or most advantageous) market for the asset or liability that are the following:

- (a) Independent of the reporting entity; that is, they are not related parties
- (b) Knowledgeable, having a reasonable understanding about the asset or liability and the transaction based on all available information, including information that might be obtained through due diligence efforts that are usual and customary

- (c) Able to transact for the asset or liability
- (d) Willing to transact for the asset or liability; that is, they are motivated but not forced or otherwise compelled to do so⁵⁷

The convergence of the U.S. GAAP definition of fair value to the IFRS definition demonstrates that, at least with respect to fair value measurements, the IFRS is essentially the same as U.S. GAAP. Because the safe harbor is unavailable to valuations that are reported under IFRS, the final regulations are not likely to enhance the administrability of valuations under Code Sec. 475 by U.S. subsidiaries of foreign banks.

Unavailability of Safe Harbor to Traders of Securities and Commodities

Lastly, the final regulations provide that the safe harbor is available only to taxpayers who are dealers in securities under Code Sec. 475(a) or who are dealers in commodities and are subject to the election described in Code Sec. 475(e)(1). Accordingly, securities traders and commodities traders are not "eligible taxpayers" for purposes of the safe harbor.

The IRS and the Treasury contend that they do not have a "full understanding" of the business model of traders so that it would be "unwise" to include them in the safe harbor at this time.⁵⁸ According to the IRS and the Treasury, the final regulations are based on the business model of dealers and the IRS and the Treasury do not understand how, for example, the bid-ask limitation would apply to traders. Apparently, the comments received by the IRS and the Treasury in response to Announcement 2003-35 and the proposed regulations failed to address whether traders, like dealers, capture spreads when they enter into securities or derivatives positions so as to be immune to changes in value in the underlying securities or derivatives.

But traders are generally interested in rapidly turning over securities to profit from price changes. Therefore, it would appear that except for securities acquired at the end of the tax year, the acquisition and disposition of securities by a trader occurs within a single tax year, so that the effect of capturing a bid-ask spread also occurs entirely within that year. Of course, when a trader holds a security for investment rather than for trading, the bid-ask spread may not be captured within the tax year. However, in those cases, the trader would not likely elect mark-to-market treatment and the issue of the appropriate valuation for the securities would not arise.

Under the final regulations, the safe harbor is unavailable to traders whether or not their valuations are consistent with Code Sec. 475, based on U.S. GAAP, or income is recognized into the income statement. For example, consider the case of entities that are Code Sec. 475(c)(1) dealers but that have also made Code Sec. 475(f) trader in securities elections to preserve the character of some of their speculative activity. These “traders” would not be able to use the safe harbor for their trading securities, even though the safe harbor is available to the same securities in their “dealer” portfolio. Also, the safe harbor is unavailable to traders, notwithstanding that both Announcement 2003-35 and the proposed regulations had contemplated their inclusion in the safe harbor. Removing traders from the safe harbor invariably means that, at least with respect to traders, the administrability of valuations under Code Sec. 475 will not be easier than it was before the safe harbor project.

The *Bank One* Case

As noted, the failure of the final regulations to provide comprehensive safe harbor to taxpayers ensures that valuation controversies between taxpayers and the IRS will continue. Specifically, traders and U.S. subsidiaries of foreign banks, because the safe harbor is not available to them, will likely continue to have disputes with the IRS over valuations. Dealers and the IRS will continue to dispute valuations of securities that are marked to market through OCI rather than the income statement. But, given the outcome of the *Bank One* case,⁵⁹ taxpayers should be concerned that their valuations may not be upheld by the courts.

The *Bank One* case involved a dispute between the taxpayer and the IRS over the valuation methodology used by the taxpayer to value certain swaps entered into by the taxpayer. The taxpayer had employed a methodology that valued the swaps at their mid-market values with adjustments for credit risk and administrative costs.⁶⁰ The IRS contended that the appropriate valuation should be mid-market values without any adjustments for credit risk and administrative costs. The Tax Court held that both the taxpayer’s and the IRS methodology for valuing the swaps failed to clearly reflect taxpayer’s income and, on its own, adopted a methodology that permitted some adjustments to mid-market values.⁶¹

On appeal, the Court of Appeals for the Seventh Circuit presumed that the proposed regulations and the ANPRM would limit the case’s precedential value. First, with respect to the distinction between

tax fair market value and fair value under U.S. GAAP, the court stated:

We note that the proposed regulation may render this distinction moot in future cases, since it would provide that “the value that the eligible taxpayer assigns to that eligible position in its applicable financial statement is the fair market value of the eligible position 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.”⁶²

Second, with respect to the different valuation methods proposed by the IRS (unadjusted mid-market values) and the taxpayer (mid-market values with further adjustments), the court stated:

We note again that the proposed regulations regarding mark-to-market accounting may render the particular application of the method disputed here inapplicable in the future. Academic literature has characterized the methodology at issue of using “the unadjusted midmarket value for most significant business purposes” as “outlying.” Linda M. Beale, *Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor*, 24 Va. Tax Rev. 301, 420 (2004) (emphasis omitted). The article further noted that the taxpayer’s approach during the years at issue “cannot be considered illustrative of current practice,” suggesting that this dispute may have little bearing on the current market or practices. *Id.* at 422.⁶³

Finally, on the valuation of interest swaps, the court stated:

Meanwhile, the Commissioner independently issued a notice of proposed rulemaking that would affect the valuation of interest swaps. See *Safe Harbor for Valuation Under Section 475*, 70 Fed. Reg. 29663 (May 24, 2005). The proposed rule sets forth a safe harbor for valuing securities such as interest swaps. Specifically, the proposed rule provides that if the valuation reported on certain financial statements mirrors the reported tax value, then the Commissioner will accept the value as fair market value. *Such a rule, if finalized, would likely bear on similar cases and may limit this case’s precedential value ...*⁶⁴

The Court of Appeals then affirmed the Tax Court's decision as it related to the taxpayer's valuation methodology. But the Seventh Circuit Court of Appeals also held that the Tax Court should not have rejected the IRS methodology, unless the Tax Court found that the methodology was "arbitrary or unlawful":

Having rejected the taxpayer's method, the tax court proceeded to examine the Commissioner's method. The tax court analyzed whether the Commissioner's own method produced the fair market value of the interest swaps. In doing so, however, the tax court failed to afford the Commissioner the deference due under the statutory scheme. Section 446, provides that "if the method used [by the taxpayer] does not clearly reflect income," such as occurred in this case in which the taxpayer's method fails to produce a fair market value, then "the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."... We observe section 446 requires that the Commissioner's method "shall" be followed. Following this language, the Supreme Court instructs that the Commissioner's "interpretation may not be set aside unless 'clearly unlawful' or 'plainly arbitrary.'" Accordingly, the tax court was required to defer to the Commissioner's method of calculating fair market value.⁶⁵

On remand, and in an unpublished opinion, the Tax Court held that the Commissioner's valuation method was not "arbitrary or unlawful" but insisted that the method did not "clearly reflect" taxpayer's income.⁶⁶ Accordingly, the Tax Court again adopted its original ruling on the case.

Despite the Court of Appeals' presumptions, it is clear that given the narrow applicability and limited utility of the final regulations, disputes between the IRS and taxpayers, such as was at issue in the *Bank One* case, will not soon disappear by reason of the

final regulations. As noted, the proposed regulations and the ANPRM contemplated the inclusion of traders in the safe harbor and they are excluded under the final regulations. Additionally, taxpayers' fair value computations would be respected only if they are recognized into the income statement. Therefore, *Bank One* type disputes are likely to continue for valuations reflected outside the income statement.

More importantly, by holding that once a court finds that a taxpayer's valuation method does not clearly reflect income the court must adopt the IRS's proposed methodology unless it is arbitrary or unlawful, the Court of Appeals' opinion is significant and may have longer lasting impact than was originally thought to be the case. Although the Tax Court again adopted its original ruling in the case, it is not clear that the Tax Court can modify the IRS's method without finding that it is unlawful or arbitrary.⁶⁷ This is because Code Sec. 446 appears to suggest that once the Tax Court finds that the taxpayer's method does not clearly reflect income, and that the Secretary's method is not "unlawful or arbitrary," the Secretary is free to compute taxpayer's income using a method that "*in the opinion of the Secretary, does clearly reflect income.*"⁶⁸ The Tax Court's unpublished opinion fails to address this critical language "in the opinion of the Secretary" and merely asserts that the court did not find that the IRS's method clearly reflected taxpayer's income. Nonetheless, in such cases, the Code Sec. 446 standard is not clear reflection of income as may be decided by a court but clear reflection of income "in the opinion of the Secretary."

Accordingly, while the final regulations may not enhance the administrability of valuations under Code Sec. 475 because of their many limitations on the use of the safe harbor, the *Bank One* case has the potential effect of forcing taxpayers to take conservative positions for valuation purposes or risk having their methodology determined to fail to clearly reflect income, resulting in the IRS valuation position being upheld unless it is arbitrary or unlawful.

ENDNOTES

¹ The absence of regulatory guidance existed despite the fact that both the Committee Report and the Conference Agreement to Code Sec. 475 contemplated that the Treasury "will authorize the use of valuation methods that will alleviate unnecessary compliance burdens for taxpayers." See H.R. CONF. REP. NO. 103-213, 103rd Cong., 1st Sess., at 613 (1993). ("It is expected that the Treasury Department will authorize the use of appropriate valuation methods that will alleviate unnecessary com-

pliance burdens of taxpayers under the bill.") H.R. CONF. REP. NO. 103-213, at 616. ("Valuation of securities. The conference agreement does not provide any explicit rules mandating valuation methods that are required to be used for purposes of applying the mark-to-market rules. However, the conferees expect that the Treasury Department will authorize the use of valuation methods that will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for Federal income tax

purposes.") See also Dep't of Treasury, General Explanation of the President's Budget Proposals Affecting Receipts 89-90 (Jan. 30, 1992). ("The mark-to-market method represents the best accounting practice in the trade or business of dealing in securities and is the method that most clearly reflects the income of a securities dealer," proposing that dealers be required to use mark-to-market accounting for their inventories "as they already do when preparing financial statements.")

² See Reg. §1.170A-1(c)(2) (“the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts”); see also Reg. §1.704-4(a)(3) (similar); Rev. Rul. 59-60, §2.02; 1959-1 CB 237; TBR 57, 1 CB 40 (1919) (“[a] fair market value that both a buyer and a seller, who are acting freely and not under compulsion and who are reasonably knowledgeable about all material facts, would agree to in a market of potential buyers at a fair and reasonable price”); *Hudson River Woolen Mills*, 9 BTA 862, 868, Dec. 3255 (same); Announcement 2003-35, IRB 2003-21, 956 (“the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts”).

The Tax Court has summarized the standards for fair market value as:

(1) The buyer and the seller are a willing buyer and a willing seller; (2) neither the willing buyer nor the willing seller is under a compulsion to buy or sell the item in question; (3) the willing buyer and the willing seller are both hypothetical persons; (4) the hypothetical willing buyer and the hypothetical willing seller are both reasonably aware of all relevant facts involving the item in question; (5) the item in question is valued at its highest and best use; and (6) the item in question is valued without regard to events occurring after the valuation date to the extent that those subsequent events were not reasonably foreseeable on the date of valuation.

Bank One Corp., 120 TC 174, 306, Dec. 55,138 (2003).

³ H.R. CONF. REP. 103-213, at 616 (1993). The Committee Report provides that fair market value will be determined by valuing each security on an individual security basis without taking into account blockage discounts. H.R. CONF. REP. NO. 103-213, at 613. (“For purposes of the House bill, fair market value is generally determined by valuing each security on an individual security basis. Thus, if a taxpayer holds a large block of securities of the same type, the securities should be valued without taking any blockage discount into account.”)

⁴ The *Bank One* case, *supra* note 2, is a very prominent result of the litigious environment created by the lack of clarity around the appropriate valuation methodology.

⁵ Act Sec. 13223(a) of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66).

⁶ See, e.g., New York State Bar Association Tax Section, *Report on IRS Announcement 2003-35 (Safe Harbor for Valuation Under Section 475)* (hereinafter referred to as the “NYSBA Report”), 2003 TNT 197-18, at ¶13 (Oct. 9, 2003) (stating that “Derivatives dealers anecdotally report that the IRS on audit routinely

challenges their adjustments to the mid-market valuation”); see also Securities Industry Association letter to the Assistant Secretary for Tax Policy, Department of Treasury and to the Chief Counsel, IRS, 2002 TNT 78-18 (Mar. 28, 2002) (urging the IRS to give priority to guidance on mark-to-market requirements: “IRS examiners are increasingly challenging taxpayers’ section 475 valuation methodologies, even though these rely on methodologies used for key non-tax purposes (e.g., financial reporting). Absent clear guidance, we seem certain to see additional costly litigation along the lines of a case now involving Bank One”).

⁷ See *Bank One Corp.*, 120TC 174, Dec. 55,138 (2003). The *Bank One* cases involved the appropriate valuation of certain interest rate swaps entered into by petitioners and were consolidated for trial. It should be noted that the cases were cases about fair market value before Code Sec. 475 was effective. In docket No. 5759-95, First Chicago Corp. (FCC) and its affiliated corporations, one of which was a corporation formerly known as the First National Bank of Chicago (FNBC), petitioned the Tax Court to redetermine the IRS determination of deficiencies of \$1,661,112 and \$2,956,794 in the affiliated group’s consolidated federal income taxes for 1990 and 1991, respectively. In docket No. 5956-97, First Chicago NBD Corp., the successor in interest to FCC and affiliated corporations, petitioned the Tax Court to redetermine the IRS determination of a \$95,156,499 deficiency in the 1993 consolidated federal income tax return of FCC and its affiliated corporations. Bank One was the successor to First National Bank of Chicago. In order to avoid confusion, this article consistently refers to the taxpayer in the *Bank One* case (both in the Tax Court and in the Seventh Circuit Court of Appeals) as “*Bank One*.”

⁸ See Letter from Marc E. Lackritz to Hon. Mark A. Weinberger, 2001 TNT 96-27 (Apr. 25, 2001) (hereinafter referred to as the “2001 SIA letter”); Letter from Saul M. Rosen and Patti McClanahan to Hon. Mark Weinberger and Hon. B. John Williams, 2002 TNT 78-18 (Mar. 28, 2002) (hereinafter referred to as the “2002 SIA letter”).

⁹ See *id.*, 2001 SIA letter.

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ See 2002 SIA letter, *supra* note 8. (“The need for guidance is only increasing. IRS examiners are increasingly challenging taxpayers’ section 475 valuation methodologies, even though these rely on methodologies used for key non-tax purposes (e.g., financial reporting). Absent clear guidance, we seem certain to see additional costly litigation along the lines of a case now involving Bank One. In addition to helping avoid disputes, bright-line rules

from Treasury and the IRS would free up scarce IRS audit resources and reduce taxpayer administrative burdens, consistent with the direction of Congress.”)

¹⁵ Announcement 2003-35, IRB 2003-21, 956 (filed by the Office of the Federal Register on May 2, 2003, 8:45 a.m., and published in the issue of the Federal Register for May 5, 2003, 68 FR 23632, and referred to as the “Advance Notice of Proposed Rulemaking” (ANPRM)).

¹⁶ The Announcement also indicated that in certain limited circumstances, it may also be appropriate to consider financial statements required to be filed with a state government or any of its agencies, a political subdivision of a state or possibly a foreign regulator, and to consider statements provided to equity holders or creditors.

¹⁷ 70 FR 29663–71.

¹⁸ Proposed Reg. §1.475(a)-4(b)(1).

¹⁹ Proposed Reg. §1.475(a)-4(c).

²⁰ Proposed Reg. §1.475(a)-4(h)(2).

²¹ Proposed Reg. §1.475(a)-4(h)(1), (j).

²² Proposed Reg. §1.475(a)-4(j)(4).

²³ Proposed Reg. §1.475(a)-4(d)(1), (2).

²⁴ Proposed Reg. §1.475(a)-4(a)(1).

²⁵ Preamble to the proposed regulations, 70 FR 29663-29671.

²⁶ Proposed Reg. §1.475(a)-4(d)(3)(iii), (4) (Examples 1–3).

²⁷ Proposed Reg. §1.475(a)-4(k).

²⁸ See, e.g., Institute of International Bankers Comment Letter, 2005 TNT 189-23 (Sept. 13, 2005); Securities Industries Association Comments to Announcement 2003-35, 2003 TNT 177-39 (July 30, 2003); and International Swaps and Derivatives Association Comments to the Proposed Regulations, 2006 TNT 52-33 (Mar. 7, 2006).

²⁹ The regulations apply to tax years ending on or after June 12, 2007. See T.D. 9328.

³⁰ Preamble to the final regulations, T.D. 9328.

³¹ *Id.*

³² See Statement of Financial Accounting Standards (FAS) 157, “Fair Value Measurements,” issued by the Financial Accounting Standards Board, September 2006 (hereinafter referred to as “FAS 157”) (¶5, defining “fair value” as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”); see also American Institute of Certified Public Accountants, Audit and Accounting Guide Brokers and Dealers in Securities, ¶7.08 (explicitly permitting the use of bid and ask prices).

³³ See ¶31 of FAS 157, providing that:

If an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value, regardless of where in the

fair value hierarchy the input falls (Level 1, 2, or 3). This Statement does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

- ³⁴ For a discussion of how debt securities are traded, see the New York State Bar Association, *Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273*, 2004 TNT 159-7 (Aug. 12, 2004).
- ³⁵ For more discussion of OTC derivatives model, see preamble to the final regulations, T.D. 9328.
- ³⁶ For more discussion of OTC physical securities model, see Securities Industry Association Comments to the Proposed Regulations, 2005 TNT 179-26 (Aug. 17, 2005).
- ³⁷ Preamble to the final regulations, T.D. 9328.
- ³⁸ *Id.*
- ³⁹ For more discussion of the capital requirements for banks, securities dealers and other financial institutions, see Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, and the Chairman, Committee on Banking and Financial Services, House of Representatives, "Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk," published by United States General Accounting Office (GAO) (July 1998) (available at www.gao.gov/archive/1998/gg98153.pdf).
- ⁴⁰ SEC Form 2069 (*Weekly Report of Assets and Liabilities for Large Branches and Agencies of Foreign Banks*), available at www.federalreserve.gov/boarddocs/reports/forms/forms/FR_206920070704_i.pdf.
- ⁴¹ For more discussion of the relationship between the balance sheet, income statement and statement of cash flows, see, e.g., Larry Walther, PRINCIPLES OF ACCOUNTING, Ch. 16 "Financial Analysis and the Statement of Cash Flows" (available at www.principlesofaccounting.com/chapter%2016.htm).
- ⁴² These are generally marketable equity securities and debt securities that a company may sell prior to maturity.
- ⁴³ E.g., a floating-to-fixed interest rate swap that allows a bank to convert interest on a floating rate bond into a more predictable stream of cash flows.
- ⁴⁴ The U.S. GAAP treatment of such derivatives is addressed by Financial Accounting Standard 52 (Foreign Currency Translation).
- ⁴⁵ See e.g., FAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*,

¶ 12 (describing trading and available for sale securities as "debt securities ... and equity securities with readily determinable values.") (available at www.fasb.org/pdf/fas115.pdf); for a more detailed discussion of the issues relating to amounts included in OCI, see letter from Edward D. Kleinbard on behalf of the Securities Industry Association, to Suzanne Boule, Office of the Chief Counsel, IRS, regarding "Advance Notice Regarding Proposed Safe Harbor Under Section 475," dated October 30, 2003 (attached to letter from Securities Industry Association, 2005 TNT 179-26 (Aug. 17, 2005)).

- ⁴⁶ Preamble to the proposed regulations, 70 FR 29663-71.
- ⁴⁷ See preamble to the final regulations, T.D. 9328.
- ⁴⁸ See Reg. §1.475(a)-4(h).
- ⁴⁹ Reg. §1.475(a)-4(h)(2).
- ⁵⁰ For a discussion of the issues raised by the convergence project, see Donald T. Nicolaisen, Chief Accountant, SEC, *A Securities Regulator Looks at Convergence*, 25 Nw. J. INT'L L. & BUS. 3 (Spring 2005), at 661; Mary Tokar, *Convergence and the Implementation of a Single Set of Global Standards: The Real-Life Challenge*, 25 Nw. J. INT'L L. & BUS. 3 (Spring 2005), at 687.
- ⁵¹ See, e.g., Speech by SEC Commissioner, Roel C. Campos, "Remarks at the Open Meeting: Concept Release on Allowing U.S. Issuers to Use IFRS," Washington, D.C. (July 25, 2007), available at www.sec.gov/news/speech/2007/spch072507rcc.htm.
- ⁵² See SEC press release: "SEC Soliciting Public Comment on Eliminating Reconciliation Requirement for IFRS Financial Statements" (July 3, 2007), available at www.sec.gov/news/press/2007/2007-128.htm.
- ⁵³ The European Union has adopted IFRS for all listed companies in the European Union in respect of their consolidated financial statements. In that regard, the European Union specifically adopted in November, 2004, IAS 39. However, the European Union modified the operation of IAS 39 for European companies through two "carve outs," which mitigated in certain respects the application of IAS 39 to European issuers in respect of (i) the rules under IAS 39 related to hedge accounting, under which hedged items and their hedges are both marked-to-market and (ii) an election under IAS 39, pursuant to which an entity may mark-to-market any financial asset or liability, including the entity's own debt. For

a discussion of the European Union's position on IAS 39, see European Commission Press Release, "Accounting Standard: Commission Endorses IAS 39," IP/04/1385 (Nov. 19, 2004), available at www.europa.eu/rapid/pressReleasesAction.do?reference=IP/04/1385&format=HTML&aged=1&language=EN&guiLanguage=en. See also "IAS 39 Financial Instruments: Recognition and Measurement—Frequently Asked Questions (FAQ)," European Commission Memo/04/265, Brussels (Nov. 19, 2004), available at www.europa.eu/rapid/pressReleasesAction.do?reference=MEMO/04/265&format=HTML&aged=1&language=EN&guiLanguage=en.

- ⁵⁴ See Technical Summary to IAS 39 "Financial Instruments: Recognition and Measurement" (prepared by IASC Foundation staff), www.iasb.org/NR/rdonlyres/1D9CBD62-F0A8-4401-A90D-483C63800CAA/0/IAS39.pdf.
- ⁵⁵ Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, ¶ 5 (Sept. 2006).
- ⁵⁶ *Id.*, at ¶ 7.
- ⁵⁷ *Id.*, at ¶ 10.
- ⁵⁸ *Id.*
- ⁵⁹ See *Bank One Corp.*, 120 TC 174, Dec. 55,138 (2003).
- ⁶⁰ *Id.*, at 243, 315. The taxpayer's valuations, however, were not the values on the last business day of the tax year as required by Code Sec. 475.
- ⁶¹ *Id.*
- ⁶² *JPMorgan Chase & Co.*, CA-7, 2006-2 USTC ¶ 50,453, 458 F3d 564, 569 (note 2) *JPMorgan Chase & Co.* became the successor in interest to Bank One Corporation in the *Bank One* case following the merger of Bank One Corporation with *JPMorgan Chase & Co.* in July 2004.
- ⁶³ *Id.*, at 571 (note 4).
- ⁶⁴ *Id.*, at 567 (emphasis added).
- ⁶⁵ See *JPMorgan Chase & Co.*, CA-7, 2006-2 USTC ¶ 50,453, 458 F3d 564, 569-571 (citations and footnotes omitted).
- ⁶⁶ *JPMorgan Chase & Co.*, No. 5956-97, 2007 TNT 99-14 (Mar. 7, 2007).
- ⁶⁷ As at the time of this publication, the second Tax Court's opinion has not been appealed by any of the parties.
- ⁶⁸ See Code Sec. 446 (emphasis added); see also *Heilig Meyers Co.*, DC VA, 2007-1 USTC ¶ 50,509 (applying Code Sec. 446 to valuation of installment accounts receivable under Code Sec. 475 and upholding valuation made by the IRS after finding that taxpayers' valuation did not "clearly reflect" income).

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