

UNITED STATES TAX COURT

BANK ONE CORPORATION (Successor in Interest to)
FIRST CHICAGO NBD CORPORATION, formerly NBD)
BANCORP, INC., Successor in Interest to FIRST)
CHICAGO CORPORATION) AND AFFILIATED)
CORPORATIONS,)
Petitioner,)
v.)
COMMISSIONER OF INTERNAL REVENUE,) Docket Nos. 5759-95
Respondent.) 5956-97
Judge David Laro)

BRIEF OF AMICI CURIAE

AMERICAN BANKERS ASSOCIATION
INSTITUTE OF INTERNATIONAL BANKERS
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.
THE NEW YORK CLEARING HOUSE ASSOCIATION L.L.C.
SECURITIES INDUSTRY ASSOCIATION
WALL STREET TAX ASSOCIATION

CLEARY, GOTTlieb, STEEN & HAMILTON
One Liberty Plaza
New York, New York 10006
(212) 225-2000
Attorneys for Amici

Of Counsel:
Leslie B. Samuels
Max Gitter
Edward D. Kleinbard
Thomas L. Evans
William L. McRae

October 12, 2000

TABLE OF CONTENTS

INTEREST OF THE AMICI AND INTRODUCTION	1
ISSUES PRESENTED	5
SUMMARY OF ARGUMENT	6
BACKGROUND ON SWAPS AND THE SWAPS MARKETS.....	8
A. OVERVIEW OF SWAPS AND ACTIVITIES OF SWAPS DEALERS	8
B. MODEL-BASED VALUATION OF SWAPS.....	13
ARGUMENT.....	20
I RESPONDENT MAY NOT REJECT A METHOD OF ACCOUNTING THAT CLEARLY REFLECTS INCOME SIMPLY BECAUSE ALTERNATIVE METHODS MAY EXIST	20
II MARK-TO-MARKET ACCOUNTING METHODS EMPLOYED BY SWAPS DEALERS IN GENERAL CLEARLY REFLECT INCOME.....	23
III SWAPS DEALERS APPLY THE SAME MARK-TO-MARKET METHODOLOGY FOR BOTH TAX AND NON-TAX PURPOSES	28
A. MARK-TO-MARKET VALUATION HAS BEEN CALCULATED CONSISTENTLY FOR TAX AND NON-TAX PURPOSES FOR DECADES.....	28
1. Market Valuation of Inventories.....	28
2. Comprehensive Mark-to-Market Accounting.....	29
B. TAX ACCOUNTING AND FINANCIAL ACCOUNTING HAVE THE SAME STANDARDS AND GOALS WHEN APPLYING MARK-TO-MARKET ACCOUNTING.....	32
C. COMPETING INTERESTS ELIMINATE SYSTEMIC BIAS IN MODEL-BASED MARK-TO-MARKET ACCOUNTING.....	37
IV MARK-TO-MARKET ACCOUNTING AS IMPLEMENTED BY SWAPS DEALERS COMPORTS WITH TAX NORMS	41
A. MARK-TO-MARKET ACCOUNTING AS IMPLEMENTED BY SWAPS DEALERS COMPORTS WITH THE HOLDING OF <u>THOR POWER TOOL CO. V. COMMISSIONER</u>	41
B. MODEL-BASED VALUATION OF SWAPS COMPORTS WITH TAX NORMS	44
C. THE ADJUSTMENTS MADE TO MID-MARKET VALUES ARE CONSISTENT WITH TAX NORMS	45
D. SWAPS DEALERS INEVITABLY EMPLOY VARYING IMPLEMENTATIONS OF THE ADJUSTED MID-MARKET METHOD.....	49

V	THE PROPER STANDARD OF REVIEW IS TO EVALUATE PROCESS, NOT NUMBERS	53
	CONCLUSION.....	56
	ANNEX A: LETTER FROM MARK PERWIEN, ISDA, TO TREASURY DEPARTMENT AND IRS, DATED MAY 9, 2000	

TABLE OF AUTHORITIES

CASES

<u>American Can Co. v. Bower</u> , 35 F.2d 832 (2nd Cir. 1929)	45-46
<u>Ansley-Sheppard-Burgess Co. v. Commissioner</u> , 104 T.C. 367 (1995).....	21
<u>Asphalt Products Co. v. Commissioner</u> , 796 F.2d 843 (6th Cir. 1986), <u>rev'd Commissioner v. Asphalt Products Co.</u> , 482 U.S. 117 (1987) (reversing on other grounds)	48
<u>Auburn Packing Co. v. Commissioner</u> , 60 T.C. 794 (1973).....	22
<u>Baltimore & Ohio Railroad Co. v. United States</u> , 603 F.2d 165 (Ct. Cl. 1979)	51-52
<u>United States v. Cartwright</u> , 411 U.S. 546 (1973)	33, 44
<u>Chesapeake & Ohio Railway Co. v. Commissioner</u> , 64 T.C. 352 (1975)	45
<u>Easter Service Corp. v. Commissioner</u> , 650 F.2d 379 (2nd Cir. 1981)	33, 44
<u>ESCO Corp. v. United States</u> , 750 F.2d 1466 (9th Cir. 1985)	52
<u>Galedrige Construction, Inc. v. Commissioner</u> , 74 T.C.M. 1055 (1997).....	22
<u>Garth v. Commissioner</u> , 56 T.C. 610 (1971).....	22
<u>Hallmark Cards, Inc. v. Commissioner</u> , 90 T.C. 26 (1988).....	22
<u>Kemon, et al. v. Commissioner</u> , 16 T.C. 1026 (1951).....	11
<u>Kroger Co. v. Commissioner</u> , 73 T.C.M. 1637 (1997).....	22
<u>Molsen v. Commissioner</u> , 85 T.C. 485 (1985).....	21, 46
<u>Orange & Rockland Utilities v. Commissioner</u> , 86. T.C. 199 (1986).....	22
<u>Osteopathic Medical Oncology & Hematology, P.C. v. Commissioner</u> , 113 T.C. 376 (1999), <u>acq. in result</u> , I.R.B. 2000-23.....	20-21
<u>Photo-Sonics, Inc. v. Commissioner</u> , 357 F.2d 656 (9th Cir. 1966).....	22, 24, 48
<u>Prabel v. Commissioner</u> , 91 T.C. 1101 (1988), <u>aff'd</u> 882 F.2d 820 (3rd Cir. 1989)	21
<u>RLC Indus. v. Commissioner</u> , 98 T.C. 457, 498 (1992), <u>aff'd</u> 58 F.3d 413 (9th Cir. 1995) ..	33-34
<u>Space Controls, Inc. v. Commissioner</u> , 322 F.2d 144 (5th Cir. 1963).....	46
<u>St. James Sugar Coop. v. United States</u> , 643 F.2d 1219 (5th Cir. 1981)	46
<u>Thor Power Tool Co. v. Commissioner</u> , 439 U.S. 522 (1979)	20, 24, 29, 33, 35, 41-44
<u>Wal-Mart Stores, Inc. v. Commissioner</u> , 73 T.C.M. 1625 (1997), <u>aff'd</u> 153 F.3d 650 (8th Cir. 1998) .	23-24
<u>Wal-Mart Stores, Inc. v. Commissioner</u> , 153 F.3d 650 (8th Cir. 1998), <u>aff'g</u> 73 T.C.M. 1625 (1997).....	21, 33

STATUTES AND TREASURY REGULATIONS

I.R.C. § 263A	48
I.R.C. § 446	52
I.R.C. § 446(a).....	20
I.R.C. § 446(b).....	20

I.R.C. § 475	passim
Treas. Reg. § 1.170A-1(c)(2)	33, 44
Treas. Reg. § 1.446-1(a)	33
Treas. Reg. § 1.446-1(a)(2)	20, 23, 27
Treas. Reg. § 1.446-1(e)(2)(ii)(b)	52
Treas. Reg. § 1.451-5(c)(ii)	46
Treas. Reg. § 1.471-2(a)	28
Treas. Reg. § 1.471-2(a)(1)	33
Treas. Reg. § 1.471-4	42
Treas. Reg. § 1.471-4(a)	15, 41-42
Treas. Reg. § 1.471-4(b)	46
Treas. Reg. § 1.471-5	6, 11, 28
Treas. Reg. § 1.471-8(a)	46
Treas. Reg. § 1.475(c)-1(a)(2)(i)	6, 11
Treas. Reg. § 1.475(c)-1(a)(2)(ii), Example 1	6, 11
Treas. Reg. § 1.1092(d)-2	10
Treas. Reg. § 20.2031-1(b)	33, 44
Treas. Reg. § 20.2031-2(f)	44
Treas. Reg. § 25.2512-1	33, 44
Prop. Treas. Reg. § 1.446-4	30-31

TREASURY MATERIALS

A.R.M. 100, 3 C.B. 66 (1920)	26
A.R.M. 135, 4 C.B. 114 (1920)	26, 29-30
F.S.A. 199944007 (July 22, 1999)	44
Notice of Proposed Rulemaking FI-16-89, 1991-2 C.B. 951	30-31
O.D. 8, 1 C.B. 56 (1919)	28
P.L.R. 9222017 (Feb. 26, 1992)	52
Rev. Proc. 92-29, 1992-1 C.B. 748	46
Rev. Rul. 74-223, 1974-1 C.B. 23	26, 29-30
T.B.R. 48, 1 C.B. 47 (1919)	28
T.D. 6336, 1958-2 C.B. 176	28
T.D. 8491, 1993-2 C.B. 215	10

LEGISLATIVE HISTORY

H.R. Rep. 103-11, reprinted in 1993-3 C.B. 237	32
H.R. Rep. 99-426, reprinted in 1986-3 C.B. 598	48
S.Rep. 99-313, reprinted in 1986-3 C.B. 133	48

REPORTS

Board of Governors of the Federal Reserve System et al., <u>Derivative Product Activities of Commercial Banks</u> (1993)	10, 12-13, 17
Department of the Treasury, <u>General Explanation of the President's Budget Proposals Affecting Receipts</u> (Feb. 25, 1993)	32
Department of the Treasury, <u>General Explanation of the President's Budget Proposals Affecting Receipts</u> (Jan. 30, 1992)	31, 32

Department of the Treasury, <u>Modernizing the Financial System: Recommendations for Safer, More Competitive Banks</u> (Feb. 1991).....	14-15, 31, 32, 44, 49, 56
New York State Bar Association, Tax Section, Committee on Financial Instruments, <u>Report on Tax Accounting for Notional Principal Contracts</u> (Sept. 28, 1989), reprinted in 36 Highlights and Documents 785 (Oct. 20, 1989)	24
Comptroller Banking Circular BC-277 (Oct. 27, 1993), Fed. Banking L. Rep. (CCH) 62 (Oct. 27, 1993)	20, 27

BOOKS

American Institute of Certified Public Accountants, <u>AICPA Audit and Accounting Guide—Brokers and Dealers in Securities</u> (2000)	34-35
Frank J. Fabozzi, <u>Valuation of Fixed Income Securities and Derivatives</u> (1998)	17
Gary L. Gastineau & Mark P. Kritzman, <u>The Dictionary of Financial Risk Management</u> (1999). 9	
Group of Thirty, <u>Derivatives: Practices and Principles</u> (1993).....	14, 15, 16-17, 27, 31, 32, 38
Robert A. Morrow, <u>Modeling Fixed Income Securities and Interest Rate Options</u> (1996)	17
Henry C. Simons, <u>Personal Income Taxation</u> (1938).....	24

ARTICLES

E. Cary Brown & Jeremy I. Bulow, <u>The Definition of Taxable Business Income</u> , in <u>Comprehensive Income Taxation 241</u> (Pechman ed. 1977)	24
Emanuel Derman, <u>The Future of Modelling</u> , 10 Risk, Special Anniversary Ed., Dec. 1997, at 164	49-51
Emanuel Derman, <u>Two Cheers for Mathematics: Facts and Fallacies about Using Financial Models</u> (unpublished manuscript based on a talk given at the Bermuda Conference on Mathematics in Business) (1999).....	53-54
Robert M. Haig, <u>The Concept of Income-Economic and Legal Aspects</u> , <u>The Federal Income Tax (1921)</u> , reprinted in <u>Readings in The Economics of Taxation</u> at 68-69 (1959).....	24
Edward D. Kleinbard & Thomas L. Evans, <u>The Role of Mark-to-Market Accounting in a Realization-Based Tax System</u> , 75 Taxes 788 (Dec. 1997).....	30
Robert H. Scarborough, <u>Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives</u> , 72 Taxes 1031 (1994).....	24
David J. Shakow, <u>Taxation Without Realization: A Proposal For Accrual Taxation</u> , 134 Penn. L. Rev. 1111 (1986).....	24
Reed H. Shuldiner, <u>Consistency and the Taxation of Financial Products</u> , 70 Taxes 781 (1992) .	24
Alvin C. Warren, <u>Financial Contract Innovation and Income Tax Policy</u> , 107 Harv. L. Rev. 460 (1993).....	24-25

LETTERS

Letter from Debra Aaron, WSTA, to IRS, dated March 11, 1997, reprinted in 97 Tax Notes Today 69-63 (Apr. 10, 1997)	4, 54, 55
Letter from Debra Aaron, WSTA, to IRS, dated April 17, 1997, reprinted in 97 Tax Notes Today 89-33 (May 8, 1997).....	4, 54
Letter from Joanne Ames, ABA, to IRS, dated September 23, 1991, reprinted in 91 Tax Notes Today 203-34 (Oct. 1, 1991).....	4
Letter from Mark Baran, ABA, to IRS, dated March 30, 1995, reprinted in 95 Tax Notes Today 77-18 (Apr. 20, 1995).....	4

<u>Letter from Cynthia Beerbower on Behalf of Nine Interest Rate Cap Dealers, to IRS, dated March 4, 1988, reprinted in 88 Tax Notes Today 69-29 (Mar. 28, 1988)</u>	30
<u>Letter from Michael Casciato, WSTA, to Treasury Department, dated August 15, 1997, reprinted in 97 Tax Notes Today 171-46 (Sept. 4, 1997)</u>	4, 54
<u>Letter from Jill Considine, NYCH, to IRS, dated March 10, 1995, reprinted in 95 Tax Notes Today 67-31 (Apr. 6 1995)</u>	4
<u>Letter from Jill Considine, NYCH, to IRS, dated October 6, 1997, reprinted in 97 Tax Notes Today 206-19 (Oct. 24, 1997)</u>	3, 54, 55
<u>Letter from David Garlock, et al., to IRS, dated August 27, 1997, reprinted in 97 Tax Notes Today 186-42 (Sept. 25, 1997)</u>	55
<u>Letter from Edward O'Brien, SIA, to IRS, dated September 20, 1991, reprinted in 91 Tax Notes Today 209-58 (Oct. 9, 1991)</u>	4
<u>Letter from Mark Perwien, ISDA, to IRS, dated September 21, 1999, reprinted in 1999 Tax Notes Today 199-26 (Oct. 15, 1999)</u>	3-4
<u>Letter from Mark Perwien, ISDA, to Treasury Department and IRS, dated May 9, 2000 (attached hereinafter as Annex A), reprinted in 2000 Tax Notes Today 102-30 (May 25, 2000)</u>	3, 19, 47
<u>Letter from Henry Ruempler, ABA, to IRS, dated August 26, 1993, reprinted in 93 Tax Notes Today 192-22 (Sept. 16, 1993)</u>	4
<u>Letter from Henry Ruempler, ABA, to IRS, dated February 28, 1994, reprinted in 94 Tax Notes Today 46-58 (Mar. 9, 1994)</u>	4
<u>Letter from Saul Rosen, Salomon Brothers Inc, to IRS, dated December 6, 1991, reprinted in 91 Tax Notes Today 255-37 (Dec. 17, 1991)</u>	19, 26, 30
<u>Letter from Saul Rosen, SIA, to IRS, dated May 3, 1995, reprinted in 95 Tax Notes Today 101-34 (May 24, 1995)</u>	4
<u>Letter from Saul Rosen, SIA, to Treasury Department, dated April 13, 2000, reprinted in 2000 Tax Notes Today 92-39 (May 11, 2000)</u>	3
<u>Letter from Lawrence Uhlick, IIB, to IRS, dated September 16, 1997, reprinted in 97 Tax Notes Today 186-43 (Sept. 25, 1997)</u>	4, 50, 54, 55

MISCELLANEOUS

<u>AICPA, Comments on Proposed and Temporary Regulations Section 1.475(b)-1T through 1.475(e)-1T Relating to Mark-to-Market for Dealers in Securities, dated May 24, 1994, reprinted in 94 Tax Notes Today 106-23 (June 2, 1994)</u>	35-36, 50
<u>Auditing Accounting Estimates, Statement on Auditing Standards No. 57, § 5 (AICPA 1988)</u> ..	34
<u>Data on the Global OTC Derivatives Markets, Swaps Monitor (visited Sept. 27, 2000)</u> < http://www.swapsmonitor.com >	9
<u>Derivatives—News & Trends, Bond Buyer, Feb. 4, 1997, at 25</u>	10
<u>Disclosure about Fair Value of Financial Instruments, Statement of Financial Accounting Standards No. 107, (Financial Accounting Standards Bd. 1991)</u>	14, 33
<u>Executive Update, Investor's Business Daily, Mar. 14, 1996, at A4</u>	10
<u>Financial Products: Lyons Says Los Alamos Section 475 Valuation Project 'Temporarily Suspended', Daily Tax Rep., Dec. 15, 1997</u>	55
<u>Financial Products: Lack of Los Alamos Software Forcing Hunt for Other Means of Valuation, Official Says, Daily Tax Rep., May 29, 1998</u>	55
<u>IRS To Unveil Pricing Model, 97 Tax Notes Today 54-6 (Mar. 20, 1997)</u>	54

ISDA, Master Agreement (Multicurrency—Cross Border) (1992)	9, 10
Merrill Lynch, 1999 Annual Report (2000).....	39
<u>Remarks by Chairman Arthur Levitt, Securities and Exchange Commission, The “Numbers Game”, Sept. 28, 1998 <http://www.sec.gov/news/speeches/spch220.txt></u>	35
<u>Remarks by Margaret Milner Richardson, Commissioner of Internal Revenue, International Fiscal Association U.S.A. Branch Annual Meeting, 1995 I.R.B. LEXIS 90; I.R. 95-19</u>	54
<u>Six To Testify At Mark-To-Market Reg Hearing, 94 Tax Notes Today 69-14 (Apr. 11, 1994)</u>	4
<u>Solicitation for Comments, Mark-to-Market Valuation Software, 62 Fed. Reg. 29188 (May 28, 1997)</u>	45, 54, 55

INTEREST OF THE AMICI AND INTRODUCTION

The American Bankers Association (“ABA”), the Institute of International Bankers (“IIB”), the International Swaps and Derivatives Association, Inc. (“ISDA”), the Securities Industry Association (“SIA”), The New York Clearing House Association L.L.C. (the “Clearing House”), and the Wall Street Tax Association (“WSTA”) (collectively the “Associations”) respectfully submit this brief as amici curiae. Our brief provides the Court with background relating to the history, operations and accounting norms of the dealer marketplace in over-the-counter (“OTC”) derivative instruments, particularly single-currency interest rate swaps (“swaps”), and then employs that information to propose legal standards for determining whether Petitioner properly applied the mark-to-market method of accounting in computing its taxable income from its OTC derivatives business. During the years at issue (its taxable years 1990-1993), Petitioner was a dealer in swaps and other OTC derivatives, and Petitioner continues as a dealer in such financial instruments today.

To our knowledge, the question of precisely how a swaps dealer should apply the mark-to-market method of accounting to its swaps business for U.S. federal income tax purposes is one of first impression. The resolution of this question has direct relevance to the tax returns of hundreds of other OTC derivatives dealers that employ mark-to-market methods for hundreds of thousands of OTC derivative instruments.

The ABA is the principal trade association of the banking industry in the United States, representing banks in each of the fifty states and the District of Columbia, including both national and state-chartered banks. The ABA membership includes community, regional, and money center banks, as well as bank holding companies, savings associations, trust companies and savings banks, with combined assets totaling over ninety percent of all banking assets in the United States.

The IIB represents and seeks to advance the interests of internationally headquartered financial firms that engage in banking, securities, and insurance in the United States. Its members include over 200 international banks that are headquartered in over 50 countries around the world. IIB member banks and their securities and derivatives affiliates are engaged in substantial securities and derivatives dealing operations in the United States. Collectively, the U.S. operations of the IIB's members are an important source of credit for U.S. borrowers and enhance the depth and liquidity of U.S. financial markets. Among its functions, the IIB is actively involved in addressing the major tax issues that arise in connection with its members' U.S. operations.

ISDA is the global trade association representing leading participants in the privately-negotiated derivatives industry, a business which includes interest rate, currency, commodity, credit and equity swaps, as well as related products such as caps, collars, floors and swaptions. ISDA was chartered in 1985, and today numbers over 500 member institutions from 37 countries. These members include most of the world's major dealers in and leading end-users of privately-negotiated derivatives, as well as associated service providers and consultants. Among its most notable accomplishments are developing the ISDA Master Agreement and advancing the understanding and treatment of derivatives and risk measurement from public policy and regulatory perspectives.

The Clearing House is an association of major commercial banks located in New York. The Clearing House regularly appears as amicus curiae in cases raising important questions of law affecting commercial banks and regularly comments on regulatory and tax matters affecting commercial banks.

The SIA was established in 1972 through the merger of the Association of Stock Exchange Firms (1913) and the Investment Banker's Association (1912). The SIA brings together the shared interests of more than 740 securities firms to accomplish common goals. SIA member-firms (including investment banks, broker-dealers, and mutual fund companies) are active in all U.S. and foreign markets and in all phases of corporate and public finance.

The WSTA was founded over fifty years ago to educate its membership in, and cooperate in the administration and understanding of, tax laws affecting the securities industry. It has approximately 300 members, comprising primarily securities firms, as well as law and accounting firms, in the New York area, and promotes educational and informational activities.

Petitioner (or one of its subsidiaries) is a member of the ABA, ISDA and the SIA, and is a member of certain clearing organizations affiliated with the Clearing House. The views expressed in this brief, however, are those of the Associations, and not of Petitioner.

The Associations have been active for many years in providing industry and market input to Congress, the Treasury Department, and Respondent on a variety of industry-related topics including the U.S. federal income taxation of OTC derivatives in general. Because our member firms have for many years consistently applied mark-to-market accounting for financial accounting purposes, internal management purposes, and risk measurement purposes (and in more recent years for tax purposes), the Associations have been particularly active over the last decade in assisting government legislators, regulators and administrators in implementing mark-to-market accounting as the norm for U.S. federal income tax purposes, as well as for other regulatory purposes.¹

¹ See, e.g., Letter from Mark Perwien, ISDA, to Treasury Department and IRS, dated May 9, 2000 (attached hereinafter as Annex A), reprinted in 2000 Tax Notes Today 102-30 (May 25, 2000); Letter from Saul Rosen, SIA, to Treasury Department, dated April 13, 2000, reprinted in 2000 Tax Notes Today 92-39 (May 11, 2000); Letter from Jill Considine, NYCH, to IRS, dated October 6, 1997, reprinted in 97 Tax Notes Today 206-19 (Oct. 24, 1997); Letter from Mark

(continued...)

The Associations are participating as amici curiae in this proceeding because of their strong interest in the development of U.S. federal income tax rules governing mark-to-market accounting for OTC derivatives dealers that comport with economic reality and sound commercial principles. The Associations believe that our member firms' extensive experience in implementing consistent mark-to-market OTC derivatives accounting systems for substantive commercial and financial purposes, as well as regulatory purposes, enables the Associations to provide relevant background on the OTC derivatives industry and to propose legal standards relevant to this proceeding that fairly balance economic and financial measures of income, the objectives of the U.S. federal income tax system, and administrability.

Some member firms of the Associations currently are under audit by Internal Revenue Service ("IRS") examining agents, or expect such audits to commence in the near future, in respect of issues broadly similar to the detailed factual valuation issues contested in this proceeding. Mindful of this fact, the Associations have restricted the arguments in this brief to those relevant to the development of the appropriate legal standards for reviewing a swaps

(...continued)

Perwien, ISDA, to IRS, dated September 21, 1999, reprinted in 1999 Tax Notes Today 199-26 (Oct. 15, 1999); Letter from Lawrence Uhlick, IIB, to IRS, dated September 16, 1997, reprinted in 97 Tax Notes Today 186-43 (Sept. 25, 1997); Letter from Michael Casciato, WSTA, to Treasury Department, dated August 15, 1997, reprinted in 97 Tax Notes Today 171-46 (Sept. 4, 1997); Letter from Debra Aaron, WSTA, to IRS, dated April 17, 1997, reprinted in 97 Tax Notes Today 89-33 (May 8, 1997); Letter from Debra Aaron, WSTA, to IRS, dated March 11, 1997, reprinted in 97 Tax Notes Today 69-63 (Apr. 10, 1997); Letter from Saul Rosen, SIA, to IRS, dated May 3, 1995, reprinted in 95 Tax Notes Today 101-34 (May 24, 1995); Letter from Mark Baran, ABA, to IRS, dated March 30, 1995, reprinted in 95 Tax Notes Today 77-18 (Apr. 20, 1995); Letter from Jill Considine, NYCH, to IRS, dated March 10, 1995, reprinted in 95 Tax Notes Today 67-31 (Apr. 6 1995); Six To Testify At Mark-To-Market Reg Hearing, 94 Tax Notes Today 69-14 (Apr. 11, 1994); Letter from Henry Ruempler, ABA, to IRS, dated February 28, 1994, reprinted in 94 Tax Notes Today 46-58 (Mar. 9, 1994); Letter from Henry Ruempler, ABA, to IRS, dated August 26, 1993, reprinted in 93 Tax Notes Today 192-22 (Sept. 16, 1993); Letter from Edward O'Brien, SIA, to IRS, dated September 20, 1991, reprinted in 91 Tax Notes Today 209-58 (Oct. 9, 1991); Letter from Joanne Ames, ABA, to IRS, dated September 23, 1991, reprinted in 91 Tax Notes Today 203-34 (Oct. 1, 1991).

dealer's implementation of a mark-to-market tax accounting system. The Associations therefore do not express any views as to the application of the legal standards proposed herein to the actual facts of Petitioner's case, which in any event have not yet been developed by the Court. As the Court considers further the matters presented in this case, the Associations stand ready to supplement this Brief as may please the Court.

ISSUES PRESENTED

This brief is being filed concurrently with those prepared by the parties to this litigation. It is our understanding, however, from the pre-trial memoranda submitted to the Court on September 5, 2000, that Petitioner has phrased the issue presented by this case as whether Petitioner's method of valuing its open swaps contracts at year-end was reasonable, while Respondent prefers to describe the case as involving (among other matters) whether Petitioner's method of valuing its open swaps contracts clearly reflected its income. In our view, either formulation should lead to the same conclusion, employing largely the same reasoning.

To avoid possible duplication of argument, however, the Associations have chosen to accept, solely for purposes of argument in this brief, Respondent's apparent contention that Petitioner's method of valuing its open swaps contracts constituted a method of accounting, and therefore could be employed by Petitioner only if that method clearly reflected Petitioner's income. As framed solely for purposes of this brief, then, the issue presented in this proceeding is whether Petitioner's implementation of the mark-to-market method of accounting in respect of its swaps business clearly reflected Petitioner's income during the years at issue.

Regardless of how the issue is framed, the enactment of section 475 did not change any legal standards relevant to the calculation of fair market value.² For taxable years ending on or after December 31, 1993, section 475 requires a swaps dealer, like Petitioner, to employ the mark-to-market method of accounting,³ but neither section 475 nor any Treasury regulations promulgated thereunder offer any specific guidance on *how* in fact to perform those mark-to-market calculations, or the standards that Respondent should employ in reviewing Petitioner's calculations, which are the points of controversy in this case.

Petitioner's right to employ the mark-to-market method of accounting for years prior to the effective date of section 475 also is not at issue in this proceeding. Indeed, Respondent has stated that it is not challenging Petitioner's right to employ mark-to-market accounting for pre-section 475 years.⁴ Respondent's Issues and Position Memorandum at 13.

SUMMARY OF ARGUMENT

A. It is settled law that, if a taxpayer employs an accounting method that clearly reflects income, Respondent may not compel the taxpayer to change that method to one preferred by Respondent. Accordingly, a swaps dealer (including Petitioner) may use any

² Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or to Treasury regulations promulgated thereunder.

³ Treas. Reg. § 1.475(c)-1(a)(2)(i) and 1(a)(2)(ii), Example 1 (confirming that a swaps dealer is in fact a securities dealer subject to section 475).

⁴ For years prior to the effective date of section 475, Treas. Reg. § 1.471-5 permitted dealers in securities to value their securities inventories at market. Similarly, a long line of administrative guidance (summarized in Section III of our Argument, below) permitted dealers in commodities that employed derivatives as hedges of their commodities positions to mark their commodities and hedge positions to market in computing their taxable income. Relying on these close analogies, and on the fact that mark-to-market accounting both conforms to industry best practices and clearly reflects income (Argument Section II), many swaps dealers adopted mark-to-market accounting in years prior to the effective date of section 475, and continued to apply the same method for years governed by section 475.

particular implementation of mark-to-market accounting that in fact clearly reflects income, *even in circumstances where Respondent believes that he can identify putatively more sophisticated valuation methodologies.*

B. In general, the mark-to-market method of accounting employed by swaps dealers (and described in Paragraph D, below) clearly reflects a swaps dealer's income, because (i) it is consistent with economic measures of income, (ii) it comports with the best accounting standards of the swaps industry, (iii) it is the only practical tax accounting system for hedged dealer activities that does not produce large annual distortions in income measurement, and (iv) it is the only tax accounting system that is practical to administer and that does not expose both taxpayers and Respondent to whipsaw and abuse.

C. Mark-to-market accounting (and its step-sibling, lower-of-cost-or-market accounting) have been employed for tax purposes for decades, not simply since the adoption of section 475 in 1993. Throughout this long history, dealers have applied mark-to-market accounting to calculate fair market values that drive important day-to-day commercial and financial decisions, including capital allocation, employee compensation, and risk measurement; these same values also are used for financial accounting and tax purposes. As a result, these valuations reflect a dealer's best estimates of true economic value and income. The particular implementation of mark-to-market accounting employed by a swaps dealer is vetted by different stakeholders with competing agendas (including important constituencies that desire a high valuation of the swaps in question). As a result, if a swaps dealer consistently employs the same mark-to-market accounting system as a driver of business decision-making, as its accounting system for financial and regulatory reporting, and as its tax method of accounting, that valuation

methodology necessarily must be objective in purpose, devoid of any systemic bias, and clearly reflect a dealer's income.

D. Because there exists only a thin secondary market for swaps, swaps dealers implement their mark-to-market accounting systems through model-based valuation systems. The valuation model widely adopted by the industry in marking swaps to market is the "adjusted mid-market method." The adjusted mid-market method assigns values to swaps based on the discounted present value of future cash flows (positive and negative) that a particular swap is expected to produce. This method of implementing mark-to-market tax accounting is consistent with U.S. tax norms.

E. Because there exist no meaningful data on the prices at which swaps are assigned in the secondary markets, no single means of implementing an adjusted mid-market mark-to-market valuation model, and no single set of input data, the only appropriate legal standard that can be applied to verify a swaps dealer's mark-to-market system as an accounting method that clearly reflects income is to review whether the dealer employs the same system for important commercial and financial purposes. If this condition is satisfied, Respondent should conclude that the swaps dealer's accounting system is objective in purpose and devoid of systemic bias, and therefore clearly reflects the swaps dealer's income.

BACKGROUND ON SWAPS AND THE SWAPS MARKETS

A. OVERVIEW OF SWAPS AND ACTIVITIES OF SWAPS DEALERS.

All OTC derivative instruments are privately-negotiated bilateral contracts, typically between a dealer and an end-user, or between two dealers, in which the parties make payments to each other of specified amounts and/or amounts determined by reference to underlying prices, rates, or the like. In a typical (or "plain vanilla") single-currency interest rate swap of the type that apparently made up the bulk of Petitioner's business in the years at issue,

one party (the fixed-rate payer) agrees to pay periodically an amount equal to a fixed rate of interest on a hypothetical (“notional”) principal amount; the counterparty (the floating-rate payer) agrees to pay periodically (typically, at the same times as the fixed rate payments are due) amounts equal to a floating rate of interest (often calculated by reference to the London InterBank Offered Rate, or LIBOR, for the relevant currency) on the same notional principal amount. Amounts due on the same date from each counterparty are netted.⁵ Interest rate swaps and other OTC derivatives typically are documented pursuant to a Master Agreement (ordinarily based on the ISDA form Master Agreement) setting out the general legal rights and obligations of the parties (e.g., representations, warranties, covenants, events of default, and measurement of damages), together with individual “Confirmations” that detail the terms of particular transactions.

Although the OTC derivatives markets are relatively new, they have grown at a staggering rate since their inception in the early 1980s. For example, interest rate swaps outstanding (measured by notional principal amount) grew from some \$300 billion at the end of 1985 to \$4.4 *trillion* by the end of 1990 (the first of the years at issue in this proceeding), and to \$9.7 trillion by the end of 1993 (the last of the years at issue). By the end of 1999, \$52 trillion of interest rate swaps, and \$94.6 trillion of OTC derivatives in general, were outstanding.⁶ The OTC derivatives markets have grown because OTC derivatives provide effective, low-cost and highly customizable means of managing risks from fluctuations in interest rates, yield curve

⁵ See generally Gary L. Gastineau & Mark P. Kritzman, The Dictionary of Financial Risk Management (1999).

⁶ Data on the Global OTC Derivatives Markets, Swaps Monitor (visited Sept. 27, 2000) <<http://www.swapsmonitor.com>>.

shapes, securities prices, commodities prices, currency rates, and similar financial risk positions, and thereby contribute towards the efficiency of the capital markets.

Unlike a publicly-traded stock or bond, a swap is merely a bilateral contract between two parties for the exchange of future cash flows. Each party to a swap is exposed to its counterparty's credit risks, and parties "select their counterparty bilaterally based on credit-worthiness and other factors in addition to price."⁷ For this reason (among others), a swap typically is not freely assignable by one party to a third party without the prior written consent of the counterparty.⁸ As a result, swaps are not executed in a form that would make them readily tradable in the secondary markets. In fact, there is today no organized trading market for existing swaps.⁹

In the absence of liquid secondary markets, the normal means of terminating an existing swap position are (i) to negotiate the termination of the swap contract with the counterparty (which usually involves paying "breakage costs"), or (ii) to enter into a second swap that offsets the first. Secondary market assignments do take place occasionally, to address special circumstances. For example, Dealer A may wish to enter into a highly customized OTC

⁷ Board of Governors of the Federal Reserve System et al., Derivative Product Activities of Commercial Banks 5 (1993). "Rigorous credit analysis of prospective and existing counterparties is essential in OTC transactions." Id.

⁸ ISDA, Master Agreement (Multicurrency—Cross Border) Section 7 (1992).

⁹ See, e.g., Executive Update, Investor's Business Daily, Mar. 14, 1996, at A4 (stating that requiring investors to mark to market may be problematic because "custom-made derivatives have no market"); Derivatives—News & Trends, Bond Buyer, Feb. 4, 1997, at 25 (stating that "in an over-the-counter derivative transaction, where there may be no market at all, valuation could be quite complicated"); T.D. 8491, 1993-2 C.B. 215, 216 (explaining that the purpose of Treas. Reg. § 1.1092(d)-2 was to treat swaps and certain other notional principal contracts as actively traded personal property for purposes of section 1092 in order to accomplish the purposes of that section, even though they are "not traded on an exchange or in a recognized secondary market").

derivative contract with Customer X, but Dealer A may be constrained by credit concentration guidelines from incurring additional credit exposure to Customer X. In such a case, Dealer A may (with the consent of Customer X) assign some existing “plain vanilla” OTC derivatives contracts between Dealer A and Customer X to Dealer B, thereby freeing up capacity to enter into the new OTC derivative.

Swaps dealers perform an economic role similar to that of traditional dealers in securities or commodities: they provide liquidity to the marketplace by standing ready to buy what customers wish to sell and to sell what customers wish to buy, regardless of their own views on prices or rates.¹⁰ In the case of interest rate swaps, the economic attribute “bought” or “sold” is interest rates: a swaps dealer thus stands ready to enter into either side (e.g., either as fixed-rate payer or floating-rate payer) of a new swap contract with customers.¹¹

Because swap contracts generally remain open until maturity or a negotiated termination between the original counterparties, and because swaps infrequently are assigned to third parties, a swaps dealer will have in place at any time a large number of swaps and other OTC derivatives. A major dealer will have many thousands of open contracts, totaling billions of dollars in notional principal amount. Dealers typically organize their outstanding swaps positions, together with related non-swap hedges, into “books”. By convention, the term “book” denotes a logical grouping of the dealer’s swaps positions and related non-swap hedges, by

¹⁰ Kemon, et al. v. Commissioner, 16 T.C. 1026 (1951); Treas. Reg. § 1.471-5 (defining a dealer in securities as “a merchant of securities...regularly engaged in the purchase of securities and their resale to customers; that is, one who as a merchant buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom”).

¹¹ Cf. Treas. Reg. § 1.475 (c)-1(a)(2)(i) (“The term dealer in securities includes...a taxpayer that, in the ordinary course of the taxpayer’s trade or business, regularly holds itself out as being willing and able to enter into either side of a transaction enumerated in section 475(c)(1)(B) [i.e. derivatives].”); Treas. Reg. § 1.475(c)-1(a)(2)(ii), Example 1 (interest rate swaps dealer).

reference, for example, to the type of financial risk contained in the book (e.g., the U.S. dollar interest rate book), or the identity of the head trader responsible for managing the book. Swaps dealers can sustain the enormous implicit leverage in such positions (and, where relevant, regulators permit such leverage) only because dealers systematically hedge the significant market risks (e.g., the risk of interest rate movements) associated with those contracts. As described in more detail below, those hedges can take the form of both swaps and non-swap financial instruments.

Because secondary market swap assignments are uncommon, one cannot value swaps as one can value publicly traded securities, by referring to the Wall Street Journal or some other financial reporting system for actual secondary market trading prices. There do exist specialized trading screens describing “indicative prices” at which dealers indicate to the institutional markets the rates or prices at which they are willing to entertain inquiries for new swaps. Those indicative prices are not, however, binding offers on the part of the dealers in question and do not necessarily equate to prices at which actual transactions are taking place. Most important, they do not directly shed any light on the value of an existing swap, which often has a fixed interest rate leg that does not reflect current market levels and a remaining maturity that would be non-standard if entered into today. Finally, a swaps “book” is itself an integrated set of at least partially offsetting risks; as a result, the riskiness of a swaps book (and therefore its value to a hypothetical assignee) is somewhat different from the simple sum of the risks of the individual positions that comprise the book.¹²

¹² In the years at issue in this proceeding, most swaps dealers valued their swaps on a swap-by-swap basis. As early as 1993, however, a U.S. Government report noted that: “For both dealers and end users market risk must be evaluated on a portfolio basis...market risk to the institution is not measured by the price sensitivity of the individual contract, but by the net price
(continued...)

For all these reasons, the valuation of a swaps book cannot look to actual secondary market transactions or to current “indicative price” quotes. Respondent’s Issues and Position Memorandum appears to agree with this proposition, as Respondent does not there argue that such occasional secondary market transactions or “indicative price” quotes are relevant to this proceeding.

B. MODEL-BASED VALUATION OF SWAPS.

In the absence of direct measures of value, swaps dealers value their swaps for important commercial and financial purposes, as well as tax purposes, through the use of mathematical pricing models that are designed to include economic factors that influence the value of the swaps, and thereby to derive a value as close as possible to the price at which such swaps could be assigned in an orderly process to another dealer. As discussed below in Section IV.D, these mathematical pricing models have evolved over time and continue to be refined even today.

The Financial Accounting Standard Board (“FASB”), the Group of Thirty, and various regulators have all recommended that swaps be valued at fair market value using model-based valuation techniques that calculate the net present value of estimated future cash flows. Since 1973, FASB has been the designated organization in the private sector for establishing standards of financial accounting and reporting. Their standards are officially recognized as authoritative by the Securities and Exchange Commission (“SEC”) and the American Institute of

(...continued)

sensitivity of the dealers portfolio of contracts.” Board of Governors of the Federal Reserve System et al., supra, at 16. As financial theory, modeling techniques, and systems capabilities improved, many dealers refined their mark-to-market methodologies to reflect these portfolio effects.

Certified Public Accountants (“AICPA”). In Statement of Financial Accounting Standards (“SFAS”) No. 107, for example, FASB explained:

If quoted market prices are not available, management’s best estimate of fair value may be based on the quoted market price of a financial instrument with similar characteristics or on valuation techniques (for example, the present value of estimated future cash flows using a discount rate commensurate with the risks involved, option pricing models, or matrix pricing models).¹³

The Group of Thirty, established in 1978, is a private, nonprofit, international body composed of senior representatives of the private and public sectors and academia. It aims to deepen understanding of international economic and financial issues, to explore the international repercussions of decisions taken in public and private sectors, and to examine the choices available to market practitioners and policymakers. In 1993, the Group of Thirty published Derivatives: Practices and Principles, a multivolume seminal report on the derivatives markets. That report concluded that “marking to market is the only valuation technique that correctly reflects the current value of derivatives cash flows to be managed” and suggested a model-based approach that discounts expected future cash flows to determine fair market value.¹⁴

In its 1991 report entitled Modernizing the Financial System, the Treasury Department also recognized discounted cash flow analysis as the best or only option where no secondary market exists:

In the absence of comparable secondary market prices for assets, under [market value accounting] some form of discounted cash flow analysis would have to be employed to estimate fair market

¹³ Disclosure about Fair Value of Financial Instruments, Statement of Financial Accounting Standards (“SFAS”) No. 107, § 17 (Financial Accounting Standards Bd. 1991).

¹⁴ Group of Thirty, Derivatives: Practices and Principles 9 (1993); Id. Appendix I at 6.

values... Existing accounting literature acknowledges that discounted cash flow analysis is appropriate where no comparable secondary market data is available.¹⁵

In conformity with Treas. Reg. § 1.471-4(a) and longstanding industry practice, dealers holding “physical” securities (or commodities) in inventory generally implement mark-to-market accounting by marking their positions to the “bid” side of the relevant replacement market. Under this methodology, “long” positions in physical securities are marked to the *bid* side of the market (i.e., the price that other dealers would pay to buy those securities), and “short” positions in physical securities are marked to the *ask* side (i.e., the price that other dealers would *charge* the taxpayer to purchase securities to cover the short position). These bid and ask prices reflect all relevant data concerning the security in question (except possibly volume discount issues), including credit risk (which is reflected in price) and consensus estimated costs of hedging and carrying the securities in inventory (which are reflected in the size of the bid-ask spread), and therefore it would be inappropriate to make significant further adjustments to those values.

Swaps dealers reach essentially analogous results through a different approach. By the mid-1990s swaps dealers almost uniformly adopted a base model that values swaps in the two-step process recommended by the Group of Thirty in its report—the adjusted mid-market model-based valuation approach, which “specifically defines and quantifies adjustments that are implicitly assumed in the bid/offer method.” Group of Thirty, supra, Appendix I at 6.

Individual swaps dealers adopted the adjusted mid-market valuation methodology at different points in time, with most adopting it in the period from the late 1980s through 1995.

¹⁵ Department of the Treasury, Modernizing the Financial System: Recommendations for Safer, More Competitive Banks XI-15 (Feb. 1991).

The adjusted mid-market method therefore represents a mark-to-market methodology that for some dealers was aspirational in nature in the years relevant to this proceeding. Petitioner, however, was an early adopter of the adjusted mid-market method. The fact that another dealer did not adopt the method until a later point in time (often because of systems constraints) is not relevant to this proceeding. Similarly, in our view no negative inference should be drawn in another case where a swaps dealer in those early years of the industry applied a method that represented its best effort (in light of its history, systems constraints, and the like) to determine fair market value, but that lacked the sophistication of Petitioner's adjusted mid-market method.

Under the adjusted mid-market method of implementing mark-to-market accounting, dealers first determine the *mid-market* value of the swap (that is, the average of the hypothetical bid and ask prices of the swap being valued) by determining the present value of the future gross cash flows expected to be received on the swap. In this first step, all swaps are valued using the same mid-market discount rate.

Second, the dealers adjust the mid-market value for certain risks and costs that are associated with the swap, but *not* reflected in the mid-market value, such as credit risks associated with a particular counterparty, hedging/liquidity costs and future administrative costs. All these costs and expenses relate directly to the value to a potential assignee of the expected gross revenue stream reflected in the mid-market mark. To avoid double counting, these adjustments then are included in income over the life of a swap, and the actual costs, losses or expenses are deducted as they are incurred.

The Group of Thirty summarized the purposes and operation of a mid-market-less-adjustments valuation model as follows:

Mid-market valuation is a marking practice that values a derivatives portfolio at the middle of the current market (the

average of bid and offer prices) less specific adjustments. In bid/offer marking, the portfolio is marked to the bid or offer side of the market. Marking to mid-market less adjustments specifically defines and quantifies adjustments that are implicitly assumed in the bid/offer method.

Once mid-market rates or prices have been determined, future cash flows are generated based on implied forward curves and prices. These cash flows are then discounted back using a zero coupon curve which is generated from the mid-market interest rate curve. The net present value of cash flows represents the mid-market value of the portfolio. Similar calculations are made under the bid/offer method.

Even in a perfectly matched portfolio, mid-market valuation does not reflect the true value of the portfolio. Although a matched portfolio has no market risk, the failure of one counterparty to perform its contractual obligations can result in a loss. Furthermore, even a matched portfolio must be managed from an administrative and operational standpoint. Therefore, two adjustments *have* to be made, reflecting expected future credit costs and administrative costs. As the assumption of matched portfolio is dropped and more complex portfolios are examined, two additional adjustments should be made: one for close-out costs and another for borrowing and investing costs. (Emphasis supplied.)¹⁶

The effect of the two-step process is to determine the *present value*—that is, the fair market value—of the expected future net cash flows from a swap or swaps book, which is the “fundamental principle of valuation...of any financial asset.” Frank J. Fabozzi, Valuation of Fixed Income Securities and Derivatives 15 (1998). See also Board of Governors of the Federal Reserve System et al., supra, at 9 (“The market value of a derivative contract is determined by

¹⁶ Group of Thirty, supra, at 9; Id. Appendix I at 6. See also, Robert A. Morrow, Modeling Fixed Income Securities and Interest Rate Options 153 (1996):

It is important to emphasize that this determination of the swap rate [under the book’s suggested formula] is under the assumption of no default risk for either counterparty to the swap contract. Default risk and credit risk spreads are important elements in the actual application of these techniques to the swap market.

calculating the present value of all expected future cash flows of the contract.”). Because determinations of net present value drive bid and ask prices in the “physical” securities and commodities markets, and because bid-ask spreads also reflect economically analogous costs and risks, the values derived by an adjusted mid-market valuation method correspond closely to prices at which swaps (or swaps books) actually could be assigned in the interdealer marketplace in an orderly manner.

Swaps dealers design their models to use adjusted mid-market price, rather than to mark their “longs” to estimated bids and their “shorts” to estimated offers, because a mid-market valuation system requires a dealer to construct and process only one swap rate yield curve (the mid-market curve), rather than separate bid and offer curves. This improves accuracy and also reduces computer processing times; the latter point is particularly important for swaps books of major dealers.

The adjustments made by swaps dealers to mid-market marks for swaps that comprise part of a market-neutral swaps portfolio typically are smaller than the bid-ask spread for a single new swap in the marketplace, because the value to a prospective buyer of an internally-hedged portfolio is greater than the value of an individual swap that requires the purchaser to incur costs in hedging that swap. Thus, to use an arbitrary example, if the bid-ask spread on “plain vanilla” interest rate swaps is four basis points in total, the total adjustments made in respect of a market-neutral swaps portfolio might aggregate two basis points. As a result, a swaps dealer employing adjusted mid-market mark-to-market accounting would record as an *immediate* profit the present value of the difference between (i) the bid-ask spread on its market-neutral swaps portfolio and (ii) the adjustments made by the dealer. The application of adjusted mid-market mark-to-market accounting to a market-neutral swaps portfolio therefore

typically *accelerates* the income of a swaps dealer, *when compared to the accrual method of accounting*, because the former method brings into current taxable income the present value of future *expected* net cash flows that have not yet been earned, in an accrual sense, but for which a buyer would be willing to pay current consideration.¹⁷ (The future net cash flows are not yet includible in income under accrual principles because they are not currently receivable and all events have not yet occurred that fix the taxpayer's right to receive them.)

The adjustments made from mid-market to reach estimates of fair market value are complex, vary from dealer to dealer, and have evolved over time, as dealers have become more sophisticated in capturing data, measuring risk and building valuation models. The adjustments made by swaps dealers *today*—which admittedly are more sophisticated in many respects than the adjustments made by a typical dealer in 1990-1993—are summarized in a submission by ISDA to the Treasury Department dated May 9, 2000 and attached to this brief as Annex A.¹⁸ In all cases, however, the purpose of these adjustments is to reflect the present value of the costs, expenses and losses expected to be incurred in earning the future expected (but not yet accrued) income stream represented by the mid-market mark. In other words, an adjusted mid-market accounting system accurately measures the present value of *net* anticipated future positive or negative cash flows, as opposed to gross cash flows.

The adjusted mid-market model implementation of mark-to-market accounting is the standard method used by swaps dealers. It is the method recommended by the Group of Thirty as described above and also, for example, by the Office of the Comptroller of Currency

¹⁷ See Letter from Saul Rosen, Salomon Brothers Inc, to IRS, dated December 6, 1991, reprinted in 91 Tax Notes Today 255-37 (Dec. 17, 1991).

¹⁸ Letter from Mark Perwien, dated May 9, 2000, supra.

(“OCC”), the bureau within the Treasury Department that charters, regulates, and supervises all national banks, including Petitioner. In a report issued in 1993 to provide guidance on risk management practices to institutions engaging in financial derivatives activities, the OCC determined that “[t]he best approach is to value derivatives portfolios based on mid-market levels less adjustments.”¹⁹

ARGUMENT

I

RESPONDENT MAY NOT REJECT A METHOD OF ACCOUNTING THAT CLEARLY REFLECTS INCOME SIMPLY BECAUSE ALTERNATIVE METHODS MAY EXIST

For purposes of argument, the Associations have accepted Respondent’s assertion that Petitioner’s method of valuing its open swaps contracts constituted a method of accounting, and therefore must be tested under the legal principles applicable to accounting methods. Those legal principles are well-established.

A taxpayer must compute its taxable income under the same method of accounting by which it regularly computes its income in keeping its books (section 446(a)), unless (i) the specific method used is contrary to the Code or Treasury regulations (Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979)); or (ii) Respondent determines, in his discretion, that such method of accounting does not clearly reflect income (section 446(b); Treas. Reg. § 1.446-1(a)(2)). Notwithstanding this broad grant of authority, “[t]he fact that the Commissioner possesses broad authority under section 446(b) does not mean that the Commissioner can change a taxpayer’s method of accounting with impunity.” Osteopathic Medical Oncology & Hematology, P.C. v. Commissioner, 113 T.C. 376, 381 (1999), acq. in

¹⁹ Comptroller Banking Circular BC-277 (Oct. 27, 1993), Fed. Banking L. Rep. (CCH) 62, 154 (Oct. 27, 1993).

result, I.R.B. 2000-23 (citing Prabel v. Commissioner, 91 T.C. 1101, 1112-1113 (1988), aff'd 882 F.2d 820 (3rd Cir. 1989)).

For taxable years ending on or after December 31, 1993, section 475 requires swaps dealers to employ the mark-to-market method of accounting, which Petitioner had previously adopted, but neither section 475 nor the Treasury regulations promulgated thereunder address the central issue in this case, which is *how* to apply that accounting method to Petitioner's open swaps positions at year-end. In fact, Respondent has never issued any regulation or administrative guidance on point. Thus, neither the statute nor administrative guidance mandates that mark-to-market accounting follow a specified methodology.

Although the law provides Respondent with considerable discretion in determining whether a method of accounting clearly reflects income, it is well settled that if a taxpayer's method of accounting *does* clearly reflect income, Respondent may *not* force the taxpayer to abandon its method of accounting in favor of an alternative method favored by Respondent. Thus, this Court has held that "[t]he Commissioner, for example, may not change a taxpayer's method of accounting from one that clearly reflects income to another one that the Commissioner believes more clearly reflects income". Osteopathic Medical Oncology & Hematology, P.C. v. Commissioner, 113 T.C. 376, 381 (1999), acq. in result, I.R.B. 2000-23 (citing Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. 367, 371 (1995)). See also Molsen v. Commissioner, 85 T.C. 485, 489 (1985) (same); Wal-Mart Stores, Inc. v. Commissioner, 153 F.3d 650, 657 (8th Cir. 1998) (having ruled that inventory shrinkage estimates are not prohibited by the Code or Treasury regulations, the court held that Respondent abused her discretion in changing Wal-Mart's method of accounting, because the method Wal-Mart used complied with Generally Accepted Accounting Principles ("GAAP"), was applied

consistently for both tax and financial accounting purposes and produced accurate results), aff'g 73 T.C.M. 1625 (1997). This rule of law has been cited with approval in a number of cases involving the valuation of inventory²⁰ and therefore should apply with equal vigor to the valuation of swaps by swaps dealers, because in the hands of a dealer swaps serve a role directly analogous to classic inventories.

²⁰ In Photo-Sonics, Inc. v. Commissioner, 357 F.2d 656 (9th Cir. 1966), while holding for the IRS on the ground that the accounting method employed by the taxpayer was contrary to the regulations, the court stated that:

The statute and regulations should not be interpreted so as to permit the taxing authority arbitrarily to impose its own preferred system of accounting upon taxpayers. If a taxpayer employs a method which is acceptable under the accounting standards, even though some might say that it does not conform "as nearly as may be to the best accounting practice," the taxpayer's choice of method should not be disturbed if it clearly reflects income. This is particularly so when a taxpayer has consistently applied his method, without the Commissioner's challenge, for a reasonable period of time.

Id. at 658 n.1. See also Garth v. Commissioner, 56 T.C. 610, 623 (1971) (holding that the Commissioner cannot have the authority to force a taxpayer to change from a method of accounting which does clearly reflect income to another method simply for the reason that the Commissioner's method might match costs against income more precisely); Auburn Packing Co. v. Commissioner, 60 T.C. 794, 800 (1973) (Commissioner cannot require taxpayer to change from the unit-livestock-price method to a method of inventory valuation that, in the Commissioner's opinion, more clearly reflects income); Hallmark Cards, Inc. v. Commissioner, 90 T.C. 26, 31 (1988) (Commissioner's broad authority to determine whether a taxpayer's accounting method clearly reflects income is limited, in that he may not reject as not providing a clear reflection of income a method of accounting employed by the taxpayer which is specially authorized in the Code or regulations and has been applied on a consistent basis (citing Orange & Rockland Utilities v. Commissioner, 86 T.C. 199, 215 (1986))); Galedrige Construction, Inc. v. Commissioner, 74 T.C.M. 1055 (1997); Kroger Co. v. Commissioner, 73 T.C.M. 1637, 1648-49 (1997) (stating that the regulations make consistency of application from year to year an important and explicit element in determining whether the inventory practice of a taxpayer clearly reflects income and holding that the taxpayer's valuation method better reflects income and the Commissioner abused its discretion in requiring a change of method).

Accordingly, if a swaps dealer's particular method of implementing a mark-to-market accounting system clearly reflects income, that implementation must be respected for federal income tax purposes. Respondent cannot compel a swaps dealer that employs a mark-to-market accounting system that clearly reflects income to adopt different methodologies, even if those methodologies arguably are more refined than those applied by the taxpayer.

* * *

We submit (and proceed to show below) that, if a swaps dealer employs a consistent adjusted mid-market implementation of mark-to-market accounting for important commercial and financial purposes as well as tax purposes, that system will be bias-free, and therefore will clearly reflect income, because: (i) that accounting method clearly reflects income as a general matter, and represents the best accounting practice in the industry; (ii) the method is used to calculate fair market values that drive important day-to-day commercial and financial decisions; (iii) the method's detailed implementation is vetted by influential stakeholders with competing interests, thereby eliminating systemic bias; and (iv) the method is consistent with tax norms regarding both property valuation and the proper matching of income and deductions.

II

MARK-TO-MARKET ACCOUNTING METHODS EMPLOYED BY SWAPS DEALERS IN GENERAL CLEARLY REFLECT INCOME

Treasury regulations and caselaw identify a few principal touchstones for determining whether an accounting method clearly reflects income. Treas. Reg. § 1.446-1(a)(2) provides that “[a] method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.” Accord Wal-Mart Stores, Inc. v. Commissioner, 73 T.C.M. 1625, 1634 (1997) (citing this

regulation with approval in holding that the taxpayer's method of accounting for inventory shrinkage clearly reflected income), aff'd 153 F.3d 650 (8th Cir. 1998). Other caselaw has emphasized the importance of matching income with expense, and achieving a proper measure of economic income without any conservative bias. See, e.g., Thor Power, 439 U.S. at 544-45 (discussing conservative accounting practices that are inappropriate for tax purposes); Photo-Sonics, 357 F.2d at 657 (importance of matching).

It is beyond question that the mark-to-market method of tax accounting in general clearly reflects income. Mark-to-market accounting has been viewed for decades as the most theoretically desirable of all the various systems of taxing income, because only mark-to-market accounting consistently measures and levies tax on a person's economic (or "Haig-Simons") income. See, e.g., E. Cary Brown & Jeremy I. Bulow, The Definition of Taxable Business Income, in Comprehensive Income Taxation 241, 242-43 (Pechman ed. 1977).²¹ In the academic and policy literature dealing with the taxation of financial products, such as swaps, commentators have regularly acknowledged the absolute superiority of mark-to-market in measuring income and the significant defects of other competing systems. See, e.g., New York State Bar Association, Tax Section, Committee on Financial Instruments, Report on Tax Accounting for Notional Principal Contracts (Sept. 28, 1989), reprinted in 36 Highlights and Documents 785, 786 (Oct. 20, 1989).²²

²¹ See also Robert M. Haig, The Concept of Income—Economic and Legal Aspects, The Federal Income Tax (1921), reprinted in Readings in the Economics of Taxation at 68-69 (1959); Henry C. Simons, Personal Income Taxation 103 (1938); David J. Shakow, Taxation Without Realization: A Proposal For Accrual Taxation, 134 Penn. L. Rev. 1111 (1986).

²² See also Reed H. Shuldiner, Consistency and the Taxation of Financial Products, 70 Taxes 781 (1992) (stating that "once one forsakes mark-to-market taxation, it becomes extremely difficult to evaluate alternative principles of taxation"); Robert H. Scarborough, Different Rules for Different Players and Products: The Patchwork Taxation of Derivatives, 72 Taxes 1031, 1049 (1994) (stating that no reform short of mandatory mark-to-market accounting would eliminate all inconsistencies in the taxation of derivatives); Alvin C. Warren, Financial Contract Innovation
(continued...)

As used by tax policymakers, then, mark-to-market accounting is the paradigm of clear reflection of income to which traditional accrual methods aspire.

Mark-to-market accounting is particularly appropriate for OTC derivatives dealers. Swaps dealers, like Petitioner, employ mark-to-market accounting for important commercial and financial purposes (as well as for tax purposes) because mark-to-market accounting is a superior method of clearly reflecting a swaps dealer's annual income. As noted, swaps dealers rely extensively on hedging techniques to reduce (or in many cases eliminate) their exposure to (at a minimum) first-order economic risks, such as a simple change in interest rates. These hedges can include (i) other OTC derivatives, (ii) long and short positions in "physical" securities, and (iii) exchange-traded futures contracts and options. Many of these hedging transactions, such as exchange-traded futures contracts, have maturities that are much shorter than the long-term swaps contracts on a swaps dealer's books, and other hedging transactions (e.g., a long position in physical securities) are regularly liquidated or unwound as new customer swaps change the risk profile of a swaps dealer's book.

Traditional accrual method accounting, which uses the realization principle as the bedrock of its income inclusion rules, can subject a swaps dealer to enormous and unpredictable distortions in the measurement of its income from its book of customer swaps and hedges because the dealer's recognized losses (for example) on short-dated hedges would offset its unrealized gains on its customer swaps as a commercial and economic matter, but unrealized

(...continued)

and Income Tax Policy, 107 Harv. L. Rev. 460 (1993) (considering a number of proposals to tax financial instruments, the most theoretically optimal of which is mark-to-market).

gain would be ignored for tax purposes. These distortions, of course, could work either in favor of the taxpayer or the government in any particular year.²³

The only practical way to eliminate these large and unpredictable timing distortions arising from a “book” of short-dated hedges and long-dated customer contracts is to adopt the mark-to-market method of tax accounting, which, by recognizing *all* economic fluctuations in value in the swaps dealer’s book of customer positions and hedges, assures that the dealer is taxed each year on its true annual change in net worth arising from its dealer activities.²⁴ Consequently, many swaps dealers were advocates of comprehensive mark-to-market tax accounting long before the adoption of section 475, and (as described in Section III, below) securities and commodities dealers (and, since the birth of the industry, swaps dealers) have for decades maintained their books on a mark-to-market basis for important commercial and financial purposes.

In 1920, for example, Respondent first permitted the adoption of a comprehensive mark-to-market accounting system for commodities dealers. A.R.M. 100, 3 C.B. 66 (1920) (describing opinion of Attorney General on validity of different inventory methods), and later A.R.M. 135, 4 C.B. 114 (1920), permitted the dealers to adopt a comprehensive mark-to-market accounting system for their open hedge contracts. The conclusions of A.R.M. 135 in turn were updated and restated in Rev. Rul. 74-223, 1974-1 C.B. 23 (“This system of bookkeeping is the

²³ Letter from Saul Rosen, dated December 6, 1991, supra (“Because the timing mismatch between long-term notional principal contracts and shorter-term hedges artificially can accelerate *either* taxable income or deductible loss, the result is a timing ‘lottery’. This lottery unpredictably may create a large tax benefit or a large tax cost relative to a dealer’s economic income from year to year.”).

²⁴ The same timing issues can arise in other circumstances—closing out an existing swap prior to maturity, for example—but the text presents the most common and dramatic cause of income distortion under the traditional accrual method of accounting.

only accurate and correct system that has been devised that truly reflects the net profit or loss of any given year's business, either fiscal or calendar.”).

Swaps dealers responded to the same hedge timing issues that confronted commodities dealers decades earlier by adopting mark-to-market accounting, and addressed the absence of liquid secondary markets by implementing that accounting method through the use of adjusted mid-market methods. That approach is followed by virtually all swaps dealers today, and conforms to the best accounting practices, as proposed by industry accounting experts. Group of Thirty, *supra*, at 9; *id.* Appendix I at 6; Comptroller Banking Circular BC-277, *supra*, at 154. Swaps dealers' adjusted mid-market implementation of mark-to-market accounting thus reflects “accepted conditions or practices in that [industry]” within the meaning of Treas. Reg. § 1.446-1(a)(2), and thereby satisfies one of the important requisites of the clear reflection of income doctrine.

Accordingly, in light of its complete identity with economic constructs of income, adjusted mid-market mark-to-market accounting methods employed by swaps dealers necessarily clearly reflect income, so long as any particular implementation does not introduce some distortion inconsistent with tax concepts. As more fully described below, the adjusted mid-market method of mark-to-market accounting as implemented by swaps dealers and described in this brief in fact does not introduce any such distortions and is consistent with other tax norms. The method therefore clearly reflects a swaps dealer's income.

III

SWAPS DEALERS APPLY THE SAME MARK-TO-MARKET METHODOLOGY FOR BOTH TAX AND NON-TAX PURPOSES

A. MARK-TO-MARKET VALUATION HAS BEEN CALCULATED CONSISTENTLY FOR TAX AND NON-TAX PURPOSES FOR DECADES.

Although this case appears to be one of first impression, the Code has contemplated the use of mark-to-market accounting methods for taxpayers in positions analogous to that of Petitioner since at least 1919. For eight decades, it has been the explicit or implicit understanding that the mark-to-market valuations made for tax purposes would be consistent with those made for financial accounting and other important non-tax purposes.

1. Market Valuation of Inventories. Since at least 1919, taxpayers have been permitted to value inventories at the lower of cost or market.²⁵ Inventory accounting must satisfy two tests: first, it must conform as nearly as practicable to the best accounting practices in the industry, and, second, it must clearly reflect income. Treas. Reg. § 1.471-2(a). From 1958 until it was superseded by section 475, Treas. Reg. § 1.471-5 specifically authorized dealers in securities to value securities inventories at (i) cost, (ii) market, or (iii) lower of cost or market, so long as the method employed by the dealer for tax purposes was *also* “the basis on which his accounts are kept.”²⁶ These requirements that a dealer’s tax accounting method for inventories conform to the method used to maintain the dealer’s internal accounts and to the accounting principles of the industry meant, in practice, that Respondent and dealers alike expected that the same valuations would be employed consistently for tax and for non-tax accounting purposes.

²⁵ T.B.R. 48, 1 C.B. 47 (1919). See also O.D. 8, 1 C.B. 56 (1919) (confirming that securities dealers, like other taxpayers, could value their inventories at lower-of-cost-or-market).

²⁶ Treas. Reg. § 1.471-5 (adopted under T.D. 6336, 1958-2 C.B. 176).

In consequence, although many cases involve disputes over the relevant “market” for purposes of applying, for example, lower-of-cost-or-market accounting (e.g., Thor Power, 439 U.S. 522), we have found no decided case in which a taxpayer’s good faith calculations of the actual fair market values of inventories, employed consistently for tax and non-tax accounting purposes, have been challenged by Respondent. It is certainly the experience of the member firms of the Associations that financial-statement/tax-accounting conformity in calculating fair market values of securities inventories has for decades been both necessary and sufficient for purposes of IRS examinations. This experience is not surprising in light of the identity between the definition and purpose of financial accounting and tax concepts of fair market value, as described in Section III.B, below.

2. Comprehensive Mark-to-Market Accounting. The same tradition of consistency holds true for comprehensive mark-to-market accounting outside the context of inventory methods. Rev. Rul. 74-223 (involving futures contracts that commodities dealers entered into as hedges) relied on the *non-tax* purposes for which the taxpayers’ mark-to-market method of accounting was employed in reaching the conclusions that the method clearly reflects income:

This system of bookkeeping is the only accurate and correct system that has been devised that truly reflects the net profit or loss of any given year’s business, either fiscal or calendar. *It is the system in use, approved by auditors who certify to the correctness of his financial statements which are the basis of his credit, and is the system accepted by his bankers for all his financial transactions and the only system which would not be false and misleading.* (Emphasis supplied.)

Essentially identical language had appeared in A.R.M. 135. It appears, then, that in both Rev. Rul. 74-223 and A.R.M. 135, the taxpayer employed the same valuations for tax and non-tax purposes, and that this fact was important to the analysis of the Committee on Appeals and

Revenue (and later the National Office of the IRS) in accepting that valuation methodology as an appropriate accounting method for tax purposes.

Prior to the adoption of section 475 in 1993, swaps dealers all confronted the short-dated-hedges/long-dated-swaps timing distortions described above. In response, many dealers—including, apparently, Petitioner—voluntarily adopted comprehensive mark-to-market tax accounting, and swaps dealers in some cases lobbied Congress to adopt rules confirming mark-to-market as a valid tax accounting method for swaps dealers.²⁷

Respondent and the Treasury Department responded to this dealer-driven request to clarify the scope of mark-to-market accounting by proposing Treas. Reg. § 1.446-4 in 1991, which would have explicitly permitted swaps dealers to place their OTC derivatives businesses onto mark-to-market systems.²⁸ In the end, the Treasury did not promulgate the proposed regulation in final form, because the enactment of section 475 rendered it moot. The proposed Treasury regulation would have *conditioned* the availability of mark-to-market accounting for a swaps dealer on that dealer *employing the same valuations for tax purposes as it employed in its financial statements*:

A dealer or trader in derivative financial instruments may elect to account for a derivative financial instrument at market value only if: ...[t]he dealer or trader values all of the derivative financial instruments that it holds in its capacity as a dealer or trader (or as hedges of such instruments) at market for purposes of computing

²⁷ See, e.g., Letter from Cynthia Beerbower on Behalf of Nine Interest Rate Cap Dealers, to IRS, dated March 4, 1988, reprinted in 88 Tax Notes Today 69-29 (Mar. 28, 1988); Letter from Saul Rosen, dated December 6, 1991, *supra*; Edward D. Kleinbard & Thomas L. Evans, The Role of Mark-to-Market Accounting in a Realization-Based Tax System, 75 Taxes 788, 798-99 (1997). The technical reason for any concern was that, while swaps are directly analogous to traditional securities inventories, swaps arguably are not directly inventoriable, because once entered into, they are not literally held for resale to other customers.

²⁸ Notice of Proposed Rulemaking FI-16-89, 1991-2 C.B. 951.

net income or loss on its applicable financial statement (as defined in § 1.56-1(c)), and the dealer or trader *uses the same method of valuing* those instruments on its income tax return... (Emphasis supplied.)²⁹

We believe that this condition of book/tax conformity was proposed because it was clear in 1992, as it is today, that the methods used for financial accounting and other substantive non-tax commercial purposes have been developed on an objective basis, without systemic bias, and clearly reflect the taxpayer's income.

The legislative history of section 475 itself indicates that Congress anticipated that mark-to-market accounting for tax purposes would be consistent with that accounting for non-tax purposes. Neither Congress nor the Administration drafted section 475 in a vacuum. Indeed, the first legislative proposal for what became section 475 (contained in the President's Budget Proposal released in January, 1992³⁰) was released only a few months after the publication of the Treasury's 1991 report, Modernizing the Financial System, and Prop. Treas. Reg. § 1.446-4, and the final legislation overlapped the preparation of the Group of Thirty's Derivatives: Practices and Principles. We therefore believe it fair to conclude that Congress was well aware of how mark-to-market accounting operated in practice in the swaps industry, and constructed section 475 in light of that current practice.

In describing the reasons for the legislation, both Congress and the President emphasized that the change in tax accounting rules would simply move tax accounting to the

²⁹ Id. at 962.

³⁰ Department of the Treasury, General Explanation of the President's Budget Proposals Affecting Receipts 89-90 (Jan. 30, 1992).

already accepted financial accounting treatment.³¹ Congress also expressed its expectation “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,”³² thus implying that Respondent should defer to the taxpayer’s normal financial accounting valuation,³³ which in the case of a swaps dealer was and is the adjusted mid-market method that was recommended by the Group of Thirty and was consistent with the Treasury Department’s 1991 report, Modernizing the Financial System.

B. TAX ACCOUNTING AND FINANCIAL ACCOUNTING HAVE THE SAME STANDARDS AND GOALS WHEN APPLYING MARK-TO-MARKET ACCOUNTING.

Swaps dealers invariably use exactly the same mark-to-market model (and valuations) for financial accounting and for tax purposes. In other cases, financial accounting and tax accounting may employ different measures of income, because each system can have

³¹ H.R. Rep. 103-11, reprinted in 1993-3 C.B. 237 (“Inventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement purposes”); Department of the Treasury, General Explanation of the President’s Budget Proposals Affecting Receipts 89-90 (Jan. 30, 1992); Department of the Treasury, General Explanation of the President’s Budget Proposals Affecting Receipts 36 (Feb. 25, 1993).

³² H.R. Rep. 103-11, reprinted in 1993-3 C.B. 237, 241.

³³ The implication that using financial accounting methods would “alleviate unnecessary compliance burdens” is buttressed by another part of the legislative history to section 475 (concerning the identification of certain securities as hedges—not the fair market valuation of securities), which provides that the use of financial accounting methods would be an adequate and efficient method for applying mark-to-market rules. “It is anticipated that the identification rules with respect to hedges will be applied in such a manner as to minimize the imposition of additional accounting burdens on dealers in securities. For example, it is understood that certain dealers in securities use accounting systems which treat certain transactions entered into between separate business units as if such transactions were entered into with unrelated third parties. It is anticipated that for the purposes of the mark-to-market rules, such an accounting system generally will provide an adequate identification of hedges with third parties.” H.R. Rep. 103-11, reprinted in 1993-3 C.B. 237, 240.

different goals. As applied to the mark-to-market accounting systems of swaps dealers, however, financial accounting and tax accounting have adopted near-identical definitions of income.

For purposes of financial accounting, “fair value” is “the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in the forced or liquidation sale.”³⁴ This is the same concept of fair market value that is used for U.S. federal income tax purposes, which is “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 the relevant facts.”³⁵ Because the two accounting regimes employ essentially the same definition for the same purposes, swaps dealers use the identical valuations for both purposes.

It is true, of course, that conformity to GAAP does not create a formal presumption that a taxpayer’s accounting method clearly reflects income, Thor Power, 439 U.S. 522. By the same token, however, GAAP conformity is helpful and relevant to this proceeding, because it confirms that the taxpayer’s accounting method conforms to the best accounting practices in the industry, Treas. Reg. § 1.471-2(a)(1) (inventories), and “will ordinarily be regarded as clearly reflecting income,” Treas. Reg. § 1.446-1(a). Cf. Wal-Mart, 153 F.3d at 657 (GAAP conformity relevant to determining clear reflection of income); RLC Indus. v. Commissioner, 98 T.C. 457, 498 (1992) (“If a particular method is acceptable under GAAP, it

³⁴ Disclosure about Fair Value of Financial Instruments, *supra* § 5.

³⁵ Treas. Reg. § 1.170A-1(c)(2) (defining “fair market value” for the purposes of the charitable contribution regulations); Treas. Reg. § 20.2031-1(b) (defining “fair market value” for estate tax purposes); Treas. Reg. § 25.2512-1 (defining “fair market value” for gift tax purposes); United States v. Cartwright, 411 U.S. 546, 591 (1973) (quoting Treas. Reg. § 20.2031-1(b) with approval); Easter Service Corp. v. Commissioner, 650 F.2d 379, 384 (2nd Cir. 1981) (quoting United States v. Cartwright).

may assist in our deciding whether the method meets the clear reflection standard.”), aff’d 58 F.3d 413 (9th Cir. 1995). We submit that GAAP conformity is particularly relevant where, as here, (i) the taxpayer has been asked to develop its mark-to-market accounting method in a complete regulatory vacuum, and (ii) the GAAP standard of income measurement (i.e., its definition of “fair value”) is explicit, objective, and synonymous with the comparable tax definition.

Financial accountants do not simply accept a swaps dealer’s implementation of mark-to-market accounting at face value. Instead, independent auditors carefully review those calculations every year. The purpose of these independent audits is to verify the reasonableness of a swaps dealer’s valuations and to ensure that the swaps and derivative contracts are fairly stated in accordance with GAAP.³⁶ In particular, auditors contemporaneously review the swaps dealer’s methodology to ensure (i) that all the appropriate facts relevant to the value of the swaps have been considered, (ii) that the valuation procedures are reasonably and consistently applied, and (iii) that the underlying documentation supports the valuation.³⁷ Auditors require that every swaps dealer’s valuation model, at a minimum, address (i) the market factors that affect swap values, (ii) credit factors, (iii) liquidity factors, and (iv) transaction and administrative costs.

As part of their procedures, auditors (i) value representative transactions in a swaps dealer’s book using valuation models independent of the swaps dealer’s tools, (ii) independently validate the appropriateness and accuracy of the market data used in the model, and (iii) evaluate the appropriateness and completeness of the dealer’s market value

³⁶ Auditing Accounting Estimates, Statement on Auditing Standards No. 57, § 5 (AICPA 1988).

³⁷ American Institute of Certified Public Accountants, AICPA Audit and Accounting Guide—Brokers and Dealers in Securities 191 (2000).

adjustments—all to ensure the swaps dealer’s valuation reflects fair value.³⁸ If the auditor concludes that a swaps dealer’s valuation procedures are inadequate or unreasonable, the auditor will be compelled to issue a qualified opinion to identify any material departure of the swaps dealer’s valuation procedures from GAAP.

It is sometimes suggested in tax cases that financial accounting has a conservative bias, and therefore is unsuited as a starting point for computing taxable income.³⁹ Whatever the former truth of this maxim, it plainly overstates the case today: the SEC, which is the ultimate regulator of financial accounting standards, has explicitly stated that the goal of financial accounting for income is accuracy, not conservatism.⁴⁰

The AICPA is an organization that is uniquely well-qualified to address the theoretical and practical aspects of mark-to-market valuation methodologies. With more than 330,000 members, the AICPA is the premier national professional association for certified public accountants in the United States. In a 1994 submission to Respondent, the AICPA outlined both the evolving nature of best accounting practices for mark-to-market accounting and the desirability of preserving consistency in valuations between tax and financial accounting statements:

Section 475 and the regulations thereunder do not define the term market value. It must be acknowledged that mark-to-market accounting is in its infancy. Theories exist, and are used in

³⁸ Id. at 139.

³⁹ Thor Power, 439 U.S. at 544-45.

⁴⁰ The chairman of the SEC has spoken out for the last two years against the practice of “earnings management” (i.e., understating *or* overstating earnings) and has demanded accuracy in the financial data presented to the investing public. See e.g., Remarks by Chairman Arthur Levitt, Securities and Exchange Commission, The “Numbers Game”, Sept. 28, 1998 <<http://www.sec.gov/news/speeches/spch220.txt>>.

practice, which provide guidance on how certain assets and instruments should be valued for economic purposes. Yet, these theories still remain the subject of legitimate debate both among economists and within the accounting professions.

We believe that tax mark-to-market accounting defined by reference to Generally Accepted Accounting Principles (“GAAP”) should be an available election. Specifically, we believe that book/tax conformity with respect to 1) the valuation of securities subject to mark-to-market accounting, and 2) the amount of income or loss recognized in GAAP financial statements and for tax purposes represents an easily administered equitable solution to the application of section 475.

* * *

As stated above, we believe book/tax conformity in valuation should govern... In most instances, management has no incentive to understate financial statement income even if it results in a reduced tax liability. Accordingly, book/tax conformity in valuation should be consistent with the underlying intent of the statute and with the Treasury Department’s concern regarding protection of the revenue base.⁴¹

In sum, financial accounting mark-to-market accounting standards for swaps dealers are the same as those of the tax law, and the application of those financial accounting standards is subject to rigorous and contemporaneous review by independent auditors. Both financial and tax accounting mark-to-market standards in turn are grounded in the bedrock of economic reality, because those valuations drive important day-to-day commercial and financial decisions. A swap valuation model that is used consistently for both book and tax purposes therefore satisfies the tax law’s objective of clear reflection of income.

⁴¹ AICPA, Comments on Proposed and Temporary Regulations Section 1.475(b)-1T through 1.475(e)-1T Relating to Mark-to-Market for Dealers in Securities, dated May 24, 1994, reprinted in 94 Tax Notes Today 106-23 (June 2, 1994).

C. COMPETING INTERESTS ELIMINATE SYSTEMIC BIAS IN MODEL-BASED MARK-TO-MARKET ACCOUNTING.

Swaps dealers use swap valuation models for one purpose: to value swap positions as accurately as possible. The values produced by these models are used, not just for tax accounting, but also for purposes of internal business management, compensation, risk measurement, financial accounting and regulatory supervision. Respondent appears to believe that a swaps dealer would tolerate a valuation model that systematically undervalued or overvalued positions. In doing so, Respondent posits that a swaps dealer would use in its business operations swaps valuations that were wholly inconsistent with commercial and financial reality.

A swaps dealer, for example, will use the identical valuations that are used for tax purposes to determine which swap positions are profitable and which are unprofitable as a commercial and financial matter.⁴² Therefore, if a swaps dealer's implementation of mark-to-market accounting were systematically to understate the value of positions (in order, for example, to achieve some tax benefit by creating a conservative bias in the marks), traders would have incentives consistently to forego profitable trades. Similarly, systematic overvaluation would cause traders consistently to enter into unprofitable trades.⁴³ In addition, if a position in a trader's book were undervalued by the firm's adjusted mid-market valuation system, the trader

⁴² Mark-to-market valuation models are used to determine profitability, but do not directly determine the rates charged a customer. Other factors will enter into the pricing decision, including, for example, one party's eagerness to do business with the other. Similarly, if a trader believes that a counterparty is highly motivated to enter into a transaction for whatever reason, the trader may be able to get an above-market price for a trade.

⁴³ For a more detailed discussion of the use of valuation models by traders, see Annex A hereto.

could improve his or her apparent profitability by unwinding the position for cash, thereby booking an illusory profit to the detriment of the firm.

Senior management employs the profit and loss figures generated by the same valuation model that is used to calculate tax “marks” to supervise the performance of swaps traders, to help set those traders’ bonuses (which form the bulk of their compensation), and to determine how much of the firm’s capital to dedicate to the swaps business. Again, systematic undervaluation would lead to undercompensation of those traders (and, eventually, senior management) and to a misallocation of the firm’s capital.

Swaps dealers generally employ the same valuation models that they use to calculate their “marks” for tax purposes in order to quantify the market risks inherent in a given position for purposes of hedging that risk.⁴⁴ A biased valuation model would cause a swaps dealer to draw incorrect inferences about the amount of risk associated with the dealer’s book of positions, with the result that positions would be either under-hedged or over-hedged. See Group of Thirty, supra, at 3 (“Incorrect valuation leads not only to inaccurate income recognition, but also to inaccurate hedging. For instance, incorrect valuation of an option can lead to an incorrect measure of its price sensitivity (i.e., delta) and consequently an inadequate hedge.”).

Similarly, dealers employ the same mark-to-market valuations that they use for tax purposes in preparing financial accounting statements on which stockholders, creditors, rating agencies and prospective swap counterparties all rely. Most prominent OTC derivatives

⁴⁴ Dealers typically monitor and adjust their risk hedges many times during the course of a day. Obviously, adjustments for creditworthiness, liquidity costs, administrative expenses and the like vary far more slowly. It therefore is the case that in hour-to-hour hedge decisions a swaps dealer may choose to ignore such adjustments, because from the perspective of a hedge time horizon, those adjustments effectively are constants. This implementation is simply a practical and simplifying application of a consistent swaps valuation model.

dealers are publicly-traded corporations. Their model-based valuations are components of public financial statements that directly impact share price, and their derivatives activities are subject to special scrutiny and disclosure. For example, Merrill Lynch & Co.'s 1999 Annual Report contained this attestation as to the market-driven basis of its valuation models, as employed both for financial accounting and for tax purposes:

Fair values for [OTC] derivative financial instruments, principally forwards, options, and swaps, represent amounts that would be received from or paid to a third party in a settlement of these instruments. These amounts are determined using pricing models based on the present value of estimated future cash flows employing mid-market valuations with appropriate adjustments. These adjustments are integral components of the mark-to-market process and relate to credit quality and concentration, market liquidity, and exposure close-out costs associated with unmatched positions. Adjustments are also made for administrative costs incurred to service periodic cash flows and to maintain hedges over the life of a contract. A portion of income related to long-term contracts is recognized as the related administrative costs are incurred.

New, complex instruments may have immature or limited markets. The precision of the pricing model for a complex product, which involves multiple variables and assumptions, will evolve over time. As the markets for these products develop, Merrill Lynch continually refines its pricing models based on experience to correlate more closely to the market risk of these instruments.⁴⁵

Because swap valuation models drive important financial and commercial results that in turn affect significant business decisions, senior businesspeople at each firm review and approve the design of those models. Since those business users demand accurate valuations of actual fair market value, it is the experience of the Associations that their member firms' tax departments have no special expertise to contribute, and therefore have no input in swap valuation model design or construction.

⁴⁵ Merrill Lynch, 1999 Annual Report 63 (2000).

Even if one could accept theoretically the notion that a swaps dealer would tolerate a systemic bias in the valuation of its derivatives positions that would distort important day-to-day business decisions, the existence of influential stakeholders with competing interests in those valuations would prevent such a bias from developing. To take the most obvious example, swaps traders and managers, whose compensations are affected by the profitability of the swaps books that they manage, obviously have a vested interest in reporting a high level of profitability, not a low one.

For all these reasons, swaps firms must employ valuation models that reasonably attempt to arrive at accurate measures of fair market values. Any dealer using a model with any systemic bias would eventually be forced out of business by competitors more capable of properly allocating resources and distinguishing profitable trades from unprofitable ones. Moreover, it would expose itself to liability both to its relevant regulators, and, if a public company, to the SEC and to its shareholders.

In sum, swaps dealers employ a consistent implementation of mark-to-market accounting to calculate the actual fair market value of their swaps books. These values drive important day-to-day commercial and financial decisions. These values also are used for financial accounting, which, in this specialized industry, has the same goals as does tax accounting. In these circumstances, we think it plain that the AICPA was correct when it urged Respondent in 1994 to employ valuations used for purposes of preparing financial statement results as the basis for determining mark-to-market valuations.

Our agreement with the AICPA's comments does not mean that we are arguing that tax accounting for swaps dealers should, in the abstract, always follow financial accounting, but rather that, in this specific situation where financial and tax accounting both have identical

objectives (i.e., to determine the fair market value of a swaps dealer’s swaps books), swaps dealers should follow for both tax and financial accounting purposes the valuations that are directly employed in running their businesses. That conformity achieves administrability. It also ensures that the figures employed for tax purposes are the most accurate that each institution can calculate, because commercial and financial decision-makers directly rely on these values to manage their businesses.

IV

MARK-TO-MARKET ACCOUNTING AS IMPLEMENTED BY SWAPS DEALERS COMPORTS WITH TAX NORMS

A. MARK-TO-MARKET ACCOUNTING AS IMPLEMENTED BY SWAPS DEALERS
COMPORTS WITH THE HOLDING OF THOR POWER TOOL CO. V.
COMMISSIONER.

Swaps dealers use reasonable business judgments to design the models that drive the valuations of their swaps books, and swaps dealers use the same fair market values for tax and financial purposes. These facts are broadly similar to the business practices of the taxpayer in Thor Power, 439 U.S. 522, but this similarity in business practices does not mean that our argument runs afoul of the holding of Thor Power.

The taxpayer in Thor Power held “excess” inventory, consisting of replacement parts and the like for tools no longer manufactured by the taxpayer, but which the taxpayer continued to support. The amount of that excess inventory exceeded reasonably anticipatable demand, but the marginal cost of carrying that excess inventory was lower than the cost of retooling to make more inventory, should demand exceed the taxpayer’s expectations. Thor Power, 439 U.S. at 545.

The taxpayer in Thor Power valued its inventories for tax purposes at the lower-of-cost-or-market. Treas. Reg. § 1.471-4(a) and caselaw effectively define “market” for this

purpose as synonymous with “replacement cost,” subject to two exceptions. Thor Power, 439 U.S. at 534. For financial accounting purposes, the taxpayer in Thor Power properly reduced its inventory values to net realizable value (essentially, scrap value), but the taxpayer continued to hold those inventories for sale to customers at the same prices as before the write-down. The taxpayer then effectively claimed as a tax deduction the amount of that write-down.

The Supreme Court held that the inventory write-down was not a permissible tax deduction, because the write-down plainly violated the “clear” regulatory scheme of Treas. Reg. § 1.471-4: the taxpayer’s replacement cost for the inventory far exceeded the written down values, and neither of the two exceptions in the relevant Treasury regulations applied to the taxpayer. Thor Power, 439 U.S. at 535-36.

The taxpayer’s only counterargument to the result required by the Treasury regulations was that its inventory write-down followed GAAP principles and sound business judgment. The Supreme Court, however, concluded that, while a tax accounting system that conforms to GAAP “in most cases...will pass muster for tax purposes,” GAAP conformity did not by itself create a presumption in favor of the taxpayer, and that an accounting method that violated an express accounting requirement in the relevant Treasury Regulations definitionally could not clearly reflect income. Thor Power, 439 U.S. at 540.

Our argument in the present matter complements, rather than contradicts, the holding of Thor Power. First, and most obviously, swaps dealers’ implementations of mark-to-market accounting do not contradict any Treasury regulation, but instead, in a vacuum of any relevant regulatory guidance, represent an unbiased methodology to measure the fair market value of property that has no established secondary market.

Second, swaps dealers do not confront the definitional problem of identifying the relevant market that confounded the taxpayer in Thor Power. The Thor Power taxpayer was a manufacturer, for which the replacement cost of inventory (i.e., its manufacturing cost) and the realizable values at which that inventory could be sold could (and in that case, did) vary substantially. In this sense, the resolution of Thor Power turned on the definitional question of which (replacement cost or realizable value) was the relevant “market.” Swaps dealers do not manufacture their swaps; for swaps dealers, “replacement cost” and “realizable value” are synonymous, and also have the same meaning as “fair market value,” which is (in this case) the interdealer market price.

Third, and most important, the Thor Power taxpayer’s inventory write-down had *no* effect on the taxpayer’s day-to-day business operations; instead, the taxpayer continued to hold the same inventories for sale at the same prices as it did before the write-down. Our fundamental point in this brief is the converse: swaps dealers design their swap valuation models to capture as accurately as possible the actual fair market values of their swaps books, because swaps dealers employ the valuations and income statements produced by those valuation models as drivers of important day-to-day business decisions, like capital allocation, employee compensation and risk measurement. Thus, in contrast to the taxpayer in Thor Power, a swaps dealer cannot afford to be conservative in valuing its swaps, because any such practice would have a disastrous impact on the firm’s operations.

Unlike the inventory valuations of the taxpayer in Thor Power, a swaps dealer’s valuation model helps to drive its business; the fair market valuations produced by the model therefore are accurate, and they are appropriate for both financial accounting and tax purposes. Our point, then, is not that tax accounting for swaps dealers should follow financial accounting,

but rather that financial and tax accounting alike should follow the valuations that are directly employed in running swaps dealers' businesses.

B. MODEL-BASED VALUATION OF SWAPS COMPORTS WITH TAX NORMS.

As previously discussed, there are no meaningful data on the prices at which swaps are assigned in the secondary markets. In the absence of such market prices, dealers rely on valuation models based on a discounted cash flow analysis, which the Treasury Department has recognized as the type of analysis that must be used to estimate the fair market value of assets when secondary market prices are unavailable.⁴⁶

Treasury regulations and caselaw consistently hold that a property's "fair market value is 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 the relevant facts."⁴⁷ Where it is impossible to measure trading prices, however, rules for valuing property have been developed that allow taxpayers to derive "market value" based on formulas and models that incorporate the particular factors relevant to the valuation of such property. For example, for purposes of the estate tax, in situations where actual sales and bona fide bid and ask prices are lacking, bonds are valued based on "the soundness of the security, the interest yield, the date of maturity, and other relevant factors."⁴⁸ Using these

⁴⁶ Department of the Treasury, Modernizing the Financial System, supra, at XI-15.

⁴⁷ Treas. Reg. § 1.170A-1(c)(2) (defining "fair market value" for the purposes of the charitable contribution regulations); Treas. Reg. § 20.2031-1(b) (defining "fair market value for estate tax purposes"); Treas. Reg. § 25.2512-1 (defining "fair market value" for gift tax purposes); Cartwright, 411 U.S. at 591 (quoting Treas. Reg. § 20.2031-1(b) with approval); Easter Service, 650 F.2d at 384 (quoting United States v. Cartwright).

⁴⁸ Treas. Reg. § 20.2031-2(f); F.S.A. 199944007 (July 22, 1999).

various factors to derive fair market value of bonds is equivalent to modeling the fair market value of swaps by using the factors mentioned as the inputs for the model.

This Court has approved the use of models to determine fair market value. In Chesapeake & Ohio Railway Co. v. Commissioner, 64 T.C. 352, 360 (1975), for example, the Court applied a valuation model that derived the fair market value of “relay” rail based on its estimated relationship to the value of new rail and salvage rail line. Respondent itself tacitly approved of using models to determine the value of derivatives for mark-to-market purposes when it initiated a project (described below, pp. 55-56) to develop its own model-based mark-to-market valuation system using the resources of the Los Alamos National Laboratory.⁴⁹

Because the unique economic characteristics of swaps make model-based valuations the only feasible method for determining their fair market value, and because administrative practice is replete with examples of model-based determinations of fair market value, model-based valuations are appropriate for marking swaps to market for tax purposes.

C. THE ADJUSTMENTS MADE TO MID-MARKET VALUES ARE CONSISTENT WITH TAX NORMS.

The adjustments made by a swaps dealer to mid-market values also are consistent with tax norms. The purpose of mark-to-market accounting is to derive annual income by measuring *value*, and the anticipated costs of earning expected (but not yet accrued) income are components of value that would be taken into account by any prospective assignee of a cash flow stream in calculating the value of that stream. More generally, adjustments are consistent with the mark-to-market method’s general rejection of realization principles, and this feature of mark-to-market accounting has been recognized by the courts. As the Second Circuit noted in

⁴⁹ Solicitation for Comments, Mark-to-Market Valuation Software, 62 Fed. Reg. 29188-89 (May 28, 1997).

1929 when discussing the valuation of inventory, “[t]he determination of value...has no relation to the principle or theory affecting the determination of *when* income is deemed to be received and *when* expenses are deemed to be incurred.” (Emphasis supplied.) American Can Co. v. Bower, 35 F.2d 832, 835 (2nd Cir. 1929). See also Space Controls, Inc. v. Commissioner, 322 F.2d 144 (5th Cir. 1963) (rejecting the characterization that a reduction in the stated value of inventory is a premature recognition of a loss); St. James Sugar Coop. v. United States, 643 F.2d 1219 (5th Cir. 1981) (allowing reduction in the value of inventory for anticipated price drop); Molsen, 85 T.C. 485 (treating an open contractual obligation of a commodities dealer employing mark-to-market accounting as, in effect, a component of inventory value, rather than an expense item); Treas. Reg. § 1.471-4(b) (allowing taxpayers using the lower-of-cost-or-market method to value inventories at selling prices less anticipated costs of disposition, even though such costs have not yet been incurred, where the usual methodology for determining “market,” *i.e.*, replacement cost, is not practical due to inactive markets).⁵⁰

Stated differently, in contrast to the accrual method of accounting, the mark-to-market method requires both the current recognition of unrealized income and the current consideration of anticipated costs that affect value.

⁵⁰ For taxpayers using realization-based methods of accounting, other similar mechanisms exist for taking into account future unrealized costs when the recognition of gross income is otherwise accelerated, in order to measure *net* income properly for the year in question. See, *e.g.*, Treas. Reg. § 1.451-5(c)(ii) (allowing taxpayers selling inventory who receive advance payments from customers to reduce income by the estimated future costs necessary to produce the inventory, when the inventory is not on hand); Rev. Proc. 92-29, 1992-1 C.B. 748 (allowing real estate developers selling properties to include in basis (and thus to reduce income by) the estimated costs of future improvements that the developers are obligated to make on the sold properties); Treas. Reg. § 1.471-8(a) (allowing retail merchants using the “retail method” of inventory accounting to reduce the ending retail value of inventory by a mark-on percentage which includes future unrealized expenses, such as selling expenses).

We do not explicitly address in this brief most of Petitioner's detailed adjustments from mid-market marks, such as its credit adjustments. Adjustment practices vary among swaps dealers and are discussed in the May 2000 ISDA submission,⁵¹ attached to this brief as Annex A. More substantively, we respectfully submit that the real issue is not the technical details of the particular design of a swaps dealer's system for making credit or other adjustments, but rather whether that system is also employed for important commercial and financial purposes, and therefore is a component of an accounting method that (because it fairly values swaps) clearly reflects income.

Respondent has raised the question as to whether taxpayer-specific adjustments, such as the administrative expenses adjustment, can ever be relevant to determining fair market value. We submit that these taxpayer-specific adjustments in fact are just as appropriate and necessary as are other adjustments, because the purpose of these adjustments, and indeed of the entire mark-to-market method, is to reach fair market value, and therefore to clearly reflect the income of the current period, not systematically to overstate or to understate that income. A swaps dealer's own administrative expenses are not, however, as obvious a component of value as other adjustments, and a more detailed explanation therefore is warranted.

In a perfect world, the relevant measure of anticipated future administrative costs would be the amount estimated by the marginal *buyer* of the cash flow stream represented by a swap contract (or swaps book). There is, however, no liquid secondary market in swaps, and as a result there are no useful market data from which to infer a (nonexistent) marginal buyer's estimate of future administrative costs.

⁵¹ Letter from Mark Perwien, dated May 9, 2000, supra.

Ignoring the present value of anticipated administrative costs would systematically overstate values (and therefore income), because *all* holders of the future cash flow will have some administrative expenses that would be reflected in the price they would be willing to pay to acquire that cash flow. Moreover, ignoring anticipated administrative costs would fail a fundamental purpose of business tax accounting, which is to achieve a matching of gross income and associated expenses. Photo-Sonics, 357 F.2d at 657 (“[T]he key to validity of an accounting method is, in accounting terms, a matching of costs and revenues and, in terms of the taxing statute, a clear reflection of income”).⁵²

Using a swaps dealer’s own anticipated administrative costs as an adjustment to mid-market marks admittedly is not conceptually perfect, when compared to using the anticipated costs of a hypothetical but nonexistent marginal buyer. This approach is, however, both administrable and closer to economic measures of value (and therefore income) than ignoring the adjustment altogether. Moreover, the administrative costs for one dealer over time should closely approximate those of other dealers, because a dealer with exceptionally high costs cannot survive in the highly competitive swaps industry over the long run. As a result, the use of a swaps dealer’s own anticipated future administrative costs as a component of its adjustments to mid-market marks is a pragmatic, administrable, and accurate surrogate for a hypothetical (but nonexistent) buyer’s estimates of the same amounts.

⁵² See also Asphalt Products Co. v. Commissioner, 796 F.2d 843, 848 (6th Cir. 1986) (rejecting taxpayer’s failure to account for inventories because “mismatching resulted in reporting that did not clearly reflect income”), rev’d Commissioner v. Asphalt Products Co., 482 U.S. 117 (1987) (reversing on other grounds); S.Rep. 99-313, reprinted in 1986-3 C.B. 133, 140 (legislative history of section 263A, stating that section 263A is intended to correct rules under prior law that “produce[d] a mismatching of expenses and the related income and an unwarranted deferral of taxes”); H.R. Rep. 99-426, reprinted in 1986-3 C.B. 598, 605 (legislative history of section 448, noting that the cash method of accounting frequently fails to measure income properly because it “produces a mismatching of income and deductions...”).

D. SWAPS DEALERS INEVITABLY EMPLOY VARYING IMPLEMENTATIONS OF THE ADJUSTED MID-MARKET METHOD.

Although the method of valuing swaps based on adjusted mid-market marks has near-universal acceptance among swaps dealers, the precise application of the method necessarily will vary among different swaps dealers, and will vary within any one swaps dealer over time. This inevitable variability results from (i) the proprietary nature of valuation models, (ii) the complexity and subjectivity of model inputs, and (iii) the constantly-evolving state of financial theory.

As the Department of the Treasury noted in 1991, “institutions that actively trade financial instruments spend millions of dollars annually attempting to improve their valuation methodologies in order to gain competitive advantage in the marketplace.”⁵³ These methodologies are proprietary to each dealer firm: dealers incur enormous costs in developing and refining these models, and they jealously protect the confidentiality of these models from competitors lest their models lose their competitive edge in valuing swaps more accurately than models used by their competition.

The complexity of valuing derivatives leads dealers to different values, because the models will often require subjective inputs (such as estimations about the volatility of a given security or of a given market) and taxpayer-specific inputs (such as administrative costs, tolerance for credit exposure, etc.). Dr. Emanuel Derman, a prominent specialist in constructing financial product valuation models (and 2000’s “Financial Engineer of the Year,” as awarded by

⁵³ Department of the Treasury, Modernizing the Financial System, supra, at XI-21.

the International Association of Financial Engineers), characterized the derivatives trading environment as “vast struggles with dispersed data and information and record-keeping, all overlaid with ambitious, sometimes astonishingly successful, attempts to describe the underlying phenomena with the classical tools of the natural sciences.”⁵⁴ The AICPA has also noted the complexity of valuation modeling and stated that financial “theories still remain the subject of legitimate debate both among economists and within the accounting profession.”⁵⁵ In these circumstances, variations among dealers are not surprising.

Because of the complexity of model-based valuations, the financial theory of modeling is constantly evolving, as is apparent from the vast resources that are allocated by the financial services industry to developing models each year. In fact, one of the major market criticisms of an attempt by Respondent to create a government-imposed derivative valuation model for tax audit purposes was that the model could only be useful if one assumed *contemporaneous audits* in part because the evolution of modeling was considered to be so rapid that attempts to audit valuations after the fact would have been flawed because of the intervening changes in technology.⁵⁶ For a sense of the magnitude and fundamental nature of the changes constantly taking place in this field, see The Future of Modelling,⁵⁷ a 1997 article in which Dr.

⁵⁴ Emanuel Derman, The Future of Modelling, 10 Risk, Special Anniversary Ed., Dec. 1997, at 164. Dr. Derman is an employee of Goldman, Sachs & Co., which in turn is a member of ISDA, the SIA and the WSTA.

⁵⁵ AICPA, Comments on Proposed and Temporary Regulations Section 1.475(b)-1T through 1.475(e)-1T Relating to Mark-to-Market for Dealers in Securities, dated May 24, 1994, reprinted in 94 Tax Notes Today 106-23 (June 2, 1994).

⁵⁶ See Letter from Lawrence Uhlick, *supra*.

⁵⁷ Emanuel Derman, The Future of Modelling, *supra*, at 164.

Derman attempted to summarize several of the major issues in modeling and make recommendations and predictions as to the future development of that science.

Respondent's Issues and Position Memorandum appears to criticize Petitioner's swaps valuation model for not taking into account, for example, Petitioner's own creditworthiness. This example in fact well illustrates the evolution of financial theory: even today, major swaps firms disagree whether an institution's own creditworthiness should be deemed relevant to a mark-to-market accounting system; in any event, we believe that virtually no firm made such adjustments in the years at issue in this case. More substantively, we submit that, under the legal standards proposed herein, it is not necessary to comb the complex facts to root out anachronisms like this from Respondent's argument, because the consistent use of a single mark-to-market accounting method for financial and commercial purposes, as well as tax purposes, ensures that the method employed represents a swaps dealer's best effort to reach fair market value at the relevant point in time (even if that mark-to-market value differs from that of another dealer), and therefore to clearly reflect income.

The caselaw is clear that the evolutionary process of valuation models does not constitute a change of accounting method for which Respondent's permission is required, because the goal of all of these incremental improvements is to better estimate fair market value. In Baltimore & Ohio Railroad Co. v. United States, 603 F.2d 165 (Ct. Cl. 1979), the taxpayer was required to determine the fair market value of "relay" rail for purposes of the "retirement-replacement-betterment" accounting system. There was no secondary market for relay rail, and as a result, the taxpayer was required to use formulae and models to estimate fair market value. The taxpayer revised its methodology for estimating the fair market value of relay rail from an outdated method to one that had been previously approved in a Tax Court decision.

The Court rejected Respondent’s argument that the revision constituted a change in accounting method and found instead that the changes in the taxpayer’s valuations reflected a “mere change in the underlying facts brought about by the adoption of a more accurate valuation formula.”⁵⁸

Similarly, in ESCO Corp. v. United States, 750 F.2d 1466 (9th Cir. 1985), the taxpayer changed its method for determining its workers’ compensation deduction from a method that claimed as a deduction the taxpayer’s cash outlays (rather than its true accrued costs) to a different method that captured those true economic costs through the use of valuation methodologies employing statistical data and actuarial techniques. The Ninth Circuit held that this improvement in the accuracy of the taxpayer’s method of computing its deduction for accrued workers’ compensation costs did not constitute a change of accounting method:

If ESCO deducted only a portion of its accrued expenses prior to 1974 because of insufficient statistical data and forecasting methodologies, the use of more sophisticated techniques in 1974 cannot be considered a change in accounting method. The new techniques more accurately predicted ESCO’s expenses and allowed it to avoid the underaccruals it had been experiencing. The increased deductions in 1974 are the result of “a change in treatment resulting from a change in underlying facts.” [Treas. Reg.] § 1.446-1(e)(2)(ii)(b). It is not a change in accounting method. Id.⁵⁹

See also P.L.R. 9222017 (Feb. 26, 1992) (“Taxpayers’ change in estimation method to determine the fair market value of property acquired by foreclosure based on factors other than the bid price required by state law, such as current appraisals and other information relating to the property’s value, does not involve a change in method of accounting under section 446 of the Code.”).

⁵⁸ Baltimore & Ohio Railroad Co. v. United States, 603 F.2d at 169-71 and n.9.

⁵⁹ ESCO Corp. v. United States, 750 F.2d 1466, 1470 (9th Cir. 1985).

**THE PROPER STANDARD OF REVIEW IS TO EVALUATE PROCESS,
NOT NUMBERS**

Swaps dealers use the same mark-to-market valuation models for tax as they use for critical non-tax purposes; these model-based valuations are essential to the proper operation of a dealer's day-to-day business; and these models are devoid of systemic bias. Consequently, a swaps dealer's consistent use of its implementation of mark-to-market accounting for tax and important commercial and financial purposes should suffice to demonstrate that the swaps dealer's particular implementation clearly reflects income.

We recognize, of course, that Respondent has a legitimate interest in auditing dealers to ensure compliance with accounting principles in general and section 475 in particular for years to which it applies. Section 475 and the Treasury regulations thereunder do not, however, explain how to calculate fair market values, and without a market to discover prices there is no single "correct" procedure for their calculation. Emanuel Derman explained the impossibility of deriving one perfectly accurate valuation based on financial modeling in a recent talk given at the Bermuda Conference on Mathematics in Business:

Financial modeling is *never* going to provide the eight-decimal place [accuracy] of forecasting of some areas of physics.

You shouldn't really expect it to. In physics, you're playing against God, and he doesn't change his laws very often. You're trying to describe the world he created with a combination of intuition and experiment and mathematics. In finance, you are playing against God's creatures, agents who value assets based on their feelings about the future in general and their future in particular; these feelings are ephemeral, or at best unstable, and fresh news on which they are based keeps streaming in. Because of this, financial valuation will always have much in common with art or antique valuation, where knowledge and experience and street sense are as important as any formula. Value clearly derives

from human beings, whereas mass and charge and electromagnetic force apparently don't. (Emphasis in original.)⁶⁰

Respondent's own attempt to find such a procedure to calculate idealized values highlights the difficulties involved. In 1995, Respondent contracted with the Los Alamos National Laboratory to produce software for valuation of derivatives, and in 1997 it unveiled this software to a select audience of industry members.⁶¹ The initiative met with considerable criticism.⁶²

Commentators illustrated their fundamental point that Respondent had embarked on a quixotic quest for an unobtainable perfect valuation system with many specific examples: (i) "because of the ephemeral and changing nature of the data inputs and modeling systems...used to value [derivatives] portfolios, it is generally not possible for the valuation of portfolios on a specific date to be recreated in an efficient and accurate manner on a later date"⁶³—and therefore the model would have been useful only in an (extremely burdensome and most-likely unworkable) system of *contemporaneous* auditing where agents of Respondent would be on site at a dealer's trading floor generating government-approved swap valuations simultaneously with the dealer producing valuations to be used by traders; (ii) even though

⁶⁰ Emanuel Derman, Two Cheers for Mathematics: Facts and Fallacies about Using Financial Models (unpublished manuscript based on a talk given at the Bermuda Conference on Mathematics in Business) (1999).

⁶¹ Remarks by Margaret Milner Richardson, Commissioner of Internal Revenue, International Fiscal Association U.S.A. Branch Annual Meeting, 1995 I.R.B. LEXIS 90; I.R. 95-19; IRS To Unveil Pricing Model, 97 Tax Notes Today 54-6 (Mar. 20, 1997); Solicitation for Comments, Mark-to-Market Valuation Software, supra.

⁶² See, e.g., Letter from Jill Considine, dated October 6, 1997, supra; Letter from Lawrence Uhlick, supra; Letter from Michael Casciato, supra; Letter from Debra Aaron, dated April 17, 1997, supra; Letter from Debra Aaron, dated March 11, 1997, supra.

⁶³ Letter from Lawrence Uhlick, supra.

Respondent accepted that the Los Alamos model would most appropriately be used to generate a range of valuations, rather than a single specific valuation, there was no agreed-upon standard on how to determine such a range or implement its use as a “safe-harbor”;⁶⁴ (iii) the Los Alamos model was incapable of accurately accounting for differing dealer-specific subjective assumptions, such as time value, exchange rate and volatility assumptions; (iv) the Los Alamos model was unable to replicate “batch processing” of derivatives (i.e., valuing an entire portfolio of derivatives, as opposed to valuing each instrument separately) without requiring dealers to go through the immensely burdensome task of translating data into a format usable by the Los Alamos model;⁶⁵ and (v) there was concern that audit agents for Respondent could not use the Los Alamos model effectively and evaluate differences between the Los Alamos values and taxpayer-produced values without significant support directly from Los Alamos National Laboratory itself for each audit.⁶⁶

Subsequently, Respondent abandoned the project.⁶⁷

Competitive pressure forces swaps dealers constantly to strive to update and improve their methodologies. For Respondent to uncover noncompliance through examination of mark-to-market values, he would have to conduct contemporaneous audits with

⁶⁴ Solicitation for Comments, Mark-to-Market Valuation Software, supra; Letter from David Garlock, et al., to IRS, dated August 27, 1997, reprinted in 97 Tax Notes Today 186-42 (Sept. 25, 1997).

⁶⁵ Letter from Jill Considine, dated October 6, 1997, supra; Letter from Lawrence Uhlick, supra.

⁶⁶ Letter from Debra Aaron, dated March 11, 1997, supra; Letter from Lawrence Uhlick, supra.

⁶⁷ Financial Products: Lyons Says Los Alamos Section 475 Valuation Project ‘Temporarily Suspended’, Daily Tax Rep., Dec. 15, 1997; Financial Products: Lack of Los Alamos Software Forcing Hunt for Other Means of Valuation, Official Says, Daily Tax Rep., May 29, 1998.

contemporaneous methodologies, and even then he would still face insurmountable problems with subjective inputs, giving rise to years of litigation over the minutiae of valuation theory.⁶⁸

As the Treasury Department has recognized:

Given the rapidity of change within the financial industry, it seems likely that for assets without active secondary markets, highly specific rules or formulas for calculating fair market values would run some eventual risk of becoming obsolete. Indeed, institutions that actively trade financial instruments spend millions of dollars annually attempting to improve their internal methodologies for pricing these instruments in order to gain competitive advantages in the marketplace. It may be unrealistic to expect that accounting-standards setters could produce detailed valuation techniques matching the sophistication and accuracy of proprietary systems generated by the private sector.⁶⁹

In these circumstances, it should be all the more apparent that Respondent and the courts should focus on process, not specific numbers, in reviewing a swaps dealer's implementation of mark-to-market accounting.

CONCLUSION

The adjusted mid-market implementation of mark-to-market accounting, if used consistently for important commercial and financial purposes, as well as for tax and financial accounting purposes, clearly reflects a swaps dealer's income. The method accords with economic norms of income, and is designed to be as accurate as possible, because the valuations produced by that method are used as drivers of important day-to-day commercial and financial decisions. The adjusted mid-market implementation of mark-to-market accounting is required as the best accounting practice for the industry, has been applied for many years, achieves a proper matching of income and related expense, and has no systemic bias.

⁶⁸ Department of the Treasury, Modernizing the Financial System, supra, at XI-21.

⁶⁹ Id.

Given the variations that must necessarily exist among the models used by different dealers, however, and given the constant evolution of modeling, there is no single model or single valuation against which Respondent can measure a dealer's valuation. Accordingly, we respectfully submit that the proper function of administrative or judicial review of a dealer's valuation model is to ensure that the model used for tax purposes is also used for business management, compensation, and other non-tax purposes in a manner that will ensure the model's trustworthiness. If a swaps dealer in fact uses a single valuation model for tax, internal management, financial accounting, compensation, and risk measurement purposes, that model clearly reflects income. Focusing administrative and judicial review in this manner protects the interests of both Respondent and taxpayers. Any other approach would lead to arbitrary valuations unconstrained by business reality (which already is reflected in the valuations employed in the swaps dealer's tax return), Treasury guidance (which does not exist), or any other objective standard.

Respectfully Submitted,

Leslie B. Samuels
Tax Court No. SL0017

Edward D. Kleinbard
Tax Court No. KE0247

Max Gitter
Thomas L. Evans
William L. McRae

Cleary, Gottlieb, Steen & Hamilton
One Liberty Plaza
New York, New York 10006
(212) 225-2000
Attorneys for Amici

New York, N.Y.
October 12, 2000