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Book-Tax Conformity and the Corporate Tax Shelter Debate: Assessing the Proposed Section 475 Mark-to-Market Safe Harbor

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BOOK-TAX CONFORMITY AND THE CORPORATE TAX SHELTER DEBATE: ASSESSING THE PROPOSED SECTION 475 MARK-TO-MARKET SAFE HARBOR

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I. INTRODUCTION

Recent, highly visible accounting scandals in which major corporations such as Enron and WorldCom inflated revenues to gain stock market advantages have affected the employment and retirement prospects of millions of Americans. Those greedy excesses, made possible at least in part by global accounting firms with the aid of sophisticated investment banks and law firms, resulted in Congress's enactment of Sarbanes-Oxley to refocus auditors and companies on the importance of transparency of financial information.[1] Those scandals also brought into question the integrity of the financial sector, because of the role of financial institutions as accommodation parties or planners of complex financial derivatives engineered for their bottom-line effect on publicly released financial statements.[2] Later scandals raised additional questions about the financial sector's ability to withstand profit pressures, as the New York attorney general and the Securities and Exchange Commission (SEC) probed the role of bank analysts in hyping stocks to favor their firms' major clients (or worse, their own firms' positions), and investigated the mutual fund industry's hidden practices of favoring certain parties by permitting them to engage in market timing of the funds. As a result of these scandals, investors have become more aware of the extraordinary power that financial institutions hold in the markets and the potential for abuse of that power.

At the same time, the potential for finance-and-tax games revealed by Enron's use of tax avoidance transactions to enhance its financial statement revenues has brought renewed interest to the relationship between financial and tax accounting.[3] One line of

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[1] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 15 U.S.C. and 18 U.S.C.).

[2] *See infra* note 406.

[3] *See, e.g.*, STAFF OF JOINT COMM. ON TAXATION, 108TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES, AND POLICY RECOMMENDATIONS (Joint

inquiry has considered the desirability and feasibility of making more tax information available to those who make investment decisions. In an earlier article about corporate tax shelters, I proposed that the SEC should ensure that investors and creditors are better informed about public companies' (and their auditors') involvement in corporate tax shelters through publication of a tax risk profile, strict liability penalties for failure to report, and enhanced internal information availability to board members about reporting companies' involvement in aggressive tax transactions.[4] Congress has recently acted to enhance penalties for failures to disclose certain aggressive tax transactions: these provisions include strict liability penalties, in some instances, and a requirement that reporting companies disclose certain penalty payments in reports filed with the SEC.[5] The Internal Revenue Service (Service) has also recently taken steps to improve required taxpayer disclosure by expanding the tax return schedule that reconciles financial statement income to taxable income for large corporations.[6] These steps towards full disclosure of

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Comm. Print 2003) (detailing, in the text and appendices, Enron's use of tax transactions to enhance its book income); Anthony J. Luppino, *Stopping the Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 COLUM. BUS. L. REV. 35 (considering book-tax issues in light of Enron scandal).

[4] *See* Linda M. Beale, *Putting SEC Heat on Audit Firms and Corporate Tax Shelters: Responding to Tax Risk with Sunshine, Shame, and Strict Liability*, 29 J. CORP. L. 219 (2004) [hereinafter *Tax Risks*].

[5] American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 811–22, 118 Stat. 1418 (providing disclosure requirements, penalty provisions, and other changes to increase effectiveness of tax shelter provisions); H.R. REP. NO. 108-755, at 375 (noting that "a public entity that is required to pay a penalty for failing to disclose a listed transaction (or is subject to an understatement penalty attributable to a non-disclosed listed transaction or a non-disclosed reportable avoidance transaction) must disclose the imposition of the penalty in reports to the Securities and Exchange Commission"); I.R.S. News Release IR 2004-38 (Nov. 16, 2004) (announcing the release of interim guidance reflecting the changes to disclosure and penalty rules for reportable transactions in accord with the American Jobs Creation Act of 2004).

[6] *See* I.R.S. News Release IR 2004-14 (Jan. 28, 2004) (releasing initial proposed Schedule M-3 for large corporation reporting of book-tax differences); DEPT. OF THE TREASURY, TREASURY AND IRS ISSUE FINAL VERSION OF TAX FORM FOR CORPORATE TAX RETURNS (Oct. 25, 2004) (releasing "final" draft of Schedule M-3 requiring large corporations to provide more detailed information regarding book-tax differences), *available at* http://www.irs.gov/businesses/corporations/article/0,,id=119992,00.html (last visited Nov. 13, 2004). Commentators have also suggested consolidating the tax return reconciliation schedule with the similar financial accounting Schedule L. *See, e.g.*, Peter C. Canellos & Edward D. Kleinbard, *Disclosing Book-Tax Differences*, 96 TAX NOTES 999 (Aug. 12, 2002) (proposing an extended tax return reconciliation schedule that would be consolidated with Schedule

aggressive tax planning are commendable, though I stand by my recommendations for even broader disclosure of the participation of reporting companies, their lenders and their auditors in aggressive tax planning transactions. Even more useful disclosure could be accomplished by generally requiring public dissemination of publicly traded companies' tax returns.

A second line of inquiry has considered the divergence between financial statement and taxable income as an indicator of corporate tax shelters. Commentators have questioned whether Congress or the Treasury Department (Treasury) should take actions to narrow the gap between tax accounting and financial accounting rules or even adopt provisions requiring conformity of tax to financial accounting (generally referred to herein as "book-tax conformity").[7] As the history of the development of tax accounting readily demonstrates, the relationship between financial and tax accounting principles has never been strictly isomorphous.[8] At the beginning of the income tax, the more advanced financial accounting profession provided ready-made guidance for tax accounting. As tax accounting developed, Congress and Treasury displayed ambivalence about the degree of conformity that should exist between the accounting rules used to measure income for financial statement purposes (referred to herein as "financial statement income" or "book income") and those used for determining the amount of taxable income. Financial accounting views, however, are frequently expressed in terms of a broadly stated normative standard favoring conformity,[9] whereby accountants mean that tax accounting should follow financial accounting (not vice versa).[10] Much of this debate rehashes old arguments underlying the almost palpable tension between the accounting profession's predominant views of the correct measurement of business income

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L). I have discussed this issue in slightly more detail in an earlier article. *See Tax Risks*, *supra* note 4.

[7] *See, e.g.*, Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/Tax "GAAP,"* 2001 COLUM. BUS. L. REV. 539; Luppino, *supra* note 3; Alvin D. Knott & Jacob D. Rosenfeld, *Book and Tax: A Selective Exploration of Two Parallel Universes (Parts One and Two)*, 99 TAX NOTES 865 (May 12, 2003) & 99 TAX NOTES 1034 (May 19, 2003) (sampling of recent articles).

[8] *See infra* Part II.

[9] *See infra* Part II.

[10] Even comprehensive conformity proposals do not extend to adjustments mandated by explicit Internal Revenue Code (Code) provisions (such as accelerated depreciation or the limitation on capital losses) that Congress intended as behavioral or social incentives (or disincentives), since they are clearly incompatible with applicable accounting standards.

and what on the surface appears to be a somewhat chaotic development of the concept of taxable income.

This Article is intended as a further contribution to this ongoing corporate tax shelter inquiry, with particular emphasis on the appropriateness of conformity for the financial sector in light of its role in the various accounting, energy derivatives, and mutual fund scandals. The Article therefore has two goals. First, it reassesses the historical arguments for and against book-tax conformity to determine whether there are normative considerations important in evaluating conformity proposals that are less emphasized in other areas of tax policy and to what extent pragmatic considerations of administrative convenience and simplification should be weighed in the balance. Second, it applies the criteria articulated in that reassessment to evaluate Treasury's tentatively proposed book-tax conformity safe harbor applicable to securities broker-dealers for marking swaps to market under section 475.[11]

In the first inquiry, this Article concludes that the most important characteristics of the tax system that should be considered in evaluating any particular conformity proposals are structural coherence and self-assessment. Does the provision conform to the overall structure of the income tax system in place or does it shift the paradigm? Does the provision result in taxpayers who must self-assess having appropriate degrees of discretion or too much potential for self-help manipulation of their tax liabilities? These same concerns are present, of course, whenever any new tax provision is evaluated. Potential book-tax conformity requirements are different mainly in the extent to which concerns about self-help manipulation come to the fore because of the necessity to account for multiyear business transactions within an annual accounting period. Furthermore, they

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[11] *Safe Harbor for Satisfying Statutory Requirements for Valuation under Section 475 for Certain Securities and Commodities*, I.R.S. Advance Notice of Proposed Rulemaking, Ann. 2003-35, 68 Fed. Reg. 23,632, 2003-21 I.R.B. 956 (May 5, 2003) [hereinafter ANPRM]. The Service has used an accelerated issue resolution (AIR) procedure to develop more (nonpublic) information on the issue. Paul Claytor, from the financial services sector of the Large and Midsize Business Division of the Service, indicated regulations would likely be forthcoming mid-year 2004 based on the Service's satisfaction with the administrability of the conformity requirement. *See* Sheryl Stratton, *ABA Tax Section Meeting, IRS Reps Highlight BOLI,* Bank One, *and Zero Month Audit Cycle*, 102 TAX NOTES 706 (Feb. 9, 2004) (reporting on Claytor's comments at the January ABA meeting). Service Chief Counsel Donald Korb stated on October 28, 2004 that he expects the Service to issue proposed rules on the elective safe harbor in the near future. DAILY TAX REPORT, Oct. 29, 2004, at G-1. The Service has yet to issue proposed regulations.

are of particular concern if applicable to an industry that has shown itself to be susceptible to profit pressures that push individual participants to "profit center" mentalities willing to take overly aggressive, self-favorable positions. Only if a conformity proposal puts minimal stress on these income-tax and anti-manipulation values should the pragmatic considerations of administrative convenience and taxpayer simplicity tip the balance to favor the conformity proposal.

The second inquiry is whether the proposed safe harbor appropriately implements the normative criteria (structural coherence and anti-manipulation) or whether its emphasis on pragmatic concerns merely facilitates financial institution tax shelter activity. The safe harbor is an ideal candidate for testing the normative hypothesis. The commercial swaps industry has undergone tremendous growth in the short period from its inception in the last quarter of the twentieth century. Valuation practices reflect both this period of tumultuous growth and the perceived importance of proprietary systems in the securities industry. The safe harbor's justification is thus almost exclusively in the language of administrative convenience and taxpayer simplification.

In assessing the safe harbor, the Article briefly discusses the Tax Court's consideration of the valuation issue in *Bank One*, the first court case to address dealer valuations of derivatives under section 475.[12] Because the case deals with the returns of an isolated taxpayer (First National Bank of Chicago, referred to hereinafter as FNBC) from more than a decade ago, however, it can only provide some

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[12] *See* Bank One Corp. v. Commissioner, 120 T.C. 174 (2003), *reprinted in IRS's, Bank One's Interest Rate Swaps Accounting Methods Don't Clearly Reflect Income, Tax Court Concludes*, TAX NOTES TODAY (May 5, 2003) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2003 TNT 86-3 [Part 1 of 2] [Part 2 of 2]) [hereinafter *Bank One*, with citations to the relevant item number or paragraph of the Lexis version]. The *Bank One* case has been a marathon litigation in the Tax Court, beginning with the filing of the bank's petition in 1995 and including two separate periods of trial, with testimony from expert witnesses for both parties as well as two appointed by the Tax Court. *See* Linda M. Beale, *Tax Court's Decision in* Bank One *Raises More Questions Than It Answers*, 21 J. TAX'N OF INVESTMENTS 3 (2003) (describing the litigation in more detail). The bank has now filed for reconsideration of the case. A Virginia bankruptcy court recently also addressed a section 475 question in a much shorter and less contentious opinion. *See* In re Heilig-Meyers Co., 94 A.F.T.R.2d ¶ 2004-5451 (Bankr. E.D. Va. Sept. 28, 2004) (allowing the Service's proof of claim against Chapter 11 debtor corporations based on corrected valuations of accounts receivable, permitted to be marked to market under the original form of section 475, and disallowance of claimed pre-petition loss under the mark-to-market rules).

guidance to the types of issues to be considered. Of more direct relevance is the swaps industry's portrayal of its valuation methodology as a proprietary discipline with individuated modeling, subjective inputs, and selective utilization. Securities dealers generally use some version of a midmarket valuation method, but they vary from each other in how they determine midmarket valuations. That determination itself may permit deferral of a significant portion of dealers' profits on swap transactions. Furthermore, dealers' adjustments to midmarket valuations to arrive at the accounting fair value of their dealer positions are uniquely determined by their proprietary technology and may, because of financial accounting's distinct focus, include reductions in value that are not supportable for determining taxable income. Perhaps the most questionable of these adjustments is the typical dealer adjustment for credit risk, which appears to include not only a component for expected default losses (i.e., a reserve for expected losses) but also a component that defers a dealer's profit margin earned by serving as a credit intermediary for the swap counterparty. This Article concludes that adjustments made by dealers may inappropriately permit deferral of the dealer spread that was intended to be accelerated under mark-to-market accounting and therefore threaten both structural coherence and the self-assessment norm.

The Article proceeds as follows. Following this introduction, Part II provides a brief history of key points in the consideration of conformity in tax accounting and the main arguments made for and against it, with particular emphasis on the development of inventory and mark-to-market accounting. That summary lays the groundwork for a discussion in Part III of the criteria by which any conformity proposal should be evaluated. Part III.A. focuses on the normative standards for evaluating conformity proposals. Part III.B. considers pragmatic issues and how those should interrelate with the normative parameters. Finally, with these guidelines in place, Part IV applies these criteria to a specific problem of current interest — Treasury's consideration of a conformity safe harbor for mark-to-market accounting for over-the-counter swaps under section 475. Following a brief overview of the swaps market, Part IV.A. describes current swaps valuation methodologies, based primarily on the industry's response to the safe harbor proposal and the current quantitative financial literature. Part IV.B. briefly reviews the *Bank One* case for additional insight into the historical development of valuation methodologies. Part IV.C. analyzes this valuation data using the criteria developed in Part III and concludes that conformity is not the right answer for valuations in a mark-to-market regime. As an alternative, Part IV.D. proposes some very tentative considerations for comprehensive valuation regulations. Part V. concludes.

II. HISTORY OF BOOK-TAX CONFORMITY: PROBLEMS AND RATIONALES

Any article on book-tax conformity must deal in some way with an inconsistent history of vague or specific attempts to achieve book-tax conformity in tax accounting, as limited by the clear reflection of income standard.[13] There are a number of alternative links between financial statement and taxable income and corresponding accounting methods that Congress (or, when applicable, Treasury) could theoretically choose to implement. First, Congress could adopt comprehensive conformity – i.e., a normative standard that supports identity of financial and tax accounting rules throughout the Code except for unique Code rules implementing behavioral incentives (or disincentives), for which adjustments between financial and tax accounting are required. Under comprehensive conformity, taxpayers (other than ordinary wage earners taxed on a cash basis) would simply be taxed on their financial statement income.

Most commentators acknowledge that numerous concerns – ranging from questions about the nature of the federal tax authority (in whom would reside the authority for determining the rules of a unified book-tax income measurement?) to questions of how to adjust for tax expenditures or public policy exceptions – make comprehensive conformity an unlikely choice.[14] Whatever its advantages or disadvantages, comprehensive conformity is not the

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[13] Various articles have dealt with aspects of the material discussed here. *See, e.g.*, Luppino, *supra* note 3, at 108–43 (providing a historical overview of conformity in terms of the statutory provisions, clear reflection case law, the accounting profession's pronouncements, and Treasury positions); Lee A. Sheppard, *Financial Accounting Conformity: Not the Silver Bullet*, 101 TAX NOTES 676 (Nov. 10, 2003) (presenting a quick overview of history and arguing that financial accounting can guide tax on some issues). The purpose here is to survey the cycles of discussion of conformity and the arguments made by proponents and opponents in order to understand the source of the continued interest in conformity and to arrive at some view of when conformity is worth pursuing.

[14] *See, e.g.*, Clarence Reimer, *Major Differences Between Net Income for Accounting Purposes and for Federal Income Taxes*, 23 ACCT. REV. 306, 307 (1948) (noting thirty-one items treated differently for tax and generally accepted accounting principles (GAAP) and considering that "[s]ome restrictions on allowing deductions may be necessary for practical tax administration").

rule today nor has it ever been in the history of the income tax.

A second possibility is conformity of tax accounting rules to the financial accounting rules within a well-defined domain, such as repair companies' accounting for rotable parts. This alternative could be implemented in one of two quite different ways. First, the tax law could permit a particular method of tax accounting for the relevant domain only when that method of accounting is used consistently for financial statement and other business purposes for that domain. This type of conformity is generally referred to as a "mandatory booking requirement" – e.g., a taxpayer cannot use a particular method to determine taxable income in respect of the domain unless the taxpayer determines financial statement income for presenting information to shareholders and creditors about that domain by the same method. Eligibility to use the last-in, first-out (LIFO) inventory accounting method for tax purposes has depended upon such a mandatory booking requirement since 1939, although there have been numerous modifications since its enactment in respect of the degree of conformity required and the particular parts and uses of financial statements that must conform.[15] The availability of a partially worthless debt deduction under section 166 in respect of debt obligations that are not evidenced by securities also requires booking: to take advantage of the deduction, a taxpayer must charge the unrecoverable portion of the debt off on its financial statements.[16] Mandatory booking requirements – even those of narrow scope in a relatively small and clearly delineated area of tax law – cause many of the same concerns as comprehensive conformity. The LIFO experience reveals that implementation of a mandatory booking requirement for a method of accounting used in a significant area of business may require complex rules with numerous exceptions to satisfy the objectives of the two separate regimes of financial and tax accounting – i.e., not just exceptions for legislated tax incentives (or disincentives) but modifications apparently required to permit the two actually disparate systems to function appropriately.

Instead of a mandatory booking requirement, a taxpayer's book method in a particular domain could be treated as a "safe harbor" for tax purposes.[17] The concept of a book-tax conformity safe harbor for

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[15] *See infra* beginning at note 75 and accompanying text.

[16] *See* I.R.C. § 166(a)(2) (authorizing losses for charged-off portions of partially worthless debts, at the Secretary's discretion); Treas. Reg. § 1.166-3(a)(2) (as amended in 1998) (requiring charge-off, including a deemed charge-off, when a creditor recognizes gain on a significant modification of a debt instrument).

[17] A thorough analysis of safe harbors is beyond the scope of this article, but it is

a particular item (or component of income determination) means that a taxpayer should be able to rely for tax purposes on consistent use of a method that satisfies generally accepted accounting principles (GAAP) for that item, so long as the method complies with any additional, secondary tax requirements such as record-keeping for verification of the taxable income so determined. Safe harbors are by their nature available to some taxpayers even though other taxpayers who are in almost all respects similarly situated to the availing

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important to note at least some of the salient features of safe harbors as they have been used in tax in order to understand how a conformity safe harbor might be evaluated. Safe harbors seldom draw scholarly comment, but they are a frequent feature of tax provisions. They are generally considered helpful because they facilitate tax administration and reduce taxpayer controversies. *See* TAX SECTION OF THE NEW YORK STATE BAR ASSOCIATION, REPORT ON IRS ANNOUNCEMENT 2003-35 (SAFE HARBOR FOR VALUATION UNDER SECTION 475) (Oct. 9, 2003) [hereinafter NYSBA RESPONSE], at 11. The safe harbor lease under section 168(f)(8), enacted by the Economic Recovery Tax Act of 1981 and later repealed by the Tax Equity and Fiscal Responsibility Act of 1982 for leases entered into after 1983, is illustrative. If the safe harbor applied, tax benefits of ownership such as depreciation deductions could be effectively assigned to a party who might not be considered the owner under general tax law principles that look to risk, reward, and ability to control and dispose of property. This type of safe harbor provides statutory certainty to replace the ambiguity inherent in a facts-and-circumstances analysis of factors relevant under the common law. If a taxpayer satisfies the specified eligibility requirements, it is generally eligible for the treatment vouchsafed to the safe harbor. Another example is the safe harbor that applies to a transferor in a purported section 351 transaction who receives stock in exchange for both property and services. The safe harbor permits stock received for services to "count" as part of a transferring control group of stock if stock received by the same transferor for property is at least 10 percent of the stock received for services. *See* Rev. Proc. 77-37, § 3.07, 1977-2 C.B. 568. Other safe harbors merely create a presumption that a compliant taxpayer is eligible for the safe harbor treatment. This type of safe harbor is itself generally phrased in broad terms that are subject to facts-and-circumstances analysis. For example, the regulations promulgated under the real estate mortgage investment conduit (REMIC) rules provide that transfers of REMIC negative-value residual interests that have a significant tax-avoidance purpose will be disregarded. *See* Treas. Reg. § 1.860E-1(c)(1) (as amended in 2002). Such a purpose exists if a transferor has knowledge at the time of the transfer that the transferee will be unwilling or unable to pay the taxes due on the interest. *Id.* However, the regulations include a provision labeled "Safe harbor for establishing lack of improper knowledge." *See* Treas. Reg. § 1.860E-1(c)(4) (as amended in 2002). The safe harbor does not guarantee that a transfer will not be penalized; instead, a transferor's "reasonable investigation" establishes a presumption that the transferor does not have improper knowledge. *Id.* Presumably, the mark-to-market valuation safe harbor under consideration by Treasury, *supra* note 11, is of the former type in that it would ensure acceptance by tax administrators of the taxpayer's valuation if the recordkeeping requirements are satisfied and the taxpayer's valuation is consistent with the required financial statement.

taxpayers may be treated differently. In the case of a tax accounting safe harbor, that means that taxpayers in the same industry with similar items to take into account, or with equivalent amounts of pre-tax economic income, might be able to use a different method with a different (higher or lower) resulting tax liability. A safe harbor could be explicitly elective. In that case, one taxpayer could opt to come within the safe harbor and receive the treatment accorded by the safe harbor, whereas another taxpayer could gamble that Treasury would approve (if brought into question on audit) a desired treatment that is different from the result under the safe harbor. The safe harbor under consideration for securities dealers' valuations of certain over-the-counter derivatives under section 475's mark-to-market regime is an elective regime.[18]

Another type of direct linkage between tax and financial accounting is tax adoption of a particular GAAP rule or principle. This type of linkage is often discussed in the literature as providing the greater part of the rationale for a specific conformity requirement rather than as an independently operating conformity regime. For example, a number of commentators have argued over the years since the initiation of the income tax that tax either already follows or should adopt the GAAP "matching principle" that defers cash receipts for services and goods until "earned" and accelerates expenses into the period when the related income is taken into account.[19] These matching principle arguments stem from accountants' deeply rooted convictions that matching yields the "right" measure of business income for all business purposes. On the other hand, significant tax commentary (tied in part to theories of statutory interpretation) views the GAAP matching principle and its lack of a time-value-of-money concept as aptly illustrating the divergence between book and tax concepts of income and as evidence that the Code establishes a concept of taxable income that is not synonymous with book income, even without the various tax preferences and penalties.[20] The famous Supreme Court trilogy of *American Automobile Ass'n*, *Automobile Club of Michigan*, and *Schlude*, in which the Court required inclusion of prepaid service income on receipt, can be viewed as recognizing that the matching

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[18] *See supra* note 11. This Article will return to the section 475 valuation safe harbor in much greater detail in Part IV, as an example of the normative and pragmatic considerations for deciding conformity issues discussed in Part III.

[19] *See infra* beginning at note 84 and accompanying text (discussing the divergent tax and accounting treatment of prepayments).

[20] *See infra* note 102 and accompanying text.

principle has no place in the tax hierarchy.[21]

Other than these direct linkages between financial and tax accounting (any of which will be referred to herein as types of "conformity requirements"), the tax law could rebuttably presume that appropriately and consistently used financial accounting methods determine taxable income. Financial accounting rules for calculating book income, in other words, would be the default method for measuring taxable income as well, unless Congress (or Treasury) provided special tax rules in a particular context or the Commissioner demonstrated in litigation under the general tax accounting provision in section 446 that conformity in a particular case failed to measure taxable income correctly. The accounting profession has often argued that tax accounting does or should include such a presumption favoring financial accounting methods, and litigating taxpayers have claimed that their consistently applied financial method of accounting should be considered acceptable under section 446 so long as it is reasonable and complies with GAAP.[22] In the seminal Supreme Court case in the area, however, the Court rejected any such presumption favoring a taxpayer's accounting method because of the radically divergent objectives of tax and financial accounting.[23]

There is at the least an evidentiary relationship between financial and tax accounting, one in which the underlying financial accounting records inform, but do not necessarily command, tax accounting.[24] This is undoubtedly true, in spite of the strong position on tax and accounting divergence expressed in *Thor Power*.[25] The Code and Treasury regulations are replete with references to methods used consistently in a taxpayer's books or customarily in the taxpayer's particular industry. This "weakest link" relevance of financial accounting follows from the demonstrable maturation of the tax system in the intervening years since financial accounting first acclaimed its own objective, scientific basis and urged that the infant tax system should follow its lead in determining income. We now recognize that taxable income is a term, defined by the structure of the tax system itself, that is not wholly synonymous with either financial accounting net income or "economic income" as determined

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[21] *See infra* note 99 and accompanying text.

[22] *See, e.g.*, *Bank One*, *supra* note 12, ¶¶ 342–50 (citing and rejecting taxpayer argument that any reasonable valuation should be acceptable).

[23] *See infra* note 129 (discussing *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979)).

[24] *See infra* note 34.

[25] *See infra* note 129 (discussing *Thor Power*).

by the financial gurus in academe and investment banks.

Interest in variants of these types of conformity proposals appears to be cyclical, perhaps reflecting heightened levels of frustration with the growing complexity of the Code and corresponding compliance and administration burdens or even ideological positions of administrations that view tax relief, whether by statutory change or regulatory fiat, as a high priority. This Part looks at key movements towards or away from greater use of financial accounting principles in tax accounting. This history informs us about the types of provisions for which conformity has been an issue, the rationales urged by conformity proponents and opponents, and the relative success of specific conformity proposals over time. As background for evaluation of the current Treasury consideration of conformity in securities dealers' mark-to-market valuations of their inventory-like derivatives positions, this Part provides more detail on the history of inventory and mark-to-market accounting.

A. Early Revenue Acts

In the early years of the income tax, tax and financial accounting lacked the sophistication present in today's accounting rules. The 1909 corporate income tax required corporations to compute income on the cash method.[26] In contrast, financial accounting had already developed accrual principles, and businesses commonly used accrual accounting. Treasury ensured by regulations that those businesses using inventory and accrual accounting would not have to maintain unrelated sets of financial records but would be able to compute their taxable income from the same evidentiary records that formed the basis for their financial statements.[27] In the Revenue Act of 1916,

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[26] The Corporation Excise Tax Act of 1909 (which included provisions imposing an income tax on corporations four years before the constitutional amendment permitted individual income taxes) made no provision for accrual accounting; instead, it used terms that we have come to understand to require a cash method of accounting: taxpayers were to include income "received" and were permitted to deduct "expenses actually paid," "losses actually sustained," and "interest actually paid." Corporation Excise Tax Act of 1909, § 38 (1st), (2d), 36 Stat. 11, 112, *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS: 1938–1861, 1008, 1012 (Prentice-Hall, Inc. 1938).

[27] *See* Regulations 31, arts. 1–5 (Dec. 3, 1909) (permitting taxpayers to use inventory accounting and to determine income based on their business books); T.D. 1675, 14 Treas. Dec. Int. Rev. 16 (1911) (original interpretive decision indicating that Treasury would not dictate a particular accounting method but would require corporations to retain books that would permit verification of income on audit);

Congress for the first time expressly permitted taxpayers to use for tax purposes either the cash method or the same non-cash method on which they kept their books, with the proviso that the method must clearly reflect income.[28]

These earliest authorities on appropriate tax accounting provide mixed signals. Treasury from the beginning clearly viewed it necessary to permit taxpayers to use at least some variant of the accrual method that many already used for financial statement purposes. There is no indication that Treasury acted from a rigid normative view that tax *should* conform in all cases to financial accounting: its motive was reasonable accommodation of businesses.[29] The usual directionality of conformity arguments (the extent to which financial accounting rules should determine tax accounting rules; not vice versa) thus appears to stem from the accidental history of the income tax as newcomer to a business world with developed accrual accounting principles.

Given the limitation imposed by the clear reflection of income standard under the 1916 act, it is clear that Congress did not contemplate that financial accounting concepts of accrual accounting

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Regulations 33, arts. 100, 104, 158, 161, 182, 183 (Jan. 5, 1914) (various provisions for accrual accounting, inventory, and use of books as guide to correct income).

[28] The 1916 Revenue Act provided that if a corporation's method of accounting clearly reflected income, the "corporation . . . may, subject to regulations . . . make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned." Revenue Act of 1916, ch. 463, § 13(d), 39 Stat. 756, 771; *see also id.* § 8(g) (similar provision applicable to individuals), *reprinted in* SEIDMAN, *supra* note 26, at 974. Most commentators interpret the 1913 act, the first to impose the income tax directly on individuals, as permitting only the cash method of accounting, though there is some uncertainty. *See* Corporation Income Tax Act of 1913, c.16, § II(G), 38 Stat. 114, 172; United States v. Anderson, 269 U.S. 422, 437–38 (1926) (stating that the 1916 act was the first to explicitly permit corporate taxpayers to use a non-cash method of accounting); Law Opinion 1059, 1921 C.B. 147 (same); Harrop A. Freeman, *Tax Accrual Accounting for Contested Items*, 56 MICH. L. REV. 727, 728 (1958) (considering it "well known that prior to 1916 the only method of accounting acceptable for tax reporting was the cash method"); Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1, 4–5 (1984) (indicating that the 1913 act required the cash method). *But see* SEIDMAN, *supra* note 26, at 974 (quoting the Ways and Means Committee Report as indicating that "present law requires that the income tax shall be levied on the accrued basis"); Donald Schapiro, *Prepayments and Distortion of Income Under Cash Basis Tax Accounting*, 30 TAX L. REV. 117, 128–35, 129 n.35 (1974–75) (analyzing the text of the 1913 act to support accrual inclusions but not deductions). The 1916 provision is now embodied in section 446(b). *See infra* note 32.

[29] *See* Gunn, *supra* note 28, at 6.

should be the sole determinant of taxable income for taxpayers using non-cash methods. The clear reflection standard functioned *at the least* as an anti-abuse mechanism whenever a taxpayer's financial accounting method wandered too far from (unstated) tax principles of income. It protected against overt taxpayer manipulation of financial accounting books to lower tax liability.[30] Although the clear reflection standard is famously circular,[31] it is the one phrase that makes clear that taxable income is to be determined by the tax system and not by some financial accounting measure of income.

It is true that the language of the basic tax accounting statutory provision set out in section 446 suggests book accounting is the basis for tax accounting.[32] Nevertheless, the section cannot be interpreted as requiring conformity of a taxpayer's tax returns to a taxpayer's financial statements. The clear reflection of income standard reduces the apparent section 446 conformity requirement to an evidentiary provision and audit aide.[33] Section 446 merely requires that taxpayers

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[30] *See* Harold Dubroff, M. Connie Cahill & Michael D. Norris, *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles*, 47 ALB. L. REV. 354, 357 (1983) [hereinafter *Clear Reflection*] (noting that the clear reflection standard may have been intended to "safeguard against hybrid account-keeping practices adopted by taxpayers to reduce taxes, for example, reporting receipts on the cash method and deductions on the accrual method").

[31]

> The statutory phrase is not only hopelessly vague but circular to boot, since the "income" that must be clearly reflected by the taxpayer's accounting method is *taxable* income, not financial, economic, or any other variety of income. In short, income is clearly reflected by an accounting method if the ultimate result of using the method is taxable income.

BORIS BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS § 105.1.6 (1981), *quoted in Clear Reflection*, *supra* note 30, at 365.

[32] *See* I.R.C. § 446(a) (stating flatly that "[t]axable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books"); I.R.C.§ 446(b) (imposing the clear reflection standard).

[33] Alan Gunn notes that the clear reflection standard "leads more often to differences than to conformity between tax and financial accounting." Gunn, *supra* note 28, at 4. After nearly a century of the federal income tax, the clear reflection standard is far from clear. It could be read to assure that the tax system does not incorporate financial accounting rules that result in distortions of some externally defined concept of "economic income," such as the Haig-Simons definition. It could be interpreted merely to require that accounting rules not violate any other statutory provisions. I believe, however, that it should be viewed as acknowledging a unique concept of taxable income that is different from financial accounting or economic income in ways mandated by the overall structure of the Code. *Cf.* BITTKER, *supra*

note 31. The fact that the income tax at its origins was understood as being essentially the same as business income does not change this result. *See Validity of Inventories Under Treasury Decision: Legal Points Involved in Recent Turnabout by Official Pronouncements Regarding Tax Accounting*, WALL ST. J., Jan. 17, 1918, at 8 [hereinafter *Validity of Inventories*] (providing the text of the Investment Bankers Association's brief in the appeal of *Doyle v. Mitchell Bros.*, 236 F. 686 (1918), to the Supreme Court, in which it argued that the clear reflection of income standard was intended by Congress to capture the accounting/business concept of income). Today's income tax should be viewed as an integral whole that defines taxable income separately from the business context or accounting rules. No accounting method can clearly reflect income if it operates contrary to the Code, since the Code is the only template for ascertaining taxable income. We cannot simply have a rule that each taxpayer shall pay his or her fair share of the federal taxes, because it is the rules that define the overall tax structure which in turn determines what a fair share would be. The Code is not specific on many details, however, so it is possible to "clearly reflect income" in areas where the Code is vague. A method may also ostensibly be in agreement with a method authorized by the Code, yet fail to reflect income clearly. The finding that the method does not clearly reflect income in that instance is not a finding that the method imposed by the tax administrator is in contravention of the Code, but rather a finding that the scope of the Code authorization does not extend to the particular situation. Although there is theoretically only one perfect measure of taxable income for any accounting period, our ability to interpret the set of rules constituting the Code does not always result in one single acceptable interpretation. The focus of clear reflection of income is, therefore, on limiting distortion from inaccurate interpretations in contexts not contemplated by the drafters rather than on making sure the income measurement is perfect. Clear reflection thus operates very much like the judicial doctrines of business purpose and economic substance; that is, it permits the tax administrator to find that a method of accounting that is ostensibly in conformity with the Code and regulations may yet be inappropriate when the overall structure of the tax system is considered. For further discussion of this concept, see *infra* Part III.A (discussing structural coherence and the income tax value). This view of the clear reflection standard is supported by several court decisions that recognize that the role of time value of money principles in the overall tax system supports a finding that a method that appears to be within the scope of applicable provisions is in fact not a clear reflection of income. *See, e.g.*, Ford Motor Co. v. Commissioner, 71 F.3d 209 (6th Cir. 1995) (holding that current deduction of the entire cost of an accrued tort settlement to be paid over time by means of an annuity was improper); Mooney Aircraft Inc. v. United States, 420 F.2d 400 (5th Cir. 1969) (disallowing deduction for zero coupon bonds given upon purchase of planes that would at best be paid in twenty years). This interpretation of the clear reflection standard as a tax-generated standard that serves as a limitation on the scope of conformity is at variance with the position of some commentators. *Compare* Leo F. Nolan II, *Can the Cash Method of Accounting Clearly Reflect Income? (Parts I and II)*, 74 TAX NOTES 1063 (Feb. 24, 1997), 74 TAX NOTES 1175 (Mar. 3, 1997) (arguing that clear reflection is satisfied when an eligible taxpayer correctly applies a permissible method of accounting) *with* W. Eugene Seago, *Clear Reflection of Income Under Section 446(b)*, 62 TAX NOTES 355, 357 (Jan. 17, 1994) (arguing that Congress intended that the Commissioner should be able to require taxpayers to adopt methods in contravention maintain financial books and records that support the numbers entered on their tax returns.[34] In the case of many ordinary transactions, the numbers in these evidentiary books will result in conforming reports for tax returns and financial statements. But in a number of other cases, such as accelerated depreciation and treatment of prepayments, financial statements and tax returns will present different results from these same numbers.

Yet in the seminal case on accounting methods from the first quarter-century of the income tax, the Supreme Court expressed its view that the purpose of tax accrual accounting "was to enable taxpayers to keep their books and make their returns according to *scientific* accounting principles."[35] The stage was thus set for the debate regarding the extent to which financial accounting rules should determine taxable income.

B. Inventories

In 1918, Congress authorized the Service to determine when inventory accounting[36] was necessary and to prescribe acceptable

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of regulations in order to satisfy the clear reflection standard).

[34] *See* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., TAX REFORM PROPOSALS: ACCOUNTING ISSUES, at 32 (Joint Comm. Print 1985) [hereinafter JCT ACCOUNTING REPORT] (noting that the requirement that accounting methods be the same as those used to keep the taxpayer's books is considered "satisfied when sufficient records are kept to reconcile the taxpayer's books with the tax return"); Neil R. Bersch & Andrea S. Nadel, *The Dilemma of Conformity — Tax and Financial Reporting*, 36TH ANN. N.Y.U. INST. ON FED. TAX'N 529, 530 (1978) (stating that the consistency with books required in section 446(a) is a mere evidentiary standard requiring taxpayers to keep records that provide evidence of taxable income); Knott & Rosenfeld, *supra* note 7, Part Two, 99 TAX NOTES at 1044 (noting that "[t]he conformity required by section 446(a) is not to a taxpayer's financial statements but to its books and records").

[35] United States v. Anderson, 269 U.S. 422, 440–41 (1926) (emphasis added). Interestingly, although *Anderson* implies that the financial accounting matching principle applies for tax to determine timing, the case itself has come to stand for the first expression of the "all events" test as a unique *tax*-based standard for determining the tax timing of inclusions and deductions.

[36] The basic concept of inventory accounting is recognition that sales proceeds from inventory items during the relevant time period cannot be treated as gross income, because a merchant generally carries some stock over from one period to the next. Merely deducting all costs associated with producing inventory would understate the income from inventory sales, since some of the costs must be associated with the retained and unsold inventory. Accordingly, gross income from inventory sales is determined by subtracting from the aggregate annual sales proceeds the "cost of goods sold" during the year. To determine cost of goods sold, the

methods for valuing inventories, "conforming as nearly as may be to the best accounting practice in the trade or business and . . . most clearly reflecting the income."[37] In requiring that the methods should conform to the extent possible to business accounting practices, Congress appeared to recognize that the range of different business models meant that no single inventory method would easily work for all: inventory rules would need to be tailored to the customs of particular business types.[38] Because financial accounting rules could be presumed to have already addressed some of the varying problems

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merchant must in some way account for stock that was on hand at the beginning of the year, additions to stock (e.g., by purchases or production) during the year, and reductions of stock (e.g., by sales or loss). Gross income from inventory sales is therefore the result of subtracting closing inventory values from the sum of opening inventory values carried over from the prior year and purchases during the taxable year. *See, e.g.*, Molsen v. Commissioner, 85. T.C. 485, 502 (1985) (noting the difference between deductions from gross income and subtraction of cost of goods sold from gross revenues to determine gross income as justification for refusing to uphold the Commissioner's ruling that the "all events" test had to be applied to items included in cost of goods sold when valuing inventory at market).

[37] Revenue Act of 1918, ch. 18, § 203, 40 Stat. 1057 (establishing basic requirements for proper inventory accounting, in substantially the same wording as in current section 471 and the regulations promulgated thereunder); Regulations 45, arts. 1581–88 (1919) (establishing rules now incorporated — with various intervening amendments — in Treas. Reg. § 1.471-1 through § 1.471-8 (1958)). Indirect authorization for inventory accounting existed under the original interpretative regulations. *See* Aluminum Casting Co. v. Routzahn, 282 U.S. 92 (1930); Doyle v. Mitchell, 247 U.S. 179 (1918); *supra* note 27 and accompanying text.

[38] Congress and tax administrators have extended this concept beyond its appropriate bounds, permitting variation of methods *within* an industry when the two methods may well result in considerably different taxable income determinations. *See, e.g.*, Treas. Reg. § 1.461-4(d)(6)(ii)–(iii) (as amended in 2004) (permitting taxpayers to treat economic performance as occurring upon delivery, acceptance, title transfer, or payment); Treas. Reg. § 1.471-6 (as amended in 2002) (permitting farmers to use either the farm-price method or the unit-livestock-price method to value livestock inventories). Much of this choice in the tax system derives from the flexibility of financial accounting rules and a presumption that flexibility about such details eases compliance for taxpayers. Recently, tax administrators have applied similar logic inappropriately to expand the ability of taxpayers to defer income from advance payments under regulatory proposals. *See, e.g.*, I.R.S. Notice 2002-79, 2002-2 C.B. 964 (proposing a revenue procedure that would modify Rev. Proc. 71-21, 1971-2 C.B. 549); Rev. Proc. 2004-34, 2004-22 I.R.B. 991 (Jun. 1, 2004) (modifying Rev. Proc. 71-21 to permit taxpayers to defer inclusion of certain advance payments until the next succeeding taxable year if not currently included for financial accounting purposes). There is little rationale for such flexibility in tax systems, however, where elections that permit taxpayers essentially to choose how they will be taxed create inappropriate discrepancies between similarly situated taxpayers.

different businesses faced in accounting for their inventories, it likely seemed reasonable for financial accounting practices to guide tax accounting rules for inventory. By again referencing the clear reflection limitation, however, Congress reinforced the notion that taxable income is uniquely defined by the tax system and that the priority to be given by the tax system to financial accounting standards is not absolute.[39]

There are two aspects of inventory accounting that require determination for either financial or tax purposes: valuation of inventory items at year-end and identification of items in inventory at year-end based on assumptions about sequencing of sales.

1. Inventory and Related Hedge Accounting: Valuation

Treasury did not at first prescribe methods for valuing inventory items, though its own internal rules only permitted inventories to be valued at cost.[40] It took little time, however, for Treasury to adopt rules conforming tax accounting for inventory with the "lower of cost or market" (LCM) method that was gaining widespread acceptance for financial accounting purposes when the income tax was enacted. Subsection a, below, discusses the LCM method. In a related development, Treasury recognized the special accounting needs of commodities merchants who had long used market valuations to determine their profits or losses on inventory hedges for business purposes. Subsection b, below, discusses this origin of the "mark-to-market" (MTM) method.

a. Lower of Cost or Market Method

LCM values inventory items using either cost or market value, whichever is lower. For financial accounting purposes, market value was essentially replacement cost or net realizable value.[41] LCM accounting thus is taxpayer favorable, in that depreciation of retained inventory items in falling markets accelerates recognition of losses

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[39] *See supra* note 33.

[40] T.B.R. 48, 1 C.B. 47 (1919) (finding that average cost inventory methods do not satisfy the revenue acts and discussing the theory behind lower of cost or market accounting), *superseded by* Rev. Rul. 71-234, 1971-1 C.B. 148.

[41] *See, e.g.*, William R. Sutherland, *Inventories: Methods, Valuation and Uniform Capitalization Rules*, at 407, C2 CCH Transactions Library (July 1988, last updated July 1991) (discussing financial accounting standards under ARB 43 providing that market means net realizable value and can generally be determined using current cost of replacement).

while appreciation due to rising markets does not result in higher tax liability.[42] In 1917, Treasury officially recognized LCM as an alternative for the typical inventories of merchants and manufacturers as well as for dealers in securities.[43] The impetus for Treasury's adoption of LCM for merchants was to accommodate their business practices.[44] The rationale for extending LCM to securities dealers was not to ensure accounting conformity, but rather to protect securities markets by discouraging securities dealers from selling off securities to realize losses.[45] There were initial doubts about the proposal. Large dealers at first indicated that they would not take advantage of the opportunity to use lower market values, because they either had realized losses or preferred to pay current tax rather than pay what they feared would be a significantly larger tax when securities

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[42] A lower value for closing inventory when market values decline below historic cost will result in higher cost of goods sold, thus reducing gross income from inventory and permitting a current deduction for the loss due to decline in value below cost. *See generally* St. James Sugar Coop., Inc. v. United States, 643 F.2d 1219, 1222-25 (5th Cir. Unit A May 1981). The LCM method does not require a taxpayer to treat any increases in market value as income, even if those increases restore amounts previously deducted as losses under this method.

[43] T.D. 2609, 19 Treas. Dec. Int. Rev. 401 (1917); *see also* Regulations 45, art. 1582 (1918).

[44] *See, e.g., Validity of Inventories, supra* note 33, at 8 (reproducing the Investment Bankers' brief for the *Mitchell Bros.* case, which asserts that "'[i]t is common knowledge that business concerns usually' inventory their goods at cost *or* market value, whichever is lowest, and determine their net income for the year on that 'basis'"). The Investment Bankers also reference a July 15, 1916 Federal Trade Commission pamphlet entitled "A System of Accounts for Retail Merchants" that "insists upon" LCM as the "true basis" for determining income and note that the U.K. tax system had adopted LCM in July 1917. *Id.* The brief defends the appropriateness of an accounting method such as LCM that permits taxpayers to reduce tax liability by deducting unrealized depreciation *without* similarly increasing their tax liability in respect of unrealized appreciation, arguing that no income tax is ever due until there is an "actual income produced and existing for the taxable year," which unrealized appreciation does not satisfy. *Id.*

[45] *See, e.g., Question of Inventories Again to the Front: Legal Difficulties in Way of Recent Treasury Decision — Some Hasty Inferences of Doubtful Value*, WALL ST. J., Jan. 11, 1918, at 6 [hereinafter *Question of Inventories*] (noting that the decision to permit LCM was "to avoid . . . marketing of securities"); *Validity of Inventories, supra* note 33, at 8 (noting that few securities dealers appeared to desire the Treasury decision permitting LCM when first suggested, but many brokers with losses that had planned to realize losses through actual sales to reduce their tax liabilities now welcomed LCM as a "fair, permanent and approved basis of income return"). Dealers apparently had high unrealized losses because of the impact on the markets of World War I and the absorption of investment capital by Liberty bonds.

appreciated.[46] Treasury faced complaints that dealers would receive windfall tax savings and belatedly referred the validity of the use of market valuations to the Attorney General.[47] The investment bankers' spokesperson responded to criticisms that the provision was a windfall by arguing that the method was necessary to ensure that taxes were based on business income: "Courts have repeatedly stated that the terms 'income' and 'profits' in tax statutes are to be understood in their business sense and certainly there is no business sense in which such corporation [with $30,000 ostensible profits but $60,000 depreciation of assets] has a profit for the year."[48]

Needless to say, nondealers soon realized that the ability to recognize unrealized losses while not being required to recognize unrealized gains was a gravy train they wanted to catch. Investment bankers urged that corporations and other holders of Liberty bonds be permitted to inventory their bonds using LCM so as to deduct losses in 1919 without selling the bonds on the market (and thereby weakening the market value of the bonds).[49] Industries that were flush with inventory after stocking up on high-priced materials for the war effort also complained about the "rigorous and inflexible character" of the tax laws governing inventory that required item-by-item accounting and did not permit writedowns to reflect reasonable business expectations of future market downturns, as permitted for financial accounting.[50] Recognizing the boon in permitting unrealized

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[46] *See Inventories For Tax Purposes: Doubtful Advantage to Be Gained by Making Use of Recent Regulations Permitting Market Valuation*, WALL ST. J., Jan. 7, 1918, at 1.

[47] *See Excess Tax Inventory Ruling Goes to Gregory: Question Raised as to Legality of Treasury Decision Fixing Basis for Tax Returns*, WALL ST. J., Jan. 10, 1918, at 9; T.D. 2649, 20 Treas. Dec. Int. Rev. 26 (1918) (indicating that returns using LCM would be "tentatively accepted" pending the outcome of the *Mitchell Bros.* case, with a requirement for filing amended returns if the decision in the case disallowed LCM). The Treasury Decision went on to define a dealer in securities as a merchant who buys and sells to customers rather than holding for investment or speculation. *Id.*

[48] *Question of Inventories*, *supra* note 45, at 8.

[49] *See Ask to Inventory Bond Losses*, WALL ST. J., Dec. 1, 1919, at 16.

[50] *See Corporation Tax Laws Are Found Burdensome: Listing of Inventories at Top Prices in Face of Probable Falling Market Especially Trying*, WALL ST. J., Dec. 22, 1919, at 6; *Tax Ruling on Inventories: Market Means Current Bid Price at Date of Inventory for the Merchandise Named*, WALL ST. J., July 29, 1920, at 8 (setting forth the text of Treasury Decision 3047 regarding definition of market value for inventory purposes); *see also* Rev. Rul. 77-364, 1977-1 C.B. 183 (ruling that market value cannot be determined by dividing inventory into classes based on sales activity and then reducing the value of each class by a percentage of cost assigned to it, where the determination of the percentage writedown is not established to be related to the

loss deductions in a realization system, both the government and commentators have since proposed LCM repeal, without success.[51]

b. Mark-to-Market Method

When the United States reinstituted the income tax, a third, MTM method of valuing inventory and related hedges had been in place for at least fifty years among cotton and grain merchants and others who dealt in commodities subject to considerable fluctuation in market value and who used various contracts to hedge their risks.[52] For financial accounting purposes, such as providing financial statements to lending banks, commodities dealers valued their generally small physical inventory at market (whether lower or higher than cost) and took their forward sales or purchases and other hedging transactions into account by marking them to market to include any appreciation

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"true market value" rather than merely reflecting an estimate of depreciation); Rev. Rul. 83-59, 1983-1 C.B. 103 (disallowing benefits of purported sales of excess inventory where there was a repurchase arrangement).

[51] *See, e.g., Finance Committee Releases Draft Statutory Language for Recommended GATT Financing (Pending Legislation)*, HIGHLIGHTS & DOCUMENTS, Aug, 25, 1994, at 2965 (proposing repeal of LCM method of accounting); Thomas L. Evans, *Lower of Cost or Market — The Need for Reform*, 64 TAX NOTES 1349, 1349 (Sept. 5, 1994) (proposing the elimination of LCM or, at the least, reforms that would eliminate some of the egregious advantages provided by the method and referencing the legislative proposal for repeal as a means of funding revenues lost under GATT); DEP'T OF THE TREASURY, GENERAL EXPLANATION OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS, at 161–62 (2000).

[52] *See, e.g.*, Appeals and Review Mem. (A.R.M.) 135, 5 C.B. 67, 69 (1921) (describing MTM as a "custom, existing over a period of approximately 50 years, for the cotton merchant . . ."), *restated and superseded by* Rev. Rul. 74-223, 1974-1 C.B. 23; Molsen v. Commissioner, 85 T.C. 485, 499 (1985) (noting that MTM "is the longstanding practice of cotton merchants . . . and was originally approved for cotton merchants and other dealers in commodities in S.M. 5693 . . . and was reapproved in Rev. Rul. 74-227"). The accounting method stemmed directly from the particularities of the commodities businesses. Instead of storing large quantities of commodities in their own facilities, grain and cotton merchants engaged in transactions that were denominated in grain elevator or warehouse receipts. The receipts entitled them to a quantity of fungible units of a particular grade of the commodity. They entered into contracts to purchase or sell the commodity using these receipts on a daily basis, for either current or future delivery. To lock in their expected profits for forward contracts at the price on the day of the transaction, they engaged in counterbalancing forward purchasing and sales or other hedging transactions. This customary business practice is described in detail in the 1920 and 1921 A.R.M.s, *supra*. A.R.M. 100, 3 C.B. 66, 67 (1920). *See generally* Bd. of Trade of Chicago v. Olsen, 262 U.S. 1 (1923) (describing the operation of the commodities exchange).

(or deduct any depreciation) since the last reporting period.[53] The effect was to recognize for book purposes both unrealized losses and unrealized gains on inventory and inventory hedges.

Under the income tax, however, commodities dealers were required to apply realization principles to determine the timing of their income and losses from contractual hedges. As a result, hedged inventory that provided reasonably steady flows of economic income would be reported under tax rules that caused the dealers to have high taxable incomes in years when hedge losses were not realized.[54] After

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> In the keeping of books in the cotton business, it has been the custom, existing over a period of approximately 50 years, for the cotton merchant to take into consideration at market his forward sales, purchases, and hedges, and if they show a profit, that is added to the season's business. If, on the other hand, they show a loss, it is deducted from the season's business. His real profit, or loss, is thereby determined for the year.

A.R.M. 135, *supra* note 52, at 69; *see also* Murphy v. United States, 992 F.2d 929, 930–31 (9th Cir. 1993) (describing the mark-to-market system of accounting for commodities futures contracts).

54 A brief description of mark-to-market accounting is perhaps in order, as background for the discussion in Part IV, *infra*. Mark-to-market, or accretion, accounting differs from the basic realization regime in which taxpayers take gains and losses into account in respect of property held by the taxpayer only upon the occurrence of a triggering event. Under a realization regime, mere increases or decreases in value of property held by the taxpayer have no effect on the taxpayer's taxable income for the year. Only when a realization event occurs, such as a disposition or other change in ownership, does the change in value figure into the taxpayer's taxable income. The taxpayer determines the amount of gain over the entire period that she held the property by comparing the sales price (or other measure of fair market value at disposition) to her cost basis in the property. Unlike a realization regime, a mark-to-market regime *accelerates into the current taxable year* any *expected* income and deductions in respect of a mark-to-market item that affect its current value and *that have not already been taken into account* in determining the taxpayer's taxable income. Marking to market thus accelerates income in reciprocal fashion to the capitalization rules that require deferral of deductions. *See* Edward D. Kleinbard & Thomas L. Evans, *The Role of Mark-to-Market Accounting in a Realization-Based Tax System*, 75 TAXES 788, 793–94 (1997) (noting that deferral and mark-to-market accretion regimes should have the same economic effect, in that they produce identical present values of tax liabilities). The acceleration mechanism is the "mark" — the determination of the item's current fair market value at the end of each taxable year — and the comparison of the current mark to the prior year-end's mark. Only changes in the mark that have taken place during the taxable year require an income inclusion or permit a deduction. That is, if an item maintained a stable fair market value after the year of acquisition, it would be "marked to market" at the end of each taxable year, but no increments of income or deduction would be taken into account in income for that year. If an item increased in value during a taxable year,

Treasury promulgated regulations permitting cost or LCM inventory accounting,[55] commodities merchants complained because the regulations did not allow them to treat their hedges as part of their inventory. This mismatch, they claimed, would impose taxes on "unearned profits."[56] They argued that Treasury should recognize the MTM method for their inventory and hedges for two primary reasons.

First, they claimed, in effect, that a MTM method for hedge contracts is not incompatible with an income tax based on realization because the margin system for determining the amount of gain or loss under a contract on a day-to-day basis, and amounts payable to or from the margin account, functions in a manner essentially equivalent to a disposition of the contract. Under a margin system, the change in value is actually paid to or from the merchant as appropriate (or accounted for in the merchant's margin account) on a daily basis.[57]

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the difference between the mark at the end of the prior taxable year and the mark at the end of the current taxable year would be taken into account. A disposition of the item during a taxable year would trigger a final accounting just as in a realization regime, except only the difference between the mark at the end of the prior year and the value at disposition (e.g., the sales price, in the case of a sale) would be taken into account. *See generally* Thomas L. Evans, *The Evolution of Federal Income Tax Accounting – A Growing Trend Towards Mark-to-Market?* 67 TAXES 824, 825 (1989) [hereinafter, Growing Trend] (describing the Haig-Simon model of economic income and its relationship to mark-to-market and realization regimes); David J. Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation*, 134 U. PA. L. REV. 1111 (1986) (proposing a system of taxation of economic income based on accrual concepts without a realization requirement).

[55] *See supra* note 43 and accompanying text.

[56] A.R.M. 135, *supra* note 52, at 70; *see also* A.R.M. 100, 3 C.B. 66, 67 (1920) (noting that "cotton merchants and dealers in grain and its products . . . have urged most strongly that the regulations at present in force, under which their inventories are taken, shall be modified to such an extent as will permit them to include in, or make a part of, their inventories, 'hedges' or transactions in 'futures,' which are recognized practices in their businesses"), *restated and superseded by* Rev. Rul. 74-227, 1974-1 C.B. 119.

[57] *See* A.R.M. 135, *supra* note 52, at 70. In brief, a margin account serves as collateral to ensure that a cotton merchant is not overcommitted and unable to perform under a futures contract with a broker. A merchant who enters into a cotton future (a commodity forward purchase contract) with a commodities broker pays a margin deposit upfront. On a daily basis, the merchant's margin account is adjusted to reflect the difference between the current mark (i.e., market value as marked for that day) and the prior mark. If the increase in the price of cotton is greater than the amount in the margin account, the merchant pays an additional margin amount equal to the excess. If the price of cotton has gone down, the merchant has available for withdrawal margin amounts previously paid, to the extent of the decline in price. The daily margin adjustment reflects the gain or loss on the contract for the 24-hour

> [I]n real practice, . . . the cotton merchant *has in hand*, if he has a profit in the transaction, his profit from day to day. On the other hand, if he loses in the transaction he *actually pays* the loss incurred from day to day.[58]

Second, they argued that MTM conforms to the accepted method of accounting for inventory and hedges in a commodities business for all other business purposes, including banking and information to equity owners. By taking inventory of supplies on hand at market, the merchants did not need to identify particular bales or assign costs on an individual item basis, a largely impossible task for the fungible commodities. By including hedges such as futures contracts in cotton in income at market as well, the merchants avoided artificially large fluctuations of income, because an appropriate hedge assured a merchant of a particular profit. In fact, the merchants claimed that

> [t]his 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 vogue, approved by auditors who certify to the correctness of [a merchant's] 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.[59]

In other words, they argued for conformity of tax with financial accounting in a situation where the accounting system had years of business experience and was considered the only workable system for their particular type of business.

Relying on the open transaction doctrine, Treasury initially

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period. *See generally* Leist v. Simplot, 638 F.2d 283, 286–88 (2d Cir. 1980) (describing the function of margin as collateral for a merchant's obligation in a commodity futures transaction); Henry Ordower, *Revisiting Realization: Accretion Taxation, The Constitution,* Macomber, *and Mark to Market*, 13 VA. TAX REV. 1, 59–75 (1993) (discussing commodities futures contracts, margin mechanisms, and the legislative history of section 1256, which justified mark-to-market accounting based on constructive receipt because of daily margin adjustments).

[58] A.R.M. 135, *supra* note 52, at 70 (emphasis added); *see also id.* at 73 (similar statement for grain merchants that "all outstanding hedging contracts are *actually settled* at the end of each day, either by collecting the profits or by paying the losses thereunder, with the same precise effect as if their holder had gone into the market and sold out his contracts for purchases of grain or bought in his contracts for its sale") (emphasis added).

[59] *Id.* at 69–70 (emphasis added).

denied commodities merchants permission to account for hedges as inventory.[60] Just one year later, however, Treasury yielded to ongoing lobbying to allow them to arrive at the same result by accounting for hedges on a MTM basis. In other words, merchants marked hedge contracts to market for determining gross income in respect of those contracts, although they were still not permitted to treat hedging transactions as part of their inventory accounting per se.[61]

The LCM method also applied to inventory of securities dealers, but they similarly were not able to apply mark-to-market accounting to their contractual liabilities, such as open short sales positions.[62] As the derivatives business developed, dealers became more concerned about the timing mismatches for their over-the-counter derivatives business. Dealers' positions in swaps and other derivatives are not

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[60] A.R.M. 100, *supra* note 56, at 70–71 (considering it "self-evident" that purchases and sales of a like quantity of a commodity could not be considered "one transaction" and indicating that "[t]here is in fact no profit or loss in the purchase of a commodity until the transaction has been completed by the sale of that particular commodity, nor is there any profit or loss in a transaction in 'futures' until the transaction has actually been closed").

[61] A.R.M. 135, *supra* note 52, at 78–79 (ruling that merchants could determine taxable income by taking into account market value of hedges); *see also* Rev. Rul. 74-227, 1974-1 C.B. 119 (updating and superseding S.M. 5693, V-2 C.B. 20 (1926) by confirming in question 4 that "commodities actually on hand at the close of the taxable year (the physical inventory) may be valued at market" because of the longstanding industry practice); Molsen v. Commissioner, 85 T.C. 485 (1985) (holding that a cotton merchant's accrual method of accounting under which cost of goods sold was determined by valuing year-end cotton inventory at market and marking to market unfixed, on-call purchases at year-end clearly reflected income). The 1921 memorandum emphasized that the position taken now did not conflict with the position stated in A.R.M. 100, because it was not necessary to treat hedges as a part of inventory in order to adopt the mark-to-market accounting method for hedge contracts; instead, the value of hedges was simply acknowledged to be a part of the "balance sheet" for determining taxable income. A.R.M. 135, *supra* note 52, at 78–79; *see also* Rev. Rul. 74-223, 1974-1 C.B. 23 (restating the position regarding tax treatment of futures contracts held by a commodities dealer at year-end). In 1981, Congress enacted a law requiring that regulated commodity futures contracts be reported on the MTM method, corresponding to the daily cash settlement employed by commodity futures exchanges for determining margin requirements. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 503, 95 Stat. 172, 327 (enacting I.R.C. § 1256); *see also* S. REP. NO. 97-144, at 157 (1981), *reprinted in* 1981 U.S.C.C.A.N. 105, 256.

[62] *See* Solicitor's Memorandum S-1179, 1 C.B. 60, 62 (1919) (ruling that marking to market could not apply to short sales positions because they were not assets). *See generally* Kleinbard & Evans, *supra* note 54, at 796 (discussing the ruling and the resulting lack of symmetry for treatment of elements of a dealer's business).

inventory in the classic sense, because they do not hold them primarily for sale to customers; rather, they enter into either side of derivative contracts with customers or other dealers and generally remain obligated under a contract throughout its term. Like cotton dealers, securities dealers hedge their positions to protect from market risk. By the early nineties, most if not all securities dealers valued their securities inventories and derivatives at market for financial statement purposes.[63] From 1958 to 1993, a securities dealer was able, under applicable regulations, to choose a tax accounting method for its physical securities inventory from any one of the three inventory methods (cost, lower of cost or market, or market), provided that the method conformed to "the basis on which his accounts are kept."[64] Most dealers "relied on mark-to-market accounting to understand and manage many of their business segments, and filed their U.S. federal income tax returns generally by reference to lower-of-cost-or-market-accounting . . . ."[65] But market valuations of physical securities under LCM created potential whipsaw problems if related derivatives positions could not also be marked to market.[66] Securities dealers

[63] House Committee on the Budget Report to Accompany the Revenue Reconciliation Act of 1993 at 237, 1993-3 C.B. 239; INV. IN DEBT AND EQUITY SEC., Statement of Financial Accounting Standards No. 115, ¶ 13 (Financial Accounting Standards Bd. 1993) (requiring inclusion in earnings of unrealized gains and losses on securities trades); Alan B. Munro & Yoram Keinan, *The Case for Book-Tax Conformity for Mark-to-Market Valuations*, 16 J. OF TAX'N OF FIN. INST. 5, 8 (2003) (noting that "the common practice in the financial derivatives industry had been to mark swaps and other derivatives to market [for financial accounting purposes]" even though it was not until 1998 that the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 133 requiring that derivatives be marked to market).

[64] T.D. 6336, 1958-2 C.B. 176 (adopting Treas. Reg. § 1.471-5 permitting securities dealers to use any one of the three methods for their securities inventories).

[65] Securities Industries Association, *Submission in Response to Advance Notice Regarding Proposed Safe Harbor Under Section 475*, at 3 (July 30, 2003) [hereinafter *SIA Response*], *available at* http://www.sia.com/TaxIssues/pdf/ANPRSubmission_section475. pdf (last visited Oct. 2, 2004).

[66] *See* Brief of Amici Curiae American Bankers Association et al. ¶¶ 55–56, 65, Bank One Corp. v. Commissioner, 20 T.C. 174 (2000) (Nos. 5759-95, 5956-97), *reprinted in Amici Contend Bank One's Derivative Swap Valuations Clearly Reflect Income*, TAX NOTES TODAY (Apr. 3, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2001 TNT 64-36) [hereinafter referred to as Amicus Brief and cited by paragraph number] (noting that traditional accrual accounting can create timing distortions from realized losses (or gains) on short-dated hedges that are offset by unrealized gains (or losses) on long-dated items and that many dealers "voluntarily adopted comprehensive mark-to-market tax accounting"). This is a curious statement, since it is not clear how a taxpayer can "voluntarily adopt" a method not permitted under the

therefore engaged in a similar campaign for tax conformity with their financial mark-to-market accounting for their entire hedged business.[67] Treasury responded with a proposed regulation permitting securities dealers and traders to elect a MTM method of accounting for their dealer activities, including derivatives and hedges: the proposal carried a sting, in that a dealer or trader could adopt MTM for derivatives only if neither the taxpayer nor any related party used LCM accounting for securities held in its capacity as a dealer or trader (or securities held as hedges).[68]

Congressional action forestalled further development of the proposed regulation. The President's 1992 budget proposals for fiscal year 1993 included a revenue raiser conforming securities dealers' tax treatment of marketable securities to their financial accounting treatment by requiring securities dealers to mark their securities

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Code, in order to prevent fluctuations of taxable income that might cause the taxpayer to incur more substantial taxes in some periods and losses in others. At any rate, for dealers who had adopted mark-to-market accounting for their derivatives portfolios for tax purposes, realization accounting for securities that hedged those customer positions would result in similar timing mismatches to those experienced earlier by commodities dealers. *See SIA Response*, *supra* note 65, at 13.

[67] *See SIA Response*, *supra* note 65, at 13 (referring to dealer lobbying for MTM authority and citing, at note 38, Letter from Cynthia Beerbower, on behalf of nine interest rate cap dealers, to D. Kevin Dolan (Mar. 4, 1988) (*reprinted in* 88 TNT 69-29 (Mar. 28, 1988)) and Letter from Salomon Brothers Inc., to K. Walli, I.R.S. (Dec. 6, 1991), *reprinted in* 91 TNT 255-37 (Dec. 17, 1991)); Kleinbard & Evans, *supra* note 54, at 797–98. *But see* Letter from Thomas A. James, Chairman of the Securities Industry Association, to Nicholas F. Brady, Treasury Secretary, Re: Mark-to-Market Accounting for Securities Dealers (June 4, 1992) (letter from the SIA arguing *against* proposed MTM legislation), *reprinted in Securities Industry Opposes Mark-to-Market Accounting*, TAX NOTES TODAY (June 25, 1992) (LEXIS, FEDTAX lib., TNT file, elec. cit., 92 TNT 131-44).

[68] Notice of Proposed Rulemaking, 56 Fed. Reg. 31,350, 1991-2 C.B. 951 (July 10, 1991) [hereinafter 1991 NPRM] (proposing regulation permitting MTM for securities dealers); Prop. Treas. Reg. § 1.446-4, 56 Fed. Reg. 31,350 (July 10, 1991) (withdrawn) (proposing MTM for securities dealers). Treasury was concerned that accounting for physical securities held in a taxpayer's capacity as a dealer or trader with the LCM method understated income by permitting recognition of unrealized losses while continuing to defer recognition of unrealized gains. The cost method also permitted understatements, because dealers were not subject to the wash sale rule of section 1091. Without a statutory change, however, Treasury could not prescribe MTM rather than LCM accounting for all securities held in a taxpayer's capacity as a dealer or trader. The proposed regulation was a back-door way to move dealers and traders and related parties to MTM accounting for those securities. The proposed regulation permitted them to avoid the whiplash caused by realization accounting for derivatives and hedging by biting the bullet of loss of LCM for physical securities held in inventory.

inventory to market rather than using LCM.[69] There was little explanation of the proposal, other than to note that it would conform financial accounting and federal income tax accounting for securities in inventory and eliminate understatement of income.[70] The proposed revenue provision went through various stages and was part of several bills, including two that passed both houses of Congress but were vetoed by the President, before its final enactment into law in 1993.[71]

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[69] *See* OFFICE OF MGMT. AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1993, RECEIPTS, PART TWO 8 (1992); STAFF OF JOINT COMM. ON TAXATION, 102D CONG., SUMMARY OF REVENUE PROPOSALS IN THE PRESIDENT'S FISCAL YEAR 1993 BUDGET, at 28 (Joint Comm. Print 1992) [hereinafter JCT SUMMARY].

[70] *See* JCT SUMMARY, *supra* note 69, at 28; DEP'T OF THE TREASURY, GENERAL EXPLANATION OF THE PRESIDENT'S BUDGET PROPOSALS AFFECTING RECEIPTS 89–90 (1992) (proposing to "conform the accounting and tax treatment of securities inventories by requiring that securities be included in inventory at their market value"); *see also* Committee on Ways and Means, Report together with Minority Views to accompany H.R. 4210, H.R. REP. NO. 102-432, at 60 (1992) (indicating that "[t]he cost method and the lower of cost or market method tend to understate taxable income compared to the market method that securities dealers use to report their income to shareholders and creditors. The market method represents the best accounting practice in the trade or business of dealing in securities and is the method that most clearly reflects the income of a securities dealer.").

[71] Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, § 13223, 107 Stat. 312, 481 (enacting section 475 mark-to-market rules for securities dealers). The proposal was included as new section 475 in a tax bill introduced in the House in February 1992, requiring dealers to mark to market both securities held in inventory and derivatives (including options, forwards, futures, notional principal contracts, short positions, and similar financial instruments). H.R. 4210, 102d Cong. § 372 (1992). In the Senate report on its substitute bill (which also included an amended version of proposed section 475), the Senate stated its concern that the LCM method permitted securities dealers to understate their taxable income. S. REP. NO. 102-77, at 89 (1992). The Senate amendment provided *two* general mark-to-market rules: one valued securities that were inventory in the hands of the dealer at fair market value and the other applied constructive sale treatment to those securities that were not inventory in the hands of the dealer. H.R. 4210, 102d Cong. § 3005 (1992) (as engrossed in the Senate). Only certain notional principal contracts were included in the definition of securities in the conference agreement: those were interest rate, currency, and equity notional principal contracts. H.R. 4210 was vetoed by the President on March 24, 1992. H.R. DOC. NO. 102-206 (1992). The MTM proposal was also included in an unemployment compensation bill, H.R. 5260, which passed the House on June 9, 1992. In the fall, a proposal in the same form as in the conference agreement to H.R. 4210 was again passed by the House and Senate. *See* H.R. 11, 102d Cong. § 3001 (1992). The report again emphasized the problem of asymmetric recognition of losses and gains under the LCM method. H.R. CONF. REP. No. 102-1034, at 770 (1992). This bill was also vetoed by the President. In 1993, the President again proposed a mark-to-market provision. *See* STAFF OF JOINT COMM. ON

During this process, the Securities Industry Association (SIA) apparently had second thoughts about the potential tax costs of accelerating recognition of gains under the mark-to-market revenue-raising provision, as evidenced by a short comment letter to Treasury expressing its "adamant" opposition to the "new tax" that represented a "substantial departure" from the basic tax principle requiring realization.[72] The provision as adopted did not retain the header indicating that its purpose was to conform tax to financial accounting, and the final bill provided for mark-to-market accounting for securities in inventory and for derivative positions and hedges. As noted, the conference report provided as explanation for the revenue raiser the potential understatement of taxable income under the LCM method when unrealized losses, but not unrealized gains, are recognized.[73]

2. Inventory Accounting: The LIFO Method

The second important factor in inventory accounting is identification of the items to be counted in inventory at the beginning and end of the inventory accounting periods and the consequent flow of values through inventory. Ordinarily, under the "first-in, first-out" (FIFO) method, inventory items are assumed to flow through a merchant's accounts in chronological order – the first items produced or purchased by a merchant must be the first items sold by the merchant. Under FIFO, the end-of-year value for retained inventory that is subtracted from the carryover inventory value from the prior

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TAXATION, 103D CONG., WAYS AND MEANS COMM. MARKUP OF ADMINISTRATION'S REVENUE PROPOSALS, at 27–31 (Joint Comm. Print 1993). It was finally enacted into law in August of 1993. Revenue Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312. Temporary and Proposed Regulations were issued in December. Temp. Treas. Reg. § 1.475(b)-1T to (d)-1T, T.D. 8505, 58 Fed. Reg. 68,747 (Dec. 28, 1993) (temporary regulations); Prop. Treas. Reg. § 1.475(b)-1 to (d)-1, 58 Fed. Reg. 68,798 (Dec. 29, 1993) (proposed regulations). Further proposed regulations were issued in 1995 and 1996. Prop. Treas. Reg. § 1.475(a)-1 to (e)-1, 60 Fed. Reg. 397 (Jan. 4, 1995); Prop. Treas. Reg. § 1.475(b)-1 to (e)-1, 61 Fed. Reg. 31,474 (June 20, 1996). Final regulations were adopted in 1996. T.D. 8700, 1997-1 C.B. 108. Congress later amended the mark-to-market rules to permit commodities and securities traders and commodities dealers to elect mark-to-market accounting. *See* The Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1001(b), 111 Stat. 251, 906 (adding sections 475(e) and (f)). The one clear purpose of the extension of marking to market for securities dealers, therefore, is its characterization throughout the legislative process as a revenue enhancer.

[72] *See* James, *supra* note 67.

[73] *See* H.R. CONF. REP. NO. 103-213, at 611 (1993).

year will tend to be higher from year to year as costs of producing inventory items increase, thus *reducing* cost of goods sold and *increasing* gross income from inventory.

"Last-in, first out" (LIFO) inventory accounting was a significant innovation in the early years of the income tax. Unlike FIFO, LIFO inventory sales during a reporting period are considered to be from the most recently purchased or produced merchandise. When inventory levels remain constant, LIFO treats the closing inventory (i.e., items that are retained and not sold) as coming entirely from the carried-over (beginning) inventory. When inventory levels increase during a year, only the increase at end of year is treated as coming from current year purchases. When inventory levels decrease during a year, the annual layers of retained inventory from prior years are considered sold in reverse chronological order. Thus, to the extent possible, LIFO allocates the most recent costs to costs of sales and the earlier costs to costs of retained inventory.[74] In a multiyear period of constantly rising prices, the result will be a *higher* cost of goods sold and *lower* gross income from inventory. Accordingly, LIFO is generally a taxpayer-favorable method compared to the ordinary FIFO method during periods of inflation.

The LIFO method developed from the "base stock" method, which was used by some taxpayers under the earliest income tax statutes but ruled impermissible by the Service and later by the courts.[75] After the adverse court decision, taxpayers lobbied for legislation permitting some variant of the base stock method for tax purposes. They succeeded over Treasury's objections in 1938, but the initial authorization was limited to a few industries that dealt in basic raw materials – leather tanning and basic metal products.[76] The

[74] *See generally* RICHARD GARRETT ET AL., ACCOUNTING METHODS – ADOPTION AND CHANGES, 572-2d TAX MANAGEMENT PORTFOLIO A-25 (2000) (explaining the LIFO method).

[75] *See* T.B.R. 65, 1 C.B. 51 (1919) (ruling base stock method impermissible); Lucas v. Kansas City Structural Steel Co., 281 U.S. 264 (1930) (same). The base stock method treated a portion of the taxpayer's inventory (an amount considered necessary to the taxpayer's business) as though it were a fixed asset carried at its original cost basis.

[76] Congress passed LIFO after the industries had lobbied Treasury for administrative relief in 1936, 1937, and 1938. Treasury was concerned that passage would lead to significant revenue losses, but Senator Johnson in a statement on the floor indicated that the method would not be applicable to "ordinary trading and manufacturing enterprises" so should not cause such a problem. SEIDMAN, *supra* note 26, at 7; *see also* Revenue Act of 1938, ch. 258, § 22(d), 52 Stat. 447, 459 (permitting use of LIFO in certain industries); *Revenue Act of 1938: Hearing on H.R. 9682 Before*

legislative history suggested that Congress had considered important the fact that those industries used LIFO for a number of non-tax purposes.[77] The 1939 act, however, expanded accessibility of LIFO accounting to all businesses with inventories, though it was assumed that financial accounting restrictions would mean that it would be available for financial accounting purposes only to those industries that required fixed quantities of raw materials for their products, such as oil refineries and textile manufacturers.[78]

At the time of the expansion, Congress also added — without explanation — a mandatory booking requirement: a taxpayer can use the LIFO method for tax purposes *only if* the taxpayer also uses LIFO for financial accounting purposes to provide information to equity owners and creditors.[79] The accounting profession viewed the requirement as a turf war with tax authorities inappropriately invading their domain.[80] Commentators indicated that the requirement was intended to *deter* the use of LIFO, on the assumption

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the Senate Comm. on Finance, 75th Cong. 145 (1938) (statement of Maurice E. Peloubet, arguing against Treasury's contention that the base stock method was not supported by accounting professionals).

[77] Senator Lonergan, for example, made the following statement from the floor:

> [I]n certain industries... , the last-in and first-out method of taking inventories, proposed by the amendment, is recognized by the leading accounting authorities as most accurately reflecting income. It is employed on their books in preparing published reports to stockholders and the New York Stock Exchange, in declaring dividends, and in statements filed with and approved by the Securities and Exchange Commission.

83 CONG. REC. 5043 (1938) (statement of Senator Lonergan), *reprinted in* SEIDMAN, *supra* note 26, at 6. The Senator went on to indicate the need for this method for the particular industries (smelting, tanning) because of the volatility of income and losses otherwise, which are "at variance with the conduct of the business." *Id.*

[78] Revenue Act of 1939, ch. 247, § 219, 53 Stat. 862, 877. In fact, taxpayers were permitted to elect to apply LIFO only to raw materials while continuing to use other methods to account for other aspects of inventory. *See* Priv. Ltr. Rul. 9445004 (Nov. 10, 1994) (discussing promulgation of T.D. 5407 in 1944).

[79] The legislative history merely restates the requirements of the Revenue Act of 1939. *See* S. REP. NO. 76-648 (1939), *reprinted in* 1939-2 C.B. 524, 528 (indicating that LIFO taxpayers must demonstrate that they have used no other method for business purposes such as income statements, loan applications and shareholder reports); *see also* Treas. Reg. § 1.472-2(e) (as amended in 1981) (setting forth criteria for satisfaction of conformity requirement).

[80] A recent article goes into some detail on the accounting profession's sense of turf rights on these issues. *See* Luppino, *supra* note 3, at 121–31, 124 (describing the "tenacity with which the accounting profession has fought against suggestions that the tax law dictate the principles to be followed in preparing financial statements").

that LIFO was generally viewed as an unsound accounting method for businesses other than the tanning and metal industries, and companies would not be willing to change to a less regarded financial accounting method for reports to their shareholders except in those few industries where it was customary.[81] The consequences, however, were far different, as "accountants developed 'theory' to justify its use for financial statement purposes [, so that t]he tail definitely wagged the dog in this case."[82]

In practice, the LIFO conformity requirement has been anything but straightforward. Over the years, questions have arisen involving writedowns of subnormal goods, treatment of affiliated corporations, use of dollar-value LIFO accounting, use of non-LIFO inventory determinations as a basis for bonuses of managers, use of supplemental explanatory information in reports to shareholders that is based on non-LIFO accounts, and preparation of interim reports or reports for managers and other insiders using non-LIFO accounting.[83]

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[81] *See, e.g.*, Richard B. Barker, *Practical Aspects of Inventory Problems Under Current Conditions: Lifo, Involuntary Liquidations*, 10TH ANN. N.Y.U. INST. ON FED. TAX'N 511, 512–13 (1952) (noting that the LIFO conformity rule was "the first and only time the revenue laws have been used specifically to control private accounting," and suggesting that those in Treasury who doubted the soundness of the LIFO method expected that corporations would not be willing to use the same method for financial accounting purposes); Arthur M. Cannon, *Tax Pressures on Accounting Principles and Accountants' Independence*, 27 ACCT. REV. 419, 420 (1952) (calling the requirement a "holding action" by the Service intended to restrict the use of LIFO). Regrettably, the conformity requirement for use of LIFO on tax returns appeared to serve merely as a strong distorting influence on financial accounting principles. For example, Herbert Miller noted that the success of LIFO was due to those accountants who supported the method because of its potential income tax advantages, even while expressing their "dislike" of the method. Herbert E. Miller, *How Much Income Tax Allocation?*, 114 J. ACCT. 46, 49 (July 1962). *But see* Rev. Rul. 74-586, 1974-2 C.B. 156 (stating that the purpose of the conformity requirement was to ensure that the LIFO method clearly reflects income for the particular taxpayer).

[82] Harold E. Arnett, *Taxable Income vs. Financial Income: How Much Uniformity Can We Stand?*, 44 ACCT. REV. 482, 491 (1969). Accountants would be pressed to rationalize adoption of a tax-advantaged method whenever there is a conformity requirement, "and accountants, if history is an accurate indicator, would succumb." *Id.* at 484.

[83] *See, e.g.*, Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 95, 98 Stat. 494, 616 (treating financially related corporate group as single taxpayer for LIFO conformity requirement); T.D. 7756, 1981-1 C.B. 316 (finalizing new rules for complying with the financial reporting conformity requirement, including supplemental and explanatory disclosures, internal management reports, interim reports, use of LCM but not MTM for LIFO inventories after January 22, 1981, and book-tax differences that may be disclosed when LIFO is used for both book and tax

These issues have generally been resolved by permitting myriad variances between the particular financial reporting item and the LIFO tax accounts, in many ways undoing the equivalency purportedly imposed by the booking requirement and casting into question whether conformity can either simplify tax rules or result in more accurate measurement of income.

C. Accrual Accounting: Current Inclusion of Prepayments and Deferral of Prepaid Expenses

The ongoing debate about conformity has been sharpest regarding prepayments. For financial accounting purposes, a matching principle operates to defer prepaid income so that it can be taken into account when the income is considered earned.[84] Similarly, financial accounting deductions are permitted for reasonably expected future costs that are viewed as reducing profits from current income (without reduction to present value).[85] When taxpayers attempted to apply these advantageous financial accounting rules for prepayments

inventory identification but book and tax LIFO numbers differ because of differences in other aspects of inventory accounting); T.D. 6539, 1961-1 C.B. 167 (adopting rules applying retroactively to the 1954 taxable year permitting the "dollar-value" method for computing LIFO inventories in terms of "base-year cost" of a pool of items); Rev. Rul. 77-50, 1977-1 C.B. 137, *obsoleted by* Rev. Rul. 88-21, 1988-1 C.B. 245 (permitting taxpayers to write down the cost of subnormal goods for financial accounting purposes even though such writedowns are not permitted for tax purposes).

[84] *See, e.g.*, OBJECTIVES OF FIN. REPORTING BY BUS. ENTERPRISES, Statement of Financial Accounting Concepts No. 1, ¶ 45 & n.12 (Financial Accounting Standards Bd. 1978) (discussing the importance of relating costs to revenues), *available at* http://www.fasb.org/pdf/con1.pdf (last visited Oct. 2, 2004). An early study of differences between tax and financial accounting provides a succinct statement of the financial accounting matching principle. *See* J.K. Lasser & Maurice E. Peloubet, *Tax Accounting v. Commercial Accounting*, 4 TAX L. REV. 343, 348 (1949) ("The determination of income by matching concurrent costs and revenues is a basic accounting concept and the determination of how and when the revenues and costs are matched is the principal problem with which accountants and businessmen deal in the statement of income. If income is required to be stated in one period and concurrent costs in another period, distortion of income in both periods is inevitable."). For further discussion of the matching principle, see *infra* note 102 and articles referenced therein.

[85] ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5, ¶¶ 76–80 (Financial Accounting Standards Bd. 1975) (discussing the matching concept in financial accounting in relation to the accrual of obligations for services to be rendered and similar issues), *available at* http://www.fasb.org/pdf/fas5.pdf (last visited Oct. 2, 2004). These accounting standards generally disregard the time value of money.

to determine their tax liabilities, the Service assessed deficiencies for underpayment of income tax. A number of court cases upheld the Service's position, relying in part on the claim of right doctrine.[86] The cases, and the sharp conflict with financial accounting rules, led to a slew of commentary and renewed calls for conformity of tax with financial accounting, especially from the American Institute of Certified Public Accountants (AICPA).[87]

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[86] *See, e.g.*, Brown v. Helvering, 291 U.S. 193 (1934) (holding that an insurance salesman accrual taxpayer must include commissions accrued and received, even though some portion might have to be returned later due to cancellation of policies); Clay Sewer Pipe Ass'n v. Commissioner, 139 F.2d 130 (3d Cir. 1943) (disallowing a deduction for future expenses required to provide services to which members were entitled for membership dues paid); S. Dade Farms v. Commissioner, 138 F.2d 818 (5th Cir. 1943) (holding that advance rental payments were income in the year received); N. Ill. Coll. of Optometry v. Commissioner, 2 T.C.M. (CCH) 664 (1943) (holding that an accrual taxpayer should include tuition prepayments in income when received); Your Health Club v. Commissioner, 4 T.C. 385 (1944) (holding that an accrual taxpayer should include prepayments for services in income when received rather than treating portions as a "reserve" for unearned income), *acq. in result*, 1945 C.B. 7 (I.R.S. 1945); S. Tacoma Motor Co. v. Commissioner, 3 T.C. 411 (1944) (finding that receipts from sales of coupons that were refundable on demand and entitled purchasers to services to be provided at some time in the future should be included in income when received); Auto. Underwriters v. Commissioner, 19 B.T.A. 1160 (1930) (holding that membership fees for services of reciprocal insurance association were income when received). *But see* I.T. 3369, 1940-1 C.B. 46 (1940) (permitting publishers to defer certain amounts received on subscriptions extending beyond the end of the taxable year). *See generally* Harold Dubroff, *The Claim of Right Doctrine*, 40 TAX L. REV. 729, 729–32, 770–71 (1985) (discussing the history of the claim of right doctrine and its application to prepaid income).

[87] *See* William J. Bowe, *Cash and Accrual Methods of Income Tax Accounting*, 3 VAND. L. REV. 60, 63 (1949) (in an article purporting to merely state "the developed law" on accounting, noting that departures from traditional accounting principles respond in part to a "basic practical principle that taxes should be collected at a time when cash is in hand, even though such a rule may violate some of the niceties of accounting science"); Cannon, *supra* note 81, at 424 (arguing against conformity because it leads accountants to "prostitute accounting principles to tax"); Freeman, *supra* note 28, at 728 (noting that "the legislative intent to bring tax law into harmony with accepted accounting principles has been clear, and this in spite of the necessity for repealing sections 452 and 462 of the Internal Revenue Code"); Alfred E. Holland, *Accrual Problems in Tax Accounting*, 48 MICH. L. REV. 149, 181 (1949) (arguing that "the legal profession has substituted legal technicalities [i.e., the claim of right doctrine] for principles of accounting"); T. Milton Kupfer, *The Financial Accounting Disclosure of Tax Matters; Conflicts with Tax Accounting Technical Requirements*, 33RD ANN. N.Y.U. INST. ON FED. TAX'N 1121, 1122–23 (1975) (noting that the AICPA in 1953 urged that conformity be restored as the guiding principle for tax, to avoid inequities and hardships for taxpayers); Lasser & Peloubet, *supra* note 84, at 344, 347, 357 (arguing that tax rules are beset by the "demon of convenience"

Responding to the growing chorus of concern, Congress included in its 1954 overhaul of the Code two sections intended to address these issues: section 452, which permitted certain prepaid income to be reported when earned under financial accounting standards, and section 462, which permitted a deduction to accrual taxpayers for a reserve for estimated future expenses, in general accordance with financial accounting standards.[88] The primary motivation was simplification of tax accounting by generally conforming it to financial accounting in this significant area of controversy.[89] These provisions were modified mandatory booking requirements, in that a taxpayer could not defer inclusions or accelerate deductions unless the inclusions were deferred and the deductions accelerated on the taxpayer's financial statements;[90] however, the benefits of deferral

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that relies on formulas rather than judgment and the "demon of anticipation" that "exact[s] his share of money presently in possession of the taxpayer but dedicated to the satisfaction of future and certain, if indefinite, liabilities and obligations" and proposing a comprehensive conformity requirement, except for tax expenditure items); Reimer, *supra* note 14, at 307 (listing thirty-one differences between book and tax accounting and arguing that GAAP "should furnish the primary guide for determining net income for all purposes, including the computation of taxable income"). The controversy continues today, often cast in terms of whether tax should incorporate the matching principle that is so important in financial accounting. *See infra* note 102 and the articles referenced therein.

[88] Internal Revenue Code of 1954 (1954 Code) §§ 452, 462 (prior to June 15, 1955 repeal), *reprinted in* JACOB MERTENS, THE LAW OF FEDERAL INCOME TAXATION: INTERNAL REVENUE CODE OF 1954 (as amended to Dec. 31, 1958), at 205–07, 214–15. The provision permitted deferral in respect of certain "liabilities," defined broadly to include an obligation to provide services, goods or use of property. Under this provision, therefore, pure services income that would likely be almost entirely net profit was permitted to be deferred up to five years beyond the taxable year of receipt. Section 462 similarly permitted a taxpayer to deduct an estimated expense. 1954 Code § 462(a).

[89] *See* T.D. 6134, 26 C.F.R. 1.452-1, 1.462-1 (June 8, 1955), 1955-1 C.B. 50, 52 [hereinafter, 1954 Regulations] (indicating that "[t]he general purpose of section 452 is to bring tax accounting more closely into harmony with generally accepted accounting principles"). The provision did not accomplish complete conformity, because the period of deferral for taxable income purposes was limited to six years but not so limited for financial accounting purposes. *Id.* at 52. A similar statement described the estimated reserve deduction. *Id.* at 60. *See also* William L. Raby, *The Meaning of 'Accrued' – Accounting Concepts Versus Tax Concepts*, 57 TAX NOTES 777, 777 (Nov. 9, 1992) (noting that the 1954 Code attempted to align tax with financial accounting in order to simplify tax accounting).

[90] *See* 1954 Regulations, *supra* note 89, at 52 (noting that "no election under section 452 may be made unless the prepaid income is deferred on the regular books of account . . . on the basis of which the taxpayer prepares his financial statements"). The regulations also stated that "no amount shall be taken into account with respect

were limited compared to financial accounting methods.[91] Adoption of the two provisions essentially imported the financial accounting matching principle into the tax system for shorter term obligations to perform services or provide goods, without time-value-of-money limitations.[92] Taxpayers gamed the system, taking advantage of a lack of transition rules to deduct expenses twice and manipulating their estimates of future expenses inappropriately to reduce their taxable income.[93] Accordingly, both sections were repealed retroactively in 1955 when the extent of revenue loss and the potential for manipulation became clear.[94]

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to estimated expenses under section 462 unless a reserve therefore has been established and is properly recorded on the regular books of account . . . on the basis of which the taxpayer prepares his financial statements"). *Id.* at 60.

[91] 1954 Code Section 452 essentially permitted deferral of prepaid income in respect of a liability for a period of up to five years after the year of receipt if deferral for that period *or longer* was permitted under the taxpayer's accrual accounting method. 1954 Code § 452(a). If the entire prepayment would not be treated as "earned" at the end of six years for financial accounting purposes, it was required to be taken into account ratably over six years for tax purposes. 1954 Code § 452(b). The estimated expense deduction also had to satisfy a reasonableness requirement, interpreted to require, where possible, a reasonable relationship to historical experience. *See* 1954 Regulations, *supra* note 89, at 61–62.

[92] The rule permitting deferral of inclusions did not require that the net present value be included, *see* 1954 Code § 452, and the rule permitting acceleration of deductions did not limit the deduction to the net present value of the estimated future expense, *see* 1954 Code § 462. However, the regulations promulgated under 1954 Code section 452 did require immediate inclusion of any prepaid amount not likely to be related to provision of future services based on prior experience. 1954 Regulations, *supra* note 89, at 54–55.

[93] John S. Nolan, *The Merit in Conformity of Tax to Financial Accounting*, 50 TAXES 761, 763 n.7 (1972) (stating that the provisions were repealed "because of a threatened large revenue loss largely attributable to their potential effect in permitting a doubling up of deductions" due to lack of appropriate transitional rules); Gilbert Simonetti, Jr., *A Challenge: Can the Accounting Profession Lead the Tax System?*, 126 J. ACCT. 66, 69 (Sept. 1968) (reporting a speech by Jerome Kurtz, U.S. Treasury Tax Legislative Counsel, in which he noted that Congress realized that there were "no clear standards of what expenses could be estimated and that taxpayers were making estimates and taking deductions for a vastly greater amount of these items than had been anticipated. The problem turned out to be, I think, that there were no clear lines as a matter of accounting principles as to what kind of expenses could properly be accrued.").

[94] Publ. L. No. 74, Act of June 15, 1955, ch. 143, § 1, 69 Stat. 134 (repealing sections 452 and 462 of the 1954 Code); *see* Am. Auto. Ass'n v. United States, 367 U.S. 687, 695 (1961) (describing the effect on tax revenues as "a disastrous impact"); Rev. Rul. 55-539, 1955-2 C.B. 246 (noting "the effect of the repeal will generally be to increase the tax liability of taxpayers who elected the methods of accounting provided

Repeal did not end the prepayment conformity controversy among courts or commentators.[95] Accepting repeal, some insisted that healthy financial and tax systems depended on independent evolution of financial and tax accounting principles.[96] Proponents of conformity claimed, however, that financial accounting was fairer and simpler for both taxpayers and the Service, and they accordingly viewed the failure to defer income until earned as a particularly "notorious" aspect of tax accounting that eliminated the beneficial flexibility inherent in financial accounting.[97] In spite of the repeal of sections 452 and 462, some thought the courts should nevertheless interpret the tax laws to conform to the financial accounting matching principle.[98] The Supreme Court considered these issues in a famous

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by sections 452 and 462 of the Code"). One commentator claimed that

> [i]t was only because the cases seemed to reverse this policy [encouraging sound accrual practices] and produce confusion that sections 452 and 462 were embodied in the 1954 Internal Revenue Code.... [But] the repeal was to close the door to double deductions and too large adjustments in one year, and not to thwart sound accounting or reverse the trend to bring tax law and accounting into harmony.

Freeman, *supra* note 28, at 746.

[95] *See, e.g.*, Schuessler v. Commissioner, 230 F.2d 722 (5th Cir. 1956) (permitting deduction in year of sale of furnaces of the estimated cost of fulfilling obligation to turn furnaces on and off for five years); Beacon Publ'g Co. v. Commissioner, 218 F.2d 697, 700–01 (10th Cir. 1955) (refusing to apply claim of right doctrine and permitting taxpayer to defer inclusions of prepaid subscriptions to periods to which they were related and suggesting that the Tax Court cases holding otherwise had misinterpreted the importance of the matching principle in tax); William M. Emery, *Time for Accrual of Income and Expenses*, 17TH ANN. N.Y.U. INST. ON FED. TAX'N 183, 193–94 (1959) (asserting that the government "has reaped rich rewards for opportunism" in the taxation of prepayments). For a comprehensive listing of relevant articles from the 1950s and 1960s, see *Clear Reflection*, *supra* note 30, at 359 n.20, 360.

[96] For example, Herbert Miller argued explicitly for separate development of accounting and tax concepts:

> The rules for determining taxable income should be thought of as part of the formula for computing a tax and should meet the requirements of a good tax system and be compatible with the objectives sought to be achieved by Congress. In contrast, the rules for determining accounting income should be directed to such objectives as producing amounts indicative of the effectiveness of management. I think we should give careful consideration to the benefits that might accrue from an effort to separate accounting and income tax concepts.

Miller, *supra* note 81, at 50–51.

[97] *Clear Reflection*, *supra* note 30, at 359 n.20, 360.

[98] *See, e.g.*, Freeman, *supra* note 28, at 746–50 (providing an appendix of forty

trilogy that addressed prepaid service income – *American Automobile Ass'n*, *Automobile Club of Michigan*, and *Schlude* – and held that deferral of prepayments for services was impermissible, at least in those particular factual circumstances.[99] In response to continued lobbying, Congress did enact limited exceptions to the deferral rule for prepaid subscription income and membership dues.[100] Based on the trilogy and those limited legislative exceptions, the Service then took the position that accrual taxpayers must include most other prepayments in income when received.[101]

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claim of right and all-events test cases in 1956-57 to demonstrate the ongoing nature of the controversy over accounting for prepayments, noting "arguments in favor of a case-to-case approval of sound accruing, rather than through the wide open invitation of section 462," and suggesting that the courts should develop the law to permit accrual for "reasonable expectancies"); Sidney Gelfand, *The "Claim of Right" Doctrine*, 33 TAXES 726 (1955) (arguing that section 452 was not necessary to permit accrual of prepayments in accord with financial accounting principles, and so its repeal "should not affect taxpayers' rights to defer receipts which in fact are not yet *earnings*"); Victor R. Wolder, *Deduction of Reserves for Future Expenses and Deferring of Prepaid Income*, 34 TAXES 524 (1956) (arguing that "appellate courts seemingly may have been stepping into the gap left by the repeal of Sections 452 and 462").

[99] Schlude v. Commissioner, 372 U.S. 128 (1963) (holding that a dance studio could not defer inclusion of prepaid dance lesson income when contracts guaranteed students a certain number of lesson hours on demand); Auto. Club of Mich. v. Commissioner, 353 U.S. 180 (1957) (holding that a club could not allocate advance payments of one year's membership fees ratably to the twelve-month period when services might be rendered); Am. Auto. Ass'n v. United States, 181 F. Supp. 255 (Ct. Cl. 1960) (holding that an automobile association could not defer recognition of annual dues paid in exchange for right to on-demand services based on statistical evidence of service demands), *aff'd* 367 U.S. 687 (1961).

[100] *See* I.R.C. § 455 (enacted as part of the Technical Amendments Act of 1958, Pub. L. No. 85-866, § 28, 72 Stat. 1606, 1625-26); I.R.C. § 456 (enacted as part of the Act of July 26, 1961, Pub. L. No. 87-109, 75 Stat. 222). Deferral of part of a prepayment in these contexts is more justifiable than in the pure service context, since a taxpayer receiving prepayments for subscriptions or club memberships will have statistically certain and generally not too remote future costs in connection with provision of the periodical or membership benefits. Nonetheless, by not requiring the net present value of the expected profit to be included upon receipt, these exceptions result in undertaxation compared to the general rules.

[101] *See, e.g.*, Rev. Rul. 80-308, 1980-2 C.B. 162 (requiring utilities to include in income fuel adjustment charges based on estimated sales but intended to recover increased fuel charges for preceding half year); Treas. Reg. § 1.451-5 (as amended in 2001) (providing only limited deferral of advance payments for sales); Rev. Proc. 71-21, 1971-2 C.B. 549 (providing only limited deferral of advance payments for services), *modified and superseded by* Rev. Proc. 2004-34, 2004-22 I.R.B. 991. The accrual method "all-events test" requires income to be included when the right to the

income is fixed and the amount can be determined with reasonable accuracy. Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 2004). This may well occur before the income has been "earned" for financial accounting purposes. Accrual deductions must also satisfy an economic performance test, which may result in deferral compared to financial accounting. *See* I.R.C. § 461(h). These rules comport with the traditional view of an income tax that requires taxpayers to make payments according to ability to pay (defined in terms of possession and control of income) in conjunction with an annual accounting system based on realization, although an income tax with full accretion taxation (considered by many proponents of an income tax to be the ideal) would not only require current inclusion of prepayments but also permit deduction of the net present value of future expenses, appropriately discounted for their remoteness and contingent nature. *See, e.g.*, Calvin H. Johnson, *The Illegitimate "Earned" Requirement in Tax and Nontax Accounting*, 50 TAX L. REV. 373, 381 (1995) [hereinafter Johnson, *Earned*] (discussing the failure of the financial accounting matching principle to consider the time value of money and the resulting miscalculation of profits). Some accountants denounced the realization income tax emphasis on the ability-to-pay fairness criterion as a tax "demon of anticipation." *See* Lasser and Peloubet, *supra* note 84, at 344. But those critics seldom point out the advantages from the financial accounting system's failure to take net present value of prepayments and accelerated deductions into account. Under the second Bush administration, the Service has again switched to expanding deferral possibilities in the name of "reduc[ing] the administrative and tax compliance burdens on taxpayers and . . . minimiz[ing] disputes between the Internal Revenue Service and taxpayers regarding advance payments." I.R.S. Notice 2002-79, 2002-2 C.B. 964, 964 (proposing a revenue procedure to supersede Rev. Proc. 71-21); *see also* Rev. Proc. 2004-34, 2004-22 I.R.B. 991 (Jun. 1, 2004) (superseding Rev. Proc. 71-21). The final revenue procedure, like the ANPRM addressed in this Article, suggests that the current tax administration supports leaving the determination of taxable income to accountants. Specifically, Rev. Proc. 2004-34 defines an "applicable financial statement," *id.* § 4.06, and allows a taxpayer to defer to the next succeeding taxable year the amount of advance payments received in the taxable year for services, certain non-services, and combinations of services and certain non-services when those payments are also deferred on the taxpayer's applicable financial statement, *id.* § 5.02(1)(a)(i)–(ii). Under the revenue procedure, the following three financial statements can qualify as an applicable financial statement, in descending priority: (1) a financial statement required to be filed with the SEC; (2) a certified audited financial statement that is used for credit purposes, reporting to shareholders, or any other substantial non-tax purpose; or (3) a financial statement required to be filed with a governmental entity other than the SEC or Service. *Id.* § 4.06. Although the revenue procedure eases compliance burdens and reduces the potential overtaxation of prepayments, it also increases the potential for undertaxation (deferral of services income that will have minimal associated future costs and hence a high net present value profit component) and adds category complexity because there are now two alternative ways in which service providers may be able to defer income: if they don't succeed under Treas. Reg. § 1.451-5, they can still use the new revenue procedure. *See* Announcement 2004-48, 2004-22 I.R.B. 998 (June 1, 2004) (announcing the issuance of Rev. Proc. 2004-34 and explaining that "the Service does not believe that the revenue procedure and the regulations should be mutually exclusive"). Not surprisingly, commentators

Concerns about proper accounting for prepayments remain in large part because of the insistence by some commentators and courts on a particular type of conformity – incorporation in the tax system of the "matching principle" from financial accounting. For example, several courts have permitted deferral of income when the time of performance was fixed and deferral permitted matching of income and related expenses.[102] As commentators have noted, these cases are arguably wrongly decided, in light of the realization principle which forms the default rule for the federal income tax system and the importance of the time value of money. Deferral of prepayments disregards the "bird in hand" nature of actual receipts at the disposal of the taxpayer as well as the fact that a portion, often substantial, of the prepayment represents net profits. Accelerated deductions that are not reduced to net present value (possibly quite small) to account for their potential nature can result in significant understatement of the net present value of profits.[103] The problem is especially acute if

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have proposed a number of measures to simplify the procedure by expanding its scope. *See* Letter from Robert A. Zarzar, Chair of the Tax Executive Committee of the AICPA, to Mark W. Everson, Commissioner of the Internal Revenue Service, *Re: Notice 2002-79, on Including Advance Payments and Advance Rentals in Gross Income* (Sept. 10, 2003) (suggesting acceleration of certain cost deductions, extension of deferral to all rental payments and to asset transfers under sections 351 or 721, aggregation of advance payments, and use of ratable inclusion or statistical sampling to determine how much must finally be included in any taxable year), *available at* http://www.cpa2biz.com/resourceCenters/Tax/Tax+Accounting/AdvancePay_RentRegs.htm (last visited Oct. 2, 2004).

[102] *See, e.g.*, Artnell Co. v. Commissioner, 400 F.2d 981 (7th Cir. 1968) (permitting deferral of ticket sales income until year in which games would be played), *action on dec.* 1970 WL 23056 (Sept. 17, 1970); Boise Cascade Corp. v. United States, 530 F.2d 1367 (Ct. Cl. 1976), *cert. denied*, 429 U.S. 867 (1976) (permitting deferral of engineering services income until performance occurred, even though time of performance was indefinite); Tampa Bay Devil Rays v. Commissioner, 84 T.C.M (CCH) 394 (2002) (permitting deferral of 1995 and 1996 payments for tickets and private suites related to games played in 1998).

[103] *See, e.g.*, Johnson, *Earned*, *supra* note 101 (discussing the understatement resulting from deferrals and the necessity of discounting future costs to determine "taxable, not-yet-earned profit"). The Service has administratively granted deferral of advance payments on sales under section 1.451-5 of the regulations. This similarly results in undertaxation, in that there is clearly a net present value profit. Support for that view is provided by Congress's enactment of the economic performance requirement for accrual of deductions for future obligations. Deficit Reduction Act of 1984, § 91(a), Pub. L. No. 98-369, § 91(a), 98 Stat. 494, 598–601 (enacting new section 461(h)). The conference agreement discussion of a tax matching principle in connection with the economic performance test should not change this conclusion. That applies to a narrow "recurring item" exception for which economic performance

the deferral of prepayments is related to future services, where the net present value of the profits is likely close to the actual prepayment.[104]

occurs no later than the first eight and one-half months of the following taxable year and makes clear that GAAP compliance will be considered relevant but "not necessarily dispositive." H.R. REP. NO. 98-861, at 871–75, *reprinted in* 1984-3 C.B. 2, 125–29.

[104] Johnson, *Earned*, *supra* note 101, at 385–86, 390. For other articles arguing that the federal income tax does not (and should not) incorporate a matching principle, see *id.*; Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17 (1998); Julie A. Roin, *Unmasking the "Matching Principle" in Tax Law*, 79 VA. L. REV. 813 (1993) (noting that the tax matching principle has nothing to do with deferring income until earned but rather attempts to prevent arbitrage by matching timing between parties to the transaction, as in the section 267 related party loss rules). Alan Gunn suggests that conventional bookkeeping does generally control — simplifying audits, saving money, and perhaps even deterring fraud. It is only when a special tax accounting rule is substantially beneficial that tax should and does depart from conformity. Since reporting income on receipt is "very sensible as a practical matter," financial accounting matching is neither normatively correct nor administratively the most reasonable approach. Gunn, *supra* note 28, at 9. For the contrary view, see M. Bernard Aidinoff & Benjamin B. Lopata, *Section 461 and Accrual-Method Taxpayers: The Treatment of Liabilities Arising From Obligations to be Performed in the Future*, 33 TAX LAW. 789 (1980) (arguing that failure of tax to follow the matching principle leads to distortions of income); Clarence B. Kelley, Case Note, *Taxation — The Claim of Right Doctrine vs. Accrual Accounting*, 9 ALA. L. REV. 143 (1956) (disagreeing with failure of tax to follow accounting's matching principle). Observing the disparate tax treatment of advance payments depending on their particular classification as payments made for goods or services (governed by the tax accounting rules discussed in the text) or payments under financial products (generally governed by specific provisions determining timing of inclusion, such as the original issue discount rules, or by analogy with such provisions), Robert Scarborough has proposed that all advance payments should be treated as imputed loans on which the lender/payer would accrue an includible investment return at a risk-free rate, such as the applicable federal rate established by section 1274. *See* Robert H. Scarborough, *Payments in Advance of Performance*, 69 TAXES 798, 801–02 (1991). Note that the categorizations to which Scarborough objects stem from the coexistence of realization regimes (applicable to sales) and mark-to-market or pseudo-mark-to-market regimes (applicable to financial products such as debt instruments). The imputed loan mechanism is, in essence, another way to extend a pseudo mark-to-market regime to a wider array of taxable items. *See* Kleinbard & Evans, *supra* note 54, at 793–94; *cf.* Thomas L. Evans, *The Taxation of Multi-Period Projects: An Analysis of Competing Models*, 69 TEX. L. REV. 1109 (1991) [hereinafter, *Multi-Period Projects*] (discussing the problems with timing models that defer gross income while permitting costs to be currently deducted and concluding that a percentage completion or rate of return approach is more appropriate for taxing multi-period projects).

D. Conformity as a Goal of the Tax System in the 1970s

In the late 1960s, there was another resurgence of interest in conformity. Accounting groups pressed for both administrative and legislative relief, especially for consistency in treatment of prepayments. Arguing that conformity with the superior discipline of financial accounting would give confidence in the correctness (and hence fairness) of the tax system, they urged that tax should conform to financial accounting in all cases except those in which conformity would contravene special tax conventions, limitations, and exclusions.[105] Although Treasury officials had earlier seriously

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[105] *See, e.g.*, Arnett, *supra* note 82, at 482, 491 (stating that the majority view of the accounting profession was that "the interests of government, business, and the public would best be served if the definition of business income subject to tax were made as nearly as possible coincidental with net income under generally accepted accounting principles" but arguing that conformity could lead to government dictation of accounting principles); Sheldon S. Cohen, *Accounting for Taxes, Finance and Regulatory Purposes — Are Variances Necessary?*, 44 TAXES 780, 780 n.1 (1966) (reporting business view that financial accounts should serve for tax accounting purposes and citing various AICPA recommendations and legislative amendments to achieve conformity). John Nolan's historical account of the conformity discussions of the 1970s quotes B. Kenneth Sanden of PricewaterhouseCoopers (then Price, Waterhouse & Co.) in an October 10, 1972 speech as calling for

> restor[ing] the 'income' tax to a tax on 'income' — not a mismatching of revenue and expenditure. The sooner this is done, and the closer the conformity, the easier the task of administrators, the greater reliance businessmen will have in the fairness of the system, legislators on the published results, and the general public that each segment is bearing its appropriate share of the tax load.

See Nolan, *supra* note 93, at 764 n.10. Nolan goes to some lengths to dispute concerns voiced by conformity critics based on the different objectives of the two accounting systems:

> The objective of income determination for federal tax purposes is, of course, as the AICPA statement of policy provides, to raise revenue in an "equitable" fashion, but "equitable" in the case of a business taxpayer means by reference to the readily determinable increase in net worth or net economic resources of the taxpayer. This is precisely the purpose of financial accounting — the measurement of such increase on a practical basis, pursuant to uniform standards to permit financial comparisons of companies within an industry and of companies in different industries.
>
> There being a general identity of objectives between tax accounting and financial reporting, there is much to be gained by permitting tax accounting to utilize the extensive discipline which has been and is being adopted by the accounting profession.

Id. at 767–68.

questioned whether a single accounting system could realistically serve the varied purposes of tax, regulatory, and financial accounting,[106] the new Nixon administration showed renewed interest in such a system. A presidentially appointed task force recommended conformity between tax and financial accounting as an appropriate way to facilitate tax compliance and enhance the perceived fairness of the tax system, repeating the reasoning offered by conformity advocates that the systems should be substantially similar because of the shared objective of determining a business's net income on an annual basis.[107]

Treasury soon took several significant steps towards greater conformity. In 1971, Treasury promulgated regulations permitting taxpayers to elect to defer inclusion of advance payments for certain sales and construction contracts until earned for financial accounting purposes, with limitations depending on the degree to which payments are front-loaded.[108] At the same time, Treasury issued a revenue

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[106] *See, e.g.*, Cohen, *supra* note 105, at 785–89 (noting the many difficulties in conforming tax and financial accounting); Simonetti, *supra* note 93, at 67–70 (reporting a 1968 Treasury official's speech pointing out serious concerns about conformity because of the need to account for special tax subsidies not reflected in financial accounting, the differing objectives of the tax and financial accounting systems, the greater flexibility permitted by financial accounting's variances in practices, and the tax system's greater concern with distinguishing substance from form); *see also* M. Edgar Barrett & Gerald J. Holtz, *The Case Against One Set of Books for Financial & Tax Accounting*, 40 FIN. EXEC. 30, 38–42 (1972) (arguing against conformity).

[107] *See* REPORT OF THE PRESIDENT'S TASK FORCE ON BUSINESS TAXATION 60 (1970) (noting that the "divergence results in unnecessary complexity and controversy"). The task force stated that

> [t]he objective of generally accepted accounting principles and tax accrual concepts is basically the same – the determination of the net income of the business on an annual basis. Both business taxpayers and government auditors are generally familiar with accounting principles, and compliance would be facilitated by conforming the determination of taxable income more closely with such principles. Business taxpayers would have greater confidence in the fairness and integrity of the tax if such differences were minimized.

Id.; *see also* Nolan, *supra* note 93 (discussing the impact of the report).

[108] T.D. 7103, 1971-1 C.B. 138 (promulgating section 1.451-5 of regulations, permitting deferral of certain advance payments for sales and long-term contracts uncompleted during the tax year in conformity with financial accounting measures). In 1986, however, Congress enacted section 460, which generally requires taxpayers to include amounts under long-term contracts under the percentage-of-completion method and thus limits deferral.

procedure extending limited deferral to advance payments for services.[109] As noted, under generally accepted accounting principles, such payments are deferred until earned.[110]

Several of these changes towards conformity also carried out important tax principles by making taxable income determinations more clearly reflect economic income. For example, Treasury adopted inventory accounting regulations setting forth the "full absorption" and "modified full absorption" methods for accounting for manufacturing direct and indirect overhead costs.[111] Prior tax methods – such as the "prime cost" method that took no overhead costs into account and the "direct cost" method that disregarded indirect costs – were not clearly permissible for financial accounting purposes and wrong as a determination of economic income.[112] An explicit purpose of adoption of the absorption method was to achieve "a greater conformity between financial and tax accounting in the matter of inventory valuation."[113] The result of the changes was to

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[109] *See* Rev. Proc. 71-21, 1971-2 C.B. 549 (providing limited deferral by permitting advance payments received in one year to be included in the next, with the intent of resolving a recurring administrative problem for companies that sell and receive payment for services without regard to year end, and thus may have received payment in December for services to be provided in January, such as airline, bus, and train companies), *modified and superceded by* Rev. Proc. 2004-34. As noted, Rev. Proc. 2004-34 provides limited deferral in additional cases. *See* discussion, *supra* note 101. The administrative relief was limited in light of the trio of Supreme Court cases, which held that advance payments for services should be included in income in the year of receipt. *See* Schlude v. Commissioner, 372 U.S. 128 (1963); Am. Auto. Ass'n v. United States, 367 U.S. 687 (1961); Auto. Club of Mich. v. Commissioner, 353 U.S.180 (1957).

[110] *See supra* note 84. As noted previously, there is a considerable history of commentary on the divergence between tax and financial accounting in respect of inclusion of prepayments for services and deferral of deductions for prepayments of expenses. *See, e.g.*, Johnson, *Earned*, *supra* note 101, at 379 (arguing that deferral of inclusion is inappropriate for both tax and financial accounting purposes because it "understates the net present value of the receipts and the contribution of the profits to the taxpayer's wealth and standard of living").

[111] *See* Use of Full Absorption or Modified Full Absorption Method of Inventory Valuation, 36 Fed. Reg. 23,809 (proposed Dec. 15, 1971) (to be codified at 26 C.F.R. pt. 1) (proposing full absorption and modified full absorption methods for valuation of inventories that required manufacturers to include both direct and indirect costs); T.D. 7285, 1973-2 C.B. 163 (finalizing inventory regulations). These rules were superseded when Congress enacted the uniform capitalization rules of section 263A in 1986 that put into place a refined system of accounting for direct and indirect costs. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 803, 100 Stat. 2085, 2350–58.

[112] *See, e.g.*, Nolan, *supra* note 93, at 762 n.5.

[113] I.R.S. News Release No. 1186 (Dec. 15, 1971) (discussing proposed full

correct gross economic inaccuracies in the determinations of taxable income in respect of inventories.

Similarly, Treasury proposed to restrict use of the "completed contract method" (CCM), an accounting method that dated back to 1918 and permitted deferral of income inclusions from long-term contracts until completion.[114] The 1971 proposal would have permitted CCM only if a booking requirement were satisfied (i.e., the same method would have to be used for financial reporting purposes).[115] Because CCM was not generally a permissible method under GAAP, the booking requirement would have resulted in limited use of CCM and inclusions of income in respect of long-term contract more in line with concepts of economic income.[116] Treasury withdrew the controversial booking requirement, but eventually CCM was repealed as part of the 1986 reforms for most long-term contracts other than home construction and certain relatively short-term contractual arrangements.[117]

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absorption method rules for valuing inventories).

[114] *See generally* JCT ACCOUNTING REPORT, *supra* note 34, at 45–49 (providing an in-depth history of Treasury's attempts to limit CCM); Regulations 33, art. 121 (1918) (permitting CCM and percentage of completion method); Note, *Deferral of Income Under the Completed Contract Method of Tax Accounting*, 64 YALE L.J. 448, 450–51 (1955) (discussing windfall benefits of tax deferral).

[115] Prop. Treas. Reg. § 1.451-3, 36 Fed. Reg. 5509 (Mar. 24, 1971) (requiring conformity).

[116] CCM was not a permissible method under GAAP. *See* Howard M. Weinman, *Conformity of Tax and Financial Accounting*, 59 TAXES 419, 426 (1981).

[117] Treasury withdrew the 1971 proposed regulations and proposed new regulations that eliminated the conformity requirement but treated financial reports as strong evidence of the reasonableness of the method. Prop. Treas. Reg. § 1.451-3, 36 Fed. Reg. 23,805 (Dec. 15, 1971). Regulations finalized in 1976 expanded availability of CCM, though limiting premature deductions of associated costs. *See* JCT ACCOUNTING REPORT, *supra* note 34, at 46–47. Treasury continued to be concerned about the tax benefits that long-term contractors derived from the method and finally proposed legislation to eliminate the method. *See* DEPARTMENT OF THE TREASURY, GENERAL AND TECHNICAL EXPLANATIONS OF TAX REVISIONS AND IMPROVED COLLECTION AND ENFORCEMENT PROPOSALS 1–4 (1982), *reprinted in* BNA DAILY TAX REP., Feb. 26, 1982, at S-2 to S-3 (indicating that the deferral of income from long-term contracts until their completion provided an unmerited tax windfall to contractors and proposing amendments to the Code and regulations that would prohibit CCM). Congress recognized that the method permitted distortions of income yet essentially codified CCM with limitations and instructions to Treasury to promulgate appropriate regulations. *See* JCT ACCOUNTING REPORT, *supra* note 34, at 48; *cf.* Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 229, 96 Stat. 493–95 (1982) (authority for regulations); Prop. Treas. Reg. § 1.451-3, 48 Fed. Reg. 10,702, 10,705-07, 10,710-16 (Mar. 14, 1983). As usual, the accounting issue

In line with its general trend towards conformity, Treasury announced a plan to restrict accounting method changes to those that would bring a taxpayer into conformity with the method it used for financial accounting purposes.[118] Regulations governing accounting for expected redemptions of trading stamps and permitting use of the "rule of 78s" for calculation of interest in conformity with financial accounting were also promulgated.[119] According to contemporary accounts, Treasury also considered proposing that Congress re-enact provisions similar to the retroactively repealed sections 452 and 462 of the 1954 Code, to allow accrual taxpayers to defer prepayments until earned under generally accepted accounting principles and currently deduct at least some estimated future expenses.[120]

Not surprisingly, while accountants continued to peddle comprehensive and specific conformity,[121] limitations on advantageous tax methods generally received a lukewarm welcome, even when the limitation was GAAP conformity. A case in point is the proposed regulation limiting the use of CCM, mentioned in the penultimate paragraph. The regulation would have limited the use of CCM to those cases where it was also used for financial reporting purposes and thus prevented the "best of both worlds" result where CCM was used to achieve tax deferral but the percentage of completion method was used for financial statements to present a smooth income trend.[122] Contemporary accounts report that opposition to the 1971 mandatory

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generated considerable controversy. *See generally* Hassan Alaghband, Comment, *Abolition of the Completed Contract Method Under Fire: A Study in Legislative Compromise*, 32 AM. U. L. REV. 1009, 1012 n.19 (1982) (discussing the controversial history of CCM and providing references to commentary of the period). The 1986 tax reforms finally repealed CCM for long-term contracts, other than home construction and certain other small construction contracts expected to be completed within two years. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 804, 100 Stat. 2085, 2358–61 (enacting section 460 of the Code, generally effective for contracts entered after February 1986). For a general discussion of the percentage of completion method (and arguments for its extension to all multi-period projects), see Evans, *supra* note 104, at 1168–1200.

[118] I.R.S. News Release No. 1125 (Apr. 14, 1971) (announcing a study to review conformity requirement with "all financial reports" for accounting method changes and suggesting exceptions would be made to take into account special regulatory requirements and tax variances (such as research and development or oil exploration expenditures)).

[119] *See* T.D. 7201, 1972-40 I.R.B. 8 (trading stamps); Rev. Rul. 72-100, 1972-10 I.R.B. 9 (rule of 78s).

[120] *See, e.g.*, Nolan, *supra* note 93, at 763.

[121] *See supra* note 105.

[122] *See supra* note 114.

booking requirement was "nearly universal" because of fears that the tax result would ultimately inhibit changes in financial accounting.[123] The AICPA, for example, affirmed its general policy in favor of conformity but explicitly opposed any mandatory booking requirement or financial statement test. Its stated primary concern was that pressure on accountants to preserve the related tax advantages would deter appropriate accounting innovations that might result in loss of those advantages.[124] In other words, it was feared that booking requirements that were intended to discourage use of a tax accounting method would instead result in "widespread adoption" of the tax-advantaged accounting method.[125] This concern that tax advantages might drive the way financial results were reported should be remembered when taxpayers suggest that reporting of the same numbers on financial statements and tax returns provides a check on the honesty of tax numbers (i.e., prevents manipulation to lower taxable income) because of the desire to impress shareholders and others with high financial statement income.

The move towards conformity lost momentum just a decade later. The American Bar Association recommended repeal of the LIFO booking requirement in 1977.[126] Treasury acknowledged that the LIFO conformity rules were suboptimal and recommended their demise in 1984.[127] About the same time, Treasury began to permit

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[123] Nolan, *supra* note 93, at 764; *see also* Bersch & Nadel, *supra* note 34, at 553 (suggesting that Treasury is using conformity to gain control of accounting principles).

[124] STATEMENT OF CONFORMITY OF TAX AND FINANCIAL ACCOUNTING (American Inst. of Certified Pub. Accountants 1971), *reprinted in* 132 J. ACCT. 75, 75–76 (Dec. 1971); *see also* Gilbert Simonetti, Jr., *Washington Report*, 2 TAX ADVISER 684, 684–85 (1971) (providing the text of the AICPA policy statement and noting AICPA's resistance to any booking requirements).

[125] Gilbert Simonetti, Jr., *Washington Report*, 3 TAX ADVISER 290, 291 (1972).

[126] ABA Comm. on Tax Accounting Problems, Rec. No. 1977-5, 30 TAX LAW. 1301 (1977).

[127] *See* 2 TAX REFORM FOR FAIRNESS, SIMPLICITY, AND GROWTH: GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS 189–90 (Nov. 1984) (explaining that repeal of the LIFO conformity method would permit firms to switch to LIFO accounting during inflationary times and prevent businesses from continuing to use FIFO accounting merely to avoid the LIFO conformity requirement). Although the LIFO method appears to be entrenched in the tax system, it should be viewed as an aberration that is explicitly permitted by statute, like any other tax expenditure that distorts economic income to achieve a non-tax purpose. Thus, it provides little guidance on what kinds of conformity should be adopted, other than to illustrate the apparent impossibility of establishing a strict book-tax conformity requirement that permits *whatever* variant of the approved method is used for book purposes to satisfy the tax requirements.

some changes to the cash method of accounting even when the changes did not result in book-tax conformity.[128]

In 1979, the Supreme Court decided *Thor Power*, a seminal tax accounting case involving the proper treatment of excess inventory writedowns.[129] The decision effectively squelched much of the conformity debate with a powerful and oft-quoted statement outlining the "vastly different objectives" of financial and book accounting:

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." In view of the Treasury's markedly different goals and responsibilities understatement of income is not destined to be its guiding light.[130]

The state of affairs was aptly described in contemporary commentary. The many differences between tax and financial accounting argued against conformity — different objectives, made worse perhaps by accounting's emphasis on prudent avoidance of misleadingly optimistic statements; different tolerance for subjectivity, with accounting rules embracing judgment and estimation; different definitions of fairness, with the primary tax fairness test of "ability to

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[128] *See* Weinman, *supra* note 116, at 419–20.

[129] Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979). The case involved inventory accounting by a merchant for its so-called "excess" inventory that it had determined might not ever be sold. The merchant reduced the value of the inventory according to one of two alternative formulas, but retained the inventory for sale and did in fact sell "excess" inventory at a nondiscounted price.

[130] *Id.* at 542 (citations omitted). The statement at the end focuses on the significant difference in approaches due to financial accounting's need to ensure that shareholders and creditors are not misled by managers' puffery regarding amount of revenue, compared to tax accounting's need for a definitive and certain answer for each annual accounting period.

pay" irrelevant for GAAP.[131] The arguments supporting conformity relied primarily on the belief that consistency in a taxpayer's determinations of his income, rather than accuracy of measurement of taxable income, was the most important goal. In addition, arguments for conformity placed central importance on flexibility to take into account the customs and norms of a particular industry. Finally, advocates of conformity simply thought that accountants had gotten it right – i.e., that accounting principles, such as matching of receipts and obligations (even when the obligation was one of providing services), were more correct than the opposing tax principles that took into account actual cash flows and the taxpayer's resulting ability to pay.

E. Corporate Tax Shelter Disclosure of Nonconforming Book-Tax Differences

As America approached the turn of the century, corporations appeared to be significantly reducing their tax burdens, as revealed by differences in income measured for book and tax purposes. This led to a new attempt to conform taxable income to financial accounting income through an alternative minimum tax (AMT) system.[132] The comprehensive reforms of the 1986 Code included a short-lived "book income preference" provision that increased AMT liability if a corporation's AMT income was less than adjusted net book income.[133] It was, in short, a partial conformity measure. Its replacement is not.

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[131] These differences, and the arguments supporting conformity, are discussed at some length in *Clear Reflection*, *supra* note 30.

[132] Individuals were subject to a limited alternative minimum tax before the 1986 reforms. *See* STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., TAX REFORM PROPOSALS: TAX SHELTERS AND MINIMUM TAX, at 63 (Joint Comm. Print 1985). The corporate minimum tax was an add-on that functioned as an "excise tax on tax preferences." *Id.* at 73.

[133] Tax Reform Act of 1986, Pub. L. No. 99-514, § 701, 100 Stat. 2085, 2326–27 (enacting former section 56(f), effective for 1987–89 taxable years, that essentially increased the AMT base by one-half of the excess of book income over the AMT income base computed without the preference). The book income preference was replaced for taxable years beginning in 1990 by an adjustment based on earnings. *See id.* at 2329–33 (enacting former section 56(g)). *See generally* Robert C. Odmark & Gary L. Tillman, *Corporate AMT Rules Under the Tax Reform Act of 1986*, 17 TAX ADVISER 656 (1986) (discussing the book-income preference); Daniel Shaviro, *Perception, Reality and Strategy: The New Alternative Minimum Tax*, 66 TAXES 91, 100–02 (1988) (noting that the book-income preference likely resulted in (i) over-taxing income because of differences in timing in the two systems and (ii) management manipulation of financial statements to reduce taxes).

The adjusted current earnings preference in section 56(g), which replaced the book income preference for tax years after 1989, utilizes the tax "earnings and profits" concept.[134]

As the average effective tax rate for corporations continued to decline, the discrepancy between book and tax income became a focus of the renewed concern with tax shelter abuses. In a 1999 Joint Committee on Taxation study, the staff noted that corporate tax shelters frequently involve losses for federal income tax purposes that are not matched by corresponding reductions to earnings for book purposes and suggested that such permanent book-tax differences, coupled with significant tax benefits, signaled avoidance behavior.[135] Treasury also identified "inconsistent financial accounting and tax treatments" as one of a short list of factors suggesting the presence of a corporate tax shelter.[136] The President's budget proposals for 2000 similarly argued that preferential financial accounting treatment characterized many corporate tax shelters.[137] Academic researchers investigating the sources of book-tax differences generally supported the views that abusive corporate tax shelter transactions were on the rise and that lack of conformity in financial and taxable income may signal potential tax avoidance transactions.[138]

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[134] *See* I.R.C. § 56(g). The 1986 reforms also eliminated (for all financial institutions other than small banks and thrifts) the reserve method for deducting worthless debts, which had been enacted in 1921 in spite of concerns that it would grant too much flexibility in the timing of deductions. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 805(a), 100 Stat. 2085, 2361; Knott & Rosenfeld, *supra* note 7, at 1046. The new rules retained, however, the booking requirement for recognition of losses due to partially worthless debt: a tax loss is permitted only if the determination is objectively supported and evidenced by a charge-off on the taxpayer's books. I.R.C. § 166(a)(2).

[135] STAFF OF JOINT COMM. ON TAXATION, 106TH CONG., STUDY OF PRESENT-LAW PENALTY AND INTEREST PROVISIONS AS REQUIRED BY SECTION 3801 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998 (INCLUDING PROVISIONS RELATING TO CORPORATE TAX SHELTERS), at 244–45 (Joint Comm. Print 1999) (stating that "while an arrangement that gives rise to a permanent difference may not in and of itself indicate tax avoidance, the combination of a permanent difference with significant net tax benefits indicates that a significant purpose of the arrangement is to avoid or evade Federal income tax").

[136] DEP'T OF THE TREASURY, THE PROBLEM OF CORPORATE TAX SHELTERS: DISCUSSION, ANALYSIS AND LEGISLATIVE PROPOSALS v, 14 (1999) [hereinafter TREASURY CORPORATE TAX SHELTER STUDY].

[137] OFFICE OF MGMT. AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2000, ANALYTICAL PERSPECTIVES 71 (1999).

[138] *See, e.g.*, TREASURY CORPORATE TAX SHELTER STUDY, *supra* note 136 (assessing the scope of the corporate tax shelter problem and considering potential

In response to the tax shelter crisis, there were a number of new proposals for greater conformity of tax to book measures of income. Perhaps one of the most comprehensive is discussed by Kenneth Wertz in a 1998 article that considers substitution of a book income tax (with minor adjustments for certain preferences) for the current corporate income tax. Proponents suggested that use of book income would significantly reduce corporate management's ability to manipulate both tax and book results.[139] Commentators noted that the proposal's effectiveness was limited in that it only addressed publicly traded companies, which themselves would continue to have considerable incentives to *understate* income in certain circumstances – e.g., to record an extraordinary loss in one year to avoid a multi-year impact or to create an upward trend in income that will be more favorably viewed by shareholders.[140] Furthermore, the

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causes and remedies); Robert S. McIntyre & T.D. Coo Nguyen, CORPORATE INCOME TAXES IN THE 1990S 2 (Inst. on Tax'n and Econ. Pol'y 2000) (stating that 41 of the 250 companies in the study reported significant profits in years when they paid no federal income tax and assessing the various reasons for the book-tax discrepancies), *available at* http://www.ctj.org/itep/corp00pr.htm (last visited Oct. 2, 2004); Lillian F. Mills & Kaye J. Newberry, *The Influence of Tax and Nontax Costs on Book-Tax Reporting Differences: Public and Private Firms*, 23 J. AM. TAX'N ASS'N 1 (2001) (concluding that book-tax differences are less an indicator of aggressive tax transactions for private firms that have fewer incentives to report nonconforming book income); Lillian F. Mills, *Book-Tax Differences and Internal Revenue Service Adjustments*, 36 J. ACCT. RES. 343 (1998) (arguing that proposed audit adjustments increase as the excess of book income over taxable income increases); Lillian F. Mills & Richard C. Sansing, *Strategic Tax and Financial Reporting Decisions: Theory and Evidence*, 17 CONTEMP. ACCT. RES. 85 (2000) (assessing the relationship between book-tax differences, audits, and probability that additional taxes will be collected); Eric M. Rice, *The Corporate Tax Gap: Evidence on Tax Compliance by Small Corporations*, *in* WHY PEOPLE PAY TAXES 125–61 (Joel Slemrod ed., 1992).

[139] *See* Kenneth L. Wertz, *A Book Income Tax: First-Order Computations*, NAT'L TAX ASS'N, 91ST ANN. CONF. ON TAX'N 314, 316 (1998) (noting that proponents of a "one-book" accounting method believe that it would result in lower transaction costs and less tax avoidance and concluding that the banking industry would have paid 18 percent more tax under a book-income tax than paid in 1993 under the regular corporate income tax).

[140] For these and other comments of a primary critic of the comprehensive conformity approach, see Calvin Johnson, *Comment: A Book Income Tax*, *in* NAT'L TAX ASS'N, 91ST ANN. CONF. ON TAX'N 319, 320 (1998) [hereinafter Johnson, *Comment*] (concluding that "[t]axing GAAP income . . . is likely to suppress valuable financial information" and arguing instead for a MTM tax on changes in stock prices). The recent revelations about the national mortgage giant Freddie Mac's significant understatement of its income through use of derivatives in order to present a less volatile earnings structure to the public is a good example of the danger in relying on financial accounting to ensure against manipulation to understate income. *See, e.g.*,

tax advantage of understated income would likely only exacerbate those already existing incentives.[141] Noting that the uneven treatment of tax preferences had discredited arguments for a comprehensive approach in the mid-1980s, Mitchell Engler proposed instead that corporate tax avoidance could be dampened through a more limited linkage not unlike the short-lived book-income preference under the AMT.[142] The expectation was that the requirement would play off the tension between management's desire to understate income for tax purposes and to puff income for financial statements to outsiders. The degree to which tax authorities can rely on this tension is uncertain if investors understand that financial statement income reflects a conservative position in order to garner tax rewards. A more innovative commentator suggested that for transactions such as synthetic leases, where corporations have benefited from tweaking the rules to get divergent book and tax treatment (i.e., rent deductions without recording debt for financial statement purposes, but interest and depreciation deductions for tax purposes), financial accounting should treat the transactions in accord with their tax treatment.[143] Rather than mandatory conformity, Treasury and Congress have thus far favored an increased emphasis on disclosure of sources of significant book-tax differences, backed by an enhanced penalty regime.[144]

John D. McKinnon & Patrick Barta, *Freddie Inquiry Snares Wall Street*, WALL ST. J., Nov. 18, 2003, at A3 (discussing Freddie Mac's estimated $4.5 billion understatement of earnings and the possible role played by Morgan Stanley and Citigroup in suspect transactions).

[141] Johnson, *Comment*, *supra* note 140.

[142] Engler, *supra* note 7 (suggesting that a comprehensive conformity approach — whether using book income as the tax base or treating it as the minimum tax base — would be problematic, but a more limited linkage for publicly traded corporations could curb corporate tax avoidance); *see supra* note 133 for a brief discussion of the AMT book-income preference.

[143] *See* Luppino, *supra* note 3. A synthetic lease is treated as a financing for tax purposes, so that an owner has interest and depreciation deductions, but as an operating lease for book purposes, resulting in no debt appearing on the tax owner's balance sheet.

[144] Treasury ultimately promulgated new corporate tax shelter regulations that mandate disclosure by corporations, material advisors, and promoters in respect of certain "reportable" transactions that are identified by selected triggers, one of which is the existence of significant book-tax differences. *See* T.D. 9046, 2003-12 I.R.B. 614 (finalizing corporate tax shelter regulations, including § 1.6011-4 requiring disclosure of participation in reportable transactions). *See generally Tax Risks*, *supra* note 4, at 249–54 (discussing the corporate tax shelter regulations). Congress then incorporated this approach to disclosure, with enhanced penalties, in the Code as part of the

F. Lessons from History

If the initial accounting rules under section 446 could at all be read in the first decades of the income tax as suggesting that book-tax conformity was a norm that should lead to the eventual comprehensive convergence of book and tax accounting, the history of attempts to achieve greater conformity demonstrates that comprehensive conformity was never a realistic choice.

Underlying most arguments for conformity was a normative assumption of identity between the net business income that was subject to reporting to shareholders and the income that was intended to be subject to taxation under the Sixteenth Amendment.[145] This assumption of identity disregards, among other things, the critical differences between tax and financial accounting objectives articulated in *Thor Power*.[146] Financial accounting's conservatism, which tends to accelerate deductions and defer inclusions, moves the net income determination substantially away from the ideal Haig-Simons base and towards a significantly understated income determination for tax purposes.[147] The assumption of identity between business and taxable income also ignores specific differences commanded by particular tax rules that provide economic incentives or disincentives, such as the exclusion of gifts and tax-exempt interest from income or the denial of deductions for lobbying expenses. In particular, it disregards the importance of annual accounting of a taxpayer's ability to pay for tax purposes. The similarity between

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American Jobs Creation Act of 2004. *See supra* note 5.

[145] *See, e.g.*, Nolan, *supra* note 93, at 767 (arguing that "[t]he Sixteenth Amendment authorizes a tax on 'income' without apportionment, and for a business taxpayer, this means *net* income, a concept which accounting standards are designed to measure").

[146] *See supra* note 129 and accompanying text.

[147] The FASB's financial statements continue to argue for a conservative approach, though noting that conservatism must be "applied with care" to avoid too strong a bias either towards revenue recognition or towards deferral. *See* QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFO., Statement of Financial Accounting Concepts No. 2, ¶¶ 92, 91–97 (Financial Accounting Standards Bd. 1980). A recent article on accounting-based valuation models emphasizes that there are three different categories of conservative accounting: (1) selection of conservative accounting policies and methods at the outset of a project, (2) use of historic cost rather than present value of expected profits, and (3) delayed recognition conservatism (asset impairment and other bad news is booked immediately, but improved business environment and other positive news is delayed). *See* Gordon Richardson & Surjit Tinaikar, *Accounting Based Valuation Models: What Have We Learned?*, 44 ACCOUNTING AND FINANCE 223, 229 (2004).

financial statement and tax income is thus a forced one, viable only at the level of abstraction where both systems purport to tax net business income.

The tax treatment of prepayments, the most prominent example of intentional divergence between financial and tax accounting, provides an important lesson regarding the coherence of the tax system. In a system that taxes income rather than consumption, investment earnings must be taxed. The combination of realization and time-value-of-money principles do not permit either deferral of income inclusions until "earned" or acceleration of expense deductions prior to economic performance.[148] Although the timing result in a realization regime may be overtaxation (compared to an optimal full accretion taxation) of those required to include prepayments and not permitted to deduct the present value of related future costs currently, overtaxation is preferable to undertaxation because of the ability of taxpayers to manipulate the structuring of transactions.[149] The enactment and immediate repeal of broad conformity provisions for prepayments, followed by congressional passage of limited prepaid subscription and prepaid membership dues provisions and the economic performance test of section 461(h) for deductions, affirmed these principles and upheld the unique structure of the tax system.

In spite of these significant substantive differences between the tax and financial accounting regimes, proponents of conformity relied on a number of primarily pragmatic arguments. They insisted that the discipline of the accounting profession and the familiarity of accountants and businesspersons with financial accounting principles would benefit tax accounting. Tax rules would be simpler if there were no special tax accounting rules. Consistency of tax and financial accounting would show that the accounting was both correct and fair, leading to "[g]reater confidence in the integrity of our tax system."[150] This concept of fairness, of course, has little relevance to the "ability to pay/benefits received" concepts generally accepted as relevant for

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[148] MTM accounting, of course, removes the realization requirement and thus can appropriately incorporate time-value-of-money principles by taking the present value of expected deductions (i.e., probability-weighted expectations) into account in determining the current mark. *See infra* note 173 and accompanying text (discussing the Cary Brown yield exemption theory).

[149] *See* Evans, Multi-Period Projects, *supra* note 104, at 1195–96 (discussing the relevant preference for overtaxation compared to undertaxation, given the ability of taxpayers to arrange transactions to minimize overtaxation).

[150] Nolan, *supra* note 93, at 768.

tax. Instead, fairness in accounting appears to be more of a procedural notion – an accounting result might be said to be fair as long as the financial statement numbers that it produces are "relevant " (to the purposes of financial reporting), "reliable" (in that they do not misrepresent the entity's business status), "consistent" (in that they do not involve ad hoc processes that vary from time to time), and "material" (in that they relate to items that make a difference to investors, without too much detail about *de minimis* concerns).[151] This concept, and its reliance on subjective judgments and flexibility for particular entities to use methods most convenient for them, downplays substantive fairness (i.e., the notion that there is a single right result, a right amount of taxable income for this taxpayer as compared to other taxpayers that may be similarly or differently situated). Furthermore, in the case of MTM accounting, dealers insisted that there simply was no feasible method for their type of business other than that used for financial accounting.

Financial accounting attempts, at heart, to describe income consistently over time, so that investors and creditors can follow the performance of one enterprise over time. Errors in precise measurement of income at any point in time are of less consequence than errors in consistency of reporting of income across time periods. Even in the modern use of financial statements to compare relative performance of different companies, consistency over time in the way the companies' reports are prepared retains considerable importance. Tax accounting, on the other hand, attempts to measure income accurately at each relevant period in time and for each taxpayer. Thus, consistency of results in spite of errors does not satisfy this tax accounting standard.

The experience with LIFO inventory accounting, the most prominent example of required conformity, directly challenges these pragmatic arguments for conformity. First, even with a mandatory booking requirement, it is at best difficult and likely impossible to *maintain* a consistent one-to-one correspondence between a particular tax and accounting rule, even if there is consistency at the outset, due to the different needs of the two systems. LIFO reporting for tax is distinct from LIFO reporting for book purposes, and non-LIFO reporting may be used for a variety of book purposes.[152] The many

[151] *See, e.g.*, QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFO., Statement of Financial Accounting Concepts No. 2, ¶¶ 46–132 (Financial Accounting Standards Bd. 1980) (discussing these key concepts).

[152] *See supra* note 83 and accompanying text.

differences between LIFO for tax and LIFO for book purposes undercut any enhanced perception of accounting correctness due to conformity, and hence also undercut the possibility of achieving greater fairness through conformity, even applying the accounting concept of fairness. In fact, the many variances between LIFO tax accounting and LIFO as it is used for financial reporting have resulted in two similarly labeled but substantially different accounting methods with all of the requirements of multiple tracking systems that two different systems entail.

Second, a mandatory booking requirement exerts pressure on accounting professionals to adapt accounting standards so that taxpayers may benefit from advantageous tax accounting.[153] As the history of LIFO accounting rules demonstrates,[154] LIFO accounting became widely accepted for accounting purposes only *after* the institution of the mandatory booking requirement for tax use of LIFO. Accountants essentially bent over backwards to find ways to use LIFO accounting because of the tax advantages it provided. In this case, conformity again did little to increase perceptions of either outcome correctness or outcome fairness. In fact, businesspeople's awareness of this historic interaction between financial accounting and tax treatments likely reduced, rather than enhanced, confidence in the integrity of both the tax and the financial accounting systems.

These historical observations carry some insights for tax administration. Generally, they suggest a cautious approach to conformity requirements that looks carefully at the very different objectives, concepts of fairness, allowances for flexibility, and potential for decreasing reasonableness over time as financial accounting measures diverge from tax accounting measures. Any conformity proposal must resolve the question of whether tax accounting rules will change or remain frozen in time as financial accounting rules metamorphose in accordance with the development of the accounting profession, regulatory changes in emphasis, and quantitative finance developments. Specifically, they suggest a need to de-emphasize the pragmatic considerations of easing taxpayer burdens and administrative tasks in order to focus on the primary objectives for tax accounting rules. At the same time, they suggest that the ability of conformity with financial accounting to introduce discipline (because the taxpayer's incentive to puff income for financial statement purposes counteracts the taxpayer's willingness to

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[153] *See, e.g.*, Arnett, *supra* note 82, at 490–91.

[154] *See supra* notes 82–83 and accompanying text.

use accounting rules to understate income for tax purposes) is limited, at best. The following Part will turn to these issues in considering what features should be paramount in evaluating a conformity proposal.

III. NORMATIVE AND PRAGMATIC CRITERIA FOR EVALUATING CONFORMITY PROPOSALS

The arguments reviewed in Part II appear weighted against conformity due to the difference in objectives and degrees of flexibility of tax and financial accounting, but no clear standard emerged from the many discussions by which to decide what arguments should hold sway in particular circumstances. The question is whether it is possible to construct an appropriate set of criteria for deciding the value of a conformity proposal in any particular instance. Those criteria must recognize the different objectives of tax and financial accounting, the considerable flexibility generally permitted in financial accounting, financial accounting's lack of a concept of fairness equivalent to the tax concept, and the potential for distortion of tax and financial accounting when one system determines the results in the other system.

As any introductory tax text makes clear, the three concerns traditionally considered determinative of tax policy are fairness, efficiency, and simplicity.[155] Like most abstract moral or philosophical issues, fairness in the context of tax regimes depends on a highly nuanced understanding. Many tax commentators suggest that a tax proposal's fairness should be measured in terms of taxpayers' ability to pay —itself a nuanced concept. It is generally assumed that similarly situated taxpayers should be taxed similarly, a requirement termed "horizontal equity."[156] Stated more broadly, horizontal equity can be viewed as creating a minimal benchmark for a distributively just system by favoring tax provisions that do not add to inequality among taxpayers. That concept of fairness is arguably weak, however, since a tax system that merely collects its revenues by maintaining the status quo between taxpayers can do little to further distributive justice.

Progressive measures (such as the progressive rate structure in the federal income tax) that are intended to tax more heavily those who have a greater ability to pay (and likely receive a disproportionately

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155 *See, e.g.*, MICHAEL A. LIVINGSTON, TAXATION: LAW, PLANNING, AND POLICY xxxiv–xxxix (2003) (discussing fairness, efficiency, and simplicity as "three principal criteria for evaluating a tax system").

156 *See id.* at xxxv–xxxvi (discussing horizontal and vertical equity).

larger share of the benefits created by governmental institutions)[157] serve distributive justice by achieving some level of redistribution that reduces inequality, thus enhancing fairness through what is generally termed "vertical equity."[158] This redistributive principle underlying concepts of fairness is, in my view, of utmost importance, since tax is the primary means by which government can redistribute resources. Redistribution, in turn, is essential in a democracy, where unequal distributions of wealth lead to accumulation of status and power that make consensus decision-making unlikely or impossible and create second-class citizens without equal access to opportunity or a fair share of tangible and intangible resources.[159] Thus, tax provisions

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[157] A thorough discussion of the "benefits received" concept of fairness is beyond the scope of this Article. Academic scholars have, however, returned to the concept as an important way to justify the need for a progressively redistributive tax system. *See, e.g.*, Deborah Geier, *Time to Bring Back the "Benefit" Norm?*, 102 TAX NOTES 1155 (Mar. 1, 2004) (responding to Herwig Schlunk's defense of the corporate tax by endorsing the concept of benefit received as an aspect of tax fairness); Herwig J. Schlunk, *Double Taxation: The Unappreciated Ideal*, 102 TAX NOTES 893 (Feb. 16, 2004) (discussing taxpayer-funded benefits received by corporations as a justification for the corporate tax); Jeff Strnad, *Periodicity and Accretion Taxation: Norms and Implementation*, 99 YALE L.J. 1817 (1990) (discussing benefits received as one of the prime concepts of tax fairness).

[158] An in-depth discussion of these issues is available in the dialogue between Louis Kaplow and Richard A. Musgrave on horizontal and vertical equity, as well as in more contemporary commentary on the need for an external moral anchor for understanding tax fairness. *See, e.g.*, Richard A. Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (Nov. 1967) (arguing that horizontal and vertical equity are aspects of a single fairness measure); Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139 (1989) (arguing that vertical equity is the appropriate fairness measure because focus on horizontal equity merely preserves the status quo); Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113 (1990) (reconsidering his conclusion that horizontal equity is derivative of vertical equity); Louis Kaplow, *A Note on Horizontal Equity*, 1 FLA. TAX REV. 191 (1992) (disputing the independent importance of horizontal equity); Richard A. Musgrave, *Horizontal Equity: A Further Note*, 1 FLA. TAX REV. 354 (1993) (restating the case for horizontal equity); Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607 (1993) (concluding that normative content can only be derived from economic or philosophical (justice) theories); Strnad, *supra* note 157 (suggesting that four primary norms support accretion taxation: reducing disparities in wealth (a fairness norm), taxing intangible benefits from holding wealth (a fairness norm), conforming to the Haig-Simons ideal income tax base (a fairness and efficiency norm), and structuring a "neutral" tax system that does not favor one type of investment over another (an efficiency norm)).

[159] Reuven Avi-Yonah is perhaps the strongest proponent of this role of redistribution in protecting the well-being of society and in possibly preventing social unrest and potential revolution. *See* Reuven S. Avi-Yonah, *Tax Stories and Tax*

should generally not be permitted to undercut equity concerns, and any that do should be based on an explicit substantive rationale that has been overtly found to override the fairness criteria.

In contrast, economists tend to emphasize efficiency, which measures economic reasonableness, as the appropriate goal of tax. As a normative standard, efficiency generally asks whether a proposed tax distorts allocative decisions, compared to a hypothetical tax-free market, by favoring one form of investment over another.[160] Given a particular tax base (e.g., a Haig-Simons income tax),[161] an efficiency analysis considers whether a particular tax provision taxes income neutrally. Under this criterion, the exclusion for meals and lodging provided for the convenience of an employer under section 119 is distortive, since it draws a line between types of employment that permit such exclusions and those that do not. As a result, it likely encourages potential employees to accept hotel employment over other employment. In spite of the apparent clarity of such examples, efficiency determinations are not absolute, both because of the hybrid nature of the overall tax structure (realization with accretion subregimes; modified Haig-Simons income tax with consumption tax subregimes) and because of the clearly different tax-expenditure rationales for particular provisions.

Nor can we be sure ex ante of the efficiency results of a particular tax provision. The incidence of tax may be shifted away from the purported bearer, and tax measures may generate unforeseen pushes and pulls on the economy. The other role for efficiency is therefore a pragmatic one of evaluating particular tax-expenditure provisions that are in fact intended to distort behavior to see if the actual incidence of tax is as intended. For example, a subsidy for an extractive industry may be intended to have a nonneutral effect of shifting the industry towards discovery of new mineral beds. If the subsidy merely results in taxpayers rearranging activity in which they are already engaged so

Histories: Is There a Role for History in Shaping Tax Law?, 101 MICH. L. REV. 2227, 2237 (2003) (condemning "sterile fights about supposedly neutral terms like the social welfare function or vertical equity" in favor of a politically and historically sensitive defense of redistribution).

[160] *See, e.g.*, David A. Weisbach, *A Partial Mark-to-Market Tax System*, 53 TAX L. REV. 95, 98–99 (1999) (discussing efficiency as a tax design criterion); JOSEPH M. DODGE et al, FEDERAL INCOME TAX: DOCTRINE, STRUCTURE, AND POLICY 127–31 (3d ed. 2004) (discussing the concept of economic efficiency).

[161] *See* Robert M. Haig, *The Concept of Income — Economic and Legal Aspects*, *in* READINGS IN THE ECONOMICS OF TAXATION 54 (Richard A. Musgrave & Carl S. Shoup eds., 1959); HENRY C. SIMONS, PERSONAL INCOME TAXATION 61–62, 206 (1938).

as to satisfy the bright-line requirements for the subsidy, it is inefficient because it results in a deadweight loss (less revenue for the government, no new exploration activity by the industry). This is a consequence of the way incentives play out pragmatically, where other influences may counterbalance the particular provision, rather than in an ideal laboratory.[162]

The third criterion frequently mentioned by tax analysts is simplicity.[163] Simplicity is an essentially pragmatic concern.[164] Given the necessity for tax revenues to fund government activities, and the reality of different taxpayers with varying levels of wealth and income in different categories of productive activities, a considerable degree of complexity in tax rules is inevitable. Simplicity comes into play whenever there is a possibility of removing a categorization from the tax laws, such as eliminating the current distinction between capital and ordinary income. Reducing complexity at the cost of fairness or efficiency, however, is less justifiable for rules that primarily affect sophisticated taxpayers (generally, those taxpayers with greater wealth and access to professional tax advisers). Simplicity should therefore be most decisive as a criterion when there is a choice between two alternatives for implementing a particular tax policy that are roughly equivalent on fairness and efficiency grounds. Otherwise, simplicity should be taken into consideration to remove complicating particulars of a proposed tax provision only if there is a *de minimis* negative impact on the fairness and efficiency of the provision or if the tax provision is one that bears directly on the tax treatment of ordinary, unsophisticated taxpayers.

This view is not likely to be a mainstream position at this time. There has been a stream of commentary over the last decade decrying the complexity of the Code and treating simplification as an important goal that should be considered very high in priority.[165] The best of

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[162] *See, e.g.*, DODGE, *supra* note 160, at 131–34 (discussing tax subsidies and incentives).

[163] *See* LIVINGSTON, *supra* note 155, at xxxiv (discussing fairness, efficiency, and simplicity as "three principal criteria for evaluating a tax system").

[164] Some commentators treat simplicity issues that reflect questions of administrability as subcomponents of efficiency concerns. *See, e.g.*, Weisbach, *supra* note 160, at 98.

[165] *See, e.g.*, Gordon D. Henderson, *Controlling Hyperlexis — the Most Important "Law and..."* 43 TAX LAW. 177 (1989) (noting approvingly Bayless Manning's view of legal complexity as a significant problem); John A. Miller, *Indeterminacy, Complexity, and Fairness: Justifying Rule Simplification in the Law of Taxation*, 68 WASH. L. REV. 1 (1993) (claiming that "the proliferation of elaborate rules in federal tax law has reached a point of extremely burdensome complexity" and asserting that

these commentaries correlates tax complexity with the economic costs from compliance with complex rules, such as additional recordkeeping burdens, enhanced need to become sufficiently informed about tax rules to be aware when professional advice is necessary, and, of course, expenses of retaining third-party advisers such as lawyers, accountants, software experts, and financial planners.[166] Even so, simplicity may be treated as a per se good that should be placed in the forefront in all planning, without recognition of the interaction of simplification (which will tend to reduce the fine tuning of provisions) with fairness goals.

In essence, I am suggesting a hierarchy of principles for deciding among tax alternatives, with fairness at the top, efficiency in the middle, and simplicity at the bottom (at least in respect of provisions applicable to sophisticated taxpayers). Clearly, there will be conflicts between fairness and efficiency, and those will ultimately be decided in the political process based on current views of the merits. I argue that simplicity should not weigh against fairness in this debate, except in the case of provisions that apply to less sophisticated taxpayers.

A. Normative Standards

In evaluating a potential conformity provision, the two most important characteristics of the tax system that reflect these joint goals of fairness and efficiency are the structural coherence of the tax system itself and the system's self-assessment feature.

1. Structural Coherence

Structural coherence focuses on the integrity of tax structure as a system established by the tax rules taken in the aggregate.[167] The

no proof of the claim is required).

[166] *See, e.g.*, JOSEPH BANKMAN, WHO SHOULD BEAR TAX COMPLIANCE COSTS? (Stanford Law & Economics Olin, Working Paper No. 279, 2004) (noting that tax compliance costs for individuals and business may reach as much as $250 billion annually), *available at* http://www.ssrn.com/abstract=519783 (last visited Oct. 2, 2004).

[167] The concept of integrity is frequently cited as critical to the rule of law and forms the core of Ronald Dworkin's jurisprudential theory. *See* RONALD DWORKIN, FREEDOM'S LAW: THE MORAL READING OF THE AMERICAN CONSTITUTION (Oxford Univ. Press 1996) (describing a constitutional theory based on integrity whereby principles that are discerned to underlie a particular right must be given full sway to uphold other rights not previously understood to exist). I argue that integrity is also critical within particular domains of law, such as the tax law, and forms the necessary basis for any theory of statutory interpretation. In particular, modifications of the

system determines the items within it: like the tax concepts of "ownership" or "obligation," both "taxable income" and "clear reflection of income" are tax concepts that take their meaning from the full body of tax law (Code, regulations, administrative interpretations, and case law) and are necessarily distinct from financial accounting concepts of income or accurate accounting.[168] The context of the tax rules as an entire system provides additional meaning to a particular tax rule. Thus, both textualist interpretations of tax rules that focus on plain meaning without regard to the place of a provision in the overall tax structure and freewheeling interpretations based on a particular judge's approach disregard structural coherence. Structural coherence requires that the tax rules applicable to a particular taxpayer in a particular context take into consideration the overall structure of the tax system. Said another way, interpretation of a tax rule in a specific context must be consistent with the overarching principles that can be abstracted from the system of rules and cannot disregard that overall structure to yield an interpretation that contradicts the structure, unless the provision unambiguously requires such an interpretation. Thus, when commentators analyze a particular tax rule and conclude that one possible interpretation of the rule simply "makes no sense,"[169] they are

existing tax structure should be interpreted whenever possible to be coherent with the pre-existing tax law. A clear statement of intent to cause a paradigm shift should be required before an ambiguous provision is interpreted as causing such a shift. That is, only a provision that is clearly stated in a way that requires it to be unambiguously interpreted to be contrary to the overall structure should be interpreted against the norm created by the overall structure.

[168] Other commentators have emphasized the importance of understanding that the Code creates a structure that must be considered in interpreting any single provision. *See, e.g.*, Deborah A. Geier, *Textualism and Tax Cases*, 66 TEMPLE L. REV. 445, 459-60 (1993) ("'Structural' issues are those involving the fundamental definition of the tax base; they are those that implicate the very notion of 'income' under an income tax. In a very real sense, the theoretical construct that we call 'income' emerges as the end result of the entire collection of sections contained in the Internal Revenue Code. . . . The underlying definition of 'income' provides a structure within which interpretation must occur.").

[169] *See, e.g.*, DAVID SCHIZER, SCRUBBING THE WASH SALE RULES 35 (Columbia Law and Economics, Working Paper No. 242, 2004) (discussing an overinclusive application of the wash sales rules in section 1091(a) to short sales when a person closes a short sale at a loss and then decides to purchase additional stock as a long), *available at* http://www.ssrn.com/abstract=494323 (last visited Oct. 2, 2004). Incoherent results such as these are often interpreted out of the statute by tax practitioners, as Schizer notes, in reliance on sometimes stretched interpretations of relevant statutory language. That is, as the front line of statutory interpretation,

in essence coming to a conclusion about the structural coherence of the system.

This concept of structural coherence draws support from the burgeoning research on the role of legal institutions in shaping the operation of economies.[170] This area of scholarship considers both the effects of individual choices on institutions and the role that institutions play in the performance of political and economic systems. Douglass North defines institutions as "humanly devised constraints that shape human interaction"— i.e., the "rules of the game."[171] A system of taxation is clearly a formal institution, in that it is comprised of formal rules that constrain taxpayers by requiring them to track their economic activity in order to pay over certain amounts to the government and by providing incentives and disincentives for engaging in various economic and personal activities.

What are the principles revealed by a structurally coherent analysis of the federal tax system? One such overarching principle defines the base of the federal income tax. Deborah Geier refers to it as the "income tax value."[172] In brief, the income tax value recognizes that income, rather than consumption or savings, forms the base of the current federal tax system. Full taxation of income is therefore a fundamental characteristic, applicable except in those cases when the tax rules explicitly provide for consumption (or other) tax treatment. In this context the growing understanding of the time value of money has led to a better rationale for certain income tax provisions. The income tax value is implemented in a tax structure that is also constructed with a realization principle, at least in part because of liquidity and valuation concerns for ordinary, generally

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practitioners inadvertently encounter the potential effects of such a rule on a transaction, realize it "makes no sense" and seek an explanation, such as exclusive application of the wash sales rules to short sales under section 1091(e), that retains coherence. Commentators who propose the tightening (or loosening) of rules so that they better fit a doctrinal model suggested to make sense out of them are following a coherence objective as well.

[170] *See, e.g.*, DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (Cambridge U. Press 1990) (developing a theory of institutions and institutional change to explain the different performances of economies).

[171] *Id.* at 3.

[172] *See* Geier, *supra* note 104, at 26 (stating that "[t]he income-tax value stands for the proposition that consumption-tax treatment should not be allowed absent a clear indication by Congress that such treatment was intended or unless the income-tax value is outweighed by values of administrative convenience if the distortion is minimal").

unsophisticated, individual taxpayers. But in order to tax income and not just consumption, the tax rules tied to realization must take into account the time value of money. Realization (resulting in deferral of gains until disposition) is therefore accompanied by capitalization (deferral of related deductions until disposition), to ensure that premature deductions do not result in nontaxation of investment gains.[173] Prepayments are included in income, to ensure that earnings in respect of the prepayment do not go untaxed. Accordingly, in situations for which full accretion accounting is permitted (i.e., mark-to-market accounting under section 475, discussed in Part IV.A.2., below), only the present value of reasonably certain expected future expenditures should offset related current income inclusions.

Although structural coherence as I have presented it entails acceptance of an income base with explicit exceptions for tax expenditures, it is clearly not the case that the Code fully incorporates a particular economic concept of income such as Haig-Simons. The sum total of the Code provisions amounts to a concept of taxable income that is similar to Haig-Simons income in various ways but yet ultimately a unique, Code-determined concept, the particulars of which evolve in small ways as provisions are changed and in large ways (that might be termed paradigm shifts) when major reforms of

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[173] *See, e.g.,* Evans, Growing Trend, *supra* note 54, at 826 (noting that "[c]apitalization rules are traditionally understood in terms of 'matching' income with expense, and thereby avoiding the deferral of tax that occurs when the costs of producing income are deducted in advance of the recognition of such income"); E. Cary Brown, *Business-Income Taxation and Investment Incentives, in* INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300 (1948) (providing the seminal discussion of the yield exemption theory that holds under certain conditions that current deduction of an investment is exactly equivalent to exemption of the return from the investment); Robert A. Green, *Justice Blackmun's Federal Tax Jurisprudence*, 26 HASTINGS CONST. L. Q. 109, 124–40 (1998) (providing a detailed discussion of the logic of capitalization in a realization system). Recently finalized regulations on intangibles capitalization appear to be mistakes in this light in the name of simplification: they reverse the ordinary expectation of capitalization for expenditures having any long-lasting benefit by identifying an exclusive subset of categories of intangibles for which capitalization is required (in contrast to the Code's treatment of expenditures as capitalizable unless deductions are permitted), permitting deductions under a twelve-month rule, and permitting current deduction of overhead and employee compensation costs in connection with acquisitions. *See* T.D. 9107, 2004-7 I.R.B. 447, 448 (stating that "an amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the IRS publishes guidance requiring capitalization of the expenditure").

the Code are instituted. Difficulty with this particularization of the concept of "income as characterized by the tax system" causes some commentators to question the validity of "tax logic" based on legislative purpose.[174] Ultimately, the notion of case-by-case legal reasoning is not incompatible with the concept of structural coherence that I have set forth here. To express this concept existentially, coherence exists to the extent that legal authorities are successful in discovering it by weaving together the various texts and sub-texts of the Code to express a logical whole.[175]

A tax system cannot be structurally coherent if the subsystems within it can be gamed or combined in unintended ways to avoid tax liability. Thus, a corollary of structural coherence is the need for rules that prevent taxpayers from taking advantage of specific provisions in order to capture a gain at the expense of the government.[176] A rule disallows a deduction for interest expense incurred to purchase or carry municipal bonds, because the interest on the bond is excluded from income. Without the interest expense disallowance rule, a taxpayer could derive an arbitrage gain from the deduction and exclusion that turns a before-tax loser into an after-tax winner.[177] Similarly, a tax matching principle (not to be confused with financial accounting's matching principle) applies between taxpayers when timing differences would otherwise distort income and deductions: payments from an accrual taxpayer to a related cash-based taxpayer cannot be deducted until the recipient includes the payment in

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[174] *See, e.g.*, Green, *supra* note 173, at 146–51 (arguing that the Code itself cannot be the source of tax scholars' "tax logic" for determining the meaning of particular Code provisions but rather the (itself ambiguous) Haig-Simons economic definition of income is an "*external* yardstick against which the provisions of the Code can be evaluated and criticized" in a process of "practical reasoning").

[175] *See* Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151, 162 (1997) (suggesting coherence as a criterion for evaluating tax regimes and noting the possibility of either "global" or "local" coherence, where "particular portions of the regime reflect a consistent framework and purpose").

[176] Deborah Geier refers to this corollary of coherence as an "anti-tax-arbitrage value" that is reflected in the structure of the tax system. *See* Geier, *supra* note 104, at 25.

[177] *Cf.* KEITH C. BROWN & DONALD J. SMITH, INTEREST RATE AND CURRENCY SWAPS: A TUTORIAL 131 (Research Found. of the Inst. of Chartered Fin. Analysts 1995) (defining "arbitrage" in the *financial* market context as "[t]he opportunity to exploit *price* differentials on two otherwise identical sets of cash flows" and noting that "[i]n arbitrage-free financial markets, any two transactions with the same risks and expected cash flows should have the same price") (emphasis added). In the tax context, of course, arbitrage exploits *tax* differentials between transactions.

income.[178]

What particular concerns does structural coherence excite in considering accounting conformity requirements? Applying a structural coherence perspective demonstrates that conformity will never be reasonable in areas where financial accounting rules have results that run directly counter to tax values. For example, tax rules do not permit deductions for additions to reserves in respect of bad debts, except for the politically necessary grandfathering of small banks when the bad debt reserve rule was generally eliminated for larger institutions.[179] Elimination of bad debt reserve deductions maintains the income tax value in the context of a realization regime.[180] Financial accounting, however, reduces earnings for such reserves across the board as part of the broader matching of income and expenses to determine net income. The rule makes sense for financial accounting, because it satisfies the goal of presenting a prudent view of an entity's financial status and hence tends to discourage businesses from increasing issuance of credit to low-quality borrowers in order to puff book income for shareholders.[181]

Conformity provisions should also be rejected under the income tax value if they result in across-the-board application of financial accounting matching principles so as to result in nontaxation of investment earnings. In retrospect, this structural coherence requirement should be seen as the underlying rationale for the repeal

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[178] I.R.C. § 267(a)(2). *See generally* Roin, *supra* note 104 (discussing this tax matching principle).

[179] *See* Evans, Growing Trend, *supra* note 54, at 840–41 (noting that the deduction for bad debt reserves "violated mark-to-market principles by prematurely reflecting losses that had not yet occurred, and by accounting for assets (net of reserves) at values that were less than their true market value" while disregarding the ability of the taxpayer to compensate for any projected losses at the time of entering into the loan through regulation of the interest rate on the loan); *see also infra* note 376 (regarding section 166(c) repeal); John Hull, Miorela Predescu, & Alan White, *Bond Prices, Default Probabilities and Risk Premiums* (2004) (noting that the large difference between historical default probabilities and default probabilities implied from bond prices is due to the "extra return [bond traders build into their prices] to compensate for the market risks and liquidity risks they are bearing").

[180] An upfront deduction effectively exempts related earnings from tax. These principles are explained in an excellent article by Noel Cunningham. *See* Noel B. Cunningham, *A Theoretical Analysis of the Tax Treatment of Future Costs*, 40 TAX L. REV. 577, 584 (1985).

[181] *See, e.g.*, David Lenter et al., *Public Disclosure of Corporate Tax Return Information: Accounting, Economics, and Legal Perspectives*, 56 NAT'L TAX J. 803 (Dec. 2003) (noting difficulty of imposing conformity in areas such as bad debt reserves where tax and financial accounting are clearly different).

of sections 452 and 462 in 1955: those provisions inappropriately incorporated the financial accounting matching principle with resultant changes to the income tax value.

Furthermore, any conformity proposal that creates arbitrage options should be rejected, unless the arbitrage opportunity can be extinguished by concurrent changes to other provisions or the conformity requirement itself is subject to an anti-abuse safeguard.[182] Arbitrage opportunities are especially likely in areas where a hybrid system operates – e.g., where two separate tax sub-regimes coexist among parties to a single transaction. For example, the enactment in 1993 of the section 475 mark-to-market accounting provision for securities dealers created such an arbitrage option.[183] It permitted dealers to function as accommodation parties to end users in transactions where the accommodating party must include a gain. Since securities dealers are required to mark to market in any event, gain recognition in the transaction is not a burden, and they can accommodate with ease.[184] Congress is left in a quandary – repeal the mark-to-market rules that have now been in use for a decade or overhaul the various special rules for nondealer treatment of notional principal contracts and other financial instruments so that end users and dealers are not treated under separate tax rules.[185] Given the

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[182] Such an anti-abuse safeguard would have to be made a part of the conformity requirement itself, or else the courts would likely interpret the conformity requirement as specifically authorizing the abusive taxpayer's practice and find no room for exercise of the tax administrator's clear reflection of income authority under section 446(b). *See, e.g.*, Edward A. Morse, *Reflections on the Rule of Law and "Clear Reflection of Income": What Constrains Discretion?*, 8 CORNELL J.L. & PUB. POL'Y 445 (1999).

[183] *See* David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. CAL. L. REV. 1339, 1357–69 (2000) (noting this arbitrage problem for section 475).

[184] *See id.* Schizer gives an example related to the "second best" move towards partial adoption (for specified taxpayers in certain situations) of full accretion taxation. A corporate taxpayer who is not a securities dealer (termed an "end user") enters into a forward contract with a counterparty. If the counterparty does not mark to market and the end user wants to realize a loss by terminating the position, the end user must pay the counterparty a termination fee that reflects any tax the counterparty has to pay on the termination gain. When the counterparty is a securities dealer who marks to market, however, it must recognize any gain in the position whether or not there is an early termination. As a result, the dealer is indifferent to acting as an accommodation party in such transactions, and the end user should be able to realize the desired loss at a lower transaction cost. *Id.* at 1368.

[185] *See id.* at 1373–77 (suggesting that Congress could alternatively provide an anti-abuse rule to undo the benefit of accommodation transactions, forego such

general consensus that mark-to-market accounting more clearly reflects taxable income, it appears it would be preferable to overhaul the rules for financial instruments. Until some such change is accomplished, the tax system remains irresolvably incoherent at this interface.

2. Self-Assessment

A second characteristic of the tax system that is especially significant in considering accounting conformity provisions is the self-assessment requirement.[186] The public fisc depends in the first

"reforms," or modify the scope of the reform by, for example, requiring end users who enter into derivatives with a mark-to-market counterparty also to use mark-to-market accounting for the derivative, with valuation information provided by the counterparty).

[186] Self-assessment by wage earners (or in respect of certain dividends and other U.S.-source fixed or determinable, annual or periodic income of foreign taxpayers not excluded from the withholding regime) is of course less demanding because they are generally subject to withholding of taxes at the source. This distinctive treatment of wage earners compared to wealthy individuals and corporations reinforces the rate advantage enjoyed by those with income from capital rather than labor and, combined with a number of recent developments exempting specific types of investment earnings from tax, suggests that there is (or is developing) a fundamental distinction in the tax system between ordinary middle- and lower-income individual taxpayers and sophisticated wealthy and corporate taxpayers. It may be that most scholarly commentary, particularly in the area of book-tax conformity, is addressed primarily to issues that affect sophisticated taxpayers. It is they who hold considerable stock and bond investments and engage in tax avoidance transactions designed by their accountants, tax advisers, or bankers. Fairness and efficiency issues are different for ordinary taxpayers who are unlikely to have the flexibility to shift their consumption patterns in order to avoid tax or invest in exotic derivatives in order to shift the timing or character of their tax liability. Ordinary Americans in the middle and lower classes of income are also the ones for whom a theoretically sound Haig-Simons tax on imputed income and/or a full accretion tax would be most difficult to understand or to bear because of liquidity and valuation issues. Those issues are of much less importance to sophisticated taxpayers. It may be, therefore, that structural coherence should be viewed as an abstraction of the tax system that should be understood in detail *only* by looking at its two different contextual variants – the structurally coherent system of rules that predominantly affects ordinary taxpayers and the sub-domain of rules governing complex financial transactions of most interest to sophisticated taxpayers. Section 475 clearly belongs in the latter set of rules. Most of the time-value-of-money rules are of primary interest to sophisticated taxpayers. As evidence, REMIC issuers generally issue "retail" classes of interests without original issue discount (OID) in increments of $1000 for ordinary taxpayers, whereas sophisticated buyers purchase interest-only and principal-only interests that require complex OID calculations.

instance on the compliance of taxpayers with the rules for determining and reporting taxable income and paying the related tax liabilities. We rely on taxpayers to come clean about their taxable income, not to hide or understate it.

It is reasonable to assume that taxpayers can generally be expected to comply when they believe that the tax system itself is fair and/or they believe that their chances of being caught in noncompliance are fairly high. When audit rates are as low as they now are, the importance of taxpayers' fears of being caught as a restraint on cheating is lessened and the importance of taxpayers' perceptions that the system is fair is heightened. Ordinary taxpayers will likely judge the system fair if they believe that they will not be required to pay too much tax in comparison to other taxpayers. Generally, this condition will be satisfied so long as taxpayers with about the same income are required to pay about the same tax, and taxpayers generally do not believe that taxpayers with more income can easily evade their fair (and larger) share of taxes.[187] In other words, taxpayers contemplating whether to comply with the tax rules or to take a chance on being caught on audit in failing to follow an applicable rule are more likely to comply if they believe that the tax system is fairly and consistently applied across taxpayers. For that to hold true, taxpayers must comply without being able to manipulate their tax liabilities to avoid or evade their fair share of the tax burden.

The more the tax rules permit manipulation of reported tax items to result in a desired tax liability for a particular taxpayer, the less fair the tax system in general will appear to taxpayers. The less fair the system seems, the less confidence there can be that most taxpayers will comply with the requirements of the self-assessment system. Concepts of tax fairness in a self-assessment system therefore require that tax rules should respect an "anti-manipulation value" that helps to ensure that taxpayers pay taxes according to their ability to pay for the annual reporting period.

This anti-manipulation value is similar to, but distinct from, the anti-tax-arbitrage value posited by Geier[188] as a corollary of structural coherence. It is similar, in that taxpayers who can avail themselves of arbitrage opportunities can reduce their overall tax liabilities, just as taxpayers who can "massage" the numbers reported on a return can reduce their overall tax liabilities. The anti-tax arbitrage value,

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[187] This text is a very general statement of the "ability to pay" concept of fairness. *See supra* notes 156–159 and accompanying text.

[188] *See supra* note 172 and accompanying text.

however, guards against a taxpayer's ability to game the interface between two categories of rules: the section 265 disallowance for interest deductions on debt used to purchase or carry qualifying municipal bonds prevents taxpayers from gaming the system to get interest expense deductions related to interest income exclusions. The anti-manipulation value is in some sense a less nuanced concept. It guards against opportunities to manipulate numbers reflected on a tax return in self-help reduction of income tax liabilities.

One feature that provides a significant opportunity for manipulation is subjectivity. A tax rule that permits subjective determinations requires considerable tax administrator resources and time to validate the reasonableness of the determination. Even if administrative enforcement resources are available, there is no single right answer, and the taxpayer will more than likely prevail in most instances so long as there is any basis for the taxpayer's particular conclusion under the rule. Accordingly, in its 1985 proposals for tax accounting reforms, the Joint Committee on Taxation noted its concern that accounting methods may be easily manipulated by taxpayers and stated that clear reflection of income does not permit "a subjective 'best guess' of what might happen in a later period."[189]

This anti-manipulation disrespect for subjectivity is the basis for the current tax system's rejection of value added by a taxpayer's psychological attachment to a expensive artwork or other in-kind item donated to charity. Such donations require an objective appraisal of the item's fair market value to hypothetical buyers and not a subjective report of a taxpayer's sentimental view of value.[190] The

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[189] JCT ACCOUNTING REPORT, *supra* note 34, at 6, 7.

[190] Section 170(a)(1) imposes a general requirement that a charitable contribution deduction be "verified under regulations." I.R.C. § 170(a)(1). In connection with the passage of the Deficit Reduction Act of 1984, Congress required Treasury to promulgate regulations establishing appraisal requirements for deductions in respect of in-kind contributions in excess of $5000 for individuals, closely held corporations, and personal service corporations. *See* Deficit Reduction Act of 1984, Pub. L. 98-369 § 155 (July 18, 1984), *reprinted in* 1984-2 C.B. Vol. 1-199-203; H.R. Conf. Rep. 98-861, 98th Cong. (June 23, 1984), at 995-997, *reprinted in* 1984-3 C.B. Vol. 2, at 249-251 (indicating that "the conference agreement requires (by statutory provision outside the Code) that the Treasury Department must issue temporary or final regulations under section 170 . . . incorporating the substantiation requirements as set forth in this section of the conference agreement" and establishing qualified appraisal rules); Treas. Reg. § 1.170A-13(c) (setting forth requirements for appraisals); DEP'T. OF THE TREASURY, DETERMINING THE VALUE OF DONATED PROPERTY (2000), *available at* http://www.irs.gov/pub/irs-pdf/p561.pdf (last visited Nov. 13, 2004) ("The appraisal must give all the facts on which to base an

constraint against subjectivity also figures into the tax system's aversion to taxation of human capital or imputed income from leisure, where valuation is inextricably tied to the particular taxpayer's inherent capabilities, personality, and subjective determination of needs.

There are several examples of the anti-manipulation value in the history of tax accounting outlined in Part II. The Supreme Court in *Thor Power* found no room under the LCM inventory accounting rules for a merchant's subjective estimates of the reduction in value of its "excess" inventory, stating that "[i]f a taxpayer could write down its inventories on the basis of management's subjective estimates of the goods' ultimate salability, the taxpayer would be able . . . 'to determine how much tax it wanted to pay for a given year.'"[191] Another example is Congress's response to the sharp uptick in deductions for reserves in the brief time during the mid-1950s that sections 452 and 462 were applicable. Taxpayers were using the provisions to deduct subjectively estimated reserves that were far larger than had been expected – raising the tax cost of the provision to $1 billion a year instead of a few hundred million.[192] Congress promptly repealed the provisions to end the abuse.[193]

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intelligent judgment of the value of the property). *Compare* American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1418 (stipulating that the charitable deduction in respect of a car donated after December 31, 2004 is equal to the price that the donee actually sells it for at auction).

[191] *See* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 536 (1978) (citation omitted). Thor Power's president had justified one of the company's aging formulae based on his own personal experience of twenty years in manufacturing. *Id.* at 528 n.5. An imprecise alternative formula with arbitrary percentage writedowns was justified on the basis that "the company 'felt some adjustment of this nature was in order.'" *Id.* at 529. The Court found generally that

> [f]inancial accounting . . . is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. . . . Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health; but the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes.

Id. at 543.

[192] *See, e.g.*, Letter from G.M. Humphrey, Secretary of Treasury, to Jere Cooper, Chair of House Ways and Means Committee (Mar. 7, 1955), *reprinted in* H.R. REP. NO. 293, at 3 (1955); Johnson, *Comment*, *supra* note 140.

[193] *See, e.g.*, Knott & Rosenfeld, *supra* note 7, at 1056 (noting that Congress was concerned about revenue loss stemming from taxpayers' subjective determinations exaggerating reserve deductions as well as the negation of income tax values).

Like other aspects of the tax system, there are exceptions to the anti-manipulation value. Most obviously, tax rules that permit taxpayer elections that can have significant impact on tax liabilities are explicit exceptions to the anti-manipulation value. One result of the existence of elections is a corollary preference for overtaxation rather than undertaxation. That is, because a taxpayer can in some cases select the appropriate tax treatment, either by choosing the structure of the transaction to conform to the desired treatment or by electing among alternative tax treatments, the tax rules should tend to overtax rather than undertax.[194]

Although some subjectivity in the tax system is unavoidable, the "anti-manipulation value" guards against provisions that grant broad discretionary power to taxpayers to make significant determinations based on their personal preferences or estimations without substantial objective supporting evidence.[195] This is most obvious in the system's many requirements for objective support for a taxpayer position rather than merely subjective determinations. The tax system's reliance on independent appraisers to determine the value of a charitable deduction under section 170 demonstrates the irrelevance of self-serving, subjective estimation of values when taxpayers make contributions of in-kind items to charities.[196] Similarly, a real estate mortgage investment conduit (REMIC) cannot use a funds-available cap on interest rates as a device to avoid complying with the definition of a permitted variable rate for bonds issued by the REMIC. Whether a cap is such a device does not depend on the REMIC sponsor's subjective intent but rests on a facts-and-circumstances analysis that looks to objective evidence of the relation of the rate to the rate payable on mortgages held by the REMIC and historic trends in

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[194] *Cf.* Evans, *Multi-Period Projects*, *supra* note 104, at 1195 (suggesting that tax systems that may in some cases result in over-taxation are preferable to those that result in under-taxation, because of the ability of firms to minimize taxation by choosing the structure of their transactions).

[195] This is not to say that the tax system has no room for taxpayer judgments based on objective facts, and these may also be subject to abuse from taxpayers that push the boundaries too far. Some tax provisions inevitably include evaluative terms that require a taxpayer (and hence the Service or the courts on audit or litigation) to make a facts-and-circumstances determination as to whether the item or transaction falls within the provision. The nondeductibility of salaries that are not "reasonable" is one example. Reasonableness does not permit subjective determinations based on an idiosyncratic view of what is desirable. Yet salaried owners of closely held corporations have still managed to manipulate their salary figures to reduce the aggregate corporate and individual taxes.

[196] *See supra* note 190 and accompanying text.

rates.[197]

The anti-manipulation value is of special importance in considering conformity requirements. Tax accounting should be flexible enough to permit variation that corresponds to significant differences among industries,[198] but it should not be so flexible as to provide multiple ways of accounting for a particular item *within* an industry, if those different methods result in significant differences in tax liability.[199] Yet GAAP accounting generally permits considerable flexibility to businesses within a particular industry in deciding how to account for various items.[200] GAAP accounting may have its own

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[197] Treas. Reg. § 1.860G-1(a)(3)(v) (as amended in 1995); *see* JAMES M. PEASLEE & DAVID Z. NIRENBERG, FEDERAL INCOME TAXATION OF SECURITIZATION TRANSACTIONS 471–73 (3d ed. 2001) (discussing funds-available caps).

[198] *See, e.g.*, Treas. Reg. § 1.471-2(b) (as amended in 1973) ("inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business"); Rockwell Int'l Corp. v. Commissioner, 77 T.C. 780, 808 (1981) (expressing the same principle), *aff'd*, 694 F.2d 60 (3d Cir. 1982). The emphasis on "best accounting practice" can be read as an implicit acknowledgement that accounting may permit a variety of methods, but tax should respect only that practice that best suits tax accounting.

[199] Current administrative guidance promulgated under various Code provisions often fails to fully satisfy this anti-manipulation value, in that there are a number of regulations that explicitly permit a variety of methods of accounting by taxpayers who are otherwise similarly situated as participants in a particular industry. *See, e.g.*, Treas. Reg. § 1.461-4(d)(6) (as amended in 2004) (permitting economic performance in the provision of property to be determined when the property is delivered or accepted or when title passes). These situations are prime targets for reform to enhance structural coherence at the same time as eliminating self-help manipulability. Note that the existence of alternatives in the regulations has been a vulnerability when the Service has challenged taxpayers' subjective judgments. Tax administrators are not permitted to require uniform results in the face of regulations that fail to prescribe uniform methods. *See, e.g.*, Hospital Corp. of Am. v. Commissioner, 71 T.C.M. (CCH) 2319 (1996) (rejecting the Service's challenge to a "hybrid" method used by the petitioner and attempt to force the hospital to use accrual accounting for hospital inventories), *aff'd*, 348 F.3d 136 (6th Cir. 2003), *cert. denied*, 2004 U.S. LEXIS 5570 (2004).

[200] *See, e.g.*, DISCLOSURES ABOUT FAIR VALUE OF FIN. INSTRUMENTS, Statement of Financial Accounting Standards No. 107, ¶ 53 (Financial Accounting Standards Bd. 1991) (acknowledging that the generality of the guidance provided for computing fair values likely reduces comparability of those values across entities); *id.* ¶ 56 (acknowledging the variance in estimating fair values across entities); *id.* ¶¶ 59–60 (acknowledging that fair value estimations "require considerable judgment" and "sophisticated assumptions"); USING CASH FLOW INFO. AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS, Statement of Financial Accounting Concepts No. 7, ¶¶ 73–74 (Financial Accounting Statements Bd. 2000) (acknowledging that estimated measurements are "inherently imprecise" and require decisions about relevance and

ambiguities that make application to a particular context much less certain. GAAP accounting is admittedly not an exact science. Comparability of results from firm to firm is ultimately less important than consistency from year to year for a particular firm. GAAP accounting "tolerate[s] a range of 'reasonable' treatments, leaving the choice among alternatives to management."[201] This leeway for managerial discretion is, in fact, "viewed as a virtue of the system."[202] The tax system's tendency to rely on bright-line rules rather than the flexibility of managerial discretion has been categorized as a formalistic and unsatisfactory solution by tax practitioners who favor the easing of compliance burdens offered by conformity.[203] In other words, GAAP requires auditors to use subjective judgments to determine the best method to portray a particular firm's financial condition. Materiality, probability, and reliability of numbers are ultimately based on management and auditor judgments, within broad guidelines that stress conservatism in order to defeat management puffery.[204] Lenter, Shackelford, and Slemrod use pension accounting to illustrate the "considerable discretion" permitted under GAAP accounting compared to tax, for which a deduction is permitted at the

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reliability that will vary among accountants and situations); *see also* Arnett, *supra* note 82, at 492–93 (noting that accounting permits a "wide range of alternative practices" and that the term "'principle' has no operational content" because it must remain "flexible" and "change as economic conditions demand"); *Clear Reflection*, *supra* note 30, at 380–81, 390 (noting that GAAP tolerates considerable estimation and subjectivity, and that its principles are "essentially judgmental in nature").

[201] Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 544 (1979).

[202] Gil B. Manzon, Jr. & George A. Plesko, *The Relation Between Financial and Tax Reporting Measures of Income*, 55 TAX L. REV. 175, 179 (2002). *But see* Johnson, *Earned*, *supra* note 101, at 390 (noting that discretion also ill serves GAAP's objective of providing useful information to shareholders and creditors, and suggesting that GAAP should not permit deductions that "exceed historical experience or other objectively verifiable measures").

[203] *See, e.g.*, Memorandum from Cleary, Gottlieb, Steen & Hamilton, The Lessons of Bank One (May 6, 2003) (general informative memorandum to clients and others in which the authors label the Tax Court's approach as a "normative" one and contrast it with their preferred "commercial imperative" approach), *available at* http://www.cgsh.com/files/ tbl_s5096AlertMemoranda/FileUpload5741/14/40-2003.pdf (last visited Oct. 2, 2004).

[204] *See, e.g.*, *Thor Power*, 439 U.S. at 542 (contrasting financial accounting's conservatism with tax); Knott & Rosenfeld, *supra* note 7, at 873 (quoting the Financial Accounting Standards Board's *Standards of Financial Accounting Concepts No. 5*, ¶ 81, regarding "skepticism" of revenue prospects and a conservative approach that recognizes expenses and losses more easily than revenues and gains).

point that cash is contributed to the pension fund.[205] They note that using GAAP accounting to compute taxable income in this instance would "greatly increase firms' ability to manipulate their tax payments."[206]

In addition, GAAP accounting often permits a choice among a number of alternative calculations designed to address the same issue.[207] For example, GAAP currently permits securities dealers to value their inventory of physical securities using any one of the following methods: average of bid and ask prices;[208] bid price for long positions and ask price for short positions;[209] average of price quotations for the security; or a valuation based on a range of bid and ask prices considered to best represent the value of the security.[210]

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[205] Lenter et al., *supra* note 181, at 819 (noting that GAAP accounting for pensions assesses factors that are subject to considerable discretion, whereas cash pension contributions are tax deductible).

[206] *Id.*

[207] *See, e.g.*, USING CASH FLOW INFO. AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS, Statement of Financial Accounting Concepts No. 7, ¶¶ 5–7 (Financial Accounting Standards Bd. 2000) (discussing the earlier Concepts Statement No. 5 that established five measurement attributes – historical cost, current cost, current market value, net realizable (settlement) value, and present (or discounted) value of future cash flows – but noting that the Board has concluded in recent years that fair value is the valuation premise for most measurements, which may be represented in some contexts by historical cost, current cost, or current market value, but not by the latter two attributes earlier set forth); MARTIN MAYER, THE BANKERS: THE NEXT GENERATION 283–313 (1997) (discussing swaps and the power of banks to manipulate values, based on the alternative methods that they may use to value swaps, so that the instruments are more clearly "marked to model" than "marked to market").

[208] The bid price of a security is the price a dealer would pay to purchase that security. The ask price of a security is the price a dealer would ask from counterparties to which it hopes to sell the security. Ask prices are higher than bid prices, except in the unusual case when a dealer lowers its ask price in order to develop a customer relationship or for some similar reason.

[209] A dealer is said to be "long" a security when it owns the security and "short" a security when it does not own the security.

[210] NYSBA RESPONSE, *supra* note 17, at 4 & n.8; AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, AUDIT AND ACCOUNTING GUIDE: BROKERS AND DEALERS IN SECURITIES ¶ 7.02 & 7.08 (2003) [hereinafter BROKER-DEALER GUIDE] (requiring fair value measurement for physical securities and permitting the various alternatives listed in the text). Note that the one alternative that is not included in the list is using ask prices for long positions and bid prices for short positions. That alternative is taboo under the accounting profession's rules, because it would accelerate income and violate the basic principle of conservatism. The FASB has a current project on fair value measurement, for which it issued an exposure draft in June 2004. The Board has tentatively concluded that, when valuing assets and liabilities that are

Since ask prices are generally higher than bid prices, this means that dealers can exercise considerable control over the valuations presented.[211] Furthermore, when there are no listed prices, dealers can determine a fair value through a number of pricing methods, using a wide range of evidence to support the determination.[212] This is especially problematic when those physical securities are hedges of dealer positions in derivatives: most dealers value those hedge securities using the bid/ask method even though the positions hedged must be valued under the MTM method, resulting in a mismatch and probable deferral of income.[213]

Both of these discretionary elements – subjective judgments in respect of amounts to be reported and a range of clearly distinct alternatives for determining income in particular contexts – make GAAP accounting particularly susceptible to the kind of scandals that have rocked the accounting world in recent years, from Rite Aid to Enron and from WorldCom to Parmalat.[214] Enron's accounting

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traded in active dealer markets, long positions must be valued at bid price, and short positions at ask, rather than permitting use of the midmarket valuation that it had earlier determined to adopt. Financial Accounting Standards Board, Proposed Statement of Financial Accounting Standards: Fair Value Measurements ¶¶ 15-17 (Jun. 23, 2004) [hereinafter Fair Value Exposure Draft]; *see* Financial Accounting Standards Board, *Minutes of the November 19, 2003 FVM Board Meeting* 2–3 (Nov. 24, 2003) (indicating that the Board has reconsidered an earlier decision to require midmarket valuations and decided that financial instruments traded in active markets in terms of bid and asked prices should be valued by using bid prices for long positions (assets) and asked prices for short positions (liabilities)), *available at* http://www.fasb.org/board_meeting_minutes/11-19-03_fvm.pdf (last visited Oct. 2, 2004). However, the Board has also tentatively concluded that offsetting positions should be valued at mid-market prices. Fair Value Exposure Draft ¶ 17.

[211] *See SIA Response*, *supra* note 65, at 34 (noting that the AICPA guidelines "provide[] a certain degree of.flexibility in determining fair value"); *see also* Leslie Rahl, ABA Panel on Financial Instrument Valuation, American Bar Association Joint Fall CLE Meeting, Oct. 1, 2004, at 13–14 (indicating considerable variability of valuation methodology).

[212] *See, e.g.*, BROKER-DEALER GUIDE, *supra* note 210, ¶¶ 7.10–.14 (noting the need for estimates based on management's good faith and taking into account various factors such as volatility, anticipated future interest rates, and term). As noted by the SIA in their response to the ANPRM, "[t]hese methods include pricing by analogy to reliable quotations of similar financial instruments, pricing models, matrix pricing, and other formula-based pricing methods," though for derivatives the recommended approach is the "mid-market levels less specific adjustments" method approved by the Group of Thirty. *SIA Response*, *supra* note 65, at 35.

[213] *See* NYSBA RESPONSE, *supra* note17, at 26–27.

[214] *See, e.g.*, Linda M. Beale, *Developments May Lead SEC to Ban Certain Tax Services Under Sarbanes-Oxley Independence Rules*, 16 J. TAX'N OF FIN. INST. 5 (2003)

scandal involved a number of different problems (including abusive tax transactions), among which was its tendency to "assign[] unrealistic values to the ultimate transaction, which in turn inflated current period profits."[215] Although management's interest in inflating income to impress shareholders and attract other investors may restrain to some extent the use of accounting flexibility to reduce tax liabilities, it is not clear that this tension between inflating book income and reducing tax income is sufficiently strong to police a conformity proposal. In the context of conformity, managers and shareholders alike may be willing to accept lower financial values to achieve significant tax savings. Managers can develop other means to signal the profitability of the firm, especially if the conformity proposal does not take the form of a mandatory booking requirement. In the case of the accounting scandal at Freddie Mac, the giant real estate mortgage quasi-governmental financial institution, similar manipulation of accounting rules was used to *defer* recognition of billions of dollars of income in order to present a less volatile earnings picture for shareholders.[216]

These recent accounting scandals, and the increasing evidence of tax shelter advice that pushes the boundaries of abusive tax transactions based on a low risk of losing in the audit lottery game, raise red flags for *any* book-tax conformity proposal, in particular because accountants would be pressured to rationalize use of accounting principles that permit the greatest tax advantage.[217] They suggest considerable room for doubt that the tension between the desire to puff income for book purposes and the desire to lower income for tax purposes would be an adequate constraint on taxpayer manipulation of resulting income, especially in extraordinarily

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[hereinafter *Independence*]; *Tax Risks*, *supra* note 4 (discussing scandals); *Parma Splat – Europe's Corporate Governance*, ECONOMIST, Jan. 17, 2004 (discussing the Parmalat scandal).

[215] In re Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549, 622–23 (S.D. Tex. 2002). According to a former Enron trader, such manipulation of accounting "was very simple. You just tweaked the assumptions on different variables, which were changed to make the return higher." *Id.* at 623 n.58.

[216] *See, e.g.*, David S. Hilzenrath, *'Swap' Deals Shifted Profit to Later Years*, WASH. POST, July 24, 2003, at E01 (discussing the use of linked swaps by Freddie Mac's derivatives traders to push more than $400 million of profits from 2001 into later years). For a discussion of the link between accounting and tax problems, see *Independence*, *supra* note 214, and *Tax Risks*, *supra* note 4.

[217] *See, e.g.*, *supra* note 66 and accompanying text (discussing the lobbying pressure applied by the securities dealers industry to argue for conformity for their hedged business).

sophisticated areas in which only an expert few are fully knowledgeable about potential profits and costs related to a particular product. These scandals are of particular concern, therefore, to conformity proposals aimed at financial institutions, because of the role of such institutions in the recent scandals and because of the ready availability of financial expertise in those institutions.

Because of the anti-manipulation value, conformity with GAAP accounting should not be considered where GAAP rules permit widely divergent net income determinations depending on the taxpayer's subjective judgments about the best way to account for an item or its choice among equally viable alternative methods. At the least, the flexibility and discretion generally permitted under GAAP must be cabined by objective benchmarks, either because the particular GAAP provision has detailed requirements that provide sufficient safeguards or because the tax system imposes additional safeguards through adjustments to the GAAP method.

B. Pragmatic Concerns

There are a number of pragmatic reasons for extending conformity requirements to new areas of tax. If a tax rule can be made entirely synonymous with an accounting rule, without any adjustments at all, then the set of tax rules becomes extraordinarily simple for any taxpayer with a sophisticated accounting department to follow. The tax rule is merely "determine your tax liability by looking at your financial statement income and multiplying by the appropriate tax rate." The taxpayer would need to maintain only one set of financial records, and income determinations would apply for tax as well as financial accounting. The taxpayer could save any costs that would otherwise be associated with making separate tax determinations in the area of the conformity requirement in preparation for filing a tax return.

Conformity has similar practical benefits for the tax administrator. The role of the tax administrator during the audit process would be considerably simplified. The only check remaining for the tax administrator to perform on audit would be to determine whether the tax values reconcile with the values reported on the specified financial statement. If the answer were yes, and there were no reason to suspect fraud in preparation of the financial statement, then the tax query would end. Although current tax return information supporting this reconciliation is limited, the problem is remedied to some extent, at least for the largest corporate taxpayers, through a new and more detailed Schedule M-3.[218] Assuming the expanded Schedule M-3 is sufficiently informative, audits of areas where conformity is the rule could verify the reconciliation.

These practical benefits of conformity, however, may apply only on a theoretical level. Real world conformity requirements are seldom, if ever, so simple, as illustrated by the extensive LIFO regulations.[219] One of the most important pragmatic considerations that creates complications for conformity provisions is the choice of financial statement with which to conform and the specification of other business uses of the information that must be demonstrated before conformity is satisfied. In the short-lived AMT book income preference provision, there were extensive regulations specifying the selection of the "applicable financial statement."[220] A similar provision would likely be necessary for the potential section 475 safe harbor.[221] The Treasury Advance Notice of Proposed Rulemaking (ANPRM) regarding section 475 valuations suggests that the statement must be one that provides an "incentive to report values . . . fairly" and that there must be a "significant use" of those values in business.[222] In the case of public reporting companies, the statement filed with the SEC is the most obvious candidate; yet the preceding discussion suggests that even companies with a single SEC statement may find it possible to please shareholders about profitability while understating income in their SEC reports.

Where public reporting companies are also regulated by another federal or state agency, the determination of the appropriate document is even more difficult. A regulatory filing is likely to be different in significant ways from a reporting company financial statement. Regulators are often interested in different information. In the case of banks, regulators are particularly interested in ensuring that banks have adequate capital to support their lending activity.[223]

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[218] *See supra* note 6.

[219] *See supra* note 83 and accompanying text.

[220] *See* Treas. Reg. § 1.56-1(c) (1990) (providing a prioritized list of financial statements to be considered as the "applicable" statement for purposes of the AMT provisions).

[221] *See, e.g.*, *SIA Response*, *supra* note 65, at 12–13, 53 (discussing the reference to the AMT applicable financial statement provision in Prop. Treas. Reg. § 1.446-4, 56 Fed. Reg. 31,350 (July 20, 1991) (withdrawn), and suggesting that a similar hierarchy of documentation would likely be necessary under the proposed safe harbor).

[222] *See* ANPRM, *supra* note 11, at 23,633.

[223] *See, e.g.*, LEONID V. PHILOSOPHOV, BAYESIAN MULTI-PERIOD MODEL FOR ASSESSING CREDIT LOSS DISTRIBUTIONS VS. BASEL II MODEL 2-3 (Dec. 11, 2003)

In the case of utilities, regulators oversee the rates charged by the utilities to their customers, and information about a utility's income and loss is relevant to whether regulators will approve a rate increase, among other things. These concerns are significantly different from tax concerns of collecting revenues from taxpayers who are able to pay while they are able to pay. Accurate income determinations for regulatory purposes therefore likely do not correspond to accurate taxable income determinations.

For closely held companies that are neither required to file a report with the SEC nor required to produce audited financial statements to lenders, conformity with an unaudited financial statement may be the only choice. If that statement is not even filed with a regulator nor subjected to an independent audit, there is little reason to suppose that such a taxpayer has adequate incentive to report numbers fairly for any purpose, much less for tax purposes. On the other hand, for companies that are subject to overlapping regulation (e.g., federal and state, multiple state, or federal and foreign regulators), there may be multiple financial statements with varying information for which the taxpayer has at least some incentive to present numbers accurately, for the particular purpose at stake. Allowing taxpayers to choose which statement is the benchmark for tax, as suggested by the New York State Bar Association Tax Section in its report on section 475,[224] appears to directly violate the anti-manipulation value. Even if it were possible to establish a hierarchy of statements, it appears that the greatest thrust of the conformity incentive (the idea that the number reported is reliable or fair in some universal sense simply because it is subject to the check and balance of

(discussing Basel II procedures for assessing credit risk and capital adequacy based on maturity, loss given default, exposure at default, and probability of a client's default within one year and developing an alternative model), *available at* http://www.ssrn.com/abstract=478161 (last visited Oct. 2, 2004). For banks, the Office of the Comptroller of the Currency favors "valuation methodologies and income reporting that result[] in a bank's taking significant reserves, deferring income recognition, and using conservative carrying values for swaps" because of its role in "oversee[ing] the risk management systems" which reflects a "cautious bias." *Bank One*, *supra* note 12, ¶¶ 122, 123. *See generally* http://www.bis.org (last visited Oct. 2, 2004) (providing information on the Basel Committee on Banking Supervision and the New Basel Capital Accord).

[224] *See, e.g.*, NYSBA RESPONSE, *supra* note 17, at 11 (suggesting that there should be a conclusive presumption that any statement filed with the SEC or another similarly tasked federal, foreign, or state government agency will represent fair value, and that taxpayers should be able to choose which statement applies when there are different valuations on different statements).

being reported to, and monitored by, others) is removed by the existence of multiple and different statements. If anything, the existence of multiple valuations for various regulatory purposes merely demonstrates the ability of quantitative finance to tweak assumptions underlying valuations and derive valuations that suit particular purposes and are therefore fair for those purposes. Rather than giving credence to such valuations for taxable income purposes, the ability to manipulate numbers depending on the purpose for which they are used suggests a need for a separate taxable income determination. Indeed, if many taxpayers already regularly prepare more than one financial statement reflecting valuations determined using different methodologies, it must be asked why the need to perform a further separate calculation to determine the taxable income valuation should be viewed as an unreasonable exercise in duplication. The fact is that every industry operates at the crossroads of multiple systems and may be required to monitor its activities and report them for any or all of those systems.

What rationales, if any, support adjustments to the numbers reported on the financial statement when they are used for tax? If a conformity requirement means absolute conformity between tax and accounting, life is indeed simple. But there are significant consequences to absolute conformity, including the ability of financial accounting standard-setters to determine what counts as taxable income in that area of the tax law, not only for the present but also for the foreseeable future. Even if Congress or tax administrators are of the view that current financial accounting rules adequately address the issues that are relevant for determining taxable income such that conformity provides an acceptable result for tax purposes, they may begin to disagree when financial accounting rules develop beyond (or simply away from) their status at the time of adoption of the conformity requirement. None of the alternatives for handling conformity in that context are satisfying.

If tax rules simply incorporate whatever changes are made in financial accounting rules, there will likely be strong pressure on accounting standard-setters to adopt accounting rules that result in more favorable tax treatment. For example, deferral opportunities might be increased by undue emphasis on the financial accounting matching principle or the demand for substantial objective evidence before a taxpayer could take into account an anticipated profit margin. We are already at that stage in respect of exotic derivatives. As noted by the SIA in its response to the ANPRM, financial accounting rules do not currently permit dealers to take into account their expected profit margin on exotic derivatives for which there is no objective evidence beyond the transaction itself.[225] Similarly, the FASB's current fair value project proposes that items that are not offset should be valued conservatively, at the bid price. Applied to swaps, that would eliminate all current income until such time as the dealer enters into an offsetting swap. Again, while this is arguably the right answer for financial accounting purposes, it is clearly not the result intended when Congress passed the MTM measure to accelerate income recognition from swaps for tax purposes. Conformity in spite of changes in the accounting rules is therefore the wrong answer for tax purposes: its adoption for tax would merely encourage dealers to focus activities so that they can derive more of their profits from exotic products that are taxed more favorably than the more common derivatives. The tail would indeed wag the dog.

If, instead, the conformity requirement "freezes" the financial accounting rules (for tax purposes only) as they are at the time the conformity rule is adopted,[226] all semblance of simplicity — and of conformity — disappears the first time that any change is made in the accounting rule. In that case, taxpayers would be required to perform the "old" financial accounting analysis for tax purposes, and the "new" analysis for financial accounting purposes. There would likely be concurrent changes in the corollary requirements — i.e., the "tax-financial accounting result" would need only be used in some particularized position in a specific financial statement, and the "new" financial accounting number could be used otherwise. These, in fact, are the results that were observed with the LIFO mandatory booking requirement.

Furthermore, even if the accounting rule is not changed, taxpayers will inevitably continue to lobby the SEC and the Service for more beneficial, tax-reducing changes in the rules. For example, companies might argue to the Service for exceptions to the standard accounting rules to permit companies to determine present values of future cash flows using worst-case scenario determinations rather than probability-weighted expected value analyses or to permit them to

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[225] *See SIA Response*, *supra* note 65, at 41 (noting that "a dealer that enters into an exotic OTC derivative contract and that cannot satisfy the evidentiary standards of EITF 02-3 cannot book an immediate profit equal to its anticipated dealer spread").

[226] Freezing the financial accounting rules as of adoption resembles the Puerto Rican "mirror" tax code, which adopts the Internal Revenue Code of 1954, with adjustments as enacted after that date by the Puerto Rican legislature. Obviously, the resulting tax code is neither beast nor fowl, but a unique artifact with some characteristics of the 1954 Code.

exclude income for tax purposes as an economic incentive, even though the income is included for financial accounting purposes. They might ask the FASB to consider further types of deductible future costs that are currently not considered in determining financial accounting income. These are typical lobbying positions, and as likely to occur as not. Any such adjustments enacted into law would write complications back into the law in spite of the conformity requirement.

These pragmatic concerns may sometimes favor and sometimes disfavor conformity proposals. For example, stability of a tax or financial accounting rule generally makes the system easier to administer and both easier to understand and simpler for businesses to report. An area of financial accounting that has been stable and well understood over a long period of time, without significant innovation, appears to be a better candidate for conformity than one with significant current development of rules. If the financial accounting area is highly unstable, the underlying hypothesis for conformity is thrown into doubt. Changes could lead to a basic *inconsistency* of financial accounting in that area with tax principles. Once conformity is in place, however, habitual acceptance may make it difficult for tax policymakers to recognize that such a change has occurred (arguably the case with the extended life of LCM and LIFO accounting). In any case, industry pressure to retain the status quo may make it politically impossible to replace an outdated conformity proposal.

Pragmatic considerations suggest that conformity is also most appropriate for entities that are not subject to overlapping regulatory regimes. Even if answers to feasibility questions are relatively easy (because there is only one financial statement and the financial accounting rules have been relatively stable), the contribution to genuine simplification for the taxpayer will be minimal if the taxpayer does not use those same values for *every* significant non-tax business purpose. Those business purposes include, where relevant, compensation, bonuses, pricing, internal reports to managers and directors, risk management, reports to shareholders, use of stock for acquisitions, shareholder redemptions, and other business situations where valuation is important. In the case of valuations, pricing, internal profit analyses, and risk management are likely the most significant non-tax uses that should be coordinated if coordination is to provide credible support for the objective reliability of the ultimate numbers entered on the return. Furthermore, if taxpayers use inconsistent values for significant business purposes, it is likely that permitting taxpayers to utilize values for tax merely because they conform with a financial statement filed with the SEC would violate the anti-manipulation value.

These pragmatic considerations appear just as readily to weigh against conformity as to favor it. But the larger question is what should be the role of pragmatic concerns, whether pro or con, in making an initial policy decision in respect of a conformity proposal. I argue that the structural coherence and self-assessment values should form the basis for the decision, because they focus on essential values. Pragmatic concerns of administrative and taxpayer convenience should only be allowed to tilt the balance in those cases where conformity itself has a *de minimis* impact on structural coherence or self-assessment or where the taxpayers most affected by a particular provision are ordinary taxpayers who generally do not have the advice and assistance of sophisticated tax counsel.[227] That will generally be true only for financial accounting systems that are well established, transparent, and not directly in conflict with general tax accounting principles. Any other resolution places simplification of the tax system at undeservedly high focus.

The next Part explores these conclusions further in considering the advisability of a book-tax conformity safe harbor for dealer valuations of derivatives under section 475.

IV. EVALUATION OF SECTION 475 CONFORMITY PROPOSAL

Treasury's consideration of a proposal to conform the tax valuation of swaps under section 475 to the valuation used for financial accounting purposes is at least in part a response to vigorous lobbying on this issue. Securities dealers have been strong proponents of conformity. When Congress enacted the MTM method for securities dealers without a conformity provision, the SIA pressured Treasury to adopt a broad book-tax conformity provision through regulations.[228] Conformity arguments also underlie, directly and by

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[227] By ordinary taxpayers I mean those individuals at the middle income or lower wage scale who do not have large accumulations of wealth. Most sophisticated taxpayers are not troubled by complexity, in spite of the tax bar's perpetual whine to the contrary. Corporations and wealthy taxpayers simply hire tax advisers to figure out the best approach, and tax advisers are paid by the hour (at least) to take on the challenge of finding ways to take advantage of a complex set of rules.

[228] The influential SIA has written the government at least twice to propose a book-tax conformity methodology for swap valuations. *See SIA Urges IRS to Give Priority to Guidance on Mark-to-Market Requirements*, 2002 TAX NOTES TODAY 78-18 (Apr. 23, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 78-18)

implication, the positions taken in briefs filed in the *Bank One* case by the bank[229] and by various industry groups as friends of the court.[230] The industry's response to the ANPRM also strongly supports book-tax conformity.[231]

[hereinafter *SIA Proposal*] (reprinting SIA letter to the Service urging that the Service adopt an attached proposal developed by the SIA for book-tax conformity for swap valuations); *SIA Seeks Guidance on Valuing Securities Under Mark-to-Market Rules*, 2001 TAX NOTES TODAY 96-27 (May 17, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2001 TNT 96-27) (same); *see also supra* note 68. The SIA has also urged the government to undertake a test project using the industry resolution program to develop appropriate verification procedures for the book-tax conformity proposal. *See* Letter from Saul M. Rosen, Chair, Committee on Federal Taxation of the Securities Industry, to Alex Shojay, Internal Revenue Service (Apr. 29, 2002), http://www.sia.com/2002_comment_letters/pdf/MTM_Ltr.pdf (last visited Oct. 30, 2004) (asserting that book-tax conformity as verified under an issue resolution program would provide a "bias-free" valuation because there is "remarkable consistency . . . in the fundamental design" since derivatives dealers "apply the same accounting methodology to their OTC Dollar Derivative books" and "implement that accounting method in a consistent manner" even though each dealer has a proprietary valuation model with "its own unique details and inputs"). Note that this claim, winnowed to its essence, is essentially a statement that all swaps dealers start with some version of a midmarket valuation (i.e., the "same accounting methodology" that provides a "consistent" "fundamental design") in a climate where the bid-ask spread is very small due to strong competition. After releasing the ANPRM, Treasury did arrange to work closely in an advance issue resolution (AIR) project with a small group of industry participants. As of the writing of this Article, Treasury had indicated that it was pleased with the results and expected to release proposed regulations soon.

229 Brief for Petitioner, Bank One Corp. v. Commissioner ¶¶ 63–65, 120 T.C. 174 (2000) (Nos. 5759-95, 5956-97), *reprinted in Bank Argues Derivative Swap Valuations Were Reasonable*, TAX NOTES TODAY (Apr. 3, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit, 2001 TNT 64-38) [hereinafter referred to as *Bank One* Brief, with citations to the relevant item number or paragraph of the Lexis version]; Post-Trial Brief for Petitioner, Bank One Corp. v. Commissioner, 120 T.C. 174 (2001) (Nos. 5759-95, 5956-97) (available from the United States Tax Court Clerk's Office) [hereinafter, *Bank One* Post-Trial Brief]; Reply Brief for Petitioner, Bank One Corp. v. Commissioner, 120 T.C. 174 (2001) (Nos. 5759-95, 5956-97) (available from the U.S. Tax Court Clerk's Office).

230 *See supra* note 66.

231 *See, e.g.*, *SIA Response*, *supra* note 65, at 2–3 (calling the conformity safe harbor "the best means of establishing a streamlined, effective, and accurate process for auditing compliance with section 475" and "see[ing] no other workable alternative"); Letter from International Swaps and Derivatives Association, Inc., to the Internal Revenue Service, Re: Proposed Sec. 475 Book-Tax Conformity Safe Harbor 3 (Aug. 4, 2003) [hereinafter *ISDA Response*] (arguing that there are "compelling policy reasons" supporting a book-tax conformity requirement and that there is "no practical alternative"), *available at* http://www.isda.org (last visited Oct. 2,

This Part addresses these issues in light of the analysis of the key normative and pragmatic criteria for evaluation of conformity proposals. Subpart A addresses the issues involved in valuations of swaps and the typical practices in the security industry revealed in considerable detail through industry responses to the ANPRM. Subpart B provides a brief overview of the *Bank One* holdings on these issues. Subpart C assesses the book-tax conformity safe harbor proposal for valuations of swaps and concludes that it should be rejected. As an alternative, Subpart D proposes that Treasury prepare comprehensive valuation regulations and presents some preliminary suggestions for issues the regulations should address.

A. Valuation of Swaps

1. The Swaps Market

A swap is a contract between two counterparties in which the parties agree to an exchange of payments at specified intervals, where the amount of each counterparty's payment is determined according to the terms of the contract.[232] By far the most common and least complex type of swap (termed a "plain vanilla" swap) is a fixed-to-float interest rate swap by which counterparties agree to simultaneously exchange payments on set payment dates based on a specified notional principal amount that does not change over the term of the contract.[233] The amount of each party's payment is determined by a rate specified in the swap: one counterparty is

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2004).

[232] *See, e.g.*, Treas. Reg. § 1.446-3(c)(1)(i) (as amended in 1994) (defining a notional principal contract as "a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts"); *Bank One*, *supra* note 12, ¶ 12 ("A swap is a bilateral agreement obligating the parties . . . to exchange at specified intervals . . . cashflows ascertained from applying specified financial prices (e.g., interest rates, currency rates) to a specified underlying amount."). Because a swap counterparty may have an obligation to pay amounts under the swap on one or more exchange dates and at other times be entitled to receive swap payments, swaps cannot be classified permanently as either assets or obligations of a counterparty.

[233] *See, e.g.*, DAVID L. SCOTT, WALL STREET WORDS: AN ESSENTIAL A TO Z GUIDE FOR TODAY'S INVESTOR 374 (rev. ed., 1997). Vanilla swaps (at least those without collateral) are economically equivalent to a package of cash settled forward contracts. *See* New York State Bar Association, *Notional Principal Contract Character and Timing Issues*, 79 TAX NOTES 1303, 1305 (June 8, 1998) [hereinafter *NYSBA Swap Report*].

obligated to make a payment determined by a fixed rate, and the other counterparty is obligated to make a payment determined by a floating rate (typically, the London Interbank Offering Rate or LIBOR).[234] The rates in a market swap are generally set so that the net present value of the expected cashflows on each leg of the swap is zero upon initiation, assuming no defaults by either counterparty and of course disregarding the dealer's bid-asked spread.[235]

Benefits and detriments under a swap due to interest rate volatility (i.e., aside from any default losses) are symmetrical on any payment date. If interest rates have risen on that date relative to the market rates prevailing at the time the counterparties entered into the swap, the counterparty paying fixed payments under the swap benefits; that is, the fixed rate payor will be entitled to receive a floating rate payment that is larger than the floating rate payment it would have been entitled to receive on the date that the parties entered into the swap. Similarly, if interest rates have fallen, the floating rate payor will benefit; that is, the floating rate payor will be entitled to receive the same fixed rate payment it would have received in a rising market, but it will owe a smaller floating rate payment than it would have been required to pay on the date the parties entered into the swap. Swap agreements therefore typically provide for payments to be made on a net settlement basis whereby the party benefiting receives a net payment of the difference between the two payment amounts.[236]

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[234] *See, e.g.*, *NYSBA Swap Report*, *supra* note 233, at 1305–06 (describing plain vanilla interest rate swaps).

[235] *See* DAVID A.DUBOFSKY & THOMAS W. MILLER, JR., DERIVATIVES: VALUATION AND RISK MANAGEMENT 318 (2003) (indicating that "swaps are priced to be zero net present value transactions for both parties, except for a (typically) small profit for the swap dealer, created by the bid-asked spread"); ELIZABETH UNGAR, SWAP LITERACY: A COMPREHENSIBLE GUIDE 52 (1998). More exotic swaps, or off-market swaps, may have terms considerably different from these, including upfront payments or other nonperiodic payments. Most exotic instruments can be bifurcated and treated as some grouping of debt instruments and options. Further discussion of exotic swaps is beyond the scope of this Article.

[236] *See* FRANK J. FABOZZI, VALUATION OF FIXED INCOME SECURITIES AND DERIVATIVES 248–49 (3d ed. 1998). Netting is an important aspect of the valuation of swaps, because of the frequency with which a single securities dealer may hold multiple swaps positions opposite the same counterparty. Without netting, a dealer paying float under a plain interest rate swap that is required to make a payment during a rising market to a defaulting fixed rate counterparty would lose the entire amount of the floating payment. With netting, such a dealer would lose only the net amount paid (i.e., the excess of the floating payment over the fixed payment). "Close-out netting" of the various swaps under a master agreement permits a

There is no denying the commercial importance of swaps. A corporation or other end user may enter into an interest rate swap to lower its risk from interest rate changes when it issues floating rate bonds in the market by entering into an offsetting float-to-fixed swap with a dealer. The corporation effectively has created a fixed rate debt that protects it from interest rate changes.[237] In addition, the fixed rate is likely a lower rate than the corporation could have issued in the market directly, thus lowering its funding costs.[238] Assuming that the corporate end user does not use mark-to-market accounting and that the swap has the same term as the debt, it can integrate the two for tax purposes and be taxed as though it had issued fixed rate debt as well.[239] End users also use interest rate swaps to speculate on movements of interest rates over the term of the swap.[240] Because the float and fixed legs of a swap both have net present values of zero at inception (again, disregarding risk premia and other elements of dealer profits), a floating rate payor will benefit as net recipient of payments when interest rates decline, and a fixed rate payor will benefit as net recipient of payments when interest rates increase.[241]

Securities dealers, on the other hand, do not primarily use swaps to reduce funding costs, protect themselves from interest rate changes, or speculate on interest rate changes, although they may enter into swaps for such reasons on occasion (such as to hedge their positions). They generally serve as middlemen who stand ready to enter into a swap with an appropriate end user at any time.[242] They take either position in a swap, and in fact they often enter into offsetting float and fixed positions in matching swaps with different counterparties. In other words, they are like other merchants who profit from buying

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nondefaulting party to benefit from netting in respect of *all* of the relevant positions with a single counterparty upon that counterparty's default. This significantly reduces the nondefaulting party's loss.

[237] *See, e.g.*, UNGAR, *supra* note 235, at 24–29 (explaining use of swaps to lower borrowing rate and to hedge interest rate risk).

[238] This is particularly true of corporations with inferior debt ratings — they can issue floating rate bonds on the market more readily than fixed rate bonds that would lose value if interest rates increased. *Id.* at 24-25.

[239] *See* Treas. Reg. § 1.1275-6 (1996) (permitting integration of qualifying debt instruments with hedges when the combined cash flows mimic a fixed or variable rate debt instrument).

[240] *See* UNGAR, *supra* note 235, at 31–32.

[241] *Id.*

[242] "Notional principal contract dealers provide liquidity for the market by standing ready to enter into these contracts with any qualified party at any time." 1991 NPRM, *supra* note 68, at 31,350.

and selling goods in the market, except that they profit from the services they provide in facilitating transactions. They act as credit intermediaries and liquidity providers for end users and for other dealers who need to enter into a particular swap position to balance their swaps portfolio.[243]

The interest rate swap market has grown exponentially over the last decade, with over $24 trillion of U.S. dollar-denominated swaps outstanding in the second half of 2002.[244] A recent International Swaps and Derivatives Association, Inc. (ISDA) survey indicates that there were interest rate and currency swaps outstanding at the end of the first half of 2004 with notional amounts totaling more than $164.49 trillion.[245] More than a decade ago in 1993, the final year in question in the *Bank One* case, FNBC was the sixteenth largest swap dealer in the world, with $114.9 billion notional principal amount of swaps outstanding and a return on equity for its global derivatives products of 33.9 percent.[246] Needless to say, tax valuations for those swaps under mark-to-market accounting is a significant area that has garnered considerable attention.[247]

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[243] *See, e.g.*, *SIA Response*, *supra* note 65, at 7 (noting that derivatives dealers do not hold derivatives positions primarily for resale, but they "perform the same economic functions of merchandising and providing liquidity as do traditional dealers, by standing ready to enter into either side of a new derivatives contract with customers . . . [and] provide credit intermediation services"). Large dealers enter into a high volume of swaps and do not match each position with an equal offsetting position, as they did more routinely in the first years of interest rate swaps. They generally enter into positions in response to customer demand and maintain dynamic hedging of their overall portfolio.

[244] BANK FOR INTERNATIONAL SETTLEMENTS, OTC DERIVATIVES MARKET ACTIVITY IN THE SECOND HALF OF 2002 (2003), *available at* http://www.bis.org/publ/otc_hy0305.pdf (last visited Oct. 2, 2004).

[245] INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC., MARKET SURVEY (2004), *available at* http://www.isda.org/statistics/pdf/ISDA-Market-Survey-historical-data. pdf (last visited Oct. 28, 2004).

[246] *See Bank One*, *supra* note 12, ¶ 171.

[247] Anyone who doubts this statement need only consider the various associations that joined in filing the Amicus Brief in the *Bank One* case (including the SIA, the ISDA, and the Institute of International Bankers). *See supra* note 66. Also revealing is the lively exchange in TAX NOTES between Lee Sheppard and Edward Kleinbard. *See, e.g.*, Lee A. Sheppard, *News Analysis — The Bank One Case: Marketing to No Market*, 91 TAX NOTES 28 (Apr. 2, 2001) (comparing FNBC's lack of substantiation of its swap valuations to that of the performer George Cohan in an earlier day); Lee A. Sheppard, *News Analysis — Bank One: The Battle of the Expert Witnesses*, 91 TAX NOTES 720 (Apr. 30, 2001) (discussing the expert witnesses' testimony about credit risk and administrative cost adjustments for mark-to-market purposes); Edward D. Kleinbard, *Some Thoughts on Market Valuation of Derivatives*,

2. Valuation for a MTM Regime

The acceleration of recognition of income (or loss) under mark-to-market accounting compared to a realization regime in respect of a swap for which payments are expected over a period of years is illustrated in a simplified example in Diagram 1, assuming an income approach to valuation based on discounted future returns from participation in the swap (without many of the refinements of quantitative finance involving probability-weighted future cash flows).[248] Assume that an off-market swap is entered into in one

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91 TAX NOTES 1173 (May 14, 2001) [hereinafter *Some Thoughts*] (indicating that the "abstruse" issues of swap valuation can be understood as a simple exercise of applying the midmarket valuation method to determine the present value of gross income from a swap portfolio and then reducing that gross income stream to net income by subtracting "absolutely predictable costs"); Lee A. Sheppard, *News Analysis – Bank One: The Court's Experts Testify*, 92 TAX NOTES 163 (July 9, 2001) (explaining testimony in detail); Edward D. Kleinbard, *A Short Course in Valuing Derivatives*, 94 TAX NOTES 380 (Jan. 21, 2002) [hereinafter *Short Course*] (reiterating the claim that valuing a swaps portfolio is similar to valuing an ongoing business, except for goodwill); Lee A. Sheppard, *News Analysis – Bank One: Judge Laro's Third Way Accounting Method*, 99 TAX NOTES 786 (May 12, 2003) [hereinafter *Third Way*].

[248] For further description of expected value accretion taxation, see, for example, Fred B. Brown, *Complete Accrual Taxation*, 33 SAN DIEGO L. REV. 1559 (1996) (discussing three possible valuation methods for MTM taxation, including a market approach based on comparable sales, a cost approach based on replacement cost, and an income approach based on discounted future returns from ownership). This simplified example assumes an income approach with a zero discount rate. In actual practice, the discount rate should reflect the upward sloping term structure of interest that represents current uncertainty as to the direction and magnitude of future changes, as well as expectations of payment based on the creditworthiness of the counterparty. *See* Joseph Bankman & William Klein, *Accurate Taxation of Long-Term Debt: Taking Into Account the Term Structure of Interest*, 44 TAX L. REV. 335, 344–45 (1989). Quantitative financial analysis has refined the approaches for determining expected values of cash flows and in fact financial standard-setters have stated as a general concept that a projection of a "best estimate" is generally less appropriate than a probability weighted analysis. *See, e.g.*, USING CASH FLOW INFO. AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS, Statement of Financial Accounting Concepts No. 7, ¶¶ 32–38, 42–45 (Financial Accounting Standards Bd. 2000) (indicating a current conceptual preference for probability-weighted expected cash flow approaches to fair value over the "traditional" approach using a best estimate of most likely payment amounts and a single interest rate convention to capture the appropriate risk premium). Where future cash flows are uncertain (both as to timing and amount), an expected value approach would determine expected cash flows based on probabilities, including credit risk related to a potential default and market risk due to interest rate volatility, and discount those flows using a risk-free interest rate. For a discussion of the development of discounted cash flow

taxable year, so that there is a payment at inception of the contract. The swap is then terminated during the third taxable year when it is in the money, resulting in a termination payment to the counterparty that made the payment at inception. Income under the realization regime is recognized only in the third taxable year, upon termination of the swap. In contrast, recognition of income under the mark-to-market regime, based on the fair market value (determined as the present value of expected payments and expenses under the swap), is spread over the entire term of the swap.

DIAGRAM 1. COMPARISON OF MARK-TO-MARKET AND REALIZATION REGIMES*

EVENT OR YEAR			*MTM TI*	*REALIZATION TI*
Inception in Year 0	Cost at inception	10		
End of Year 1	FMV	11		
	Change	+1	+1	0
End of Year 2	FMV	12		
	Change	+1	+1	0
Termination	Termination payment	15		+5
	Change	+3	+3	
	AGGREGATE TI		+5	+5

*FMV = fair market value; TI = taxable income

Annual income or expenses that figure into the fair market value of the swap are taken into account under the ordinary accrual rules that would otherwise apply.[249] Done properly, this does not result in

analysis, see Edward W. Trott & Wayne S. Upton, *Expected Cash Flows*, 1 UNDERSTANDING THE ISSUES 2–3 (Financial Accounting Standards Bd. May 2001) (describing the older "traditional approach" as a "single set of estimated cash flows and a discount rate commensurate with the risk involved" in contrast with the "expected cash flow approach" based on probability-weighted cash flows), *available at* http://www.fasb.org/articles&reports/UI_vol1_series1.pdf (last visited Oct. 2, 2004); Financial Standards Accounting Board, *Minutes of the August 27, 2003 FVM Board Meeting* 2 (Aug. 27, 2003) (discussing the "expected present value technique" and the "discount rate adjusted approach (present value technique)" in connection with the fair value measurement project, and noting that probability-weighted cash flows may either be adjusted for systematic risk and then discounted at a risk-free rate or discounted using a rate that incorporates a risk premium), *available at* http://www.fasb.org/board_meeting_minutes/08-27-03_fvm.pdf (last visited Oct. 2, 2004).

[249] *See, e.g.*, *SIA Response*, *supra* note 65, at 6–7 (noting that "a dealer's annual net income from its dealer operations comprises (i) its mark-to-market gains or losses,

double-counting of either income or deductions: the fair market value of an item at the end of any taxable year reflects the expected stream of income and expenses in respect of that item over its remaining term.[250] The fair market value of a swap should decline after a payment has been received, resulting in a negative adjustment to income for economic depreciation for that year, all else being equal.[251] The decline in value and the payment offset each other, so that payment is effectively included in income at its present value in the year when it is first reflected in the mark and not in the year that it is actually received. A simplified example illustrating this relationship between the annual mark of a swap providing for a stream of payments and related expenses is set out in Diagram 2, below.

DIAGRAM 2. RELATIONSHIP BETWEEN MTM AND INCOME/EXPENSE*

YEAR	*PAYMENTS RECEIVED*	*EXPENSES PAID*	*FMV*	*CHANGE IN FMV*	*TI*
Year 0			[+50 at inception]		+50
Year 1**	+12	-2	+40	-10	0 (+12 -2 -10)
Year 2	+12	-2	+30	-10	0 (+12 -2 -10)
Year 3	+12	-2	+20	-10	0 (+12 -2 -10)
Year 4	+12	-2	+10	-10	0 (+12 -2 -10)
Year 5	+12	-2	0	-10	0 (+12 -2 -10)
			AGGREGATE TI		+50

*FMV = fair market value; TI = taxable income

**Assume the swap is entered in year one at no cost to either party but the taxpayer at acquisition expects net income of 50 from the swap over its term (assuming a zero discount rate to present value). Also assume that payments received under the swap and swap-related expenses are constant over the term.

This discussion has assumed that the value of the swap is readily determinable at inception and at the end of each taxable year. In the real world of securities dealers' mark-to-market accounting, however, not all items that must be marked to market are created equal. In

plus (ii) net cash returns on its mark-to-market assets, *less* (iii) related costs and expenses").

[250] *See generally* ROBERT A. JARROW, MODELING FIXED INCOME SECURITIES AND INTEREST RATE OPTIONS 150–57 (1996) (describing discounted expected cashflow method for determining value); *Bank One*, *supra* note 12, ¶¶ 82, 92–94 (discussing the standard expected cashflows analysis of market value in the swaps market).

[251] For further discussion of economic depreciation, see Cunningham, *supra* note 180, at 584.

particular, derivative positions that a securities dealer enters into with counterparties, such as swaps, options, or forwards, are considerably different from inventory securities such as stocks and bonds. Values of corporate shares, ownership interests in publicly traded partnerships, or corporate debt included in inventory are generally easily determined: they are assets of the holder that are intended to be sold or traded rather than held to term, and they are, in fact, frequently sold or traded on established markets at quoted prices. In contrast, a position in a swap agreement is generally held to maturity, is not readily tradable on an established market,[252] and may be either an asset or a liability to its holder at any point during its term depending on the volatility of interest rates and other factors and the corresponding directionality of the net payment requirement between counterparties.

a. Statutory and Administrative Guidance

Section 475 applies both to physical securities that are inventory in the hands of a dealer and to derivatives held at the close of a taxable year that are not inventory in the hands of the dealer. For the former, the section merely indicates that physical securities should be valued in inventory at their fair market value. The section applies a constructive sale mechanism for valuing swaps and other derivatives that are not inventory in the hands of a dealer, requiring a securities dealer to recognize gain or loss on derivatives contracts that come within the definition of "security" as though the security were sold for its fair market value on the last business day of the taxable year.[253] Interest rate and currency swaps are treated as securities for purposes of this constructive sale rule,[254] as are any dealer hedges of those

[252] In fact, an assignment of a swap documented under a standard ISDA form agreement generally requires the consent of the counterparty. *See, e.g.*, INTERNATIONAL SWAP DEALERS ASSOCIATION, INC. (N/K/A/ INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.), 1992 ISDA MASTER AGREEMENT (LOCAL CURRENCY – SINGLE JURISDICTION) 8 (1992), *available at* http://www.isda.org/publications/1992masterlc.pdf (last visited Oct. 2, 2004).

[253] I.R.C. § 475(a)(2). *But cf.* I.R.C. § 475(a)(1) (for stocks and bonds held in a dealer's inventory, requiring that those items be included in inventory at their fair market values as of the end of the taxable year, with no need for a constructive sale provision).

[254] I.R.C. § 475(c)(2)(D) (defining "security" to include any "interest rate, currency, or equity notional principal contract" but not swaps based on commodities prices). The elective mark-to-market regime for commodities dealers includes notional principal contracts as well as certain other derivatives in respect of actively

swaps.[255]

The statute provides little guidance, however, on the appropriate method of determining a swap's fair market value for purposes of the constructive sale. The section does not define "fair market value," nor does any other provision of the Code. Taxpayers have long relied on Treasury regulations promulgated under the charitable contribution provisions, which define the term as "the price at which the [relevant] property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."[256] A string of cases provide a judicial gloss on the term, including the recent decision in *Bank One*, in which Judge Laro focused on various elements of the fair market value definition as developed in administrative and case authorities to conclude that fair market value is the price at which an item, "valued at its highest and best use," would be exchanged between a hypothetical willing buyer and hypothetical willing seller, neither under any compulsion to engage in the exchange and both reasonably aware of all relevant contemporaneous facts but unaware of future events that are not reasonably foreseeable.[257]

Section 475 does provide some information that is relevant to valuations of swaps. First, it makes clear that the capitalization rules of sections 263(g) and 263A do not apply to swaps that are marked to market.[258] In the ordinary realization regime, those rules defer

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traded commodities. *See* I.R.C. § 475(e)(2)(B).

[255] I.R.C. § 475(c)(2)(F).

[256] Treas. Reg. § 1.170A-1(c)(2) (as amended in 1996); *see also* Treas. Reg. § 1.704-4(a)(3) (as amended in 1997) (partnership regulations); § 20.2031-1(b) (as amended in 1965) (estate tax regulations); § 25.2512-1(b) (as amended in 1992) (gift tax regulations); Rev. Rul. 59-60, 1959-1 C.B. 237 (similar). In addition, rules promulgated under section 471 explain the meaning of market for the "replacement cost" market valuation used for inventory lower-of-cost-or-market accounting. *See* Treas. Reg. § 1.471-4(a)(1) (as amended in 1993). Speaking at a D.C. Bar Tax Section meeting in late May, 2003, Bob Williams, special counsel to the associate chief counsel (financial institutions and products), suggested that there was "no reason to assume that the definition of fair market value for section 475 purposes means anything other than fair market value as it has been used in the past, . . . citing the standard of what a willing buyer would pay a willing seller." Sheryl Stratton, *Dilating Derivatives Guidance Requires Industry Input, IRS Says*, TAX NOTES TODAY (May 28, 2003) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2003 TNT 102-2).

[257] *See Bank One*, *supra* note 12, ¶¶ 354–59. *See also* Part IV.B., *infra* (discussing the Tax Court's consideration of the differences between fair value and fair market value components).

[258] I.R.C. § 475(d)(1).

otherwise accrued and allowable deductions by requiring capitalization of costs having a sufficient nexus to the production of tangible property and costs of acquisition of property acquired for resale.[259] The legislative history for section 475 explains that capitalization is not necessary, since fair market value encompasses those costs.[260] This is consistent with the general understanding of both capitalization rules and mark-to-market tax accounting as providing an appropriate means of ensuring that expenses are not taken into account in a way that results in illegitimate deferral of taxes — i.e., a *tax* principle of matching of income and related expenses.[261] Accordingly, when Congress enacted the uniform capitalization rules, it similarly noted that they were not intended to alter the then-current rules for valuation of inventories on a basis other than cost (e.g., market value, in lower-of-cost-or-market inventory accounting).[262] Treasury also addressed the interaction of mark-to-market accounting and the capitalization rules for inventory in the Preamble to the uniform capitalization rules. It indicated that the capitalization rules apply for *replacement cost* determinations of fair market value, but not for constructive sale determinations "where

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[259] *See* I.R.C. § 263(g)(1) (requiring that interest expense to purchase or carry a straddle position be capitalized); § 263A(a)(2) (setting forth the so-called "uniform capitalization rules" requiring that direct costs and the "proper share" of "allocable" indirect costs, such as compensation and quality control, be included in cost of goods sold for inventory property and capitalized as basis for noninventory property). The regulations under section 263A provide extensive guidance in respect of which types of indirect costs must be capitalized and how indirect costs are allocated to particular property. *See, e.g.*, Treas. Reg. § 1.263A-1(e)(3)(iii) (as amended in 2000) (listing indirect costs not capitalized, including selling and distribution costs, research and experimental expenditures, section 165 losses, income taxes, unsuccessful bidding expenses, and deductible service costs); § 1.263A-1(e)(4) (providing further information about capitalizable and deductible service costs); § 1.263A-1(f) (specifying cost allocation methods). *See also supra* note 173 (discussing recent capitalization regulations).

[260] H.R. REP. NO. 103-111, at 665 (1993).

[261] *See generally* Evans, *supra* note 54, at 825–33 (discussing the rationale and interaction of uniform capitalization rules with mark-to-market requirements and noting that "[c]apitalization rules are traditionally understood in terms of 'matching' income with expenses, and thereby avoiding the deferral of tax that occurs when the costs of producing income are deducted *in advance of* the recognition of such income") (emphasis added) (citations omitted). In other words, deferring deductions through capitalization rules "approach[es] a mark-to-market result with respect to the production of property" in a realization regime. *Id.* at 826. In contrast, a mark-to-market regime calls for the opposite balancing — acceleration of dealer spreads and related expenses (at present values).

[262] *See* H.R. REP. NO. 99-841, at II-305 (1986).

the market valuation used by the taxpayer generally equals the fair market value at which the taxpayer would sell its inventories to its customers less, if applicable, *only* the direct cost of disposition."[263] This authority may be relevant in considering the relevant market for valuing swaps and what types of adjustments for expected future expenses are reasonable in valuing swaps. It suggests that the constructive sale mechanism is meant to require taxpayers to determine values in the higher-value, retail market in which customers or dealers might purchase items, without either blockage discounts or control premia.[264]

Second, the literal terms of the statute mandate a single, specific time for valuation – the last business day of the taxable year.[265] Although Congress considered that there might be reasons for requiring or allowing other valuation dates, it left it to tax administrators to permit other valuation dates through regulations.[266] Treasury has not yet promulgated regulations under section 475 providing guidance on valuation issues, with the result that all dealers must value their noninvestment securities for tax purposes as of the last business day of the taxable year.[267]

Finally, the mark-to-market requirement appears to apply by the

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[263] T.D. 8482, 58 F.R. 42,198, 42,201 (Aug. 9, 1993) (emphasis added). This statement regarding replacement cost valuations comports with the regulations promulgated under section 471. Treas. Reg. § 1.471-4(a)(1) (as amended in 1993) (defining market as the aggregate prices of the direct and indirect elements of cost required to be included in inventory under the uniform capitalization rules, but indicating that valuations in inactive markets should be derived from information the taxpayer has about specific purchases, compensation paid for cancellation of contracts, or lower offering sale prices minus costs of disposition (if they do not vary materially from actual prices around the date of inventory)).

[264] *See, e.g.*, Post-Trial IRS Brief, *infra* note 355, Part III, at 442–611 (discussing the Service's position that the fair market value requirement of section 475 requires that swaps, like stocks and bonds, be valued using a mean-quotation method that looks at the weighted average of bid and ask prices among the full range of potential buyers and sellers, rather than confining the analysis to the interdealer market).

[265] I.R.C. § 475(a)(2)(A).

[266] I.R.C. § 475(a) (flush language, second sentence). The House Report made clear that the language was intended to permit regulatory exceptions to the year-end timing of the mark to market for noninventory securities. H.R. REP. NO. 103-111, at 661 (1993).

[267] Judge Laro relied on this requirement, among others, to find that Bank One's valuation method failed to satisfy section 475. *Bank One*, *supra* note 12, ¶¶ 377–79 (holding that section 475 requires valuation on the last business day of the taxable year and finding that the bank failed to value its swaps appropriately by not valuing them on that date).

literal terms of the statute to each dealer position in a swap rather than to a book or portfolio of swaps and hedges in the aggregate. The statute requires valuation of "any" noninventory security as though a sale of "such security" had taken place at the end of the taxable year.[268] The legislative history, however, treats this issue somewhat ambiguously. The House included a provision to prevent blockage discounts and explicitly stated in its report that "fair market value generally is determined by valuing each security on an individual security basis."[269] Although that language emphasizes case-by-case valuation, the use of the term "generally" implies that Congress thought there would be some circumstances in which aggregate valuation might be more appropriate. Congress also clearly understood that individual valuations of an entire portfolio of positions might be burdensome in some circumstances. Accordingly, the Conference agreement did not include a special provision governing blockage discounts, and both the House and Conference Reports stated Congress's expectation that Treasury regulations would provide valuation methods to "alleviate unnecessary compliance burdens."[270] In the case of the Conference Report, the statement of expectation came immediately following a blunt statement that Congress did not mandate *any* particular valuation methodologies in the legislation itself.[271] That statement undercuts the security-by-security interpretation of the Code language. The Service agrees, and in a 1999 private letter ruling explicitly states its position that "[n]either Section 475 nor the regulations thereunder impose such a requirement [to value each security on an individual basis]."[272]

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[268] I.R.C. § 475(a)(2) ("[i]n the case of any security"); § 475(a)(2)(A) ("as if such security"). This also comports with understanding under the lower-of-cost-or-market system of section 471. *See* Treas. Reg. § 1.471-4(c) (requiring market and cost to be determined for "each article on hand").

[269] H.R. REP. NO. 103-111, at 665 (1993).

[270] *Id.*

[271] H.R. CONF. REP. NO. 103-213, at 616 (1993) ("The conference agreement does not provide any explicit rules mandating valuation methods that are required to be used for purposes of applying the mark-to-market rules. However, the conferees expect that the Treasury Department will authorize the use of valuation methods that will alleviate unnecessary compliance burdens for taxpayers and clearly reflect income for Federal income tax purposes").

[272] IRS FSA 199909005 (Nov. 17, 1998). A securities dealer working group, in comments on FASB's fair value project, has expressed support for the FASB's view that large positions in securities should be valued with block discounts. Letter from the Bond Market Association, the ISDA and the SIA to Suzanne Q. Bielstein, Director — Major Projects and Technical Activities, FASB (Sept. 2, 2004) at 5

The legislative history statement of expectation that Treasury would relieve compliance burdens should not be misread as a congressional instruction to Treasury to adopt book-tax conformity for swap valuations.[273] The securities dealers urged Congress at the time of the enactment of section 475 to incorporate book-tax conformity into the statute.[274] Congress could easily have written section 475 to accommodate securities dealers' demands for a mark-to-market conformity rule, but chose not to do so. It should not therefore be treated as though it had done so when it merely stated its expectation that regulations providing guidance would, *to the extent possible while clearly reflecting income*, prevent unnecessary compliance burdens.

In the decade since the enactment of section 475, Treasury has failed to provide definitive guidance addressing valuation questions. The ill-fated "Los Alamos Project" was an attempt to develop valuation software that could be used by the Service in audits to test taxpayer valuations; however, the project ultimately died from underfunding (combined with critical industry barbs).[275] The *Bank*

[hereinafter, Fair Value Comment Letter], *available at* http://www.idsa.org (last visited Nov. 30, 2004). This position illustrates the likelihood that tax valuations based on a conformity safe harbor may result in valuations that differ markedly from those contemplated by Congress upon enactment of the section 475 revenue raising provision.

[273] Securities dealers at times overstate the import of the legislative history by treating it as revealing an intent to have Treasury adopt book-tax conformity. *See, e.g., ISDA Response, supra* note 231 (stating that a book-tax conformity safe harbor "would carry out Congressional intent in enacting section 475").

[274] *See* Letter from Hal I. Gann, to the Internal Revenue Service (July 25, 1997) (indicating that Congress considered and rejected the proposal to adopt legislatively a book-tax conformity approach to mark-to-market accounting), *reprinted in Attorney Criticizes Mark-to-Market Software*, TAX NOTES TODAY (Aug. 21, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit., 97 TNT 162-27).

[275] *See Remarks by Margaret Milner Richardson, Commissioner of Internal Revenue, International Fiscal Association U.S.A. Branch Annual Meeting,* I.R.S. News Release IR-95-19, 1995 I.R.B. LEXIS 90 (Mar. 2, 1995); John Iekel, *IRS To Unveil Pricing Model,* TAX NOTES TODAY (Mar. 20, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit., 97 TNT 54-6); Debra M. Aaron, *Wall Street Group Airs Views on Valuing Derivatives,* TAX NOTES TODAY (Apr. 10, 1997) (LEXIS, FEDTAX lib., TNT file, elec. cit., 97 TNT 69-63); *IRS Seeks Comments on Mark-to-Market Software,* 97 TNT 104-28 (May 30, 1997); Gann, *supra* note 274 ; Jeremy Holmes, *Financial Products: Lyons Says Los Alamos Code Sec. 475 Valuation Project 'Temporarily Suspended',* 1997 DAILY TAX REPORT 240, at G-5 (Dec. 15, 1997); Lynne A. Brzezenski, *An Update on the Code Sec. 475 Mark-to-Market Rules for Affiliated Groups,* 3 J. TAX'N FIN. PROD. (Fall 2002) (noting complexity of the valuation issues and extensive government resources devoted to the *Bank One* case).

One litigation itself demanded a large investment of government resources over an extended period of time to litigate complex issues on the cusp of financial innovation that are subject to evolving understanding by the very businesses that deal in them day to day. Not unexpectedly, Treasury was under considerable pressure to produce guidance. While waiting for the Tax Court's decision, Treasury announced that guidance addressing valuation under section 475 was a high priority.[276] Perhaps concerned that the upcoming decision was likely to muddle the question even more, Treasury released its request for comments on a book-tax conformity proposal just hours prior to the announcement of the decision.[277]

b. Industry Practices

(1) Midmarket Valuation Methodology

Even prior to the release of the *Bank One* decision, it was clear that there was no single industry standard for marking swaps to market for tax purposes, in the sense of an easily documented and replicable model that applies the same assumptions and produces clearly verifiable and comparable results from the same underlying information throughout the industry.[278] The financial industry freely acknowledges the existence of — and indeed insists upon the competitive importance in their broker-dealer businesses of the distinctive computations resulting from — finely tuned proprietary systems for determining "fair value" for financial accounting

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[276] *See* DEP'T OF THE TREASURY, 2002-2003 PRIORITIES FOR TAX REGULATIONS AND OTHER ADMINISTRATIVE GUIDANCE (July 10, 2002), *available at* http://www.treas.gov/press/releases/docs/pgp.pdf (last visited Nov. 13, 2004).

[277] *See supra* note 11.

[278] "There is no single, 'correct' methodology for arriving at fair market value." *Bank One* Brief, *supra* note 229, ¶ 4, at Item 1; *see also Bank One* Post-Trial Brief, *supra* note 229, at 101 (reviewing the legislative history of section 475 and concluding that "Congress fully understood that there was no one correct methodology of mark-to-market valuation in the case of instruments not actively traded on a secondary market and that valuation in such cases could be extremely complex"); DISCLOSURES ABOUT FAIR VALUES OF FIN. INSTRUMENTS, Statement of Financial Accounting Standards No. 107, ¶¶ 53 & 68 (Financial Accounting Standards Bd. 1991, as amended) (acknowledging that "by providing general rather than detailed guidance [on how to estimate fair value, the Board] has potentially reduced the comparability of the fair value information among entities" and that "for assets with no quoted prices, variations in the methods used to estimate the fair value of liabilities with no quoted prices might reduce the comparability of fair value information among entities").

purposes.[279] At the same time, dealers claim to use consistently the same overall valuation methodology and assert that there is "no practical alternative" to tax acceptance of the proprietary valuations arrived at through their idiosyncratic applications of this general methodology.[280]

What dealers' proprietary models clearly have in common is a generally accepted *procedural approach* to valuation based on one or another of the quantitative financial models for discounting expected cash flows to present value. These models are used to determine the "midmarket value" between the prevailing bid and ask prices for that type of swap.[281] In other words, a dealer essentially values its position

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> In recent years, financial institutions and others have developed and implemented a variety of pricing tools designed to estimate the fair value of assets and liabilities. It is not possible here to describe all of the many (often proprietary) pricing models currently in use. However, those tools often build on concepts similar to those outlined in this Statement as well as other developments in modern finance, including option pricing and similar models.... To the extent that a pricing model includes each of the elements of fair value, its use is consistent with this Statement.

USING CASH FLOW INFO. AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS, Statement of Financial Accounting Concepts No. 7, ¶ 54 (Financial Accounting Standards Bd. 2000). The elements of fair value are (i) future cash flow estimates, (ii) expectations related to variations in timing or amount of cash flows, (iii) time value of money considerations, (iv) risk premia, and (v) other factors, such as illiquidity and market imperfections. *Id.* ¶ 23; *see also SIA Response*, *supra* note 65, at 56 (indicating that "[e]ach taxpayer has developed its own internal systems to facilitate its particular operations and business model").

280 *ISDA Response*, *supra* note 231, at 3 (indicating that there is "no practical alternative" to a book-tax conformity approach); *see also infra* notes 292–297 and accompanying text (regarding the industry's description of its methodology as "consistent" across the industry even though it requires extensive subjective determinations).

281 *See* Amicus Brief, *supra* note 66, ¶ 31 (quoting FASB as suggesting a valuation "technique" that determines the "present value of estimated future cash flows using a discount rate commensurate with the risks involved"); *id.* ¶ 32 (quoting the Group of Thirty's conclusion that marking to market "correctly reflects the current value of derivatives cash flows to be managed"); *id.* ¶ 33 (quoting Treasury's study of bank regulatory capital requirements as indicating that "some form of discounted cash flow analysis would have to be employed to estimate fair market values"); ACCOUNTING FOR DERIVATIVES INSTRUMENTS AND HEDGING ACTIVITIES, Statement of Financial Accounting Standards No. 133 (Financial Standards Accounting Bd. 1998) (providing guidance on valuations of derivatives), *as amended by* Statement of Financial Accounting Standards No. 149. *See generally* FABOZZI, *supra* note 236, at 248–49 (describing valuation of interest rate swaps purely in terms of payments to be made or received under the instrument, and determining changes

in a swap (reflecting the income it is permitted to record for financial accounting purposes) at a rate that is between (a) the *prevailing* fixed rate that dealers are generally willing to pay to other dealers to receive a floating rate (the bid rate) and (b) the *prevailing* fixed rate that dealers generally demand to receive from end users on a matched swap in which the dealer pays a floating rate (the ask rate).[282] Accordingly, there has been an industry, regulatory, and accounting consensus as to the relevance for non-tax business purposes of the midmarket value: midmarket values are the base component of the

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in value based on changes in market interest rates using forward rates to determine the payments under the floating side). In essence, this valuation methodology treats interest rate swaps as a "package of forward contracts" where the price of the swap is the price of a package of forwards that have the same settlement dates and the underlying for the forward is the same reference rate. *Id.* at 242. There is considerable learning on the mathematical formulae that are used to price interest rate swaps. *See, e.g.*, Bernadette A. Minton, *An Empirical Examination of Basic Valuation Models for Plain Vanilla U.S. Interest Rate Swaps*, 44 J. OF FIN. ECON. 251 (May 1997) (comparing valuation models based on replicating portfolios of futures with those based on replicating portfolios of noncallable corporate par bonds and considering the effect of differential counterparty risk); Sanjiv R. Das, Rangarajan K. Sundaram & Suresh M. Sundaresan, *A Simple Unified Model for Pricing Derivative Securities with Equity, Interest-Rate, Default and Liquidity Risk*, WORKING PAPER SERIES, AFA 2004 SAN DIEGO MEETINGS (Jan. 2003) (providing a model for pricing derivatives with equity, interest rate and default risk or for extracting probabilities of default from market data), *available at* http://www.ssrn.com/abstract=472680 (last visited Oct. 2, 2004).

[282] *See, e.g.*, *Bank One* Brief, *supra* note 229, ¶ 20 (defining "midmarket value" as "the present value of the net interest payments that the parties had agreed to exchange[,] calculated on the basis of the market's CURRENT interest rate reference point for each maturity"); *see also id.* ¶ 70 (noting that John Parsons, an expert witness, agreed that Devon software for determining midmarket value was "a generally accepted methodology widely employed for calculating the market value of a swap"); *supra* note 229 (noting the SIA's assertion that dealers consistently use *some form* of midmarket valuation); *Bank One* Post-Trial Brief, *supra* note 229, at ¶ 60 (noting that quoted ask and bid rates are obtained through broker surveys but "[t]here is no public data on the end-user market or on the effective spread for actual transactions in the dealer market"). The interest rate reference point for each maturity used in determining midmarket valuations is based on the current yield curve, sometimes called the "term structure of interest rates." BROWN & SMITH, *supra* note 177, at 136 (defining "yield curve" as a "graphical depiction of the current yields to maturity versus time for a set of financial instruments that are alike in all respects (e.g., liquidity, taxation, default risk) except for maturity [that is a]lso known as the time structure of interest rates when referring to yields on zero-coupon, default-free securities") (emphasis omitted). Valuing the long side of the swap at the bid price at inception would result in zero current value, which clearly would not reflect income nor satisfy the mark-to-market goal of accelerating income recognition into the present compared to a realization method of accounting.

reported market values of swaps and other OTC derivatives for most dealers' non-tax business purposes.

This unadjusted midmarket valuation is substantially consistent and precise, even across different dealers, because of the standard mathematical formulas used and the availability of similar vendor-provided computer software programs for this purpose.[283] As an acceptable financial accounting estimate of the expected income stream over the term of a swap or other derivative, however, midmarket value entails a number of modeling assumptions about the term structure of interest rates, market risk, pricing, and even dealer profit margins. The midmarket value for any particular position will vary depending on the discount rate used. Dealers use proprietary techniques and judgments to determine appropriate discount rates. The midmarket value will also vary depending on the pricing model input to determine the prevailing bid-ask rates – including observed exchange-traded prices, prevailing prices in over-the-counter trades, or prices from pricing services.[284]

Assuming appropriate discounting and pricing models, midmarket valuation should accelerate the recognition of at least a part of the spread that a dealer expects to earn over the term of a swap for acting as a credit intermediary and liquidity provider into the year that the contract is entered into, compared to valuing the swap at the bid price (or ask price, in the case of a short swap).[285] Note, however, that a particular swap may be executed at a premium – the dealer may negotiate a higher price than the quoted ask price. Dealers typically "quote wider spread[s] . . . for less creditworthy counterparties."[286] In

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[283] *See Bank One* Brief, *supra* note 229, ¶¶ 26, 69–70 (discussing the Devon software for determining midmarket value from inputs including interest rates and contractual terms of swaps and noting the replicability of the values produced by it); *Bank One* Post-Trial Brief, supra note 229, at 29 (noting that because the bank relied so heavily on its accuracy, the Devon software's output "was tested by traders, by the back office, by FNBC's systems department, by its internal auditors, and by its outside auditors"); DUBOFSKY AND MILLER, *supra* note 235, at 343–66 (discussing the standard forward and bond analogies for valuation of swaps).

[284] *See SIA Response*, *supra* note 65, at 37.

[285] *See, e.g.*, Kleinbard & Evans, *supra* note 54, at 792 (discussing pricing); JARROW, *supra* note 250, at 153 (assuming no default risk, a swap is priced at a fixed rate that results in the swap having zero value at initiation); FABOZZI, *supra* note 236, at 245 ("the swap rate is the interest rate that will make the present value of the payments on the fixed-rate side equal to the payments on the floating-rate side"). Marking the swap to midmarket value therefore results in a positive present value, causing the dealer to recognize income in that amount for the taxable year.

[286] DUBOFSKY AND MILLER, *supra* note 235, at 312.

Dubofsky's example, the regular bid-ask quote is 27/24 basis points, resulting in a dealer spread of 3 basis points; but the bid-ask for less creditworthy counterparties is 30/20, resulting in a 10-basis-point dealer spread.[287] Assume that a dealer has offsetting positions in swaps with less creditworthy counterparties. In that case, a midmarket valuation based on quoted bid and ask prices would appear to understate the dealer's profit from the offsetting positions by eliminating the risk premium received.

(2) Adjustments to Midmarket Valuation

It is clear from the preceding description that midmarket values should represent a fairly consistent determination of "contractual future *gross* cash flows" from a financial accounting perspective, although disregarding certain elements of a dealer's expected profits.[288] The unadjusted midmarket valuation of individual swaps is therefore considered merely the first step in determining the financial accounting fair value of a dealer's swaps portfolio. Bank regulators early on pressed for adjustments to these midmarket valuations as a way to ensure that banks did not overstate the value of their swaps portfolios for bank regulatory purposes.[289] A task force of accounting and broker-dealer representatives operating under the auspices of the

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[287] *Id.*

[288] *SIA Response*, *supra* note 65, at 26. It is not clear, however, whether this description is entirely accurate, since the midmarket valuation is based on quoted bid and ask prices and not on the particular contract rates, which may reflect a premium because of creditworthiness, funding requirements, or other issues. In addition, the midmarket valuation will be higher or lower if the discount rate is decreased or increased relative to the "neutral" current rate for AA or higher rated counterparties. If either or both of these factors come into play, the midmarket valuation itself may already reflect some reduction compared to the present value of expected future gross cash flows determined in respect of the actual swap price.

[289] *Bank One* Brief, *supra* note 229, ¶ 62 (federal bank regulators at the Office of the Comptroller of the Currency recommend adjustment for future costs to avoid overstatement of income for bank regulatory purposes); *Bank One* Post-Trial Brief, *supra* note 229, at 24 (stating that one of the purposes behind the OCC's issuance of Banking Circular 277 in 1993 "was to tell bank dealers that it would be wrong to continue valuing their derivatives at midmarket without adjustments because they would be overvaluing their portfolios and overstating their income"). Bank regulators, of course, have a conservative focus of ensuring that there is no *over*statement of income, given the importance of capital adequacy for financial businesses and the need to monitor future expectations of capital needs. This unilateral concern with avoiding overstatement is not the same as the tax requirement of clear reflection of income.

so-called Group of Thirty (a private group comprised of representatives of various financial, academic, and international sectors) recommended that dealers should make adjustments to midmarket valuations for unearned credit spread, close-out costs, investing and funding costs, and administrative costs.[290] In arriving at swap fair values, dealers therefore perform one or more second-step adjustments to the midmarket valuation, generally on a portfolio-wide basis.[291]

The industry tends to describe the "'adjusted mid-market' valuation methodology" as one that is "universally followed," but the devil is in the details of what particular dealers do in particular

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[290] GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES (1993) [hereinafter GROUP OF THIRTY STUDY] (reporting the recommendations of the task force established by the Group of Thirty and the results of a dealer survey conducted in January and February of 1993), *available at* http://www.group30.org (last visited Oct. 2, 2004); *see also ISDA Response*, *supra* note 231, at 6 (noting that the Group of Thirty, Office of the Comptroller of the Currency, Governors of the Federal Reserve, and GAAP all support an adjusted midmarket method for valuing OTC derivatives). In the period covered by the *Bank One* litigation, many dealers made *no* adjustments to midmarket valuation. *See Bank One* Brief, *supra* note 229, ¶¶ 59, 61 (indicating no consensus prior to 1993 that adjusted midmarket valuation was appropriate, and noting that the 1993 Group of Thirty survey on derivatives practices found that "a number of dealers were valuing derivatives for reporting purposes at the midmarket level WITHOUT adjustments"); GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES, FOLLOW-UP SURVEYS OF INDUSTRY PRACTICE, at iii, 12 (1994) [hereinafter GROUP OF THIRTY FOLLOW-UP SURVEY] (follow-up survey of dealers in late 1994, finding that, out of 125 dealer respondents of 300 surveyed, 44 percent valued derivatives using unadjusted midmarket values and a bare majority of 51 percent used adjusted midmarket values). In its post-trial brief, however, Bank One argued that those dealers who were using unadjusted mid-market values were "not claim[ing] that unadjusted mid-market was the right approach; rather, they had not yet developed the systems needed to measure the adjustments." *Bank One* Post-Trial Brief, *supra* note 229, at 24.

[291] *See, e.g.*, *SIA Response*, *supra* note 65, at 26 (claiming that it would be "inconsistent with the business model" to value each derivative individually, and noting that "dealers do track *unadjusted* midmarket values on a contract-by-contract basis, [but] contracts are broken into their constituent cash flows for purposes of determining *adjusted* midmarket values"). According to the SIA, portfolio-wide adjustments avoid the overstatement of credit risk that would result under a swap-by-swap approach from disregarding close-out netting of multiple contracts with the same counterparty. The SIA suggests this is a reasonable approach, much like valuing the goodwill of a business, and not in conflict with the constructive sale terminology of the statute, which should be understood to refer to hypothetical bids for a dealer's portfolio in the interdealer market. *Id.* at 27–28.

instances.[292] There is no industry agreement about the detailed implementation of adjustments to reduce midmarket values.[293] The SIA acknowledged that the method itself "is in a continual state of refinement and evolution" and that there is no uniform way in which dealers implement it.[294] Dealers use varying proprietary technologies in their unique implementation of valuation adjustments and apply "subjective judgments" for reducing the midmarket value by additional carveouts.[295] The dealers' proprietary systems differ "in non-trivial respects" sanctioned by GAAP, which aims to incorporate values used in the business, rather than to "sanction one specific methodology."[296] Some dealers reduce the swap midmarket values for certain types of credit risk, some for administrative costs, and some for both or neither or other costs.[297] This Article generally will refer to adjustments made to midmarket value for credit risk as "credit risk carveouts" and adjustments for administrative costs as "administrative carveouts." The following paragraphs describe a number of these adjustments and the rationales supporting them.

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[292] *SIA Response*, *supra* note 65, at 23.

[293] *See, e.g.*, Amicus Brief, *supra* note 66, ¶ 21 (noting that there is "no single means of implementing an adjusted midmarket mark-to-market valuation model, and no single set of input data"); Munro & Keinan, *supra* note 63, at 13 (stating that "[c]urrently, there is no standard practice in the market with regard to the type or amount of specific adjustments taken by dealers").

[294] *SIA Response*, *supra* note 65, app. A at 60; *see also ISDA Response*, *supra* note 231, at 18 (claiming that variations in techniques are not different valuation methods, but acknowledging that the "single method of valuation (the adjusted midmarket method) . . . is constantly evolving").

[295] *See SIA Response*, *supra* note 65, at 51 (demonstrating that the specifics of implementation of midmarket valuation methodology varies); *Bank One* Brief, *supra* note 229, ¶¶ 25–31 (FNBC used its "subjective judgments" that considered both theory and practice to adjust the midmarket value produced by the Devon system upon the initiation of a swap for (i) credit risks, based on the bank's own credit analysis, and (ii) administrative costs, based on quarterly re-determinations of the costs of administering existing swaps).

[296] *SIA Response*, *supra* note 65, at 58.

[297] *See Bank One* Brief, *supra* note 229, ¶ 22 (asserting that the "most commonly made" adjustments to midmarket values were "for credit considerations and administrative costs"); *id.* ¶ 61 (mentioning the 1993 Group of Thirty Study); *id.* ¶ 63 (indicating that, by 1993, adjusted values were in use by "some of the industry's largest dealers" and, by 1994, two-thirds of large dealers were either using or planning to use some adjustments); Munro & Keinan, *supra* note 63, at 5.

(a) Valuation Model Adjustments

Vendor software and mathematical valuation models, developed to reflect up-to-date mathematical analysis of derivatives, are fairly common to a number of dealers.[298] Dealers nonetheless make adjustments to the valuation model itself, based on their own internal research, comparisons with other model outputs or to account for their particular views on particular modeling questions on which there is a significant difference of opinion.[299]

(b) Market-Risk Adjustments

Dealers also make portfolio-wide market-risk adjustments.[300] Clearly, market risk is a major concern with interest rate swaps for which the volatility of interest rates can change the relative value of a dealer position overnight. If a dealer has entered into a swap under which the dealer pays a floating rate of interest, a sharp increase in interest rates could cause the contract to move from an asset to a net obligation of the dealer. Dealers therefore typically make a market-risk adjustment that takes into account their determination of the risk of loss from changes in interest rates on temporarily unhedged positions.[301] This adjustment may in fact completely eliminate, at least temporarily, the dealer spread that would otherwise be taken into account under the midmarket valuation system (because it reduces the fair market value by "up to half the bid/offer spread" – i.e., by the portion of the actual spread taken into account under the midmarket valuation system).[302] Neither the ISDA nor the SIA indicates that these adjustments are weighted in any way by the firms' historical experience with these types of losses.[303] Rather it appears that *all*

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[298] *See, e.g.*, *Bank One*, *supra* note 12, ¶¶ 85–88 (describing Devon software for midmarket valuations); *infra* note 310 (noting various software models for credit risk).

[299] *See ISDA Response*, *supra* note 231, at 12; *SIA Response*, *supra* note 65, app. A at 60–61.

[300] *SIA Response*, *supra* note 65, app. A at 61–62 (discussing bid-offer adjustments for unhedged positions that reflect possibility that dealer may have to close out an unhedged position at a lower price).

[301] *ISDA Response*, *supra* note 231, at 14.

[302] *Id.* at 13 (noting that these reductions do not ever *exceed* the entire bid/offer spread because a dealer can always enter into an offsetting position rather than hedge each type of risk inherent in a particular derivative); *see also SIA Response*, *supra* note 65, app. A at 61–62 (same).

[303] *See ISDA Response*, *supra* note 231, at 13–14; *SIA Response*, *supra* note 65, app. A at 61–62.

unhedged swap income is automatically deferred. When a dealer later enters into an appropriate hedge, the deferred income is taken into account by an adjustment that increases the swap's value to reflect the hedge protection.

Some dealers also temporarily reduce the reported income on a swap for "market risk valuation due diligence." This is a charge that reduces the value of complex contracts for the period during which due diligence has not yet been completed.[304] Again, it appears that such dealers may arbitrarily eliminate the entire dealer spread otherwise taken into account under the midmarket method for the period during which due diligence remains incomplete.

(c) Liquidity and Concentration Adjustments

Dealers may also reduce reported portfolio values for various types of "liquidity" or "concentration" adjustments to take into account the possibility that they may have to close out a particular contract at unanticipated cost, especially for exotic derivatives and large concentrations of a particular type of position.[305] The assumption is that a large block of positions will be costly to close because of the saturation of the market and the likelihood that a dealer would have to pay a premium to another dealer to take on the positions. Such reductions in value are sometimes permitted under financial accounting's conservatism.[306] Again, there is no indication

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[304] *ISDA Response*, *supra* note 231, at 16–17.

[305] *SIA Response*, *supra* note 65, app. A at 62–63 (discussing liquidity adjustments for "unhedgable risk[s]" and "concentration adjustments" for risks of incurring close-out costs related to holding exceptionally large positions). Compare the dealers' position in support of block discounts, *see Fair Value Comment Letter*, *supra* note 272, with the original House provision explicitly denying consideration of block discounts, *see supra* note 269 and accompanying text.

[306] Note that Statement of Financial Accounting Standards No. 133 generally precludes the taking into account of blockage factors. *See Accounting for Derivative Instruments and Hedging Activities, Statement of Financial Accounting Standards No. 133:* ¶ 315 (Financial Accounting Standards Bd. June 1998, as amended) ("Consistent with Statement 107, the definition of fair value in this Statement precludes an entity from using a 'blockage' factor . . . in determining the fair value of a large block of financial instruments."). However, as the exposure draft issued in the FASB's current fair value measurements project indicates, the BROKER-DEALER GUIDE allows broker-dealers to use blockage factors when estimating the fair value of large positions of financial instruments in certain circumstances, based on an assessment of factors such as the size of positions held and the liquidity of the market. Fair Value Exposure Draft, *supra* note 210, at ¶ 6 n.5; *see* Broker-Dealer Guide, *supra* note 210, ¶ 7.11 (instructing management to "take into consideration all indications of value

that historical experience of the percentage of derivatives that result in such unanticipated close-out costs is used to establish a ceiling for the amount of adjustments made.

(d) Credit Carveouts

Perhaps securities dealers' most ubiquitous and most flexible adjustments (almost always *reductions* of the fair market value otherwise determined based on expected income streams) are those for credit risks — adjustments related to the basic concern that a counterparty will default on its obligation to make payments under a swap. Standard texts on swap pricing discuss the necessity of taking the risk that a counterparty will default into account in determining the price for a swap,[307] and thus dealers make various credit risk adjustments to midmarket valuations in order "to reflect the evolving creditworthiness of a dealer's counterparties."[308] That is, by entering into an interest rate swap that requires it to pay a fixed rate for float, a less creditworthy end-user counterparty can essentially borrow funds at a lower fixed rate and over a longer term than it could if it raised funds by issuing bonds in the capital markets.[309] The swap spread (i.e., the amount in excess of the rate on comparable Treasury notes that it will pay to the dealer that receives fixed payments on the swap), however, will differ depending on its creditworthiness. All else being equal, a less creditworthy counterparty will generally pay a larger spread over Treasuries than a more creditworthy counterparty.

Significantly, a dealer's credit-risk adjustments to its swaps valuations do not directly translate to a discounted value for probability-weighted expected losses from counterparty defaults, the most obvious candidate for permissible adjustments for tax purposes and one for which there are increasingly sophisticated quantitative finance computational models.[310] In fact, there appears to be a wide

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that are available in determining the fair value" of a financial instrument, including the "[s]ize of position held and the liquidity of the market").

[307] *See, e.g.*, FABOZZI, *supra* note 236, at 241 ("In any agreement between two parties that must perform according to the terms of a contract, counterparty risk is the risk that the other party will default.").

[308] *SIA Response*, *supra* note 65, app. A at 63.

[309] *See* Chand Sooran, *Interest Rate Swaps* (2003), *at* http://www.finpipe.com/intrateswaps.htm (last visited Oct. 2, 2004).

[310] The advance in credit derivative markets has resulted in a number of sophisticated mathematical models for measuring the amount and likelihood of a credit default loss. *See, e.g.*, Oren Cheyette & Tim Tomaich, *Empirical Credit Risk* (July 1, 2003) (determining credit risk for corporate bonds based on empirically

range of practices in respect of credit carveouts, demonstrating that dealers have considerable flexibility under financial accounting rules to use subjective judgments and internal estimates for these decisions. From the dealer's perspective, the increased spread due to credit risk described in the preceding paragraph will serve various functions: it will make up, in part, for any actual loss because of counterparty default (i.e., the current income stream from the swap with the risk premium is more than sufficient to offset the payments the dealer must make and the dealer's expected profit margin, with the excess cash flows available to absorb some or all of any potential loss if the counterparty defaults). Therefore, it will also compensate the dealer for acting as a credit intermediary in respect of the counterparty – i.e., for providing the service of assuming credit risk in respect of that counterparty's ability to make payments under the swap.[311]

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motivated model), *available at* http://www.ssrn.com/abstract=415080 (last visited Oct. 2, 2004); Kay Giesecke, *Credit Risk Modeling and Valuation: An Introduction*, Cornell University Working Paper Series (June 23, 2004) (providing an overview of modeling for credit risk and credit-risky securities and discussing in particular the structural approach to credit risk based on assessment of firm assets and the reduced form approach based on stochastic operations), *available at* http://www.ssrn.com/abstract=479323 (last visited Oct. 2, 2004); Robert A. Jarrow, David Lando & Fan Yu, *Default Risk and Diversification: Theory and Applications* (June 2, 2003) (showing an equivalence between two measures of default risk as a way to facilitate pricing and management of credit risk), *available at* http://www.DefaultRisk.com/pp_corr_13.htm (last visited Oct. 2, 2004); Robert Jarrow & Yildiray Yildirim, *A Simple Model for Valuing Default Swaps when both Market and Credit Risk are Correlated* (Dec. 10, 2001) (presenting a simple formula for valuing default swaps and using the model to infer default probability parameters in data from 22 companies), *available at* http://www.DefaultRisk.com/pp_crdrv_16.htm (last visited Oct. 2, 2004); Yoram Landskroner & Alon Raviv, *Credit Spread Implied by Convertible Bonds Prices* (Oct. 2003) (deriving a model for credit risk from convertible bond data), *available at* http://www.ssrn.com/abstract=461720 (last visited Oct. 2, 2004). Vendor models, such as Mark-to-Future, RiskMetrics, CreditMetrics, and CreditRisk+ are available. *See, e.g.*, Algorithmics, Inc., Mark-to-Future: *A Framework for Measuring Risk and Reward* (referencing the various trademarked vendor software for measuring risk), *at* http://www.algorithmics.com/marktofuture/mtf-print.shtml (last visited Oct. 2, 2004). These models "in practice often yield quite different results when loss distributions of a banking portfolio are forecast." Alfred Hamerle & Daniel Rosch, *Parameterizing Credit Risk Models*, EFMA 2004 Basel Meetings Paper, *available at* http://ssrn.com/abstract=500304 (last visited Nov. 13, 2004). The authors suggest ways to reduce model risk by deriving parameters from observed default data within a unified framework. *Id.* at 5.

[311] *See* DUBOFSKY AND MILLER, *supra* note 235, at 312 (describing change in bid-ask spread based on credit risk); Petitioner's Proposed Findings Of Fact, *Bank One*, at 39–40 (describing a component of market price for bearing credit risk variously as compensation for capital held in reserve, compensation for bearing credit risk, a

One type of credit carveout reduces income for "unearned credit spread," described by the SIA as "the risk that the dealer will not receive payments because of anticipated defaults by the counterparty."[312] Unearned credit spread adjustments take into consideration, in one way or another according to dealers' proprietary systems, some measure of the risk of default due to concerns in respect of the counterparty's creditworthiness. The creditworthiness measure itself is not an objective factor readily available in the market and used by all derivatives dealers. Instead, the creditworthiness of a counterparty is generally determined by a dealer's internal management practices and may have little correlation with third-party ratings of the counterparty, such as those produced by the major credit rating agencies.[313] The SIA's statement on this issue is worth quoting in some detail, as it reveals the dealers' strong sense of entitlement to determine creditworthiness according to their own idiosyncratic judgments.

> It is *not* current market practice for our members to look merely to a counterparty's rating from a major credit rating agency in order to evaluate the counterparty's creditworthiness. Instead, dealers develop their own assessments based upon such factors as the price for hedging against the counterparty's credit risk in the credit derivatives market and the trading price of the counterparty's debt relative to Treasury obligations. . . . In other cases, *a dealer may simply disagree with a rating agency's assessment* of a counterparty's credit quality. For these reasons, even though a counterparty may have a rating of "AA" from Standard & Poors, it nonetheless may be appropriate (and not redundant) to make a downward credit adjustment in respect of that counterparty, even where the relevant yield curve assumes a hypothetical "AA" credit.[314]

Treatment of a dealer's own creditworthiness is another clear example

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residual risk component not captured by probabilistic models of expected losses, or a risk premium).

[312] *SIA Response*, *supra* note 65, app. A at 63.

[313] For a general discussion of ratings and rating agencies, see U.S. SECURITIES AND EXCHANGE COMMISSION, REPORT ON THE ROLE AND FUNCTION OF CREDIT RATING AGENCIES IN THE OPERATION OF THE SECURITIES MARKETS (Jan. 2003) (report completed in connection with Sarbanes-Oxley Act), *available at* http://www.sec.gov/news/studies/credratingreport0103.pdf (last visited Oct. 2, 2004).

[314] *SIA Response*, *supra* note 65, at 50 (second emphasis added).

of the flexibility allowed under the financial accounting rules. Those rules currently permit dealers to choose whether or not to take changes in their own creditworthiness into account in evaluating the effect of credit risks on fair value, and most dealers do *not* do so.[315] To its credit, the Financial Accounting Standards Board (FASB) has expanded its understanding of discounted cash flow determinations of value and in that project has moved, at least in concept, to the view that each counterparty's creditworthiness is relevant to fair value.[316] As a statement of concepts, however, SFAC 7 only establishes the FASB's position on the ideal accounting for an issue: it has no effect on actual accounting rules until it is explicitly adopted as part of specific guidance.[317]

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[315] *See, e.g.*, NYSBA RESPONSE, *supra* note 17, at 6 (noting that the *Bank One* court's decision requiring consideration of a dealer's own creditworthiness was controversial and that many dealers adjust only for their counterparty's status); *ISDA Response*, *supra* note 231, at 25 (noting that variations in dealer techniques, including whether to take the dealer's own creditworthiness into account, are "all permissible under GAAP" and "have no relevance under a safe harbor based on book-tax conformity"); DISCLOSURES ABOUT FAIR VALUE OF FIN. INSTRUMENTS, Statement of Financial Accounting Standards No. 107, ¶ 68 (Financial Accounting Standards Bd. 1991), *as amended* (indicating that some entities estimate fair value by considering changes in the entities' own credit risk while others do not and concluding that it would be inappropriate to mandate one position at this time); *see also ISDA Response*, *supra* note 231, at 16 (suggesting that netting offsetting positions, which is generally done in portfolio-wide credit risk adjustments, reduces the understatement of income caused by not taking the dealer's creditworthiness into account). The usual rationale given by dealers for not adjusting for changes in their own creditworthiness in the tax context is the exemption of a dealer's own debt from the mark-to-market requirement under section 475. *See, e.g.*, *Short Course*, *supra* note 247 (admitting that taking a dealer's own creditworthiness into account would be more accurate economically, but suggesting that the existence of the exemption from mark-to-market accounting for dealer debt should be viewed as also applying to the liability aspect of swaps). This argument is unconvincing. Although swaps may at times be liabilities and at times assets during the term of the swap contract, they are not debt instruments per se for tax purposes, and they are specifically required to be marked to market under section 475. The rules that apply to debt obligations held outside the mark-to-market system should not interfere with a dealer's appropriately marking to market an item explicitly subject to the mark-to-market system.

[316] *See* USING CASH FLOW INFO. AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS, Statement of Financial Accounting Concepts No. 7 (SFAC 7), ¶¶ 78–88 (Financial Accounting Standards Bd. 2000) (indicating that a dealer's creditworthiness is relevant to fair value measurement).

[317] In its current project on fair value measurements, the FASB is in the process of elevating much of the guidance from SFAC 7 to top-level GAAP. Specifically, the exposure draft for that project provides that an entity must incorporate the effect of its own creditworthiness when estimating the fair value of its liabilities. Fair Value

Furthermore, swaps dealers may already be substantially protected from actually suffering *any* loss under a swap contract due to various credit enhancement provisions. Single transaction netting ensures that only the net payment due between parties need exchange hands.[318] Multiple transaction close-out netting permits a dealer to aggregate its swaps with a defaulting counterparty and refrain from making any offsetting payments under those contracts that it might otherwise owe to the defaulter, thus significantly reducing any potential loss.[319] Collateral is almost always required for interest rate swaps with counterparties with inferior credit records, and that collateral may be required to be adjusted if the counterparty's credit rating declines below the level at the time that the contract is entered into.[320] It is clear that collateral reduces risk of loss, perhaps to near zero (considering transaction costs).[321] Declines in creditworthiness can also serve as triggers that require termination of a contract before a default occurs. Yet in spite of the ubiquitous practice of reducing income for very broad categories of credit risks, dealers are also given flexibility under financial accounting rules to reduce fair value for credit risk even though a transaction is supported by the presence of collateral and other credit enhancement measures.[322] The securities

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Exposure Draft, *supra* note 210, at ¶ 5 n.4; *see also id.* at ¶ A23-A27. Dealers have criticized this approach, noting the Basel Committee's objection from the banking regulatory perspective. *See Fair Value Comment Letter*, *supra* note 272, at 52.

[318] *See* FABOZZI, *supra* note 236, at 248–49.

[319] Darrell Duffie, the Tax Court's expert, testified that netting agreements reduce credit exposure. Expert Report of Darrell Duffie, *Bank One Corp. v. Commissioner*, 120 T.C. 174 (2003) (Nos. 5759-95, 5956-97), 18–19 [hereinafter Duffie Report], *available at* http://www.stanford.edu/~duffie/bankone.pdf (last visited Oct. 2, 2004).

[320] *See* GROUP OF THIRTY FOLLOW-UP SURVEY, *supra* note 290, at 76–77.

[321] *See, e.g.*, Michael Johannes & Suresh Sundaresan, *Pricing Collateralized Swaps*, 8–11, (Columbia Working Paper Series, May 29, 2003) (noting that use of collateral is "widespread" and "growing," with "nearly all" investment bank swaps collateralized in 2001, and that market participants assume collateralized swaps are default-free, freeing up capital for other purposes and expanding the list of potential counterparties), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=412342 (last visited Oct. 2, 2004). Collateral is clearly a significant facet of the securities dealers' business: Goldman Sachs is reported to have held $6.6 *billion* of collateral at the end of 1999. *Id.* at 11. The ISDA estimates that approximately $1.0 trillion of collateral was in use at the beginning of 2004, an increase of 40% from the prior year. INTERNATIONAL SWAPS AND DERIVATIVES ASS'N, INC., ISDA Margin Survey 2004, *available at* www.isda.org (last visited Nov. 13, 2004).

[322] *SIA Response*, *supra* note 65, app. A at 63. The SIA indicates, without sufficient explanation, that "although various types of credit enhancements (such as

dealers' organizations note that dealers' adjustments do "generally" consider credit enhancement.[323] The Group of Thirty Follow-Up Survey indicates that as long ago as 1994 many dealers' derivatives contracts had provisions that required credit enhancement when a counterparty was downgraded.[324]

The responses of the securities dealers' associations to the ANPRM do not provide a detailed description of the manner in which typical dealers determine the amount of the expected future cash flows that will be deferred because of the dealer's assessment of the counterparty's credit quality, nor do they state explicitly that the appropriate measure of the amount of an unearned credit spread adjustment for a particular swap is the expected default loss under a swap as determined using reasonably bounded measures from quantitative financial analysis. In fact, the financial accounting rules for derivatives valuations do not require any particular objective, historical evidence of default patterns on swaps (whether general defaults, defaults by counterparties in a particular industry, or defaults by the particular counterparty) or default information from the credit default swaps industry to be taken into consideration in order for a securities dealer to reduce income on account of expected default losses.[325]

Moreover, in some cases, the input that a dealer uses in implementing its credit carveouts may at best be tied to the bank's historical experience with loan defaults and its institutional processes for determining amounts at risk under loans, rather than to

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the posting of collateral or netting arrangements) may reduce, or even eliminate, the need for a downward credit adjustment, there are certainly circumstances in which a credit adjustment is appropriate, even though a credit enhancement feature has caused the counterparty risk to rise to the level of the credit rating used to determine the yield curve." *SIA Response*, *supra* note 65, at 50.

[323] *ISDA Response*, *supra* note 231, at 15.

[324] *See* GROUP OF THIRTY FOLLOW-UP SURVEY, *supra* note 290, at 76–77.

[325] In its current project on fair value measurements, the FASB has expressed its preference for the use of "market inputs" when estimating fair value, which "shall be determined based on information that is timely, originated from sources independent of the entity, and used by marketplace participants in making pricing decisions." Fair Value Exposure Draft, *supra* note 210, at ¶¶ 9 & 12. The exposure draft stops well short of *requiring* use of such market inputs in all cases: it states that "[v]aluation techniques used to estimate fair value shall *emphasize* market inputs" but then acknowledges that "market inputs might not be available without undue cost and effort, [thus] requiring the use of significant entity inputs derived from an entity's own internal estimates and assumptions." *Id.* at ¶¶ 9 & 24.

statistically significant historical evidence on swap defaults.[326] One traditional method of measuring the amount of potential default losses on derivatives is to determine a "fractional exposure," which is "calculated by measuring the mark-to-market exposure of a swap, cap, or floor at every future settlement date using each of several projected interest rate paths and then selecting the worst-case scenario."[327] The particular measure depends on the dealers' requirements as to number of interest rate paths projected and required degree of confidence in the outcome. These may be set by some policy-making group within management. The estimate of cash flows is then discounted using a risk-adjusted rate. This general type of present value determination is described by the FASB as the "traditional approach" to present value analysis, one that is best suitable to situations of considerable cash flow certainty – e.g., where both timing and amount can be correlated with a readily tradable asset.[328]

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[326] *See infra* note 329 and accompanying text (describing FNBC's practices in this regard in some detail).

[327] BROWN & SMITH, *supra* note 177, at 133.

[328] *See* Edward W. Trott & Wayne S. Upton, *Expected Cash Flows*, 1 UNDERSTANDING THE ISSUES 2–3 (Financial Accounting Standards Bd. May 2001) (describing the "traditional approach to present value" and suggesting that it may be less useful than the "expected cash flow approach" that uses probability-weighted expected values), *available at* http://www.fasb.org/articles&reports/UI_vol1_series1.pdf (last visited Oct. 2, 2004). The FASB discussions of the fair value measurement project have returned to these two concepts and the FASB has tentatively concluded that both represent permissible discounted present value approaches to valuation. *See* Fair Value Exposure Draft, *supra* note 210, ¶ A3 & n.10 (Jun. 23, 2004) (labeling the expected cash flow approach the "expected present value technique" and the traditional approach the "discount rate adjustment technique"). In its discussions of present value techniques, the FASB acknowledged that the discount rate adjustment technique is the one "more widely used in practice." *See, e.g.*, Financial Accounting Standards Board, *Minutes of the August 27, 2003 FVM Board Meeting* 1, 2 (Aug. 27, 2003), *available at* http://www.fasb.org/board_meeting_minutes/08-27-03_fvm.pdf (last visited Oct. 2, 2004). The handout for the August 27, 2003 FASB meeting indicated that "[t]he present value technique most often used for estimating market prices is one of discounting expected cash flows using a discount rate that incorporates a risk premium for the systematic risk inherent in the expected cash flows." Financial Accounting Standards Board, *Board Meeting Handout* (Aug. 27, 2003), *available at* http://www.fasb.org/board_handouts/08-27-03_fvm.pdf (last visited Oct. 2, 2004). The FASB describes the discount rate adjustment technique as "us[ing] a single set of cash flows from the range of possible estimated amounts. . . . The cash flow(s) are discounted at a rate commensurate with the risk inherent in the cash flow(s) (risk-adjusted discount rate)." Fair Value Exposure Draft, *supra* note 210, at ¶ A9. Further, "because discount rates should reflect assumptions about risk that are not otherwise considered in the cash flows, the

A version of this traditional approach was used by FNBC, as revealed in some detail in the *Bank One* litigation.[329] In the case of FNBC, expected loss percentages were assigned even to highly creditworthy counterparties — including those whose publicly available credit

discount rate adjustment technique is based on the assumption that the discount rate can fully incorporate the risk inherent in the cash flows." *Id.* ¶ A10.

[329] *See Bank One* Brief, *supra* note 229, ¶¶ 76–89, 130–36; *see also Bank One* Post-Trial Brief, *supra* note 229, at 29–32 (discussing FNBC's process for calculating the credit adjustment). In short, the bank first determined a loan equivalent amount as the aggregate sum of Monte Carlo simulations for future scenarios set to calculate maximum potential exposures at an arbitrarily chosen 80% confidence level. This maximum credit exposure did *not* take into account any loss-offsetting benefits of cross-defaults or other credit triggers to terminations, arrangements for multiple-transaction closeout netting, collateral, or other credit enhancements. *Bank One* Brief, *supra* note 229, ¶¶ 81–84. FNBC argued that it should be allowed to take the higher credit adjustment because it was neither administratively feasible to take close-out netting into account nor clear that all countries would enforce netting. *Id.* ¶¶ 83, 136. FNBC then determined the portion of this maximum exposure that it would treat as a credit carveout, using a formulaic table for loan credit risk that assigned expected loss percentages based on internally generated debtor credit classifications (treating the swap counterparty as debtor). *Id.* ¶¶ 85–87. For example, if a counterparty to a swap were assigned to class 2, the table indicated that the percentage of the loan equivalent amount for that swap that should be treated as an expected loss was 0.10 percent. *See Bank One*, *supra* note 12, ¶ 264. The table was changed during the period in question in ways that generally increased the amount of loss expected in the earlier years of loans or swaps. The class assigned to a counterparty was not necessarily derived from the publicly available credit ratings of counterparties published by credit rating agencies or from other objective information. *Cf.* STANDARD & POOR'S CREDIT MARKET SERVICES, CORPORATE RATINGS CRITERIA 61 (July 30, 2003) (discussing Standard & Poor's issuer or counterparty credit ratings that provide "a current opinion on an issuer's overall capacity to pay its financial obligations"), *periodically updated versions available at* http://www2.standardandpoors.com/spf/pdf/fixedincome/CorpCrit2004.pdf. The table did not reflect the swaps business or actual swap default loss histories. *See Bank One* Brief, *supra* note 229, ¶ 85 (noting that a credit strategy committee assigned the loss factor for each risk classification "based on historical experience and judgment"); *id.* ¶ 87 (defending use of same loss factors used for loans, on the basis that a default in one obligation would be likely to cause a swap to be terminated, with balances due treated as a receivable, and claiming that there was insufficient history to determine swap default data); *see also* Respondent's Trial Memorandum, Bank One Corp. v. Commissioner, 120 T.C. 174 (2000) (Nos. 5759-95, 5956-97) (presenting table of classifications and percentages used by the bank), *reprinted in IRS Outlines: Arguments and Preparations for Trial on Derivative Swaps*, TAX NOTES TODAY (Apr. 3, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit, 2001 TNT 64-41), ¶ 89 [hereinafter referred to as IRS Trial Memo, with citations to the relevant item number or paragraph of the Lexis version].

ratings were higher than the bank's own credit rating.[330] The income that the bank recognized in the year a swap was initiated was sometimes adjusted downward by a credit carveout even in respect of the most creditworthy counterparties for which the bank had no default experience, to reflect the potential that any counterparty's creditworthiness could decline.[331] In one case, the carveout was 137 percent of the midmarket value of the swap.[332]

Securities dealers also generally reduce their swaps' valuations for another type of carveout related to credit risk — a "capital charge for unanticipated credit losses."[333] According to the securities dealer organizations, this charge represents "the cost of the return that must be paid to capital held to absorb the risk that credit losses will exceed the highest anticipated level."[334] The SIA claims that these adjustments should be allowed because risks of lower capital returns

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[330] *See Bank One* Brief, *supra* note 229, ¶¶ 134–35. In its post-trial brief, FNBC strongly defended its practice of assigning expected loss percentages even to those counterparties with higher credit ratings than FNBC's credit rating. First, it noted Duffie's testimony that he had never stated that a downward credit adjustment was always inappropriate when a counterparty's rating was higher; rather, he stated that a downward adjustment might or might not be proper. *Bank One* Post-Trial Brief, *supra* note 229, at 67–68. Second, it argued that the Service had failed to prove that FNBC actually had a significant number of swaps with higher-rated counterparties or that the amount of credit adjustments related to higher-rated counterparties was significant. *Id.* at 68.

[331] *See id.* ¶ 134. In marking a swap to market, FNBC did not routinely redetermine a new mark-to-market value taking into account any adjustment to the credit carveout as income; instead, it took the deferred income represented by credit carveout into income ratably over the term of the swap. In other words, the credit carveout was not re-determined annually to account for any increase (or decline) in the counterparty's credit risk that might have required the bank to take into account in the valuation of the swap a positive (or negative) "catch-up" amount reflecting the change in credit risk. *Id.* ¶¶ 88–89, 130–32. To reflect the increase in value of the swap for each period without default, the bank ratably amortized the credit carveout into income. *See id.* ¶¶ 88, 132 (also noting that in 1992 the bank began amortizing the credit carveouts for all swaps booked in a quarter into income in the aggregate over the weighted average life of those swaps). Even if a particular swap was terminated (possibly resulting in a termination payment in the bank's favor or recognition of a mark-to-market loss), the bank apparently did not include the remaining unamortized credit carveout in income at that time but rather continued to defer recognition according to its pre-determined amortization schedule.

[332] Post-Trial IRS Brief, *infra* note 355, at 87–88 (discussing the credit risk adjustment on a Daewoo Securities Europe swap).

[333] *SIA Response*, *supra* note 65, app. A at 64.

[334] *Id.*; *ISDA Response*, *supra* note 231, at 16.

than anticipated are "inherent" in swap portfolios.[335]

(e) Administrative Costs Adjustments

A second type of carveout for future administrative costs is likely used at least for some types of costs and some business purposes by all securities dealers. According to the ISDA, administrative charges typically include maintenance costs for monitoring contracts and processing payments (including both systems and operational costs) as well as legal and other costs of documenting swaps agreements.[336] Because dealers do not generally have access to average market data for administrative costs, dealers simply apply their own internally generated projections of their future administrative costs as a reduction to the current market value of their swaps portfolios. According to the SIA, administrative adjustments are now only made for a dealer's marginal costs, not for the fully allocated share of direct and indirect costs of the dealer's business.[337]

(f) Investing and Funding Costs Adjustments

A further downward adjustment to the value of a swaps portfolio supported by the Group of Thirty covers investing and funding costs for swaps.[338] These adjustments in effect permit a current deduction for the estimated future costs of borrowing funds to support a derivative position. In particular, this carveout covers costs of potential borrowings to cover cash flow mismatches over the life of

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[335] *SIA Response, supra* note 65, app. A at 64.

[336] *ISDA Response, supra* note 231, at 16.

[337] *See SIA Response, supra* note 65, app. A at 64 n.92. FNBC's practices, however, illustrate the range that has been permitted. The bank determined its administrative carveouts dynamically. Based on surveys of its various departments, the bank fully allocated budgeted costs to its existing swaps according to its judgment of costs required to manage the portfolio of swaps to maturity. *See Bank One* Brief, *supra* note 229, ¶¶ 91–92, 138; *Bank One* Post-Trial Brief, *supra* note 229, at 32–33 (describing FNBC's process for calculating its administrative carveouts and acknowledging that the allocation of certain budgeted costs to swaps "called for a degree of judgment" and that "a potential for bias" existed, but arguing that any such bias would cause an *understatement* of the administrative carveout (and, consequently, an overstatement of swap value) because the personnel who determined the carveouts preferred smaller adjustments so that higher profits resulted); *Bank One*, *supra* note 12, ¶¶ 216–18 (describing FNBC's administrative cost carveouts in greater detail).

[338] *See* GROUP OF THIRTY STUDY, *supra* note 290, at 17–18 (discussing types of adjustments).

the swap — e.g., the possibility that a bank may need to borrow to cover cash payments under the swap because it may not have sufficient liquid assets to make required payments, at a point in the future when the swap may have become a liability.[339]

(3) Business Uses of Valuations

Dealers continue to insist that book-tax conformity would provide a form of financial accounting "discipline" to tax valuations through use of consistent numbers for both tax and certain business purposes and that this discipline would serve the tax system well by ensuring "accurate" valuations.[340] The fact is, however, that dealers vary as much in how they use GAAP valuations for non-tax business purposes as they do in how they implement credit adjustments. The *Bank One* case likely reflects an outlying case (and the least supportable practice) in this regard: FNBC used the *unadjusted* midmarket value for most significant business purposes — pricing swaps, making presentations to management, managing risks, reporting to regulators, and reporting profit information to shareholders in some contexts. It apparently only used an *adjusted* midmarket valuation for its tax returns and on its financial statement.[341] Yet is it clear that banks today currently use adjusted midmarket valuations for non-tax business purposes that are *both* sufficiently correlated with tax purposes to support the use of the same value for tax purposes *and* sufficiently removed from additional layers of subjective decision-making as to be indicative of an incentive to report numbers fairly that supports the use of the same value for tax purposes? A priori, it would appear that the two most important functions most likely to be correlated to taxable income concepts and fairness incentives are pricing and risk hedging. That is, if the valuation reported to tax administrators is determined by the same procedure that determines how a dealer will price the derivative to a counterparty, that reinforces the likelihood that the tax value is not tweaked in some way to get an appropriate result. Similarly, if the

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[339] *See SIA Response*, *supra* note 65, app. A at 65.

[340] *SIA Response*, *supra* note 65 at 57 (stating that "in cases where the valuation of a position involves a non-trivial level of complexity or judgment, the discipline of book-tax conformity serves both the IRS and taxpayers well in ensuring that the valuations are accurate"); *ISDA Response*, *supra* note 231, at 6 (reporting views that adjusted midmarket method is "the best available method" and "will be applied *accurately* by dealers") (emphasis added).

[341] *See Bank One*, *supra* note 12, ¶ 388 (Tax Court findings in this regard).

valuation reported to tax administrators is the same as the value that is used for risk management purposes, to determine what hedges to purchase and when, then that practice would provide some support for the fairness of the credit and market risk adjustments to tax value.

The conformity safe harbor proposal asked for comments on this issue.[342] The SIA states that "[m]ark-to-market valuation models are used to determine a firm's profitability" but notes that these models "do *not* directly determine the prices charged to a customer."[343] In discussing which financial statement would be appropriate for the booking requirement, the SIA Response notes that reports filed with all federal agents "employ the same mark-to-market valuation process,"[344] leaving it unclear whether the value reported in each case is the same adjusted midmarket value, since the "process" encompasses the *unadjusted* midmarket valuation as well as any number of *adjusted* values.[345]

Similarly, the ISDA asserts that the requirement that dealers determine values for financial reporting and regulatory purposes provides "strong incentives not to undervalue" swaps.[346] The ISDA states that dealers use the values for any one or more of a number of non-tax purposes, including "(a) to manage market and credit risk, (b) compensate key personnel, (c) evaluate lines of business, and (d) to determine which transactions to enter into (or hold) and which transactions to avoid (or terminate), and the prices at which such transactions are entered into or terminated."[347] The ISDA indicates, however, that specific valuations are not directly traceable to many of these business uses; that is, dealers take valuations into account in making compensation and pricing decisions, but they also take other factors into account. As a result, those business decisions cannot be directly linked to the same valuations underlying MTM income reported on tax returns.[348] Furthermore, securities dealers determine

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342 *See* ANPRM, *supra* note 11.

343 *SIA Response*, *supra* note 65, at 52 (emphasis added).

344 *Id.*

345 I understand from Edward Kleinbard (the principal author of the *SIA Response*), however, that this ambiguity was not intended and that the SIA believes that dealers do use the same values for all the business purposes discussed in the report.

346 *ISDA Response*, *supra* note 231, at 18–19.

347 *Id.* at 30–31.

348 The ISDA qualifies its statement about business use of valuations for pricing by noting that valuations "are taken into account" but "actual prices are *necessarily* affected by other factors as well." *Id.* at 31 (emphasis added). A similar qualification

the unadjusted midmarket value on a swap-by-swap basis (and record that number for each swap in their books), but determine portfolio adjustments and gain or loss from a derivatives book on an aggregate basis, making it difficult to assess any direct business use of the valuations used in tax returns.[349]

B. The Bank One *Decision*

Although the *Bank One* case cannot be considered illustrative of current practice more than a decade after the years at issue in the litigation, it is worth considering in at least some detail in order to understand the relation between the bank's business and tax valuations and the extent of control that the bank exercised over its valuations. It is not surprising that tax litigation in this context of highly innovative financial instruments, subject to changing but very flexible financial accounting standards, would necessarily be complex and weighted with expert judgments. The *Bank One* litigation[350] fulfilled that expectation. The primary question in the case is the validity of the bank's "adjusted midmarket method" of valuing its swaps portfolio.[351] Rejecting the bank's arguments for a "business judgment" standard that would essentially require tax administrators

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regarding "other factors" applies to the statement about use to determine compensation bonuses. *Id.* It is not clear how such indirect impacts of valuations can be shown to be reflected in pricing, if the pricing decisions are as discretionary in relation to the value determinations as this statement would suggest. The ISDA goes on to argue that a conformity safe harbor need only require that a dealer "take[] the profit and loss . . . effects of the adjusted mid-market values into account in making decisions with respect to one or more of the four non-tax business uses identified in the preceding paragraph." *Id.* Note that this does not even explicitly require that the same values be used for at least one of these nonbusiness uses as for tax.

[349] *ISDA Response, supra* note 231, at 34.

[350] *See Bank One, supra* note 12.

[351] As a litigation strategy, the Bank One and Amicus Briefs carefully use the "adjusted midmarket method" terminology to refer to customary practice among swap dealers, even though for the tax years in question there were more dealers who determined midmarket values without adjustments than ones that used adjustments. *See* GROUP OF THIRTY STUDY, *supra* note 290, at 50 (Group of Thirty 1993 survey data indicating that 48 percent used midmarket values without adjustments and 37 percent used midmarket values with adjustments, while 24 percent used gross or net bid prices (or offer, for applicable short positions)). It appears that it would be more appropriate to refer to the industry-wide valuation approach, at least in the 1993–1994 time period, as the "midmarket method" and then to discuss the many specific manners of implementation, including various adjusted midmarket methods according to each dealer's own proprietary technologies and subjective decisions about risk parameter determinations.

to accept the results of internal valuation processes, the Tax Court held that the case raised a method of accounting question subject to the section 446 clear-reflection-of-income requirement.[352]

The tax administrator has "broad discretion" under section 446(b) to determine whether a taxpayer's method of accounting clearly reflects income; therefore, decisions of the tax administrator are entitled to considerable deference at trial under the "abuse of discretion" standard of review.[353] Similarly, when a court determines that the Commissioner had adequate basis to conclude that the taxpayer's method of accounting failed to clearly reflect income, considerable deference is due the Commissioner's decision as to the

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[352] *See Bank One*, *supra* note 12, ¶¶ 311–14 (relying on regulations to find that issues of proper timing of particular items of income or expense are questions of method of accounting as well as issues relating to the choice of overall accounting method and inventory cases under section 481 regarding changes from improper to proper methods of valuing inventory), citing Hitachi Sales Corp. of Am. v. Commissioner, T.C.M. (CCH) 2659 (1994).

[353] Ansley-Sheppard-Burgess Co. v. Commissioner, 104 T.C. 367, 370 (1995) ("Section 446(b) vests the Commissioner with broad discretion in determining whether a particular method of accounting clearly reflects income."); Prabel v. Commissioner, 91 T.C. 1101, 1112 (1988) ("Under section 446(b), [the Commissioner] has 'broad powers of determining whether accounting methods used by a taxpayer clearly reflect income.'"), *aff'd*, 882 F.2d 820 (3d Cir. 1989). The taxpayer has a "heavy burden" of proof to show that the Commissioner's decision is plainly wrong — i.e., that the Commissioner had no rational basis for asserting that the taxpayer's method failed to clearly reflect income. *See, e.g.*, *Ansley-Sheppard-Burgess Co.*, 104 T.C. at 371 ("to prevail, a taxpayer must prove that the Commissioner's determination [that the taxpayer's method does not clearly reflect income] is arbitrary and capricious and without sound basis in fact or law"); *Prabel*, 91 T.C. at 1112 (indicating that a taxpayer has a "heavy burden" to establish that the Commissioner abused his discretion in requiring a change in method). In the seminal Supreme Court case interpreting the appropriate standard for review of the Commissioner's decision as to a method of accounting, the Court held that the government's "interpretation of the statute's clear-reflection standard 'should not be interfered with unless *clearly unlawful*.'" Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979) (quoting Lucas v. Am. Code Co., 280 U.S. 445, 449 (1930)) (emphasis added). A court reviewing the Commissioner's discretionary decision "is not to determine whether in its own opinion [the taxpayer's] method of accounting... 'clearly reflect[ed] income,' but to determine whether there is an adequate basis in law for the Commissioner's conclusion that it did not." RCA Corp. v. United States, 664 F.2d 881, 886 (2d Cir. 1981) (reversing the Tax Court's finding of abuse of discretion). If the taxpayer's method does reflect income clearly, however, the Commissioner may not override that method. *See, e.g.*, Molsen v. Commissioner, 85 T.C. 485, 498 (1985) (upholding taxpayer's method of accounting for on-call purchases by marking them to market as clearly reflecting income). *See generally Prabel*, 91 T.C. at 1112 (summarizing the case law on deference to the Commissioner).

method that the taxpayer should have employed to clearly reflect income.[354]

The government acknowledged that the bank's purported goal of taking into account appropriately allocable expected costs, so that the net present value of its swaps book represents its net profits, can in theory lead to an appropriate market value and hence clear reflection of income.[355] The court found, however, that FNBC did not carry its

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[354] Prabel v. Commissioner, 882 F.2d 820, 823 (3d Cir. 1989) (attributing "broad discretion" to the Commissioner "to determine whether an accounting method clearly reflects income and to choose an accounting method which does clearly reflect income"), *aff'g* 91 T.C. 1101 (1988); Am. Fletcher Corp. v. United States, 832 F.2d 436, 442 (7th Cir. 1987) (Cudahy, J., concurring) (where the taxpayer had kept sloppy records, noting that taxpayers cannot protest if the Commissioner's proposed accounting method is "workable"); *Bank One, supra* note 12, ¶ 320 (quoting Judge Cudahy's statement in the context of discussing the bank's failure to substantiate its records, but not adhering to the *American Fletcher* approach). Generally, a court upholds the Commissioner's decision to impose another method, so long as that method does not further distort income. *See, e.g.*, Ford Motor Co. v. Commissioner, 71 F.3d 209, 217 (6th Cir. 1996) (affirming the Tax Court in upholding the method imposed by the Commissioner, even though the taxpayer could not have adopted that method on its own and even though another alternative "might have been ... more logical"), *aff'g* 102 T.C. 87 (1994). If the Commissioner's method is found to be wanting, most courts return a decision for the taxpayer. *See, e.g.*, Harden v. Commissioner, 223 F.2d 418, 421 (10th Cir. 1955) (refusing to uphold the government's requirement that a mausoleum owner change its method of accounting to segregate separate construction phases when the government continued to acquiesce in the owner's failure to capitalize the cost of mausoleum construction, and therefore permitting the taxpayer to continue to use his admittedly inappropriate accounting method), *revising and remanding* 21 T.C. 781 (1954).

[355] *See, e.g.*, Pre-Trial Brief for Respondent, Bank One Corp. v. Commissioner, 120 T.C. 174 (2000) (Nos. 5759-95, 5956-97) (Oct. 13, 2000) ("Respondent does not dispute that, in theory, a midmarket value computation of swaps might legitimately be adjusted for credit risk in order to clearly reflect income."), *reprinted in IRS Argues Bank's Accounting for Derivative Swaps Do Not Clearly Reflect Income*, TAX NOTES TODAY (Apr. 3, 2001) (LEXIS, FEDTAX lib., TNT file, elec. cit, 2001 TNT 64-39), ¶ 10 [hereinafter referred to as *IRS* Brief]; *see also id.* ¶ 105 ("Respondent has never denied that, for methodologies that assume all swap parties have the same credit worthiness, adjustments for credit risk might be appropriate to reflect the probability that payments will not be received if one of the counterparties has a lower credit rating than that assumed by the methodology."); Post-Trial Brief for Respondent, Bank One Corp. v. Commissioner, 120 T.C. 174 (2001) (Nos. 5759-95, 5956-97) (September 7, 2001) (available from the United States Tax Court Clerk's Office), at 124 ("Respondent again reiterates that he does not dispute that, in theory, a mid-market value computation of swaps might legitimately be adjusted for credit risk in order to clearly reflect income when the counterparty has a lower credit rating and there are no credit enhancements.") [hereinafter, Post-Trial IRS Brief]; *id.* at 444 ("For swaps between counterparties with different credit ratings, theoretically, the

burden of showing that its methodology clearly reflected income, because (among other reasons) it consistently valued derivative positions on a date other than the one prescribed in the statute, possibly resulting in significant distortions due to changes in values in the stub period after the bank made its determinations.[356] Accordingly, the Tax Court could have simply deferred to the government's decision that the bank should have used unadjusted midmarket valuations for its swaps, based on its finding that (i) there was no consensus in the industry on required adjustments, (ii) important aspects of the bank's swaps business (including pricing and bonus determinations) were conducted based on unadjusted midmarket values, and (iii) the taxpayer failed to substantiate its tax reporting position.[357] Instead, the court decided a "naked question of substantive law,"[358] prescribing normative guidance for determining the fair market value of a swap.[359]

The first question the court addressed was the definition of fair market value under section 475(a)(2). Concluding formalistically that the tax term is more precise than the similar "fair value" term used in financial accounting, the court found that fair market value is determined for a hypothetical transaction between willing buyer and willing seller in respect of the highest and best use, where neither is under compulsion of any sort and both have reasonable knowledge of relevant facts.[360] Based on the importance of a hypothetical

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fair market value of some swaps might be less than mid-market value (suggesting a negative adjustment to mid-market value) . . . .").

[356] *See, e.g.*, *Bank One*, *supra* note 12, ¶ 210 n.36 (evidence of significant swing in value for a swap between the date of actual valuation and the end of the taxable year, from $104,233 as of Dec. 20, 1991 to $97,721 on Dec. 31, 1991).

[357] Further support for the government's position was provided by the weak justification for credit adjustments for a majority of the bank's swaps because of credit enhancements and/or higher-rated counterparties and the reasonable assumption that failure to take an adjustment for the balance of the portfolio would not be distortive, given the diversity of the portfolio and the fact that the bank took positions on either side of swaps. There was also some objective evidence that other adjustments were likely to be *de minimis* based on the thin secondary market evidence of a midmarket benchmark for the bank's actual swap buyouts.

[358] RCA Corp. v. United States, 664 F.2d 881, 886 (2d Cir. 1981).

[359] *Bank One*, *supra* note 12, ¶ 427 (indicating that it would be "far better . . . to have an acceptable valuation method as to these products, even though checkered by occasional variance, than to remain in the gray twilight of uncertainty").

[360] *See, e.g.*, *id.* ¶¶ 351–72 (exploration of judicially developed components of fair market value definition). Interestingly, in the still tentative fair value measurement project, the FASB has moved towards incorporation of the broader definition of fair value used by the *Bank One* court. *See* Fair Value Exposure Draft, *supra* note 210,

transaction that permits a dealer to get the best price, the court concluded that the relevant market for determining fair market value is not the interdealer market in which a dealer hedges its transactions but the end-user market in which a dealer interacts with customers.[361] Comparing this tax definition with the applicable accounting definition of fair value, the court concluded that the accounting definition was sufficiently different to reject book-tax conformity. The court focused on the tax definition's emphasis on willing parties under no compulsion to make the deal, whereas the applicable accounting statement appears to eliminate for consideration only the compulsion that results from forced sales or liquidations. This suggests that the accounting concept of fair value may be more susceptible to discounting for liquidity, asset concentrations, and market saturation or similar effects that operate to reduce the price a seller might get in a hypothetical market. Similarly, the court concluded that the tax valuation required a dealer to take into account the "best use" price. That implies, in the case of swaps, the customer-oriented (end-user) market with its wider spreads rather than a dealer-oriented market with its more-restricted bid-offer spreads.

Based on this analysis of the proper concept of fair market value and the market in which to assess it, the court outlined the following normative requirements of an acceptable method of valuation that FNBC's valuation methodology failed to satisfy (set out by opinion paragraph number).

Regarding credit carveouts:

¶¶ 392-394 carveouts reflect changes in value due to changes in creditworthiness required;

¶ 4-5 (defining fair value as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties" and stating that "[f]air value presumes the absence of compulsion (duress)").

361 *Bank One*, *supra* note 12, ¶¶ 373–83 (developing a hypothetical model of the property (bonds), valuation date (end of taxable year), and market (end users) for testing fair market value). The Service had argued strongly for the importance of the hypothetical seller/hypothetical buyer concept in understanding section 475's constructive sale concept and suggested a strong analogy between the method for determining fair market value for swaps and the mean-quotation method for valuing stocks and bonds. *See* Post-Trial IRS Brief, *supra* note 355, at 445 (describing a three-step process and drawing the analogy with stocks and bonds). Securities dealers, in responding to the FASB's fair value project, have recently noted a concern regarding which transaction costs associated with entering into the "most advantageous market" can be taken into account in determining fair value for different types of instruments. *See Fair Value Comment Letter*, *supra* note 272, at 4 (comparing paragraphs B9 and 23(f) of the Fair Value Exposure Draft).

¶ 395	no time lags occur between carveouts and taxable year of income;
¶ 396	carveouts consider both parties' creditworthiness;
¶ 400	counterparties of AA or higher credit rating require no carveout;
¶¶ 401-402	netting, collateral, and other credit enhancements modify carveouts;
¶ 406	carveouts are dynamic (i.e., adjusted each year for changes);
¶ 409	carveouts cannot be based on overstated loss exposure estimates;
¶¶ 410-411	carveouts must consider mirror and offsetting swaps;
¶ 412	carveouts are made on a swap-by-swap basis; and

Regarding administrative carveouts:

¶ 414	administrative carveouts are required;
¶ 415	carveouts are only for incremental costs;
¶ 417	carveouts may reflect taxpayer-specific costs; market data not required;
¶ 424	carveouts are made on a swap-by-swap basis.

The importance of the *Bank One* decision is difficult to assess. It relates to a particular taxpayer, in respect of accounting practices that are in some ways outdated now (e.g., the static treatment of credit risk) and that in other ways do not conform to the norms of the accounting industry, according to the industry's reports of its practices (e.g., the limited use of adjusted midmarket values for business purposes beyond inclusion in financial statements for reporting to the SEC). To the extent the practices that the decision addresses are no longer used, the normative standards are little more than a rule not to do something that is not being done.

On another level, however, the decision appears clearly relevant to the current inquiry. The practices of FNBC, and the defenses it made to those practices, shed light on the extent to which at least some banks have taken advantage of whatever idiosyncrasies exist in the accounting rules to adjust reportable income for federal income tax purposes. The lack of any apparent financial accounting limitation on the amount of the credit risk adjustment to fair value, for example, permitted the bank to claim an adjustment that resulted in negative value for swaps that it had entered into with an expectation of making a profit. Furthermore, the ability of the bank to tweak its results according to its idiosyncratic determinations about relative risks (for example, by changing the percentages used for determining maximum loss) demonstrates that financial institutions have considerable flexibility under the accounting rules to incorporate their own internal proprietary evaluation systems into the statements presented to shareholders. When these numbers are also incorporated "verbatim" into the tax return as the measure of taxable income, this amounts to an ability (whether currently used with this intent or not) to use the mark-to-market system to defer taxation and control the bank's tax liability. Nothing in the decision, therefore, supports a conclusion that dealers' proprietary computational methods for determining fair value of derivatives, based on their own internal, subjective assumptions about market and counterparty risks, should generally be presumed to reflect income clearly for tax purposes.

C. Assessment of the ANPRM Safe Harbor

Given the outcome in *Bank One*, the industry was likely heartened by the release, on the same day as the Tax Court's decision, of the ANPRM suggesting that Treasury was finally considering granting a business judgment method to determine taxable income in respect of securities dealers' swaps portfolios – i.e., through grant of a book-tax conformity safe harbor for derivatives valuations.[362] The objective of this Part is to assess the proposed conformity safe harbor. This Part will consider the valuation methodology described in Subpart A, aided by the Tax Court's normative guidance in Subpart B and with particular attention to the adjustments made to midmarket value. The goal is to determine whether the financial accounting valuation methodology based on various types of present value computations violates either the income tax or anti-manipulation value (or both) and whether the pragmatic concerns weigh on the positive side sufficiently to overcome any minor problems for the income tax and anti-manipulation values.

In issuing the ANPRM, the Service and Treasury asked for industry comments to guide them in their exploration of a safe harbor, especially in areas of substantial uncertainty. The ANPRM proposes three basic principles that the conformity proposal should satisfy and discusses a number of questions relevant to each of the principles. Those questions indicate that the government retains significant doubts that financial accounting valuation methodologies will produce

[362] *See* ANPRM, *supra* note 11.

consistently appropriate tax valuations.[363]

The three principles set forth in the ANPRM as necessary conditions for a conformity safe harbor are: (1) consistency with section 475, (2) appropriate incentives to report values fairly on applicable financial statements, and (3) suitable means of substantiation and reconciliation of book and tax numbers.[364] It is worth considering how these principles relate to the criteria set out in Part III of this Article as important in evaluating conformity proposals.

First, the ANPRM gives some indication of the depth of the consistency requirement from the Treasury's perspective. The ANPRM explains that consistency with section 475 requires the following: that evaluations be determined on the last day of the taxable year as required by the Code; that taxpayers recognize annual gains and losses from changes in value; and that taxpayers take into account disposition gains and losses (computed by reference to prior year-end values).[365] The first requirement stems directly from the text of the Code provision, imposing a bright-line rule of end-of-year valuation unless modified by regulation. The latter two requirements derive directly from the requirements for full accretion taxation in an income tax system. These three requirements are clearly necessary to satisfy structural coherence, and the consistency principle can therefore be viewed as Treasury's attempt to ensure that a conformity safe harbor would not violate the structural coherence requirement.

The question, however, is whether these minimal requirements are sufficient to satisfy the demands of structural coherence. It could be said that consistency with a particular provision is structurally coherent at a micro level defined by the particular Code provision. But there are a number of other requirements of structural coherence that are not specifically mentioned in the ANPRM and may not be reflected in the proposed safe harbor. A provision (such as the conformity safe harbor) could therefore be only superficially consistent with a particular Code provision and ultimately fail to satisfy the overall criterion of structural coherence.

Second, the requirement that a taxpayer have incentives to report valuations fairly in non-tax contexts appears to be an attempt by

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[363] Following the issuance of the ANPRM, the government initiated an AIR program with a number of securities dealers. Comments from Treasury officials suggest that a proposed regulation incorporating a safe harbor election may be released by the end of 2004, based on this AIR program. *See supra* note 11.

[364] *Id.*

[365] *Id.*

Treasury to set a standard for evaluating the conformity safe harbor in terms of the anti-manipulation value set out in Part III. As in the case of the structural coherence requirement, however, the Treasury has left too much unsaid about the essential characteristics of the anti-manipulation standard and has focused on possible means of satisfying the standard that simply fall short in this context. The requirement that taxpayers have incentives to report financial statements fairly is on the surface a vague standard without necessary roots in the tax system. The ANPRM contemplates that this standard will be satisfied if taxpayers merely (1) report the valuations used on tax returns on a single approved financial statement (perhaps one out of a number of different financial statements with different valuations used for different purposes) and (2) also make "significant" non-tax business use of those valuations.[366] This incentives principle appears not to demand enough of the financial accounting measure.

For example, one could imagine a regulatory regime applicable to banks that required banks to maintain an actual cash reserve, determined as a percentage of all assets, solely for liquidity purposes. The regulator's model could require consistency across all banks by setting forth a particular methodology for determining the amount of a bank's cash reserve. To reflect banks' ability to borrow on short notice, the regulator might require the percentage to be based on each bank's credit rating, as established by taking the average of the published ratings of the bank by nationally recognized credit rating organizations. Asset values might be required to be determined by using a particular expected cash flow valuation model constructed by the regulatory regime and not subject to proprietary modifications. In response to industry concerns that high reserves would restrict earnings possibilities, however, the regulator might adopt an explicitly conservative approach to value that limited input assumptions in such a way as to ensure that values of assets will be *understated* compared to the banks' internal valuations based on their own profit analyses and/or compared to independent credit rating agency analyses. A bank employing such a system to arrive at low valuations of its derivatives could honestly affirm that it had an incentive to report values fairly for the liquidity reserve system — i.e., as reflecting fair values as understood for that specific purpose. Those reported values might also comport with the measurement of fair value for financial accounting purposes (and be reported on the entity's financial statements filed with the SEC), because of the flexible approach to

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[366] *Id.*

industry- and firm-specific proprietary judgments about appropriate assumptions in making fair value determinations. As a result, the hypothetical financial statement would reflect intentionally conservative (low) valuations as required for liquidity determinations, and the conformity safe harbor would permit those low valuations to be treated as appropriate measures for taxable income purposes. In spite of the taxpayer's incentive to report the numbers fairly for these financial statement purposes and in spite of the evidence that the financial statement and evaluative standard would satisfy both the banking regulators and the SEC, the incentive to report fairly under this standard would do little to reassure us that the values as reported are appropriately determined for taxable income purposes. In fact, this hypothetical clearly demonstrates that values that are fairly reported for other regulatory purposes may simply be wrong for tax purposes.

Finally, the requirement of adequate substantiation also derives from the anti-manipulation value. This requirement is by no means unique to conformity proposals or indeed to tax accounting issues but goes to the heart of tax compliance needs. If tax administrators do not have the ability to verify valuations used on a tax return by confirming that they are indeed the basis for the financial statement and business uses claimed (or whatever other requirements are imposed by the safe harbor), a taxpayer could simply manipulate the numbers at will to lower its tax liability while still puffing its book income.

1. Income Tax Value

As noted in the preceding section, dealers insist that book-tax conformity makes sense for MTM valuations, because the financial reports and other internal business uses of the values ensure that they are "as accurate as dealers can make them."[367] The problem with this argument from accuracy is that it assumes part of the question. Does financial accounting measure values in the same way that tax accounting should measure values? If large swaps dealers have not been marking their swaps to market correctly for tax purposes because of excessive carveouts permitted under applicable financial accounting and regulatory rules, they may have consistently understated their federal income taxes. This is true even when the amount of understatement of income in respect of any one swap is

[367] *ISDA Response*, *supra* note 231, at 29.

relatively small compared to the size of the transaction, as may ordinarily be the case. Furthermore, any assertion that comparatively small excess carveouts and rapid turnover reduces tax inaccuracy to an immaterial level disregards the fact that any deferral of tax on swaps through the carveout methodology is reiterated with the addition of each new swap. Deferrals of excessive carveouts across time over a large swaps portfolio would amount to an interest-free loan of indefinite duration from the government, providing a substantial benefit to swaps dealers.[368]

In fact, the information provided by the dealers makes it clear that the fair value measurement for swaps does not satisfy the income tax value requirement for tax purposes. While the Tax Court's approach to this issue is formalistic, in terms of specific factors that are treated as components of the fair value determination for financial accounting and the fair market value determination for tax purposes, the conclusions reached by the court ultimately have merit. Fair market value is a tax-specific term that is intended to reflect the income tax value in which it is grounded. That is, the MTM rule explicitly jettisons any consumption tax treatment that is otherwise permitted in our hybrid system, including the realization requirement that defers taxation on unrealized gain. Since Congress clearly evidenced its intent here to treat unrealized gain under income tax principles, it is inconsistent with income tax values to continue to allow effective deferral of unrealized gain by allowing financial accounting norms to control the permissibility of various carveouts. Hence, constructive sale determinations of fair market value require consideration of a hypothetical sale between willing and knowledgeable parties under no compulsion to enter into a transaction. Discounts to value due to illiquidity of a seller that holds a concentrated position or an exotic and hard-to-place derivative would be inappropriate, since those discounts suggest a degree of compulsion to accept less than fair market value in the exchange. Reductions in value due to extraordinarily high administrative costs of the exiting party similarly would be inappropriate, because a hypothetical counterparty in the market would have only the average administrative costs of market participants. Disregard of the hypothetical seller's creditworthiness in comparison to the current counterparty would lead to an incorrect price, since the hypothetical

[368] The *Bank One* expert, Professor Duffie, calculated that the credit and administrative cost carveouts, even if all dealers claimed carveouts in the relatively small amounts at stake in the *Bank One* case, would aggregate about one billion dollars annually for the industry. *See* Post-Trial IRS Brief, *supra* note 355, at 379.

seller will seek out a buyer that will be of equal or lower credit rating, in order to achieve the highest market price. Furthermore, several of the specific adjustments permitted for fair value accounting and in harmony with the fundamental principles of prudent accounting are in conflict with the income tax value of a structurally coherent tax system. Least supportable are credit carveouts that serve to defer services income until "earned" for accounting purposes. The following sections further consider these adjustments.

a. Market Risk Adjustments for Unhedged Positions

Systematic market risk adjustments for unhedged positions[369] may not have any merit in determining taxable income under a MTM accounting system. The sole result of a market-risk adjustment appears to be to *defer income recognition* in respect of the spread that the dealer anticipates earning, until a hedge is in place. This is the very income for which MTM accounting was intended to accelerate recognition. Even if some expected loss amount would be reasonable in determining fair market value, that amount should be related to the objective evidence and historical experience about market-risk losses during unhedged periods. In contrast, the dealers' discussion suggests that the amount of the market risk adjustment is generally the full amount of the spread between prevailing bid and ask rates, rather than a loss percentage determined from historical experience of market losses during initial periods when positions are unhedged. Overstating the deduction from gross income by treating the entire spread on every unhedged swap as an expected loss until a hedge is in place will understate income under a full accretion accounting system if the lack of a hedge extends over year-end. That understatement clearly violates the income tax value. A market risk adjustment on swaps entered into at fiscal year-end and intentionally left unhedged until after the beginning of the next taxable year in order to take advantage of this understatement in income for the year also would violate the anti-manipulation value.

b. Concentration Adjustments

A similar observation applies for concentration adjustments (i.e., additional costs for unanticipated close-outs of especially large positions). There are two potential problems with concentration adjustments. First, if they are not based on historical, objective

[369] *See supra* notes 300–303 and accompanying text.

evidence of losses actually incurred in respect of similar positions, they may merely defer the inclusion of spread income rather than accelerate appropriate deductions. That deferral is a direct violation of the income tax value. Second, concentration adjustments directly contravene legislative intent, in that Congress did not intend for blockage discounts to be considered in applying section 475.[370] The SIA's effort to distinguish the dealers' practice of discounting for concentration from Congress's concern with blockage discounts is unconvincing.[371] The discount due to unloading an aggregate large, unhedged position appears in fact equivalent to the price-depressing effect of offering a large number of a particular item for sale at one time. There would likely be few dealers, much less end users, who could or would wish to take on the aggregate concentration. The fact that a large number of such positions was suddenly available would likely deflate the value of positions taken on by any one dealer or end user. Third, it is likely that any dealer entering into a position in an exotic derivative contract or a concentrated position in respect of a particular counterparty regularly charges a correspondingly higher premium than it would charge for positions in more customary contracts. If the pricing model for determining midmarket value does not take such premia into account, the midmarket value would already represent a downward adjustment. Any further downward adjustment in respect of concentration risk would be at least partially duplicative.

c. Funding Cost Adjustments

The adjustment for funding costs is particularly troubling. Recall that this adjustment is made to take into account the possibility that the market will turn against the dealer, with the result that the dealer will be required to make an exceptionally large payment at a time when it is relatively illiquid.[372] In that case, the dealer might find that its cost of borrowing would be higher than ordinary, due to its inability to defer borrowing until it could line up a more advantageous line of credit. The problem is that a bank's liquidity is not determined

[370] *See* H.R. REP. NO. 103-213, at 613 (1993).

[371] *See SIA Response*, *supra* note 65, app. A at 63 (asserting that concentration adjustments are different because they relate to the total amount of a particular type of risk without regard to the number of different items subject to that risk, whereas blockage discounts typically refer to the price-depressing effect of concurrent offerings of a large block of the same item).

[372] See discussion *supra* note 339 and accompanying text.

solely by its dealer subsidiary but by its overall loan portfolio and investment strategy. Current deduction of these speculative future costs in respect of a securities dealer unit would permit a bank to maintain more of its assets in illiquid (invested) form than would otherwise be possible. In other words, the availability of a current deduction (in the form of lower fair value determinations) for a potential future liquidity crisis of this nature may have the effect of shifting resources that would otherwise be held to provide liquidity to illiquid investments, in violation of the income tax value. These adjustments have the effect of permitting banks a deduction for a liquidity reserve for their overall business, through the back door of funding cost adjustments for their swaps portfolios.

The market-risk adjustments, concentration adjustments, and funding costs adjustments may be reasonable from the perspective of financial reporting. By adjusting the value of a swap for every possible adverse future event that could result in a dealer's failing to earn its expected profit, the financial accounting rules ensure that dealers are not able to puff their earnings statements with speculative assumptions about future cash flows. For the income tax value, however, such broad and speculative reductions of the "ability to pay" amount appear unjustifiable, especially if dealers generally terminate positions to avoid worst-case scenarios. It could be argued that the mark-to-market method was not meant to take account of any losses other than a dealer's best estimates (using today's sophisticated quantitative financial tools) of the negative cash flows in respect of the instrument itself based on assumptions about the volatility of interest rates. Even if these broader categories of potential losses are appropriately included in the present value analysis, the amount should be bounded by objective evidence of past historical experience.

d. Credit Risk Adjustments Deferring Credit Intermediary Fees

Several related questions arise in connection with dealers' credit carveouts. What, if any, correlation should there be between a dealer's determination of potential exposure to default loss under a swap and its determination of anticipated gross income under the swap (assuming arguendo that the midmarket valuation appropriately measures gross income)? To what extent should a dealer be required to determine its credit carveout on the basis of its own or publicly available information about swaps default losses rather than by using measures of creditworthiness and default probabilities developed in its loan business? Assuming that in almost all cases the functional role of a swaps dealer is to serve as a liquidity provider and credit intermediary, is it ever appropriate *for tax purposes* for a swaps dealer to defer its entire unearned credit spread based on Monte Carlo projections of payment flows due to market changes? To what extent is the repeal of the bad debt reserve deduction in former section 166(c) relevant to whether a dealer can take a credit carveout for losses that may never materialize?

The *Bank One* court concluded that a credit carveout is mandatory, based on economic experts' testimony regarding the various components of midmarket valuation of a swap.[373] It may be worth stepping back to consider the possible rationales in a mark-to-market system for a credit carveout that defers a portion of a dealer's income for reasons related in some way to credit risk and whether some of those rationales are more appropriate to a mark-to-market regime than others. There are at least two possible reasons for deferring dealer income related to credit risk: (1) to avoid treating as income the portion of the apparent value of a swap that is expected (using stochastic methods to determine expectations) not to be realized because of default losses, and (2) to spread the inclusion of income from serving as a credit intermediary over the period that the dealer provides the credit intermediation function by accepting exposure to a counterparty's credit risk.

The first rationale assumes that mathematical projections can predict at an appropriate level of certainty what portion of a swap contract's income stream will be lost because of a swap default and therefore should be taken into account as a reduction in the fair market value of the swap at each year end. Applying the Tax Court's approach, a hypothetical buyer would base the price that he would pay for the dealer's position on objective information such as contract terms, current interest rates, and creditworthiness. If the available information indicates a potential for a default loss on the swap, the price would be discounted appropriately.[374] Discounting the value of

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[373] *See Bank One*, *supra* note 12, ¶¶ 424, 426 (noting that experts agree that credit and administrative costs must be deducted from midmarket value to determine fair market value and holding that such adjustments must be made to clearly reflect income).

[374] In the case of a buyer that is a dealer rather than an end-user who is entering into the transaction as a market maker and not as a market taker, the discount would have to be sufficient to provide the new dealer an expected profit in spite of the potential for a default loss, or the dealer would not do the deal. Dealers, however, might also be interested in purchasing the position as a hedge for other dealer positions and thus not expect to make a dealer spread on the deal.

the swap for its potential for default losses at taxable year end during the term of the swap may therefore be necessary to arrive at its true fair market value. This suggests, however, that no deduction in value for credit risk is appropriate at initiation of a swap, since the dealer's price will take into account the counterparty's creditworthiness (much as the interest rate on a loan compensates for future default losses). Applying the expected cash flows analysis of value leads to the same conclusion. Positing that the assumptions underlying the determinations of default loss probabilities and amounts are correct, the credit carveout merely accelerates reasonably expected swap default losses into the present to reduce the swap's gross income stream, which is also accelerated into the present.[375] A credit carveout for reasonably expected default losses therefore appears appropriate in a mark-to-market regime, even though not permitted for taxpayers in a realization regime.[376]

Various documents suggest that the credit risk adjustment taken by dealers is broader in scope than expected default losses and hence also implements the second rationale of deferring service compensation. For example, in the years subject to litigation, FNBC explicitly described its credit carveouts in its annual report as

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[375] Bear in mind that this section is considering the viability of credit carveouts only from a functional perspective in order to answer the question *why* a credit carveout should be permitted in the mark-to-market context. This does not end the inquiry, since the mechanism for determining the amount of the carveout must also be considered in order to be sure that the carveout merely provides for a reasonable expected swap default loss. In other words, a proper inquiry must also ask what assumptions should determine *how much* of a credit carveout to permit in the mark-to-market context. *See infra* Part IV.D. for discussion suggesting that the amount of the carveout should be based on objective, historical data of swap default loss experience (or credit default swap pricing) and no carveout should be permitted for swaps with *de minimis* default risk or adequate collateral.

[376] Congress repealed the deduction for additions to bad debt reserves for all but small banks as part of the 1986 reforms. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 805, 100 Stat. 2085 (repealing Code sections 166(c) and (f)). Prior law permitted taxpayers to deduct reasonable additions to reserve accounts to offset their estimate of the uncollectible portion because of debtor defaults. A formula based on a six-year rolling-loss experience was typically used to determine the reasonableness of additions to reserves. *See* Black Motor Co. v. Commissioner, 41 B.T.A. 300 (1940), *aff'd on other issues*, 125 F.2d 977 (6th Cir. 1942), *acq*. 1940-1 C.B. 1. Since neither the Code nor the legislative history of the passage of section 475 states that the prohibition against deduction of bad debt reserves is suspended for the MTM regime, it could be argued that there is no basis for any credit carveout. *See supra* note 179 and accompanying text (suggesting that a deduction for bad debt reserves may violate mark-to-market principles by reducing asset values below their true market values).

deferring its compensation for accepting exposure to credit risk: "Derivative financial instruments used in trading and venture capital activities are valued at prevailing market rates on a present value basis.... Where appropriate, compensation for credit risk and ongoing servicing is deferred and taken into income over the term of the derivatives."[377]

The Group of Thirty's discussion of credit carveouts similarly suggests that the financial accounting concept of carveouts attributable to credit risk is not synonymous with, and in fact is considerably broader than, the tax concept of reasonably expected default losses:

> Two adjustments to mid-market are necessary even for a perfectly matched portfolio: the "unearned credit spread adjustment" to reflect the credit risk in the portfolio; and the "administrative costs adjustment" for costs that will be incurred to administer the portfolio. The unearned credit spread adjustment represents amounts set aside to cover expected credit losses *and to provide compensation for credit exposure.*[378]

These statements demonstrate that a credit carveout is viewed for regulatory and financial accounting purposes as deferring compensation for assuming credit exposure so that it can be taken into account periodically over the term of the swap — i.e., as *a risk premium that a dealer earns in addition to the amount necessary to cover expected default losses.*[379] In other words, the credit carveout as

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[377] *Bank One*, *supra* note 12, ¶ 199 (quoting FNBC's 1993 annual report). The Service noted this deferral function when it looked at the fact "that credit and administrative carve-out adjustments played little or no part in any of [FNBC]'s activities, other than possibly reporting to bank regulatory agencies whose concerns tended toward conservatism and in its income deferrals for financial statement purposes." Post-Trial IRS Brief, *supra* note 355, at 472; *see also id.* at 498-500 (discussing the deferral of servicing and credit intermediary income when credit carveouts are not based on realistic market assessments of expected losses due to credit risks).

[378] *Bank One* Brief, *supra* note 229, ¶ 60 (emphasis added) (quoting GROUP OF THIRTY STUDY, *supra* note 290, at 9–10); *Bank One* Post-Trial Brief, *supra* note 229, at 24 (same).

[379] The *Bank One* court also noted the bank's description of the use of credit risk adjustments to achieve financial accounting matching:

> The compensation that results from the bid/offer rate differential should neither be all currently recognized in income at the inception of a swap, nor

described in these documents comprises (at least) two parts (justified for financial accounting purposes by the two rationales set out in the second paragraph of this subsection): (1) an amount equivalent to a bad debt reserve for reasonably expected future swap default losses and (2) a fee deferral mechanism for the portion of the bid-to-mid spread on the swap that corresponds to the fee earned by the swaps dealer in respect of its function as a credit intermediary.[380]

The fee deferral is not structurally coherent with section 475's mark-to-market regime, under either an expected cashflow understanding of accretion taxation or the constructive sale mechanism set out in the Code section. Under an expected cashflow analysis of mark-to-market value, the compensation paid to a dealer for acting as a credit intermediary should form part of the stream of payments that are discounted to present value. There is no corresponding credit-related *cost*, other than a potential loss upon a default of the counterparty, that must be accelerated into the present.[381] While a credit carveout functioning as a fee deferral mechanism may satisfy financial accounting's matching principle by deferring income until "earned," it does not satisfy the income

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> all deferred over the life of a swap. Instead swap compensation should be allocated between current and deferred income recognition based on when it is earned (i.e., a portion up front and a portion over time). Based on an analysis of what the bid/offer rate differential represents, the Bank values its swap contracts using the mid-point between market bid and offer rates. The difference between this valuation and a bid or offer price paid or received by the Bank is treated as deferred income designed to provide compensation for inherent credit risk and periodic administrative costs related to the swaps.
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> . . . The per annum credit deferral is recognized in income on a straight line basis over the life of the swap agreement. The rationale for the income deferral for the inherent credit risk is to defer an appropriate amount of income to match compensation paid to assume credit risk over the period of the risk.

Bank One, *supra* note 12, ¶ 286 (quoting from the bank's petition).

[380] *See, e.g.*, Post-Trial IRS Brief, *supra* note 355, at 218 (pointing out FNBC's reliance, in its proposed findings of fact, on the need to reduce midmarket values for the dealer's expected profit margin at swap inception). Of course, any additional risk premium reflected in a particular swap rate in excess of the prevailing quoted rate is also deferred until received, since it is not included in the midmarket valuation number.

[381] *See also Third Way*, *supra* note 247, at 789 (suggesting that the unearned credit spread covers both losses and a capital charge for opportunity costs).

acceleration goal of section 475.[382] Deferral of compensation for the credit intermediation function thus appears to undo the intended mark-to-market acceleration of that portion of income into the present and fails to satisfy the structural coherence value.

Similarly, applying the Tax Court's approach to the constructive sale of section 475(a)(2), a hypothetical buyer would base the price that he would pay for the dealer's position on objective information such as the terms of the contract and current interest rates. The hypothetical buyer would also consider the creditworthiness of the counterparty in order to reduce the price offered to account for expected default losses. As an end user (the applicable market for considering the constructive sale under the *Bank One* case),[383] the buyer would not expect to earn income as a credit intermediary but would enter into the swap to combat interest rate changes, reduce its costs of funding, or speculate on market trends.[384] Consequently, the buyer would not discount the price by an amount to ensure an expected profit as compensation for assuming a credit intermediary function. Again, the deferral of compensation income for credit intermediation is not appropriate in a mark-to-market system under this analysis.[385]

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[382] Recall that section 475 was enacted as a revenue raiser. *See supra* note 69 and accompanying text.

[383] *See supra* note 361 and accompanying text.

[384] *See supra* notes 238–241 and accompanying text; *see also Bank One*, *supra* note 12, ¶¶ 36–39 (discussing reasons for end-user participation in swaps market); Schuyler K. Henderson, *Swap Credit Risk: A Multi-Perspective Analysis*, 44 BUS. LAW. 365 (1989) (same).

[385] *See, e.g.*, Post-Trial IRS Brief, *supra* note 355, at 208 (asserting that the midmarket method without adjustment values swaps properly based on the analogy with the market for stocks and bonds where credit risk adjustments are reflected in price); *id.* at 211 (asserting that valuation at reduced values is not a market-based approach). The Service stressed the importance of considering the various reasons a dealer may enter into a transaction.

> Valuation at . . . bid price ignores half of the relevant transactions. Some dealers will enter into the fixed leg of a swap and receive their bid price. Other dealers enter into the fixed leg of the same kind of swap and pay another dealer's ask price. Valuation at the bid price counts only the first kind of transactions. There is no reason to believe that the second kind of transactions are less indicative of value. A market comparables approach would take both kinds of transactions into account. A true mid-market value takes both kinds of transactions into account.

Id. at 212. The Post-Trial IRS Brief also sets out a negotiation scenario to illustrate how hypothetical sellers will arrive at a midmarket price as the typical resolution. *See*

Another potential problem with credit carveouts is the mechanism used by dealers to determine the expected default loss. Current quantitative finance literature provides a wide variety of tools for assessing credit risk, each subject to assumptions of the user about relevant parameters, such as creditworthiness of counterparties, concentrations, and volatility of markets.[386] Use of these models leaves considerable leeway to a dealer to give excess weight to parameters that may overstate the amounts determined for expected default losses. Accepted financial accounting and bank regulatory mechanisms for determining a dealer's charges for credit risk adjustments may calculate swap default losses through processes that are also used for loan default losses.[387] Because historical data on defaults on loans demonstrates a substantially higher default rate than the rate for swaps, this use of loan loss mechanisms in swap determinations would likely overstate expected swap default losses and the effect of credit risk exposure on swaps pricing. In both cases, there would also be an excess credit risk adjustment representing an impermissible deferral of a dealer's service compensation for acting as a credit intermediary – exactly the income that is intended to be accelerated under the mark-to-market rules.[388]

The second type of credit risk adjustment made by some dealers, a capital charge for unanticipated credit losses,[389] also violates the income tax value. This carveout amounts to an indefinite deferral of swap spreads, with the amount determined in the aggregate in respect of a dealer's entire swaps portfolio. The charge reduces fair values for financial accounting purposes to reflect foregone investment returns for capital held in reserve. Put another way, the charge effectively lowers the income recognized on a swap to account for this additional return to capital that is expected to be paid in respect of capital held

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id. at 222. *See also supra* note 374 (contrasting buying dealers who demand a spread with hedging dealers who do not).

[386] *See supra* note 310.

[387] *See e.g., Bank One, supra* note 12, ¶ 147 (noting that dealers' determinations of loss factors were "generally derived from the bank's experience with loans to borrowers"); *supra* note 326 and accompanying text (discussing use of bank loan processes to determine amount of expected swap loss).

[388] In *Bank One*, the Service considered FNBC to be "using its carve-outs as a tax shelter" by which it sought to defer profits and accelerate losses based on its use of credit carveouts on swaps where it was the net payor, on nonexistent swaps, and in amounts exceeding the dealer spread on the swap, such as a carveout amount to 137 percent of the swap value. Post-Trial IRS Brief, *supra* note 355, at 601, 601–02.

[389] *See supra* note 334 and accompanying text (regarding credit carveouts for capital charges for unanticipated credit losses).

in reserve. It effectively treats the equity return demanded by shareholders on a bank's capital reserves as a cost allocable to swaps. That is equivalent to allowing a corporation a deduction for dividends paid, which is a violation of basic principles of the income tax.

2. Anti-Manipulation Value

Even if book accounting methods did not raise structural coherence questions of lack of consistency with section 475's basic requirements, there would still remain a strong concern that book valuations permit too much flexibility to satisfy the anti-manipulation value. The securities dealers argue for flexibility, claiming that their book determinations should be acceptable as accurate for tax purposes merely because they are reasonably determined under a generally accepted methodology that is consistently applied by each dealer. Assuming arguendo that most dealers generally make substantially similar types of adjustments to midmarket valuation, however, it is not clear (1) that there is any consistency in the determinations different dealers make regarding what types of adjustments to apply for business purposes other than tax valuations or (2) how the existence of a general methodology with considerable subjective judgments and idiosyncratic proprietary systems provides any measure of "accurate" valuation. Reasonableness for financial accounting purposes may be the epitome of unreasonableness for tax purposes — witness the improper deferral of services income that occurs under the financial accounting matching principle in respect of prepayments. The arguments from consistency within a particular dealer's business do little to assuage concerns about manipulative potential. A dealer can be consistent in overstating the discount rate used in determining midmarket values and consistent in overstating adjustments made to those midmarket values, resulting in too low a tax liability.

Subsection a. considers the anti-manipulation concerns underlying the dealers' main argument for conformity based on the consistency and reasonableness of their valuations. Subsection b. considers the broad range of flexibility permitted under the financial accounting rules, and the tendency of recent financial accounting rule-setting in the wake of the Enron and WorldCom scandals to reinforce financial accounting's conservative focus on delaying recognition of income unless there is little possibility of any intervening event that may reduce the amount of income that should be recognized.

a. Securities Dealers' Arguments for Conformity

The heart of the securities dealers' case for conformity relates to the ANPRM's second proposed principle: that valuations derived for business and accounting uses should result in fair and accurate valuations for tax purposes and that use of the valuation in an appropriate financial statement and in significant non-tax business uses would satisfy that requirement. They have compared derivatives accounting to inventory accounting, with its historic (and, I have argued, inappropriate) layers of permissible methods, to urge that tax rules for MTM valuations be "flexible and pragmatic" with room for considerable variation even among businesses within a particular industry.[390] The question at stake here is whether tax values should permit the kind of individuated and subjective taxable income determinations that would follow from granting permission to each dealer to use its own proprietary subjective judgments in determining swap values, without any limitations other than those imposed by financial accounting fair value measurement rules.

Dealers argue that consistency of methodology across tax and one or more non-tax uses is essentially all that matters. FNBC's litigation strategy, for example, rested on a claim for respect for its particularistic determinations of swap mark-to-market values for tax purposes, essentially without substantiation, on the grounds that its methodology (1) was "a *consistent* methodology applied *consistently* over time" within its own operations and (2) provided a "reasonable" valuation, from a business judgment perspective, that "strikes the appropriate balance between accuracy and practicality."[391] The

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[390] *See, e.g., SIA Response, supra* note 65, at 8. The SIA's argument goes on to note that "tax inventory methods largely follow best practice accounting methods, so long as such methods meet the clear-reflection-of-income test." *Id.* at 9. This statement is not helpful, since the issue at stake is to decide whether the clear reflection of income test requires nonconforming tax inventory methods. The letter argues the need to "sacrifice[] economic precision to reflect the practical realities of business operations." *Id.* But "practical realities" are not at stake here. The securities dealer business is in fact uniform in certain respects — so much so that dealer spreads are less than five basis points on vanilla interest rate swaps.

[391] *Bank One* Brief, *supra* note 229, ¶¶ 3, 4, 52 (emphasis added); *see also Bank One* Post-Trial Brief, *supra* note 229, at 22 ("Petitioner's swaps were valued at the same amounts in its general ledger, its financial statements and its tax returns, as well as in its internal monthly management reports.... [T]he methodology that FNBC selected was reasonable; it was implemented in a systematic, unbiased manner; and it was consistent with generally accepted industry practices during the years at issue."). The bank also asserted that the statement in the legislative history expressing an

Amicus Brief in the *Bank One* case was quite specific on this point (though it avoided use of the book-tax conformity label): it argued that any dealer's "particular implementation" of a mark-to-market accounting methodology is an "objective," bias-free, clear reflection of income so long as it is consistently used for non-tax business, regulatory, and financial accounting purposes.[392] Edward Kleinbard, a well-known tax lawyer who works closely with the SIA, has written separately to make much the same argument for book-tax conformity.[393] The SIA Response to the safe harbor ANPRM focuses on the accounting profession's general views of clear reflection of income as merely requiring a consistent, workable means of recording regular business income. The group argues that reasonable reliability and consistency should be considered especially important in this area, quoting heavily from a few court cases on general inventory valuation methods that emphasize straightforwardness and reasonableness rather than accuracy or any structurally coherent view of the way taxable income differs from book income.[394] The response then emphasizes as a separate pragmatic concern the need for a

expectation that Treasury would relieve taxpayers of compliance burdens when possible while still clearly reflecting income should be treated as a legislative intent that Treasury would defer to business judgments and accept valuations that conformed to book valuations. *Bank One* Brief, *supra* note 229, ¶ 52; *see also Bank One* Post-Trial Brief, *supra* note 229, at 101–02 ("Congress fully understood that there was no one correct methodology of mark-to-market valuation in the case of instruments not actively traded on a secondary market and that valuation in such cases could be extremely complex. . . . Particularly in such a setting, the tax system should take the economic endeavors of the Petitioner's business as it finds them and impose a tax thereon in as administrable and unobtrusive manner as possible."). This argument is flawed. Congress had the opportunity to legislate conformity and chose not to do so. The expression of an expectation of relieving burdens should not be taken as an instruction to do what Congress failed to do. The bank also hoped to find support for its admittedly idiosyncratic methodology by reliance on valuation cases arguably permitting subjective and uncertain valuations under a deferential business judgment standard. *See, e.g.*, *Bank One* Brief, *supra* note 229, ¶¶ 45–47 (arguing that courts have given considerable deference to a taxpayer's subjective business judgment in valuation cases dealing with inventory, bad debts, insurance reserves, and pension reserves); *Bank One* Post-Trial Brief, *supra* note 229, at 89–91 (same); *Bank One* Brief, *supra* note 229, ¶ 48 (arguing that "practical constraints" in valuation cases require reliance on a taxpayer's business judgment; otherwise, courts would be in the position of "fine-tuning or second-guessing" business decisions); *Bank One* Post-Trial Brief, *supra* note 229, at 91 (same).

[392] Amicus Brief, *supra* note66, ¶¶ 19, 21.

[393] *See Some Thoughts, supra* note 247, at 1173, 1175 (espousing book-tax conformity as the only administrable solution).

[394] *See SIA Response*, *supra* note 65, at 4–5 & 4 n.10.

method that is "relatively easy to use, not . . . unduly burdensome and [can] be applied consistently from period to period."[395] The group pointedly argues that any valuation methodology under section 475 must necessarily satisfy the accounting profession's matching principle.[396] In other words, the response argues for conformity based almost entirely on pragmatic, simplicity-based concerns and the accounting-driven matching principle. The premise is that tax values will be satisfied by a taxpayer's "good faith calculations" that are "employed consistently."[397]

Interestingly, the ISDA Response includes a subtle threat. Book-tax conformity will avoid substantial costs, it asserts, because dealers would likely challenge any alternative valuation method developed by the Service as not being *accurate*, either because it failed to take into account factors that are considered important for financial accounting purposes or because it gave different weight to those factors than given in financial accounting.[398] This argument is tautological, since it assumes that fair market value for tax purposes can be nothing other than what the financial accounting world concludes is the appropriate measure of book income.[399] Note that any tax alternative might also be based on a midmarket method, but require or permit only specific kinds of adjustments. Since there is currently no true methodological

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[395] *Id.* at 6.

[396] *Id.* at 5. *But see supra* note 102 and accompanying text (discussing the failure of those who argue for a tax matching principle to understand the overall tax structure and referencing the significant commentary against any such tax matching principle).

[397] *SIA Response*, *supra* note 65, at 11. A naïve citizen might ask why an ordinary taxpayer with an average income around $40,000 that contributes a ten-year-old vehicle to the Red Cross would be required to receive and maintain in its tax records a statement from the charity indicating the value of the vehicle, but a sophisticated taxpayer such as the Goldman Sachs securities dealing unit should be trusted to designate the value of its multibillion dollar derivatives portfolio using its proprietary valuation system based on its good faith efforts.

[398] *ISDA Response*, *supra* note 231, at 8 (claiming that "even if it were possible for the Service and the Treasury Department to develop, constantly update and administer an alternative methodology for determining the fair market value of OTC derivatives, it is unlikely that any such alternative would be as *accurate* as the adjusted mid-market method now used by dealers") (emphasis added).

[399] The counterargument posited here is that even if the terms defining fair market value for tax purposes and fair value for book purposes appear substantially similar, that does not mean that fair value as determined under financial accounting principles can fairly be used for tax purposes. This is because of the two values — structural coherence and anti-manipulation — that require compatibility with the rest of the tax structure and less variation than is acceptable for book purposes.

uniformity among dealers, and any adjustments permitted under the tax regulations would presumably be more careful to take into account tax principles, it is hard to see how this bald assertion of greater "accuracy" for financial accounting income concepts could be true.

Without dealing straightforwardly with the current concern with market inefficiencies caused by flawed or fraudulent audits, the SIA Response suggests that GAAP valuations should be considered fair since they are used for a range of other business purposes, such as internal business and risk management, compensation, and regulatory purposes, and "are subject to rigorous checks and balances by different influential stakeholders."[400] Valuations should satisfy tax, it suggests, since traders would not want their compensation to be based on a conservative bias.

These arguments have several shortcomings. First, the claim that undervaluing derivatives to achieve tax purposes would be detrimental to the OTC derivatives business because traders would forego new profitable trades and unwind existing profitable trades appears simplistic in light of the recent accounting scandals. If a dealer knowingly and systematically undervalued its derivatives, it could compensate by systematically taking into account in its internal assessment of its profit status that the numbers produced to satisfy the tax objective were less than the "actual" profits from the trades. Freddie Mac, for example, had no trouble knowing that it had considerable profits, even though it had intentionally and systematically lowered its reporting of profits by engaging in various swaps and other transactions, in order to smooth out its earnings statements.[401] Second, because tax and financial accounting principles are not equivalent, determinations of value and related compensation bonuses under financial accounting principles may satisfy traders and dealers even though the values understate income for tax purposes.[402] Although internal consistency is not sufficient for proper taxation, internal consistency *is* all that counts in being able to distinguish "good" traders to be rewarded with bonuses (those with more deals at higher values) from "bad" traders. Third, accuracy of valuations according to financial accounting principles is what counts for dealers,

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[400] *SIA Response*, *supra* note 65, at 16.

[401] *See supra* note 140 and accompanying text.

[402] *See, e.g.*, Post-Trial IRS Brief, *supra* note 355, at 476–77 (noting that FNBC's traders' bonuses were determined using unadjusted midmarket values and that even the head of trading was unaware of the administrative and credit costs that might reduce the value of swaps whose revenues were used for determining compensation).

and this is not always the same as accuracy for tax purposes because of the matching principle that defers income by accelerating recognition of various costs that may not be recognized for tax purposes. Finally, one of the most important uses of valuations is hedging of risks, and dealers typically hedge market risks based on midmarket valuations without adjustments for credit risks, administrative costs, or liquidity needs.[403] If midmarket valuations are good enough for this extraordinarily important purpose, it is not clear why they are not appropriate as measures of taxable income.

The ISDA argues that any audited financial statement that is provided to the SEC or any regulatory body or to shareholders or creditors should satisfy the requirement that dealers have an incentive to report values fairly.[404] This would include valuations reflected in consolidated statements and statements of non-U.S. affiliates filed with non-U.S. regulatory bodies. The association argues that these statements are trustworthy because of audits or regulatory review that ensure that the valuation methodology is reasonably and consistently applied.

This confidence in the trustworthiness of financial statements based on independent audits (assuming arguendo that the fair values reflected there are appropriate for tax purposes if accurately derived) disregards the current concern about the lack of trustworthiness of financial audits arising from the widespread abuse of accounting rules at Enron, WorldCom, Dynergy, Freddie Mac, HealthSouth, Parmalat, and other corporations.[405] These accounting scandals involve major publicly traded corporations that in many cases used special purpose subsidiaries, financially engineered transactions using swaps and other derivatives, and/or the active assistance of financial institutions as accommodation parties.[406] At Parmalat, for example, the scandal may

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[403] *See SIA Response, supra* note 65, at 17.

[404] *ISDA Response, supra* note 231, at 29.

[405] *See, e.g.*, Gretchen Morgenson & Reed Abelson, *Suit Says Ernst and UBS Knew of HealthSouth Fraud*, N.Y. TIMES, Jan. 9, 2004, at C2 (noting suspected roles of an accounting firm and investment bank in the HealthSouth fraud); *Parma Splat — Europe's Corporate Governance*, ECONOMIST, Jan. 17, 2004 (indicating that auditors are at the center of the Parmalat scandal, as in the case of Enron); Erik Portanger, David Reilly & Peter Mayer, *Grant Thornton Cuts Ties to Unit Over Parmalat*, WALL ST. J., Jan. 9, 2004, at A9 (indicating that accounting firm had cut ties with its Italian unit because of the unit's possible involvement in the multibillion dollar Parmalat accounting fraud); *supra* note 216 (discussing the recent accounting scandals and providing further references).

[406] *See, e.g.*, Emily Thornton & Mike France, Commentary, *Enron's Bankers: A Great Prison Escape*, BUS. WK. ONLINE, July 31, 2003 (reporting that Citigroup and

involve monies essentially laundered through offshore subsidiaries in order to provide dividends to the founder. These accounting scandals demonstrate special concerns about the reliability of information that is reflected through several layers of corporate structure.[407] It seems unreasonable to add to the power of financial statements (by permitting book income to determine a corporation's tax liability, in part) at a time when the independence of auditors and public trust in

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J.P. Morgan paid $300 million to settle government claims that their derivatives groups assisted Enron in structuring transactions to manipulate its numbers), *at* http://www.businessweek.com/bwdaily/dnflash/jul2003/nf20030731_4717_db042.htm (last visited Oct. 2, 2004); *supra* note 216 (discussing the role of banks as accommodation parties in corporate tax shelters). While some might argue that financial institutions deserve more respect and an assumption of trustworthiness *ab initio* because of their fiduciary role, financial institutions have been as involved as other large corporations in attempting to structure transactions to reduce their own tax liabilities or to profit from assisting others in developing potentially abusive transactions or in misusing the market structure. *See, e.g.*, Associated Press, *Firms Pay $241.8 Million To Settle Charges*, N.Y. TIMES, Mar. 31, 2004, at C5 (noting that five specialist firms, including a Goldman Sachs subsidiary, would settle charges related to illegal trading practices); Riva D. Atlas, *Trades Backed By Big Banks Draw Interest of Regulators*, N.Y. TIMES, Jan. 9, 2004, at C1 (indicating that regulators are focusing on the role of Bank of America and another bank in supporting improper mutual fund trading through total return swaps and noting the similarity to financial institutions' assistance in helping Enron manipulate its results); Carrick Mollenkamp, *Bank of America Faces Allegations*, WALL ST. J., Nov. 12, 2003, at C15 (reporting claim "that the bank used 'creative accounting' in booking financial losses"); Andrew Pollack, *Sealed Indictment is Said to Charge Bank With Fraud*, N.Y. TIMES, Aug. 28, 2003, at C1 (reporting indictment for fraud against Credit Lyonnais); Glenn R. Simpson, *Banks Shifted Billions Into Funds Sheltering Income From Taxes*, WALL ST. J., Aug. 8, 2003, at A1 (reporting that nation's biggest banks set up captive regulated investment companies to avoid state (and possibly federal) income taxes on their interest income); Randall Smith & Tom Lauricella, *Regulators Probe Roles of 2 Banks in Fund Scandal*, WALL ST. J., Jan. 9, 2004, at C13 (noting financial and other support for questionable mutual fund trading); Deborah Solomon, *Deals & Deal Makers: SEC to Vote on Its Settlement Involving Wall Street Analysts*, WALL ST. J., Apr. 24, 2003, at C6 (reporting $1.5 billion settlement with ten Wall Street firms for role in stock analysts' misleading of investors). Because of financial institutions' questionable practices in connection with the accounting scandals, the Sarbanes-Oxley Act mandated a report on financial services. *See Financial Services Report of Corporate Accountability Act of 2002*, 2002 TAX NOTES TODAY 80-19 § 18 (Apr. 22, 2002) (LEXIS, FEDTAX lib., TNT file, elec. cit., 2002 TNT 80-19).

[407] *See, e.g.*, Patrick Barta, *Restatement by Freddie Puts Fannie on Spot*, WALL ST. J., Jan. 12, 2004, at C1 (stating that the mortgage companies' "business and financial statements have become so complex that they are effectively 'unanalyzable'" and suggesting that financial institutions' financial statements are also hard to decipher, in large part because of their "large volume[] of derivatives") (quoting James Bianco, president of a Chicago-based fixed-income research firm).

corporate financial officers is at a low ebb.

In addition to questions about the integrity of the audit process itself, the inherently subjective nature of fair value measurements raises further concern about the reliability of those measurements. As the Office of the Chief Auditor of the Public Company Accounting Oversight Board has noted, "[m]any fair value measurements result from approximations, rather than exact measures, and involve numerous estimates, classifications, judgments, and allocations."[408] When fair value measurements rely primarily on entity-specific assumptions rather than on market-based inputs, the reliability of those measurements is difficult to verify because auditors cannot observe management's expectations.[409] The inherent difficulty in auditing management's expectations was illustrated in the failed Enron audits, in which most of the terms of the energy contract transactions were not observable market conditions.[410]

Interestingly, while touting the consistency of the general midmarket method, the ISDA argues against any requirement of consistency across dealers (other than at the most general level of assumption that all dealers use one form or another of an adjusted midmarket methodology). This statement is worth quoting in its entirety.

> ISDA, however, also believes that it is critically important that the Service and the Treasury Department not use the differences in nomenclature and techniques that exist among dealers either to conclude that a safe harbor should not be prescribed or that such a safe harbor should be based on a single set of techniques mandated in the safe harbor following a survey of dealer practices. In this connection, even if all dealers were required to make the same types of adjustments, they would likely not make identical determinations of value because their assumptions regarding creditworthiness of counterparties, projected future market changes, etc. would not be identical.[411]

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[408] Office of the Chief Auditor, Public Company Accounting Oversight Board, *Auditing Fair Value* (Sept. 8-9, 2004) (discussion paper for Standing Advisory Group meeting), *available at* http://www.pcaobus.org/documents/standards/SAG/2004-09-08-09_SAG_ Meeting/Fair_Value.pdf.

[409] *Id.*

[410] *See id.*

[411] *ISDA Response*, *supra* note 231, at 35.

In other words, securities dealers are well aware that financial accounting rules permit considerable variation between dealers in the way they calculate their income under the mark-to-market approach, and they want this same flexibility to apply for tax purposes as well. One might wonder if the reason for this insistence has more to do with lowering tax burdens than easing administrative difficulties. After all, it is clear that dealers do not use exactly the same valuation output for all business purposes. Why would it be so hard to determine a separate tax valuation if it is not so hard to determine a separate valuation for bonus, internal risk management, or other non-tax business purposes?

b. Variations in Applying the Basic Midmarket Valuation Model

Although dealers almost universally use similar valuation models for interest rates swaps that treat the swaps as a series of forward contracts, financial accounting permits a number of differences in the calculations providing the basic midmarket valuation for vanilla swaps under these models. Dealers are free to determine the pricing model and discount rate without reliance on any specified set of objective criteria. This ability to manipulate the values based on the choice of discount rate or pricing model could be used to consistently lower taxable income, even though the dealer also would have to report lower book income. It is not clear that the impetus to report high income for shareholders and creditors is sufficient to overcome the temptation to manipulate taxable income to lower tax liabilities, which would also be viewed favorably by shareholders and creditors.[412]

The differences in value can be significant. For example, if one dealer habitually adjusts the discount rate to reflect its judgments regarding the creditworthiness of counterparties that are all equally rated by a major credit rating agency (e.g., Standard & Poor's AA rating), while another dealer does not adjust the discount rate for AA or higher rated counterparties, the income reported by the first dealer may be significantly less, determined in respect of a large number of swaps initiated in any one year, than the income reported by the second dealer, even though their transactions are otherwise equivalent.

Financial accounting rules also permit dealers to use different mathematical models for pricing their swaps, if they can provide a

[412] *See, e.g., supra* note 140 (discussing Freddie Mac accounting scandal).

reasonable basis for doing so. As a result, many dealers may not be using the most accurate models for determining value when the swaps book consists in large part of collateralized swaps. Recent research suggests that the value of collateralized swaps can be more accurately determined by models built on futures rates than by the standard models for noncollateralized swaps assuming a package of forward contracts.[413] Almost all standard interest rate and currency swaps are collateralized, and this collateralization significantly reduces or totally eliminates credit risk, so it may be that the valuation models currently used for financial accounting purposes consistently understate swaps income by permitting any credit risk adjustment. If the proposed safe harbor is adopted, there will be no incentive for swaps dealers to change their valuation models to take the recent research on collateralization into account. As in the case of LIFO accounting, the advantageous tax accounting result is likely to drive the financial accounting rule, and swaps valuation methods that give the better result for tax purposes will be retained.

c. *Flexibility of Credit Carveouts*

Another set of issues relates to the particular methodologies used to determine whether any credit carveout is appropriate under the terms of particular swaps. Does the combination of collateral and netting provisions essentially eliminate all risk of loss? To what degree do other provisions, such as special credit triggers or third party guarantees, negate any credit carveout? The question here is not whether the broad procedural approach of midmarket valuation is generally appropriate, but rather whether the extraordinary flexibility permitted under financial accounting rules is simply inconsistent with the anti-manipulation tax requirement. The disagreement between the government and FNBC in the *Bank One* litigation can be understood as raising essentially this question in the context of an examination of the details of carveouts – namely, (1) the potential for inappropriate and significant deferral of income by frontloading certain deductions that appear to function primarily as either a conservatively measured, *bank-wide* bad debt reserve (i.e., not just an appropriate reserve in respect of the reasonably determined expected losses on a securities dealer's positions) or a deferral of spread income until "earned" under the financial accounting matching principle and (2) the myriad variations in ways of implementation, resulting, in

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413 *See* Johannes & Sundaresan, *supra* note 321 and accompanying text.

Bank One, in a tendency to understate income and, in general, in substantial methodological inconsistencies that permit manipulation by taxpayers.[414] The carveout step appears to be more a statement of aspirations than a refined methodology[415] and has significant potential for distortion of taxable income. To the extent that those adjustments are based on an individual taxpayer's subjective determinations, without any relation either to an accepted methodology that is consistently applied across taxpayers or to objective benchmark information (e.g., credit ratings, default loss histories, or other data) that is available to all taxpayers, any claim for reliability appears misplaced.

Furthermore, a dealer's own creditworthiness is clearly a factor in the amount of any expected loss (or gain) on default.[416] The failure of

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[414] *See, e.g.*, *IRS* Brief, *supra* note 355, ¶ 166 (claiming that the bank's particular implementation of midmarket valuations was unlikely to *over*state income and the many inappropriate carveouts were likely to significantly *under*state income, with the result that the unadjusted midmarket values "were closer to fair market value than the values after credit carve-outs and administrative adjustments"); Post-Trial IRS Brief, *supra* note 355, at 562 (criticizing the bank's use of its credit exposure model (CEM) to calculate its carveout amounts because the CEM "is not a measure of how the marketplace currently values the swap or the current exposure" and "it provides no measure whatsoever of whether interbank swap dealers in the marketplace with less exposure to that customer, would be willing to enter into a swap with that customer at prevailing rates); *id.* at 567, 570 (criticizing the bank's failure to take into account the impact of netting, cross-default agreements, offsetting swaps, and other types of protective features that the bank used to reduce its exposure to a counterparty's default potential and stating that "[i]n the face of its failure to incorporate netting, petitioner cannot establish that its own adjusted value is closer to the true fair market value than the unadjusted mid-market value"); *id.* at 572-73 (criticizing the bank's failure to take into account various credit enhancements, such as guarantees and collateral, because those enhancements "may be so effective as to make a credit adjustment inappropriate" due to the fact that they may "effectively bring a counterparty to an equivalent rating of an AA-rated counterparty," in which case the "credit risk is already assumed in the discount rate used to arrive at the net present value for the swaps.

[415] For instance, it is not clear that swaps dealers habitually take both parties' creditworthiness into account, take credit carveouts only for low-rated counterparties where there is a non-*de minimis* risk of an actual default loss, limit the amount of the credit carveout to the unadjusted midmarket value, or otherwise ensure that the idiosyncratic components of their particular credit risk management systems do not result in significant understatements of their swaps income.

[416] Few dealers take their own creditworthiness into account. *See supra* note 315 and accompanying text. This failure results in errors in the determination of potential economic losses from swap defaults. *See* Duffie Report, *supra* note 319, at 26–28 (discussing consideration of dealer's own creditworthiness); *Bank One*, *supra* note 12, ¶¶ 396–98 (discussing the economic impact of a dealer's own likelihood of default and

swap valuation methods to take a dealer's own creditworthiness into account would be especially significant in those cases where a counterparty's rating is *higher* than the dealer's yet *lower* than a credit rating equivalent to Standard & Poor's AA rating. In that case, a dealer would likely *reduce* the income recognized on the swap with the counterparty by a credit adjustment to reflect the fact that the counterparty's credit rating is lower than the credit rating assumed for the prevailing bid-ask rates. At the same time, the dealer would likely *not increase* the income recognized to reflect the fact that the dealer is more likely to default than the counterparty. While the FASB has made it clear that it considers the creditworthiness of both parties relevant to fair value determinations,[417] it may well be that establishment of a tax safe harbor at a time when many dealers continue not to take their own declines in creditworthiness into account may tend to fossilize the financial accounting rules at the earlier stage.

The role of offsetting swaps is also relevant.[418] A dealer that engages in a swap with one counterparty (call this counterparty A) and an offsetting swap with another counterparty (counterparty B) can only come out ahead on one of the swap positions. If the market favors counterparty A (so that the dealer must pay A), then the market will necessarily favor the dealer in its swap with counterparty B, resulting in no net detriment to the dealer in the aggregate under the two swaps. If counterparty A becomes less creditworthy, the dealer will be at risk of loss from a default by counterparty A only when the swap with counterparty A is in the market to the dealer –

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holding that dealers must take their own creditworthiness into account under the mark-to-market regime). As explained, a swap is neither pure obligation nor pure asset. If a dealer were to default on a swap when the dealer owed a significant payment under the swap, the dealer would have gain commensurate with the amount of the unpaid obligation. Again, the analogy of swaps to corporate bonds is helpful. If a corporation issues a bond that pays a 5 percent coupon annually with compound interest, any accrued but unpaid interest is, in effect, a further principal amount that accrues interest for the duration of the period in which it is unpaid. A dealer that defaults on a payment obligation under a swap is in a position similar to a corporate issuer that defaults on the payment of accrued and unpaid interest at maturity of the bond.

[417] *See* USING CASH FLOW INFO. AND PRESENT VALUE IN ACCOUNTING MEASUREMENTS, Statement of Financial Accounting Concepts No. 7, ¶¶ 78–88 (Financial Accounting Standards Bd. 2000).

[418] Mirror and offsetting swaps were also at issue in the *Bank One* litigation, because the bank overstated its credit carveouts in respect of mirror and offsetting swaps. *Bank One*, *supra* note 12, ¶¶ 410–11.

i.e., when the dealer expects to *receive* a net payment from counterparty A rather than to make a net payment to counterparty A. Since the dealer is perfectly hedged with the offsetting swap with counterparty B, counterparty A's decline in creditworthiness will not be an issue when market conditions are such that the dealer is expecting to receive payments under the offsetting swap from counterparty B. Thus, an offsetting position in a second swap with a third party not only reduces market risk but also reduces the credit risk from exposure to a default of the counterparty to the first swap.[419] It is not clear that securities dealers take this type of reduction in credit risk into account in their adjustments to midmarket valuations. Certainly, the responses of the dealer groups to the ANPRM failed to explain in detail the nature of the credit adjustments undertaken and the extent to which they correct for these potential errors in credit adjustments. Again, the ability to manipulate the adjustments in these ways represents a serious flaw for tax purposes.

Securities dealers' potential use of parameters for credit exposure from their loan businesses also permits significant manipulation of valuations leading to overstatements of downward adjustments for credit risks. First, the use of loan loss estimates derived from a bank's regular lending business alone may significantly overstate the potential for swap defaults. The rate of swap defaults appears to be substantially lower than bond default rates.[420] In fact, in the *Bank One* litigation, the bank's experience with swap defaults was so limited that it could only produce information about five or six defaults over an extended period from the start of its swaps business to the early 1990s.[421] The explanation for why the probability of default is lower for swaps than ordinary debt is as follows.[422] In general, default on any financial contract only occurs when two conditions exist: (1) one

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[419] This is another area in which the *Bank One* decision is flawed and should not be followed by the Service in its development of valuation regulations. By leaving out any explicit mention of mirror or offsetting swaps in his list of nine reasons and by explicitly including the requirement that determinations be made on a swap-by-swap basis, Judge Laro let stand an inconsistency that bears directly on a dealer's determination of permissible credit carveouts and potentially distorts the measure of income.

[420] *See, e.g.*, Duffie Report, *supra* note 319, at 12 (noting that "incidence of default on short-term obligations by AA quality borrowers is exceptionally small"); *Bank One*, *supra* note 12, ¶ 265 (noting that swaps are "less risky" than loans).

[421] *See IRS* Trial Memo, *supra* note 329, ¶ 91.

[422] The following discussion is adapted from Ludger Hentschel & Clifford W. Smith, Jr., *Derivatives Regulation: Implications for Central Banks*, 40 J. MONETARY ECON. 305–46 (1997).

party owes a payment under the contract and (2) that party is insolvent. When a financial contract involves ordinary debt, the debtor always owes a payment under the contract, and default will occur if the debtor is insolvent. In the case of a swap, however, each party to the contract potentially will owe a payment at various points over the life of the contract. Even if one of the parties becomes insolvent, default occurs only if the insolvent party also owes a payment under the contract at that particular time—i.e., the insolvent party's position in the swap is out of the money. The likelihood of the insolvent party being out of the money is small for two reasons: (1) if the party is using the swap to hedge its risks rather than speculate, its swap is likely to be in the money at the time it is insolvent and (2) the use of swaps to hedge risks decreases the likelihood of insolvency.[423]

Second, even when there are defaults on swaps, the resultant default loss amounts are generally significantly less than the losses under defaulted loans of similar principal amounts. An interest rate swap with a notional principal amount of $1 million would have a significantly lower loss amount at risk at inception than a corresponding loan with a principal amount of $1 million. In the case of the swap, the nondefaulting party is not subject to the loss of any principal payment on default of the counterparty, and single transaction netting provisions limit the nondefaulting party's loss upon a payment failure to the difference between the payment due from the defaulting counterparty and the payment due from the nondefaulting party. Accordingly, the "swap rate correction for default risk is only about one hundredth of the bond rate correction for default risk," and any correction upon initiation of a swap for credit risk "is normally extremely small."[424] Any securities dealer that relies too heavily on assumptions built from loan portfolio experience and internal processes for assigning credit risks will likely have inordinately high credit carveouts.

Use of a bank's historical experience with a loan portfolio as a

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[423] For example, assume a party X has floating rate debt, but has hedged the risk of increased interest rates by entering into a pay fixed, receive floating swap. A sharp increase in interest rates will increase the payments due under X's debt and thus increase the probability of insolvency, but the increase in interest rates will also cause his pay fixed, receive floating swap to be in-the-money. Additionally, the increased payments received under the swap due to the increased interest rates will help X meet his obligations under the floating rate debt and avoid insolvency. If X had not entered into a swap, the increased interest rates might have pushed him to insolvency and, consequently, to default.

[424] Duffie Report, *supra* note 319, at 13.

model for swap default analysis may permit banks intentionally or inadvertently to distort the determination of the amount at risk in respect of swaps in yet another way. Banks tend to evaluate their risks of losses on loans conservatively. That conservative estimate primarily affects how they risk-manage their portfolio of loans and whether they (and their regulators) believe that they have sufficient capital to sustain their banking operations. Regulators tend to encourage banks not to overestimate the quality of their loan portfolios. Because a loan puts a lender at risk for the principal amount as well as the payment stream (without offset), a bank could experience significant loss or a liquidity crisis upon a sudden default of a small number of its largest loans. Furthermore, if there is a general market disruption resulting in less liquidity and credit availability generally, banks may find that they cannot sell troubled loans as readily as desired. Because vanilla swaps differ significantly, in that there is no principal amount at stake and netting provisions or other credit enhancement typically offset a considerable portion of the risk of loss on default, the conservative tendency of loan risk assessment processes — actually encouraged by bank regulators and financial accounting principles — would in itself tend to understate the measure of income for tax purposes.

Furthermore, the flexibility under accounting rules that permits a bank to rely on subjective internal determinations of the parameters for expected losses to be input into its proprietary models, including the extent to which it wishes to "reserve" for maximum loss swap default scenarios, is a direct violation of the anti-manipulation value. An obvious flaw in FNBC's methodology, for example, was its misuse of a simulation program intended to generate maximum loss scenarios and its use of loss factors based on loan default experiences, leading to some negative adjustments in respect of counterparties with credit ratings of AA or better or on swaps for which the bank did not expect to be a net receiver of cash.[425] FNBC's methodology put it in the position of subtracting apples from oranges. The loss determined under its credit carveout methodology had no relation to the midmarket valuation as of the time that the dealer entered into a swap. Imagine that a dealer enters into a swap with a midmarket value of 10. Applying a methodology for computing credit carveouts

[425] *See Bank One*, *supra* note 12, ¶¶ 236–37 (adjustments on swaps with most creditworthy counterparties and when bank not a net receiver of cash); *id.* ¶ 254 (bank's own credit rating downgraded at some point to risk class 3, roughly equivalent to A or BBB credit rating, which would have been below its typical counterparties in risk grades 1 and 2).

that emphasizes maximum potential losses by selecting a confidence level that includes a large number of radical and generally unlikely swings in underlying reference rates, the dealer concludes that the expected loss under the swap is 13. Applying that expected loss to the midmarket valuation results in a negative mark-to-market value for the swap of -3. Dealers who regularly entered into swaps for which they expected such losses would be out of business. In the hypothetical, it is likely that the dealer has entered into the swap with the expectation of making a profit, and this extreme loss amount is an inappropriate measure of potential loss that serves primarily to defer income (or to satisfy a conservative regulatory function). In fact, any credit risk carveout upon initiation of a swap may be inappropriate, because dealers enter into swaps to make a profit and set swap terms accordingly.

The considerable flexibility generally permitted dealers under financial accounting rules also raises anti-manipulation concerns. The rules generally permit dealers to rely on a range of predominantly subjective estimates as part of the valuation process, without requiring that the estimates be tied to any particular objective benchmarks.[426] Such flexibility appears to directly violate the anti-manipulation value in an area such as valuation methodology where estimates can have a significant impact on overall income recognition.

Consider a simple example of the way that a dealer could distort taxable income with subjective estimates. Assume a corporate end user (E) enters into two swaps with identical terms with two different dealers (D1 and D2). In both cases, E pays a fixed rate and the dealers pay a floating rate. Assume that both dealers have been assigned AAA credit ratings by Standard & Poor's, and assume that E has a single A credit rating. Consequently, both dealers demand a premium from E to enter into the swap with E. Assuming that the prevailing bid-ask spread for AA or higher-rated counterparties for this type of swap is 10 basis points (i.e., 6% ask; 5.9% bid, with a midmarket value of 5.95%), the dealers might negotiate a rate for the swap that corresponds to a 14 basis point bid-ask spread. In determining its values for tax purposes, D1 assesses E based on various factors, including a desire to understate income if at all possible for tax purposes. D1 therefore reduces the value of the swap

[426] When the financial accounting rules do tighten requirements to ensure that valuations are based on objective evidence, they tend to use those requirements to force dealers to adopt more conservative income inclusions, rather than to limit the carveouts available. *See infra* notes 431–432 and accompanying text (discussing EITF Issue No. 02-3).

at year-end by a credit carveout from the credit risk adjusted swap rate using prevailing bid-ask prices that is double the credit carveout determined by D2.[427] If D1 uses this gambit throughout its swaps portfolio, it would show substantially less taxable income than D2 for a particular year, achieving a significant deferral.

Finally, credit enhancements are routinely incorporated in swap agreements and virtually eliminate loss on default in most instances.[428] Yet financial accounting rules permit considerable variability in how a dealer treats credit enhancements in valuing its swaps positions. Accordingly, some dealers do not always take credit enhancement into account, and dealers that do take it into account may vary in the weight they give particular types of enhancement.[429] With this type of flexibility, a dealer could distort the valuation numbers intentionally, without financial accounting consequences, in violation of the anti-manipulation value.

Understanding that this highly subjective estimation could be viewed as incompatible with tax accounting, the SIA reported on a movement within the financial accounting standard-setting process to "maximize the role of objective, verifiable data in the process of determining fair value for derivatives and securities by establishing clearer standards as to which types of evidence are acceptable."[430] The Emerging Issues Task Force (EITF) undertook a project (EITF 02-3) intended to provide guidance as to the type of evidence required for dealers to recognize income in respect of certain exotic derivatives.[431]

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[427] For D2, the credit adjustment is only 1 basis point, reflecting the single A rather than AA rating of E. Accordingly, D2 calculates its net income as 4 basis points—i.e., one half the bid-ask spread (5 basis points) minus the credit adjustment (1 basis point). D1, however, has exaggerated the expected risk of loss. Its calculations show only 3 basis points of net income—i.e., one half the bid-ask spread (5 basis points) minus the credit adjustment (2 basis points). In this case, the unadjusted midmarket value (5 basis points) would be significantly closer to the accurate determination of taxable income than the values arrived at using the subjective adjusted midmarket methodology (4 basis points and 3 basis points, respectively, for the two dealers): one-half the actual bid-ask spread for the premium swap (7 basis points) minus the credit adjustment (2 basis points) equals net income of 5 basis points (which is the same as the unadjusted midmarket value).

[428] *See, e.g., supra* note 321.

[429] *See supra* note 320.

[430] *SIA Response, supra* note 65, at 39.

[431] *See* EITF Abstracts, Issue No. 02-3: *Issues Involved in Accounting for Derivatives Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities* (last discussed Mar. 20, 2003) ¶ 6 (noting that one issue is whether unrealized gains on energy contracts can be recorded without evidence from "quoted market prices or other current market transactions"),

The EITF project or similar proposals may result in some limitation on dealers' ability to use their own subjective value estimates. Such approaches appear to throw the baby out with the bath water if used for tax purposes, however, in that the goal is to *prevent dealers from recognizing any of their initial dealer spread* on exotic derivatives (on which dealers expect to earn higher-than-average spreads in part because of the custom design of the derivative) *unless they can substantiate the valuation* with observable market data.[432] This statement exemplifies the financial accounting conservative aim to prevent puffery. Dealers argue that this deferral of their spread income should be respected for tax purposes,[433] but it is hard to see how the conservatism of this approach can be reconciled with the MTM goal of enhancing revenues by accelerating recognition of dealer spreads. The statement's aim at reducing puffery is a financial accounting objective that has no place in tax.

Furthermore, even if the enhancement of the anti-manipulation value provided by the increased emphasis on objective evidence reported by the industry in respect of EITF 02-3 were considered important enough to outweigh the likely increased deferral of spread recognition for more exotic derivatives, there is no guarantee that the final form of the financial accounting rules would adequately protect the anti-manipulation value. Although the FASB decided not to address EITF 02-3 in its current project on Fair Value Measurements, it plans to address related issues in its project on revenue recognition.[434] Certainly the history of attempts to reform financial

¶ 7 (noting concern regarding recognition of revenue when fair value is "estimated based solely on internal valuation models"), ¶¶ 14–16 (reporting October 25, 2002 decision to rescind EITF Issues 98-10 and 00-17 and concluding that additional guidance is needed from FASB "with respect to measuring fair value in the absence of quoted market prices or current market transactions with similar terms and counterparties"). EITF 02-3 includes a footnote in which the FASB staff reports that the Financial Accounting Standards Statement No. 133 definition of fair value requires an estimate made using the "best information available in the circumstances," which the FASB staff interpreted to mean the transaction price, in the absence of quoted market values. *Id.* ¶ 16, n.3. As a result, the FASB staff indicated that no gain should be recorded unless the fair value is based on a quoted price or other market data, or "a valuation technique incorporating observable market data." *Id.* The overall approach is thus a conservative one that refuses to allow management to "puff" revenues based on estimates of likely profits from derivatives.

[432] *See ISDA Response*, *supra* note 231, at 27 (noting that dealer's initial spread would be deferred under EITF 02-3 unless there was objective evidence of value).

[433] *See id.* at 28.

[434] Fair Value Exposure Draft, *supra* note 210, ¶¶ C22-C23.

accounting to expense stock options is not very encouraging in this regard.[435]

3. Pragmatic Concerns

This Article has demonstrated that the case for a book-tax conformity safe harbor under section 475 rests largely on concerns about the administrative infeasibility of detailed tax rules in the context of rapid innovations and the potentially onerous burden of records maintenance to substantiate valuations under special tax rules and disputes with tax authorities during audits regarding those valuations. The ISDA indicates that the Service could not "deconstruct a dealer's portfolio adjustments to determine the actual effect of those adjustments on gain or loss for a single position."[436]

In fact-specific contexts, it always will be simpler and less costly for a taxpayer to import a financial accounting number onto its tax return, and less costly for the government to accept such a number than to audit details that are of particular relevance to tax accounting. These concerns are not distinguishable from similar concerns that arise *whenever* a tax provision imposes more stringent substantiation requirements than required for book purpose, institutes a less flexible method of reporting than permitted under financial accounting, or applies a classification or timing rule that necessitates reconciliation of different tax and accounting numbers.

In the derivative valuation context, these arguments based on simplicity are simply not convincing. Banks have already demonstrated that they use a variety of valuations for different purposes, making it hard to accept their argument that to calculate a particular type of value for tax would be an onerous burden. Again the experience with LIFO accounting is helpful. Since adoption of the mandatory booking requirement, financial accounting and tax rules have moved in different directions, and thus LIFO numbers for tax purposes may not be the same as LIFO numbers for book purposes. These complications are a bother, but do not rise to the level of disrupting business. The same would likely be true of a separate tax determination of derivative values.

Furthermore, today's electronic capabilities make both

[435] Arthur Levitt's reform attempts at the SEC were successfully stifled by lobbyists' pressure on Congress. *See* ARTHUR LEVITT, TAKE ON THE STREET: WHAT WALL STREET AND CORPORATE AMERICA DON'T WANT YOU TO KNOW 109 (2002) (describing congressional interference with financial accounting regulation).

[436] *ISDA Response*, *supra* note 231, at 34.

calculations and storage of data much simpler than it would have been twenty or even ten years ago. It is not difficult to imagine that banks could relatively easily create software modifications to make the appropriate tax determinations based on the output of the software used to produce their adjusted midmarket valuations for financial accounting purposes. Additionally, given the range of electronic storage and retrieval systems, there appears to be no reason why retention of appropriate records in electronic format should be overly burdensome on securities dealers.

The dire picture painted by securities dealers if they are not permitted to simply report book numbers for tax purposes does not hold up. Although the concerns about extra accounting burdens and potentials for disputes on audit are real, they cannot outweigh significant structural coherence and anti-manipulation concerns in a context where the self-assessment value is threatened. Simply put, simplicity cannot provide a reason for why the tax administrator should not have as much right to demand a tax-appropriate valuation as the bank regulator has to demand a banking-appropriate valuation.

D. Alternative Proposal for Comprehensive Valuation Regulations

Shoehorning taxable income determinations of value into financial accounting rules that are designed with different goals and are in an unusual state of flux could prove costly for the tax system. Accordingly, this Article proposes that Treasury should address securities dealers' genuine uncertainties by issuing comprehensive regulations on permissible valuation methodologies under section 475. Mark-to-market regulations need not be more complex than those necessary in other regimes governing taxpayers today, such as the rules governing uniform capitalization, accelerated cost recovery, or consolidated returns. Any tensions between section 475 and securities dealers' business models are best resolved through tailored regulatory guidance that provides sufficient latitude to businesses without sacrificing the goals of tax policy and the particular demands of a mark-to-market regime.

A regulatory project would take some time and require considerable input from the dealer community and interested practitioners. It is beyond the scope of this Article to do more than suggest a few of the areas that comprehensive regulations should address and some approaches that might prove workable. It should be noted, however, that such a project is inevitable even if an elective conformity safe harbor is adopted, since any taxpayers who did not elect into the conformity safe harbor would require guidance on proper considerations to be applied in determining valuations. This fundamental need for comprehensive regulations means that the proposed conformity election offers less of a reduction in burden for Treasury than for electing taxpayers. It is merely another election that permits taxpayers to reduce their tax burden relative to other similarly situated taxpayers, rather than being required to determine taxable income under generally prevailing rules.

1. Credit Carveouts

As the discussion on credit carveouts has shown, these carveouts are particularly prone to violate the structural coherence and anti-manipulation values. Regulations should therefore provide specific bright-line rules for determining whether a taxpayer is entitled to take a credit carveout and the range of carveouts permitted.

a. Permissibility of a Carveout

First, whether any carveout is necessary in respect of a particular swap will depend on various provisions in the particular swap agreement that reduce credit risk in respect of a dealer's counterparty or increase the return to the dealer under the swap because of a reduction in its own creditworthiness. The *Bank One* court appropriately required that dealers take credit enhancements such as collateral, netting, and credit triggers into account. Each of those provisions reduces or eliminates credit risk.[437] A swap with various of these credit enhancements essentially has zero default risk. The regulations should acknowledge the importance of collateral and

[437] For example, when a swap is collateralized, collateral is generally posted at intervals so that it is maintained in the amount of the current mark-to-market value of the swap. Market participants treat collateral as entirely eliminating risk of default loss. *See* Johannes & Sundaresan, *supra* note 321, at 3. However, there may be an incremental benefit (cost) of receiving (posting) collateral that impacts collateralized swap rates. *Id.* at 1 (swap pricing theory for swaps as portfolios of forward contracts that can be equated with par bonds does not hold true in the case of collateralized swaps, which require a futures-based swap curve to account for "costly collateral"). Similarly, when a swap is conducted with a counterparty subject to a close-out netting agreement, the amount of loss is restricted to the net payment due. Both single-transaction netting and multiple transaction netting should significantly reduce risk of loss on default. *See, e.g.*, Jean-David Fermanian & Olivier Scaillet, *Sensitivity Analysis of VAR and Expected Shortfall for Portfolios under Netting Agreements* (Working Paper, Aug. 2003), at 3–4, 14–16, *available at* http://www.hed.unige.ch/professeurs/ SCAILLET.Olivier/pages.web/Home.Page.htm.

other credit enhancements in the swaps market and disallow credit risk adjustments for swaps that are protected by those mechanisms, unless the protection in the particular instance is insubstantial.

Moreover, the regulations should disallow any credit carveout whatsoever at inception of a swap contract. This disallowance stems directly from the pricing assumptions underlying the efficient market hypothesis: the price and terms (length of contract, termination triggers) are assumed to reflect all relevant information, including current information about the credit status of the counterparties. The dealer must be considered to have protected itself from any foreseeable counterparty credit risk at the outset of the contract through those terms. This is especially important since the midmarket value forming the basis of the valuation takes into account quoted bid-ask spreads rather than the specific rate a dealer may have negotiated in respect of a particular counterparty, in the case of counterparties with inferior creditworthiness. Any credit carveout at inception of a swap would almost certainly understate taxable value and result in undertaxation, just as in the case of bad debt reserve deductions prior to the repeal of section 166(c).

Even if Treasury were to permit a credit risk carveout at inception, it should at the least be limited to ensure current inclusion of a reasonable minimum dealer profit (determined as a percentage of the midmarket valuation).[438] In other words, no credit carveout should be permitted to the extent that it exceeds the midmarket value (after other adjustments) minus a minimum profit allowance. This suggestion accords with the reality that dealers enter into swaps to make a profit: a credit carveout that eliminates any expected dealer profit at the outset is operating to defer the dealer's service income rather than to offset gross income by expected default losses.

Similarly, the *Bank One* court held that FNBC should have considered the relative creditworthiness of the two counterparties, with upward adjustments in the value of a swap when its creditworthiness declines relative to its counterparty's creditworthiness. This requirement is economically appropriate, in that it will result in more accurate valuations of swaps. Accordingly, no credit carveout should be permitted at inception for swaps for which the counterparty enjoys better creditworthiness than the dealer, in accord with the general principle enunciated above, and any decline

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[438] This could also be stated in terms of mid-to-bid spread. *Cf. Duffie Report, supra* note 319, at 8 (noting that carveouts should not reduce profits below the dealer's bid price threshold).

in a dealer's creditworthiness over the term of the swap should result in a positive increment to valuation (and thus a reversal of any credit adjustment previously taken in respect of a counterparty's credit risk).

Furthermore, the regulations should require that carveouts be based on objective information that is publicly available (such as credit default swap (CDS) information, credit agency ratings, and bond rates) or verifiable and documented by the taxpayer (such as historic swap default rates and amounts).[439] This requirement stems from the basic premise that measuring income consistently across similarly situated taxpayers promotes fairness and efficiency.[440] In an ideal tax system, the symmetrical nature of swap credit risk would result in corresponding valuation adjustments by the counterparties, to the extent adjustments are appropriate:[441] the fair market value to one would be the negative of the fair market value to the other.[442] The importance of symmetry argues for the development of objective benchmarks (e.g., term of a swap, counterparty CDS spreads or credit ratings, contractual credit enhancement, pool risk diversification characteristics) by which parties can determine eligibility for, and amount of, a credit carveout.

Given the anti-manipulation concerns inherent in permitting dealers to rely too heavily on subjective estimates for fair value computations, as well as the problems arising when using their loan businesses as a proxy for credit risk, the important question becomes whether objective data exists for measuring credit risk. Although still

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[439] Current research on credit risks suggests that credit ratings and bond spreads provide a more accurate assessment of credit risk than companies' internally generated analyses. Current research on credit risks suggests that CDs and bond spreads incorporate market information differently and CDs pricing may be the most informative about default risk. *See, e.g.*, ROBERTO BLANCO ET AL., AN EMPIRICAL ANALYSIS OF THE DYNAMIC RELATIONSHIP BETWEEN INVESTMENT-GRADE BONDS AND CREDIT DEFAULT SWAPS (Bank of England, Working Paper No. 211, 2003), *available at* http://www.bankofengland.co.uk/wp/index.html.

[440] *See generally* JOSEPH DODGE, THE LOGIC OF TAX, 88–95 (1989) (discussing fairness principles); *supra* note 158 and accompanying text (same).

[441] In other words, if the dealer's own creditworthiness declines, leaving the counterparty in the position of discounting the value of its position in the swap to account for a greater potential of loss, the dealer's position in the swap should increase in value (i.e., a negative credit carveout) to reflect the potential relief that the dealer would receive on default from the obligation to make payments to the counterparty.

[442] *IRS* Brief, *supra* note 355, ¶ 113; *see also* Post-Trial IRS Brief, *supra* note 355, at 538 (noting that "whenever a downward adjustment to mid-market value is justified for a swap, a corresponding upward adjustment to mid-market value is justified for another swap").

young, the CDS market has the potential of becoming a major source for such data. The market for credit derivatives began in the early 1990s in New York and London and has been growing rapidly ever since.[443] For example, in 1997, the British Bankers' Association estimated that the outstanding notional value of credit derivative contracts was $170 billion.[444] That same group estimated that the outstanding notional value of credit derivative contracts at the end of 2003 had grown to $3548 billion.[445] By the end of 2006, the credit derivatives market is expected to grow to $8206 billion.[446] The CDS market is by far the largest segment of the overall credit derivatives market: in 2003, it made up 51% of the total market, which amounts to approximately $1809 billion in outstanding notional amount of CDS contracts.[447]

A CDS enables a protection buyer (who may or may not actually hold obligations of a reference entity) to protect itself against losses that would result from a reference entity's default on designated obligations.[448] The most direct single-name CDS works as follows. A protection buyer (A) wishes to protect itself from default losses on a reference entity (C) obligation. A and the protection seller (B) enter into a swap whereby B agrees to make a payment to A, determined by reference to a notional amount, upon C's default on a designated reference obligation. The notional amount and the terms of the reference obligation are selected to compensate A for the loss that A will experience if C defaults on the obligation A actually holds.[449] For that protection, A pays B a premium, generally in the form of periodic payments expressed as a per annum percentage (in basis points) of the notional amount of the contract.[450] Physical settlement requires the protection buyer to deliver obligations that are specified in the

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[443] PHILLIP J. SCHONBUCHER, CREDIT DERIVATIVES PRICING MODELS: MODELS, PRICING AND IMPLEMENTATION 4 (2003).

[444] *Id.* at 4 tbl. 1.1.

[445] BRITISH BANKERS' ASSOC., CREDIT DERIVATIVES REPORT 2003/2004 (EXECUTIVE SUMMARY), *at* http://www.bba.org.uk/content/1/c4/44/93/cd_executive_summary.pdf.

[446] *Id.*

[447] *Id.*

[448] *See* Edward D. Kleinbard, *Competitive Convergence in the Financial Services Markets*, 2003 TAXES 225, 243-44.

[449] *See generally* SCHONBUCHER, *supra* note 443, at 15; Patrick Houweling & Ton Vorst, *Pricing Default Swaps: Empirical Evidence* at 4-5 (Nov. 14, 2003), *available at* http://ssrn.com/abstract=294799.

[450] David Rule, *The Credit Derivatives Market: Its Development and Possible Implications for Financial Stability*, FIN. STABILITY REV., June 2001, at 118.

contract (generally ones that are pari passu with the reference obligations) and requires the protection seller to pay the full notional principal amount of the contract, while cash settlement requires the protection seller to pay the difference between the notional amount and the trading value of the reference obligations following the credit event.[451] The various credit protection contracts thus transfer risk of loss in respect of a default by the reference entity on designated obligations from the protection buyer to the protection seller.[452]

The CDS market can be an important resource for assessing credit risk because a CDS essentially isolates the credit risk in an obligation and allows that risk to be exchanged in an arms-length transaction. Credit risk is isolated because the protection buyer, which has an underlying exposure to the reference entity, retains the market risk inherent in the obligation (e.g., the risk that the value of the obligation will change due to changes in interest rates) but hedges itself against the risk of the reference entity defaulting by selling that risk to the protection seller.[453] Therefore, the premium paid by the protection buyer to the protection seller is the price of the reference entity's credit risk.[454] As the CDS market matures and becomes more liquid, it will develop into a valuable source of objective information about the credit risk of entities.[455] Currently, however, pricing models are still used to value many of the component risks, and these pricing models may or may not provide a reasonable estimation of the market prices of CDSs.[456]

Accordingly, based on the increased availability of information on relative credit rankings of parties, especially through credit default swaps, it might be possible for Treasury to establish one or more

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[451] *See* Kleinbard, *supra* note 448, at 244.

[452] *Id.* at 227.

[453] *See* SCHONBUCHER, *supra* note 443, at 15.

[454] The premium generally is not affected by the estimated risk of counterparty default because if the protection seller is not willing to assume the default risk of the protection buyer, it will either not enter into the contract or eliminate that risk by, for example, demanding that the buyer provide collateral or make an up-front, rather than periodic, premium payment. Houweling & Vorst, *supra* note 449, at 5.

[455] Rule, *supra* note 450, at 117; Roberto Blanco, Simon Brennan, & Ian Marsh, *An Empirical Analysis of the Dynamic Relationship Between Investment Grade Bonds and Credit Default Swaps*, Bank of England Working Paper No. 211 (2003), *available at www.bankofengland.co.uk/wp/index.html* (suggesting that credit risk is priced in both bond and CDS markets, but price discovery primarily occurs in CDS markets) (last visited Nov. 18, 2004).

[456] *See* Houweling & Vorst, *supra* note 449, at 29 (suggesting that pricing models underestimated credit risk as priced in the market for speculative grade entities).

credit risk filters that indicate that a default loss is highly unlikely, at the time of valuation, based on objective terms of swaps and other publicly available information regarding the creditworthiness of the counterparties, and therefore disallow credit risk adjustments to swap values whenever this filter applies. For example, the relative creditworthiness of the two parties could be determined based on publicly available information about their credit ratings, CDSs, or bond issuances. Regulations could establish the following characteristics of a counterparty's credit rating, CDSs, or bond issuances as indicative that it would be inappropriate to establish a carveout for credit risk in respect of that counterparty:

- An average credit rating, as assigned by public credit rating agencies, equal to or higher than the taxpayer's own rating, or
- An average market price on credit default swaps in respect of the counterparty that is equal to or lower than the average price on similar credit default swaps in respect of the dealer, or
- A current issuance of bonds with a fixed or floating rate coupon equal to or lower than the taxpayer's own bonds, or
- A weighted average coupon rate on outstanding bonds that is equal to or lower than the taxpayer's weighted average coupon rate, unless the counterparty's bonds have been issued over the last four years at a rate that has increased during a period when interest rates generally were stable or decreasing; or
- A weighted average coupon rate on outstanding bonds that has declined when measured over a five-year look-back period and that is not at the time more than 100 basis points greater than the weighted average coupon rate of the taxpayer's outstanding bonds.

The regulations should also clarify that a credit carveout is permitted only for reasonably expected default losses and may not be broadened to provide deferral of any risk premium that provides compensation to a dealer for its credit intermediary function.[457] This ensures that the services income related to the swap will be taken into account upon inception of the swap and not deferred, in accordance with the original intent of the mark-to-market revenue enhancement provision to accelerate recognition of dealer swap income.

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[457] *See supra* note 290 and accompanying text (indicating that deferral of credit intermediary service provider income violates structural coherence).

b. Amount of a Carveout

Second, the regulations could provide a formula to establish ceilings on acceptable carveouts – e.g., no more than one-tenth of a basis point for each 100 basis points of spread between the counterparty's and taxpayer's bond rates, or some other amount that Treasury determines is appropriate based on industry data and the results of the ongoing AIR program with broker-dealers. For example, it may be that the spread between the two parties' CDS prices would provide the most appropriate basis for a formulaic ceiling on swap carveouts. Alternatively, dealers could be required to maintain detailed records of swap losses due to defaults, and rules similar to the *Black Motor Company* six-year rolling-loss formula for increases to bad debt reserves could be used to set a ceiling to ensure that credit carveouts are based on relevant swap default loss historical experience.

It might also be appropriate to require a reasonable minimum profit[458] as a limit on credit carveouts throughout the life of the swap. Recognition of credit carveouts that reduced or eliminated this minimum profit amount would be permitted only upon the actual default of the counterparty. This would accord with the general hesitation in an income tax system to recognize losses before they occur, which was reinforced by the elimination of the deduction for additions to bad debt reserves in section 166(c).[459]

Finally, Treasury regulations governing credit carveouts should include a general anti-abuse rule requiring that a dealer's method for determining credit carveouts be consistent with its method for determining midmarket valuations and the expectation that a dealer enters into a swap intending to make a profit. These limitations would provide a means of reconciling the MTM rules with the intent of the rules for bad debt reserves while at the same time preventing dealers from being able to take a bad debt reserve for their loan books through the back door of an adjustment to their swaps portfolio.[460]

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[458] See *supra* note 438 and accompanying text.

[459] *See supra* note 179 and accompanying text.

[460] Inappropriate use of loan experience to determine swap credit carveouts would mean that the credit carveout for swaps would overstate the amount at risk of default loss. Assuming that a dealer's actual default losses are consistently less than its carveout amounts, the excess carveouts act as a deferral engine to defer substantial amounts of dealer operating income that should be taken into account and taxed in the first year of the swap. This deferral engine serves as a back-door way to create an otherwise impermissible deductible bad debt reserve in respect of the rest of the

2. Swap or Portfolio?

The discussion of regulatory limitations on credit adjustments assumed that gross valuations and adjustments are made on a swap-by-swap basis. The Tax Court in *Bank One* explicitly ruled that carveouts must be determined on a swap-by-swap basis rather than on a portfolio basis. Although the literal language of the statute appears to require a swap-by-swap valuation,[461] there are arguments for reading the statutory language more broadly in light of its purpose. Recall that the genesis of mark-to-market accounting lay in the desire of securities and commodities dealers for a "cure for the timing mismatches that otherwise would result from reporting the income of a *hedged trading business* on a non-realization basis for inventory and a realization basis for everything else."[462] The suitability of mark-to-market for hedged businesses, that is, rests most particularly on the fact that net income must be determined from aggregate portfolios where either the individual positions cannot be discretely valued or discrete valuation is likely to be an administrative and financial burden to the taxpayer even while potentially distorting the measurement of income. Where positions can be discretely valued without such burdens, other sophisticated timing regimes, such as the capitalization systems under sections 263 and 263A, are sufficient.[463]

Thus, assuming for this purpose that a dealer's particular carveouts and methods of determining their values are acceptable, portfolio-based assessments of carveouts may be necessary to satisfy structural coherence in the context of section 475. As each position is added to the portfolio, the relevant characteristics of the portfolio change. Tracking the portfolio provides information on overall volatility, term, net expected cash flows and liquidity concerns, net exposure to risky counterparties, and other factors that are relevant for profit and loss analysis and risk management. This is particularly true in respect of adequate reserves for expected default losses. Because dealers now manage risk on an aggregate basis for an entire portfolio, they can take into consideration collateral and netting provisions, as well as mirror and offsetting swaps and partial hedges across the portfolio. Risk is dispersed over the entire portfolio, reducing the quantum of risk in respect of a particular swap.

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dealer's business, in the guise of accelerating potential default losses to match the accelerated income stream on the swaps. *See supra* note 376.

[461] *See supra* note 268 and accompanying text.

[462] Kleinbard & Evans, *supra* note 54, at 797–801 (emphasis added).

[463] *Id.* at 791.

If, however, the court's swap-by-swap ruling were taken literally to mean that each swap is considered as a *stand-alone instrument* without regard to other instruments in a dealer's portfolio, it appears that risk determinations would be inherently inaccurate. Under a stand-alone analysis, it would be impossible for a dealer to make risk and profit/loss determinations by taking into account any portfolio-wide characteristics. In particular, risks and expected cash flows in respect of a particular swap would be determined without regard to the existence of a matching or partially offsetting swap or other hedge or multiple-transaction netting arrangements. Market and credit risk of the isolated swap would be overstated, and the dealer's swap income would be understated.[464] The result would be a significant distortion not in line with the goals of mark-to-market accounting.

On the other hand, the Tax Court's decision may be amenable to an interpretation that avoids the distortion of a stand-alone assessment of risk while still adhering to the literal item-by-item valuation requirement imposed by the decision and arguably required by the statute. Under this view, the swap-by-swap determination is primarily a *substantiation* requirement related to the anti-manipulation value. A dealer would keep a separate record or schedule for each swap in which it would record the year-end mark for each swap, including both the midmarket value determined for that swap and any carveout amounts allocated to that swap. The record would essentially document the mark-to-market basis account for that swap. That separate schedule, however, would not be generated in a vacuum.

[464] Credit risks and market risks are reduced by the pool balancing effects of diversification. Assume Dealer (DR) enters into a series of offsetting fixed to float swaps, in which Counterparties A, B, C, and D pay fixed to DR and DR pays fixed to counterparties E, F, G, and H, all under master agreements that permit cross netting upon a default event. If counterparty E defaults and does not make a floating payment to DR at the same time that counterparty A defaults and does not make a fixed payment to DR, then DR will not have a default loss, since DR would have merely passed the float payment from E over to A. Market risk would also be overstated for a stand-alone swap, because there would be no way to recognize the risk reduction from the overall hedging of the portfolio. If hedging costs are included in administrative cost adjustments (which may have been the case in *Bank One*), then those administrative costs may also be overstated to some degree. Note that credit and market risk are related. Suppose in the hypothetical that A is a poor credit risk and E is a good credit risk. A defaults, but E does not. DR therefore receives a floating rate payment from E, but DR does not have to pass it along to A because of A's default. A's default as to these offsetting swaps is harmless, because the contract was in the money to A and not in the money to DR. A's credit risk is therefore only a concern when the market favors DR rather than A.

For example, a central component of a swap's basis is its midmarket value at the end of the first year. It is possible that dealers would continue to determine midmarket values separately for each individual swap. They may, however, determine midmarket values for groups of swaps acquired in a defined accounting period. Treasury might provide that it would not be distortive in certain cases for dealers to determine midmarket values for particular books of swaps and allocate those values to particular swaps in proportion to their notional principal amounts. Treasury regulations could establish the characteristics of portfolios for which a book-wide determination is not distortive and the types of information that a dealer should retain to verify the determination.

Similarly, it might be that systems could be developed to permit credit carveouts to be determined on a pool basis, with particular regard for limitations specified in Treasury regulations along the lines developed in the preceding section. For example, credit carveouts would reflect reduced credit risk of portfolio arrangements such as offsetting swaps and close-out netting, in addition to the credit enhancement provided by single-transaction netting, collateral, and other items that effectively eliminate risk for a particular swap. That aggregate credit risk could be allocated to particular swaps according to formulas that take into consideration the criteria used in establishing the amount of the overall carveout amounts.

For example, Treasury regulations in accord with the previous subsection would provide that a swap between investment grade parties with credit enhancement of a certain type (credit triggers, single transaction netting as well as a close-out netting agreement, or specified levels of collateral) would not merit any credit carveout, could not be allocated any portion of pool risk, and could not be treated as contributing to pool risk. A dealer's determination of pool risk would also have to take into account the lowering of risk when the dealer enters into offsetting positions and the increase in risk when offsetting positions are terminated, allocating that change proportionately among all of the offsetting positions. In other words, the regulations could set forth a broad scheme for a scheduler system that would track data on each separate swap position by reference to its particular terms but with regard to other positions in the portfolio, taking into account the risk reduction offered by a hedged portfolio but allocating that risk reduction appropriately to individual swaps. The scheduler system would ensure that basis for the swap is tracked appropriately and permit the dealer to recognize the correct amount of income (or loss) when a swap is bought out or otherwise terminated prior to maturity.

The advantage of this sort of swap-by-swap method, especially from the government's perspective, is that it provides a spreadsheet summary, documented over the life of the swap, recording the relevant midmarket values, carveout, and mark-to-market increments of income or loss. The government could easily determine on audit whether a dealer had appropriately recalculated midmarket values and carveout amounts at year-end and included (or deducted) the corresponding incremental amounts as required. Like depreciation adjustments and other items for which there is substantial detail as well as substantial differences in timing between financial and tax accounting, accountants should be able to develop systems to track the needed reconciliation information.

The disadvantage, from the dealer perspective, is that this approach would require development of an appropriate record system, to the extent a dealer does not currently maintain accounts for each swap. It is difficult to assess how burdensome this requirement would be in practice. On the one hand, Kleinbard indicates that dealers currently perform the midmarket valuation and carveout determinations on a portfolio-wide basis.[465] The industry's response would likely be that it is an unreasonable burden for major swaps dealers to generate and maintain these kinds of individual records of this nature. The dealers may well view a comprehensive recordkeeping requirement as substantially negating the advantages of mark-to-market accounting.[466] On the other hand, dealers also apparently claim to "carefully document[] their adjustments as case-by-case exercises in valuation" to demonstrate the trustworthiness of their numbers, although they may consider such recordkeeping a wasteful exercise.[467] If dealers have already been documenting their adjustments on a case-by-case basis, there is no reason that they should not be able to continue to do so. Even if a conformity safe harbor is provided, it is likely to require dealers to provide supplemental documentation beyond the information available in the applicable financial statements.

In summary, these proposals suggest that Treasury must provide explicit guidance on measurement of carveouts. Manageable

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[465] *See, e.g.*, *Some Thoughts*, *supra* note 247, at 1174 (discussing valuation of a swaps portfolio and adjustments on a portfolio-wide basis).

[466] *Cf.* Kleinbard & Evans, *supra* note 54, at 794 (noting that one of the reasons for preferring a mark-to-market system is "that it obviates the need to identify the particular *future* item of income or loss to which a current item relates").

[467] *Id.* at 818.

solutions for maintaining and reconciling different book-tax methods have been developed in other contexts, such as the uniform capitalization rules and accelerated cost recovery system. There is no reason to believe that equally practicable solutions cannot be developed here.

V. CONCLUSION

In light of the renewed attention garnered by the relationship between book and tax accounting, this Article reviews the history of interest in conformity and examines the abstract principles of fairness and efficiency that have served as guidance for the tax system over several decades. The Article concludes that the most important features of the tax system to consider when evaluating conformity proposals are whether the conformity proposal is structurally coherent with the tax provisions at stake and whether the conformity proposal supports the self-assessment characteristic of our voluntary compliance scheme by not providing too many opportunities for manipulation of the measure of taxable income. Only when these two features are appropriately respected can pragmatic concerns for simplifying taxpayers' compliance burdens and tax administrators' enforcement burdens merit consideration.

This Article also assesses the section 475 safe harbor for valuations of derivatives currently under consideration by the government. The case for conformity is based on easing compliance for securities dealers. Securities industry participants insist that they follow a universal and predictable methodology that the government should respect solely because the resulting valuations (with or without certain adjustments) are also used for some business purposes other than tax reporting and are reported on trustworthy financial statements. Their case rests almost exclusively on the pragmatic argument from simplicity and administrative convenience. Undoubtedly, their lives will be simpler if they can simply import book income values to tax returns.

This Article takes issue with those proponents of conformity and suggests instead that there is a strong case *against* adopting a conformity requirement or safe harbor for securities dealers' mark-to-market accounting for derivatives. The negative case rests on the two prongs outlined in the earlier section of the Article: structural coherence and anti-manipulation. Structural coherence concerns are raised by the deferral of income resulting under financial accounting because of tax-inappropriate adjustments or because it requires a more conservative approach to income inclusion, particularly in respect of exotic derivatives. Ultimately, these results violate the income tax value.

Anti-manipulation concerns arise because of accounting flexibility that permits (or even encourages) material inconsistencies among taxpayers that are otherwise similarly situated and the potential for manipulation of timing of income through use of highly subjective data to achieve tax or financial accounting goals. Using mark-to-market accounting to manipulate timing of income goes against the very essence of the tax mark-to-market method, which is intended to mandate a current accounting of the increases in net wealth represented by increases in value. The potential for abusive manipulation of timing in the guise of marking to market is particularly worrisome in this era of corporate accounting and tax shelter scandals, such as those at Enron and Freddie Mac, that often involve the use of complex derivatives to manipulate the timing of recognition of income for book and/or tax purposes. The major financial institutions have been far from guiltless in these scandals, as a cursory glance at the headlines from the last two years readily reveals. In particular, banks have used their expertise in derivatives and other structured financial products to assist large corporations in developing ways to accomplish their goals of manipulating accounting (and possibly tax) income. Should we simply trust these large financial institutions to get it right when they are reporting their own transactions for tax purposes?

This Article proposes that Treasury should address the continuing uncertainties about derivatives valuations under the mark-to-market rules by issuing comprehensive regulations that establish guidelines for permissible valuation methodologies. Tailored regulatory guidance offers the best hope of ensuring that dealers are consistently reporting their swaps income. Those regulations should be able to provide guidance to businesses while ensuring that the principles underlying the mark-to-market regime are upheld. Book-tax conformity should be put back in the box where Congress left it when it enacted section 475. Financial accounting rules that permit a large measure of flexibility to the reporting entity simply do not provide the assurance of consistency with the anti-manipulation value that the tax law requires in the case of mark-to-market valuations.