



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

ASSISTANT REGIONAL COUNSEL (LC)
ATTN:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL (FIELD SERVICE)
CC:DOM:FS

SUBJECT: Of Swaps on Mark-to-Market Method - Valuation

This Field Service Advice responds to your memorandum dated April 30, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

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ISSUE:

What factors should be considered in valuing swaps under a mark-to-market method of accounting?

CONCLUSION:

Further factual development is necessary to determine whether it is appropriate in this case to allow adjustments for credit risk and administrative expenses in valuing swaps for years before and after the enactment of I.R.C. § 475.

FACTS:

For the years at issue, D, A was a financial concern that operated through subsidiaries and branches. A's primary wholly-owned operating subsidiary, B, provides banking, foreign exchange trading, leasing and other financial services through branches, divisions and subsidiaries in the United States and foreign countries. During D, B entered into numerous swaps transactions which are the subject of this advice. The notices of deficiencies disallowed under sections 446 and 475 swap income deferrals arising from adjustments for credit risk and administrative expenses.

B began using a mark-to-market method of accounting apparently sometime in E. We have limited knowledge about the assumptions and variants B used in applying its mark-to-market method, other than its adjusting for the aforementioned credit risk and administrative expenses. For the F years, B valued its swaps by using a method that measured tentatively at the midpoint between the quoted bid and offer. B adjusted the tentative midpoint calculation by carving out credit risk and administrative expenses. B contends that without the adjustments, its mark-to-market method of reporting swap income would accelerate into income the present value of the future net cash inflows under the swap agreements.¹

LAW AND ANALYSIS

This case concerns the valuation of swaps for years before and after the effective date of section 475. Section 475 is effective for tax years ending on or after December 31, 1993. For years prior to the effective date of section 475, there was no requirement that swap dealers use a mark-to-market method of accounting; section 446 only required that the method used clearly reflect income. The swap

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accounting regulations under Treas. Reg. § 1.446-3 were not effective until Dec. 13, 1993.

For the earlier years at issue here, G, Notice 89-21, 1989-1 C.B. 651, was the only published guidance on the income tax treatment of swaps. Although that Notice specifically provides for the tax treatment of lump-sum payments, and not periodic payments, it is nevertheless helpful here as it signaled the direction in which the Service was headed. The Notice provides that income from lump-sum payments should be taken into account over the life of the swap. Thus, neither front-loading nor back-loading of lump-sum payments would be proper tax accounting for swaps. The Notice also provides that any reasonable method that recognizes income over the life of the swap is appropriate and will be considered to clearly reflect income.

The H year, however, is more problematic. Section 475 requires a fair market value standard for the mark-to-market method. It is likely that the swap regulations under Treas. Reg. § 1.446-3 were not in effect for most if not all of B's H swaps, given the effective date of the regulations. Furthermore, the swap regulations specifically provide that if there is a conflict between the regulations and section 475, the rules of section 475 apply. See Treas. Reg. §1.446-3(c)(1)(iv). [REDACTED]

[REDACTED] Accordingly, our analysis focuses on the H year.

Section 475 (a) requires that dealers in securities use a mark-to-market method of accounting. Under that method, inventory securities must be included in inventory at fair market value. For securities that are not inventory in the hands of the dealer and that are held at the close of a taxable year, the dealer must recognize gain or loss as if the securities were sold for their fair market value on the last business day of that taxable year. Section 475(c)(1) defines "dealer in securities" in part, as a taxpayer that regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in certain types of securities with customers in the ordinary course of its trade or business. Section 475(c)(2) defines "security" to include interest-rate and currency notional principal contracts, and options on such contracts, among other instruments. Based upon the information provided, B meets the definition of a dealer in securities for purposes of section 475.

Although section 475 requires a fair market valuation, it does not define "fair market value." No definition of fair market value can be found in its legislative history. Thus, we look elsewhere for guidance. One source is regulations for other Code sections. See Treas. Reg. § 1.170A-1(c)(2); Treas. Reg. §§ 20.2031-1(b) (estate taxes) and 25.2512-1 (gift taxes). A standard definition under these regulations provides that:

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts.

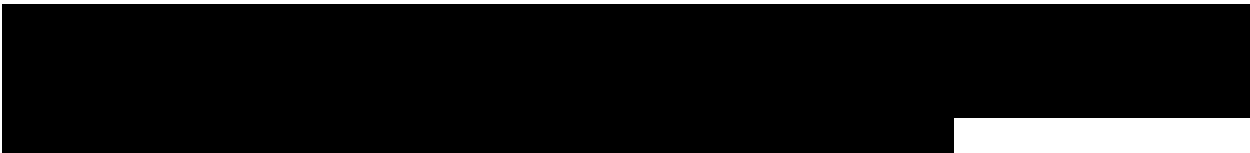
The Service's position has been consistent throughout the years as to the meaning of fair market value. Treas. Reg. §§ 20.2031-2 and 25.2512-2 (estate and gift tax regulations) provide that in the case of stocks and bonds, if there is a market for them, then their fair market value is derived from selling prices or from the bid and asked prices in the market. If the selling prices or the bid and asked prices are not available, then fair market value is determined by taking the following factors into account:

(1) In the case of corporate or other bonds, the soundness of the security [i.e., the risk of default], the interest yield, the date of maturity, and other relevant factors; and

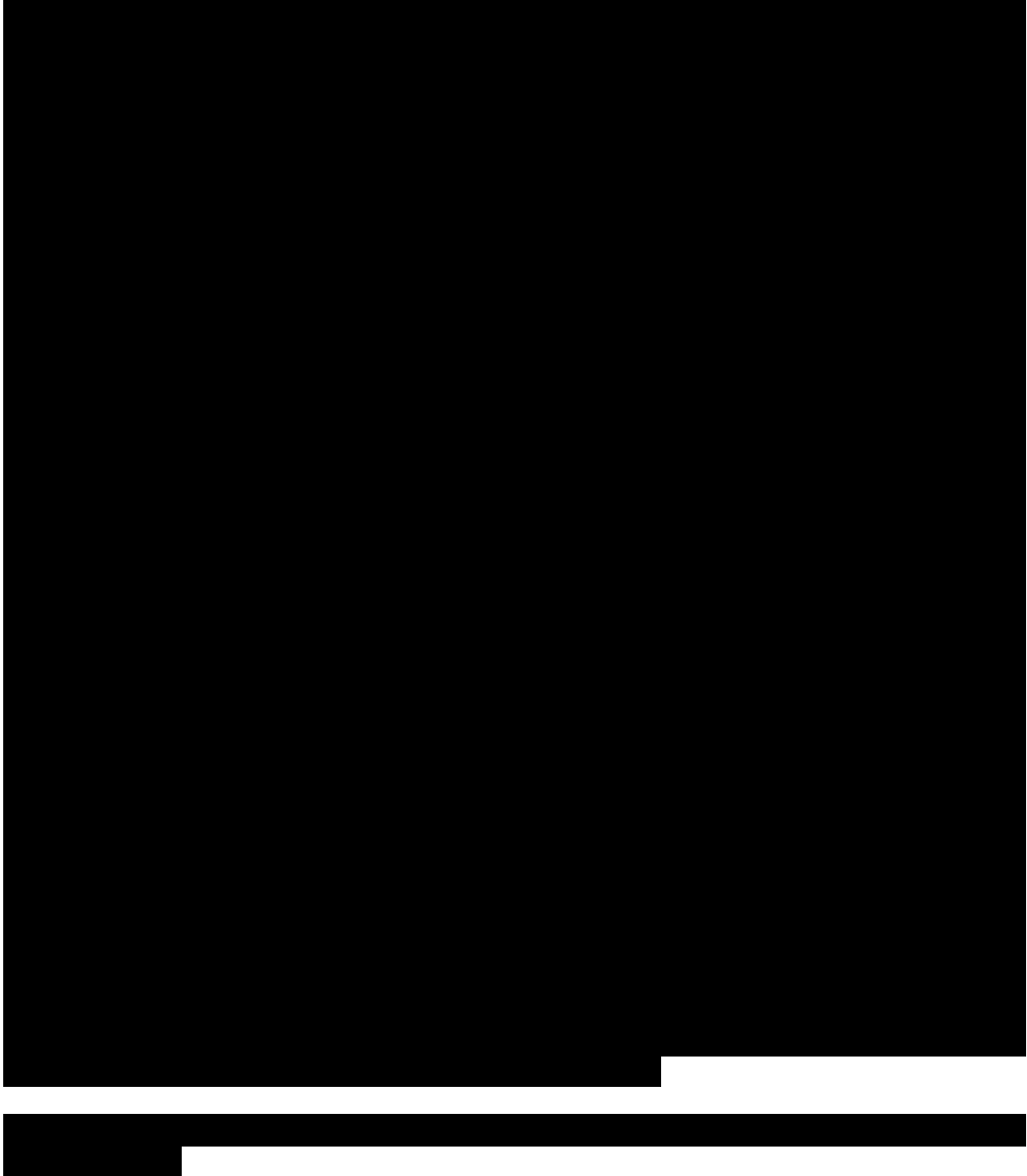
(2) In the case of shares of stock, the company's net worth, prospective earning power and dividend paying capacity, and other relevant factors.

See Treas. Reg. 20.2031-2(f) and 25.2512-2(f). See also Rev. Rul. 65-192, 1965-2 C.B. 259 (applying fair market value principles set forth in estate and gift tax regulations to corporate stocks and bonds).

The regulations under section 83 provide that the fair market value of a stock option that is actively traded on an established market is determined by applying the estate tax valuation rules for stocks and bonds. Treas. Reg. § 1.83-7(b)(1).



CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:



[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]



Please call if you have further questions.

CAROL NACHMAN
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