December 7, 2005

Hon. Mark W. Everson  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Proposed Safe Harbor Regulations under Section 475

Dear Commissioner Everson:

Enclosed are comments on proposed regulations under section 475 regarding safe harbor. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Dennis B. Drapkin  
Chair, Section of Taxation

Enclosure

cc: Eric Solomon, Acting Deputy Assistant Secretary of the Treasury (Tax Policy)  
Donald L. Korb, Chief Counsel, IRS  
Michael J. Desmond, Tax Legislative Counsel, Treasury Department  
Robert H. Dilworth, Senior Advisor to Assistant Secretary of the Treasury (Tax Policy)  
Michael. S. Novey, Associate Tax Legislative Counsel, Treasury Department  
Viva Hammer, Attorney-Advisor, Treasury Department  
John W. Rogers III, Attorney, IRS  
Marsha A. Sabin, Attorney, IRS
COMMENTS CONCERNING PROPOSED REGULATIONS RELATING TO AN ELECTIVE SAFE HARBOR FOR DEALERS IN SECURITIES, DEALERS IN COMMODITIES, AND TRADERS IN SECURITIES AND COMMODITIES

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by Dan Brody of the Section’s Financial Transactions Committee. These comments were reviewed by Alan Munro and Glenn N. Eichen of the Financial Transactions Committee. The comments were further reviewed by Kevin Keyes, Chair of the Committee, by David C. Garlock of the Section’s Committee on Government Submissions and by Peter J. Connors, Council Director for the Financial Transactions Committee.

Although the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: December 7, 2005
Executive Summary

Our comments address two concerns. The first is the relationship of the scope of the proposed safe harbor for determining fair market value to the underlying policy goal. The second is the application of the safe harbor as it relates to current industry practices.

In brief:

1. The Scope of the Proposed Safe Harbor is Unduly Narrow

   A. The definition of an eligible method should not limit application of the safe harbor to those mark-to-market adjustments which are recognized through the income statement. This limitation will effectively preclude application of the safe harbor rule in many situations in which it would be beneficial to both the taxpayer and the Government.

   B. If a taxpayer consistently uses a verifiable methodology for calculating market values for some financial statement purpose, the regulations should permit use of this methodology for recognition of taxable income. The regulations should provide a mechanism or explanation as to how the data supporting financial statement valuations are to be used to support tax valuations.

2. The Safe Harbor Regulation Should Allow the Use of “Bid” or “Ask” Prices So Long as Such Prices Are Consistently Applied

   The use of bid or ask prices, when consistently applied, will produce a result that clearly reflects income. Although the Government seems to perceive a potential for abuse in the use of bid or ask prices, we believe the Government’s concern is misplaced. In any case, we believe the approach taken in the Proposed Regulations to prevent this perceived abuse is unnecessarily restrictive. We believe the perceived abuse can be addressed by permitting dealers to use bid or ask prices, but requiring consistent application.

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Detailed Discussion

Code section 475(a)(2) requires that a dealer treat as sold for fair market value on the last business day of the taxable year any non-inventory securities held by such dealer. Determining the fair market value of financial instruments that are actively traded on an established exchange is relatively straightforward. However, derivative instruments such as swaps are not actively traded. In fact, there is no liquid secondary market for the purchase and sale of swaps. See Bank One Corp. v. Commissioner, 120 T.C. 174, 197 (2003). In addition, the prices at which swaps are entered into are not publicly disclosed. Id. at 198-99. Without active trading price data, it has been difficult and costly both for dealers and the IRS to apply the “fair market value” standard to instruments such as swaps for purposes of marking to market under Code section 475.

The IRS and Treasury (the “Government”) have proposed regulations — Prop. Reg. § 1.475(a)-4 (the “Proposed Regulations”)—which attempt to solve this problem by establishing a safe harbor methodology for the marking to market of such securities. According to the preamble to the Proposed Regulations, the aim of the safe harbor is to reduce the taxpayer’s (and the Government’s) administrative burden without sacrificing the clear reflection of taxpayer income. This aim is consistent with the legislative history of Code section 475. Referring to Code section 475, the Conference Committee report on the Omnibus Budget Reconciliation Act of 1993 (the “Conference Report”) states, “[T]he 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.” Conference Report at 616.

1. The Scope of the Proposed Safe Harbor is Unduly Narrow

A. The definition of an eligible method should not limit application of the safe harbor to those mark to market adjustments which are recognized through the income statement.

Under Prop. Treas. Reg. § 1.475(a)-4(d)(2)(ii), the safe harbor is available only if the taxpayer’s mark is recognized through the income statement, rather than through Other Comprehensive Income or through an adjustment to the balance sheet. We submit that this distinction will impede the use of the safe harbor and in many situations will render it impractical or unusable.

Generally Accepted Accounting Principles (“GAAP”) in many cases prohibit recognition of the mark to market adjustment through the income statement until a future event has occurred. Upon the occurrence of this future event, those prior mark to market adjustments are transferred from the balance sheet to the income statement. In those instances, there would be readily auditable information available to support the taxpayer’s mark to market. We see no reason why such mark to market adjustments should not be eligible for the proposed safe harbor. We note that timing differences between recognition of financial statement income and taxable
income are not unique to mark to market accounting. We also note that unlike many other areas in which timing differences occur, marking an item to market in calculating taxable income is just as likely to result in increasing taxable income as decreasing taxable income, thus it is not susceptible to manipulation of taxable income.

If the objective of the regulations is to permit taxpayers to utilize a verifiable calculation method that clearly reflects income, without providing taxpayers the opportunity to manipulate taxable income, then the safe harbor should not limit applicability to marks through the income statement.

B. If a taxpayer consistently uses a verifiable methodology for calculating market values for some financial statement purpose, the regulations should permit use of this methodology for recognition of taxable income.

The safe harbor as drafted is not a true conformity rule, nor does it appear to be intended as one. This is evident by the limited application to those mark to market adjustments which are recognized through the income statement, and the exclusion of those marks which are recognized through Other Comprehensive Income.

More generally speaking, there will be instances in which GAAP presentation will diverge from the tax law. For example, GAAP may dictate Lower of Cost or Market (“LCM”) presentation of some securities for which the tax law dictates mark to market recognition. Thus, for financial statement purposes, the taxpayer may be recognizing mark to market losses (but not gains). On its tax return, however, the taxpayer is required to recognize both gains and losses. The taxpayer will have valuation models or methods that support the taxpayer’s financial statement presentation, and these models or methods will have verifiable market data.

Although GAAP may have prohibited the taxpayer from using the valuation data in those instances where value has increased, the valuation data should nonetheless be allowed to support mark to market income recognition on the taxpayer’s tax return.

Again, if the objective of the regulations is to permit taxpayers to utilize a verifiable calculation method that clearly reflects income, without providing taxpayers the opportunity to manipulate taxable income, then the safe harbor should not limit application to marks that are recognized on the income statements. If the taxpayer consistently uses a verifiable methodology for calculating market values for some financial statement purpose, then the safe harbor should permit consistent use of this methodology for recognition of taxable income, even though GAAP may sometimes allow and other times prohibit this recognition for financial statement purposes. In addition, the regulations should provide a mechanism or explanation as to how the data supporting financial statement valuations that are not recognized through the income statement are to be used to support tax valuations.

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2. The Safe Harbor Regulation Should Allow the Use of “Bid” or “Ask” Prices So Long as Such Prices Are Consistently Applied

A. Determining the Fair Market Value of Physical Securities

For purposes of marking physical securities to market under Code section 475, many in the securities industry take the position a) that for tax purposes the valuation of such securities is governed by Reg. § 1.471-4(a), which states that the market value of inventory is based on the bid price for the assets in inventory and b) that the determinative market price is the price offered within the dealer community to replace the asset, not the price offered to retail customers. See “SIA Comments on Possible Securities and Commodities Dealer Safe Harbor,” TAX NOTES TODAY (July 30, 2003), 2003 TNT 177-39 at footnote 50, citing D. Loveman & Son Export Corp., 34 T.C. 776, 796 (1960), aff’d per curiam, 296 F.2d 732 (6th Cir. 1962), cert. denied, 369 U.S. 860 (1962). As a corollary, if the security were a short position, the market value should be based on the dealer ask price for the asset. Id. Thus, the determination of fair market value of a dealer’s physical securities can be accomplished by a relatively straightforward methodology.

B. Use of Bid and Ask Pricing in Derivative Contracts

The approach used to value physical securities for tax purposes is inadequate for the valuation of derivative securities, because the bid and ask prices used by dealers in derivative instruments serve a purpose different from the bid and ask prices used by physical securities dealers. In the case of physical securities, when a dealer purchases a security, it typically intends to resell that security and earn a profit on the sale. However, in the case of derivatives dealers, the dealer is most often a party to the contract—as in the case of interest rate swaps—and remains a party throughout the life of the contract. The dealer therefore does not typically reap a profit by its sale of the derivative, as is the case with physical securities. Rather, the dealer enters into numerous derivatives contracts, some as “buyer” and some as “seller,” and earns a profit based on the spread between the price at which it “buys” (the bid price) and the price at which it “sells” (the ask price) under the contracts.

For example, under a standard interest rate swap agreement, two streams of payments are exchanged. One counterparty pays to the other periodic payments based on a fixed annual rate and a notional principal amount. The other counterparty pays to the first floating rate periodic payments. If the swap is priced “at-market,” the expected present value of the floating rate payments equals the present value of the fixed rate payments. In other words, the expected net present value of the swap is zero.

A securities dealer dealing in swaps stands ready to enter into a swap agreement as either the “buyer” or “seller” of the swap, depending on the needs of the other counterparty. If the dealer is to be the buyer of the swap (i.e., the fixed rate payor), it offers to buy at a bid price (the fixed rate it offers to pay) which is less than the at-market price for the swap. If the
dealer is to be the seller (i.e., the fixed price recipient), it offers to sell at an ask price (the fixed price it demands to receive) which is greater than the at-market price for the swap. The following example illustrates this point:

**Example 1**  Assume Dealer is the buyer of a swap in which the floating leg pays 12-month LIBOR. Assume further that if the swap were at-market, the fixed leg of swap would pay 4.00%. Dealer takes the fixed leg and offers instead a bid price of 3.95%—lower than the at-market fixed rate. The .05% difference represents value to the dealer for entering into the swap.

Conversely, if Dealer is to be the seller of the swap, it offers to sell at an ask price which is greater than the at-market price for the swap. As in the above example, assume Dealer is the seller of a swap in which the floating leg pays 12-month LIBOR and an at-market fixed rate would be 4.00%. Dealer sets its ask price by requiring the counterparty to pay 4.05% on the fixed rate leg of the swap. Again, the .05% difference represents value to the dealer for entering into the swap.

As Example 1 illustrates, a dealer can reduce the risks it incurs on one swap by entering into an offsetting swap with another counterparty. If a dealer enters into both swaps in Example 1 with respect to the same notional amount, the dealer has eliminated the market risk it bears because any interest rate change in LIBOR that would create a loss to the dealer on the first swap is offset by equivalent gain to the dealer on the second swap, and vice versa. In addition, the dealer can expect to earn a return (assuming the creditworthiness of each counterparty) equal to the spread between the bid price on the first swap and the ask price on the second swap. No matter what happens to LIBOR over the term of the two swaps, the dealer will earn a .10% spread per year on the notional principal amount. This spread represents the dealer’s profit—it reimburses the dealer for the services it performs (and risks it takes) as a market maker in swaps (e.g., as merchandiser, liquidity provider, and credit intermediary).

C. Proposed Disallowance of Bid and Ask Pricing

The Proposed Regulations would disallow the use of certain values for securities—even where the values are based on “fair value” reporting under GAAP—if the values are too close to the “bid” or “ask” value of the security. See Prop. Reg. § 1.475(a)-4(d)(3)(i). Describing this provision, the preamble to the Proposed Regulations states:

In addition to the basic requirements, the safe harbor also imposes certain limitations that ensure minimal divergence from fair market value. Under the first limitation, which applies only to securities and commodities dealers, except for eligible positions that are traded on a qualified board or exchange (as defined in section 1256(g)(7)), the financial accounting method must not result in values at or near the bid or ask values, even if the use of bid or ask values is permissible in accordance with U.S. GAAP. This limitation is based upon the business model for...
derivative contracts held by dealers in those derivatives, the model underlying most of the public comments received in response to the ANPRM.

According to the comments, dealers seek to capture and profit from bid-ask spreads by entering into positions that, in the aggregate, offset each other. The bid-ask spread contains the dealer’s profit and compensates the dealer for all risks and expenses. The origination of such a balanced portfolio may, therefore, be seen as creating a synthetic annuity, with a value that is largely immune from market-related changes in the values of the component securities. For these eligible positions, such as interest rate swap contracts, use of bid or ask values approximates realization accounting and, therefore, fails to cause recognition of the present value of the synthetic annuity in the taxable year that the annuity is created. Consequently, the valuation method described in § 1.471-4(a)(1) generally fails to satisfy the limitation set forth in paragraph (d)(3)(i) of these proposed regulations.

D. There is No Policy Reason for Taxing the Future Value of Dealers’ Bid-Ask Spread on Swaps

Example 1 illustrates that when a dealer enters into two offsetting swaps, it can create for itself a “synthetic annuity” that results from the bid/ask spread. Marking to market both swaps based on a consistent pricing methodology will result in the dealer being taxed in the year in which it enters into the offsetting swaps on the discounted value of this annuity stream. Allowing a dealer to use bid pricing for long swaps and ask pricing for short swaps, on the other hand, would result in no taxable income at inception. The dealer would be taxed as it receives the net fixed payment resulting from the two offsetting swaps. As a policy matter, it is not clear that it is appropriate to tax the dealer in advance, when a significant portion of the value of the spread relates to services that the dealer will be rendering in the future. The timing issue should depend on what the dealer is viewed as doing for the net revenue it will receive. The dealer is being compensated for at least the following:

(1) arranging the swaps,

(2) bearing the counterparty credit risk, and

(3) administration (i.e., doing the required periodic calculations).

The first service arguably is completed at inception—although, one can argue by analogy to how traditional securities dealers are compensated that the derivatives dealer should not be viewed as being compensated up-front for this service. A traditional securities dealer collects the bid/ask spread on a given security it has purchased only when it sells the security. The dealer does not collect the spread at the purchase date. The other two services—bearing counterparty credit risk and administration—clearly occur over the entire term of the swaps.
It is true that in the very early days of interest rate swaps, spreads could be as large as 100-200 basis points. Arguably, in those days, much of the spread was earned at inception. As market spreads have narrowed, however, it seems reasonable to conclude that the only one of the three bases for compensation that has shrunk appreciably is the arrangement fee. Credit risk compensation has likely remained static—although there may have been some improvement in managing credit risk as dealers gain more experience with existing protections, such as netting, and also build in new protections. Also, administration has likely long-ago reached the point of lowest cost—although there may be a trade-off between lowering the relatively miniscule mechanical computation costs versus the other administrative tasks performed by increasingly higher-wage earning workers. Given that much of what remains of derivative dealer spreads can be viewed primarily as compensation for services performed over the life of the derivatives—i.e., bearing credit risk and administration—taxing the present value of such compensation up front seems inappropriate from a policy perspective.

E. The Government Should Allow the Consistent Use of Bid or Ask Valuation

If, however, one believes that there is in fact an abuse potential inherent in the “synthetic annuity” posited in the preamble, the response in the Proposed Regulations nonetheless, goes beyond what is necessary to address the problem. As noted above, the Proposed Regulations would require the use of mid-market valuation in all cases. Prop. Reg. § 1.475(a)-4(d)(3)(i) provides in relevant part:

[T]he valuation standard used for the applicable financial statement of an eligible taxpayer must not permit values at or near the bid or ask value. Consequently, the valuation method described in § 1.471-4(a)(1) generally fails to satisfy this paragraph (d)(3)(i). The restriction in this paragraph (d)(3)(i) is satisfied if a resulting value is closer to the mid-market value than it is to the bid or ask value.

It is possible, however, to capture and tax the income from the “synthetic annuity” described in the preamble to the Proposed Regulations without requiring the use of mid-market pricing. This can be done by allowing dealers to mark securities subject to Prop. Reg. § 1.475(a)-4 either to bid, ask, or mid-market value, but also by requiring that the dealer mark all instruments subject to the regulation consistently. So long as all instruments are marked consistently, regardless of whether the dealer is the buyer or seller of the swap, the value of all income attributable to the “synthetic annuity” is effectively brought into taxable income currently. An example illustrates this point:

Example 2 In Example 1, Dealer earned a .10% annual spread on the two swaps based on a bid price on the first swap of 3.95% and an ask price on the second swap of 4.05%. Assume that at the end of the taxable year, the going bid price in the interdealer market for a swap identical to the first swap remains 3.95% and the going ask price remains 4.05%. The “mid-market” price on each swap would be 4.00%. Assume further that the .10% spread represents $100,000
in total expected net present value to the dealer as of the close of the taxable year. $50,000 is allocable to the “bid-to-mid” spread on the first swap and the remaining $50,000 is allocable to the “bid-to-mid” spread on the second swap.

If Dealer were allowed under Code section 475 to mark its position on the first swap to market using the bid price and mark its position on the second swap to market using the ask price, the $100,000 in expected net present value escapes taxation at inception of the swaps. Instead, that income would be recognized over the terms of the swaps as the “annuity” is received.

Assume, rather, that Dealer marks both positions to market using the mid-market price (4.00%), as required by the Proposed Regulations. By marking its long position on the first swap\(^6\) from 3.95% to 4.00%. Dealer recognizes income of $50,000 on the first swap. Similarly, by marking its short position on the second swap from 4.05% to 4.00%, Dealer recognizes income of $50,000 on the second swap. Thus a total of $100,000 in income would be brought currently into Dealer’s income, and would therefore be taxable income under the Proposed Regulations. This methodology requires the dealer to recognize in income the value of the “synthetic annuity” with which the Government is concerned.\(^7\)

Assume instead that Dealer marks all of its positions to market for book purposes using the current ask price—in this case 4.05%. Dealer would mark its long position on the first swap from 3.95% to 4.05%. Dealer therefore recognizes gain of $100,000 on the first swap, because the mark captures the entire bid/ask spread (3.95% to 4.05%). The value of the Dealer’s short position on the second swap has not changed—Dealer entered into the second swap at 4.05% and the current ask is 4.05%. Therefore, Dealer recognizes no income on the second swap. The result is the same as the result using mid-market values—$100,000 in total income is recognized for book purposes and would therefore be taxable under the Proposed Regulations. The result is also the same if Dealer were to mark all of its positions to market using current bid prices.

As Example 2 illustrates, to require the use of mid-market values is unnecessary. The “synthetic annuity” that represents the dealer’s profit in a balanced swap portfolio can be brought into income immediately just as effectively where the dealer marks all positions to bid or all positions to ask. Because dealers generally have balanced or nearly balanced swap portfolios, such an approach therefore reflects taxpayer income just as clearly as mid-market pricing does. Assuming such an approach would be permissible under United States GAAP, the Proposed Regulations should not prevent its use.

Importantly, such an approach would also ease the administrative burden on taxpayers as well as the Government, because it would allow them both to rely on the taxpayer’s GAAP-compliant financial statements to a greater degree than under a system that requires the use of mid-market
prices. Therefore, such an approach is completely in harmony with the legislative history of Code section 475 which, as noted above, provides, “[T]he 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.”

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1. See discussion at 2.A. below.
2. Code section 475 was enacted as part of the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66.
4. To reduce credit exposure, the two payment streams are netted and only the net amount constitutes an obligation from the paying party to the counterparty.
5. Under a standard interest rate swap agreement, the “buyer” is the counterparty that receives floating rate payments and pays fixed rate payments, while the “seller” is the counterparty that pays floating rate payments and receives fixed rate payments.
6. Recall that in Example 1, Dealer was the buyer of the first swap, meaning Dealer pays a fixed amount and receives a floating amount. On the second swap, Dealer’s position is reversed—Dealer receives a fixed amount and pays a floating amount.
7. The present value of the annuity will be less than the sum of the future annuity payments because of discounting. As the actual annuity payments are received, they are also included in income, but the dealer will have a deduction from marking the two swaps to market. The deduction will be less than the inclusion because the present value of the remaining annuity payments increases as they become closer in time. The difference between the annuity payment includible in income and the deduction for the decrease in the combined value of the two swaps is equivalent to the accrual of original issue discount.