120 T.C. 174 (2003)

A financial institution's method of accounting for interest rate swaps must clearly reflect income under I.R.C. § 475, and adjustments to mid-market values must properly reflect credit risk and administrative costs.

Summary

Bank One (FNBC), a financial institution, entered into interest rate swaps. FNBC valued its swaps at mid-market values but deferred income recognition for perceived credit risks and administrative costs. The IRS determined this method didn't clearly reflect income and adjusted it. The Tax Court held that neither FNBC's nor the IRS's method clearly reflected income. The court directed the parties to compute FNBC's swaps income in a manner consistent with the opinion, allowing for adjustments to mid-market values for credit risk and incremental administrative costs, dynamically adjusted for creditworthiness.

Facts

FNBC engaged in the business of interest rate swaps. For tax years 1990-1993, FNBC valued its swaps at mid-market value but carved out amounts representing perceived credit risks of counterparties and estimated administrative costs. These carved-out amounts were treated as deferred income. FNBC used the Devon Derivatives System to calculate mid-market values. FNBC generally required ISDA documentation for its swaps.

Procedural History

The IRS determined deficiencies in FNBC's consolidated federal income taxes for 1990, 1991, 1992, and 1993, challenging FNBC's "swap fee carve-outs." The Tax Court consolidated the cases for trial, briefing, and opinion.

Issue(s)

Whether FNBC's method of accounting for its swaps income clearly reflected its swaps income under I.R.C. § 475?

Whether the IRS's method of accounting for FNBC's swaps income clearly reflected that income under I.R.C. § 475?

Holding

No, because FNBC's values were not determined at the end of its taxable years and did not properly reflect adjustments to the midmarket values which were necessary to reach the swaps' fair market value.

No, because a swap's mid-market value without adjustment does not reflect the swap’s fair market value.

Court’s Reasoning

The Tax Court reasoned that the mark-to-market rule of I.R.C. § 475, including the valuation requirement, is a method of accounting subject to the clear reflection of income standard of I.R.C. § 446(b). The court found that FNBC’s method did not clearly reflect income because the values were not determined at year-end and did not properly reflect adjustments to mid-market values. The court also found the IRS’s method deficient because mid-market value alone does not reflect fair market value. The court stated, “to arrive at the fair market value of a swap and other like derivative products, it is acceptable to value each product at its midmarket value as properly adjusted on a dynamic basis for credit risk and administrative costs.” The court emphasized a proper credit risk adjustment reflects the creditworthiness of both parties, while a proper administrative costs adjustment is limited to incremental costs.

Practical Implications

This case provides guidance on the proper accounting method for interest rate swaps under I.R.C. § 475. It clarifies that while mark-to-market accounting is generally acceptable, adjustments must be made to mid-market values to reflect credit risk and administrative costs. The case highlights the importance of considering the creditworthiness of both parties in a swap and limiting administrative cost adjustments to incremental costs. This case informs how financial institutions should value and report income from derivative financial products and provides a framework for the IRS to evaluate these methods.

