First Chicago Corp. & Subs. v. Commissioner, 120 T. C. 294 (2003) (U. S. Tax Court, 2003)

In First Chicago Corp. & Subs. v. Commissioner, the U. S. Tax Court ruled that First Chicago National Bank of Chicago's (FNBC) method of valuing its interest rate swaps using adjusted midmarket values did not clearly reflect income under Section 475 of the Internal Revenue Code. The court rejected FNBC's adjustments for credit risk and administrative costs, finding that they did not accurately represent fair market value due to various methodological flaws. This decision underscores the importance of properly valuing financial derivatives for tax purposes and clarifies the standards for mark-to-market accounting under federal tax law.

Parties

First Chicago Corp. and its subsidiaries (Petitioner), including First National Bank of Chicago (FNBC), sought redetermination of tax deficiencies determined by the Commissioner of Internal Revenue (Respondent) for the years 1990, 1991, and 1993. FNBC was the primary subsidiary involved in the swaps business during the relevant years.

Facts

FNBC, a major participant in the swaps market, dealt primarily in interest rate swaps, currency swaps, and commodity swaps. It was a national bank regulated by the Office of the Comptroller of the Currency (OCC) and part of the First Chicago Corp. group, a bank holding company regulated by the Federal Reserve Board (FRB). FNBC used a mark-to-market method to value its swaps portfolio, adjusting midmarket values for credit risk and administrative costs. These adjustments were claimed to defer income recognition over the life of the swaps. The Commissioner challenged these adjustments, asserting they did not clearly reflect income for tax purposes.

Procedural History

The Commissioner determined deficiencies in First Chicago Corp. 's consolidated federal income tax for 1990, 1991, and 1993, stemming from FNBC's claimed "swap fee carve-outs. " FNBC petitioned the U. S. Tax Court to redetermine these deficiencies. The court consolidated the cases for trial and briefing. The trial involved extensive testimony, including from expert witnesses appointed by the court, and focused on whether FNBC's method of accounting for its swaps complied with Section 475.

Issue(s)

Whether FNBC's method of accounting for its swaps, including adjustments for credit risk and administrative costs, clearly reflected income under Section 475 of the Internal Revenue Code?

Rule(s) of Law

Section 475 of the Internal Revenue Code requires dealers in securities to mark their securities to market at the end of each taxable year. The fair market value of a security, as defined by Treasury regulations, 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 relevant facts. The mark-to-market method must reflect this fair market value.

Holding

The court held that FNBC's method of accounting for its swaps, which involved adjusting midmarket values for credit and administrative costs, did not clearly reflect income as required by Section 475. The court also found that the Commissioner's proposed method of using unadjusted midmarket values alone did not clearly reflect income either, as it failed to account for necessary adjustments to reach fair market value.

Reasoning

The court's reasoning focused on several key points:

– FNBC's method did not value swaps at the end of the taxable year as required by Section 475, using an early closing date instead.

– The method failed to account for the creditworthiness of both parties to the swap, considering only the counterparty's credit risk.

– FNBC's credit adjustments were based on a static rather than a dynamic procedure, not reflecting changes in market conditions or credit ratings over time.

– The adjustments did not account for credit enhancements such as netting provisions and collateral, which reduce credit risk.

– Administrative costs adjustments were computed using FNBC's fully allocated costs rather than incremental costs, which are relevant to fair market value.

– The court rejected FNBC's reliance on industry practices and regulatory guidance, noting that these did not override the statutory requirement to mark to market at fair market value.

The court emphasized that a proper mark-to-market method must reflect fair market value, which requires adjustments for credit risk and administrative costs based on actual market conditions and the characteristics of the specific swaps. The court directed the parties to compute the fair market value of each swap using a dynamic approach that considers both parties' creditworthiness and incremental administrative costs.

Disposition

The court directed the parties to file computations under Rule 155 reflecting the fair market value of FNBC’s swaps, using midmarket values adjusted dynamically for credit risk and incremental administrative costs.

Significance/Impact

This case is significant for clarifying the application of Section 475 to financial derivatives, particularly interest rate swaps. It establishes that mark-to-market accounting must accurately reflect fair market value, requiring consideration of both parties’ creditworthiness and the use of a dynamic valuation approach. The decision impacts how financial institutions account for swaps for tax purposes, potentially affecting billions of dollars in tax liabilities. It also underscores the importance of aligning tax accounting methods with the statutory requirements of Section 475, despite industry practices or regulatory guidance.

