

Book Tax Conformity for Financial Instruments

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BOOK TAX CONFORMITY FOR FINANCIAL INSTRUMENTS

Yoram Keinan

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BOOK TAX CONFORMITY FOR FINANCIAL INSTRUMENTS

*Yoram Keinan**

I. THE BOOK-TAX CONFORMITY DEBATE

Since the introduction of the corporate income tax in the United States in 1909, both lawyers and accountants have discussed whether to allow corporate taxpayers to use income reported by corporations to their shareholders on their financial reports under Generally Accepted Accounting Principles (“GAAP”) as the basis for imposing corporate income tax.¹ Similar discussions have taken place in other countries, particularly in Europe in recent years.² As

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1. Mitchell L. Engler, *Corporate Tax Shelters and Narrowing the Book/Tax “GAAP,”* 2001 Colum. Bus. L. Rev. 539; Terry Shevlin, *Symposium on Corporate Tax Shelters Part II: Commentary: Corporate Tax Shelters and Book-Tax Differences*, 55 Tax L. Rev. 427 (2002); George K. Yin, *Business Purpose, Economic Substance, and Corporate Tax Shelters: Getting Serious About Corporate Tax Shelters: Taking a Lesson from History*, 54 SMU L. Rev. 209 (2001); Calvin Johnson, *Using GAAP Instead of Tax Accounting is a Bad Idea*, 83 Tax Notes 425 (April 19, 1999); Alvin D. Knott and Jacob D. Rosenfeld, *Book and Tax: A Selective Exploration of Two Parallel Universes*, 99 Tax Notes 865 (May 12, 2003); Anthony J. Luppino, *The Enron End-Runs and Other Trick Plays: The Book-Tax Accounting Conformity Defense*, 2003 Colum. Bus. L. Rev. 35, 108, 144; John Ensminger, *Concerto for Piano vs. Orchestra: Can Tax and Financial Accounting Harmonize on Hedges?* 16 Akron Tax J 23 (2001).

2. Sabine D. Selbach, *The Harmonization of Corporate Taxation & Accounting Standards in the European Community and Their Interrelationship*, 18 Conn. J. Int’l L. 523 (2003). See also Victor Thuronyi, *What Can We Learn From Comparative Tax Law?* 103 Tax Notes 459 (Apr. 26, 2004) (“In a number of countries, there has in recent

of today, several countries apply general book-tax conformity,³ while several others apply it only to financial instruments.⁴ In the United States, limited book-tax conformity already exists, to some extent, in the tax law, under the clear-reflection-of-income principle contained in section 446,⁵ and in other specific provisions.⁶ Commentators agree, however, that currently, a general book-tax

years been a partial movement in favor of greater reliance of tax on financial accounting.”)

3. For example, Belgium, Japan the Netherlands and Switzerland have common tax and financial accounting standards. See Secretary to the Treasury and the Commissioner of Taxation, *Taxation of Financial Arrangements, An Issue Paper* (December 1996), appendix 4.1. In Germany, there is an almost complete identity between tax and financial accounting. See Thuronyi (2004), *supra* note 2. According to Thuronyi, civil law countries tend to apply book-tax conformity more than common law countries. *Id.*

4. As Thuronyi indicates:

In many developing and transition countries the answer will be found in the financial accounting rules, because the rules for taxation of business enterprises are based on these accounting principles. Those rules tend to be more flexible than accounting rules set forth in the tax laws themselves and may provide a basis for dealing sensibly with new financial instruments in such a way that there is not a significant threat to erosion of the tax base from use of such instruments. By contrast, in countries that formulate their tax rules independently of accounting principles, it may be necessary to provide detailed rules for the taxation of financial instruments so that taxpayers cannot use them to avoid taxation.

Thuronyi, Victor, *Taxation of New Financial Instruments*, 24 *Tax Notes Int'l* 261, 263-64 (1999).

For a discussion on book-tax conformity for financial instruments in other developed countries, see Robert Moncrieff, *Next Steps for Debt and Derivatives: The U.K. Finance Act 2002*, 4(1) *Journal of Taxation of Financial Products* (Winter 2003); Ruano, *Spain: General Nonresident Tax Treatment of Financial Products*, 4(2) *Journal of Taxation of Financial Products* (Spring 2003); Australian Issue Paper, *supra* note 3.

5. All references are to the Internal Revenue Code of 1986, as amended.

6. For example, in Regs. § 1.471-2(b), Treasury has followed Congressional intent in IRC § 471 by focusing on the need to “give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business,” and has authorized the use of values as shown in taxpayers’ books to determine the cost of goods on hand for tax purposes. Similarly, in regulations concerning the last-in, first-out method of accounting, Treasury has conditioned the use of that method on book-tax conformity. Regs. § 1.472-2(e). Finally, under IRC § 166(a)(2), the amount of a business bad-debt deduction for partial worthlessness of a security is limited to the amount “charged off within the taxable year” for accounting purposes. See Knott and Rosenfeld, *supra* note 1, § III(B).

conformity regime for corporate tax is not feasible.⁷ In addition, courts often discuss the different roles of tax and accounting rules, generally concluding that tax does not have to follow books in all cases.⁸

Congress and Treasury have recently realized that non-conformity of certain items could be viewed as abusive to a significant extent;⁹ therefore, in the reportable transactions regulations, Treasury set forth rules that would require taxpayers to disclose if they have treated a transaction differently for book and tax purposes.¹⁰ The Joint Committee's report on Enron also reveals that in certain transactions discussed therein, Enron was seeking accounting rather than tax benefits.¹¹

This article does not endorse utilizing *general* book-tax conformity for corporations in the United States¹² but rather discusses current conformity and

7. See generally Johnson, *supra* note 1, *cf.*, generally Yin, *supra* note 1.

8. As emphasized by the U.S. Supreme Court in *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 542-43 (1979):

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. Consistent 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. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

See also *PNC Bancorp, Inc. v. Comm'r*, 212 F.3d 822, 832 (3d. Cir. 2000), discussing the application of FAS 91 for tax purposes.

9. Yin, *supra* note 1, at 225.

10. T.D. 9046, 68 F.R. 10161 (Mar. 4, 2003).

11. See Joint Committee on Taxation, Report on Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations, Executive Summary (Feb. 2003) available at <http://www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html>.

12. Support for the idea that only limited conformity is desired could be found in a statement made by former Treasury Secretary Paul O'Neill: "eliminating some of the myriad differences between book and tax accounting would go a long way toward demystifying both corporate financial statements and the book/tax reconciliation on Schedule M-1 of corporate returns." See O'Neill Letter to Grassley on Public Disclosure

non-conformity between tax and accounting rules for financial instruments and explores possible alternatives to conform the non-conforming aspects.¹³ I do not suggest that GAAP will substitute tax law but only provide guidance pertaining to financial instruments.¹⁴ This article presents three major examples of Code provisions in which Congress's specific intent was to conform tax rules to the then existing GAAP: section 1256, section 475, and the original issue discount (OID) rules.

Generally, there are five key *tax* issues involved with financial instruments: (i) classification; (ii) timing; (iii) valuation; (iv) character; and (v) source.¹⁵ Nevertheless, only the first three are important for GAAP, and only these three are therefore discussed herein.

As of today, not only is the tax treatment of financial instruments often different from GAAP, but it is also incoherent and based on various criteria. In addition to the traditional cash and accrual tax accounting methods for financial instruments, there are various other methods of taxing financial instruments.¹⁶ In particular, while several types of *taxpayers*, such as dealers, must mark financial instruments to market, other *instruments*, such as futures contracts, are marked-to-market based on the *instrument's identity*. Finally, instruments used for hedging are subject to special timing rules.¹⁷

The Financial Accounting Standards Board's (FASB) increasing focus on financial instruments in recent years and, most notably, the issuance of FAS 133 (a comprehensive set of accounting standards for derivatives and hedging

of Corporate Tax Returns 2002 TNT 196-18 (Aug. 16, 2002). See also Engler, *supra* note 1, at 559-61, presenting a non-comprehensive approach pursuant to which only specified items will be subject to conformity.

13. For a similar view, see generally Ensminger, *supra* note 1.

14. For a proposed comprehensive regime pursuant to which GAAP would be the single set of rules for public corporations, and corporations would pay tax equal to the tax rate times their book income, see Engler, *supra* note 1, at 541. Another alternative suggested by Engler is that book income would become the tax base only if it exceeds taxable income calculated under the existing tax rules (i.e. a "floor approach").

15. The General Report (Plambeck, Rosenbloom and Ring) in *Tax Aspects of Derivative Financial Instruments*, Cahier de droit fiscal international, vol. 80b, IFA, 1995.

16. Notional principal contracts, for example, are taxed annually on the basis of their periodic and non-periodic cash flows. See generally Regs. § 1.446-3.

17. Steve Rosenthal and Mark Price, *Time for Reconciliation of Tax and Accounting for Derivatives*, 84 Tax Notes 895 (Aug. 9, 1999).

transactions),¹⁸ as amended by FAS 138¹⁹ and FAS 149,²⁰ provide an opportunity for Congress and Treasury to revisit their positions regarding the tax treatment of financial instruments, particularly those of hedging transactions and derivatives.²¹ This article explores potential harmonization between FAS 133 (and other relevant accounting guidance) and the taxation rules for similar transactions.²²

May 2003 saw the occurrence of two significant events relating to conforming mark-to-market valuations rules under section 475 with those used for financial accounting purposes:²³ (i) the issuance of a decision in *Bank One Corp. v. Comm'*²⁴ and (ii) the issuance of an advance notice of proposed rulemaking (“ANPRM”)²⁵ to request comments on a possible safe harbor that would allow financial statement values of securities to be used on tax returns.²⁶ The IRS’s growing interest in book tax conformity for financial instruments is also reflected in the recently proposed regulations on contingent notional principal contracts (NPC), in which the IRS provided for an elective mark-to-market treatment for certain NPCs that are being marked to market for accounting purposes.²⁷

This article will proceed as follows: Part II discusses arguments for and against book-tax conformity in general, and for financial instruments in particular, and the alternative routes to achieving conformity. Part III discusses

18. FAS 133: Accounting for Derivative Instruments and Hedging Activities. (June 1998).

19. FAS 138: Accounting for Certain Derivatives Instruments and Certain Hedging Activities (an Amendment to FASB Statement No. 133) (June 2000).

20. FAS 149: Amendment of Statement 133 on Derivatives Instruments and Hedging Activities (Apr. 2003).

21. Commentators have argued that with FAS 133, the accounting system comes much closer to satisfying the clear reflection of income standard. See Ensminger, *supra* note 1, at 95, citing David S. Miller, *Reconciling Policies and Practice in the Taxation of Financial Instruments*, 77 *Taxes* 236, 244 n.122 (1999).

22. *Id.* See also Rosenthal and Price, *supra* note 17.

23. See, generally Alan B. Munro and Yoram Keinan, *The Case for Book-Tax Conformity for Mark-To-Market Valuation*, 16(6), *Journal of Taxation of Financial Institutions* 5 (July/August 2003).

24. 120 T.C. 174 (2003).

25. Safe Harbor for Satisfying Statutory Requirements for Valuation under § IRC 475 for Certain Securities and Commodities, 26 CFR Part I, REG-100420-03.

26. The rules under FAS 133 and related GAAP pronouncements are expected to play a key role in the valuation guidance because the main purpose of the ANPRM has been to explore possible use of those accounting rules for purposes of § IRC 475.

27. REG-166012-02, 69 F.R. 8886 (Feb. 26, 2004). The proposed regulations also resolve certain character issues relating to notional principal contracts, which are beyond the scope of this article. For an in-depth discussion on the proposed regulations, see David Garlock, *The Proposed Notional Principal Contract Regulations – What’s Fixed? What’s Still Broken?* 102 *Tax Notes* 1515 (Mar. 22, 2004).

the current relationship between book and tax rules in the United States pursuant to the clear-reflection-of-income doctrine under section 446 and provides a brief overview of the reportable transactions regulations. Part IV provides a brief description of the accounting bodies and guidance that will be discussed herein. Part V explores the three key issues involved in financial instruments that are relevant for both books and tax, namely classification, valuation, timing and valuation, valuation; provides an in-depth discussion on current conformity and non-conformity for financial instruments; and suggests various alternatives for conforming the non-conforming elements. Finally, Part VI shows how book-tax conformity for financial instruments enhances simplicity, certainty, neutrality, and administrability of the U.S. federal income tax rules for financial instruments.

II. PROS AND CONS OF CONFORMITY FOR FINANCIAL INSTRUMENTS

A. Arguments for Conformity

1. Advantages of the Mark-to-Market Method

Adoption of book-tax conformity for financial instruments will move the U.S. tax system much closer to a mark-to-market regime and further from the realization principle.²⁸ Commentators have regularly discussed the superiority of mark-to-market accounting in measuring income and the significant defects of competing systems.²⁹ In *Bank One*, the Tax Court stated that:

“Mark-to-market accounting has for decades been considered by academia and other commentators to be the most theoretically desirable of all the various systems of taxing income in that mark-to-market accounting

28. David A. Weisbach, A Partial Mark-to-Market Tax System, 53 Tax L. Rev. 95 (1999) (“Haig-Simons taxation generally is viewed as the ideal form of income taxation.”); David A. Weisbach, Tax Response to Financial Contract Innovation, 50 Tax L. Rev. 491 (1995) (“A mark-to-market system, for example, would solve many timing problems presented by financial contracts.”); Deborah H. Schenk, Taxation of Equity Derivatives: A Partial Integration Proposal, 50 Tax L. Rev. 571 (1995) (“The global approach that holds the most appeal for a system that seeks to tax both consumption and accumulation is accretion taxation or universal mark-to-market accounting.”); Alvin C. Warren, Jr., Commentary, Financial Contract Innovation and Income Tax Policy, 107 Harv. L. Rev. 460 (1993) (“one potential policy response to the issues discussed here would be to expand further the category of assets that are marked-to-market for tax purposes.”)

29. Haig, The Concept of Income – Economic and Legal Aspects, The Federal Income Tax (1921), in Readings in the Economics of Taxation, at 68-69 (Musgrave & Shoup eds. 1959); Simons, Personal Income Taxation 103 (1938).

consistently measures and levies tax on a taxpayer's economic (or Haig-Simons) income. (footnote omitted)³⁰

In that respect, conforming books and tax rules for financial instruments on the basis of a mark-to-market timing treatment will be a welcomed change. FASB has stated in FAS 133 that its long-term objective is to require mark-to-market treatment to all financial instruments.³¹ In addition, FASB has considered applying mark-to-market regime to liabilities.³² Commentators, however, have also warned of the potential drawbacks of the mark-to-market regime, particularly the liquidity concern.³³

2. The Advantages of the Financial Accounting System

In Rev. Rul. 74-223,³⁴ (involving futures contracts that commodities dealers entered into as hedges) the IRS stated 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 use, approved by auditors who certify to the correctness of his 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 item which would not be false and misleading.

The Securities Industry Association ("SIA") suggested that:

[t]he methods used for financial accounting and other substantive non-tax commercial purposes have been developed on an objective basis, without systematic bias, and clearly reflect the taxpayer's income.³⁵

These statements are particularly true with respect to financial instruments, because financial accounting rules for financial instruments are

30. Bank One, 120 T.C. at 228-230 (citing various commentators).

31. FAS 133, supra note 18, ¶ 216.

32. See Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value, FASB Preliminary Views (Norwalk, Conn.: FASB, 1999).

33. Cf. David Weisbach (1999), supra note 28, at 105 ("the problems of valuation and liquidity are not sufficient to overcome the benefits.")

34. 1974-1 C.B. 23.

35. SIA Comments on Possible Securities and Commodities Safe Harbor, 2003 TNT 177-39 (Sept 12, 2003), ¶ 28.

more simple,³⁶ neutral, and coherent than are tax rules.³⁷ In particular, accounting rules apply a uniform approach to financial instruments,³⁸ as opposed to tax rules, where different taxpayers and different instruments are subject to different rules. As three leading accounting commentators indicate: “Debt securities are reported at fair value not only because the information is relevant, but also because it is reliable.”³⁹

3. Reducing Administrative Burden

From a tax compliance perspective, book-tax conformity for financial instruments is welcomed. One of the arguments for conformity that was made by the International Swaps and Derivatives Association (“ISDA”) in its comments to the ANPRM is the reduction in costs associated with the adoption of conformity rules.⁴⁰ In particular, banking and financial institutions will greatly benefit from using GAAP as the basis for the taxation of financial instruments because it will alleviate some of the hardship involved in valuation of different types of securities and commodities by setting forth a unified standard.⁴¹ Accounting for financial instruments requires a tremendous amount of time and expertise, and creating one single reporting mechanism for book and tax will alleviate the burden of formulating two separate statements.

4. Book-Tax Conformity for Financial Instruments in Other Countries

In addition to the growing convergence in accounting and tax principles, several countries have particularly moved towards book-tax conformity for financial instruments.

36. Former Assistant Treasury Secretary for Tax Policy Pamela Olson, in emphasizing the need for tax simplification, stated that “[w]e have complicated compliance by legislating detailed rules on the calculation of taxable income that differ from the rules used to calculate book income, creating inevitable disparities that undermine confidence in our tax and financial accounting systems.” See Olson’s Tax Policy Speech at TEI In New York, 2002 TNT 244-35 (Dec.18, 2002).

37. Rosenthal and Price, *supra* note 17, at 906.

38. For example, all derivatives are subject to mark-to-market.

39. Donald Kieso, Jerry Weygandt and Terry Warfield, *Intermediate Accounting* (11th Ed. 2004) at 837.

40. ISDA Comments on Possible Securities and Commodities Safe Harbor, 2003 TNT 189-22 (Aug. 04, 2003), ¶ 21. ISDA believes that allowing book-tax conformity for over-the-counter (OTC) derivatives contracts will avoid substantial costs for both the IRS and dealers. If dealers are not permitted to value their OTC derivatives in the same way they do under GAAP for financial reporting purposes, the result will be endless disputes as to the value of particular positions and the propriety of particular valuation practices.

41. See generally Munro and Keinan, *supra* note 23.

As stated by ISDA:

[a] number of other major industrial countries require securities dealers to compute their income for tax purposes based on their income as determined for financial reporting purposes. If the United States uses the same approach, it will be starting with the same base these other countries do in allocating income of a global dealing operation among the different jurisdictions in which the operation is conducted. If the United States does not start with the same base as its trading partners, a securities dealer would be subject to tax on more (or less) than 100% of its worldwide income in a particular year, even if all jurisdictions use the same method for allocating that income. In contrast, use by all countries of the same base would eliminate one major potential source of over or under taxation of a dealer taxable in a number of different jurisdictions.⁴²

Most notably, recent tax legislation in England has aligned tax treatment of financial instruments with that reported in the financial statements.⁴³ In Spain, corporate tax rules follow accounting principles, and one commentator suggested that when the accounting guidelines for financial instruments are finalized, the tax rules would follow.⁴⁴ Finally, a similar approach has been proposed in Australia.⁴⁵

5. Reduce Incentives to Enter into Tax Shelters

In its July 1999 report on tax shelters, Treasury indicated that certain book-tax differences may be viewed as tax shelters.⁴⁶ In addition, the Joint Committee's report on Enron reveals that many transactions described therein were entered into for purposes of obtaining a benefit from a book-tax difference.⁴⁷ As a commentator indicated: "An ideal tax shelter . . . is one that permanently reduces taxable income without a similar reduction in book income. That is, the ideal corporate tax shelter gives rise to permanent differences."⁴⁸

42. ISDA comments, *supra* note 40, ¶ 27.

43. This approach is reflected in the recently enacted Finance Act of 2002. See, generally, Moncrieff, *supra* note 4.

44. See generally Ruano, *supra* note 4.

45. Australian Issue Paper, *supra* note 3, at 44-45.

46. Treasury Dep't, *The Problem of Corporate Tax Shelters: Discussion, Analysis and Legislative Proposals* (July 2, 1999), at 21, reprinted in 1999 TNT 127-12.

47. See Joint Committee on Taxation Report on Enron, *supra* note 11.

48. Shevlin, *supra* note 1, at 433.

Another commentator concluded:

The entire class of shelters with this common characteristic [book-tax difference] would end if corporations were taxed on their adjusted book income. [footnote omitted] By linking taxable income to book income, Congress would eliminate the ability of corporations to explore unintended and undesirable deviations between the two measures. Congress would gain greater control over the corporate tax base; intended book-tax disparities could be specifically authorized but unintended ones would essentially end.[footnote omitted] The rule would have similar characteristics to section 469: it would be broad, reasonably clear, and very outcomes-oriented, with tax consequences literally being determined by the “bottom line.” Tax results would not depend upon taxpayer intent, motive, or similar factors.⁴⁹

Another commentator also emphasized the limited role of disclosure as opposed to a substantive change in law:

Better disclosure of book-tax differences is only a first, though critical, step in more effective use of book-tax comparative analysis to identify and eliminate abusive tax and financial accounting practices. Regulatory actions in addition to the imposition of improved disclosure requirements – such as book-tax consistency requirements imposed from both the tax and securities regulation perspective for potentially abusive transactions – also merit consideration.⁵⁰

Thus, a significant class of tax shelters will be eliminated if book and tax rules for financial instruments are conformed. As set forth below, recent reportable transactions regulations would generally require taxpayers to report book-tax differences of more than \$10 million. Nevertheless, this is only a reporting rule, and does not, substantively, eliminate the potential problem. Generally, commentators agree that reporting rules will not significantly reduce

49. Yin, *supra* note 1, at 225. See also Weisbach (1999), *supra* note 28, at 106.

50. Anthony J. Luppino, *supra* note 1, at 48.

the use of tax shelters.⁵¹ To significantly reduce potential tax shelters, book-tax differences must be eliminated.⁵²

B. Arguments against Conformity

Book-tax conformity is easier said than done. There are a number of reasons why this article proposes not applying a general book-tax conformity in the United States federal income tax system (or, in other words, why it does not propose creating a federal income GAAP tax), but applying it only for financial instruments.

First, and most important, the roles of the accounting and tax systems differ; while the former are designed to verify that the valuation methodology is reasonable⁵³ and to test whether it has been applied on a sample basis, the purpose of the latter is to reach the most accurate reflection of the taxpayer's income.⁵⁴ As commentators indicated, "conforming the two systems is at odds with the two very different functions that the systems are designed to perform."⁵⁵ In addition, as the U.S. Supreme Court indicated in *Thor Power*,

51. *Id.* See also David. A. Weisbach, *The Failure of Disclosure as an Approach to Shelters*, 54 SMU L. Rev. 73 (2001); Treasury, *The Problem of Corporate Tax Shelters*, *supra* note 46, at 15 ("Although some disclosure of book-tax disparities is required both for Federal income tax and GAAP purposes, the amount of detail is limited and provides the IRS with little evidence concerning the existence of corporate tax shelters.")

52. See Engler, *supra* note 1, at 540.

53. A natural tension exists under GAAP between the company's managers, who generally prefer that financial statements reflect high net income, and the company's auditors, who tend to question the acceleration of income or the deferral of expenses. See Yin, *supra* note 1, at 227. See also, Johnson, *supra* note 1, at 425.

54. *Thor Power*, *supra* note 8.

55. Shevlin, *supra* note 1, at 434, elaborating that:

[t]he objective of financial accounting is to provide information relevant to decisionmakers such as investors (shareholders), lenders, suppliers, and other interested external parties. The objective of the Code is first and foremost to raise revenue to fund government operations and programs, to achieve social objectives (such as income redistribution), to achieve economic goals (such as encouraging desirable economic activities through tax incentives), and, in my opinion not the least important, to maintain popularity of the political parties and to assist in re-electing individual members. I simply do not see how these conflicting objectives can be achieved within one set of rules. And if we allow modifications to book income as a starting base, how long will it be before we are back to the current system (which already could be characterized as book income being the starting base with many modifications to arrive at taxable income)?

accounting guidance constitutes relatively flexible “principles,” which may not ensure identical treatment of identical transactions, while tax law strives for more accuracy.⁵⁶ Nevertheless, in my view, accounting and tax’s different roles should not prevent policy makers from conforming the rules only for financial instruments.⁵⁷

Second, accounting rules are not sufficiently comprehensive to form the rules required for financial instruments. For example, GAAP do not deal with the character of income, an element that is important in jurisdictions where the rates for capital gains differ from the ordinary income rates. Thus, conforming book and tax rules would still leave the character issue unsettled.⁵⁸

Third, as of today, the private sector (i.e., FASB), rather than Congress, sets forth the accounting principles. Generally, commentators agree that accounting principles need to be independent from government interference.⁵⁹ As one commentator indicated, the accounting profession has been very clear in asserting that the Government should not “have a hand in determining the application or formulation of the principles to which the tax law was being

56. *Thor Power*, 439 U.S. at 544.

57. As Engler indicates: “[D]espite their stated differences, taxable income and book income share a common core: net income as a barometer of profitability.” See Engler, *supra* note 1, at 558.

58. If character of income from financial instruments will be ordinary in all circumstances, as David Garlock suggests, this would eliminate this problem. See, generally Garlock (2004), *supra* note 27. Alternatively, the capital gains preference could be eliminated. See Weisbach (1999), *supra* note 28, at 123.

59. See generally Selbach, *supra* note 2, on the EU directive approach. For an in-depth discussion on the reaction of the accounting profession to book-tax conformity, see Anthony J. Luppino, *supra* note 1, at 119-131. See also Terry Shevlin, *supra* note 1, at 436, stating that:

If taxable income were to be more closely linked to book income rules, how would the standards be determined? Would the FASB need to consult with Congress every time the FASB debated an accounting issue that had book income consequences? Would Congress not meddle in the setting of standards but alternatively separately consider the income and tax consequences of any book income rule change and issue a modification for purposes of calculating taxable income? I believe that this would become very cumbersome and the standard setting process would become even more cumbersome than at present.

asked to conform.”⁶⁰ For this reason, I suggest below that tax rules will follow GAAP and not vice versa, so that GAAP will remain independent.⁶¹

Fourth, conforming book and tax rules would limit the accounting and tax institutional ability and authority to initiate changes to the systems.⁶² In particular, assuming tax rules will follow GAAP, conformity may limit the tax authorities’ response to new instruments because Congress and Treasury will have to wait for FASB’s reaction when a new instrument is introduced.

Fifth, some commentators have indicated that book-tax conformity will motivate reporting entities to report lower earnings simply to reduce their tax bill and it might have the effect of degrading the quality of financial reporting.⁶³ As Professor Johnson indicates, “[d]riving down reported income would be terrible for the efficiency of the stock market.”⁶⁴

Finally, applying a mark-to-market regime to most financial instruments could have some adverse impact. In particular, it has been argued that *liquidity* is a major drawback of a mark-to-market regime.⁶⁵

C. Alternative Routes to Achieve Conformity

1. Mandatory Conformity

Congress and Treasury may set forth mandatory book-tax conformity for financial instruments that will apply to all taxpayers. Mandatory conformity could be achieved in two ways. The first alternative is for Congress to set forth in the tax Code a broad provision pursuant to which taxpayers must follow, for tax purposes, the classification, timing, and valuation principles *they* use for financial accounting purposes.⁶⁶ The benefit of this alternative is that when a certain relevant accounting principle changes, it would not be necessary to

60. Anthony J. Luppino, *supra* note 1, at 123.

61. As set forth below, I suggest that Congress and Treasury revise current tax rules for financial instruments to conform them to corresponding accounting principles. I do not, however, suggest that a taxpayer will be required, or allowed, to apply its particular financial accounting treatment for tax purposes.

62. Knott and Rosenfeld, *supra* note 1, § IV,A(2)(a).

63. Johnson, *supra* note 1, at 427.

64. *Id.*

65. See Reed Shuldiner, A General Approach to the Taxation of Financial Instruments, 71 Tex. L. Rev. 243 (1992); Noel Cunningham and Deborah Schenk, Taxation Without Realization: A “Revolutionary” Approach to Ownership, 47 Tax L. Rev. 725 (1992); Edward D. Kleinbard, Equity Derivative Products: Financial Innovation’s Newest Challenge to the Tax System, 69 Tex. L. Rev. 1319 (1991). Cf. Weisbach (1999), *supra* note 28, at 105.

66. See generally Yin, *supra* note 1, at 225, suggesting a broad provision similar to IRC § 469. Under this approach, taxpayers will follow their book treatment of financial instruments in their returns. *Id.*, at 224.

change the corresponding tax rules, because taxpayers would, automatically, apply this treatment in their tax return. The disadvantage of this alternative, however, is that identical entities may be subject to different tax rules, because conformity will be applied on an entity-by-entity basis rather than uniformly. In particular, not all taxpayers are subject to GAAP, and if taxpayers follow their book treatment, taxpayers who are not subject to GAAP may be subject to different tax treatment than are taxpayers who are subject to GAAP.

Alternatively, Congress and Treasury may decide to re-write the tax rules pertaining to financial instruments based on current corresponding GAAP. In other words, financial accounting principles pertaining to financial instruments, including FAS 133, will guide Congress and Treasury in formulating such rules.⁶⁷ Under this alternative, tax rules will be similar for all taxpayers, regardless of whether they are subject to GAAP or not.⁶⁸ The disadvantage of this alternative is that tax law will be less flexible in reacting to changes in financial accounting principles. For example, as discussed in greater detail below, FASB may decide in the near future to expand mark-to-market treatment to issuers of debt instruments. If and when this change in accounting treatment of liabilities occurs, and assuming the tax authorities wish to maintain conformity, it will require a comprehensive change in tax law pertaining to the tax treatment of liabilities.

Generally, the difference between the two alternatives pertains to neutrality. In my view, the latter alternative is preferred because it will be applied to all taxpayers and will enhance neutrality in the tax system. On the other hand, because of the relative flexibility of financial accounting principles,⁶⁹ it is possible that two identical reporting entities will be subject to different financial accounting treatment, but only one will be subject to a conforming tax rule.

2. Mandatory for a Specific Type of Instrument and Elective to Others

Under this approach, some types of taxpayers will be required to follow book-tax conformity for financial instruments, while others will do it on an elective basis. For example, banking and financial institutions will be required to conform books and tax, while other types of taxpayers will do it on an elective basis.⁷⁰ Under this approach, tax law pertaining to financial instruments

67. For a similar view, see, generally Ensminger, *supra* note 1.

68. Cf. Engler, *supra* note 1, at 598, suggesting that only public corporations will be subject to tax in accordance with their book income.

69. Thor Power, 439 U.S. at 544.

70. As of today, most banks constitute “dealers” in securities and, therefore, are subject to mark-to-market treatment for both tax and financial accounting purposes, under IRC § 475 and FAS 115, respectively.

will not be revised because not all taxpayers will be subject to conformity. The problem with such an approach is that the current piecemeal tax rules will remain effective, and it will create more complexity in the form of parallel tax regimes, one for electing taxpayers, and another for non-electing taxpayers.

3. All Taxpayers May Elect to Apply Book-Tax Conformity

Under an elective approach, taxpayers will be able to elect conformity for financial instruments.⁷¹ For example, in the recently proposed contingent NPC regulations, the IRS stated in the preamble that:

[t]axpayers who use a mark-to-market method for financial reporting purposes may adopt the elective mark-to-market method to reduce their tax and accounting administrative burden for NPCs.⁷²

This provision, however, applies only to notional principal contracts with non-periodic payments. The IRS acknowledged that it is considering the expansion of the scope of the proposed regulations (and presumably, the mark-to-market election) to other instruments.⁷³

In addition, in recent years, the IRS has stated in different contexts that allowing taxpayers to elect a tax accounting method in accordance with their financial reporting methods would greatly benefit not only the taxpayers but also the IRS.⁷⁴ The ANPRM suggested a safe harbor that would allow taxpayers to use, for purposes of section 475, the values used on their financial statements. It is expected that the future regulations will adopt this approach in accordance with the ANPRM.⁷⁵

The main disadvantage of an elective approach is that not only will current incoherent tax rules for financial instruments remain effective, but some taxpayers will still apply these old rules, while others will follow their books. This kind of dual system again, will just increase complexity.

In my view, Congress and Treasury should consider revisiting the current tax rules for financial instruments and use current corresponding GAAP for this purpose. Otherwise, the benefit from having some taxpayers apply conformity might be outweighed by the additional complexity resulting from the

71. In certain cases, Congress and IRS allow an elective mark-to-market treatment, but not necessarily in accordance with the accounting treatment. See generally IRC § 475(f) (election for traders) and IRC § 1296 (mark-to-market election for PFIC stock).

72. REG-166012-02, *supra* note 27.

73. *Id.*

74. See REG-100420-03, *supra* note 25.

75. See generally Munro and Keinan, *supra* note 23.

creation of a dual system. The only way, therefore, to improve the current piecemeal tax rules for financial instruments, is to revise them.

III. CURRENT RELATIONSHIP BETWEEN BOOK AND TAX RULES

A. Clear Reflection of Income

Section 446(b) requires that a taxpayer use a method of accounting that clearly reflects income. Section 446(a) requires a taxpayer to compute its taxable income under the method of accounting used in keeping the taxpayer's books.⁷⁶ An accounting method that is acceptable under GAAP might be unacceptable for federal income tax purposes, because it does not clearly reflect income.⁷⁷ However, the Tax Court indicated that an important factor in the clear-reflection-of-income determination is whether the taxpayer is consistently using an established method of accounting that is consistent with GAAP and is prevalent in the relevant industry.⁷⁸

Nevertheless, it is clear that as of today, the starting tax base for all taxpayers is not book income. As set forth above, several discussions have been made to use book income as the starting tax base;⁷⁹ however, so far, neither Congress nor Treasury has accepted any of them. Nevertheless, for financial instruments, tax rules that are based on prevailing financial accounting principles could be viewed as reflecting income more clearly than do the current piecemeal tax rules.⁸⁰

76. The term "books" for purposes of IRC § 446(a) has been interpreted so as to include memorandum journal entries and accounting work papers containing accounting adjustments necessary to convert the items of income and expense recorded in the taxpayer's books to the tax accounting method. See *Patchen v. Comm'r*, 258 F.2d 544, 546 (1958). This interpretation is necessary because financial accounting and tax accounting have different criteria for income inclusion and expense deduction.

77. *Bank One*, 120 T.C. at 226-27, citing *Thor Power Tool Co. v. Comm'r*, 439 U.S. at 538-44; *Am. Auto Ass'n v. United States*, 367 U.S. 687 6 L. Ed. 2d 1109, 81 S.Ct. 1727 (1961); (1961); *Hamilton Ind., Inc v. Comm'r*, 97 T.C. at 128 (1991); *Sandor v. Comm'r*, 62 T.C. 469, 477 (1974), aff'd 536 F.2d 874 (9th Cir. 1976).

78. Id. Regs. § 1.446-1(a)(2) states that a method of accounting "ordinarily" will clearly reflect income when it "reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business."

79. See Yin, *supra* note 1, at 224.

80. See Ensminger, *supra* note 1, at 95.

B. Reportable Transactions Regulations

In recent years, Treasury and IRS have issued regulatory and administrative guidance in connection with tax shelters.⁸¹ The most significant guidance focuses primarily on requiring disclosure of transactions that may be considered abusive.⁸² The IRS has also implemented certain organizational changes designed to improve the agency's collection, utilization, and dissemination of information regarding tax shelters.⁸³ The fundamental purpose of the reportable transactions regulations is to require disclosure of transactions that might be viewed as "tax shelters." In the regulations, Treasury set forth rules that would require taxpayers to disclose if they treated a transaction differently for book and tax purposes. Pursuant to Regs. section 1.6011-4(b)(6), the existence of a book-tax difference of \$10 million or more, by itself, may render a transaction "reportable" for tax purposes. Nevertheless, there are numerous exceptions to this rule.⁸⁴

A significant book-tax difference is defined in the regulations as:

a transaction where the amount for tax purposes of any item or items of income, gain, expense, or loss from the transaction differs by more than \$ 10 million on a gross basis from the treatment of the item or items for book purposes in any taxable year.⁸⁵

As of today, numerous such differences exist, some of which are permanent (i.e., the *amount* of income or deduction differs), while others are temporary (i.e., the *timing* of income or deduction differs).⁸⁶ As opposed to permanent differences, temporary differences arise when items of income and deductions are includable in income or deductible as expenses for tax and financial reporting purposes at different times. A taxpayer reports such

81. For example, the reportable transaction regulations (Regs. § 1.6011-4, T.D. 9046, 68 Fed. Regs. 10161, Mar. 3, 2003) and proposed amendments to Circular 230 (REG-122379-02, 68 F.R. 75186-75191, Dec. 30, 2003).

82. T.D. 9046, 68 Fed. Reg. 10,161 (Mar. 4, 2003). The six types of transactions that constitute "reportable" are: listed transactions, confidential transactions, transactions with contractual protection, loss transactions, transactions with a significant book-tax difference, and transactions involving a brief asset holding period.

83. See John D. McKinnon, IRS, Reorganizing, to Sharpen Fight Against Abusive Corporate Tax Shelters, Wall St. J., Feb. 3, 2000, at A4.

84. Rev. Proc. 2003-25, 2003-1 C.B. 601. A discussion of these exceptions is beyond the scope of this article.

85. Regs. § 1.6011- 4(b)(6)(i).

86. Gil B. Manzon, Jr. and George A. Plesko, The Relation Between Financial and Tax Reporting Measures of Income, 55 Tax L. Rev. 175, 183 (2002).

differences on its Schedule M-1⁸⁷ the federal corporate tax return.⁸⁸ In addition, pursuant to FAS 109,⁸⁹ a reporting entity must report in its financial statements information concerning deferred tax assets and liabilities.⁹⁰

IV. RELEVANT ACCOUNTING BODIES AND GUIDANCE

A. Financial Accounting Standards Board (FASB)

The FASB was created in 1973 and is the professional organization primarily responsible for establishing financial reporting standards in the United States.⁹¹ Generally, the Securities and Exchange Commission (“SEC”), which was created pursuant to the Securities Exchange Act of 1934,⁹² has recognized guidance issued by FASB as authoritative.⁹³ FASB issues the following types of guidance: (i) Statements of Financial Accounting Standards (SFASs), each of which addresses a specific topic in financial accounting; (ii) Interpretations of Statements or pronouncements of predecessor bodies; and (iii) Technical Bulletins. FASB has also issued seven Statements of Financial Concepts (SFACs), the purpose of which is to set forth a conceptual framework for financial reporting.⁹⁴

87. Reconciliation of Income (Loss) per Books with Income per Return.

88. IRS Form 1120, U.S. Corporation Income Tax Return (2001). The Schedule M-1 will be revised and titled “Schedule —3” starting from December 31, 2004. See Rev. Proc. 2004-45, 2004-31 IRB 1; IR-2004-91, IRS Announces Release of Schedule M-3 for Corporations (July 7, 2004), printed in 2004 TNT 131-16.

89. FAS 109, Accounting for Income Taxes (FASB 1992). See generally Manzon and Plesko, *supra* note 86, at 183-184; David A. Weisbach, Ten Truths About Tax Shelters, 55 Tax L. Rev. 215, 227 (2002).

90. A temporary difference creates deferred tax asset or liability, while a permanent difference is reported on either the equity section of the balance sheet or the income statement. See Manzon and Plesko, *supra* note 86, at 182.

91. Bank One, 120 T.C. at 216-17.

92. Securities Exchange Act of 1934, ch. 404, 13(b), 48 Stat. 881, 894-95. Generally, publicly-traded companies in the United States, including non-U.S. companies, are required to file financial statements with the SEC that are prepared in accordance with U.S. GAAP. Nevertheless, many nonpublicly traded companies not subject to the SEC supervision also employ GAAP. See SIA Comments, *supra* note 35, ¶ 71.

93. Knott and Rosenfeld, *supra* note 1, at footnote 22, citing, SEC 1973 Policy Statement (principles promulgated in FASB Statements and Interpretations considered by SEC to have substantial authoritative support). See also SIA Comments, *supra* note 35, ¶ 70.

94. Knott and Rosenfeld, *supra* note 1, § I(D).

B. International Accounting Standards Committee (IASC)

The accountancy bodies of a number of industrialized countries established the IASC in 1973. The IASC enhances improvement and harmonization of accounting standards by formulating and publishing accounting standards that are intended to be acceptable worldwide. The standards set forth by the IASC are titled International Accounting Standards (“IAS”), and have acquired a status as indicators of internationally acceptable practice.⁹⁵

C. Guidance on Financial Instruments

As part of its financial instruments project, the FASB has issued several statements. In 1990, the FASB issued FAS 105,⁹⁶ which required a footnote disclosure of the extent, nature, and terms of financial instruments such as swaps, which contain off-balance-sheet risk. In 1991, the FASB issued FAS 107,⁹⁷ which required a footnote disclosure of the fair value of financial instruments for which it was practicable to estimate fair value but did not require formal recognition of such instruments in the financial statements. The term fair value was defined as:

[t]he amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. If a quoted market price is available for an instrument, the fair value to be disclosed for that instrument is the product of the number of trading units of the instrument times that market price.⁹⁸

95. See generally Selbach, *supra* note 2, at 553-55.

96. FAS 105, Disclosures of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk (Mar. 1990).

97. FAS 107, Disclosures about Fair Value of Financial Instruments (Dec. 1991).

98. FAS 107 allowed a variety of methodologies for estimating fair values, including the use of midmarket values if any adjustments thereto were likely to be negligible or not cost effective to estimate reliably. The FASB recognized in FAS 107 that quoted market prices did not exist for custom-tailored instruments such as swaps and recommended that “an estimate of fair value might be based on the quoted market price of a similar financial instrument, adjusted as appropriate.” The valuation issue is discussed in greater detail below.

FAS 115,⁹⁹ issued in 1993, addresses the accounting rules for investments in equity securities that have readily determinable fair values (i.e., marketable securities) and for all investments in debt securities. In 1994, the FASB issued FAS 119,¹⁰⁰ which required a footnote disclosure of the nature, terms, and fair values of derivatives.

In 1998, the FASB issued FAS 133,¹⁰¹ which requires all derivatives to be recorded on the balance sheet at fair value (i.e., marked-to-market) and sets forth special accounting standards for hedging transactions. FAS 133, has been revised several times, particularly by FAS 149. FAS 133 replaced the disclosure requirements under FAS 105 and FAS 119. Finally, FAS 150,¹⁰² issued in 2003, sets forth standards for how an issuer should classify and measure certain instruments with characteristics of both liabilities and equity.

In addition to the above statements, numerous other documents have been issued by accounting bodies on financial instruments.¹⁰³ This article, however, discusses only the most important ones.

V. KEY ISSUES IN ANALYZING FINANCIAL INSTRUMENTS

A. General

The tax treatment of a financial instrument can be determined in accordance with (i) the identity of the instrument and its associated cash flows; (ii) the identity of the taxpayer; or (iii) the purpose for which the transaction is entered into by the particular taxpayer. Ideally, the tax treatment of a particular instrument should be determined by considering all three elements. Nevertheless, as a practical matter, it is very hard to apply all three elements at the same time. As of today, the taxation rules for financial instruments in the United States do not follow a consistent pattern. Specifically, while some rules emphasize the *identity of the instrument* (e.g., notional principal contracts regulation and section 1256), other rules emphasize the *identity of the taxpayer* (e.g., section 475). Finally, some rules focus on the *purpose of the transactions*

99. FAS 115, Accounting for Certain Investment in Debt and Equity Securities (May 1993).

100. FAS 119, Disclosures about Derivative Financial Instruments and Fair Value of Financial Instruments (Oct. 1994).

101. FAS 133, *supra* note 18.

102. FAS 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity (May 2003).

103. For example, the Emerging Issues Task Force of the FASB (the "EITF") issued guidance in early 2003 to address valuations of energy derivatives. This guidance is commonly viewed as an authority for valuation of all derivatives. See EITF Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities."

(e.g., hedging rules). Some current regimes apply more than one approach to some extent, but incoherently.¹⁰⁴

By contrast, financial accounting rules are more coherent and generally apply a uniform approach for financial instruments.¹⁰⁵ Generally, FAS 133 requires all derivatives to be mark-to-market, while FAS 115 requires all securities that are not held to maturity to be marked-to-market.

B. Substance over Form

In many cases, taxpayers develop transaction forms that facially differ from their real economic substance in order to obtain the resulting tax benefits. Under the substance-over-form doctrine, the IRS and the courts have the power to re-characterize a transaction in accordance with its substance if such substance is demonstrably contrary to its outward form.¹⁰⁶ In some cases, taxpayers have successfully challenged *their own* transaction form, subject to limitations under the “*Danielson*” doctrine.¹⁰⁷

Similarly, under GAAP, the substance of a transaction rather than its form should be reported in financial statements, especially if presenting the form rather than the substance would be misleading.¹⁰⁸

FASB Concepts Statement No. 2 states:

Substance over form is an idea that also has its proponents, but it is not included because it would be redundant. The quality of reliability, and, in particular, of representational faithfulness, leaves no room for accounting representations that subordinate

104. For example, IRC § 1256, which generally applies the first approach, excludes from its application hedging transactions. Similarly, the notional principal contract regulations generally do not apply to transactions that are subject to mark to market treatment under IRC § 1256 or IRC § 475. Finally, the hedging regulations do not apply to § 475 transactions. See Rosenthal and Price, *supra* note 17, at 901-05.

105. *Id.* at 906.

106. Joseph Isneberg, *Musing on Form and Substance and Form in Taxation*, 49 Chi. L. Rev. 859 (1982).

107. *Comm’r v. Danielson*, 378 F.2d 771 (3rd Cir. 1967) cert. denied, 389 U.S. 858 (1967); *Helvering v. Lazarus*, 308 U.S. 252 (1939); *Estate of Weinert v. Comm’r*, 294 F.2d 750, 755 (5th Cir. 1961).

108. For an-depth discussion on the accounting substance-over-form concept, see Rick Stephan Hayes and Richard Baker, *The Concept of Substance Over Form: A Discussion Based on the Cinderella Story (1999)*, <http://panopticon.csustan.edu/cpa99/html/hayes.html> (Critical Perspectives on Accounting conference, 1999).

substance to form. Substance over form is, in any case, a rather vague idea that defies precise definition.¹⁰⁹

The IASC has also indicated that “prudence, substance over form, and materiality should govern the selection and application of accounting policies.”¹¹⁰

International Accounting Standard (IAS) No. 1 states that:

Transactions and other events should be accounted for and presented in accordance with their substance and financial reality and not merely their legal form.¹¹¹

The IASC specifically refers to substance over form in standards dealing with finance leases,¹¹² joint ventures,¹¹³ and related party transactions.¹¹⁴

109. FASB Concept Statement No. 2, Appendix B, ¶ 160. In addition, Accounting Principles Board’s Statement No. 4 provides that:

Financial accounting emphasizes the economic substance of events even though the legal form may differ from the economic substance and suggest different treatment. . . . Although financial accounting is concerned with both the legal and economic effects of transactions and other events and many of its conventions are based on legal rules, the economic substance of transactions and other events are usually emphasized when economic substance differs from legal form. . . . Usually the economic substance of events to be accounted for agrees with the legal form. Sometimes, however, substance and form differ. Accountants emphasize the substance of events rather than their form so that the information provided better reflects the economic activities represented. See Hayes and Baker, *supra* note 108.

110. *Id.*

111. *Id.* as the IAS Framework ¶ 35, elaborates:

The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an enterprise may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the enterprise continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not faithfully represent the transaction entered into (if indeed there was a transaction).

112. IAS 17, ¶ 3 and 13. Substance over form is explained in regard to leases:

While the legal form of a lease agreement is that the lessee may acquire no legal title to the leased asset, in the case of finance leases

Finally, in England, U.K. Accounting Standards Board's (ASB) Financial Reporting Standard 5 sets forth that: (i) the substance of transactions should be recorded; (ii) greater weight should be given to aspects that are likely to have an economic effect; (iii) complex transactions should be analyzed to see whether the entity's assets or liabilities have been affected; and (iv) if assets and liabilities are identified then general tests need to be applied to see whether they should be recognized.¹¹⁵

C. Classification of Financial Instruments

1. Overview

An entity's balance sheet contains three categories: assets, liabilities and equity.¹¹⁶ The value of an entity's assets must be equal to the sum of its liabilities and equity.¹¹⁷ Each item in the balance sheet must be reported in one of these categories.¹¹⁸ As a result, it is important for financial accounting purposes to classify each item and report it in the appropriate section of the balance sheet. The classification issue becomes even more important with respect to financial instruments, because different instruments are subject to different treatments.¹¹⁹

Classifying financial instruments that are composed of several basic instruments, or instruments with characteristics of both debt and equity, is not an easy task. One alternative is to adopt an integrative approach pursuant to which different positions are aggregated and the combined instrument is subject

the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of the useful life.

113. IAS 31, ¶ 18 and 26. In addition, the IASC states that when reporting an interest in a jointly controlled entity in consolidated financial statements, it is essential that a venture reflects the substance and economic reality of the arrangement, rather than the joint venture's particular structure or form. In considering each possible related party relationship, attention is directed to the substance of the relationship, and not merely the legal form.

114. IAS 23 ¶ 3.

115. See Hayes and Baker, *supra* note 108.

116. "Elements of Financial Statement of Business Enterprises," Statement of Financial Accounting Concepts No. 6 (Stamford, Conn.: FASB 1980), ¶ 35.

117. *Id.*

118. *Id.*

119. See, generally "Reporting Income, Cash Flows and Financial Positions of Business Enterprises," Proposed Statement of Financial Concepts (FASB 1981), ¶ 51.

to a certain treatment according to its combined identity.¹²⁰ Another alternative is to disaggregate the taxpayer's position into its basic ingredients and to impose a certain treatment on the overall position on the basis of the basic ingredients' treatment.¹²¹ A third alternative is to simply treat the instrument on the basis of its legal distinction (i.e., form over substance). While the first two approaches are economic-based approaches, the third one focuses on the form rather than the substance.

In this article, I attempt to neither revisit the debt v. equity rules nor decide whether integration or bifurcation is superior. Instead, I suggest that financial accounting and tax classification rules be conformed so that an instrument is not treated differently for book and tax purposes. To facilitate such conformity, I suggest that financial instruments be divided into two groups: derivatives¹²² and non-derivatives (i.e., basic instruments). In turn, each group will also be divided into two sub-categories: while a position in a derivative will constitute either an asset or a liability, non-derivative instruments will be classified as either debt or equity instruments. A holder of a non-derivative instrument will be viewed as holding an "asset," while its issuer will be viewed as owing either a liability (for issuing a debt instrument) or equity (for issuing an equity security). Thus, each instrument will be classified for both financial accounting and tax purposes as an asset, liability, or equity, in accordance with accounting concepts. Finally, the so-called "hybrid instrument" class should be eliminated for both tax and accounting purposes.¹²³

2. Basic (Non-Derivatives) Instruments: Distinguishing Between Debt (Liability) and Equity

(i) Exploiting Book and Tax Differences

Debt provides certain tax advantages to its issuer because business interest expenses are deductible.¹²⁴ Nevertheless, the issuance of debt also tends

120. For an in-depth discussion on integration and bifurcation, see, Weisbach (1995), *supra* note 28, Jeff Strnad, Commentary – Taxing New Financial Products in a Second Best World: Bifurcation and Integration, 50 *Tax Law Rev.* 545 (1995); Schenk, (1995), *supra* note 28.

121. *Id.*

122. For purposes of this distinction, I suggest that the definition of a "derivative" for both financial accounting and tax purposes be conformed under the principles of FAS 133, as set forth in greater detail below.

123. See, generally, FAS 150, ¶ B56, which suggests that presentation between the liabilities and equity sections of the balance sheet is inappropriate.

124. See, generally, IRC § 163(a) (2004).

to depress the issuer's stock price and credit ratings.¹²⁵ As a result, under certain circumstances, corporations prefer to obtain equity financing for financial accounting purposes, and debt financing for tax purposes.¹²⁶ Generally, financial accounting rules for classifying an instrument as a liability or equity do not conform to the corresponding tax rules, and corporations may enjoy various opportunities to achieve such a benefit.

(ii) *Section 385*

Section 385 addresses the treatment of certain interests in corporations and provides authority to the IRS to set forth regulations to determine whether an instrument constitutes debt or equity, or part debt and part equity.¹²⁷ In 1981, Treasury issued regulations under section 385, that proved to be controversial and finally were withdrawn. In the absence of regulatory guidance, the characterization of an instrument as debt or equity has been determined pursuant to case law.¹²⁸

125. See David. C. Garlock, *Taxation of Debt Instruments* (2004), at § 1.01[B], footnote 72. See also CEO Tax Group Backs Dividends-Paid Deduction, 86 TNT 168-51 (Aug. 12, 1986).

126. MIPSs, for example, are securities with which corporations can achieve this result. Garlock, *supra* note 125, at § 1.01[B][3]. The basic idea behind MIPS and similar products is that an intermediate entity is interposed between the investors and the borrower, which is treated as a pass-through entity for tax purposes but is consolidated with the issuer and hence effectively disregarded for financial accounting purposes. The intermediate entity issues nonvoting preferred interests to the investors (and a small voting common interest to the issuer or a third party) and uses the proceeds to purchase a long-term debt instrument from the issuer. As long as the entity is respected for tax purposes as separate from the issuer, the debt is given effect for tax purposes and so the issuer gets an interest deduction. If the entity is consolidated with the issuer under GAAP, then the debt is ignored for that purpose and the issuer is simply treated as having issued some form of preferred interest to the public. Accountants have generally been comfortable that this interest need not be shown on the balance sheet as debt, but rather as a form of "mezzanine" equity. *Id.*

127. Section 385 lists factors that such regulations may take into account in determining whether a debtor-creditor or a corporation-shareholder relationship exists, including: (i) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest; (ii) whether there is subordination to or preference over any indebtedness of the corporation; (iii) the ratio of debt to equity of the corporation; (iv) whether there is convertibility into the stock of the corporation; and (v) the relationship between holdings of stock in the corporation and holdings of the interest in question.

128. An equity interest has traditionally been defined as embarking on a corporate venture and taking the risks of loss attendant upon it, so that one might share in the profits of its success, whereas debt has been defined as an unqualified obligation

Courts have developed guidance in this area by identifying factors that are relevant to the characterization of an obligation as debt or equity for U.S. federal income tax purposes,¹²⁹ including: (i) whether there is an unconditional promise on the part of the debtor to pay a sum certain; (ii) whether the creditor has the right to enforce the payment of principal and interest; (iii) whether the rights of the creditor are subordinated to those of general creditors; (iv) whether the instrument gives the creditor the right to participate in the management of the debtor; (v) whether the debtor is thinly capitalized; (vi) whether there is identity between the creditor and shareholders of the debtor; (vii) whether funds are repaid on the due date; (viii) the intent of the parties; (ix) the presence of a maturity date; (x) the payments' source; (xi) the instrument's label placed by the parties; (xii) the ability of the debtor to obtain loans from outside lenders; and (xiii) the use of the proceeds by the debtor.¹³⁰

The IRS also attempted to set forth in Notice 94-47¹³¹ its own debt v. equity guidelines which generally are consistent with the above common law principles.

(iii) Accounting Classification Rules

“Liabilities” are defined for financial accounting purposes as:

[p]robable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.¹³²

to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof. See Garlock, *supra* note 125 at § 1.01[B], citing *Farley Realty Corp. v. Comm'r*, 279 F.2d 701 (2d Cir. 1960); *United States v. Title Guarantee & Trust Co.* 133 F.2d 990, 993 (6th Cir. 1943).

129. Some courts have placed more weight on certain factors than on others, and not all factors have been considered by every court in analyzing a debt-equity characterization issue. However, courts have been consistent in finding that no particular factor is conclusive in making such a determination.

130. Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369 (1971). See also *Laidlaw Transportation, Inc. v. Comm'r*, T.C. Memo. 1998-232.

131. 1994-1 C.B. 357.

132. SFAC. No.6, ¶ 35.

“Assets” generally mirror liabilities and, accordingly, are defined as:

[p]robable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.¹³³

Finally, “equity” is defined as:

[t]he residual interest in the assets of an entity that remains after deducting its liabilities. In a business enterprise, the equity is the ownership interest.¹³⁴

FAS 150¹³⁵ was developed in response to concerns expressed by preparers, auditors, regulators, investors, and other users of financial statements about issuers’ classification of certain financial instruments with characteristics of both liabilities and equity that have been presented either entirely as equity or between the liabilities section and the equity section of the statement.¹³⁶ FAS 150 sets forth standards for how should an *issuer* classify and measure several types of such instruments.

Pursuant to FAS 150, the relationship between the parties to the transaction, in addition to the transaction’s form, should govern in determining whether the instrument constitutes a liability or equity.¹³⁷ An issuer is required to classify the following instruments as liabilities (or assets in some circumstances): (i) mandatorily redeemable financial instruments;¹³⁸ (ii) an obligation to repurchase the issuer’s equity shares by transferring assets;¹³⁹ and

133. *Id.*, ¶ 25.

134. *Id.*, ¶ 49.

135. FAS 150, *supra* note 102.

136. *Id.*, ¶ B2.

137. FAS 150 does not apply to (i) features that are embedded in a financial instrument, such as conversion and conditional redemption features, which do not constitute derivatives in their entirety, and (ii) convertible bonds, puttable stock, or other outstanding shares that are conditionally redeemable. *Id.*, ¶ 16-17 pg. 5.

138. *Id.*, ¶ B20.

139. An instrument, other than stock, that, at issuance, embodies an obligation to repurchase the issuer’s equity shares, or is indexed to such an obligation, and that requires or may require the issuer to settle the obligation by transferring assets (e.g., forward purchase contracts and written put options on the issuer’s stock, that are to be physically settled or net cash settled). Such contracts constitute liabilities because they (i) embody an unconditional obligation to repurchase the issuer’s stock (or instruments that are indexed to such an obligation) and (ii) require or may require the issuer to settle the obligation by transferring assets. *Id.*, ¶ 11, B26-B29.

(iii) an obligations to issue a variable number of shares.¹⁴⁰ While FAS 150 determines that all three instruments should be classified as liabilities and not equity, only the first one could be viewed as equivalent to indebtedness.¹⁴¹

Mandatorily redeemable financial instruments are instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.¹⁴² Such instruments are classified as liabilities under FAS 150, although in form they are equity, because they: (i) embody a current obligation that entails settlement by future transfer of assets at a specified or determinable date or on occurrence of a specified event; (ii) provide the issuer with no discretion to avoid a future sacrifice of assets; and (iii) result from a transaction – the issuance of the instrument – that has already happened. Although FAS 150 did not specifically state that such instruments constitute “indebtedness,” it did state that payments or accrual of “dividends” payable to holders are reported as interest costs.¹⁴³

140. An instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares, if, at inception, the monetary value of the obligation is based solely or predominantly on any of the following: (i) a fixed monetary amount known at inception (e.g. forward contract to issue a variable number of shares so that the value to be issued is pre-determined and not subject to changes in the stock’s value); (ii) variations in something other than the fair value of the issuer’s equity shares (e.g., a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer’s equity shares); or (iii) variations inversely related to changes in the fair value of the issuer’s equity shares, for example, a written put option that could be net share settled. Although this type of instrument does not satisfy the definition of “liabilities” under SFAC No. 6, the relationship between the parties constitutes debtor-creditor relationship and, therefore, if the above requirements are met, they are classified as liabilities under FAS 150. *Id.*, ¶ A22 B32.

141. The second and third types of instruments do not constitute indebtedness but rather constitute derivatives.

142. See FAS 150, Appendix D1. An example of such an instrument is a trust preferred security issued in the following manner: A trust issues preferred securities to outside investors and uses the proceeds to purchase from a financial institution an equivalent amount of debentures having stated maturities. The debentures are the trust’s only assets. When interest payments are made on the debentures, the trust distributes the cash to the preferred securities’ holders. The trust preferred securities must be redeemed upon the debentures’ maturity. Para A4-A5.

143. *Id.*, ¶ A5.

Pursuant to FAS 150, the most important aspect of a “liability” is the existence of an unconditional “obligation.”¹⁴⁴ In addition, to be classified as a liability rather than equity, an obligation must not expose its holder to certain risks and benefits to which an owner of equity interests is normally exposed.¹⁴⁵ In that respect, exposure to changes in the fair value of the issuer’s stock is a characteristic of equity.¹⁴⁶

Both accounting and tax principles, in attempting to identify what constitutes indebtedness, apply three related but distinct terms: “indebtedness,” “liability” and “obligation.”¹⁴⁷ The U.S. Supreme Court held in *Deputy v. DuPont*¹⁴⁸ that an obligation to return borrowed stock pursuant to a securities lending arrangement does not constitute “indebtedness” for tax purposes. In Rev. Rul. 95-26,¹⁴⁹ the IRS ruled that such an obligation constitutes “liability” for purposes of section 752.¹⁵⁰ Thus, for tax purposes, an obligation to return the borrowed stock under a short sale constitutes a “liability” but not “indebtedness.”¹⁵¹

FAS 150 applies to instruments that constitute “liabilities” and not necessarily “indebtedness.” Thus, its scope is broader than the particular debt v. equity classification issue. Nevertheless, in my view, FAS 150 is an important step in conforming tax and book principles for distinguishing between debt and equity because it emphasizes some of the important elements that have been used by courts and the IRS in such determinations. In particular, with respect to the mandatorily redeemable financial instruments, the following elements suggest that it could be viewed as indebtedness for tax purposes: (i) an unconditional obligation; (ii) to pay a sum certain; (iii) on a fixed maturity date; (iv) with the intention to create a debtor-creditor relationship. On the other hand, the form of the instrument is stock, and there is no discussion in FAS 150 on

144. *Id.*, ¶ B 33. A similar approach was taken by the IASC. In June 2002, the IASC issued an Exposure Draft, Amendment to IAS 32, Financial Instrument: Disclosure and Presentation, and IAS 39, Financial Instruments: Recognition and Measurement. Pursuant to ¶ 22 of IAS 32, when a preferred share provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the shares at or after the particular date for a fixed or determinable amount, the instrument meets the definition of a financial liability and is classified as such. FAS 150, ¶ B78.

145. *Id.*, ¶ B36.

146. *Id.*, ¶ B37.

147. See, Garlock, *supra* note 125, at § 1.01[A]. The first term is the narrowest, while the last is the broadest because every debt is a liability, and every liability is an obligation, but the converse statements are not true.

148. *Deputy v. DuPont*, 308 U.S. 488 (1940).

149. 1995-1 C.B. 131.

150. See also, *Salina P’ship LP, FPL Group, Inc. v. Comm’r*, 80 TC (C.H.) 686 (2000).

151. Garlock, *supra* note 125, at § 1.01[A].

creditors rights, subordination, participation in management or thin capitalization.

The tax treatment of mandatorily redeemable preferred shares is uncertain. On the one hand, in *United States v. South Georgia Ry. Co.*,¹⁵² the court held that preferred shares were equity, stating the “entire absence here of the most significant, if not the essential feature of a debtor and creditor as opposed to a stockholder relationship, the existence of a fixed maturity for the principal sum with the right to force payment of the sum as a debt in the event of default.”¹⁵³ On the other hand, “although a fixed maturity date appears to be essential to a finding that an instrument constitutes debt, the presence of a fixed maturity date clearly does not by itself preclude an instrument with such a feature from being treated as stock.”¹⁵⁴

Nevertheless, FAS 150 was intended to neither set forth general guidance for distinguishing between debt and equity nor conform such rules to existing tax classification rules. Accordingly, as of today, neither GAAP nor tax law contain an adequate set of rules for distinguishing between debt and equity.

Table I below summarizes the differences between the common law elements for distinguishing between debt and equity and the ones used by FASB in FAS 150.

152. 107 F.2d 3, 5 (5th Cir. 1939).

153. See, Garlock, *supra* note 125, at § 1.01[B].

154. *Id.* at 1.10, citing Rev. Rul 78-142, 1978-1 C.B. 111, as an example.

Table I

Element	Common Law	FAS 150
Unconditional promise/obligation	X	X
Sum certain (not connected to equity's value)	X	X
Creditor's rights	X	
Subordination	X	
Participation in management	X	
Thin capitalization	X	
Creditors/shareholders identity	X	
Repayment of funds on the due date	X	
Intent of the parties to create creditor-debtor relationship	X	X
Fixed maturity date	X	X
Source of payments	X	
The label of the instrument	X	
Obtaining loans from outside lenders	X	
Use of the proceeds	X	

(iv) Integration/Bifurcation

While tax law combines limited integration and bifurcation elements (although it prefers integration on the grounds that the substance of the taxpayer's activities will be more apparent if those activities are viewed collectively), FASB clearly rejected the integration approach in FAS 133 and 150¹⁵⁵ and adopted a bifurcation approach on the grounds that the latter is more accurate.¹⁵⁶

a. Integration of Debt Instruments with Certain Hedging Transactions

Regulation section 1.1275-6 provides for the integration of a debt instrument with a hedge. A section 1.1275-6 hedge is any financial instrument if such combined cash flows permit the calculation of a yield to maturity under the principles of section 1272, or the right to the combined cash flows would qualify as a variable rate debt instrument that pays interest at a qualified floating rate or rates.¹⁵⁷

155. See FAS 133, *supra* note ¶ 12-16; FAS 150, *supra* note 102, ¶ 15.

156. See Ensminger, *supra* note 1, at 24.

157. The synthetic debt instrument has the following characteristics: (i) its issue date is the first date on which the taxpayer entered into its components; (ii) its term is the period beginning on the issue date and ending on the maturity date; (iii) its issue price is the adjusted issue price of the debt instrument on the issue date; (iv) its adjusted issue price is determined in the manner of a debt instrument subject to the general OID rules; and (v) its stated redemption price at maturity is the sum of all amounts paid or

Similarly, pursuant to Regulation section 1.988-5(a), an “integrated economic transaction” consists of a “qualifying debt instrument” and a “Section 1.988-5(a) hedge.” The two components are integrated into a synthetic instrument that reflects the underlying components of both the debt and the hedge.¹⁵⁸ A “qualifying debt instrument” is any debt instrument, regardless of whether the payments under the debt are denominated in, or determined by reference to, a nonfunctional currency.¹⁵⁹ A “section 1.988-5(a) hedge” includes a spot contract, futures contract, forward contract, option contract, notional principal contract, currency swap, and similar transactions¹⁶⁰

For financial accounting purposes, integrated transactions under Regulations section 1.1275-6 or section 1.988-5 are treated as separate transactions.¹⁶¹ Issuers have been benefitting from such book tax difference by integrating a debt instrument and a call option for tax purposes (thereby securing OID deductions) while keeping the instruments separate for book purposes.¹⁶² As discussed below, this book-tax difference, as opposed to a book-tax difference arising from a contingent payment debt instrument, is permanent.

to be paid on the debt instrument and the hedge, reduced by all amounts received or to be received on the hedge. See Regs. § 1.1275-6(f).

158. A “qualifying debt instrument” and a “§ 1.988-5(a) hedge” form an “integrated economic transaction” if all of the following requirements are met: (i) all payments to be made or received under the debt instrument (or amounts determined by reference to a nonfunctional currency) are fully hedged such that a yield to maturity in the currency in which the synthetic debt instrument is denominated can be calculated; (ii) the hedge is identified on or before the date it is settled or closed; (iii) none of the parties to the hedge are related; (iv) in the case of a qualified business unit with a residence outside of the United States, both the debt instrument and the hedge are properly reflected on the books of such qualified business unit throughout the term of the hedging transaction; (v) both the debt instrument and the hedge are entered into by the same entity; and (vi) if the taxpayer is a foreign person engaged in a U.S. trade or business and enters into the debt instrument and hedge in the course of such trade or business, then all items of interest or expense would have been effectively connected with such U.S. trade or business throughout the term of the transaction had integration treatment not been available under the regulations. See Regs. § 1.988-5(a).

159. Regs. § 1.988-5(a)(3)(i).

160. Regs. § 1.988-5(a)(4)(i).

161. Ensminger, *supra* note 1, at 69.

162. For example an issuer of a convertible note may purchase a call with a strike price that is identical to the conversion price of the convertible bond. The premium paid for the call is economically equivalent to discount on the convertible debt. The taxpayer can integrate the call with the convertible debt and may deduct the premium as OID. To achieve this goal, the call must have maturity date and number of shares similar or identical to those on the convertible debt, so that the convertible debt is fully hedged. See Regs. § 1.1275-6(b)(4).

The purpose of the tax integration rules has been to properly match the timing and character of the hedging transaction with those of the hedged item. As I suggest below, mark-to-market treatment will apply to all hedging transactions and to certain hedged items (including issued debt instruments). Thus, the tax integration provisions will be unnecessary, because taxpayers will simply mark both the hedge and hedged item to market in accordance with FAS 133.

b. Investment Units (Synthetic Convertibles) v. Convertible Debt

Although the conversion feature of a convertible debt instrument could be viewed as a call option on the issuer's stock, a convertible debt is not bifurcated into the debt and the option for tax purposes.¹⁶³ Therefore, for tax purposes, the issue price of the convertible bond is not allocated between the debt and the implicit call option.¹⁶⁴

On the other hand, if a debt instrument is issued with other property (such as warrants to purchase the issuer's stock), the combined issuance constitutes an "investment unit" the issue price of which is allocated between the debt and the warrants.¹⁶⁵ The allocation is based on the relative fair market values of the components that comprise the unit. Once the issue price has been allocated between the debt and the warrants, the two components take separate paths; the debt is governed by sections 1272 and 1273, and subsequent transactions affecting the warrants are governed by section 1032 for the issuer and section 1234 for the holder.¹⁶⁶

In Rev. Rul. 2003-97,¹⁶⁷ among other things, the IRS set forth guidance pertaining to separability of financial instruments for tax purposes. The IRS ruled that a debt instrument and a forward contract issued together as an investment unit will be treated as separate financial instruments, provided the following four conditions are met: (i) the holder has the unrestricted legal right to separate the debt instrument from the forward contract,¹⁶⁸ and is not economically compelled to keep the unit un-separated; (ii) the forward contract provides that, in the event of issuer's bankruptcy, it will terminate and the holder of the unit will be treated as a creditor of the issuer; (iii) the notes will remain outstanding after the remarketing for a significant period (disregarding

163. See generally Jeff Strnad, Taxing Convertible Debt, 56 SMU L. Rev. 399 (2003).

164. *Chock Full O'Nuts Corp. v. U.S.*, 453 F.2d 300 (2d Cir. 1971); Garlock, *supra* note 125, at § 10.01[C][1].

165. IRC § 1273(c)(2) and Regs. § 1.1273-2(h).

166. See generally Garlock, *supra* note 125, at § 10.01[B].

167. 2003-34 I.R.B. 380.

168. The holder can do it either by substituting a Treasury strip as collateral or by settling the purchase contract for cash and retaining the note.

any period during which the notes are callable by the issuer); and (iv) on the issue date, it is substantially certain that the remarketing of the notes will succeed.

APB Opinion No. 14 sets forth principles for distinguishing between investment units (particularly debt issued with a warrant) and convertible debt. For GAAP purposes, the proceeds from the sale of a debt instrument with a “detachable stock warrant”¹⁶⁹ are allocated between the two securities because two separate instruments are involved each of which can be separately traded.¹⁷⁰ By contrast, a convertible debt is not viewed for GAAP purposes as two separate instruments and the value of the “option” component of the instrument is not separately allocated.¹⁷¹

Note that APB Opinion No. 14 focuses only on the right to trade the instruments separately. Thus, it appears that the standard under Rev. Rul. 2003-97 is stricter than the corresponding financial accounting principle. Accordingly, two instruments may be treated as a single instrument for tax purposes but as an investment unit for financial accounting purposes if they can be traded separately, but do not satisfy the other three requirements of Rev. Rul. 2003-97. For example, if the maturity dates of the debt instrument and the warrant are very close, the IRS may take the view that they are inseparable, under Rev. Rul. 2003-97. I suggest, therefore, that Rev. Rul. 2003-97 will be limited to its facts, and that Treasury will set forth, in regulations, general guidance on separability of instruments for tax purposes that are consistent with corresponding financial accounting guidance.

c. Embedded Derivatives

A financial instrument is bifurcated for tax purposes only in limited circumstances.¹⁷² Under FAS 133, on the other hand, some financial instruments are bifurcated into two components: the basic instrument and the “embedded

169. A “detachable warrant” is a warrant that can be traded separately from the bond. See APB Opinion No. 14.

170. While the debt instrument remains outstanding until its maturity, the warrant to purchase the issuer’s stock could be exercised prior to the debt instrument’s maturity. *Id.*

171. *Id.* But cf. Kieso et. al., *supra* note 39, at 780, (challenging FASB’s distinction between convertible debt and debt issued with a warrant and arguing that they should be treated similarly).

172. For example, Regs. § 1.446-3(g)(4)(providing that a significant non-periodic payment made under a notional principal contract is viewed as an embedded loan for tax purposes).

derivative.”¹⁷³ Generally, if the economic characteristics and risks of embedded derivative are not clearly and closely related to those of the host instrument, the embedded derivative should be separated and accounted for under FAS 133 on a mark-to-market basis.¹⁷⁴ For example, if a debt instrument is convertible into a specified number of shares of the debtor or another entity’s common stock, the conversion option is separated from the host contract and marked-to-market as a derivative under FAS 133.¹⁷⁵

Clearly, the embedded derivative rules in FAS 133 are inconsistent with current tax rules. As of today, tax law has not yet recognized the possibility of taxing embedded derivatives separately from their host contract. To conform the book and tax rules, therefore, tax policy makers must consider adopting the embedded derivative approach for contingent payment debt instruments and similar instruments with embedded derivatives.¹⁷⁶

(v) Derivative Instruments: Assets or Liabilities

Generally, with respect to traditional instruments such as debt instruments or stock, financial accounting and tax rules follow a similar approach pursuant to which an issuer of a debt instrument owes a liability, while the holder of the instrument holds an asset. In addition, an issuer of a stock is viewed as issuing an equity interest, while the holder of the stock holds an asset.

The question of asset v. liability arises with respect to derivatives. There are at least two parties to a financial transaction.¹⁷⁷ A transaction that is consummated at market rates cannot be objectively profitable to all the parties if the transaction is “zero-sum,” as is frequently the case with derivatives.¹⁷⁸ For example, a plain vanilla swap with a fixed rate that is equal to the current mid-market rate¹⁷⁹ is said to be “at market” and has a zero value to both parties (this is the situation at the inception of the contract).¹⁸⁰ If the fixed rate is *above* the

173. An example of an embedded derivative is a debt instrument the interest payments on which fluctuate with changes in the S&P 500. See FAS 133, *supra* note 18, ¶ 12-16. On the other hand, an embedded option allowing the issuer to call, or the holder to put, a debt instrument is “clearly and closely related” to the host contract and, therefore, does not constitute an embedded derivative. *Id.*, ¶ 60(d).

174. FAS 133, ¶ 12-16.

175. *Id.*, ¶ 60(k).

176. Ensminger, *supra* note 1, at 95-96, citing Weisbach (1995), *supra* note 28.

177. Nicholas Gunther, *Economics and Compaq v. Comm’r*, 2002 TNT 209-28 (October 28, 2002).

178. *Id.* See also Kevin D. Dolan, Notice 98-5 Foreign Tax Credit Arbitrage, 455 PLI/Tax 1029, 1049-1050 (1999).

179. The mid-market rate is the midpoint of the bid and ask rates for a specified maturity, which equals the fixed rate for which the present value of the cash flows from the fixed leg equals the present value of the projected cash flows from the floating leg.

180. *Bank One Corp. v. Comm’r*, 120 TC 174, 202 (2003).

current mid-market rate, the swap is said to be “above market” and has positive value to the party that receives the fixed payments. Conversely, an interest rate swap with a fixed rate *below* the current mid-market rate is “below market” and has negative value to the party that receives the fixed payments. Thus, when the swap has a positive market value for one party, it must have an identical negative market value for the counterparty.¹⁸¹

For example, on January 1, 2004, Corporation X issues \$1,000 of 10-year, 10% fixed-rate bonds. To protect against risk of loss if the market interest rate drops, Corporation X enters into a swap with Counterparty Z pursuant to which X will receive fixed payments at 10% on a notional amount of \$1,000 and pay Z a variable rate that is based on the mid-market rate in effect. Thus, at inception, the mid-market rate is presumed to be also 10%, and each party’s initial value is zero. At the end of 2004, interest rates drop to 8%, so the mid-market rate is below 10%. Thus, at the end of 2004, Corporation X has positive value with respect to the swap, while Counterparty Z has an identical negative value.

A similar analysis applies to forward contracts.¹⁸² Option contracts are generally not “zero-sum” contracts because a premium is paid; however, the same asset/liability analysis could be applied to options.¹⁸³

It is unclear whether derivatives such as swaps constitute “property” for tax purposes because they have zero value at inception, and either positive or negative value throughout their term.¹⁸⁴ Various statutory provisions¹⁸⁵ and court decisions indicate that derivatives could be viewed, under particular circumstances, as “property.” In FSA 1999-985,¹⁸⁶ the IRS relied on Ferrer¹⁸⁷ in ruling that an interest rate swap is viewed as “property” because it constitutes a “bundle of rights and obligations.” The IRS also indicated that forward and futures contracts constitute “property.”

181. David M. Schizer, Frictions as a Constraint on Tax Planning, 101 Colum. L. Rev. 1312, 1358 (2001) (“Since firms could either owe or be entitled to a payment, this value could be negative or positive”).

182. See Notice 98-5, 1998-1 C.B. 334. For example, on 1 January 2003, taxpayer A, a producer of oil, enters into a forward contract with purchaser B, for the delivery of 1,000 barrels of crude oil in 18 months (on 1 July 2004) at a price of \$20 per barrel. If on Dec. 31, 2003 the price of crude oil is \$18 per barrel, A will have a profit of \$2 per barrel, and B will suffer an identical loss. Similarly, if on Dec. 31, 2003 the price of crude oil is \$24 per barrel, A will suffer a loss of \$4 and B will have an identical gain.

183. Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279.

184. See Garlock (2004), *supra* note 27, at 1518-19.

185. See Regs. § 1.1092(d)-1(c) (treating NPCs as “personal property” for purposes of the straddle rules.)

186. Field S. Adv. Mem. 1999-985 (Aug. 6, 1992).

187. *Comm’r v. Ferrer*, 304 F. 2d 125, 131 (2d Cir. 1962).

It is less clear, however, whether a position in a derivative contract that becomes “underwater,” also constitutes “property.” In *Stavisky v. Comm’r*,¹⁸⁸ the Tax Court held that:

[p]etitioner was a party to a bilateral contract with mutual rights and obligations, not a mere obligor. Had the market price of Mo-Pac shares “when issued” declined instead of risen, his rights under his contract would have outweighed his liabilities . . . and he would have been the payee to sell rather than the payor as the result of the transaction of December 1951. . . . We think it clear that in such case he would have been in the position of having sold a portion of his rights under the contract . . . and are not prepared to hold that a given transaction is or is not a sale or exchange from day to day depending on the vagaries of the securities market. . . . The transaction of December 1951 was in form and substance a transfer to Sutro of petitioner’s rights and liabilities under the contract, not a mere cancellation or release from liability.¹⁸⁹

Until today, however, *Stavisky* has not been applied outside of the “when issued” contracts context.¹⁹⁰ In *Bank One*, the court indicated that the contract becomes a liability when it is “underwater.”¹⁹¹ Several commentators have expressed a similar view.¹⁹² The Tax Court’s decision in *Bank One* on this point is consistent with fundamental accounting and tax rules. Accordingly, at any given time, one party to a derivative transaction should be viewed as holding an asset while the counterparty should be viewed as owing a liability.

For GAAP, the answer is certain. As set forth above, pursuant to SFAC 6, an entity’s “liabilities” constitute “probable future sacrifices of economic benefits . . . to transfer assets or provide services to other entities in the future

188. 34 T.C. 140 (1960), aff’d, 291 F.2d 48 (2d Cir. 1961).

189. Id. at 142-43. See also, Gen. Couns. Mem. 35,475 (Sept. 11, 1973) (“The mere fact that the obligations outweighed the rights thereunder in terms of comparative values does not prevent the transaction from constituting a sale or exchange.”) (citing *Stavisky*).

190. See Kirk Van Brunt, Tax Aspects of REMIC Residual Interests, 2 Fla. Tax Rev. 149, 207 (1994), note 193, citing the New York State Bar Ass’n, Tax Section, Comm. on Financial Instruments, Report on Proposed Regulations on Methods of Accounting for Notional Principal Contracts (Jan. 6, 1992), reprinted in 24 Highlights & Documents 633, 656 n.84 (Jan. 16, 1992).

191. *Bank One*, 120 TC at 217.

192. See Garlock (2004), supra note 27, at 1518-1519, note 24. See also ABA Tax Section Members Comment On Hedging Regulations, 94 TNT 66-19 (February 10, 1994) text accompanying note 57; Edward D. Kleinbard and Suzanne F. Greenberg, Business Hedges After Arkansas Best, 43 Tax L. Rev. 393 (Spring, 1988), note 139.

as a result of past transactions or events,” while its “assets” constitute “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.” Accordingly, if at a given point in time, an entity holds a position the expected cash flows from which exceed its carrying costs, such an entity holds an “asset.” By contrast, if the contract’s carrying cost exceeds the expected cash flows from the contract, the holder should be viewed as owing a liability. Pursuant to FAS 133, derivatives represent rights or obligations that meet the definition of “assets” (future cash inflows due from another party) or “liabilities” (future cash outflows owed to another party) and should be reported in the financial statement as either assets or liabilities.¹⁹³ Thus, an “underwater” derivative contract constitutes a liability for accounting purposes, while an “overwater” contract constitutes an asset.¹⁹⁴ As I suggest below, both liabilities and assets will be marked-to-market for tax purposes, in accordance with FAS 133.

3. Conclusions

As summarized below in Table II, for both tax and financial accounting purposes, financial instruments should be classified as follows:

Table II		
Assets	Liabilities	Equity
Holder of a Debt Instrument	Issuer of a Debt Instrument	
Holder of an Equity Interest		Issuer of an Equity Security
Holder of a Position in a Derivative with a Positive Value	Holder of an “Underwater” Position in a Derivative	

With respect to the debt/equity distinction, I do not expect that FASB will set forth debt/equity guidance in the near future. In addition, a statutory set

193. FAS 133, *supra* note 18, ¶ 3.

194. *Id.*

of debt/equity classification rules is not expected in U.S. tax law.¹⁹⁵ FASB and Treasury should work together to issue such guidance and conform the rules.

D. Timing

A tax accounting method is any method or practice that affects the *timing* of recognition of income and deductions. Generally, a taxpayer can utilize one of the following accounting methods for tax purposes: (i) cash method; (ii) accrual method; or (iii) special methods such as original issue discount, notional principal contracts, contingent payment debt instruments and mark-to-market.¹⁹⁶ As of today, recognition of income and expenses on financial instruments may be different for book and tax purposes. For example, a taxpayer may be required to mark some instruments to market for tax purposes but not for book purposes and vice versa.¹⁹⁷

1. Cash and Accrual Accounting Method

Under the accrual accounting method, a reporting entity must determine when it must recognize revenues, gains, expenses, and losses.¹⁹⁸ As opposed to the cash method, an entity under the accrual method reports the effects of events in the periods in which those events *occur* rather than in the periods in which

195. Some countries, however, have successfully enacted such rules in recent years. In Australia, the New Business Tax System (Debt and Equity) Bill 2001, which was passed by the federal Parliament, and received Royal Assent on October 1, 2001, set forth rules for hybrid instruments. The new standards classify instruments as debt or equity for tax purposes based on their economic substance rather than on their legal form. The underlying policy of the new measures is that the key feature that distinguishes debt from equity is that debt involves the effective obligation of the issuer to return to the investor an amount equal to at least the amount received by the issuer. See Hayes, Daniel Appleby, and Emanuel Hiou, Australian Tax Wrap-Up, 13 J. Int'l Tax'n 18 (2002).

196. IRC § 446(c)(3); Regs. § 1.446-1(a)(1).

197. For example, while FAS 133 requires companies to mark derivatives to market, for tax purposes, hedging transactions match the timing of income, expense, gain or loss on the hedging transaction with that of the hedged item, under Regs. § 1.446-4. In addition, some hedged items, including issued debt instruments, are marked-to-market under FAS 133 but not for tax purposes. Finally, some marketable equity securities that are not held for sale to customers are marked-to-market for accounting purposes under FAS 115 but not for tax purposes. In contrast, securities purchased from customers and held to maturity may be subject to mark-to-market for tax purposes under § 475 but not for accounting purposes.

198. Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 5: Recognition and Measurement in Financial Statements of Business Enterprises ¶ 36 (1984), available at <http://www.fasb.org/pdf/con5.pdf> ("SFAC 5").

cash is *received* or *paid*.¹⁹⁹ For financial accounting purposes, “revenues” and “gains” are defined, respectively, as “inflows or other enhancements of assets”²⁰⁰ and “increases in net assets” of the entity.²⁰¹ Similarly, “expenses” and “losses” are also defined, respectively, as “outflows or other using up of assets”²⁰² and “decreases in net assets.”²⁰³

For financial accounting purposes, *income* is recognized only when it is both realized (or realizable) and earned.²⁰⁴ For tax purposes, however, income is included in gross income for the tax year in which it is actually or constructively received, unless other specific method (such as mark-to-market) applies.²⁰⁵ Accrual method taxpayers recognize income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy.²⁰⁶

The following concepts guide financial accounting treatment of *expenses*: (i) allocating costs to the appropriate period so as to match them with the revenues they help to generate; and (ii) recognizing losses when they are probable.²⁰⁷ By contrast, for tax purposes, pursuant to section 461(h)(1), a liability is incurred, and may be deducted, only when all events have occurred that establish the fact of liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.

This article suggests that book and tax timing rules for financial instruments be conformed in accordance with prevailing financial accounting concepts. In particular, with respect to derivatives, it is suggested that both assets and liabilities be marked-to-market at the end of the year, in accordance with FAS 133. With respect to non-derivatives, transactions entered into for investment purposes²⁰⁸ will be subject to the taxpayer’s regular accounting method (i.e., cash or accrual), while all other instruments will be subject to mark-to-market.²⁰⁹

199. Id., ¶ 139.

200. Id., ¶ 78.

201. Id., ¶ 82.

202. Id., ¶ 80.

203. Id., ¶ 83.

204. Id., ¶ 36.

205. IRC § 446(c)(3); Regs. § 1.446-1(a)(1).

206. Regs. § 1.451-1(a).

207. SFAC 5, supra note 198, ¶ 86; SFAC 6, supra note 132, ¶ 146-149.

208. Section 475 excludes securities held-for-investment from mark-to-market, while GAAP does so for “held-to-maturity” debt securities. IRC § 475. I recommend herein that these two standards be conformed.

209. Under FAS 133, cash flow hedges are measured at fair value, but changes in the fair value are reported under “other comprehensive income,” as opposed to fair value hedges for which changes in the fair value are reported in the net income. Similarly, available-for-sale securities are reported at fair value, but, again, changes in

2. Current Timing Rules for Basic (Non-Derivative) Instruments

(i) Debt Instruments

A cash-method taxpayer must recognize interest income in the year in which it is actually or constructively received,²¹⁰ while interest expense is generally recognized in the taxable year in which it is actually paid.²¹¹ Pursuant to the accrual method, interest income is generally recognized when all of the events have occurred to fix the right to receive the interest income, and the amount of that income can be determined with reasonable accuracy.²¹² Interest deduction is generally recognized in the taxable year in which it is accrued.²¹³ Accrual of expenses occurs when:

all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.²¹⁴

Generally, financial accounting concepts pertaining to recognition of interest are similar.²¹⁵ Most corporations use the accrual basis of accounting: they recognize interest income when it is earned, and recognize expense in the period incurred. Cash basis entities recognize income only when it is received, and expense upon payment of such an expense.²¹⁶ Interest income is recognized as revenue.

the fair value are reported under “other comprehensive income,” as opposed to trading securities for which changes in the fair value are reported in the net income. The IRS and most commentators, however, agree that both methods constitute a mark-to-market method, even though the changes in the fair value are reported under different sections. See Ensminger, *supra* note 1, at 25, for FAS 133. See. Rev. Rul 93-76, 1993-2 C.B. 235.

210. IRC § 451(a); Regs. § 1.451-1(a). Income is constructively received by a taxpayer in the year in which it is credited to the taxpayer’s account, set apart for him, or otherwise made available so that the taxpayer may draw upon it at any time, or could have drawn upon it during the taxable year if notice of intention to withdraw had been given. See Regs. § 1.451-2(a).

211. IRC § 163 (a); Regs. § 1.461-1(a)(1).

212. Regs. § 1.451-1(a).

213. To accrue, a liability must be: (i) binding and enforceable, (ii) may not be contingent on the occurrence of a future event, and (iii) the debtor must have a reasonable belief that the liability will be paid in due course. *Superior Garment Co. v. Comm’r.*, TC 1965-283.

214. Regs. § 1.461-1(a)(2).

215. Compare contingent payment debt instruments, which are discussed in greater detail below.

216. SFAC 5, *supra* note 198, ¶ 139.

As set forth in greater detail below, for tax purposes, a holder of a debt instrument recognizes changes in the instrument's value under the mark-to-market method only if the instrument is held for dealing/trading purposes pursuant to section 475. For financial accounting purposes, a debt instrument is marked-to-market unless it is held-to-maturity, or, in some circumstances, if a "fair value" hedge under FAS 133 hedges it. The issuer of the debt instrument, however, does not mark its liability to market for tax purposes, but may be required to do so for financial accounting purposes if the debt is hedged by a fair value hedge under FAS 133. In addition, as discussed above, FAS 150 requires that the instruments discussed therein (which are classified as liabilities) be reported at fair value.

(ii) Original Issue Discount (OID)

In theory, there are generally three possible ways to recognize OID:²¹⁷ (i) the constant yield method pursuant to which, the issuer and holder of the discount obligation accrue the portion of the discount as interest income and expense based on a constant method;²¹⁸ (ii) accrual of interest income and expenses based on a straight line using a ratable accrual;²¹⁹ and (iii) account for OID income and expenses only at maturity.

The legislation of the modern OID rules is an example of Congress's attempt to conform tax timing rules to corresponding GAAP. Prior to 1981, OID

217. A debt instrument has OID equal to the excess, if any, of its stated redemption price at maturity over its issue price. Thus, OID is the excess of what a borrower is obligated to repay when the loan becomes due over the amount borrowed. See Garlock, *supra* note 125, at § 2.01.

218. This approach was adopted by Congress in § 1272(a)(1). Interest income received and interest expense paid are recognized annually under a yield-to-maturity method, regardless of whether it is actually received or paid. An important advantage of that method is that it is consistent with market practice. However, its main disadvantage is that it is complex to administer and might not be suitable to all taxpayers. Another disadvantage of that method is that it normally taxes holders prior to the time in which they actually receive the income, potentially infringing the "ability to pay" principle. Lawrence Lokken, *Taxation of Derivatives and New Financial Instruments*, in United Nations, *International Cooperation in Tax Matters*, 1998, at 53.

219. This method had been utilized in the United States between 1969 and 1982. According to that method, the discount income is computed and then allocated in equal portions along the holding period. The ratable accrual method has few advantages including its computation simplicity, when compared with the constant accrual method. Nevertheless, it also suffers from the same disadvantages of the constant accrual method, that is, recognizing income well before the actual cash payments are received. Lokken, *supra* note 218, at 54.

tax rules had been inconsistent with those applied under GAAP.²²⁰ In particular, former section 1232 provided that an amount received by a holder on retirement of corporate debt instruments was treated as an amount received in exchange of such debt.²²¹ In 1969 (P.L. 91-172), Congress amended § 1232 to provide for the inclusion of OID (measured on a straight-line basis) in the holder's income irrespective of the holder's regular method of accounting. This rule applied, however, only to corporate debt instruments, which constituted capital assets in the hands of the holder.²²²

In 1982, former sections 1232A and 1232B were enacted to change the straight-line accrual into a yield-to-maturity method in measuring OID.²²³ Former section 1232A applied to all debt instruments that were capital assets in the holder's hands other than those issued by natural persons. In the Deficit Reduction Act of 1984 (DEFRA), P.L. 98-369, the rules for the measurement and timing of OID as well as the treatment of stripped bonds were extensively revised.²²⁴ DEFRA also added rules addressing similar time value of money issues including sections 1276 through 1278 (measurement and timing of market discount), sections 1281 through 1283 (treatment of discount on certain short-term obligations), section 1286 (treatment of stripped bonds), and section 1288 (OID on tax-exempt obligations).

One of the purposes of enacting the above comprehensive set of rules was to conform tax rules to the corresponding principles that had been developed over the years for financial accounting purposes.²²⁵ GAAP, however, generally do not distinguish between OID, market discount or bond premium, but treat them all as discount (or premium) to be currently accrued.²²⁶ For financial accounting purposes, OID, market discount and bond premium are computed under an "effective interest method," which is similar to the yield-to-maturity method.²²⁷ This is different than the corresponding tax treatment

220. See Peter C. Canellos and Edward D. Kleinbard, *The Miracle of Compound Interest: Interest Deferral and Discount After 1982*, 38 *Tax L. Rev.* 565, 567 (1983).

221. *Id.*

222. *Id.*, at 568.

223. *Id.*, at 568-569, *Discussing the Tax Equity and Financial Responsibility Act of 1982*, Pub. L. No. 97-248, 96 Stat. 324 (1982).

224. Former §§ 1232, 1232A and 1232B were repealed, and the revised OID rules were enacted under §§ 1271 through 1275.

225. See Canellos and Kleinbard, *supra* note 220, at 567-69.

226. Financial Accounting Standards Board, *Statement of Financial Accounting Standards*, No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases* (1986); available at <http://www.fasb.org/st/#fas91> (FAS 91).

227. Pursuant to Accounting Principles Board Opinion 12:

The objective of the interest method is to arrive at a periodic interest rate (including amortization) which will represent a level effective

pursuant to which bond premium is recognized currently (unless the taxpayer elects to recognize an allocable portion of the premium as an offset to the interest income from the bond),²²⁸ and market discount is included when principal payments are made, unless the taxpayer elects a current inclusion.²²⁹

In my view, to simplify the tax rules and conform them to financial accounting principles, OID, market discount and bond premium should be treated similarly, and be currently accrued on a yield-to-maturity basis. Generally, current bond premium rules are already equivalent to the flip-side of the OID rules with respect to the issuers (but still elective for holders), except for minor differences.²³⁰ On the other hand, the legislative history of the market discount rules reveals that although Congress was aware of the fact that OID and market discount are economically indistinguishable, it enacted a separate set of rules for market discount to address various complexities and perceived abuses that existed twenty years ago.²³¹

During the past twenty years, several legislative proposals have been made to conform the tax OID and market discount rules.²³² In October 1987, the House of Representatives passed a bill that generally would have required the current accrual of market discount.²³³ The Senate version, however, omitted this proposal and it was never enacted.²³⁴ In its budget for the years 2000 and 2001,

rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period. The difference between the periodic interest cost so calculated and the nominal interest on the outstanding amount of the debt is the amount of periodic amortization.

228. IRC § 171(a).

229. IRC §§ 1276-1278. The difference between OID and market discount is that a holder is not required to accrue market discount currently. Instead, the market discount rules generally require holders, including accrual basis holders, to take market discount into account only upon the receipt of the proceeds of a disposition or retirement or a principal payment, and then only to the extent accrued. See Garlock, *supra* note 125, § 11.01 (citing S. Rep. No. 98-169, at 155 (1984)).

230. Garlock, *supra* note 125, § 12.01.

231. *Id.*, § 11.01, indicating that “[t]he 1984 committee reports show that Congress also knew that taxpayers were purchasing market discount bonds with borrowed funds, deducting interest on such indebtedness currently and ultimately receiving the difference between the purchase price and the total principal payments as capital gain” (citing S. Rep. No. 98-169, at 155 (1984)). In addition, Congress was concerned that “holders would have difficulty determining annual inclusions without information reporting, which is required in the case of OID.” *Id.* § 11.01 n.6.

232. *Id.*, § 11.01 n. 6.

233. *Id.* (citing Omnibus Budget Reconciliation Act of 1987, H.R. 3545, 100th Cong., 1st Sess., § 10118).

234. *Id.* (citing H.R. Rep. No. 100-391, at 1056-57 (1987) and H.R. Rep. No. 100-495, at 932-33 (1987)).

the Clinton Administration set forth a similar proposal pursuant to which, holders that use an accrual method of accounting would have to include market discount in income on a constant-yield basis as it accrues. To address the concern of debt instruments with a deep discount, the instrument's yield for this purpose would have been limited to the greater of (i) the original yield-to-maturity of the debt instrument plus five percentage points, or (ii) the applicable Federal rate at the time the holder acquired the debt instrument plus five percentage points.²³⁵ The proposal was never enacted.²³⁶ In my view, it is time to re-introduce a similar proposal and conform the book and tax rules for OID, market discount and bond premium.

(iii) Equity Securities

For tax purposes, dividend income is recognized as received as cash or other property when it is unqualifiedly made subject to the shareholder's demands.²³⁷ No corresponding deduction is allowed for the payor, unless the recipient is a corporation.²³⁸

For financial accounting purposes, the holder recognizes dividend income in accordance with its normal accounting method (i.e., cash or accrual).²³⁹ Dividend income is recognized as revenue. With respect to the issuer, when the board of directors declares a cash dividend, the amount of declared dividend is recorded as a liability to the issuer (dividend payable). Upon payment, the liability is reversed, and the credit is recorded for cash. With respect to dividends in property (non-cash), when such a dividend is declared, the issuer must restate at fair value the property to be distributed, recognizing

235. Id. Such a limitation is equivalent to the High Yield Debt Obligation ("HYDO") limitation rules. Section 163(e)(5) provides special rules for OID on applicable HYDOs. In general, an interest deduction could be deferred until paid or even permanently disallowed in part if the debt instrument is a HYDO. IRC § 163(e)(5)(A). An applicable HYDO is defined in § 163(i)(1) as any debt instrument (i) that has a maturity date more than five years from the issue date, (ii) where the yield to maturity on the instrument equals or exceeds the sum of the applicable AFR in effect on the issue date plus five percentage points, and (iii) the instrument has "significant OID." A debt instrument is treated as having significant OID for this purpose if, at the end of any accrual period ending after the fifth year from the issue date, the cumulative accrual of interest and OID on the instrument exceeds the sum of the actual interest paid from the issue date until the end of that accrual period and the product of the yield to maturity and the instrument's issue price. IRC § 163(i)(2)

236. Garlock, *supra* note 125, § 11.01 n.6.

237. Regs. § 1.301-1(b).

238. See generally § 246.

239. See generally Recognition and Measurement in Financial Statements of Business Enterprises, Statement of Financial Accounting Concepts No. 5 (Financial Accounting Standards Bd. 1984), available at <http://www.fasb.org/pdf/con5.pdf>.

any gain or loss as the difference between the property's fair value and carrying value at the date of declaration. As a result, the amount of dividend is recorded as a debit to retained earnings.²⁴⁰

As discussed in greater detail below, changes in the security's value are subject to different tax rules. Pursuant to section 475, a holder of a stock is subject to mark-to-market treatment if the stock is held for dealing/trading purposes, while the issuer is never subject to mark-to-market. For financial accounting purposes, a holder of a *nonmarketable*²⁴¹ equity security is subject to the cost method pursuant to which:

[a]n investor records an investment in the stock of an investee at cost, and recognizes as income [only] dividends that are distributed from net accumulated earnings of the investee since the date of acquisition by the investor. Dividends received in excess of earnings subsequent to the date of investment are considered a return of investment and are recorded as reductions of cost of the investment.²⁴²

A holder of *marketable* equity securities is generally subject to mark-to-market treatment under FAS 115, if the holding is less than 20% of the issuer's stock (i.e., passive investment). With respect to a holder of more than 20%, the stock is generally not subject to mark-to-market.²⁴³ The issuer, on the other hand, is not subject to mark-to-market for financial accounting purposes, for both marketable and non-marketable equity securities.

3. Timing Rules for Derivatives

(i) Options, Forwards and Futures

Some derivatives are subject to mark-to-market treatment if they fall under section 1256 ("section 1256 contracts"). An option that constitutes either

240. See generally Kieso et. al, *supra* note 39, ch. 15.

241. A non-marketable equity security is a security for which there is no readily available pricing information. See The Equity Method of Accounting for Investments in Common Stock, Accounting Principles Board Opinion No. 18, ¶ 6a (1971).

242. *Id.*

243. A discussion of the financial accounting principles pertaining to holding of more than 20% is beyond the scope of this article. Generally, I suggest below that if an investor holds more than 20% of a corporation, the stock will not be subject to mark-to-market.

a “dealer equity option,”²⁴⁴ or a “non-equity option”²⁴⁵ is marked-to-market as a section 1256 contract. Pursuant to section 1234(b), a grantor of an option that is not a section 1256 option does not recognize income until the option expires, lapses, is exercised, is sold, or is disposed of; such an option constitutes an “open transaction.”²⁴⁶ A premium paid or received is recognized when sale, exchange, expiration, or closing (offsetting) transaction occurs.²⁴⁷ When the option is exercised this event is, generally, treated as non-taxable purchase of the underlying asset.²⁴⁸

Similarly, a non-section 1256 forward contract constitutes an “open transaction.”²⁴⁹ A forward contract is a privately negotiated contract that provides for the sale and purchase of property for a specified price on a specified date.²⁵⁰ Until a non-section 1256 forward contract is sold, exchanged, settled, or allowed to lapse, the transaction is treated as open, and any gain or loss to the parties is correspondingly deferred.²⁵¹

Futures contracts, in general, are economically similar to forward contracts except that they are: (i) standardized; (ii) traded at regulated futures exchanges; (iii) used by clearing organizations; (iv) subject to the mark-to-market system; and (v) able to be closed before maturity.²⁵² Futures contracts are generally subject to section 1256.

The legislation history of section 1256 provides another example of Congress’s willingness to follow GAAP pertaining to financial instruments. Section 1256 was added to the Code as part of the Economic Recovery Tax Act of 1981.²⁵³ The legislative history indicates that section 1256 was enacted to

244. A “dealer equity option” is any option that is (1) an equity option, (2) purchased or granted by an options dealer in the normal course of its activity in dealing with options, and (3) listed on the qualified board or exchange on which such options dealer is registered. IRC § 1256(g)(4). An “equity option” is an option (i) to buy or sell stock or (ii) the value of which is determined, directly or indirectly, by reference to (a) any stock, (b) group of stocks, or (c) stock index. IRC § 1256(g)(6).

245. A “non-equity option” is any listed option that is not an equity option.

246. Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279.

247. Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279.

248. Rev. Rul. 88-31, 1988-1 C.B. 302; Rev. Rul. 70-598, 1970-2 C.B. 168; Rev. Rul. 78-182, 1978-1 C.B. 265.

249. See *Lucas v. North Tex. Lumber Co.*, 281 U.S. 11 (1930). See, generally, Steven M. Rosenthal & Liz R. Dyor, *Prepaid Forward Contracts and Equity Collars: Tax Traps and Opportunities*, 2 *J. Tax’n Fin. Prod.* 1, 35 (Winter 2001).

250. See Lewis R. Steinberg, *Using OTC Equity Derivatives for High-Net-Worth Individuals*, reprinted in *The Use of Derivatives in Tax Planning* (Frank J. Fabozzi ed., 1998) 210, 217.

251. See Rosenthal & Dyor, *supra* note 249, at 35.

252. See Kevin M. Keyes, *Federal Taxation of Financial Instruments and Transactions* (3d ed.), § 13.02[1].

253. Pub. L. No. 97-34, § 503(a), 95 stat. 327 (1981).

overcome the tax sheltering impact of certain commodity futures trading strategies and to harmonize the tax treatment of commodities futures contracts with the realities of the marketplace under what Congress referred to as the doctrine of constructive receipt.²⁵⁴ When section 1256 was enacted, futures transactions were marked-to-market for accounting purposes.²⁵⁵ Pursuant to the Technical Corrections Act of 1982 (“1982 TCA”) and the Deficit Reduction Act of 1984 (“DEFRA”), Congress expanded the applicability of the operational rules of section 1256 to apply to certain foreign currency contracts and options.²⁵⁶

Section 1256(a) provides for the basic tax consequences applicable to the acquisition and holding of a position in a section 1256 contract. A section 1256 contract constitutes either “regulated futures contract,”²⁵⁷ “foreign currency contract”²⁵⁸ or “dealer securities futures contract.”²⁵⁹ Pursuant to section 1256, a contract held by a taxpayer at the close of the taxable year is marked-to-market on the last business day of each taxable year, and any gain or loss is then taken into account.²⁶⁰ As stated above, the rationale behind this rule is that in a futures contract, the parties have immediate access to the funds every day (through the margin accounts).²⁶¹

254. S. Rep. No. 97-144, at 156-57 (1981), reprinted in 1981 U.S.C.C.A.N. 105, 255-256.

255. Although Accounting for Futures Contracts Statment of Financial Accounting Standards No. 80 was issued by the Financial Accounting Standards Board in 1984, accountants had been utilizing a mark-to-market method for futures contract prior to 1981.

256. H.R. Conf. Rep. No. 97-986, at 24-27 (1982); H.R. Conf. Rep. No. 98-861, at 898-917 (1984) reprinted in 1984 U.S.C.C.A.N. 1445, 1586-1605; S. Rep. No. 98-169, at 284-97 (1984).

257. A contract “with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and . . . which is traded on or subject to the rules of a qualified board or exchange.” IRC § 1256(g)(1).

258. A negotiated contract, traded in the interbank market, requiring the delivery of a foreign currency, or which can be settled with reference to the value of a foreign currency. IRC § 1256(g)(2)(A).

259. A futures contract that a dealer enters into in the normal course of trade or business activity of dealing in such contracts and that is traded on a qualified board or exchange. IRC § 1256(g)(9).

260. Forty percent of the gain or loss is treated as short-term capital gain or loss, and 60% is treated as long-term capital gain or loss. See IRC § 1256(a)(3)(A) and (B).

261. Stephen B. Land, Defeating Deferral: A Proposal for Retrospective Taxation, 52 Tax L. Rev. 45, 60 (1996) (“The realization requirement is meaningless for futures contracts that are marked-to-market, because the exchange rules impose a sort of realization event on a daily basis”).

As noted above, one of the stated goals of section 1256 was to promote book-tax conformity for instruments covered thereunder. Nevertheless, as of today, the scope of section 1256 is much narrower than that of FAS 133; while FAS 133 requires all derivatives to be marked-to-market, section 1256 requires only limited types of derivatives to be marked-to-market. Thus, to conform book and tax timing rules for derivatives, the scope of section 1256 should be broadened to include all derivatives (both “underwater” and “over-the-water” positions).

(ii) *Notional Principal Contracts*

A notional principal contract is defined in Regulations section 1.446-3(c) 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.²⁶²

Notional principal contracts include interest rate swaps, basis swaps, interest rate caps, interest rate floors, commodity swaps, equity swaps, and similar agreements. Section 1256 contracts, debt instruments, options and forward contracts do not constitute notional principal contracts.²⁶³

The notional principal contracts regulations group all payments under notional principal contracts into three categories: (i) periodic payments; (ii) non-periodic payments; and (iii) termination payments. A party to a notional principal contract must annually include in gross income any “net income” from the contract or is allowed to deduct any net cost.²⁶⁴

All taxpayers, regardless of their method of accounting, must recognize the ratable daily portion of a *periodic* payment²⁶⁵ and a *non-periodic* payment²⁶⁶ for the taxable year to which such portions relate. A *non-periodic* payment must

262. Regs. § 1.446-3(c)(1)(i).

263. Regs. § 1.446-3(c)(1)(ii).

264. Regs. § 1.446-3(d). The timing regulations may be overridden by (i) IRC § 475, which requires dealers to account for notional principal contracts under the mark-to-market method, (ii) IRC § 446, if the notional principal contract is part of a hedging transaction, (iii) IRC § 1092, if a notional principal contract is part of a straddle; and (iv) IRC § 956, if the deemed payments on a loan embedded in notional principal contracts having significant non-periodic payments are deemed to constitute loans, and, to this extent, interest income or expense would arise and would be accounted for under the interest accrual rules.

265. Regs. § 1.446-3(e)(2)(i).

266. Regs. § 1.446-3(f)(2)(i).

be amortized and recognized over the contract term in a manner that reflects the economic substance of the contract.²⁶⁷ Where the contract term is subject to extension or termination, amortization must be made over the reasonably expected term of the contract.²⁶⁸ A *termination* payment is recognized by the original party to the contract as income or deduction when the contract is extinguished, assigned, or exchanged.²⁶⁹ An assignee must treat a *termination* payment as a *non-periodic* payment made or received under the contract as in effect immediately after the assignment.²⁷⁰

On February 26, 2004, the IRS released proposed regulations pertaining to timing and character of notional principal contracts with contingent *non-periodic* payments.²⁷¹ In the proposed regulations, the IRS stated that with respect to *any* notional principal contract with a *non-periodic* payment (contingent or not contingent), a taxpayer that marks such instruments to market for book purposes could elect to do so for tax purposes.²⁷²

FAS 133 requires all derivatives, including notional principal contracts, to be marked-to-market. Accordingly, the financial accounting treatment of notional principal contracts differs from their tax treatment, unless section 475 applies. Because notional principal contracts constitute “derivatives” pursuant to FAS 133, effectively, all taxpayers who are subject to GAAP reporting principles will be able to elect a mark-to-market treatment for notional principal contracts with *non-periodic* payments.

As David Garlock indicates:

Perhaps because of the complexity of the Noncontingent Swap Method, or perhaps because marking to market is arguably the best way to clearly reflect income, the proposed regulations permit most taxpayers to elect mark-to-market accounting for NPCs with nonperiodic payments.²⁷³

Thus, if the proposed regulations are adopted in this form, a partial elective timing conformity would be achieved for notional principal contracts with non-periodic payments. In my opinion, however, the tax authorities should go one step further and provide for conformity with respect to all notional principal contracts, in accordance with FAS 133. Under this view, the NPC timing rules, including the proposed contingent NPC regulations will become

267. Id.

268. Regs. § 1.446-3(f)(3).

269. Regs. § 1.446-3(h)(2).

270. Regs. § 1.446-3(h)(3).

271. 69 Fed. Regs. 8886 (Feb. 26, 2004).

272. Id., Prop. Regs. § 1.446-3(i).

273. Garlock, (2004) *supra* note 27, at 1522.

unnecessary, because all notional principal contracts will be subject to mark-to-market.

4. Mark-to-Market for Dealers and Traders

(i) General

Since 1973, GAAP have required securities firms to prepare their financial statements by employing mark-to-market accounting for their dealer operations.²⁷⁴ These rules are currently set forth in FAS 115. For tax purposes, section 475 requires securities dealers to mark their securities to market, and allows securities traders, commodities dealers and commodities traders to elect a mark-to-market treatment.²⁷⁵ Thus, as a general matter, both GAAP and the tax Code require the use of mark-to-market accounting for dealers in securities.²⁷⁶ Nevertheless, this conformity is incomplete; while section 475 focuses on the *taxpayer's identity* (i.e., dealer/trader) FAS 115 focuses on the *purpose of the transaction*. Another reason for the non-conformity is the difference between the tax standard of “held-for-investment” and the financial accounting standard of “held-to-maturity.” Finally, available-for-sale securities, which are marked-to-market under FAS 115, may not be subject to the same treatment under section 475, because traders are subject to mark-to-market only if they elect so. As a result, as illustrated in Table III below, certain securities could be subject to mark-to-market for accounting purposes and not for tax purposes, and vice versa.

Table III

Security	Section 475 Treatment	FAS 115 Treatment
Marketable equity security (held less than 20%)	Could be held-for-investment and not marked-to-market	Generally marked-to-market
Negligible sales of trading securities	Not marked-to-market	Marked-to-market
Securities purchased from customers and held-to-maturity	Marked-to-market	Not-marked-to-market
Debt instrument held not for sale to customers, but no intention to hold until maturity	Not marked-to-market unless the holder elects to be subject to section 475	Marked-to-market as “available-for-sale” security
Commodities	Could be marked-to-market if an election is made	Not marked-to-market

274. SIA Comments *supra* note 35, ¶ 6.

275. IRC § 475(f).

276. Dep't of the Treasury, Summary of the Administration's Revenue Proposals for Fiscal Year 1994, at 46 (Feb. 1993).

In Revenue Ruling 93-76²⁷⁷ the IRS specifically addressed the relationship between FAS 115 and section 475 and ruled that:

The classification of a security under financial accounting principles is not dispositive of the treatment of the security for federal income tax purposes. For example, for purposes of section 475 of the Code, a security may in certain cases qualify for the held-for-investment exception to the mark-to-market rules even though, under applicable financial accounting principles, the security is classified as available for sale.

(ii) Section 475

The objective of the mark-to-market method under section 475 is achieving “clear reflection of income” within the meaning of section 446.²⁷⁸ In advocating book-tax conformity, Treasury noted in 1992 that the mark-to-market method used by securities dealers:

[R]epresents 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.²⁷⁹

Congress also indicated that section 475 would move tax rules pertaining to dealers in securities closer to the already accepted accounting treatment principles.²⁸⁰

Pursuant to section 475(a), all securities held by a dealer are marked-to-market unless they are specifically identified as being excluded from mark-to-market treatment. Under section 475(b)(1), the mark-to-market rules do not apply to securities that are identified by the dealer as being exempt from mark-to-market in the following situations: (1) any security held for investment;²⁸¹

277. 1993-2 C.B. 235.

278. Joint Comm. on Tax'n, Tax Reform Proposals: Accounting Issues, JCS-39-85, at 6 (Sept. 13, 1985).

279. U.S. Dep't of the Treasury, General Explanations of the President's Budget Proposals Affecting Receipts (Jan. 1992).

280. See *Bank One Corp. v. Comm'r* 120 T.C. 174, 296-97 (2003) (citing H. Rept. 103-111, at 661, 1993-3 C. B. at 237) (“Inventories of securities generally are easily valued at year end, and, in fact, are currently valued at market by securities dealers in determining their income for financial statement purposes.”); Dep't of the Treasury, General Explanations of the President's Budget Proposals Affecting Receipts 36 (Feb. 1993); Dep't of the Treasury, General Explanations of the President's Budget Proposals Affecting Receipts 89-90 (Jan. 1992).

281. IRC § 475(b)(1)(A).

(2) any debt instrument acquired or originated by the taxpayer in the ordinary course of its trade or business, which is not held for sale;²⁸² and (3) any security that is a hedge with respect to either a security not subject to the mark-to-market rules or to any position, right to income, or liability that is not a security in the hands of the taxpayer.²⁸³

For purposes of section 475, a “dealer in securities” is a taxpayer who regularly purchases securities from, or sells securities to, customers in the ordinary course of a trade or business, or regularly offers to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.²⁸⁴ Whether one is a dealer in securities will be determined on the basis of all the facts and circumstances.²⁸⁵ The statute is disjunctive; therefore the purchasing of securities alone, or the sale of securities alone, if purchased or sold to customers in the ordinary course of business could cause a taxpayer to be considered a dealer.²⁸⁶ Certain categories of taxpayers who would otherwise be dealers in securities are exempt from dealer status.²⁸⁷

The term “security” is very broad, and includes: (1) share of stock in a corporation; (2) partnership or beneficial ownership interest in a widely held or publicly traded partnership or trust; (3) note, bond, debenture, or other evidence of indebtedness; (4) interest rate, currency, or equity notional principal contract; (5) evidence of an interest in, or a derivative financial instrument in, any security described above, or any currency, including any option, forward contract, short position, and any similar financial instrument in such a security

282. IRC § 475(b)(1)(B).

283. IRC § 475(b)(1)(C).

284. IRC § 475(c)(1).

285. Regs. § 1.475(c)-1(a).

286. Note that this definition may create a mismatch between tax and book treatment of securities, because a taxpayer who regularly purchases securities from customers, but holds them to maturity, may be required to mark these securities to market under § 475, but will be viewed as holding them to maturity (and therefore, not subject to mark-to-market) for financial accounting purposes under FAS 115.

287. For example, taxpayers whose principal activity consists of selling nonfinancial goods and services for which they extend credit to the purchasers of such goods and services are not dealers in securities under IRC § 475, even if the taxpayer subsequently sells the evidences of indebtedness so acquired. Regs. § 1.475(c)-1(b). In addition, a taxpayer that regularly purchases securities from customers in the ordinary course of business is not a dealer in securities under IRC § 475 unless it sells more than a “negligible” portion of the loans or securities so acquired. Regs. § 1.475(c)-1(c)(1)(i). A negligible amount of sales is either: (a) selling all or part of fewer than sixty loans, or (b) selling all or part of loans, the total adjusted basis of which is less than 5% of the total basis of the debt instruments acquired in the year. Regs. § 1.475(c)-1(c)(2). These exceptions can create a book-tax mismatch because holders of such instruments may be required to mark them to market under FAS 115.

or currency (excluding any contract to which section 1256(a) applies); and (6) a position that (i) is not a security described in (1), (2), (3), (4), or (5), (ii) is a hedge with respect to such a security, and (iii) is clearly identified in the dealer's records as being described in this subparagraph before the close of the day on which it was acquired or entered into (or such other time as the Secretary may by regulations prescribe).²⁸⁸ Certain items are excluded from the definition of a security for purposes of section 475.²⁸⁹ Most notably, the term security does not include the taxpayer's liabilities, the taxpayer's stock and debt instruments issued by the taxpayer.

A trader in securities or a dealer or a trader in commodities may elect to be governed by section 475.²⁹⁰ If a trader in securities makes an election under section 475(f), it follows most of the rules of section 475. The rules of section 475 apply to commodities held by an electing commodities dealer in the same manner as they apply to securities held by a securities dealer.²⁹¹ Note that the application of section 475 to physical commodities creates another book-tax difference, because commodities are not marked-to-market for GAAP purposes.

(iii) FAS 115

FAS 115 sets forth principles for (i) investments in equity securities that have readily determinable fair values (i.e., "marketable securities"), and (ii) for all investments in debt securities.²⁹² These investments are to be classified in three categories and accounted for as follows:

288. IRC § 475(c)(2).

289. Those items include: (1) a security if § 1032 prevents the taxpayer from recognizing gain or loss with respect to that security (includes stock of the taxpayer and any options on the stock e.g., a mutual fund would not be treated as a dealer in securities because it sells and redeems its own shares); (2) liabilities of the taxpayer; (3) a REMIC residual interest acquired on or after January 4, 1995, and negative value REMIC residuals acquired before January 4, 1995; (4) synthetic debt that is treated as integrated debt under Regs. § 1.1275-6; and (5) non-financial customer paper as defined in IRC § 475(c)(4). Regs. § 1.475(c)-2.

290. IRC §§ 475(e) and 475(f).

291. IRC § 475(e)(1). A commodity is: (A) a commodity which is actively traded; (B) a notional principal contract with respect to a commodity described in (A); (C) an evidence of an interest in a derivative in a commodity such as an option, forward contract, futures contract, short position, or similar instrument in a commodity; and (D) any position which is not a commodity described in subparagraph (A), (B), or (C), but is a hedge of such commodity. IRC § 475(e)(2).

292. Non-marketable equity securities are subject to the cost method under APB Opinion 18, ¶ 6a.

Trading Securities: Debt and marketable equity securities that are bought and held principally for the purpose of selling them in the near term.²⁹³ For this purpose, “trading” means: (i) frequent and active buying and selling; (ii) used to generate profits; (iii) from short-term differences in prices.²⁹⁴ Trading securities are reported at fair value, with unrealized gains and losses included in net income.²⁹⁵ An unrealized holding gain or loss constitutes the net change in the fair value of a security from one period to another, exclusive of dividends or interest revenue recognized but not received.

Held-to-Maturity: Debt securities that the investor has the positive intent and ability to hold to maturity are reported at amortized cost and not fair value.²⁹⁶ A security is classified as held-to-maturity if the reporting entity has both (i) the intent and (ii) the ability, to hold the security to maturity.²⁹⁷ An entity should not classify a security as held-to-maturity if it intends to hold the security for an indefinite period. As commentators indicate, by definition, equity securities have no maturity date and cannot be treated as held-to-maturity.²⁹⁸

Available for Sale: Debt and equity securities not classified as either held-to-maturity or trading securities are also reported at fair value, with unrealized gains and losses related to changes in the fair value of the instruments reported as “other comprehensive income”²⁹⁹ and as a separate component of shareholders’ equity.³⁰⁰ Thus, changes in the security’s fair value are not reported as part of the entity’s *net income* until the security is disposed of.

Table IV summarizes the basic accounting principles pertaining to investment in non-derivative securities:³⁰¹

293. Accounting for Certain Investments in Debt and Equity Securities, Statement of Financial Accounting Standards No. 115, ¶ 12a (Financial Accounting Standards Bd. 1993).

294. Id.

295. Id. ¶ 13.

296. Id. ¶ 7.

297. Id.

298. Kieso et. al, supra note 39, at 920.

299. “Comprehensive income” includes all changes in equity during a reporting period except those resulting from investment by owners and distributions by owners. Thus, it includes all the elements reported in net income and gains and losses that bypass net income but affect shareholders’ equity. The items that bypass net income constitute “other comprehensive income.” Reporting Comprehensive Income Statement of Financial Accounting Standards No. 130 (Financial Accounting Standards Bd. 1997).

300. Accounting for Certain Investments in Debt and Equity Securities, Statement of Financial Accounting Standards Bd. No. 115) ¶¶ 12b and 13.

301. See generally Kieso et. al., supra note 39 at 859.

Table IV

Category	Valuation	Unrealized Holding Gains and Losses	Other Income Effects
Non-Marketable Equity Securities	Amortized cost	Not recognized	Dividend when declared. Gain/Loss when security is sold
Held-To-Maturity (only debt) Securities	Investment shown at amortized cost	Not recognized	Interest when earned. Gain/Loss when security is sold
Trading (debt and equity) Securities	Investment shown at fair value	Recognized in net income	Interest when earned. Dividend when declared
Available-For-Sale (debt and equity) Securities	Investment shown at fair value	Recognized as "other comprehensive income" and as separate component of equity.	Interest when earned. Dividend when declared
Equity Securities (Holding more than 20%)	Investment shown at amortized cost, and adjusted by proportionate share of investee's net income and reduced by dividend received	Not recognized	Dividend is recognized to the extent of the investee's earnings or losses reported subsequent to the date of investment. Gain/Loss when security is sold

Transfers between any of the categories are accounted for at fair value. For example, when available-for-sale securities become held-to-maturity, the investment is recorded at the day of transfer at fair value. This rule ensures that a reporting entity cannot escape fair value recognition by transferring investment to the held-to-maturity group.³⁰²

To conclude, under FAS 115, any security that is not held-to-maturity is marked-to-market. Thus, the standard for determining which securities must be marked-to-market may not conform to the section 475 standard. In my view, the purpose of section 475, particularly after the enactment of section 475(f)

302. Id. at 857.

(the trader election), is to apply a mark-to-market treatment to all securities except for the ones held for investment. In general, this is also the purpose of FAS 115.

The best way to achieve conformity on that issue is to follow a purposive approach.³⁰³ Accordingly, section 475 should be revised to change the focus from the *taxpayer* to the *purpose* of holding the instrument.³⁰⁴ Put broadly, an instrument that is held for investment will be subject to the cash or accrual method, while all other types of investments will be marked-to-market.³⁰⁵ It is necessary, therefore, to set forth a clear and consistent definition for the term “held-for-investment,” because, as of today, this standard is not entirely similar to the held-to-maturity standards under FAS 115.³⁰⁶ To conform these two standards, it may be assumed that an *investor* in securities must have the positive intent and ability to hold them until maturity. Under this assumption, a security held-to-maturity will be viewed as held for investment, and such a security will be subject to the accrual or cash method and not marked-to-market.

In addition, it is important to distinguish between investments in debt and equity securities. Investments in debt instruments will be subject to the above treatment (i.e., except for held-to-maturity securities, all other securities are marked-to-market).³⁰⁷ Equity securities, on the other hand, will be subject to cash or accrual method, unless (i) the taxpayer holds less than 20% of the issuing corporation, and (ii) the securities are marketable. As a result, most investments in debt instruments will be subject to mark-to-market (i.e., cash and accrual methods will be the exception) while most investments in other corporations, except for the ones that are clearly passive investments, will continue to be subject to the cash or accrual method of accounting.

(iv) Treatment of Issuers

FAS 115 applies only to *investment* in securities. Similarly, section 475 does not apply to liabilities of the taxpayer as well as stock and debt instruments issued by the taxpayer.³⁰⁸ The issuing of a debt instrument is treated as a liability

303. A purposive approach would apply a certain tax treatment in accordance with the taxpayer’s subjective intent in entering into the transaction.

304. For the advantages of a purposive approach to financial instruments, see Australian Issue Paper, *supra* note 3.

305. Under this proposal, the elective mark-to-market for traders under § 475(f) will become mandatory. See § 475(b)(1)(A), (c)(2).

306. Most notably, under FAS 115’s standard, a marketable equity security cannot be defined as held-to-maturity, because, by definition, a stock does not have an identified maturity date. On the other hand, a holder of stock may be viewed, for tax purposes, as holding it for investment purposes, and not be subject to § 475.

307. Cf., Weisbach at 110-11, *supra* note 28, (suggesting that all investments in debt instruments will be marked-to-market).

308. Regs. § 1.475(c)-2(a)(1), (2).

for financial accounting purposes, while the issuance of equity securities is reported under the “equity” portion of the balance sheet. The issuer reports debt instruments on a cash or accrual basis rather than fair value basis.³⁰⁹ Similarly, the issuer’s equity is not reported on a fair value basis either. Accordingly, from an issuer’s perspective, mark-to-market treatment does not apply to non-derivative transactions.³¹⁰ Note, however, that in a recent report concerning valuation of financial instruments, the FASB indicated that in the future, this approach may be revisited, and certain liabilities will be subject to mark-to-market.³¹¹

The *purpose* of issuing a non-derivative instrument (debt or equity) is to obtain funding for the issuer. This purpose could be viewed as the flip side of investment purpose. Thus, issuers of non-derivative instruments should be treated similarly (opposite side) to holders of the same instrument who hold the instruments to maturity. Accordingly, unless the rules of FAS 133 pertaining to hedged items apply (see below), issuers of non-derivative instruments should be subject to the cash or accrual method with respect to the recognition of deductions.³¹²

5. Contingent Payment Instruments

Generally, the tax treatment of financial instruments that contain contingent payments does not conform to the financial accounting treatment of such instruments. The reason for the non-conformity is Treasury’s attempts to create innovative methods to tax such instruments, in contrast to the accounting principle of conservatism.³¹³ In particular, whereas Treasury issued contingent payment debt instruments (CPDI) regulations in 1996³¹⁴ and, recently, proposed regulations pertaining to contingent swaps, no such developments have occurred in the accounting world. As a result, contingent payment instruments are generally subject to tax in accordance with their *expected* schedule of payments,

309. Id.

310. A notable exception is a hedged item that is hedged with a “fair value” hedge under FAS 133, which must be marked-to-market. In addition, FAS 150 requires that the instruments discussed therein be reported at fair value, and as discussed above, a mandatorily redeemable financial instrument can be viewed as a debt instrument.

311. See Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value, FASB Preliminary Views (Norwalk, Conn.: FASB, 1999).

312. Cf. Weisbach, *supra* note 28, at 111-14, (suggesting that issuers of debt instruments should be subject to mark-to-market). For a similar argument from the financial accounting profession, see Kieso et. al., at 858.

313. Accounting for Contingencies, Statement of Financial Accounting Standards No. 5, ¶¶ 82-84 (Financial Accounting Standards Bd. 1975).

314. T.D. 8674, 61 Fed. Regs. 30,133 (June 14, 1996) (codified 26 C.F.R. pt. 1).

while GAAP imposes a wait-and-see approach to such instruments (with potential bifurcation of the contingent component, if it constitutes an “embedded derivative” under FAS 133).

(i) Contingent Payment Debt Instruments (CPDI)

A CPDI that is publicly traded at issuance, or is issued for money or publicly traded property, must be accounted for under the noncontingent bond method.³¹⁵ Under this method, interest accrues in the first instance as if the CPDI were a comparable fixed-rate debt instrument and then appropriate adjustments are made to account for the difference between the actual payments on the CPDI and the assumed payments on the comparable noncontingent bond.³¹⁶ Applying the noncontingent bond method requires the following steps: (i) determine the comparable yield as of the issue date; (ii) determine the projected payment schedule as of the issue date;³¹⁷ (iii) determine the daily portions of interest; and (iv) adjust the amount of income or deductions for differences between projected and actual contingent payments.³¹⁸ If the actual amount of a contingent payment becomes fixed at an amount that differs from the projected amount of the payment, the difference results in either a positive or negative adjustment.³¹⁹

A CPDI that is issued for non-publicly traded property is taxed under a different method.³²⁰ Under this alternative, the contingent and non-contingent components are separated and accounted for separately; while the latter portion is taxed under the OID rules (assuming no qualified stated interest), the former is subject to the wait-and-see method.³²¹

315. Regs. § 1.1275-4(b).

316. Regs. § 1.1275-4(b)(2).

317. Regs. § 1.275-5(b)(3)(i), (ii). The projected payment schedule consists of all noncontingent payments and a projected amount for each contingent payment. Regs. § 1.1275-4(b)(4)(ii). The payment schedule is determined as of the debt instrument’s issue date and remains fixed throughout the term of the debt instrument. Regs. § 1.1275-4(b)(3)(ii).

318. Regs. § 1.1275-4(b)(3)(iii)-(iv).

319. Regs. § 1.1275-4(b)(6). A net positive adjustment in a tax year is treated by the taxpayer as additional interest for the taxable year. Regs. § 1.1275-4(b)(6)(ii). A net negative adjustment first offsets the interest that accrued on the debt instrument for the taxable year based on the projected payment schedule. Regs. § 1.1275-4(b)(6)(iii)(A). If the net negative adjustment exceeds the amount of interest accrued on the debt instrument for the tax year under the projected payment schedule, then generally, the excess is treated as an ordinary loss by the holder (and as ordinary income by the issuer) subject to certain limitations. Regs. § 1.1275-4(b)(6)(iii)(B).

320. Regs. § 1.1275-4(c).

321. Regs. § 1.1275-4(c)(4)(i).

(ii) Contingent Notional Principal Contracts

The proposed contingent NPC regulations³²² adopted a variation on the noncontingent swap method described in Notice 2001-44³²³ (which is generally similar to the non-contingent bond method under the CPDI regulations). The noncontingent swap method requires (1) projecting initially what the contingent payment will be; (2) accounting annually for the appropriate portions of the projected contingent amounts; (3) re-projecting the contingent amounts annually; and (4) reflecting amounts attributable to the difference between projected and re-projected amounts through adjustments that are spread over a one-year period.³²⁴ As an alternative, the proposed regulations also provide an elective mark-to-market method for notional principal contracts with non-periodic (contingent or non-contingent) payments.³²⁵

The major difference between the non-contingent bond method and the non-contingent swap method is the annual adjustment of the projection in the latter method. As set forth above, the non-contingent swap method is closer to a mark-to-market regime than the non-contingent bond method.³²⁶

(iii) Accounting Conservatism

A “contingency” is defined in FASB Statement No. 5 as:

[a]n existing condition, situation, or set of circumstances involving uncertainty as to possible gain . . . or loss . . . to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.³²⁷

322. See REG-166012-02, *supra* note 27; see also Garlock, *supra* note 27.

323. 2001-2 C.B. 77.

324. REG-166012-02, *supra* note 27 at 69 Fed. Reg. 8887; see also Garlock (2004), *supra* note 27.

325. REG-166012-02, *supra* note 27 at 69 Fed. Reg. 8887-88.

326. Garlock (2004), *supra* note 27, at 152.

327. FAS 5, *supra* note 313, ¶ 1. The principle of conservatism is stated in SFAC 5, ¶ 81:

In assessing the prospect that as yet uncompleted transactions will be concluded successfully, a degree of skepticism is often warranted. Moreover, as a reaction to uncertainty, more stringent requirements historically have been imposed for recognizing revenues and gains than for recognizing expenses and losses, and those conservative reactions influence the guidance for applying the recognition criteria to components of earnings.

Generally, under GAAP, a contingency is accrued only when the following condition is met: the amount of the gain or loss can be reasonably estimated.³²⁸

Revenues and gains are recognized for financial accounting purposes only when (a) they are realized or realizable and (b) they are earned.³²⁹ Expenses and losses are recognized when the benefits are used up in delivering or producing goods or services or when previously recognized assets are expected to provide reduced or no further benefits.³³⁰

Accordingly, for financial accounting purposes, issuers of CPDIs generally recognize payments actually paid, and holders recognize income actually received, while for tax purposes, recognition of income and expenses is made under a projected payment schedule. Nevertheless, if the contingent component constitutes an “embedded derivative” under FAS 133, this component is marked-to-market, while the host debt instrument is subject to the cash or accrual method.³³¹ The timing difference between book and tax, which is reported on the taxpayer’s Schedule – 1, is temporary, but could become permanent under certain circumstances.³³² Under FAS 109, this temporary tax difference creates a deferred tax liability, because taxes to be paid will be higher in the future.³³³

I suggest that the embedded derivative rules contained in FAS 133 should apply for tax purposes (for both the holder and the issuer).³³⁴ Put broadly, if an instrument could be bifurcated into a host contract and embedded derivatives (i.e., the economic characteristics and risks of embedded derivative are not clearly and closely related to those of the host instrument), tax law should follow FAS 133, and impose a mark-to-market treatment on the embedded derivative component, and a wait-and-see method for the host contract. On the other hand, if the contingency does not satisfy the embedded derivative standard, the whole instrument will be subject to the taxpayer’s normal accounting method.

To illustrate, in Rev. Rul. 2002-31,³³⁵ the description of the instrument was as follows: on January 1, 2002 the issuer issued for \$625 a 20-year debt instrument with a stated principal amount of \$1,000. Beginning after January 1, 2005, contingent interest would be payable for any six-month period ending

328. FAS 5, supra note 313, ¶¶ 8-9. See also Knott and Rosenfeld, supra note 1, at § II(A)(2)(b)(i).

329. SFAC No. 5, supra note 198, ¶ 83.

330. Id. ¶ 85.

331. FAS 133, supra note 310, ¶ 12; see also Weisbach (1999), supra note 28, at footnote 47.

332. FAS 109, supra note 89.

333. Id.

334. For a similar view, see Ensminger, supra note 1, at 37-38.

335. 2002-1 C.B. 1023.

on June 30 or December 31 if the average market price of the *debt instrument* were greater than 120% of the instrument's accreted value. The amount of the contingent interest payable would be equal to the greater of (1) the regular cash dividend per share of the issuer's common stock for the six-month period multiplied by the number of shares into which the debt instrument could be converted, or (2) a certain percentage of the average market price of the debt instrument for the measurement period. Except for the contingent feature, the instrument did not provide for any stated interest.

The contingent component of the instrument could be bifurcated and accounted for separately. The CPDI regulations have recognized a bifurcation method for debt instruments issued for non-publicly traded property (but applied a different method). Such bifurcation could be used for purposes of separating the contingent component and taxing it as an embedded derivative.

Nevertheless, even if the contingent component is bifurcated, its economic characteristics and risks must not clearly and closely relate to those of the host instrument.³³⁶ In the above example, the test should be applied to the contingent interest *trigger* (i.e., 120% of the instrument's accreted value) and semi-annual *amounts*. In my view, if both the trigger and amount are based on the instrument's value (for example, if only the second alternative for the amount of contingent interest is relevant), the contingent component may not be treated as an embedded derivative under FAS 133. On the other hand, if both the trigger and amount of contingent interest are based on the value of the issuer's stock, the contingent component should be viewed as an embedded derivative.³³⁷ In this case, the CPDI should be bifurcated for tax purposes, and each component should be taxed separately. The IRS may take the view that section 163(I) applies to this type of instrument on the grounds that it is a "disqualified debt instrument" because amount of the contingent interest on the notes and the threshold for determining when the interest is required to be paid is determined by reference to the value of the issuer's stock.³³⁸ Nevertheless, in

336. FAS 133, ¶ 11(a).

337. Under ¶ 61(h) of FAS 133, the changes in fair value of a stock and the interest yield on a debt instrument are not clearly and closely related. On the other hand, FAS 133 precludes embedded derivative accounting for issuers of convertible debt, because the embedded derivative in this case is indexed to the *issuer's* stock. See FAS 133, *supra* note 18, ¶ 11(a), 199 (ex.3).

338. Section 163(I) applies to deny a deduction for interest on a debt instrument having a substantial amount of principal or interest payable in or required to be determined by reference to the value of the issuer's stock (either mandatorily or at the issuer's option). Section 163(I)(3)(B). A "disqualified debt instrument" is defined as any indebtedness of a corporation which is payable in equity of the issuer or a related party. Section 163(I)(2). Indebtedness is treated as payable in equity of the issuer or a related party if: (A) a substantial amount of the principal or interest is required to be paid or converted, or at the option of the issuer or related party is payable in, or convertible into

my view, if the bifurcation approach of FAS 133 is imported into tax law, section 163(l) should not apply to the CPDI because the contingent component (or the equity component in this case), is accounted for on a mark-to-market basis. This approach is consistent with Rev. Rul. 2003-97³³⁹ in which the IRS ruled that the debt instrument component of the investment unit is not a disqualified debt instrument under section 163(l) on the grounds that it is separate from the forward contract.

Finally, with respect to contingent swaps, such instruments will be subject to the mark-to-market treatment, in accordance with FAS 133.³⁴⁰

6. Hedging Transactions

FAS 133 requires companies to record derivatives at their fair value (i.e., marked to market). Tax hedging rules, on the other hand, match the timing of income, expense, gain or loss on the hedging transaction with that of the hedged item.³⁴¹ Generally, tax hedging rules do not result in marking the hedging transaction to market, unless the hedged items are subject to mark-to-market.³⁴² This article will suggest that book and tax hedging rules be conformed by the adoption of the principles of FAS 133 for tax purposes.³⁴³

(i) Tax Hedging Rules

In 1994, the IRS issued regulations concerning the tax treatment of hedging transactions.³⁴⁴ These regulations include timing rules (Regs. section 1.446-4) and character rules (Regs. section 1.1221-2).³⁴⁵ The definition of a

the issuer's stock; (B) a substantial amount of the principal or interest is required to be determined, or at the option of the issuer or a related party is determined, by reference to the value of the stock; or (C) the indebtedness is part of an arrangement which is reasonably expected to result in payment of the debt with or by reference to the stock. Section 163(l)(3)(A)-(C).

339. 2003-34 I.R.B. 380.

340. FAS 133 ¶¶ 57b, 59e.

341. Regs. § 1.446-4(b).

342. Regs. § 1.446-4(e)(2).

343. For a similar view, see Ensminger, *supra* note 1; Rosenthal and Price, *supra* note 17. Nevertheless, while these two commentators focused primarily on hedging transaction, this article takes a much broader perspective.

344. See T.D. 8555, 59 Fed. Reg. 36,360 (for Reg. § 122-2); T.D. 8554, 59 Fed. Reg. 39,356 (for Reg. § 1.446-4).

345. The character of a hedging transaction is determined under Regs. § 1.1221-2(a), which provides that the term "capital asset" does not include property that is part of a hedging transaction. Therefore, any item of income, deduction, gain, or loss stemming from a hedging transaction is ordinary. In this article, I discuss only the timing aspects of the hedging rules.

“hedging transaction” includes two elements: (i) it must be a transaction that a taxpayer enters into in the normal course of its trade or business, primarily to manage the risk of interest rate changes, price changes, or currency fluctuations;³⁴⁶ and (ii) the risk being managed must relate to ordinary obligations incurred or to be incurred, or borrowings made or to be made by the taxpayer.³⁴⁷

Under the hedging timing rules, the taxpayer’s method of accounting for a hedging transaction must “clearly reflect income.”³⁴⁸ Accordingly, the accounting method used must “reasonably match” the timing of income, deduction, gain, or loss from the hedging transaction with that from the hedged item. For example, where the *hedged item* is marked-to-market under the taxpayer’s method of accounting, marking the *hedge* to market clearly reflects income.³⁴⁹

(ii) FAS 133

FAS 133 requires all derivatives to be recorded on the balance sheet at fair value and sets forth special accounting standards for the following three different types of hedging transactions: (i) hedges of changes in the fair value of assets, liabilities, or firm commitments (“fair value hedges”)³⁵⁰ are recorded at fair value in the balance sheet, with any unrealized gains and losses recorded in net income; (ii) hedges of the variable cash flows of forecasted transactions (“cash flow hedges”)³⁵¹ are also recorded at fair value in the balance sheet, but unrealized gains and losses are recorded in equity, as part of “other comprehensive income” and (iii) hedges of foreign currency exposures of net investments in foreign operations (“foreign currency net investment hedges”) are special cases of the above two types of hedges.³⁵² Derivatives used for

346. If an asset is not acquired primarily to manage risk, the purchase or sale of that asset is not a hedging transaction, even if the terms of the asset happen to manage the taxpayer’s risk with respect to other assets or liabilities. Reg. § 1.1221-2(d)(5).

347. Section 1221(b)(2)(A). Regs. § 1.1221-2(b).

348. Regs. § 1.446-4(b).

349. Regs. § 1.446-4(e)(2).

350. Generally, fair value hedges protect against changes in value caused by fixed terms, rates, or prices. FAS 133 requires corporations to recognize in income, in the period that a change in value occurs, gains or losses from a derivative designated as a fair value hedge. In addition, changes in the fair value of the hedged item (i.e., the asset, liability, or firm commitment), to the extent they are attributable to the risk, are also marked to market.

351. A cash flow hedge involves hedging the exposure of an asset or liability, or a forecasted transaction, to variability in expected future cash flows attributable to a particular risk. FAS 133, *supra* note 18, ¶ 4.

352. FAS 133, *supra* note 18, ¶ 4.

speculation (or non-hedging) purposes are recorded at fair value, with unrealized gains and losses recorded in net income.³⁵³

A hedging instrument generally can only be a derivative that satisfies the following requirements: (i) cash flows or fair value from the instrument must fluctuate and vary based on changes in one or more underlying variables; (ii) the instrument must be based on one or more notional amounts and/or payments; (iii) the instrument requires no, or insignificant, initial net investment; and (iv) the instrument can readily be settled by a net cash payment.³⁵⁴

In addition, if the hedge is a fair value hedge, the reporting entity must mark the hedged item to market to the extent changes in the fair value of the hedged item are attributable to the risk designated as being hedged.³⁵⁵

To constitute a qualified hedging transaction under FAS 133, a derivative must be “highly effective” in offsetting exposure to risk due to changes in fair value of cash flows from the hedged item.³⁵⁶ Thus, to the extent the hedge is effective, the standard for fair value hedges results in offsetting changes in the fair values of cash flows on the hedge and the hedged item.³⁵⁷

353. Id. at summary.

354. See id. ¶ 9.61-f. Examples of derivatives that satisfy these requirements include swaps, options, futures, forwards, swaptions, caps, collars and floors. Id. ¶ 6. “Regular way” securities trades such as purchases or sales of securities that settle in the normal course for the particular security do not constitute “derivatives” under FAS 133. Id. ¶ 10(a).

355. Id. ¶ 36, 4, et al.

356. Id. ¶¶ 389-95.

357. Id.

Table IV summarizes the basic principles of FAS 133:³⁵⁸

Table IV			
Derivative Use	Accounting for Derivative	Accounting for Hedged Item	Common Examples
Speculation	Fair value, with unrealized gains/losses recorded in net income	Not applicable	Call or put options on a stock
Fair Value Hedge	Fair value, with unrealized gains/losses recorded in net income	Fair value, with unrealized gains/losses recorded in net income	Interest rate swap hedge of a fixed-rate debt instrument
Cash Flow Hedge	Fair value, with unrealized gains/losses recorded in other comprehensive income, and reclassified in income when the hedge's cash flows affect earnings	General accounting principles	Use of a futures contract to hedge a forecasted purchase of inventory

As of today, book and tax hedging rules do not conform. While tax rules generally match the timing of income and deductions from the hedging transaction with that of the hedged item, FAS 133 requires that all hedging derivatives be marked-to-market, and in some circumstances (fair value hedges), the timing of the hedge will be matched to the hedged item by marking both of them to market.³⁵⁹

To conform book and tax timing rules for hedging transactions, the revised tax hedging rules should state that derivatives used for hedging (and that satisfy the risk management standard) should be marked-to-market. With respect to the hedged items, this rule applies only to fair value hedges under FAS 133. As of today, tax hedging rules do not distinguish between the three types of hedges described in FAS 133. To allow conformity on this point, the tax hedging rules must first define "fair value hedge" in accordance with FAS 133 and specify that only hedged items that are being hedged with a fair value hedge will be marked-to-market.

358. Kieso, *supra* note 39 at 876.

359. In addition, except for the timing mismatch, not all GAAP hedges are tax hedges (e.g., capital asset hedges) and not all tax hedges are GAAP hedges (e.g., certain hedges that fail the GAAP effectiveness requirement). See, e.g., Ensminger, *supra* note 1, at 28-30.

*E. Valuation*³⁶⁰

Commentators have considered valuation as a significant obstacle for applying a mark-to-market regime in U.S. tax law.³⁶¹ In *Bank One*, the Tax Court held that the treatment of an item for financial accounting and tax purposes may differ, and a method of accounting that is acceptable for accounting purposes may be unacceptable for tax purposes because it does not clearly reflect income.³⁶² Nevertheless, the Tax Court held it was acceptable for the bank to use its accounting mark-to-market method for purposes of section 475 as long as such method actually arrived at the swaps' fair market value.³⁶³

1. Fair Market Value v. Fair Value

The Tax Court asserted that a taxpayer could use its accounting mark-to-market method for purposes of section 475, but only if the value for book purposes meets the tax fair market value standard.³⁶⁴ The term "fair market value" is not specifically defined for purposes of section 475.³⁶⁵ The Tax Court reviewed the evolution of the term "fair market value" and summarized it as follows:

The primarily judicially developed standards as to fair market value are: (1) The buyer and the seller are a willing buyer and a willing seller; (2) neither the willing buyer nor the willing seller is under a compulsion to buy or to sell the item in question; (3) the willing buyer and the willing seller are both hypothetical persons; (4) the hypothetical willing buyer and the hypothetical willing seller are both reasonably aware of all relevant facts involving the item in question; (5) the item in question is valued at its highest and best use; and (6) the item in question is valued without regard to events occurring after

360. For an in-depth discussion of this issue, see Munro and Keinan, *supra* note 23.

361. See, generally, commentary *supra* note 55. Cf. Weisbach, *supra* note 28, at 105 ("the problems of valuation and liquidity are not sufficient to overcome the benefits").

362. 120 TC 174, 290-91 (2003).

363. *Id.* at 291.

364. *Id.*

365. See § 475. For purposes of other Code sections, the courts generally define the term as: "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 a reasonable knowledge of relevant facts." See *McDonald v. Comm'r*, 764 F.2d 322 (5th Cir. 1985). (*U.S. v. Cartwright*, 411 U.S. 546, 551 (1973)).

the valuation date to the extent that those subsequent events were not reasonably foreseeable on the date of valuation.³⁶⁶

Pursuant to FAS 133, “fair value is the most relevant measure for financial instruments and the *only* relevant measure for derivatives.”³⁶⁷ Fair value represents the amount at which an asset (liability) could be purchased (incurred) or sold (settled) in a current transaction between willing parties. (i.e., a transaction other than a forced or liquidation sale).³⁶⁸

The Tax Court held that the terms “fair market value” and “fair value”³⁶⁹ differ primarily for the following reasons: (i) under the fair market value standard, the buyer and seller must be reasonably aware of all facts relevant to the property to be valued, while no such requirement exists with respect to the fair value standard; (ii) under the fair market value standard, neither the buyer nor the seller can be under a compulsion to buy or sell the property, while under the fair value standard, the property must not be the subject of a forced sale or liquidation (i.e., a narrower requirement); (iii) under the fair market value standard, the buyer and seller are both considered to be hypothetical rather than actual persons, while no such requirement exists with respect to the fair value standard; and (iv) under the fair market value standard, the property to be valued must be valued by viewing the property in its highest and best use, and no such requirement exists with respect to the fair value standard.³⁷⁰

Table VI below summarizes the differences between the two standards, as indicated by the Tax Court:³⁷¹

366. Bank One, 120 TC at 306.

367. FAS 133, supra note 18, ¶ 17.

368. See FAS 107, supra note 97, ¶¶ 5-6. See also Munro and Keinan, supra note 23.

369. As the Tax Court indicated in footnote 66 of the *Bank One* decision:

For purposes of financial accounting, the term “fair value” denotes primarily: (1) Value determined by bona fide bargain between well-informed buyers and sellers; the price for which an asset could be bought or sold in an arm’s-length transaction between unrelated parties; value in a sale between a willing buyer and a willing seller, other than in a forced or liquidation sale. (2) An estimate of such value, in the absence of sales or quotations (e.g., the approximation of exchange price in nonmonetary transactions). Kohler’s Dictionary for Accountants 211 (6th ed. 1983).

370. 120 TC at 309 n. 66 (quoting Kohler’s Dictionary for Accounts 211 (6th ed. 1983)).

371. See *Id.*

Table VI		
Element	Fair Market Value	Fair Value
Willing buyer and seller	X	X
Neither party is compelled to buy or sell	X	
The property must not be the subject of a forced sale or liquidation		X
The buyer and seller are both hypothetical persons	X	
The buyer and the seller are both reasonably aware of all relevant facts	X	X
The item in question is valued at its highest and best use	X	
The item in question is valued without regard to events occurring after the valuation date	X	

These differences should not limit taxpayers' ability to use financial statement values of securities on tax returns.³⁷² Under both definitions, the predominant element is the willing buyer and seller principle, and in my opinion, applying each standard in most cases should result in closely similar (if not identical) values. As a practical matter, valuation of derivatives can never be completely accurate. Therefore, in my view, the definition of "fair market value" for purposes of the tax mark-to-market rules should conform to the definition of "fair value" under GAAP.

2. Valuation of Swaps: GAAP v. Section 475

The most significant issue in *Bank One* was the appropriate valuation method of interest rate swaps (and potentially, other derivatives) for section 475 purposes.³⁷³ The Tax Court suggested that valuation methods used for book purposes might not satisfy the required valuation method for tax purposes.³⁷⁴ FAS 133 was not effective for any of the years under dispute in *Bank One*.³⁷⁵ During the relevant years, however, the common practice in the financial derivatives industry had been to mark swaps and other derivatives to market. To value its swaps, the taxpayer utilized an adjusted mid-market method, which is

372. Weisbach, *supra* note 28, at 107-108, (indicating that requiring valuation for both tax and accounting would help both systems by creating a tension that prevents under- or over-valuation and by simplifying the system through uniformity.)

373. 120 T.C. 174 (2003).

374. *Id.* at 290-91.

375. *Id.* at 220.

economically similar to the bid-ask method in most cases.³⁷⁶ Under such a method, the bank calculated each swap's mid-market rate,³⁷⁷ and then calculated credit³⁷⁸ and administrative cost³⁷⁹ adjustments for the swaps and added or subtracted those amounts to arrive at the swaps' values.³⁸⁰

The adjusted mid-market method, a common method used by dealers to value their portfolios, was also recognized as a valid method by the G-30.³⁸¹

376. *Id.* at 244. The bid-ask method is a market-based method, which generally requires a comparison of the subject property with a comparable property, sold in an arm's-length transaction under comparable circumstances. Under this method, each swap generally is valued by: (i) identifying a comparable transaction; (ii) ascertaining the bid or ask price for that comparable swap; and (iii) adjusting the ascertained price to reflect any differences between the comparable swap and the swap being valued. The bid price is the fixed interest rate that a swap dealer is ready to pay in exchange for a specified floating rate. The ask price is the fixed interest rate that the dealer demands to receive in exchange for paying a specified floating rate. The ask rate is greater than the bid rate, and the dealer's maximum net profit when taking the opposite sides on two identical swaps is the difference between the fixed rate it receives and the fixed rate it pays. See Munro and Keinan, *supra* note 23, at 12.

377. Mid-market is an income-based method that values property by computing the present value of the estimated future cash flow generated from that property. The mid-market rate is the midpoint of the bid and ask rates for a specified maturity, which equals the fixed rate for which the present value of the cash flows from the fixed leg equals the present value of the projected cash flows from the floating leg. As a practical matter, dealers do not use this method, because adjustments are necessary to reflect true income. See Munro and Keinan, *supra* note 23, at 13.

378. A credit adjustment is required to the extent that it properly reflects the change to the swap's mid-market value on account of the actual parties' respective creditworthiness, taking into account all the facts and circumstances that would enhance or diminish each party's creditworthiness. Munro and Keinan, *supra* note 23, at 13-14.

379. The swaps' fair market value should include an administrative costs adjustment. Munro and Keinan, *supra* note 23, at 14.

380. Bank One, 170 TC at 243.

381. *Id.* at 221; see also Munro and Keinan, *supra* note 23, at 13. The G-30 is a private, nonprofit international entity composed of very senior representatives of the private and public sectors and academia. It was organized to deepen understanding of international economic and financial issues and to examine the choices available to market practitioners and policymakers. In July 1993, one of the G-30's working groups issued a report titled "Derivatives: Practices and Principles," which focused on bank regulatory concerns and generally defined a set of sound risk management practices for dealers and end users. Recommendation 3 of the G-30 report stated:

Derivatives portfolios of dealers should be valued based on mid-market levels less specific adjustments, or on appropriate bid or offer levels. Mid-market valuation adjustments should allow for expected future costs such as unearned credit spread, close-out costs, investing and funding costs, and administrative costs.

Munro and Keinan, *supra* note 23, at 13 n. 24.

The Tax Court held that it was acceptable for the bank to have used its mark-to-market method for purposes of section 475 as long as the method actually arrived at the fair market value of its swaps.³⁸²

The (“ANPRM”),³⁸³ which was issued on the same day the Tax Court’s decision in *Bank One* was released, suggests a safe harbor that would allow the taxpayer to elect to use the same values used on its financial statements for purposes of section 475, subject to the following eligibility standards: (i) any mark-to-market methodology used on the financial statement would have to be sufficiently consistent with the mark-to-market methodology required under Section 475; (ii) the financial statement would have to be one for which the taxpayer has a strong incentive to report values fairly;³⁸⁴ and (iii) if requested, the taxpayer would have to “timely provide” the IRS with the information and documents necessary to verify the relationship between the values reported on the financial statement and the values used for purposes of Section 475.³⁸⁵

3. Valuation of Other Derivatives

Primarily, *Bank One* discussed valuation of swaps; however, in footnote 68 of the decision, the Tax Court indicated that its decision may apply more broadly to other derivatives subject to section 475:

We hereinafter limit our analysis to the treatment of interest rate swaps. We believe on the basis of our understanding of the other financial derivatives at issue that the tax treatment of those derivatives follows naturally from our decision as to

382. 120 TC at 291.

383. REG-100420-03, *supra* note 25.

384. *Id.* Pursuant to the ANPRM, two factors are relevant in establishing that the taxpayer has a strong incentive to report the value of securities and commodities fairly in its financial statements: (i) reporting of values on a financial statement required to be filed with the SEC (e.g., a 10-K) or with any other federal (or state, local or foreign, in limited circumstances) government agencies; and (ii) significant use of reported values in the taxpayer’s business, including risk management activity and employee compensation. *Id.*

385. *Id.* The Treasury and the IRS requested comments regarding the following issues: (i) potential differences between mark-to-market treatment for financial reporting and § 475; (ii) whether the “fair value” standard used for accounting purposes may be used as a proxy for the “fair market value” standard required under § 475; (iii) whether GAAP (and, as suggested, § 475) permits valuation of securities at bid price; (iv) whether adjustments for administrative and credit risk costs should be allowed; and (v) what other types of adjustments should be permitted in valuation of securities and commodities. *Id.*

FNBC's interest rate swaps. If we are mistaken on that point, then either party may bring this to our attention.³⁸⁶

In addition, Treasury asked for comments regarding possible application of the rules to securities traders as well as to commodities dealers and traders.³⁸⁷

In my opinion, it is necessary to set forth one single valuation standard for all instruments that are marked-to-market. This single definition should be consistent with FAS 107's definition of "fair value."³⁸⁸ Generally, the bid-ask method is applicable to both derivatives and non-derivatives, because it simply determines the value of an instrument in accordance with the bid-ask prices of a comparable instrument in the market.³⁸⁹ This method has been viewed by GAAP as reflecting the "fair value" of a financial instrument.³⁹⁰ Alternatively, for large banks and financial instruments, it could be more feasible to apply the adjusted mid-market method (which is economically equivalent to the bid-ask method).

4. The Bifurcation Approach

As the Tax Court in *Bank One* explained, economically, an interest rate swap is analogous to back-to-back loans.³⁹¹ By entering into the swap, the parties exchange a fixed-rate bond for a floating-rate bond of the same maturity and face value.³⁹² Accordingly, the Tax Court suggested that with respect to an interest rate swap, rather than identifying a comparable transaction, an interest rate swap could be bifurcated into two debt instruments, each of which could be separately compared to a comparable hypothetical debt instrument.³⁹³ Under this analogy, the fair market value of a swap should be equal to the difference between: (i) the price at which a willing buyer and seller would agree to buy/sell the fixed leg and (ii) the price at which a willing buyer and seller would agree to buy/sell the floating leg.³⁹⁴

The bifurcation approach may be helpful in applying the bid-ask method not only to swaps but also to other types of securities. Economically, a

386. *Bank One* 120 T.C. at 211 n. 68.

387. REG-100420-03, supra note 25.

388. See FAS 107, supra note 97, ¶ 5.

389. *Id.* at 919.

390. *Id.*

391. *Bank One*, 120 TC at 190-91.

392. *Id.* The fixed leg may be viewed as a bond issued by the fixed-rate payor, the interest rate of which equals the fixed rate payable on the swap. *Id.* The floating leg may be viewed as a bond issued by the floating-rate payor, the interest rate of which is the agreed upon floating rate on the swap. *Id.*

393. *Id.*

394. *Id.*, at 311.

derivative can be bifurcated into different instruments each of which is a security under section 475.³⁹⁵ Thus, if the regulations to be issued ultimately reject book-tax conformity (or offer guidelines for securities outside the safe harbor), they should at least set forth a method for valuation of the basic building blocks of financial instruments – debt, forwards and options. These basic valuation standards could apply to almost any type of security or derivative.³⁹⁶

5. Conclusions

Neither the IRS nor taxpayers want to determine valuations through expensive litigation. Therefore, there is pressure from both sides that Treasury set forth, by regulations, clear and unambiguous valuation standards for section 475 purposes.³⁹⁷

As a starting point, the regulations should make it clear that FAS 107's "fair value" is equivalent to the "fair market value" standard used for tax purposes. In providing for book-tax conformity safe harbor, the IRS may take one of the following approaches:³⁹⁸

1. Pure Conformity: The regulations can simply state that the method used by the taxpayer for accounting purposes is appropriate for tax purposes. This method is the most simple for taxpayers and the easiest to verify by the IRS.

2. Mid-Market Plus Adjustments: The regulations can allow proprietary adjustments to the mid-market method in accordance with *Bank One*, which, as set forth above, reflects the common practice among derivatives dealers.

3. Pure Bid-Ask Method: This method may be nearly equivalent to mid-market with adjustments for plain vanilla securities with little inception gain and is consistent with administrative practice for traditional debt and equity securities. For taxpayers that use this method for books it would be less expensive to comply with and easier for the IRS to verify given the lack of adjustments; however, for large-scale derivative dealers, the adjusted mid-market method may be more efficient.

4. Alternative Tests: Finally, the regulations may determine that taxpayers would be allowed to apply any method that clearly reflects

395. For example, the IRS has argued that a swap could be viewed as a series of forward contracts. See Notice of Proposed Rulemaking (FI-16-89), 1991-2 C.B. 951, 952; see also TAM 9730007 (April 10, 1997).

396. See Munro and Keinan, *supra* note 23.

397. *Id.*, at 17.

398. *Id.*

income pursuant to section 446 (for example, apply the bid-ask and adjusted mid-market method and report values at the lower of the two amounts).³⁹⁹

VI. SUMMARY OF THE PROPOSAL

A. Proposed Timing Rules for Non-Derivatives (Debt Instruments)

1. Debt Instruments held as assets will be marked-to-market, unless they are held for investment.
2. Debt Instruments issued by a taxpayer will be subject to the taxpayer's normal accounting method (cash or accrual), unless they constitute "hedged items."
3. CPDIs will be bifurcated if the contingency portion constitutes an "embedded derivative."

B. Proposed Timing Rules for Non-Derivatives (Equity Securities)

1. Marketable equity securities held as assets (less than 20% holding) will be marked-to-market.
2. Non-marketable equity securities held as assets will be viewed as held-to-maturity and, therefore, will be subject to the taxpayer's normal accounting method (cash or accrual).
3. Equity securities issued by a taxpayer will be subject to the taxpayer's normal accounting method (cash or accrual), unless they constitute "hedged items."

C. Proposed Timing Rules for Derivatives

1. All derivatives will be marked-to-market in accordance with FAS 133.
2. Embedded derivatives will be separated and accounted for on a mark-to-market basis.
3. A hedging instrument can only be a derivative.
4. All hedging transactions will be marked-to-market.
5. Hedged items that are being hedged with a "fair value" hedge will be marked-to-market.

399. Id.

D. Proposed Valuation Principles

1. Valuation for GAAP purposes will be used for tax purposes.
2. Valuation of derivatives and non-derivatives will be based on the “fair value” concept.
3. Non-derivative instruments will be valued in accordance with the bid-ask method.
4. Derivatives will be valued in accordance with either the bid-ask method or the adjusted mid-market method.

VII. CONCLUSIONS

The proposal set forth in the article is that GAAP would generally form the basis for classification, timing and, valuation rules pertaining to financial instruments. In particular, this proposal will incorporate certain features of GAAP, including substance-over-form, mark-to-market, and valuation methods, into the relevant tax rules, thereby achieving greater conformity in the tax and accounting rules treatments of financial instruments. Once these elements are incorporated into the tax law, taxpayers who are not subject to GAAP (such as individuals and small businesses) will also be able to follow these principles.

From a tax policy perspective, my proposal will enhance simplicity, certainty, neutrality, and administrability. On the other hand, the tax system may become less flexible in responding to new financial instruments.

In general, the tax law should be as simple as possible for taxpayers to understand and to apply to the applicable circumstances. Under my proposal, simplicity will be achieved because most instruments will be subject to mark-to-market, and as Professor Weisbach indicates, it will significantly eliminate “complex, realization-based rules and the uncertainty created by realization-based taxation.”⁴⁰⁰ On the other hand, some taxpayers, especially small businesses (which may not be subject to GAAP reporting principles), may find mark-to-market treatment more complicated. In my view, the majority of taxpayers who will be subject to mark-to-market under my proposal (i.e., non-investors in non-derivative instruments and parties to derivatives) will be sophisticated taxpayers that are generally subject to GAAP. Thus, the overall result will be a simplification of the rules.

Certainty will be achieved through a comprehensive set of rules that reflects the substance, rather than the form, of an instrument.⁴⁰¹

A neutral tax system is one that does not distort the economic decisions of taxpayers. In the case of financial instruments, neutrality will be achieved because most financial instruments will be subject to mark-to-market as a result,

400. Weisbach, *supra* note 28 at 122.

401. See Schenk, *supra* note 28, at 574, (defining this element as “universality.”)

instruments with the same substance will be taxed consistently.⁴⁰² In addition, adoption of a bifurcation approach would enhance consistency because all the building blocks of derivatives will be taxed similarly.

One major goal of the proposed conformity is to reduce compliance costs. Following a taxpayer's financial accounting treatment for tax purposes would greatly increase compliance. Therefore, administrability will be achieved because the conforming rules will be easier to comply with and administer.⁴⁰³

402. Weisbach, *supra* note 28, at 131-32. This element can also be defined as consistency. (See also Strnad, *supra* note 28, at, 548.)

403. See, e.g., Yin, *supra* note 1.