CLEARY GOTTLIEB

Seventh Circuit Decides Appeal of *Bank One* Mark-to-Market Swap Valuation Tax Case

New York
August 9, 2006

The Seventh Circuit today decided the taxpayer's appeal of the *Bank One* case.[1] *Bank One* addresses the details of how a securities dealer should calculate the year-end mark-to-market values of its portfolio of open interest rate swap positions.[2]

In brief, the Seventh Circuit rejected the taxpayer's appeal, but did not simply affirm the Tax Court's opinion. Instead, the Seventh Circuit vacated part of the Tax Court's decision, and remanded the case to the Tax Court for further proceedings consistent with the appellate decision.

The Seventh Circuit began its analysis by describing Internal Revenue Code section 475 (the provision that mandates mark-to-market accounting for securities dealers). The court then concluded that section 475's standard of "fair market value" should govern the valuation of the taxpayer's interest rate swap portfolio in this case, notwithstanding the fact that section 475 technically applied only to the last taxable year in controversy.

The Seventh Circuit next concluded that the appropriate standard to apply in reviewing both the Tax Court's findings of fact and the lower court's legal analysis was whether the Tax Court had committed "clear error." In a brief discussion, the Seventh

[1] *JPMorgan Chase & Co., successor in interest to Bank One Corporation*, *vs. Commissioner of Internal Revenue*, Slip Opinion Nos. 05-3730 & 05-3742 (7th Cir. Aug. 9, 2006) (hereinafter, "Slip Opinion").

[2] For an analysis of the Tax Court's opinion in *Bank One*, *see* McRae, "Financial Modeling from the Bench: *Bank One* and the Internal Revenue Service's Attempt to Fix the Consequences," 17 Journal of Taxation and Regulation of Financial Institutions 19 (Nov./Dec. 2003).

© Cleary Gottlieb Steen & Hamilton LLP, 2006. All rights reserved.

This memorandum was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice.

Circuit affirmed the Tax Court's core findings that "fair value" under Generally Accepted Accounting Principles was not synonymous with "fair market value," and that the taxpayer's valuation methodology did not reach fair market values. The Seventh Circuit's reasoning in respect of both these issues relied principally on its determination that the Tax Court's findings of fact and legal analysis did not contain any clear error.[3]

Having affirmed the Tax Court's rejection of the taxpayer's valuation methodology, the Seventh Circuit then turned to the Tax Court's rejection as well of the Commissioner's alternative valuation methodology, which was basically to value the taxpayer's interest rate swaps at their *unadjusted* mid-market values. The Tax Court had rightly concluded that unadjusted mid-market values do not in fact represent the fair market values of interest rate swaps held by a dealer, and therefore rejected the Commissioner's determination in this case. Instead, the Tax Court (relying on its own experts) developed its own methodology, and ordered the parties (in post-decision proceedings) to compute the taxpayer's deficiency by applying that methodology to the taxpayer's facts.[4]

The Seventh Circuit rejected the Tax Court's alternative valuation methodology as flowing (in effect) from a clear error in analysis. In the Seventh Circuit's view, the Tax Court's error was *not* substantive – that is, the Seventh Circuit did not conclude that, as a matter of law, swaps should be valued at their unadjusted mid-market values – but rather was the result of the Tax Court's failure to show sufficient deference to the Commissioner's valuation methodology. In the view of the Seventh Circuit, once the Tax Court properly had rejected the taxpayer's valuation methodology, the Tax Court had no choice but to accept the Commissioner's alternative methodology, unless that approach in

---

[3] Slip Opinion at 10-11. We believe that in fact the Tax Court's analysis of this issue was plainly erroneous, *see* McRae, *supra* note 2, but the "clear error" standard is a difficult one for an appellant to satisfy.

[4] As the Seventh Circuit observed, this process in turn has been contentious, and the parties never succeeded in agreeing what the taxpayer's tax liability would be under the Tax Court's methodology.

turn was "clearly unlawful" or "plainly arbitrary."[5] Here, the Seventh Circuit concluded, the Tax Court failed to apply the proper clearly unlawful/plainly arbitrary standard to the Commissioner's alternative methodology.[6] The Seventh Circuit therefore remanded the case with directions to the Tax Court to apply in further proceedings the proper "deferential standard,"[7] and to hold for the Commissioner if the taxpayer cannot carry its (heavy) burden of proof that, under the facts of this case, the Commissioner's method is arbitrary or unlawful.[8]

In our view, the most remarkable aspect of the Seventh Circuit's opinion is not the analysis described to this point, but rather the care that the court took to minimize the precedential value of its opinion, or of any future Tax Court opinion that might hold for the Commissioner. The Seventh Circuit did so in a series of subtle but important observations. Most directly, the Seventh Circuit limited the precedential effect of any possible future Tax Court opinion affirming the Commissioner's unadjusted mid-market method in an important footnote:

> Although the details of the Commissioner's proposed method are not essential to our opinion, we note that the Commissioner proposed using the taxpayer's unadjusted midmarket values as the fair market value. Although the Commissioner agreed in principal [sic] with making adjustments to the midmarket values, the Commissioner did not find adjustments warranted in this case. On appeal, the Commissioner has maintained, as it did below, that the taxpayer's own reporting of the unadjusted values as well as its failure to maintain required records justified leaving the values unadjusted. *We understand that the Commissioner would use a method that adjusts the midmarket value, but such a method was not appropriate or*

---

5 Slip Opinion at 11-12.

6 Slip Opinion at 14.

7 Slip Opinion at 13.

8 Slip Opinion at 14.

> *possible in this case* because of the taxpayer's financial reporting statements and imperfect record keeping.[9]

Similarly, in summarizing the facts, the Seventh Circuit described the Commissioner's proposed alternative valuation methodology as the best method that the Commissioner could derive "under the circumstances in this case."[10] In the view of the court, those circumstances in turn related both to a series of factual "deficiencies" in the details of the taxpayer's methodology,[11] and to the taxpayer's "failure to maintain required records."[12] Thus, the Seventh Circuit concluded, "any inadequacies with the Commissioner's method that are due to the taxpayer's failure to keep or provide records, to the extent that it affected the Commissioner's choice of method, may be taken into account" by the Tax Court on remand in applying the "deferential" standards articulated by the Seventh Circuit.[13]

In passing, the Seventh Circuit clearly signalled its frustration with the resources and time that the Tax Court and the parties have devoted to date to the valuation issues in this case.[14] The Seventh Circuit also expressed its hope that this case would have limited precedential value by virtue of the promulgation of final Treasury regulations adopting the "book-tax conformity" safe harbor for section 475 securities valuations issued in proposed form in 2005.[15] "Such a rule, if finalized," wrote the court, "would likely bear

---

9 Slip Opinion at note 6 (emphasis supplied).

10 Slip Opinion at 4.

11 Slip Opinion at 10.

12 Slip Opinion at note 6.

13 Slip Opinion at 14.

14 The Seventh Circuit noted that "[i]t would behoove the tax court and the parties on remand to focus narrowly on deciding the precise issues remaining in this case, and to make progress without duplicating the extensive work already invested in this case." Slip Opinion at 15.

15 Slip Opinion at 5 (citing Safe Harbor for Valuation Under Section 475, 70 Fed. Reg. 29663 (May 24, 2005)). The 2005 proposed regulations are discussed in our memorandum dated May 25, 2005, titled

on similar cases and may limit this case's precedential value."[16] The Seventh Circuit concluded its discussion of this point with the tart observation that "[m]ore timely rulemaking might have prevented or at least facilitated resolution of this present dispute."[17]

Although the taxpayer lost its appeal in *Bank One*, on balance, we believe that the Seventh Circuit's opinion will be modestly helpful to most securities dealers confronting audit challenges in respect of their mark-to-market valuations of their portfolios of open derivatives positions. First, the Seventh Circuit implicitly approved the use of mark-to-market accounting even for years prior to the effective date of section 475. Second, the Seventh Circuit explicitly rejected the Tax Court's independently derived mark-to-market accounting method as a tax norm. Third, as the previous paragraph suggests, the Seventh Circuit plainly believes both that final "safe harbor" Treasury regulations should promptly be issued, and that those regulations should inform the resolution even of pre-effective date controversies.

CLEARY GOTTLIEB STEEN & HAMILTON LLP

EDK

"Proposed Treasury Regulations Offer Dealers and Traders Safe Harbor for Section 475 Mark-to-Market Valuations." *See also* Securities Industry Association, Submission Regarding Proposed Regulations Establishing Book/Tax Conformity Safe Harbor Under Section 475 (Aug. 17, 2005), published in 2005 TNT 179-26 (Sept. 16, 2005), and Securities Industry Association, Submission Regarding Record Retention and Production Requirements in Proposed Regulations Establishing Book/Tax Conformity Safe Harbor Under Section 475 (July 13, 2005), published in 2005 TNT 150-11 (Aug. 5, 2005).

[16] Slip Opinion at 6.

[17] *Id*.

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
1 212 225 2000
1 212 225 3999 Fax

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
1 202 974 1500
1 202 974 1999 Fax

PARIS
12, rue de Tilsitt
75008 Paris, France
33 1 40 74 68 00
33 1 45 63 66 37 Fax

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
32 2 287 2000
32 2 231 1661 Fax

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
44 20 7614 2200
44 20 7600 1698 Fax

MOSCOW
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
7 501 258 5006
7 501 258 5011 Fax

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
49 69 97103 0
49 69 97103 199 Fax

COLOGNE
Theodor-Heuss-Ring 9
50668 Cologne, Germany
49 221 80040 0
49 221 80040 199 Fax

ROME
Piazza di Spagna 15
00187 Rome, Italy
39 06 69 52 21
39 06 69 20 06 65 Fax

MILAN
Via San Paolo 7
20121 Milan, Italy
39 02 72 60 81
39 02 86 98 44 40 Fax

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
852 2521 4122
852 2845 9026 Fax

BEIJING
Twin Towers – West
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
86 10 5920 1000
86 10 5879 3902 Fax