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TO: Professor Robert Wootton
FROM: Megan Heinzelman, Esq.
DATE: March 30, 2010
RE: Credit Default Swap Withholding Tax

Recently, our firm was engaged by sophisticated clients to issue opinions regarding the Federal income tax treatment of entering into a credit default swap ("CDS") financial product.[1] More specifically, our issue relates to whether the amounts paid by a United States protection buyer to a foreign protection seller constitute income that is subject to withholding tax or an insurance-premium excise tax. An amount paid is subject to withholding if it is either (a) fixed or determinable annual or periodical income, or (b) other amounts, such as distributions from a domestic corporation that may not be dividends.[2]

In Notice 2004-52, the IRS and the Treasury requested comments on the appropriate tax treatment of a CDS.[3] Commentators suggested the legal rights and obligations are analogous to other existing types of financial transactions and these existing laws should govern the tax treatment of a CDS.[4] The Notice indicated that there are at least four existing categories in which a CDS could be reasonably analogized to for tax purposes, including a guarantee, insurance, contingent put option, and a notional principal contract ("NPC").[5]

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[1] References hereinafter are to sections of the Internal Revenue Code and Code of Federal Regulations cited "IRC" and "Treas. Reg."
[2] IRC § 1441.
[3] Notice 2004-52, 2004-2 C.B. 168. (Aug. 9, 2004).
[4] *Id.*
[5] *Id.*

The United States generally does not impose any tax on option premiums and NPC payments made to a foreign counterparty, or on certain interest payments.[6] In contrast, fees paid by a United States person to a foreign person for the guarantee of a United States debt obligation are subject to a thirty percent withholding tax.[7]

On September 9, 2005, the New York State Bar Association submitted a report to the IRS and the Treasury responding to Notice 2004-52 urging guidance on a "most pressing" issue of tax consequences to cross-border transactions because of the "deal-breaking" effect of the application of withholding tax or United States net-based income tax payment made to foreign persons.[8] The Association strongly recommended that any guidance issued by the Treasury treat a conventional CDS as a type of financial instrument for which a body of law exists; insisting the most obvious analogy is to treat a CDS as a form of NPC.

Moreover, on November 7, 2005, the New York State Society of Certified Public Accountants submitted a report to the Government addressing tax consequences of a CDS, suggesting that a CDS transaction "comfortably fits" within the NPC regime and that new specific guidance is not necessary regarding the characterization of these transactions since the fundamental tax principals are well established.[9]

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[6] Treas. Reg. § 1.1441-2(b)(2)(i)(no withholding from option premium); Treas. Reg. § 1.1441-4(a)(3)(i)(no withholding on notional principal contract payments); Treas. Reg. § 1.1441-1(b)(4)(i)(exemption from withholding for portfolio interest).

[7] Treas. Reg. § 1.1441-2(a)-(b)(United States source income which is fixed or determinable annual or periodic is subject to withholding; fixed and determinable annual or periodic income includes all income included in gross income unless specifically excepted; guarantee fees not specifically excepted).

[8] Notice 2004-52.

[9] New York State Society of Certified Public Accountants, Taxation of Financial Instruments and Transactions and Investment Management Committees, "Statement on Credit Default Swaps Provided in Response to IRS Notice 2004-52," November 7, 2005.

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Although taxpayers are cautious in structuring CDS transactions and assume the transaction is taxable as an NPC, the IRS, on audit, potentially could recharacterize a transaction as a guarantee or an insurance contract. Recharacterization of these transactions is seemingly possible because of tax policy underlying the consequences surrounding financial derivative transactions. A CDS treated as an NPC or as an option allows for tax avoidance. For example, the purchase of CDS protection by a United States subsidiary from its overseas parent, indirectly or directly, may allow the export of capital free from withholding. A cash payment can be made to the foreign parent through the CDS market overseas at a lower effective tax rate and free from United States Federal income tax. Further, a CDS effectively provides economic protection equivalent to that provided by an insurance contract that is effectively unregulated, free from withholding tax, excise tax, and capital requirements.

Unfortunately, the Notice does not go beyond informing taxpayers the Service is aware of the problems and indentifies various analogies. To avoid possible recharacterization, a prudent strategy for clients entering a CDS is to utilize the standard documentation for derivatives provided by the Internal Swaps and Derivatives Association, Inc.[10] The ISDA Master Agreement is a pre-printed bilateral framework agreement by which the parties are required to select certain options and may modify sections of the agreement if desired. Additionally, we should conduct due diligence inquiries, such as authority, regulatory and licensing issues when dealing with different types of counterparties, such as banks, corporations, insurance companies and fund managers.

[10] ISDA 2002 "Master Agreement."

Brief Conclusion

In my analysis, a CDS most closely resembles an NPC or a contingent put option for Federal income tax purposes, both of which require no withholding of tax. However, without further guidance, it remains uncertain as to which existing body of tax law will control the Federal income tax consequences of a CDS. The tax and withholding consequences of each of these potential treatments are different, and until further guidance issued, investors in credit default swaps must determine which analogy fits their instrument best.

Credit Default Swaps

A very common form of credit derivative is the CDS. The largest participants in the CDS market are global banks. Under the basic agreement, a party to the agreement, the protection buyer, makes a periodic premium payment to the other party, the protection seller, for a set term. The amount of the periodic payment is a percentage of the notional amount agreed upon by the parties and is based on the parties' assessment of the credit risk of the referenced asset. This notional amount is generally determined by factors, including the value of the underlying asset, a contractually negotiated formula that determines the counterparties' obligations to each other based on that value, and the counterparties' creditworthiness. In return, the protection seller agrees to "settle" with the prospective buyer if a "credit event" occurs with respect to the referenced asset, as defined in the CDS agreement. A credit event occurs when a referenced entity fails to pay, defaults, files for bankruptcy, or possibly restructures its debt. On the occurrence of a credit event, the protection seller usually pays the protection buyer an amount that reflects the loss in value of the referenced obligation.

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Credit derivatives are a way for a party to transfer credit risk. The protection buyer does not need to own the referenced obligation, and often does not. Standard terms of these contracts make a domestic protection buyer take the burden of any withholding tax, in addition to any obligations they might have under IRC § 1441.

Insurance

A CDS is unlikely to be characterized as insurance for Federal income tax if the protection buyer does not own the referenced obligation, as is often the case. Without ownership creating an insurable interest in the obligation, it is unlikely that the CDS transaction is considered insurance. Requiring a taxpayer to be at risk and to transfer that risk should be instructive to distinguish insurance from financial instruments and bets.[11]

The United States Supreme Court formulated four separate features that distinguish insurance from other contractual arrangements.[12] These features include the form and regulatory treatment of the contract, the existence of an insurable risk, the transfer or shift of that risk, and the pooling and distribution of the insurance risk by the party assuming it.[13] Courts and the Service maintain that insurance must protect against economic loss only.[14] Although a CDS may transfer insurance risk, an investor who assumes this risk does not usually assume the risks of a sufficiently large number of underlying obligors, so as to pool and dilute the risks in the same sense as an insurance contract.

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[11] *Home Title I*, 50 F.2d 107, 109 (2d Cir. 1931) "the insured must have some interest at risk, for otherwise the contract is a wager."
[12] *Helvering v. Le Gierse*, 312 U.S. 531 (1941).
[13] *Id.*
[14] *Allied Fidelity Corp. v. Comm'r*, 66 T.C. 1068 (1976); *aff'd*, 572 F.2d 1190 (7th Cir. 1978).

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However, credit derivatives do transfer a form of insurance risk in the sense that the risk of economic loss arising from a defined contingency is shifted to the credit protector after the contract's execution. In a Field Service Announcement, the Service suggested that given a sufficient degree of risk distribution, risk shifting is irrelevant to the determination of whether a valid insurance arrangement exists for Federal tax purposes.[15] Thus, it may not appear necessary for a risk-protected party to be at risk or to transfer risk in order to be treated as having written insurance. Further, in Revenue Ruling 2004-75, the Service held that income received by a nonresident alien under the contracts issued by a foreign branch of a domestic life insurance was United States source fixed or determinable annual or periodical gains, profits, and income and that was subject to thirty percent tax and withholding under IRC §§ 871(a) and 1441.[16]

Alternatively, if the payment is not subject to withholding, IRC § 4371 provides that either a four percent or one percent excise tax is imposed on premiums paid by a United States person to any foreign insurer for casualty, life, sickness, or accident insurance with respect to hazards, risks, losses, or liabilities within the United States. This excise tax applies unless the premiums received by the foreign insurer are effectively connected with its trade or business within the United States and subject to income tax on a net income basis.[17] The purpose of the excise tax is to prevent a foreign insurer or reinsurer, operating in a low-tax jurisdiction, from achieving a competitive advantage over its domestic counterpart with respect to a United States

[15] F.S.A. 1999-10-724 (Jan. 25, 1999).
[16] Rev. Rul. 2004-75, 2004-75 C.B. 109 (Aug. 2, 2004).
[17] I.R.C. § 4372(a).

risk.[18] Despite the broad view, the excise tax will only apply if the contract constitutes insurance for Federal income tax purposes, and if the recipient is treated as an insurer or reinsurer, not merely a foreign person.[19] Thus, apparently, payments made on an option, NPC, or a debt instrument which serves as an alternative to insurance for risk-protected party but fails to qualify as insurance for Federal income tax purposes are not subject to the excise tax. It is unlikely that a payment on a CDS would be subject to IRC § 4371.

Guarantees

A CDS is very unlikely to be classified as a guarantee. A guarantee is a contract to assume an economic liability if the guaranteed party should default on its obligations. Courts have held that the source of guarantee fees is determined by analogy to the source of interest income, and therefore by reference to the residence of the obligor.[20] Further, many protection buyers have nothing to guarantee. A guarantee requires the protection buyer own the referenced obligation, which in a CDS transaction, the foreign protection buyer often does not. Additionally, the payment that the protection seller would make would be the amount that the protection buyer lost, rather than assuming the debt, as would a guarantor.

Notional Principal Contracts

[18] *Neptune Mut. Assoc. Ltd. of Bermuda v. U.S.*, 862 F.2d 1546, 1549 (Fed. Cir. 1988). "Before the enactment of the predecessor statute to section 4371, foreign insurers who did not maintain a domestic agent could write casualty insurance on risks located in the United States without incurring any federal tax liability."

[19] I.R.C. § 4371 applies only to a policy of insurance or reinsurance.

[20] *Bank of Am. v. United States*, 680 F.2d 142, 150 (Ct. Cl. 1982); Field Service Advice 2001-47-033 (Nov. 23, 1001)(guarantee fees paid by a domestic taxpayer to its foreign parent were fixed or determinable annual or periodic payments, and were characterized as United States source).

An NPC that provides for contingent nonperiodic payments likely will control a CDS payment's withholding tax treatment. An NPC is defined by Treasury Regulations 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."[21] A specified index includes an index based on objective financial information.[22] For an index to fall within the definition of objective financial information it neither can be within the parties' control nor be based on information unique to one party's circumstances.[23]

Where there is an outbound payment on a cross-border NPC, there is no withholding of tax because the payment is considered a foreign source.[24] However, while undoubtedly a minority view, some practitioners have suggested that credit default swaps should be classified as options under current law.[25] Under an NPC, a nonperiodic payment is "any payment made or received with respect to a notional principal contract that is not a periodic payment or a termination payment."[26] An NPC is a bilateral agreement, and there must be an exchange. Each party is required to make at least one payment. Thus, because under a CDS contract the protection seller may never make a payment, it appears that a NPC may not be an appropriate analogy. The protection seller is only obligated to make one entirely contingent payment, and the protection seller's payments are similarly uncertain because the premium payments cease if a

[21] Treas. Reg. § 1.446-3(c)(1)(i).
[22] § 1.446-3(c)(4)(ii).
[23] *Id.*
[24] Treas. Reg. § 1.863-7(b) (sources payments at the residence of the recipient); Treas. Reg. § 1.1441-4(a)(3).
[25] Tax Analysts, Tax Notes, January 30, 2006.
[26] § 1.446-3(f)(1).

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credit event occurs. Further, neither party needs to prove that it incurred a loss to collect on a CDS. Thus, it does not appear prudent to so easily conclude that the best analogy is an NPC.

Options

The tax treatment of an option may control a CDS payment's withholding tax. Certainly, a CDS that calls for the protection seller to take the referenced obligation off a protection buyer's hands resembles a series of put options. A put is an option that gives the holder the right to sell a specified number of shares of a specific stock at a set price within a certain time period. The maker of the option is the person required to purchase the stock if the option is exercised. An option is subject to open transaction treatment, and a series of put options is very appealing because of the "wait and see" accounting method.

A CDS is similar to the definition of an option provided by the Tax Court in *Freddie Mac v. Commissioner*.[27] The court stated that a contract is an option "when it provides (A) the option to buy or sell, (B) certain property, (C) at a stipulated price, (D) on or before a specified future date or within a specified time period, (E) for consideration."[28] Further, the court stated "an essential characteristic of an option contract is that one party is obligated to perform, while the other party may decide whether or not to exercise his rights under the contract."[29] A CDS fits the court's requirement because the protection seller is "obligated to perform" in all credit event circumstances. Additionally, the fact that the protection buyer is automatically deemed to exercise its right in accordance with the contract in a manner that maximizes its payoff under the

[27] 125 T.C. 248 (2005).
[28] *Id.* at 261.
[29] *Id.* at 262.

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terms of the contract is essentially equivalent to a contract that does not automatically deem the protection buyer to exercise its rights in such a case.

An option premium, whether paid upfront or in installments, is neither deductible from nor includible in income until the contract is sold, is exercised, expires, or is otherwise terminated. There is no withholding tax on option premiums paid, and trading in options does not give rise to carrying on a trade or business within the United States.[30]

Conclusion

Financial derivatives continue to remain unregulated, and taxpayers are uncertain of the Federal income tax treatment of entering into a CDS. The Service issued its Notice in 2004, yet it remains unsettled whether there is a withholding tax required by a domestic protection buyer to a foreign protection seller under a CDS agreement. A CDS most closely resembles an NPC or a contingent put option for Federal income tax purposes, both of which require no withholding of tax. However, without further guidance, it remains uncertain as to which existing body of tax law will control the Federal income tax consequences of a CDS. Thus, we should not give definitive conclusions on the withholding tax treatment of a CDS transaction.

[30] Notice 2004-52; IRC § 864(b).