Request for Information About Credit Default Swaps

Notice 2004–52

I. PURPOSE

This notice requests further information regarding certain financial transactions commonly known as credit default swaps in connection with the consideration by Treasury and the IRS of taxpayer requests for specific guidance on the tax treatment of credit default swaps.

II. BACKGROUND

A credit default swap (CDS) generally refers to a contractual arrangement in which one party (the protection buyer) buys from a counterparty (the protection seller) protection against default by a particular obligor (the reference entity) with respect to a particular obligation (the reference obligation). Typically the protection buyer either pays a single lump sum, or it pays periodical regular fees either until a defined credit event occurs or until the maturity of the CDS if no credit event occurs. Following the occurrence of a credit event, the protection seller typically either pays the protection buyer an amount reflecting the reference obligation's loss in value from the date the CDS was established or purchases from the protection buyer at a pre-determined price an obligation (the deliverable obligation) that is expected to approximate the post-credit-event value of the reference obligation. Although certain standard contractual terms and conditions may be used, the reference obligation, the deliverable obligation, the credit events covered, and the protection seller's obligation upon the occurrence of a credit event are all matters of negotiation between the parties.

A large international market for CDSs has developed. Market participants include commercial banks, broker-dealers, insurance companies, hedge funds, and special-purpose securitization vehicles such as synthetic collateralized debt obligations. Commercial banks may buy protection in order to manage credit risk associated with a particular loan and may sell protection in order to acquire synthetic exposure to other loans. Broker-dealers may buy and sell protection in the course of providing market liquidity. Insurance companies may buy and sell protection both in the conduct of their investment activities and in the conduct of their insurance activities. Hedge funds may buy and sell protection in order to manage risk, speculate, or acquire synthetic exposure. Securitization vehicles may sell protection in order to acquire synthetic exposure.

Recent news reports suggest that market participants are considering the creation of CDS indexes through which participants could buy and sell protection on a defined basket of credit exposures on standardized terms.

Several market participants have requested specific guidance regarding the tax treatment of CDSs. Treasury and the IRS recognize the significance of the CDS market and are aware that the market is rapidly evolving. Treasury and the IRS believe that CDSs deserve careful study so that appropriate guidance can be issued.

III. TAXPAYER REQUESTS FOR GUIDANCE

Several taxpayers and industry groups have requested guidance on the tax treatment of CDSs and the taxpayers that enter into them. Among the questions they have raised are:

- whether amounts paid by a U.S. protection buyer to a foreign protection seller constitute income that is subject neither to withholding nor to the insurance-premium excise tax;

- whether a protection seller could be considered to be engaged in a trade or business within the United States by virtue of entering into CDS agreements;

- whether a CDS gives rise to:

  - passive income for purposes of the passive foreign investment company rules;

  - qualifying income for purposes of the publicly traded partnership rules; or

  - unrelated business taxable income; and

- the timing of recognition of income for the protection seller and expense for the protection buyer.

The concerns raised relate particularly, although not exclusively, to the treatment of payments from a protection buyer within the United States to a protection seller outside the United States. In response to these taxpayer requests, Treasury and the IRS are thoroughly analyzing all of the tax issues raised by CDSs and expect to issue guidance.

Submissions generally have argued that the legal rights and obligations under a CDS are sufficiently analogous to those in other types of existing financial transaction that the tax treatment of the analogous transactions should govern the tax treatment of a CDS for all purposes of the Code. See, *e.g.*, *Bank of America v. United States*, 680 F.2d 142, 149–50 (Ct. Cl. 1982) (commissions for bankers' acceptances sourced for foreign tax credit purposes in same manner as interest because predominant feature of acceptance is substitution of credit and because interest is closest analogy in source rules).

Some possible analogies for a CDS include a derivative financial instrument such as a contingent option or notional principal contract, a financial guarantee or standby letter of credit, and an insurance contract. A variety of theories have been advanced in the existing literature both for and against these analogies. Other commentary recommends an alternative to the analogue approach. Following is a brief survey of some of the theories that have been advanced.

A CDS has been analogized to a contingent put option that the option buyer is entitled to settle either for cash value or by physical exercise with respect to the deliverable obligation following the occurrence of a credit event. Option premium generally is not subject to withholding. Trading in such options may not give rise to a "trade or business within the United States" pursuant to the securities-trading safe harbor under section 864(b).

A CDS has been analogized to certain notional principal contracts providing for contingent nonperiodic payments. Some commentators have argued that CDSs with periodic payments, among other features, meet the definition of a notional principal contract; however, commentators disagree about the scope of CDSs that may fall within the definition of notional principal contract. Payments with respect to a notional principal contract generally are not subject to withholding. Trading in such notional principal contracts may not give rise to a trade or business within the United States. Special timing rules may apply to notional principal contracts.

A CDS has been analogized to a guarantee. Guarantee fees have been analogized to commissions for letters of credit, which are sourced in the same manner as interest. See *Centel Communications Co. v. Commissioner*, 920 F.2d 1335, 1343–1344 (7th Cir. 1990) (citing *Bank of America*). In addition, guaranteeing obligations and issuing standby letters of credit from within the United States could constitute engaging in a trade or business within the United States. Some commentators have distinguished CDSs from guarantees on the basis that a credit event under a CDS requires performance by the protection seller without regard to whether the protection buyer sustains an actual loss. A relevant factor in this regard may be how much of the CDS protection-buying market consists of persons who do not have or expect to be exposed to credit risk.

A CDS has been analogized to a form of insurance. Insurance premiums paid to a foreign person with respect to a U.S. risk are subject to excise tax. Moreover, insuring risks from within the United States could constitute engaging in a trade or business within the United States. Some commentators have distinguished CDSs from insurance on the basis, as described above, that no actual loss need be sustained in order to give rise to an obligation under a CDS. Some commentators have noted the Supreme Court's opinion in *Helvering v. LeGierse*, 312 U.S. 531 (1941), that the essence of insurance activity is the shifting and distribution of insurance risk. These commentators have suggested that many protection sellers do not shift or distribute risk with respect to CDSs in this way, and that it is not clear how a protection buyer could know how its counterparty manages risk with respect to a particular CDS.

Some commentators have suggested consideration of an approach to determine the tax treatment of CDSs other than classification by analogy to other types of financial transaction. Instead, they have proposed that the tax treatment of payments with respect to a CDS could be determined by analyzing various elements of the CDS transaction, including the nature of the reference obligation and whether a party to the CDS provides financial services to customers.

IV. REQUEST FOR COMMENTS

The foregoing brief overview indicates that the economic similarity of a CDS to various financial transactions tends to blur the distinctions between possible analogies and that the various analogies correspond to significantly different tax treatment.

Treasury and the IRS believe that additional information is needed in order to respond to taxpayer requests for specific guidance regarding the appropriate tax treatment of amounts paid and received with respect to a CDS. Treasury and the IRS are particularly interested in information regarding:

- CDS contractual terms, both standard and negotiated, particularly with respect to credit events, subrogation rights, security interests in collateral, and collateralization requirements in general;
- CDS pricing, particularly with respect to guarantees, contingent options, and insurance;
- operation of the CDS market, particularly with respect to price quotation and dissemination;
- market practice regarding hedging, the management of basis risk, and the timing of CDS transactions relative to the assumption and disposition of analogous risks; and
- the regulatory capital, GAAP, and internal booking treatment of CDSs by various market participants.

Treasury and the IRS also welcome any other information that market participants believe may be relevant.

V. SUBMISSION OF COMMENTS

Taxpayers may submit written comments to: CC:PA:LPD:PR (Notice 2004–52), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (Notice 2004–52), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments electronically via the following e-mail address: *Notice.Comments@irscounsel.treas.gov*. Please include: Notice 2004–52 in the subject line of any electronic communications.

DRAFTING INFORMATION

The principal authors of this notice are Paul Epstein, Theodore Setzer, and Steven Jensen of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Mr. Epstein, Mr. Setzer, or Mr. Jensen at (202) 622–3870 (not a toll-free call).