

*Notice 2004-52-Internal Revenue
Service Request for Information
about Credit Default Swaps
Advisory 2004-07*

November 2, 2004

***Summary of the Internal Revenue Service Request for Information about
Credit Default Swaps***

Overview

In general, a credit default swap (a "CDS") is a derivative contract whereby one party buys credit protection from a counterparty (the "Protection Buyer" and the "Protection Seller," respectively) on a debt security, or loan of an obligor (the "Reference Obligation" and the "Reference Obligor," respectively).

The Protection Buyer makes a single payment or makes multiple periodic payments (collectively "Premiums") in exchange for the Protection Seller's obligation, upon the occurrence of one or more defined credit events (each, a "Credit Event"), to either:

- (a) pay the loss or diminution in value of the Reference Obligation resulting from a defined or specified credit event, or
- (b) purchase the Reference Obligation at a predetermined price.

Credit events in CDSs typically include:

- (a) rating downgrade or bankruptcy of the Reference Obligor,
- (b) technical or payment defaults on the Reference Obligation, and
- (c) other events that may affect the credit of the Reference Obligor or Obligation.

A CDS may relate to a single Reference Obligation or to pools of Reference Obligations. CDSs often are used to structure synthetic securitizations, such as synthetic collateralized debt obligations (CDO) or collateralized loan obligations (CLO) whereby an offshore entity is

funded by issuing debt and equity securities. The issuer then uses the proceeds from the issued securities as collateral to enter into a CDS with a Protection Buyer.

Although synthetic CDOs and CLOs are common transactions, there has always been uncertainty as to the tax treatment of CDSs. The tax uncertainty has been especially true with respect to whether Premiums paid by a *domestic* Protection Buyer to the offshore Protection Seller (the synthetic CDO/CLO issuer) are subject to U.S. withholding taxes.

Many practitioners and commentators have taken the position that properly structured CDSs should be treated as notional principal contracts for tax purposes (“NPCs”). Typically, if a contract is characterized as a notional principal contract, no U.S. withholding taxes are imposed on the Premiums paid to an offshore Protection Seller since the Premiums would be “sourced” offshore under Treasury Regulation Section 1.863-7.

Other areas of tax uncertainty have been:

- (a) Whether CDS Premiums are subject to insurance excise taxes;
- (b) Whether an offshore Protection Seller is deemed to be engaged in a U.S. trade or business and subject to U.S. taxation; and
- (d) Whether, the timing of the accrual of payments on CDSs is governed by the NPC, option, guarantee or insurance rules.

The tax uncertainty has led many taxpayers to request that the Internal Revenue Service (the “IRS”) issue specific guidance regarding the tax treatment of CDSs. In response to the requests, the IRS issued Notice 2004-52 on July 19, 2004, requesting information about the structuring and pricing of CDSs.

The IRS indicates that CDSs have economic similarities to various financial transactions such as options, swaps, guarantees, and insurance. The notice further provides that the IRS believes it needs additional information from market participants before it can provide meaningful guidance.

SFG Observation: *Tax practitioners and market participants generally have had a positive reaction to the IRS’s approach of gathering information before issuing guidance since this approach should lessen the likelihood of unintended consequences.*

The IRS Request

The IRS acknowledges that the taxpayer requests typically have provided that CDSs are “sufficiently analogous” to existing financial transactions that already have clear governing tax rules such as:

- Cash or physically settled put options (Premiums generally are not subject to withholding);
- NPCs with contingent payments (Premiums generally are not subject to withholding);
- Guaranties (Premiums generally could be subject to withholding or the activity of issuing guaranties potentially could subject the Protection Seller to U.S. trade or business taxation concerns); and

- Insurance contracts (Premiums generally could be subject to excise taxes or the activity of issuing insurance potentially could subject the Protection Seller to US trade or business taxation concerns).

SFG Observation: *Most of the submissions to the IRS probably indicate that CDSs are structured so that their economics are significantly distinguishable from guarantees and insurance.*

The IRS also indicates in the Notice that other submissions have proposed that the tax treatment should not be determined by analogy to other types of financial transaction, but rather each element of a CDS transaction should be analyzed and characterized based on its individual characteristics.

SFG Observation: *Presumably, this would require characterizing each component of a CDS by looking through to the Reference Obligation and analysing the activities of the parties to the CDS. It is not clear whether the IRS prefers this method or the characterization by analogy method.*

Additional Information

The Notice indicates that the IRS is particularly interested in receiving information from market participants on the following subjects:

- CDS contractual terms including credit events, subrogation, security interests, collateralization and general requirements;
- CDS pricing, particularly with respect to guarantees, contingent options, and insurance;
- CDS market operations such as price quotation and dissemination;
- hedging market practices and basis risk management;
- the timing of CDS transactions relative to the assumption and disposition of analogous risks; and
- the regulatory capital, GAAP, and internal treatment of CDSs by market participants.

SFG Observation: *The requested information appears to indicate that the IRS is interested in the various ways CDSs are structured, operated and priced to determine if they are economically distinguishable from or analogous to:*

- (a) insurance or guaranty arrangements,
- (b) NPCs (swaps), or
- (c) put options.

Discussions with the IRS after the Notice has been issued have revealed that the IRS would welcome all market information regarding CDSs, even items not specifically enumerated in the Notice, such as whether CDSs are structured so that a party can terminate the contract without making a termination payment.

Next Steps

The notice is a positive step for the IRS to provide guidance on the treatment of CDS. In a September 13, 2004 interview with Tax Analysts, IRS Deputy Chief Counsel (Technical)

Nicholas J DeNovio indicated that the IRS has received a “great deal of information” on the issue but that they would also like to receive information from all of the different market participants.

Similarly, at a September 23, 2004 meeting of the Washington D.C. Bar’s Financial Product Committee, Dale Collinson, IRS special counsel (financial institutions and products), indicated that the IRS has received few comments on the issue from the insurance industry.

Interested parties should consider submitting information to the IRS to facilitate their review and analysis as well make sure the IRS fully understands their concerns and issues.

Questions

Please contact Trent Johnson at (202) 414-1484, Frank Serravalli at (646) 471-2669, or Debbie Rappoport-Bigman at (646) 471-2876, for more information concerning CDSs or other structured finance strategies.

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