Authorities learn from market on taxation of credit default swaps

By Eva Farkas-DiNardo, Alston & Bird

A credit default swap can take on one of several forms. A typical single name CDS is a contract for the transfer of credit risk with respect to the debt obligations of a single issuer, usually written for a five-year term. A single name CDS is generally documented on standard documentation developed by the International Swaps and Derivatives Association (ISDA) for derivatives transactions. An index CDS is another, relatively recent type of CDS on a standardized index of entities that usually include large names in given segments of the market so as to guarantee some diversity. The contract term is normally five years. Ten-year single name or ten-year index CDS products are also gaining in popularity.

A CDS can take other forms or variations, such as a collateralized debt obligation (CDO), a single tranche CDS, CDS on high yield bonds, CDS options, and others. The markets for these various types of CDS product largely overlap, although certain types may be preferred by certain market participants based on a variety of factors. For example, some investors may enter into CDS agreements as Protection Buyers to hedge their credit risk with respect to a Reference Obligation, while dealers may enter into CDS agreements as Protection Sellers to increase their return.

A growing international market for CDS products

The international market for CDS products has been growing rapidly during the last decade. Current market participants include commercial banks, insurance companies, brokers and securities dealers, hedge funds and special purpose securitization vehicles. The growth of the CDS market led market participants to pose questions with respect to the US federal taxation of CDS products and of market participants entering into CDSs. From the mid-1990s, commentators generally began to express the view that CDS products should be treated as notional principal contracts or options for US federal tax purposes. However, as certain features of CDS products resemble guarantees or insurance, the US federal tax treatment of which is markedly different from the US federal tax treatment of notional principal contract and options, the proper characterization and tax treatment of CDS products remained, and still remains, unclear. The uncertainty resulted in taxpayers and industry groups requesting guidance from the Internal Revenue Service (IRS), including:

- whether an amount paid by a US Protection Buyer to a foreign Protection Seller is income subject to US withholding tax;
- whether a foreign Protection Seller could be deemed to be engaged in a US trade or business by virtue of entering into CDS agreements;
- what types of income CDS products may give rise to under various US tax regimes; and
- what is the timing of recognition of income for a Protection Seller and of deduction for a Protection Buyer.

IRS request for information

Recognizing the need for guidance in light of the growing CDS market and increasing number of requests for guidance from market participants, the IRS issued Notice 2004-52 (Allocation of income and deductions – trade or business within US – credit default swaps) seeking public comment on the US tax treatment of CDS products, in particular those involving one non-US participant, in anticipation of issuing guidance. The IRS specifically requested information with respect to:

- CDS contractual terms (in particular with respect to credit events, subrogation rights and certain other terms);
- CDS pricing (in particular with respect to guarantees, options, and insurance);
- operation of the CDS market;
- Market practice (in particular with respect to hedging, timing of transactions and other factors); and
- Regulatory capital, GAAP and internal booking treatment of CDS products by market participants.

The IRS plans to use taxpayer and market participant submissions in considering and evaluating the issues on which taxpayers requested guidance.

What is a credit default swap?

A credit default swap (CDS) is a type of credit derivative, constituting the largest component of the credit derivatives market. A CDS is a contractual agreement for the transfer of credit risk with respect to a debt instrument. The transferor of the credit risk (Protection Buyer) buys from the transferee of the credit risk (Protection Seller) the right to a payment in the event of default (Credit Event) by a certain obligor (Reference Entity) with respect to a certain obligation (Reference Obligation). The Protection Buyer generally pays the Protection Seller a single lump sum amount or makes periodic payments until the Credit Event occurs or the CDS matures. In return for such payments, following the occurrence of the Credit Event, the Protection Seller either (1) pays the Protection Buyer an amount representing the difference between the value of the CDS at the time it is established and its value at the time the Credit Event occurs (Cash Settlement) or (2) buys from the Protection Buyer an obligation of the Reference Entity for its face value (Physical Settlement), the value of which is about the same as the value of the Reference Obligation following the Credit Event. The Protection Buyer is not required to own or suffer a loss on the Reference Obligation at the time the Credit Event occurs.

Most commentators believe that CDS products could be classified as notional principal contracts, guarantees, put options, or insurance, but for various reasons, including tax policy reasons, commentators and market participants are generally of the opinion that CDS products should perhaps be classified as notional principal contracts.

Market participants and industry groups respond to IRS request

In response to the IRS's request for information, various market participants and industry groups submitted their comments and recommendations to the IRS. The submissions generally provided information on the issues addressed by the government in the request, but many of the groups also presented their analyses and recommendations with respect to the US federal tax treatment of CDS products.

CDS contractual terms

In general, the key contractual terms in CDS agreements include:

- Credit events: in addition to the standard ISDA credit events such as bankruptcy failure to pay, and Obligation Default, a CDS credit event may include restructuring
- Restructuring: ISDA definitions provide definitions for restructuring, including the reduction or deferral of payments resulting from the weakened financial situation of the company
- Settlement: the CDS agreement may provide for Cash Settlement or Physical Settlement
- Conditions for payment: the general conditions for payment include a Credit Event Notice, Notice of Publicly Available Information (in the case of Cash Settlement), and Notice of Intended Physical Settlement (in the case of Physical Settlement)
- Subrogation rights: CDS products generally do not contain subrogation rights, although in CDSs with Physical Settlement the Protection Seller has the same rights as the holder of the Reference Obligation
- Valuation: valuation procedures for CDS products with Cash Settlement are often subject to negotiations as the occurrence of a Credit Event will usually negatively effect the price of the obligation

CDS pricing

The pricing methods for CDS products have been examined in the past by various rating agencies and market participants. These studies generally show that CDS pricing models are mathematical and take factors into account such as the likelihood of default and the expected rate of recovery. Other factors affecting pricing include accounting differences in treatment, liquidity, and the maturity of the contract.

CDS prices are generally disseminated by intermediaries electronically (via their website). Alternatively, prices can be obtained by calling dealers and traders.

CDS market practice and participation

The largest participants in the CDS market are banks and insurance companies. Banks are often Protection Buyers, shifting credit risk for commercial and regulatory reasons. However, banks often sell protection so as to diversify their portfolios, although this trend is more applicable to small, regional banks.

Insurance companies generally serve as the Protection Sellers, but studies indicate that market participation varies by type of insurance. For example, for life insurance companies CDO activity tends to be the key credit derivatives activity and such CDOs are viewed as fixed income assets. On the other hand, certain property and casualty insurance companies are no longer active as Protection Sellers.

Reports indicate that hedge funds are very active in the CDS market as well, potentially representing as much as one-third of the credit derivatives market. Hedge funds normally use CDS products to take a synthetic long or short position with respect to a Reference Obligation with the goal of maximizing overall returns. On the other hand, securities dealers usually act as intermediaries in the CDS market.

Regulatory capital, GAAP, and internal accounting treatment of CDS products

The GAAP treatment of a CDS depends on whether the CDS satisfies the definition of a derivative under Financial Accounting Standards No 133 or, in the alternative, whether it is can be deemed a financial guaranty contract. If a CDS is considered a derivative financial instrument, both the Protection Buyer and the Protection Seller mark-to-market the CDS contract on the income statement. If the CDS is not deemed a derivative financial instrument, the Protection Seller is generally required to record the CDS at fair market value under FASB Interpretation No 45. Subsequent accounting treatment depends on the accounting policy of the Protection Seller. For statutory accounting purposes, CDS products are generally characterized as derivatives.

Market participants and industry groups provide recommendations and analysis regarding US federal tax treatment of CDS products

Various groups and participants submitted not only the information requested by the IRS, but also provided their recommendations and analyses for the US federal tax treatment of CDS products, responding to the concerns previously raised by market participants and taxpayers, as such concerns were reflected in the IRS notice. Submissions generally addressed the proper classification of CDS products, US withholding tax issues, the timing of income and deductions, and the character of gain and loss, as well as the recommended US federal tax treatment of CDS products. The market participants and commentators discussed in their submissions the classification of CDS products in relation to other existing financial arrangements such as notional principal contracts, guarantees, options and insurance, as follows.

Classification of CDS products

CDS products v notional principal contracts

CDS products are sufficiently similar to notional principal contracts and the adaptation of the rules applicable to notional principal contracts would be practicable and preferable to the development of a new set of federal tax rules. A typical CDS product meets the definition of a notional principal contract, as set forth in Treasury Regulations section 1.446-3(c), which provides that a notional principal contract is 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. The similarities with CDS products are apparent in that in the case of certain CDS products the Protection Buyer pays the Protection Seller a certain amount at specified intervals, the amount payable is calculated by reference to a specified index and the amount is paid upon a notional amount. In addition, the Protection Seller promises to pay the Protection Buyer an amount, calculated by reference to the Reference Obligation.

However, there are certain differences between the two products. First, in the case of CDS products with Cash Settlement, there are no payments at specified intervals. Second, the Protection Seller makes only one payment, following the occurrence of a credit event.

CDS products v guarantees

Typical CDS products can be viewed as the Protection Buyer purchasing, for an amount of guarantee fees, a guarantee from the Protection Seller in exchange for the Protection Seller's payment to the Protection Buyer in case of default. However, to receive payment under a guarantee, the purchaser of a guarantee actually has to own the property with respect to

Biography

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which the guarantee is purchased, which is not a requirement for CDS products. In addition, guarantees are not traded in the open market and are generally issued at the time of the issuance of a debt obligation for the entire term and principal amount of the debt obligation. The terms of guarantees are also not standardized and are generally subject to negotiation by the parties.

CDS products v put options

Similarly, while both CDS products and put options protect the Protection Buyer against a decline in the value of a particular property over a given time period, in exchange for an amount of consideration, put options differ in that they are exercisable when the value of the property declines by any amount and for any reason.

CDS products v insurance

Although CDS products can also be viewed as resembling insurance, with the Protection Buyer purchasing insurance from the Protection Seller against loss of value of a given property, the analogy is weak as the purchaser of insurance must own the property insured, whereas in the case of CDS products, the Protection Buyer need not own the Reference Obligation. In addition, the markets are dissimilar in that insurance is issued by licensed insurance providers and the terms of insurance may be subject to negotiation.

US withholding tax on payments to non-US parties

Market participants are generally of the opinion that payments made to non-US payees in a CDS transaction should not be subject to US withholding tax. Payments to non-US payees can be subject to US withholding tax under sections 1441 or 1442 of the Internal Revenue Code (Code) if the payment is (i) a fixed or determinable annual or periodical amount (FDAP), (ii) from US sources, or (iii) not effectively connected with a US trade or business (in which case it would be subject to regular tax rates under the Code). If a certain payment meets these requirements and is subject to withholding, a withholding tax of 30% will be imposed, subject to reduction by a treaty. A payment by a US payor to a non-US payee in a CDS transaction can be viewed as a FDAP payment if there are multiple payments or even if there is only one payment (Treas. Reg. Section 1.1441-2(b)(1)(ii)). Although the Code and the regulations do not provide for an exception for CDS products, there is an exception for notional principal contracts, if the non-US payee is not engaged in a US trade or business. Thus, by analogy, this rule could be adopted for CDS products as well, assuming that CDS products are classified or treated as notional principal contracts.

Commentators suggest that imposing a withholding tax on CDS products would be detrimental to the CDS market. There are numerous non-U.S. participants and U.S. parties make significant payments to those non-U.S. payees. If a withholding tax were imposed, the non-U.S. parties would be likely to meet their CDS needs in another market where no withholding tax is imposed at present (e.g., London), leaving U.S. participants with less opportunities and in fact leaving the U.S. market less competitive.

Treatment of non-US party to CDS transaction as engaged in a US trade or business

Commentators also generally agree that the treatment of a non-US party to a CDS transaction as engaged in a US trade or business would be detrimental to the continued development of the CDS market in the US. If a non-US person conducts business activities in the US, the income effectively connected with the conduct of that US trade or business will generally be subject to US income tax at graduated rates. The Code provides for certain exceptions, but the exceptions are generally limited to business activities that consist of trading in securities or commodities through an independent agent in the US (if the non-US person does not have an office in the US through which the securities or commodities transactions are conducted) and business activities that consist of the non-US person's trading for its own account (if the non-US person is not a dealer in securities or commodities). These exceptions are available so as to encourage foreign, passive investment in the US markets.

These exceptions could be applied to non-US persons engaged in CDS transactions as CDS products are analogous to other financial products, that is, notional principal contracts. In addition, the driving force behind making such exception available to non-US participants would be the same as the one that led the government to enact the exceptions for foreign passive investments in securities or commodities.

Timing rules with respect to income and deductions

The IRS and the Treasury Department issued proposed regulations (REG 166012-02, 69 FR 8886 (February 24 2005)) with respect to the timing and character of income from notional principal contracts. The proposed regulations generally abandon the "wait-and-see" approach taxpayers and market participants largely adopted before the issuance of the proposed regulations and instead provide that non-periodic payments should be allocated over the term of a notional principal contract so that the true economic substance of the transaction is properly reflected. The proposed regulations allow either mark-to-market accounting or the swap regime to implement this principle.

The regulations do not address the applicability of these rules to CDS products and it is not clear whether these rules could be applicable to CDS products. Some commentators encourage the application of the previous "wait-and-see" approach for CDS transactions so that, generally speaking, payments are deductible when made and are not spread out over the term of the product. If such "wait-and-see" treatment is not deemed proper or practicable by the government, other commentators propose that the CDS products be eligible for the mark-to-market accounting option provided in the proposed regulations, allowing for accounting treatment similar to notional principal contracts. Another suggestion is the application of the timing rules applicable to notional principal contracts, with certain modification.

Help for tax authorities

The information and analysis submitted by the various commentators and market participants should be sufficiently helpful in assisting the Treasury Department and the IRS to further analyze the treatment of CDS products and provide guidance to taxpayers and market participants. The IRS issued Notice 2004-52 during the summer of 2004 and commentators have been submitting their letters and analyses for the last year. The issues presented clearly require the attention of the IRS and the Treasury Department and underscore the need for guidance. In the meantime, we eagerly look forward to receiving that guidance. Although it is not known what the guidance will look like, to keep the U.S. market competitive, CDS products should be treated similar to notional principal contracts, no US withholding tax on payments to foreign participants should be imposed and that a safe harbour similar to that applicable to notional principal contracts should also apply to CDS products so that a foreign party is not deemed engaged in a US trade or business solely by reason of engaging in a CDS transaction.