new york state society of
NYSSCPA
certified public accountants

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November 7, 2005

CC:ITA:RU (Notice 2004-52)
Room 5226
Internal Revenue Service
POB 7604
Ben Franklin Station
Washington, D.C. 20044

By e-mail: Comments@irscounsel.treas.gov

Re: Statement on Credit Default Swaps Provided in Response to IRS Notice 2004-52

To Whom it May Concern:

The New York State Society of Certified Public Accountants, the oldest state accounting association, represents approximately 30,000 CPAs that will implement the provisions of any guidance ultimately issued by the Treasury Department and the Internal Revenue Service ("IRS") with regard to the tax treatment of credit default swaps. The NYSSCPA thanks the Treasury Department and the IRS for the opportunity to comment on and provide information with respect to Notice 2004-52.

The NYSSCPA Taxation of Financial Instruments and Transactions and the Investment Management Committees deliberated Notice 2004-52 and prepared the attached comments. If you would like additional discussion with each of the committees, please contact Steven Kaplan, chair of the Taxation of Financial Instruments and Transactions Committee at (212) 284-1733, Leon Metzger, chair of the Investment Management Committee at (203) 861-3232, Peter Connors, member of the Taxation of Financial Instruments and Transactions Committee at (212) 506-5120 or Ernest J. Markezin, NYSSCPA staff at (212) 719-8303.

Sincerely,

President

Attachment

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1-3160 PC7/PC7

NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

TAXATION OF FINANCIAL INSTRUMENTS AND TRANSACTIONS

AND INVESTMENT MANAGEMENT COMMITTEES

STATEMENT ON CREDIT DEFAULTS SWAPS

PROVIDED IN RESPONSE TO IRS NOTICE 2004-52

NOVEMBER 7, 2005

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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

This report responds to the request for certain information regarding credit default swaps ("CDS," in the singular form) made in Notice 2004-52, 2004-32 I.R.B. 168 (7/19/2004) (the "Notice"). Specifically, the Notice requests information regarding the following (as well as any other information that market participants believe may be relevant):

1. CDS contractual terms, both standard and negotiated, particularly with respect to credit events, subrogation rights, security interests in collateral, and collateralization requirements in general;

2. CDS pricing, particularly with respect to guarantees, contingent options, and insurance;

3. operation of the CDS market, particularly with respect to price quotation and dissemination;

4. 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

5. the regulatory capital, GAAP, and internal booking treatment of CDSs by various market participants.

In addition, this report discusses certain U.S. federal income tax issues with respect to CDSs.

The Taxation of Financial Instruments and Transactions Committee of the New York State Society of Certified Public Accountants consists of approximately 50 members while the Investment Management Committee has approximately 40 members. Members work for public accounting firms and private industry, including banks, insurance companies, and investment funds.

Part A of this report responds to the request for specific information made in the Notice. Part B of this report discusses selected tax issues about CDSs raised in the Notice.

DISCUSSION

A. Response to Specific Information Request Made in Notice 2004-52.

1. CDS Contractual Terms.

a. Overview. Under a typical CDS, (a) a protection buyer agrees to pay a protection seller[1] either (1) a periodic amount that is a fixed number (or less frequently, a variable number) of basis points applied to a notional principal amount over the term of the CDS or (2) less frequently, an upfront premium, and (b) the protection seller agrees to pay the protection buyer the difference between the par value of the reference security of the same notional amount if a "reference entity" (typically, the issuer or guarantor of the reference security)[2] is subject to a "credit event." In certain situations, a CDS may provide for physical settlement where the protection seller may require the protection buyer to deliver the "deliverable obligation" to the protection seller in exchange for the par amount. A "credit event" occurs when a reference entity fails to pay, defaults, files for bankruptcy, or possibly restructures its debt (see subsection d.).

b. Use of ISDA Documentation. In our experience, the vast majority of CDS trades are made pursuant to standardized documentation for derivatives transactions, developed by the International Swaps and Derivatives Association, Inc. ("ISDA"), generally referred to as the ISDA Master Agreement.[3] The industry-wide adoption of standardized terms has been a key factor in the development and growth of the CDS market. Moreover, trades settle on the basis of market convention and there is rarely much negotiating to vary market-standard terms.

The ISDA Master Agreement may be supplemented by a series of schedules and definitions. Included in these definitions could be the 2003 ISDA Credit Derivatives Definitions (the "2003 Definitions"), which revised credit derivatives definitions first published in 1999. The 2003 Definitions have become the standard benchmark for the documentation of privately negotiated CDS transactions governed by the ISDA Master Agreement. Among other things, the 2003 Definitions provide a number of options for the definition of "Restructuring" (see subsection d.), a mechanism for contract transfers, revisions relating to Successor and several credit events and provisions relating to

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[1] A buyer pursuant to a CDS is said to be buying protection and a seller is said to be selling protection. Buying protection has a similar credit risk profile to that of selling a bond short and is essentially "short" credit risk. Alternatively, selling protection has a similar credit risk profile to that of owning a bond or loan and essentially is "long" credit risk.

[2] A CDS may reference a single entity or a portfolio of reference entities. In a portfolio CDS, the protection seller is exposed to the credit risk of more than one reference entity included in the portfolio to the extent of the notional value of the CDS. The top five most-frequently cited reference entities (both bought and sold) in a recent survey by Fitch Ratings were Ford, GM, France Telecom, Daimler Chrysler AG, and Deutsch Telekom AG. *See* Fitch Ratings Special Report, "Global Credit Derivatives Survey" (Sept 2004).

[3] Unless otherwise defined, capitalized terms appearing in the remainder of this report have the meanings assigned to such terms in the ISDA Master Agreement or in the 2003 Definitions (promulgated by ISDA).

guarantees, Sovereign CDSs, novation of CDS transactions, and alternative procedures if the Bond or Loan specified in the Notice of Physical Settlement is not delivered.

For most trades, market participants use the ISDA documentation and an associated confirmation of trade (a "confirm") because the framework for credit issues between the two counterparties generally has been resolved to the extent the parties previously have negotiated an ISDA Master Agreement.

c. Negotiated Terms. CDS terms include:

(a) Term of Agreement;

(b) Notional Amount;

(c) Fixed Payment;

(d) Floating Payment; and

(e) Settlement Terms.

d. Credit Events. Typical Credit Events that permit cash or physical settlement may include:

(a) Bankruptcy;

(b) Obligation Acceleration;

(c) Obligation Default;

(d) Failure to Pay;

(e) Obligation Repudiation; and

(f) Restructuring.

The one credit event that has been the subject of controversy, however, is Restructuring. Although there has been a great deal of standardization in the past couple of years as to what the market convention is, the CDS, depending in which region it is located, can trade with different Restructuring terms. In the 2003 Definitions, ISDA provides several options for determining whether a Restructuring has occurred and/or for different settlement terms upon a Restructuring from those applicable to other credit events.

e. Settlement Terms. The CDS will specify cash or physical settlement. Upon a credit event, if the CDS specifies physical settlement, the protection seller pays the buyer par for the specific reference security. If the CDS specifies cash settlement, the protection seller typically pays the buyer the difference between (1) par and (2) the final value to which the reference security or obligation has fallen. Such value is measured by a dealer poll at a particular point in time after the credit event.

Alternatively, this value can be defined as the difference between par and a pre-determined assumed recovery rate (generally a percentage of the notional principal amount) instead of the actual decline in value.

f. Conditions for Payment. The CDS will prescribe certain conditions for payment. These include:

(a) Credit Event Notice;

(b) Notice of Publicly Available Information for cash-settled CDSs; and

(c) Notice of Intended Physical Settlement for CDSs that provide both cash and physical settlement options.

g. Valuation Procedures. The valuation procedures for a cash-settled CDS can be subject to some negotiation. One area of concern relates to the impact on valuation following a credit event and the fact that, in the immediate aftermath of a Credit Event, prices for a reference obligation could be unusually low.

Rating agencies generally rate synthetic collateralized debt obligation ("**CDO**") transactions, and they have a particular interest in the valuation procedures that apply to the CDS component of the CDO transaction. CDOs are debt instruments issued by special purpose entities that are backed by a group of assets, which are often loans. A typical synthetic CDO transaction combines a debt instrument with a CDS through a trust vehicle. The effect is to create a debt instrument, the pay-off on which replicates another debt instrument. A typical synthetic CDO involves an entity (e.g., a special purpose vehicle or single member LLC) raising capital through the issuance of a debt instrument and investing the proceeds in a high-quality investment with little to no default risk. The investors are then exposed to credit risk by having the entity sell credit protection on a specific entity or referenced portfolio. Rating agencies generally prefer that the calculation agent wait some minimum number of days after the Credit Event (typically 45-60 days) before valuing the reference obligation so that the valuation can be made under stable market conditions.

In the case of a cash-settled CDS, the protection seller will often require the protection buyer to give the seller a right to buy the reference obligation at the winning-bid level determined through the aforementioned auction process in order to protect the seller from low bids and to give the seller a right to realize any value that it believes the reference obligation might have above the bid price.

h. Subrogation Rights. A typical CDS does not provide for subrogation rights, except for physical settlement CDSs where the protection seller has the same rights as a holder of the reference obligation.

i. Security Arrangements. Provisions relating to security arrangements, such as security interests, collateralization requirements, and guarantees, generally are negotiated for in an umbrella ISDA Master Agreement (typically in a

related Credit Support Annex) rather than for a specific CDS transaction. However, there are instances where the amount of the collateral will vary.

2. CDS Pricing.

CDS pricing involves sophisticated quantitative analysis that incorporates numerous variables and assumptions. Each market participant, using its own proprietary software and credit-risk modeling techniques, could arrive at a different quote. Market participants, however, appear to apply the same general formula.

a. Basic Inputs. As discussed in Part A.1.a., a CDS provides for two payment components: (1) the protection buyer makes fixed periodic payments or an upfront payment and (2) the protection seller makes a contingent payment only after a credit event occurs. On the CDS commencement date, its value to each party should be zero. Thus, the contingent payment component less the fixed payment component should equal zero. The CDS premium (also referred to as the "spread" or "fixed rate") that makes this equation equal to zero results in a theoretical CDS price.

The process of solving for the CDS price such that the contingent payment component less the fixed payment component equals zero relies extensively upon one's credit-risk model. The following inputs are required to determine the value of each leg:

- the probability of default (determined by credit rating);
- recovery rates (typically assumed to be constant); and
- choice of a "risk-free" rate.[4]
- credit quality of the reference entity and protection seller;
- correlation between the reference entity and protection seller;
- maturity of the contract.[5]

b. Theoretical Models. By integrating each of the inputs discussed in subsection a. above, two major theoretical credit-risk models have developed:

- **Structural form models**: pioneered by Merton (1974) and Black and Scholes (1993). The basis for these models is that a firm defaults when the value of the firm's assets falls below a specific level.[6] These models assume that by

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[4] Nomura Fixed Income Research New York, *Credit Default Swap (CDS) Primer* (May 2004), available at http://www.securitization.net/pdf/content/Nomura_CDS_Primer_12May04.pdf.

[5] Janet Tavakoli, Credit Derivatives & Synthetic Structures 127 (John Wiley & Sons, Inc. 2001).

[6] Patrick Houweling & Ton Vorst, Pricing Default Swaps: Empirical Evidence 6-7 (Nov. 2003) (Erasmus University Rotterdam); Haibin Zhu, *An Empirical Comparison of Credit Spreads Between the Bond Market and the Credit Default Swap Market 3* (August 2004) (Bank for International Settlements).

analyzing specific financial data about a particular entity, one can infer a predictable default time.[7] These models make use of the Black-Scholes-Merton ("BSM") option-pricing model, assuming that the firm has an option to default on its obligations and will exercise it when its asset value falls below its liabilities.[8]

- **Reduced-form models**: (or intensity-based models) initially developed by Jarrow and Turnbull (1992) and subsequently examined by Duffie and Singleton (1999) and Hull and White (2000). The basis for these models is that a firm's default is an unpredictable event governed by default intensity and hazard rate and, thus, is independent of a firm's value and capital structure. Reduced-form models are based on market information and observations such that they do not depend on entity-specific data.[9]

Jarrow argues that the key difference between the structural and reduced-form models is simply the information assumed to be known by the modeler.[10] As the assumed information changes, each model can be transformed into the other.[11] Because the reduced-form models assume information similar to those observed by the market, reduced-form models generally are preferred by market makers and dealers for pricing and hedging credit risk.[12]

c. Discounted-Spread Alternative. At any time after commencement, one can value a CDS using either of the two theoretical frameworks discussed in subsection b. above, or, alternatively, a "discounted-spread approach." Under either theoretical framework, a market participant uses its own proprietary credit-risk modeling techniques to determine the intrinsic value of a CDS (i.e., what it believes the CDS value to be) and compares it to current market prices. In contrast, the discounted-spread approach compares the contract price of a CDS to the current market price of a similar CDS. One computes the difference between the spreads and calculates the present value. This approach easily allows one to mark-to-market a CDS contract and determine the relevant gain or loss.

Electronic Pricing Information. Bloomberg provides three models which are available to its subscribers:

- discounted spread

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7 Robert A. Jarrow & Philip Protter, *Structural Versus Reduced Form Models: A New Information Based Perspective*, J. of Inv. Mgm't, Second Quarter 2004, at 1-10.

8 Jeffrey R. Bohn, *A Survey of Contingent-Claims Approaches to Risky Debt Valuation*, The J. of Risk Finance, Spring 2000, at 53-70.

9 Fan Yu, Default Correlation in Reduced-Form Models, 1-2 (April 2005) (University of California, Irvine); *see* Houweling & Vorst, *supra* note 22, at 6; *see also* Zhu, *supra* note 22 at 3; *see also id.*

10 Jarrow & Protter, *supra* note 22, at 2.

11 Bohn, *supra* note 22, at 55.

12 *See* Jarrow & Protter, *supra* note 22, at 5.

- J.P. Morgan model
- modified Hull-White model.

Many market participants use one of the Bloomberg models to provide indicative pricing.

d. Comparison to NPC Pricing. CDSs have often been compared to contingent put options, financial guarantees, notional principal contracts, and insurance.[13] With regard to pricing, however, CDSs are most similar to notional principal contracts ("**NPC**," in singular form). Like CDS pricing, one generally values an NPC by subtracting the variable component from the fixed one. In contrast, one values options using the BSM (or other) option-pricing model, which incorporates the strike price, current underlying price, time to expiration, implied underlying asset volatility, and risk-free rate. CDS pricing also differs significantly from insurance contract pricing, which uses actuarial tables to determine price.

e. Comparison to Pricing Guarantee Contracts.

A guarantee is a contract to assume an economic liability if the guaranteed party should default on its obligations. Thus, a guarantee typically enables the guaranteed party to borrow a larger amount and/or at lower interest rates from a third party lender than it would have been able to on a stand-alone basis.

While there is little academic data on the pricing of guarantee contracts, it is our understanding that the starting point in pricing a guarantee is generally the respective company's credit rating. In addition, Basel II plays a role because banks need to allocate capital for the risk of the contract.[14] Banks will then take these two factors into account and charge a spread that will enable them to earn a reasonable profit. However, the size of the transaction, and the customer relationship, may be a factor in arriving at the final pricing.

Companies that enter into guarantee contracts with affiliates need to price those contracts for transfer pricing purposes. These intercompany transactions must be priced at levels that are consistent with a price that would be paid by unrelated parties operating under substantially similar circumstances (i.e., the "arm's-length principle"). Accordingly, an analysis of transfer pricing methodologies can provide insight into the pricing of guarantees for other purposes. Unfortunately, current transfer pricing rules do

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13 *See* D. Garlock, H. Leventhal and A. Munro, *E&Y Comments on Tax Treatment of Credit Default Swaps* 2005 TNT 16-21.

14 In January 2001 the Basel Committee on Banking Supervision released the second version of its proposal for a new capital adequacy framework. In this release the Committee announced that an internal ratings-based approach could form the basis for setting capital charges for banks with respect to credit risk in the near future. For more details *see* Evelyn Hayden, *Are Credit Scoring Models Sensitive With Respect to Default Definitions? Evidence from the Austrian Market* (February 2003) (University of Vienna, Dep't. of Business Administration).

not specify methods that could be used to demonstrate the arm's length nature of a guarantee fee.[15]

For these purposes, it is our experience that guarantees are priced first by estimating the credit rating of the borrower including the impact of the guarantee. This can be done by comparing the interest rate and length of the guaranteed loan with bond yield curves. The next step is to estimate the interest rate that the guaranteed entity would have faced on the borrowing in the absence of the guarantee. The interest rate differential between the rate of the borrower faces as a stand-alone entity and the rate inclusive of the guarantee establishes an upper bound for the guarantee price. An alternative methodology would be to price a guarantee by pricing the estimated expected amount of additional equity capital that would be required to mimic the impact of the guarantee.[16]

The Z-score is a discriminant score of a linear discriminant function that combines the standardized independent variables and financial ratios for predicting bankruptcy. The Z-score has been used by practitioners to assist them with pricing guarantees for transfer pricing purposes..[17]

3. CDS Market Operations.

CDS price quotation is standardized as a basis-point spread per annum applied to a notional amount paid quarterly. For less "liquid" credits, the norm is an upfront premium and a set number of points. There are more than 400 specific global companies for which indicative CDS prices can be obtained through Bloomberg or internet sources.

Dealers transacting among themselves and with end users provide the market's liquidity. To date, automated exchanges, such as CreditEx, do not really provide liquidity—their role is to act as pricing indicators. As the market adopts additional standardization, one would expect that the automated dealing alternative will become more liquid, and therefore displace a substantial portion of current voice dealing.[18] Like other OTC derivatives, however, one would not expect automated alternatives to displace all dealers.

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15 Robert Plunkett, Ph.D, "Transfer Pricing for Intercompany Financial Transactions (Outline of Existing Rules and Proposed Approach)", Journal of International Taxation, July 2005.

16 Robert Plunkett, *supra* note 16.

17 The Z-score was originally developed in 1968 by Dr. Edward I. Altman in his paper entitled *Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy* that appeared in the Journal of Finance. The Z-score combined five common business ratios using a weighing system calculated by Dr. Altman. Dr. Altman has made subsequent comments to his 1968 paper. For example, see Edward I. Altman, *Predicting Financial Distress of Companies: Revisiting the Z-Score and Zeta Models* (July 2000) (NYU Stern Business School).

18 A the link to the DTC site representing their service for post-trade processing of CDS, among other OTC derivatives is: http://derivserv.dtcc.com/productsvces/index8641.html.

Moreover, Dow Jones has 15 CDS indices. The number of reference entities varies per index. The underlying portfolios consist of plain vanilla CDSs using standard contracts.[19]

As hedge funds, asset managers, and fund administrators increase their involvement with CDS, a need for pricing verification, independent of specific dealer quotes, is evolving. Vendors are contracting with dealers to populate comprehensive databases, which will enable CDS investors to determine NAV of their CDS positions tagged with the associated referenced-entity code.[20]

Standardization will lead to an even more dynamic, broader market. Accordingly, one would expect the market to adopt defined capital requirements similar to the specific guidelines that have been identified for other OTC derivatives transactions.

4. Certain Market Practices.

a. Overview. The largest players in the CDS market are global banks. Other participants include hedge funds, mutual funds, broker-dealers, insurance companies, and financial guaranty companies.

(i) Banks. While banks typically are net buyers of protection, the need to transfer risk without removing assets from their balance sheet or involving borrowers creates an incentive for both the buying and selling of CDSs. Banks also use the CDS market to diversify their portfolios of loans, which can be concentrated in certain industries or geographic areas.

(ii) Hedge Funds. Hedge funds typically have been net buyers of protection. Traditionally, hedge funds have primarily used CDS to purchase protection as part of convertible arbitrage strategies.[21] More recently, hedge funds have been using CDSs as part of a wider range of strategies that employ CDSs as an alternative to cash positions. As these strategies become increasingly sophisticated, hedge funds are transacting CDS on both sides of the market, creating synthetic long- and short-bond positions.

(iii) Insurance Companies.

(1) In General. Insurance companies participate in the CDS market, primarily as sellers of protection according to the results of a 2004 "Global Credit Derivatives Survey". However,

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19 See http://www.djindexes.com/mdsidx/downloads/credit_derivative/rules.pdf.

20 Kentouris, Chris, "Pricing Right," *Securities Industry News*, April 18, 2005, page 1.

21 Simply put, one can view convertible arbitrage as a long bet on volatility and credit, i.e., implied volatility will rise and credit spreads will narrow. If the trader believes that volatility will rise but credit spreads will widen, he or she will buy credit protection to mitigate the credit risk embedded in the convertible arbitrage position.

although the insurance industry's gross sold position continued to grow significantly, the activities of AIG Financial Products ("AIG"), the dominant player in this market, distort these results.[22] When excluding AIG, absolute global insurance industry CDS exposure actually fell.[23] This appears to be the result of reduced holdings of CDOs and a continued pullback from selling protection by non-insurance subsidiaries in favor of a strategic focus on more conservative investing and core underwriting lines.[24] Life insurers have reduced their CDO holdings after several years of declining credit quality and increased impairments.[25] Several property and casualty and reinsurance companies have exited lines of business that previously sold credit protection.[26]

(2) CDOs. CDO activity is the primary credit derivatives activity of U.S. insurance companies, particularly life insurers.[27] While many consider investing in CDOs as the selling of credit protection, most insurance companies do not view it that way. Instead, most merely think of CDOs as a fixed-income asset category like corporate bonds and mortgage-backed securities.[28]

(3) Replication Transactions. State regulation generally prohibits U.S. insurance companies from selling unfunded CDSs, instead requiring them to replicate a cash position by matching a CDS with a cash instrument such as a U.S. Treasury security. As a result, capital charges in a replication transaction generally will be the same as it is for directly holding a bond. Accordingly, insurers generally will write CDSs only when the pricing is more attractive in the derivatives market than in the cash market.

(iv) Financial Guarantors. Financial guaranty insurance provides protection against financial loss as a result of default, changes in interest rate levels, differentials in interest rate levels between markets or products, fluctuations in exchange rates between currencies, inconvertibility of one currency into another, inability to withdraw funds held in a foreign country resulting from restrictions imposed by a

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22 *See* Fitch Ratings Special Report, "Global Credit Derivatives Survey-Single-Name CDS Fuel Growth," (September 7, 2004).

23 *Id.* Generally, Fitch believes that the appetite for North American insurance companies to provide credit protection via CDS, including CDOs "will continue to wane."

24 *Id.* at 4.

25 *Id.* at 12.

26 *Id*.

27 *Id*.

28 *Id*.

governmental body, i.e., sovereign risk, changes in the value of specific assets or commodities, financial or commodity indices, or price levels in general.

The financial guaranty sector continues to grow, although at a slower rate than the overall CDS market. This is because of a number of factors including a tight-spread environment, concerns over FAS 133 mark-to-market earnings volatility, and less demand for senior portfolio CDS protection as the primary hedgers rely on dynamic hedging strategies.[29]

The majority of CDS exposure is in the form of pooled synthetic CDOs.[30] The primary bond insurers have, on average, ceded more than 20 percent of their gross CDS/CDO exposures to various monoline and multiline reinsurance companies.[31] Use of reinsurance has allowed financial guarantors to free up capital consumed by the large notional amount of business written.

5. GAAP, Regulatory Capital and Internal Accounting Treatment.

a. GAAP. To determine the appropriate accounting for a CDS under GAAP, the first step is to determine if the CDS meets the definition of a derivative under FAS 133[32] or, alternatively, whether it qualifies as a financial guaranty contract. The guidance on this question appears in paragraphs 6 through 9 and 10(d) of FAS 133.

If the CDS is characterized as a derivative financial instrument, the protection seller marks-to-market the contract through the income statement and the protection purchaser also marks-to-market the contract through the income statement. Hedge accounting applies only if the CDS is designated and effective as a hedge. Under hedge accounting, (1) the change in value of an existing hedged item ascribable to credit risk is also marked to market through the income statement or (2) the change in the value of the CDS is included in a component of shareholder equity (until the forecasted transaction affects earnings) if the CDS hedges the credit risk of a forecasted transaction. Because hedge accounting is available only under narrow circumstances and is generally not permitted for writers of CDS, most counterparties do not try to obtain hedge accounting designation.

If the CDS is not characterized as a derivative, it is likely that the protection seller will be required to record the CDS initially at fair value based upon FIN 45.[33] Subsequent measurement guidance will depend on the writer's own accounting policy.

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29 *Id*. at 5.

30 *Id* at 5.

31 *Id*. at 11.

32 Statement of Financial Accounting Standards No. 133, " Accounting for Derivative Instruments and Hedging Activities."

33 FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others."

FIN 45 does not provide guidance; instead, it notes that several alternatives exist in practice. According to the FASB staff, the initial fair value accounting for the CDS does not itself justify mark to market accounting in subsequent periods, a view apparently shared by the SEC staff.

For the protection purchaser, a non-derivative CDS is not marked to market in periods subsequent to acquisition. Many purchasers would carry the contract at cost or amortize the cost over the protection period, recognizing any gain when realizable under FAS 5. is applied.[34]

b. Insurance Regulatory Capital. For statutory accounting purposes ("STAT"), most CDSs are characterized as derivatives, unless issued by a monoline financial guarantor. A monoline financial guarantor is an insurance company authorized by a State Insurance Department that only writes financial guarantee business, and may insure such things as bonds, CDOs, CDSs, project finance and guaranteed investment contracts. The default accounting treatment for CDSs is to mark-to-market the transaction through surplus (the balance sheet) and recognize through earnings (the income statement) when realized. Under replication accounting ("RSAT"), an insurance company may link a written CDS with a Treasury security from the CDS commencement date as RSAT and thereafter account for it at amortized cost.

B. Certain U.S. Federal Income Tax Issues.

1. Issues Raised in the Notice.

The Notice indicates that taxpayers have requested guidance regarding:

- 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.

Of the foregoing issues, we believe that the most fundamental issues relate to whether the amounts paid by a U.S. protection buyer to a foreign protection seller constitute income that is subject to withholding tax or the insurance-premium excise tax.

[34] Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies."

This would be the case if the Internal Revenue Service determined that the contracts were not either options or notional principal contracts, but were instead either guarantees or insurance contracts. As guarantees, there might be withholding if the fees were considered U.S. source and as insurance contracts, the premiums would be subject to the insurance excise tax. As guarantees, there might also be withholding tax if there were a default and the underlying instrument did not qualify for portfolio debt treatment.

For the transaction to be considered a guarantee, the CDS would need to relate to a specific instrument or group of instruments, and a guarantor would need to have the contractual right to sue the defaulting party. For the instrument to be considered an insurance contract there would need to be both risk shifting and risk distribution.[35] The issuer of the contract would need to have the right to sue the defaulting party.[36]

It is our experience that issuers are well aware of the tax risk associated with the position that contracts might be regarded as insurance or guarantees. It is also our experience that this is a particularly narrow class of transactions. For the most part, the market has moved past the situations where classification of the instrument is a close call. In many transactions, the underlying referenced debt instrument is not held by either of the parties, and if there is a default that requires financial settlement, there is a range of instruments which may be used to physically settle. It is our experience that most taxpayers treat CDSs as NPCs and that both end-users and dealers follow this practice. It is also our experience that taxpayers are cautious in structuring transactions so that transactions comfortably fit within the NPC regime, rather than taking the risk that the Internal Revenue Service, on audit, will recharacterize a transaction as an insurance or guarantee contract. In our view, new specific guidance is not needed regarding the characterization of these transactions, since the fundamental tax principles are well established.

2. Potential Application of the Contingent Notional Principal Contract Regulations.

The proposed regulations issued in February 2004[37] regarding the treatment of contingent payments have potential application to CDS, although we believe that such a result was unintentional. In general terms, those regulations require that contingent payments be estimated, and that the parties be considered to have made loans to one another in amounts that are tied to the estimated contingent payment. In addition, the estimated value of the contingent payment is required to be re-evaluated with income inclusions being made for the difference. Part of the rationale for the proposed regulations was to ensure conformity with those contingent debt instruments subject to the non-contingent bond method of Treasury Regulation Section 1.1275-4. Commentators have taken issue with the application of those regulations to equity based

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35 *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

36 Nirenberg, David Z. and Steven L. Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes* Journal of Taxation 82, August, 1997.

37 REG. 166012-02, 69 FR 8886 (Feb. 26, 2004).

notional principal contracts. However, unlike equity derivatives, whether or not a CDS will pay is contingent upon there being a credit event. Thus, the event requiring the contingent payment is itself contingent. A contingency of such nature would not require application of the non-contingent bond method. For this reason, we believe that CDS are distinguishable from those contracts that the Internal Revenue Service intended to include in the proposed regulations. Thus, we believe that when those regulations are finalized, they should exclude all contracts containing a contingent payment where the payment itself is contingent. The need to resolve this is even more compelling with CDSs, as further uncertainty could imperil the growth of the market in the United States.

3. Concerns of the Insurance Industry.

a. In General. Members of our committees that are associated with the insurance industry have raised specific concerns. In particular, they have raised the concern that any IRS clarification that a CDS is to be taxed "as accounted" for or on a strict form over substance basis by U.S. taxpayers, and not subject to withholding or insurance-premium excise tax, or that entering into CDS agreements does not by itself establish a U.S. trade or business, may open the door to aggressive tax management strategies.

However, this subgroup also believes that there are two areas of potential tax planning strategies that would not be in the public interest if they were allowed to proceed without some anti-avoidance provision. The first is an unintended use of plain vanilla CDSs. The second (and more difficult to detect and define) is derived from a plain vanilla CDS.

b. Export of capital free of withholding. The purchase of CDS protection by a U.S. subsidiary from its overseas parent, either directly or through an intermediary, may allow the export of capital without withholding. For example, assume that a U.S. subsidiary maintains a large portfolio of investment-grade securities. The U.S. subsidiary purchases CDS protection on all or part of the portfolio from an investment bank, effectively paying the credit spread on the portfolio to the investment bank. The overseas parent sells equivalent CDS protection to another (or the same) investment bank (or overseas affiliate). In this manner, cash flow can be paid to the foreign parent through the CDS market overseas at a lower effective tax rate, avoiding withholding taxes and paying a competitive market spread instead. Allowing the export of capital, without any withholding taxes, in this instance would not be in the public interest. Had the transaction been structured as interest or a dividend the transaction would be subject to withholding tax at the appropriate treaty rate. Had the transaction been structured as an insurance contract, the transaction would be subject to insurance-premium excise tax at the appropriate treaty rate.

c. Unlicensed financial-guarantee business. The use of the ISDA CDS provisions may allow willing counterparties effectively to enter into the financial guarantee business, albeit on an unlicensed basis. The reference security will tend to be more obscure, and the credit events may be a little expanded, but a CDS can very effectively provide economic protection equivalent to that provided by financial-

guarantee insurance, but without the state license, federal excise tax, or capital requirements.

Thus, if a CDS acts as a mere substitute for an insurance contract, both tax and insurance regulation will be avoided. This would not be in the public interest. If guidance is issued by the IRS suggesting that instruments that merely follow the form of a CDS, but which have the risk shifting and transfer characteristics that are more properly associated with insurance, an anti-avoidance provision may be necessary.

APPENDIX

Additional References

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