

Current Federal Tax Developments

By David S. Miller and Shlomo Boehm

New Developments in the Federal Income Tax Treatment of CDSs

Overview

Most taxpayers treat credit default swaps (CDSs) as derivatives for federal income tax purposes. This treatment allows a foreign hedge fund with a U.S. manager to write protection under a CDS without the fund being treated as engaged in a trade or business for U.S. federal income tax purposes, and without the fund being subject to a federal withholding tax or excise tax on the periodic payments it receives.

On September 22, 2008, the New York State Insurance Department issued Circular Letter 19, which concludes that certain CDSs may be treated as insurance for purposes of New York Insurance Law section 1101 and that New York State intends to regulate CDSs as insurance. Subsequently, on November 20, 2008, Eric Dinallo, the New York State Superintendent of Insurance, announced before a Congressional committee that New York will indefinitely delay its plan to regulate CDSs, pending federal action.¹ Nevertheless, the question remains whether New York State treats CDSs as insurance. This treatment would throw into question the federal income tax treatment of CDSs that are subject to New York law.

This column discusses the U.S. federal income tax treatment of CDSs, and the effect of Circular Letter 19 on that treatment. This column also describes a proposal to establish a federally regulated clearinghouse for CDS, and the federal income tax treatment of CDSs that would be held in the clearinghouse.

The Federal Income Taxation of CDSs

The Treatment of CDSs As Derivatives (and Not Insurance) for Federal Income Tax Purposes

At least until New York State issued Circular Letter 19, CDSs were generally treated as “derivatives” and not



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as insurance for federal income tax purposes, so long as the “protection buyer” (*i.e.*, the party making payments in exchange for protection against a default of the reference obligation) was not required pursuant to the contract to own the underlying reference obligation. CDSs were generally treated as derivatives even if the protection buyer held or reasonably expected to hold a material interest in the referenced obligation.

These consequences would not arise if the Treasury and the IRS were to issue guidance providing that, notwithstanding New York State’s decision to regulate CDSs as insurance, CDSs are not insurance for federal income tax purposes.

States may write protection under a CDS without causing the vehicle to be subject to U.S. corporate income tax.⁹ (This exemption from federal corporate tax was expressly granted by Congress to encourage foreigners to hire U.S. investment managers for their trading activities and because these trading companies do not compete with U.S. companies.) However, if CDSs are treated as insurance, and the manager is physically located in the

United States, the vehicle (or its foreign investors) would be subject to federal income tax.¹⁰

■ An offshore hedge fund or other offshore vehicle may write protection under a CDS and receive periodic swap payments without being subject to federal withholding or excise tax.¹¹ (This exemption exists because the United States generally imposes withholding tax only on income from investments in the United States. A hedge fund that enters into a CDS has not invested capital in the United States. However, if CDSs are treated as insurance, periodic swap payments paid to an offshore vehicle would be subject to a special federal excise tax on insurance premiums.)

The Federal Income Tax Definition of Insurance

There is no statutory or regulatory definition of insurance for federal income tax purposes. However, in *E. Le Gierse*,² the Supreme Court identified four relevant factors to determine whether a contract is insurance: (i) the form and regulatory treatment of the contract,³ (ii) the existence of “insurance risk,”⁴ (iii) the transfer or shift of that risk,⁵ and (iv) the pooling and distribution of the insurance risk by the party assuming it.⁶

In concluding that CDSs are treated as derivatives (and not as insurance) for federal income tax purposes, taxpayers have relied on the first two factors: namely, that CDSs are not in form insurance or generally regulated as insurance and, because credit derivatives do not require the protected party to own the underlying, the underlying risk is not insurance risk.⁷

Effect of Treating CDS As Derivatives (and Not As Insurance) Instruments for Federal Income Tax Purposes

If a CDS is respected as a derivative (and is *not* treated as insurance) for federal income tax purposes:

- A U.S. partnership may write protection and not be subject to federal corporate tax. (U.S. partnerships are not generally subject to federal corporate income tax. An insurance company, however, is treated as a “per se corporation” for federal income tax purposes and a U.S. insurance company is subject to U.S. corporate income tax.)⁸
- An offshore hedge fund or other offshore vehicle with a manager physically located in the United

New York State Letter Increases the Risk That CDS Are Treated As Insurance for Federal Income Tax Purposes

In Circular Letter 19, the New York State Insurance Department suggested that a CDS may constitute an insurance contract under New York Insurance Law section 1101 if it is entered into by a party that, at the time the agreement is entered into, holds or reasonably expects to hold a “material interest” in the referenced obligation.¹² Other states are contemplating similar action.¹³ Although the New York Superintendent of Insurance subsequently announced that New York would delay its plans to regulate CDSs, it is unclear whether New York currently treats CDSs as insurance.

If New York treats CDSs as insurance and determines that insurance risk exists whenever there is a reasonable expectation that the protected party reasonably expects to hold a material interest in reference obligation, then, absent contrary guid-

ance, possibly all four of the *Le Gierse* tests might be satisfied. As discussed below, if CDSs are treated as insurance for federal income tax purposes, potentially disastrous consequences follow.

The Disastrous Consequences if CDSs Are Treated As Insurance for Federal Income Tax Purposes

If CDSs that are regulated as insurance for state law purposes are also treated as insurance for federal income tax purposes, then the following situations could occur:

- An offshore hedge fund or other foreign person with an onshore manager that enters into CDSs could be treated as engaged in a trade or business in the United States and subject to a 35-percent income tax (and, possibly, additional branch profits tax).¹⁴
- A partnership (or other entity that is treated as a flow through entity for federal income tax purposes) that writes protection under CDSs could be treated as a per se corporation for federal income tax purposes; if the flow through entity is organized in the United States, it could therefore be subject to a federal corporate tax.¹⁵
- Payments on the CDS by a U.S. person to a foreign person could be subject to excise tax.¹⁶

Potential Solution

These consequences would not arise if the Treasury and the IRS were to issue guidance providing that, notwithstanding New York State's decision to regulate CDSs as insurance, CDSs are not insurance for federal income tax purposes.¹⁷ Personnel from New York State's Department of Insurance have contacted officials of the U.S. Treasury Department to discuss the possibility of such guidance.

Federally Regulated Clearinghouse or Exchange

It is currently contemplated that a federally regulated clearinghouse will be established for CDSs.¹⁸ If a federally regulated clearinghouse is established and the CDSs that are held through the clearinghouse are not treated as insurance for any state law purposes (either by reason of the states' decision not to exercise their authority for CDSs held through the clearinghouse or by reason of federal preemption), then these CDSs should continue to be treated as derivatives for federal income tax purposes. Moreover, it is unlikely that, in the absence of a change to current federal tax law, the establishment of a federally regulated clearinghouse will affect the current federal income tax treatment of CDSs as derivatives. However, the establishment of a CDS exchange would raise additional issues.

More specifically, Code Sec. 1256 provides that "Section 1256 contracts" are generally marked-to-market for federal income tax purposes (*i.e.*, Section 1256 contracts are treated as terminated at the end of each year for their fair market value and gain or loss is recognized), and gains and losses on Section 1256 contracts are treated as 60-percent long-term capital gains and 40-percent short-term capital gains. A Code Sec. 1256 contract includes a contract that is traded on or subject to the rules of a national securities exchange that is registered with the Securities and Exchange Commission, a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission, or certain other exchanges designated by the Treasury as a qualified board or exchange. It is not contemplated that a CDS entered through the clearinghouse would satisfy this definition. Nevertheless, it is possible that a CDS entered into through an exchange could qualify as Section 1256 contracts.

ENDNOTES

¹ See Superintendent Eric Dinallo, Testimony to the United States House of Representatives Committee on Agriculture, *Hearing to Review the Role of Credit Derivatives in the U.S. Economy* (Nov. 20, 2008), www.ins.state.ny.us/speeches/pdf/sp0811201.pdf.

² *E. Le Gierse*, S Ct, 41-1 USTC ¶10,029, 312 US 531 (1941).

³ *Id.*, at 540 ("Congress used the word 'insurance' in its commonly accepted sense").

⁴ *Id.*, at 539 ("We think the fair import of subsection (g) is that the amounts must be received as a result of a transaction which involved an actual 'insurance risk' at the time the transaction was executed").

⁵ The Court stated:

That these elements of *risk-shifting* and *risk-distributing* are essential to a life insurance contract is agreed by courts and commentators. ... Accordingly, it is logical to assume that when Congress used the words 'receivable as insurance' in section 302(g), it contemplated amounts received pursuant to a transaction possessing these features.

Id., at 539-40.

⁶ *Id.*, at 539-40 ("That these elements of *risk-shifting* and *risk-distributing* are essential to life insurance contract is agreed by courts and commentators. ... Accordingly, it is logical to assume that when Congress used the

words 'receivable as insurance' in section 302(g), it contemplated amounts received pursuant to a transaction possessing these features"); see, e.g., *Sears, Roebuck & Co.*, 96 TC 61, 100-02, Dec. 47,132 (1991), *aff'd*, CA-7, 92-2 USTC ¶50,426, 972 F2d 858 (1992) (listing insurance risk, risk shifting, risk distribution, and the presence of forms commonly accepted as insurance in the trade, as the hallmarks of insurance); *AMERCO, Inc.*, 96 TC 18, 38, Dec. 47,130 (1991), *aff'd*, 92-2 USTC ¶50,571, 979 F2d 162 (1992) (reciting the elements of insurance derived from *Le Gierse*).

⁷ *Id.*, at 540 ("Congress used the word insurance in its commonly accepted sense");

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Kidde Industries, Inc., FedCl, 98-1 USTC ¶50,162, 40 FedCl 42 (1997) (in determining whether an arrangement is properly treated as insurance, the court focused on whether the arrangement was “consistent with commonly accepted notions of insurance”); *Sears, Roebuck & Co.*, CA-7, 92-2 USTC ¶50,426, 972 F2d 858, 863 (in concluding that a contract constitutes insurance, the court was influenced by the fact that “states recognize the transaction as ‘real’ insurance for purposes of mandatory-insurance laws”); FSA 2001-04-011 (Oct. 19, 2000) (a “health service plan” provided by an HMO was not an insurance contract, in part because, under state law, the health service plan was treated as a prepaid contract for services and not an insurance contract) (citing *Jordan v. Group Health Associates*, CA-DC, 107 F2d 239 (1939)); *W.H. Luquire Burial Ass’n Co., Inc.*, CA-5, 39-1 USTC ¶9342, 102 F2d 89 (1939) (relevant that burial association regulated as an insurance company).

See also *Le Gierse*, *supra* note 2, 312 US, at 539 (“We think the fair import of subsection (g) is that the amounts must be received as a result of a transaction which involved an actual ‘insurance risk’ at the time the transaction was executed”); *Home Title Insurance Co.*, CA-2, 1931 CCH ¶9377, 50 F2d 107, 109 (1931) (“the insured must have some interest at risk, for otherwise the contract is a wager ...”); *A.W. Epmeier*, CA-7, 52-2 USTC ¶9510, 199 F2d 508, 509-510 (1952) (“Risk is essential, and equally so, a shifting of its incidence from one to another”).

⁸ Reg. §301.7701-2(b)(4) (listing insurance companies as per se corporations); Code Sec. 831 (providing that insurance companies are subject to the corporate level tax on

its taxable income).

⁹ Code Sec. 864(b)(2) (providing that trading in stocks and securities in the United States does not constitute a trade or business in the United States); proposed Reg. §1.864(b)-1 (very generally provides that “derivatives” are treated in the same manner as a security for purposes of Code Sec. 864(b)(2)); Preamble to proposed Reg. §1.864(b)-1, 63 FR 113, at 32164 (June 12, 1998) (providing that prior to the effective date for the proposed regulations, taxpayers may take any reasonable position under Code Sec. 864(b)(2) with respect to derivative transactions).

¹⁰ Insurance is not an instrument that is protected under the Code Sec. 864(b)(2) safe harbor or the regulations or proposed regulations that interpret section 864(b)(2).

¹¹ Reg. §1.863-7(b) (the source of notional principal contract income is determined by reference to the residence of the recipient as determined under Code Sec. 988); Code Sec. 881(a) (imposing withholding tax only on a foreign corporation’s U.S.-source income); Reg. §1.441-1(b)(2)(i) (option premiums not subject to withholding); Code Secs. 4371–4374 (imposing an excise tax on insurance instruments).

¹² Circular Letter 19 indicates that the issue will be addressed in a subsequent opinion to be prepared by the New York State Insurance Department’s Office of General Counsel.

¹³ State regulators from a number of other states have indicated that they are contemplating characterizing CDSs as insurance for regulatory purposes. See Raymond Lehman, *States Could Claim Stake as Credit Default Swap Regulators*, BESTWIRE, Oct. 20, 2008.

¹⁴ As discussed above, offshore funds with onshore managers generally rely on a safe harbor provided in Code Sec. 864(b)(2) to

avoid being treated as engaged in a trade or business in the United States. However, the safe harbor does not include protection for parties that write insurance.

¹⁵ Reg. §301.7701-2(b)(4) (listing insurance companies as per se corporations); Code Sec. 831 (providing that insurance companies are subject to the corporate level tax on its taxable income).

¹⁶ Code Sec. 4371 (imposing a one-percent to four-percent excise tax on certain insurance premiums).

¹⁷ There is some precedent for such a determination. *Allied Fidelity*, 66 TC 1068, Dec. 34,033 (1976) (holding that a corporation primarily engaged in the business of acting as a surety on bail bonds did not qualify as an insurance company for tax purposes, notwithstanding its regulation as an insurance company under state law); *Industrial Life Ins. Co.*, DC-SC, 72-1 USTC ¶9381, 344 F.Supp 870 (1972), *aff’d*, CA-4, 73-2 USTC ¶9533, 481 F2d 609 (1973) (state chartered life insurance company was not insurance company for tax purposes); GCM 39,146 (May 1, 1984) (“in light of the inconsistent approaches taken by the various states, we do not believe that state classification provides us with any meaningful guidance” as to whether warranty contracts constitute insurance for federal income tax purposes”).

¹⁸ In a November 14, 2008, Treasury Department press release, the President’s Working Group on Financial Markets announced a number of initiatives to strengthen OTC derivatives oversight and infrastructure, including “the development of credit default swap central counterparties.” The press release indicated that some of the central counterparties would commence operations before the end of 2008.

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