TAXATION OF CREDIT DEFAULT SWAPS: A GUARANTEED SOLUTION?

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I. Introduction

The devastation resulting from the financial crisis of 2008 cannot be overstated. While myriad factors could have contributed to the recent economic crisis, one financial instrument that the crisis highlighted was the credit default swap ("CDS"). CDSs are complex financial derivatives that many blame for bringing down AIG and necessitating its subsequent bailout.[1] Although recent legislation has addressed to some extent the regulatory treatment of CDS contracts for purposes of the securities markets,[2] no regulatory treatment exists on the taxation of these instruments.[3] Practitioners agree that the revenue generated through these financial instruments should be taxed; however, significant disagreement exists as to how these instruments should be taxed.[4]

This disagreement poses a problem for a few reasons. First, CDSs are derivatives that by their nature are risky and unstable as

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[1] Matthew Karnitschnig, Liam Pleven, and Serena Ng, *Government Hikes AIG Bailout to $150 Billion with New Deal*, WALL ST. J., Nov. 10, 2008, at A1.

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 721-774, 124 Stat. 1376 (2010) (Modifying various acts including Gramm Leach Bliley Act, and the Truth in Lending Act, among others).

[3] I.R.S. Notice 2004-52, 2004-32 I.R.B. 168 ("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.").

[4] Bruce Kayle, *The Federal Income Tax Treatment of Credit Derivative Transactions*, *in* TAX LAW AND PRACTICE 2009, at 1071, 1108-1152 (PLI Tax Law and Estate Planning, Course Handbook Ser. No. 897, 2009) (discussing various ways that CDS transactions might be taxed).

demonstrated by the recent financial crisis.[5] The lack of agreement on how to tax the instruments potentially destabilizes the financial market even further by creating more uncertainty. Second, the volume of CDS contracts in existence creates the necessity of having a clear idea on how to treat CDSs for tax purposes. At the pre-financial crisis height of the CDS market, experts estimate that financial institutions had written hundreds of billions of dollars of CDS contracts on Fannie Mae and Freddie Mac assets[6] and AIG by itself had written at least $440 billion worth of CDS contracts.[7]

To its credit, the Department of the Treasury ("Treasury") has solicited information on CDS deals and guidance as how to tax those transactions.[8] In 2004, the Treasury requested information and suggestions pertaining to the common features of a CDS contract, how the income from CDS deals should be characterized, analogies between CDS and other financial instruments and CDS pricing.[9] Currently, however, the Treasury has not yet promulgated any rules on the issue.[10] The Treasury's inaction leaves financial entities with little guidance on how to structure deals to achieve tax-optimal results.[11] Various options are available to utilize as models for taxing CDSs, such as treating CDSs as a notional principal contract,[12] an

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[5] For a good example of how AIG's use of CDSs created a tangled web of investments in the financial community that eventually brought down AIG, see Serena Ng, *AIG, Goldman Unwind Soured Trades—Move on Mortgage Deals Leaves Insurer with Loss of About $2 Billion*, WALL ST. J., Apr. 12, 2010, at C1.

[6] Serena Ng & Liz Rappaport, *Crisis on Wall Street: Credit-Swap Players Puzzle over Fan-Fred Fallout—Lehman Situation Adds to Urgency to Settle Questions*, WALL ST. J., Sep. 15, 2008, at C3.

[7] Serena Ng, *The Financial Crisis: AIG at Risk: Financial Firms Gird for Backlash From Weakened AIG*, WALL ST. J., Sept. 17, 2008, at A10.

[8] I.R.S. Notice 2004-52, 2004-32 I.R.B. 168.

[9] *Id.*

[10] *Cf. Id.*

[11] Samuel D. Brunson, *Elective Taxation of Risk-Based Financial Instruments: A Proposal*, 8 HOUS. BUS. & TAX L. J. 1, 18-19 (Fall 2007). I do not delve into the many different new taxation schemes that scholars or practitioners could propose to tax CDSs. Instead, I focus on how CDSs can be placed within current taxation schemes.

[12] Steven L. Kopp & David Z. Nirenberg, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. TAX'N 82, 89-91 (August 1997).

option,[13] as an insurance contract,[14] or under a completely different tax regime.[15]

This note argues that fundamental CD transactions, where the protection buyer owns the underlying reference entity, should be taxed as guarantees. Naked CDS transactions occur when the protection buyer does not own the underlying reference entity and as a result these transactions challenge the basic guarantee/CDS analogy. In part II, I introduce both CDSs and guarantees. In part III, I examine the legitimate proposed options that exist to tax CDSs. In part IV, I examine the guarantee taxation scheme and the fit that exists between it and the basic CDS agreement. I also discuss the difficulties presented by naked CDS transactions. In part V, I look at the functional similarities of CDSs and guarantees as strength to support taxing CDSs similarly to guarantees. I end this note with a few suggestions for further research.

II. Introducing the Instruments

A. What is a CDS?

A CDS is a financial contract that allows a "protection buyer" to pay the "protection seller" a specific amount to guarantee that the protection seller will cover the protection buyer should a specific "credit event" occur.[16] The buyer (usually a sophisticated financial institution) will pay a fixed payment to the seller (also a sophisticated financial institution) in exchange for protections should certain credit events occur.[17] The International Swaps and Derivatives Association ("ISDA") has stated that a credit event can

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[13] *See* Ari J. Brandes, *A Better Way to Understand the Speculative Use of Credit Default Swaps* 14 STAN. J.L. BUS. & FIN. 263, 277-82 (Spring 2009).

[14] For a discussion on the similarities and differences between a CDS contract and an insurance contract *see* Arthur Kimball-Stanley, Note, *Insurance and Credit Default Swaps: Should Like Things be Treated Alike?*, 15 CONN. INS. L.J. 241, 265 (Fall 2008).

[15] *See generally* Brunson, *supra* note 11, at 18-19 (arguing that all financial instruments should be taxed on an elective method where the taxpayer can choose how she wishes the instrument to be taxed but cannot change that election later).

[16] Brunson, *supra* note 11, at 2-3.

[17] Don Bendernagel et al., *Credit Derivatives: Usage, Practice, and Issues*, *in* CORPORATE LAW AND PRACTICE 2004, at 409, 418 (PLI Corp. Law and Practice, Course Handbook Ser. No. 1458, 2004).

be at least one of the following: "bankruptcy, obligation acceleration, obligation default, failure to pay, repudiation/moratorium and restructuring."[18] Additionally, the parties may contractually agree upon whatever credit event they desire.[19] Unlike a basic insurance agreement, the credit event does not need to result in the protection buyer's actually losing money.[20] The parties can settle the CDS contracts by physical or cash settlement.[21]

An example helps explain the basic functions of a CDS deal. Suppose Company A issues $100 in corporate bonds. Company B buys those corporate bonds, yet worries about Company A's financial stability. So Company B negotiates an agreement with Company C where Company C would pay a specified sum if the bonds default.[22] That contract is a CDS, the bonds are the reference obligation and the default of the bonds is a credit event. For that protection guarantee, Company B would pay Company C a specified premium. Oftentimes, the CDS contract will require the insuring company to post collateral in case the value of the asset underlying the CDS falls.[23]

In addition to using CDSs to hedge against the risk of default, some financial institutions buy CDSs against a company even when they do not possess that company's bond or other debt instrument. Rather, they buy CDSs to speculate on the credit worthiness of that company.[24] Continuing the example above,

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[18] Jongho Kim, *From Vanilla Swaps to Exotic Credit Derivatives: How to Approach the Interpretation of Credit Events*, 13 FORDHAM J. CORP. & FIN. L. 705, 755-56 (2008).

[19] *Cf. Id.* at 757.

[20] Janis Sarra, *Symposium: Financial Market Destabilization and the Role of Credit Default Swaps: An International Perspective on the SEC's Role Going Forward*, 78 U. CIN. L. REV. 629, 632 (2009).

[21] Lawrence Lokken, *Taxation of Credit Derivatives*, Scholarly Article, University of Florida Levin College of Law, University of Florida Legal Studies Research Paper No. 2009-39, *available at* http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=689596 (last visited October 30. 2010).

[22] *See* Leah Campbell & Robin Choi, *State Initiatives to Regulate Credit Default Swaps Deferred Pending Federal Action*, METRO. CORP. COUNSEL, Sep. 2009, Northeast Edition, at 20, *available at* http://www.metrocorpcounsel.com/pdf/2009/September/20.pdf.

[23] Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1.

[24] Campbell & Choi, *supra* note 22, at 20.

Company D believes that Company A will default on its loans, so it buys the CDSs against Company A from Company C. This type of transaction is called a "naked" CDS. The note discusses naked CDSs later and the problems that they pose for tax planning purposes.

B. What is a Guarantee?

Fundamentally, a guarantee is simply a promise by one party to meet the financial obligations of another party. Guarantees play a backstop role in the financial world. In its most basic form, a guarantee is a contractual agreement between two parties that actually involves three entities: the obligor, the creditor and the guarantor. If an obligor wants a loan from a creditor, but the creditor is uncertain that the obligor will be able to make the debt payments on the loan, either party may seek a guarantor to guarantee the debt payments of the obligor in order for the creditor to make the loan.[25] Although there is no standard definition for a guarantee, the Internal Revenue Code ("IRC") states that "the term 'guarantee' includes any arrangement under which a person…assures, on a conditional or unconditional basis, the payment of another person's obligation under any indebtedness."[26] An example from the insurance industry helps explain this concept.[27] Suppose Axel Insurance Corporation provides annuity policies to various corporate customers. Axel and the companies it insures worry that it will not have the funds to cover these policies should they all come due at the same time. To overcome this potential problem, Axel contacts Blaze Bank and works out an agreement whereby Blaze will cover any amount remaining should Axel fail to meet its financial obligations under the annuity contracts. In this situation, Axel is the obligor, the corporate companies it insures are the creditors and Blaze is the guarantor.

Guarantees operate across a wide sphere. A teenager's parents can act as a guarantor on their child's first car loan

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[25] For a more complete discussion on the definition and uses of a guarantee see W. Thomas Conner, Address Before the American Law Institute-American Bar Association Continuing Legal Education Conference: Recent Regulatory Developments Relating to Guarantees and Other Financial Support Agreements and Their Potential Impact on Variable Contract Issuers (Nov. 16-17, 2006), *in* SMO39 ALI-ABA 61, 68-73 (2006).

[26] Kayle, *supra* note 4, at 1125 (citing 26 U.S.C. § 163(j)(6)(D)(iii) (2010)).

[27] The basic structure of this example comes from Conner, *supra* note 25, at 65-66.

transaction. [28] A business can guarantee the personal loan of one of its founders. An investment bank may want to borrow cash from another financial actor but must first secure a guarantee from a traditional bank before the financial actor will lend the funds. These are just a few examples of how guarantee relationships work in everyday transactions.

III. Competing Taxation Solutions

Taxing CDSs like guarantees is not the only option available. Scholars and practitioners have developed theories about how the government should tax CDSs. Some have put forth the idea of treating CDSs as options,[29] as notional principal contracts,[30] as insurance,[31] or under a completely different regime.[32] The first three are generally regarded as credible possibilities. Thus, I will examine the tax structure that these different possibilities would place on the typical CDS arrangement.

A. Taxing CDSs as an Option?

A legitimate argument exists for treating CDSs as options for tax purposes based on the similarities between the features of an option and the features of a CDS.[33] The tax court has said that an option is a contract that "provides (A) the option to buy or sell, (B) certain property, (C) at a stipulated price, (D) on or before a specific future date or within a specified time period, (E) for consideration."[34] Another case has defined an option as "(1) a continuing offer to do an act, or to forbear from doing an act, which does not ripen into a contract until accepted; and (2) an agreement to leave the offer open

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[28] The idea for these basic examples comes courtesy of David S. Miller, *Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis*, 48 TAX LAW. 103, 105-06 (Fall 1994).
[29] *See* Brandes, *supra* note 13, at 277-82.
[30] Kopp & Nirenberg, *supra* note 12, at 89-91.
[31] For a discussion on the similarities and differences between a CDS contract and an insurance contract *see* Kimball-Stanley, *supra* note 14.
[32] Brunson, *supra* note 11, at 18-19.
[33] Brandes, *supra* note 13, at 277-79.
[34] Brandes, *supra* note 13, at 278-79 (citing Fed. Home Loan v. Comm'r, 125 T.C. 248, 261 (2005)).

for a specified or reasonable period of time."[35] Other experts have defined an option as the payment of an amount for the right to conclude a transaction at a later date.[36]

A CDS could arguably fit within these definitions of an option. For example, CDSs contain similar features to options in that one can buy/sell CDS contracts, some CDS agreements are based on certain property, each CDS contract is sold at a specific price for consideration and each CDS contract expires on a certain date.[37] In the typical CDS contract the protection seller offers to pay a certain amount on the occurrence of a credit event and that offer is open for a specific period of time.[38] Indeed, the option arrangement that CDSs seem to fit most closely is that of a put option.[39] In a put option transaction the holder will pay a premium to the writer of the option and the writer will agree to purchase a specific property at a certain time for a certain price.[40] For example, A might pay a $100 premium to B in exchange for B's promise to purchase 300 shares of C Corporation from A if A should so demand 75 days hence for $5 per share.[41] CDSs resemble put options specifically when they are physically settled.[42] "A physically-settled swap can be seen as an option held by the credit protection buyer to sell reference obligations to the credit protection buyer for a strike price equal to the obligations' face amounts on the occurrence of a credit event."[43] Thus, because of the similarities between CDS and options, a compelling argument exists for classifying CDS as options for tax purposes.

The Treasury has issued fairly straight-forward guidelines on the taxation of options.[44] The purchaser of an option will capitalize

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[35] Kayle, *supra* note 4, at 1120-21 (citing Old Harbor Native Corp. v. Comm'r, 104 T.C. 191, 201 (1995)).
[36] Kevin J. Liss, *The Option Conundrum in Tax Law: After All These Years, What Exactly is an Option?* 63 TAX LAW 307, 311 (Spring 2010).
[37] Brandes, *supra* note 13, at 268-70.
[38] Kayle *supra* note 4, at 1121.
[39] DAVID MILLER, THE USE OF DERIVATIVES IN TAX PLANNING 100 (Frank J. Fabozzi ed., 1998). The interesting thing to note about the example from this source is that although the author uses the term "put option," he is actually describing the basic CDS arrangement.
[40] Lokken, *supra* note 21, at 16.
[41] *See id.*
[42] *Id.*
[43] *Id.*
[44] *See e.g.*, Rev. Rul. 78-182, 1978-1 C.B. 265, 1978 WL 42024.

the cost of the option premium and the entity writing the option does not immediately include that premium in income.[45] Rather, the amount of gain or loss on the option will wait until the option is exercised, sold, or allowed to expire.[46] The character of the gain or loss will be the same character as the property to which the option refers,[47] and the source of the income depends on the residence of the taxpayer.[48] Continuing from the put option transaction above, if we assume that A has paid the $100 premium to B in exchange for the right to put 300 shares of C Corporation to B in 75 days for $5 per share from A then A's exercise of that option would be treated as a sale of 100 C shares by B for $1500 (300 times $5). For the purposes of this example, we will also assume that A has a tax basis of $500. A has an amount realized of $1500, he has an adjusted basis of $500 and he is paid an option premium of $100. The result is a gain of $900 ($1500 minus $600).[49] Likewise, at the time of exercise B will take that $100 it received into calculating gain or loss on the stock that it recently sold by decreasing its basis by the $100.[50] The character of both A and B's gain or loss will be determined by the stock that they held.

One could imagine carrying this option taxation scheme to CDSs in the following way. Assume the most basic CDS transaction: B purchases CDS coverage from C against the default of Corporation A's bonds. Under the option guidelines, neither B nor C would take that premium into account at the moment it occurred. Instead, they would wait until a recognizable event happened. That event could be the expiration, sale, or exercising of the contract if a credit event occurs. Just like the option regime, the parties could wait until that moment to take the income into account. Thus, this most basic type of CDS contract at first blush could fit for tax purposes as a contingent put option.

A thorough look at the relationship between CDS agreements and options shows fundamental inconsistencies that make it difficult

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[45] STAFF OF JOINT COMM. ON TAXATION, 110TH CONG., REPORT ON PRESENT LAW AND ANALYSIS RELATING TO THE TAX TREATMENT OF DERIVATIVES 15 (Comm. Print 2008) (citing Rev. Rul. 78-182, 1978-1 C.B. 265).
[46] *Id.*
[47] *Id.*(citing 26 U.S.C. § 1234 (2010)).
[48] *Id.* (citing 26 U.S.C. § 1234(b)(1) (2010)).
[49] *See* Lokken, *supra* note 21, at 17.
[50] Rev. Rul. 78-182, 1978-1 C.B. 265 (referring to section D3 of the ruling).

to classify CDSs as put options. A fundamental feature of any option agreement is the strike price. The strike price is the contractually agreed upon amount that the holder of the option will pay the option writer for the stock held by the writer. This analogy does not always hold in the CDS context where there is no equivalent to the strike price. One may argue that the strike price is equivalent to the amount of the payment should a credit event occur. This argument does not address the fundamental difference between the two instruments. The strike price is used so that the option holder can acquire an asset in exchange for consideration. This feature is not present in the CDS context. When the protection seller pays the protection buyer after a credit event, the protection seller is not acquiring an asset. Instead, it is transferring assets to the protection buyer and receiving nothing in return; it puts forth consideration but receive no consideration itself. This presents a fundamental difference in the function of these two financial instruments that cuts against treating them similarly for tax purposes.

The basic taxation framework for options also presents difficulty in the CDS context. As previously mentioned, the option taxation scheme takes a wait-and-see approach. No party recognizes any payment for tax purposes until the option is exercised, sold, or retired.[51] Options exist so that individuals and companies can bet on the direction of the underlying security. The typical CDS arrangement does not contemplate this type of transaction.[52] One can infer from the regulations that this uncertainty is one of the reasons why the Treasury allows option holders and writers to use a "wait-and-see" approach.[53] CDS payments between the parties are more certain than options and so a wait-and-see taxation approach is unnecessary. The contract will specify whether the payments are periodic or a one-time lump sum payment. Because those payments are more consistent, it would not make sense for protection sellers to hold off on the recognition of that income.

Finally, a structural argument exists that argues against treating CDSs as options for tax purposes. Most CDS agreements

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[51] Rev. Rul. 78-182, 1978-1 C.B. 265 (pulling from § C of the ruling).

[52] Granted, this argument does not hold true for naked CDS situations where the protection buyer is using a CDS to short a company's stock.

[53] Rev. Rul 78-182, 1978-1 C.B. 265. In its introduction the ruling specifically discusses a financial actor's use of puts, calls, and straddles to deal with market volatility.

have a term of five years.[54] Option agreements, on the other hand, have a variety of terms in order to meet the parties' needs. Again, the wait-and-see approach is appropriate for options exactly because their terms are so varied. Because the structure of CDSs is more certain it does not make sense to place a tax scheme designed for an uncertain time frame onto a certain time frame. Considering that the basic pricing, payment flows and structure of CDSs and options differ, the option taxation scheme provides a less than adequate solution to the basic CDS taxation problem.

B. As a Notional Principal Contract?

In addition to treating CDS as a guarantee or an option, some have argued that CDSs should be treated for tax purposes as a notional principal contract ("NPC").[55] The Treasury defines an NPC as:

> 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.[56]

A notional principal amount is "any specified amount of money or property that, when multiplied by a specified index, measures a party's rights and obligations under the contract, but is not borrowed or loaned between the parties as part of the contract."[57] [58]

Breaking down the definition of an NPC, the typical CDS agreement meets the definition of an NPC.[59] The first requirement is

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[54] Lokken, *supra* note 21, at 18.
[55] Kayle, *supra* note 4, at 1108-18.
[56] Treas. Reg. § 1.446-3(c)(1)(i) (1994).
[57] *Id*. § 1.446-3(c)(3).
[58] The inspiration for the presentation of these regulations comes from order in laying out these regulations can be attributed to David Garlock, Howard Leventhal & Alan Munro, *Ernst & Young Comments on Tax Treatment of Credit Default Swaps*, TAX NOTES 855, 858-59 (Feb. 14, 2005).
[59] *Id.* at 858 (noting that most practitioners agree that a typical CDS agreement following the ISDA Master Agreement meets the definition of a notional principal contract).

that the CDS must be a financial instrument. The Treasury Regulation provides examples financial instruments that qualify as NPCs, such as "interest rate swaps, currency swaps, basis swaps . . . and similar agreements."[60] The regulations also specify what an NPC is not: 1256(b) contracts, futures or forward contracts, general debt instruments, or option contracts.[61] In reviewing this initial requirement, CDS agreements seem to fit the basic contract envisioned by the regulations as qualifying as an NPC. Many of the contracts cited by the regulations as examples of an NPC are exotic derivatives, just like CDSs, and so the catch-all "similar agreements" may include CDS agreements. However, the regulations state that options contracts are not an NPC.[62] Thus, arguing for NPC treatment of CDS agreements forecloses the possibility of treating the CDS as an option.

The second requirement of an NPC is that it must include payments made in reference to a specified index.[63] A specified index is merely an "index that is based on objective financial information."[64] Three types of payments are permitted: periodic, termination and nonperiodic.[65] Periodic payments are those that are received under an NPC at intervals of a year or less.[66] A termination payment is one that is

> …made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party under a notional principal contract…. A termination payment includes a payment made between the original parties to the contract (an extinguishment), a payment made between one party to the contract and a third party (an assignment) and any gain or loss realized on the exchange of one notional principal contract for another. Where one party assigns its remaining rights and obligations to a third party, the original non-

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[60] Treas. Reg. § 1.446-3(c)(1)(i).
[61] *Id*. § 1.446-3(c)(1)(ii).
[62] *Id.*
[63] *Id*. § 1.446-3(c)(2).
[64] *See* Garlock et al., *supra* note 58, at 858 (citing Treas Reg. § 1.446-3(c)(2)(iii)).
[65] *See generally* Treas. Reg. § 1.446-3.
[66] Treas. Reg. § 1.446-3(e)(1) (1994).

> assigning counterparty realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event under section 1001.[67]

A nonperiodic payment is a catch-all term that covers payments received under an NPC that are not a periodic payment or a termination payment.[68]

A basic example showing what type of financial instruments the regulations envision as an NPC helps to understand how the regulations capture certain types of financial transactions. For example, suppose X and Y enter into a contract whereby X will make monthly payments to Y based on the 90-day U.S. dollar LIBOR on $10 million and Y will pay X $100,000 (derived by taking one-fourth of 4 percent of $10 million) to X monthly.[69] [70] Both the LIBOR and the 4 percent meet the definition of a specified index.[71] The notional amount in this example is $10 million and that amount is the basis for which the payments each party makes to each other are computed.[72] The result is that this is an NPC.[73]

One can see how the basic CDS situation would fit the NPC regulations in the context of periodic payments. In a CDS agreement, the protection buyer will make periodic payments to the protection seller in exchange for the protection seller's coverage under the CDS. These payments are often calculated in reference to either a fixed or floating index based on a notional amount.[74] That notional amount is usually made by looking at the principal amount of the reference obligation.[75] Like the example above, there are periodic payments, an index and a notional amount. Furthermore, the protection buyer

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[67] *Id.* § 1.446-3(h).
[68] *Id.* § 1.446-3(f)(1).
[69] Lokken, *supra* note 21, at 19.
[70] This is only a basic example. There are many different and complicated financial transactions that can fall within the definition of NPC. *See, e.g.*, KEVIN M. KEYES, DESCRIPTION OF NOTIONAL PRINCIPAL CONTRACTS 2-30. (Frank J. Fabozzi ed., 1998) (describing various financial transactions that constitute NPCs).
[71] *See* Lokken, *supra* note 21, at 19.
[72] *Id*.
[73] *Id.*
[74] Garlock et al., *supra* note 58, at 858.
[75] *Id.* at 858-59.

makes the payments for consideration.[76] Thus, the NPC regulations appear to be satisfied. The resulting character of the payments under a NPC is that the recipient recognizes the payments as income and the payor recognizes an expense for the period in which the payments were made.[77] Nonperiodic payments in a CDS contract would not change the result.[78]

Some have suggested that the protection seller's payment to the protection buyer after a credit event could qualify as a termination payment.[79] As the definition of termination payment sets forth, any payment made by a party to extinguish its rights under the contract would be a termination payment.[80] When the protection seller pays out the contractually specified amount to the protection buyer after the occurrence of a credit event, the protection seller is essentially extinguishing its obligations under the contract. This treatment, however, misses a key distinction between a payment event under a credit event and a termination payment. When a party makes a payment under a credit event it is because the contract requires it.[81] The regulations defining 'termination payment' suggest that the contract does not require the protection seller to make the payment.[82] Rather, the protection buyer chooses to close out their position. Thus, the definition of 'termination payment' under the regulations does not adequately encompass the payment that occurs upon a credit event.

A more thorough review of the regulations governing NPCs shows that taxing CDSs under this regime presents other difficult issues. First, as mentioned above, the regulations give examples of NPCs as being "interest rate swaps, currency swaps," etc.[83] At first glance, a reader might see the proliferation of the word "swap" in the regulations and think that because CDSs contain the word "swap" that these instruments are alike. However, significant differences

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[76] Lokken, *supra* note 21, at 23 (citing Treas. Reg. § 1.446-3(c)(1)(i)).
[77] *Id.* at 20 (citing Treas. Reg. § 1.446-3(e)(2)).
[78] The regulations would characterize the payments as nonperiodic and the parties would need to recognize both the income and expenses relating to that contract over the contract term. *See* Lokken, *supra* note 21, at 21(citing Treas. Reg. § 1.446-3(f)(2)(i)).
[79] Kayle, *supra* note 4, at 1115-16.
[80] Treas. Reg. § 1.446-3(h)(1).
[81] Kayle, *supra* note 4, at 1115-17.
[82] *Id.*
[83] *Id*. § 1.446-3(c)(1)(i).

exist in those instruments. For example, a currency swap involves the literal exchanging of one currency for another.[84] An interest rate swap involves two parties who trade their respective interest streams with each other through contract.[85] CDSs, on the other hand, are not swapping anything. Indeed, the name "credit default swap" is misleading. The counterparties in a CDS transaction are not swapping assets that they currently have;[86] instead, they are working to provide a backstop should a credit event occur. This is a fundamental difference of these two transactions. Thus, from a technical perspective, CDSs are not similar creatures to the types of instruments covered by the treasury regulations.[87] A CDS is fundamentally different in its nature from the types of financial instruments that are governed as NPCs.

A second issue arises surrounding the treatment of the CDS credit event under the NPC regulations. Under a CDS contract, a credit event will trigger a payment from the protection seller to the protection buyer. The problem arises in how to treat that payment under the NPC regulations. Because the payment happens only once, one cannot classify it as periodic. At most, it must be a nonperiodic payment.[88] If the payment is classified as nonperiodic, then the regulations require that the payment be spread out over the life of the contract.[89] This is a problem in the CDS situation because there is no certainty that the credit event will occur. The parties cannot spread a nonperiodic payment over the terms of the contract if no one knows

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[84] U.S. COMMODITY FUTURES TRADING COMM'N, *CFTC Glossary*, *available at* http://www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/glossary_co.html.

[85] CAL. DEBT & ADVISORY COMM'N, *Understanding Interest Rate Swap Math & Pricing* 1, 1-2, July 2007, *available at* http://www.treasurer.ca.gov/cdiac/publications/math.pdf (last visited Oct. 12, 2010).

[86] Companies that engage in interest rate or currency swaps for example are swapping their assets or the right to receive a stream of assets with one another.

[87] A further technical reason for not treating CDSs similarly to NPCs can be found in Brandes *supra* note 13, at 275-76 (citing Treas. Reg. § 1.446-3(c)(1)(i)). Brandes points out that the definition of a NPC in the treasury regulations references "payment of amounts" between counterparties. This regulation presupposes money changing hands. In a CDS contract, the protection seller may never need to make a payment.

[88] Lokken, *supra* note 21, at 23.

[89] *Id.* (citing Treas. Reg. § 1.446-3(f)(2)).

whether the nonperiodic payment will occur.[90] The amount of the payouts would add to the confusion caused by this regime. In the recent financial crisis, AIG made billions of dollars in payouts to multiple companies.[91] The current NPC regulations would not adequately deal with those payments.

An interest rate swap highlights the contracts between an NPC and a CDS. In an interest rate swap, which is an NPC, two parties will contractually agree to swap payments based on certain indexes. Although the parties do not necessarily know the amount of the payment stream that they will receive because the index may be a floating one, both parties are certain of receiving payments of some kind. Contrast that situation with the CDS agreement where the protection buyer is uncertain if he will receive a payment and the protection seller is uncertain if he will have to make a payment. They know that they will each receive payments, but they do not know if there will be any cash flow to the protection buyer. Thus, the fundamental notion of payments in the NPC regulations is frustrated by the CDS situation because multiple uncertainties exist regarding certain payment streams.

A final problem with taxing a CDS like an NPC is that some CDS contracts call for a single payment from the protection buyer.[92] An NPC requires payments at "specified intervals."[93] "Specified intervals" requires multiple payments. Should this interpretation hold and should the Treasury decide to apply the NPC regulations to CDSs, then a significant portion of CDS contracts would escape NPC treatment simply by having a lump-sum payment.[94] The Internal

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[90] Garlock et al., *supra* note 58, at 859-61. The treasury has proposed regulations to deal with timing and character issues involving contingent nonperiodic payments. However, the authors of the cited article argue strongly against applying those regulations to CDSs should CDSs be classified as NPCs.

[91] Mary Williams Walsh, *A.I.G. Lists Firms To Which It Paid Taxpayer Money*, N.Y. TIMES, Mar. 16, 2009, at 1*available at* http://query.nytimes.com/gst/fullpage.html?res=9C0DE5D6173FF935A25750C0A96F9C8B63 ("Financial companies that received multibillion-dollar payments owed by A.I.G. include Goldman Sachs ($12.9 billion), Merrill Lynch ($6.8 billion), Bank of America ($5.2 billion), Citigroup ($2.3 billion) and Wachovia ($1.5 billion).").

[92] Garlock et al., *supra* note 58, at 859.

[93] *Id.* (citing Treas. Reg. § 1.446-3(c)(1) (1994)).

[94] *Id.* (stating how CDS contracts could avoid such regulation by requiring a lump-sum payment.).

Revenue Service ("IRS") could remedy the situation through a clarification of the regulations; nonetheless, the current form of the regulations remains a problem for purposes of classifying CDSs as NPCs.

C. As Insurance?

If CDSs provide payouts when unfortunate events happen, should we not just label these contracts as insurance and tax them the same way? Indeed, during the height of the financial crisis, certain states threatened to bring issues of CDS within the control of their insurance regulatory bodies.[95] This approach, however, suffers from multiple problems. First, if extended to its logical consequence, many different types of financial deals would be considered insurance on many different levels.[96] Take, for example, an average person investing in the commodities market. That person may have a long position in Middle Eastern oil but because they are not fully confident in their choice they also take a short position in that same market. They do this to hedge their position, or in other words, they are providing their long position with insurance should an undesired event occur. Likewise, a similarly significant problem exists for purposes of classifying CDS as insurance due to the way the insurance industry is regulated. Insurance is regulated at the state level and CDSs may not meet the definition of insurance in every state.[97] Trying to impose a tax on a CDS by treating it like insurance would pose a regulatory headache because the IRS would need to find a way to overcome the difficulties of working with not only fifty different state insurance agencies but also fifty different definitions of whether a CDS contract fits the definition of insurance. Thus, taxing CDSs as insurance is not a practical solution to the problem both because of definitional and functional issues.

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[95] *See* Serena Ng & Liz Rappaport, *Crisis on Wall Street: New York Tries Taming Credit-Default Swaps—State to Regulate Certain CDS Pacts as Insurance Deals*, WALL ST. J., Sep. 23, 2008, at C3 ("New York regulators are attempting to tame parts of the unregulated credit-default-swaps market by requiring some sellers of these contracts to become insurance companies.").

[96] The basic idea for this argument comes from Brandes, *supra* note 13, at 270-71.

[97] Brandes, *supra* note 13, at 271. Also, note that Brandes raises several other reasons why taxing CDSs as insurances do not mix in 271-74.

IV. The Guarantee Tax Structure and CDSs

A. The Guarantee Tax Structure is an Optimal Solution for CDSs

The IRS should treat guarantees and CDSs similarly for tax purposes because CDSs fit well within the current guarantee taxation scheme. In a guarantee, there are two basic parties: the party providing the protection (the guarantor) and the party covered by that protection (the obligor).[98] Although some uncertainty exists in the taxation of these parties, the basics of the transaction are fairly clear. Regarding tax treatment of the guarantor, the IRS has generally characterized guarantee fees paid by the obligor to the guarantor as ordinary income.[99] The guarantor takes those fees into account according to their normal method of accounting.[100] Should an actual credit event occur, the guarantor is normally entitled to deduct the payment when made as a "bad debt."[101] Some uncertainty does exist regarding the sourcing of the income. The sourcing of the income refers to whether the income is paid by a U.S. resident or a foreign person.[102] The obligor's residence should determine the source of the income.[103] The question is whether the obligor for sourcing purposes is the obligor under the reference asset or the party actually paying the fees.[104] The outcome of this question would result in different tax consequences for withholding purposes.[105]

Turing to the tax treatment of the obligor, periodic guarantee fees made by the obligor are currently deductible as an ordinary expense,[106] and a lump sum guarantee payment is treated as an

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[98] David S. Miller, *An Overview of the Taxation of Credit Derivatives*, 484 PLI/TAX 1287, 1293 n.3 (2000).
[99] *Id.* at 1294.
[100] *Id.*
[101] *Id.* at 1296 (quoting Treas. Reg. § 1.166-8 (a)(1)).
[102] *See generally* LEXISNEXIS TAX ADVISOR, CHAPTER 4B:3 RULES ON THE SOURCE OF INCOME (2010).
[103] Miller, *supra* note 98, at 1295 (citing Bank of America v. United States, 680 F.2d 142, 150 (Cl. Ct. 1982); private letter ruling 9651052 (June 19, 1996)).
[104] *Id.*
[105] Kayle, *supra* note 4, at 1128-30.
[106] Miller, *supra* note 98, at 1297 (citing Revenue Ruling 70-544, 1970-2 C.B. 6; Revenue Ruling 70-545, 1970-2 C.B. 7. *See also* Revenue Ruling

amortizable payment.[107] Sourcing for the obligor is easier to determine. Payments received by the obligor will be treated as directly from the issuer: those received from a foreign issuer will be foreign-source income, and those issued from a U.S. issuer will be U.S.-source income.[108]

In considering a solution to the problem of how to tax CDSs, issues of timing, character and source are critical.[109] The payments in the CDS situation find a satisfying solution in the guarantee context. Under a guarantee scheme, the basic tax treatment of the payments that flow between the protection seller and protection buyer find excellent treatment because these payments are similar in nature to the payments that the protection buyer makes to the protection seller. As mentioned above, guarantee fees that the debtor pays are treated as currently deductible business expenses.[110] In the CDS context, the payments are either a stream of payments or a lump-sum payment. Comparatively, the payments made by the obligor will be either in lump sum or as a stream of payments. If the guarantee scheme were to apply to CDSs, the protection buyer would deduct the payments made to the protection seller as an ordinary business expense.[111]

On the other end of the deal, the payments that the guarantor receives function analogously to the payments that the protection seller receives from the protection buyer. Using the guarantee scheme, the protection seller would take the payments when it receives them into ordinary income.[112] The analogy further applies to other significant aspects of a guarantee-type agreement. When a credit event occurs, payments made to the obligor are treated as a "bad debt" and the guarantor can deduct those payments as an expense.[113] Likewise, the protection seller would be able to treat those payments it makes on the instrument as a bad debt. The protection buyer in the CDS would treat any payments received from

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71-399, 1917-2 C.B. 433, amplified by Revenue Ruling 72-376, 1972-2 C.B. 647; Revenue Ruling 84-10, 1984-1 C.B. 155; General Counsel Memorandum 39113 (October 7, 1983) (corresponding to Revenue Ruling 84-10); private letter ruling 8110142 (December 12, 1980)).

[107] *Id.*

[108] *Id.*

[109] Lokken, *supra* note 21, at 14.

[110] Miller, *supra* note 28, at 110.

[111] Kopp & Nirenberg, *supra* note 12, at 92.

[112] *Id.*

[113] Miller, *supra* note 98, at 1296.

the protection seller on the occurrence of a credit event as the amount realized from a sale of the reference security or as a principal payment.[114] On the issue of timing, the payments made and received would be matched to the "periods to which the payments relate . . . ."[115] Thus, applying the guarantee scheme to tax CDSs seems logical because of the similarities between these two instruments with respect to the roles of the parties.

The sourcing rules currently in place for guarantees further support the argument for taxing CDSs like guarantees. Sourcing is a term of art that determines whether payments on an investment or other asset are subject to U.S. Federal tax.[116] For example, suppose a United States citizen were to buy and sell stock in a foreign corporation for a sizeable profit. That citizen would be subject to U.S. income tax rules because she lives in the United States, even though her gain results from a company that does not do business within the United States.[117] The sourcing rules applicable to guarantees are quite clear and provide a good pattern for CDS transactions as well.[118] The sourcing rules are codified in 26 U.S.C. §§ 861 and 862, but specific regulations apply to guarantees. For example, Reg. § 1.861-2(a)(5) states that "if interest is paid on an obligation of a resident of the United States by a nonresident of the United States acting in the nonresident's capacity as a guarantor of the obligation of the resident, the interest will be treated as income from sources within the United States."[119] Reg. § 1.862-1(a)(5) states that "if interest is paid on an obligation of a nonresident of the United States by a resident of the United States acting in the resident's capacity as a guarantor of the obligation of the nonresident, the interest will be treated as income from sources without the United States."[120] Thus, interest income from payments made on a

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[114] Kopp & Nirenberg, *supra* note 12, at 92.
[115] Kayle, *supra* note 4, at 1127.
[116] *See generally* LEXISNEXIS TAX ADVISOR, CHAPTER 4B:3 RULES ON THE SOURCE OF INCOME (2010).
[117] *Id.* at 4B:3.12[d].
[118] Kayle, *supra* note 4, at 1081 (describing the tax treatment of guarantees as "simple, intuitive and almost entirely settled").
[119] Treas. Reg. § 1.861-2(a)(5) (1997).
[120] I.R.S. Gen. Couns. Memo 38646 (Feb. 27, 1981) (citing Treas. Reg. § 1.862-1(a)(5) (1983)).

guarantee, regardless of the residency of the payer, are taxed according to the residency of the obligor, the income's source.[121]

This sourcing arrangement could apply to CDSs for several reasons. First, the guarantee sourcing rules fit within the basic framework of a CDS agreement. The sourcing rules mention payments made "on an obligation."[122] In a CDS transaction, the protection seller makes payments when a credit event occurs on a reference entity.[123] As contemplated in the sourcing rules, those payments are made on an obligation for the protection seller to cover the protection buyer.

Second, like guarantees, a CDS can involve multiple parties covering various aspects of a single, often complex transaction. The same financial institutions that provide these financial guarantees, however, may also be involved in CDS transactions. [124] This reduces transaction costs because financial institutions are already familiar with the guarantee sourcing rules and thus the learning curve for reporting these transactions for tax purposes would not be as steep. Given the industry-wide trend toward standardizing CDS contracts,[125] using the guarantee method of taxation would streamline the process so that all of the actors involved will know how to deal with their CDS contracts. This would facilitate a more efficient tax system overall as well as create less of an administrative headache for financial companies working in these areas.

Finally, from the perspective of the sourcing rules, it makes sense to tax CDS as guarantees because of the variety of companies that engage in CDS transactions. Many of the CDS deals involve not only U.S. companies, but rather they may include foreign companies, with or without branches in the United States.[126] With the current

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[121] I.R.S. Gen Couns. Memo 38646 (Feb. 27, 1981).
[122] Treas. Reg. §§ 1.861-2(a)(5) (1997), 1.862-1(a)(5) (1983).
[123] Brunson, *supra* note 11, at 2-3.
[124] See Serena Ng & Lavonne Kuykendall, *Crisis on Wall Street: MBIA is Sued Over a Split of Businesses*, WALL ST. J., Mar. 12, 2009, at C3 for an example of a major financial player being involved in both the CDS and financial guarantee business.
[125] Erika W. Nijenhuis & Diane G. Simons, *Securities Industry and Financial Markets Association (SIFMA) Letter to Steven A. Musher Regarding Standardized Credit Default Swaps*, 906 PLI/TAX 47, 51 (Apr. 12, 2010).
[126] For a brief example of Goldman Sachs and J.P. Morgan Chase making swap agreements with foreign institutions and countries see Luca Di Leo & Susanne Craig, *Europe's Economic Woes: Fed Examines Swaps Deals by Goldman and Others*, WALL ST. J., Feb. 26, 2010, at A10 (2010).

sourcing rules, these companies would know how to label their income without confusion. Writing a completely new set of sourcing rules for CDS transactions would increase the transactional costs for these companies and for regulators, and slow needed liquidity in the financial markets. Therefore, the sourcing rules currently in place provide further support for taxing CDSs as guarantees because of the sourcing rules currently in place.

B. Naked CDS Transactions Challenge the Basic Guarantee/CDS Analogy

Although an apt analogy in many respects, all of the elements of a CDS agreement would not fit comfortably into the taxation scheme of a guarantee. Classifying a CDS as a guarantee makes the most sense when the protection buyer owns the underlying obligation.[127] In a naked CDS transaction, the protection buyer does not own the underlying reference entity; rather the buyer is simply betting on the creditworthiness of the institution that has issued the obligation.[128] The protection buyer does not necessarily care that performance of that entity is guaranteed to happen.[129]

For example, suppose I get tired of being a lawyer and decide to enter the chocolate industry. Wanting to provide the best chocolate, I buy an interest in a cooperative cocoa bean farm in Madagascar. Being a wise investor, I realize that my profits will suffer should the farm fail to provide me with my monthly supply of cocoa beans. So, I negotiate with a financial company a CDS contract to cover any lost profits due to a loss of supply. The payout on the CDS will allow me to either keep those dollars or use them to buy cocoa beans from elsewhere. This arrangement represents the classical CDS context because I own the underlying entity.

To extend this analogy to the naked CDS situation, suppose that Wall Street banks and other financial actors get wind of a potential violent rainstorm off the coast of Southeastern Africa.

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[127] David Z. Nirenberg & Steven L. Kopp, *Credit Derivatives: Tax Treatment of Total Return Swaps, Default Swaps, and Credit-Linked Notes*, 87 J. TAX'N 82, 91-92 (Aug. 1997).

[128] Sarah N. Lynch, *Crisis on Wall Street: New York will Suspend its CDS Plan*, WALL ST. J., Nov. 21, 2008, at C2.

[129] Kayle, *supra* note 4, at 1126-27. Here, Kayle argues that the possibility that the protection buyer does not own the reference entity in a CDS transaction militates against treating the CDS as a guarantee for tax purposes.

Hoping to make a profit, these banks and financial institutions negotiate CDS contracts with each other based on the likelihood that the cocoa farm will fail to provide me with my supply of cocoa beans for the week. This transaction takes place, at least in part, because each side believes its respective forecast is correct. The naked protection buyer seeks to pay a small premium for a big payout, and the protection seller believes that it will receive free money in the form of premiums on which it will never make good.[130] The difference between the financial actors and me in the example is that I actually own an interest in the cocoa bean farm whereas the investors do not. This naked CDS arrangement presents a problem because the financial actors who made the naked CDS deals will not be the ones who insist that the farm perform on its obligation to provide me with beans or go after the CDS protection seller to compensate me for my losses. Although concerned with the outcome for the purposes of the transaction, the financial actors deal only with each other. They do not care whether I get my beans. Thus, the normal guarantee relationship does not exist in a naked CDS transaction. Given the great number of naked CDS transactions in the marketplace,[131] this difference represents a significant issue.

Although significant, the issue is not insurmountable. There are a few ways to deal with this issue from a regulatory perspective. Perhaps the simplest solution would be to create a set of attribution rules for naked CDS transactions. In the context of corporate tax planning, the attribution rules are complex and designed to prevent corporations or individuals from sheltering income from taxes.[132]

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[130] For an excellent article looking into AIG's business practices that exemplified the belief that it would never need to pay out big on CDS deals, see Carrick Mollenkamp et al., *Behind AIG's Fall, Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1.

[131] Along with short-selling, naked CDS transactions are a beloved target for politicians and several proposals have been floated that would ban these transactions. *See, e.g.,* American Clean Energy and Security Act of 2009, H.R. 2454, 111th Cong §355 (2009); Prevent Unfair Manipulation of Prices Act of 2009, H.R. 2448, 111th Cong. § 7 (2009). Naturally, if these transactions were to be banned, then there would not be an issue for tax purposes here. However, a ban is unlikely and certainly was not a part of the recently passed Dodd-Frank bill. *See generally* Dodd-Frank, *supra* note 2.

[132] For an exhaustive treatment of the attribution rules in a corporate tax-planning atmosphere, see Reuven S. Avi-Yonah & Karen B. Brown, *The Attribution Rules (Portfolio 554)*, BNA TAX & ACCOUNTING, available on file with the author of this note.

Although this stated goal of the attribution rules may not necessarily apply to the CDS context, the concept of applying attribution rules that create constructive ownership could work for tax purposes. For example, an investor with a naked CDS position could be attributed as owning the reference obligation. The investor would then take into account the timing, character and source of that reference obligation. Delineating how this tax scheme would work is outside the scope of this note; however, the possibility of applying such a scheme seems persuasive.

Another solution to the naked CDS problem might be to do nothing at all. This would preclude naked CDS integration with the reference obligation. The tax implication of doing nothing is that naked CDS holders would be subject to withholding taxes.[133] In addition to resolving the tax issue, from a public policy perspective, this would disincentivize investors from engaging in naked CDS transactions. Some public officials wish to ban the transaction[134] Providing less than ideal tax treatment might be a compromise with those who think the transactions should be allowed.

V. Functional Similarities between Guarantees and CDSs Strengthen the Argument for Treating CDSs and Guarantees Similarly for Tax Purposes

A. Risk-Hedging Roles

Both CDSs and guarantees serve a risk-hedging function. A lender uses a guarantee when it does not feel secure about the borrower. Without a guarantee, the lender will likely not loan the borrower the amount she requests. Likewise, a financial company use CDS contracts to protect itself should the reference entity not perform as desired. The risk hedging function in both types of transactions allows these products to provide liquidity to the financial markets and facilitate transactions that otherwise would not be possible for one reason or another. Although two fundamentally

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[133] Kayle, *supra* note 4, at 1129 (arguing that payments made by the protection buyer likely would meet the "fixed or determinable annual or periodical amounts ("FDAP")" requirement and, if the payments had a U.S. source, the payor would be required to withhold at a rate of 30 percent").

[134] American Clean Energy and Security Act of 2009, H.R. 2454, 111th Cong §355 (2009); Prevent Unfair Manipulation of Prices Act of 2009, H.R. 2448, 111th Cong. § 7 (2009).

similar transactions need not necessarily receive the same tax treatment, the functional similarity between CDSs and guarantees supports the idea that they should be treated similarly for tax purposes.

B. Secondary Liability Instruments

CDS and guarantees should be treated similarly for tax purposes because they both provide "secondary liability."[135] Neither a guarantee nor a CDS protection seller pays unless the original obligor remains solvent. For example, in a guarantee relationship, the guarantor will not need to pay the creditor until the obligor defaults on his payments.[136] Likewise, the protection seller will, generally, only need to pay out when a credit event occurs.[137] This "secondary liability" function of CDSs and guarantees strengthens the proposition that they should be treated similarly for tax purposes. Again, CDSs and guarantees perform the same basic function. Thus, it follows that it would make sense to tax these instruments similarly.

C. Cash Flow Triggers

Another reason that CDSs and guarantees should be taxed similarly has to do with the way the cash begins to flow between the protection buyer and seller and the guarantor and the creditor. In both of transactions, the cash does not begin to flow until either the occurrence of a credit event or a failure to make a payment.[138] At the time the parties enter into the transaction, most parties do not want the credit event to trigger or the obligor to miss a payment.[139] Certainly, in both situations whether the cash flows between the parties is not a foregone conclusion at the beginning of the contract.

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[135] For a discussion on how guarantees are secondary liability instruments see David S. Miller, *Federal Income Tax Consequences of Guarantees: A Comprehensive Framework for Analysis*, 48 TAX LAW. 103, 107 (Fall 1994).

[136] *Id.* at 106-08.

[137] *International Finance: Regulators See Orderly CDS Market*, WALL ST. J. Mar. 10, 2009, at C2.

[138] Bruce Kayle, *Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions*, 50 TAX LAW. 569, 598 (Spring 2007).

[139] This does not hold true for actors who engage in naked CDS transactions with the bet that a credit event will occur.

Indeed, by their very nature as "secondary liability" financial tools, the parties do not conceive them as being regularly used. This is important because for the purposes of finding a home for CDS in the tax world it makes sense to place CDS in an area that corresponds to one of the main features of a CDS; namely, there is neither a certainty nor an expectation that money will flow between the two counterparties in every transaction.

D. Industry Use

Since CDSs and guarantee contracts between businesses are often private affairs, it is difficult to consider how the industry views these two products. During the recent financial crisis, however, many companies struck deals involving financial guarantees and CDSs that ended poorly and resulted in litigation. These recent cases and the information contained in the court records provide an excellent glimpse into how the industry views these financial products. Furthermore, the cases tend to strengthen the argument that CDSs and guarantees should be treated similarly by showing that the financial industry uses the instruments in similar ways.

For example, in *In re Merrill Lynch Auction Rate Sec. Lit.*, the defendants used CDSs and guarantees to make financial bets. [140] Although the main issue of this case does not involve whether guarantees should be treated as CDSs,[141] it is nonetheless informative as to how the industry uses these instruments similarly. In this case, the Louisiana Stadium and Exposition District ("LSED") owned and operated the Louisiana Superdome ("Superdome").[142] LSED wanted to refinance its debt in order to take advantage of lower interest rates.[143] Merrill Lynch functioned as the underwriter and after a series of unfortunate events involving LSED, Merrill Lynch advised LSED to issue securities with a synthetic fixed rate structure.[144] A synthetic fixed rate structure "is created when a borrower issues variable rate bonds then enters into a variable-to-fixed interest rate

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[140] *See In re Merrill Lynch Auction Rate Sec. Lit.*, No. 09 MD 2030, 2010 WL 1924719 (S.D.N.Y. May 11, 2010).

[141] The issues in this matter involved various contractual claims of LSED against Federal Guaranty Insurance Company (FGIC). *Id*. at 1.

[142] *Id.*

[143] *Id.*

[144] *Id.*

swap."[145] LSED eventually accepted Merrill Lynch's proposal and issued a series of bonds with these synthetic features.[146] LSED also purchased insurance policies for the bonds from Financial Guaranty Insurance Company ("FGIC").[147] At the same time that FGIC was engaged in business with LSED, it was also engaged in selling guarantees and CDS agreements to holders of securities of collateralized debt obligations ("CDOs").[148] When the housing market crashed, FGIC was unable to meet its insurance obligations to LSED. Further, it was unable to meet the increased demands placed on it by the weak housing market and the guarantee/CDS products it had sold backing the synthetic CDOs.[149] For the purposes of this note, the important aspect of the transaction was the fact that FGIC used CDSs and guarantees similarly. That is, it used them both to back CDOs. This shows that at least functionally, a major company in the financial industry was using these two products similarly, bolstering the argument that these two products should receive similar tax treatment.

Other case law examples demonstrate this practice. In *MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, LaCrosse sold CDS protection to Merrill Lynch, backing CDOs.[150] The CDSs had been issued by MBIA.[151] MBIA created these CDS contracts by essentially mimicking financial guarantees. MBIA ensured that the CDOs would continue to perform by inserting financial guarantee insurance policies in the CDS contracts.[152] As in the previous case, MBIA used financial guarantees and CDS contracts interchangeably. Indeed, in this situation, MBIA had inserted a "financial guarantee" into the CDS contract.[153] In light of the fact that the industry seems to

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[145] GEORGE K. BAUM & CO., *Synthetic Fixed Rate—Interest Rate Swaps*, *available at* http://www.gkbaum.com/is/swap101.pdf (last visited Oct. 18, 2010).
[146] *Merrill Lynch*, 2010 WL 1924719, at 2.
[147] *Id*.
[148] *Id.*
[149] *Id.*
[150] MBIA Ins. Corp. v. Merrill Lynch, Pierce, Fenner & Smith Inc., No. 601324/09, 2010 WL 2347014 (N.Y. Sup. Ct. Apr. 9, 2010) (involving "11 credit default swap contracts (CDSs) whereby LaCrosse sold credit protection to Merrill Lynch, in relation to underlying security, held by Merrill Lynch, in the form of 'collateral debt obligations' (CDOs)").
[151] *Id.* at 1
[152] *Id.*
[153] *Id.*

treat these two financial products similarly from a business perspective, these two products should be taxed similarly for that same reason.[154]

1. The Similarities between CDSs and Guarantees Warrant Similar Tax Treatment for Purposes of Equity, Transparency and Market Risk.

Because of the similarities between CDSs and guarantees, taxing the two similarly would be equitable. All taxpayers who engage in CDS or guarantee transactions should be treated in a rational and equal way.[155] The basic guarantee taxation scheme is settled[156] and as long as the financial players follow the logical structure of a CDS transaction, then each of those transactions should be taxed in the same way.

The "step-transaction doctrine" prevents a CDS transaction from being structured so that it avoids taxation under the guarantee scheme and the corresponding effect on policy goals. In *Commissioner v. Court Holding Co.,* the Supreme Court stated that "the incidence of the tax depends on the substance of the transaction."[157] Determining how a transaction will be taxed depends on the substantive result of the transaction. A party may not insert various steps into a transaction in order to take the transaction outside of the IRC when the result would have been taxable had those steps not been taken.[158] Thus, practitioners would have a difficult task trying to create a transaction that mechanically would not meet the rules, but would substantively function like a CDS, and

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[154] Although other similar cases do not explicitly interchange the terms as in the cases above, they do not draw a factual distinction between guaranteeing financial products through financial guarantees and CDSs. Rather, the practice is simply to guarantee financial products, and CDSs are a means used to achieve that goal. *See*, *e.g.*, In re Ambac Fin. Group, Inc. Sec. Lit., 693 F. Supp. 2d 241, 249 (S.D.N.Y 2010) (observing that the general business model of AMBAC was to guarantee CDOs with no distinction made between CDSs and financial guarantees).

[155] Anthony C. Infanti, *Tax ~~Equity~~*, 55 BUFF. L. REV. 1191, 1197-99 (January 2008).

[156] Kayle, *supra* note 4, at 1081.

[157] 324 U.S. 331, 334 (1945).

[158] *Id.*

still be successful in avoiding the tax. IRS officials will look to the overall effect of the transaction and not the initial mechanical steps.

For example, suppose that Dexter Corporation ("Dexter") decides to acquire all of the stock of Felix Corporation ("Felix") in exchange for stock of Dexter.[159] As soon as Dexter acquires Felix's stock, Dexter decides to liquidate and distribute Felix's assets to its shareholders. If these transactions were taken separately, there would be two separate transactions: a stock for stock acquisition followed by a liquidation. For the purposes of the step transaction doctrine, however, these transactions are "stepped" together so that for tax purposes the transaction is treated as a stock for assets transaction.[160] In the context of CDS and guarantee transactions, this doctrine helps prevent financial institutions from shirking the rules in order to avoid taxation.

Because the tax rules for basic guarantee transactions are fixed, taxing CDS transactions like guarantees would be transparent. Practitioners should know how to apply them in various situations. The transparency of the guarantee tax system, however, does not necessarily mean that the rules are simple.[161] Guarantee relationships can be complex and require complex tax planning.[162] However, the equitable and transparent nature of taxing CDS transactions like guarantees should outweigh the disadvantage of complexity, especially in light of the experience practitioners already have with guarantee taxation.

2. Reduce Market Risk?

In addition to the tax and policy implications of taxing CDSs like guarantees, a coherent and tested tax structure might reduce the riskiness associated with CDS contracts. Additionally, the regulators might be able to reduce some of the uncertainty involved. Reporting CDSs on income tax returns could give the IRS better data on CDSs, which could enable it to create guidelines that reign in the risk of these instruments without stifling their functionality.

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[159] See *Step Transaction Doctrine*, PILLSBURY TAX PAGE, *available at* http://pmstax.com/acqbasic/stepTran.shtml (last visited September 25, 2010).
[160] *Id.*
[161] *See, e.g.*, Miller *supra* note 28.
[162] *Id.*

E. Disparate Industry Treatment?

Although the above examples present similar industry treatment of CDSs and guarantees and thus an argument to tax the two instruments similarly, some case law indicates that the industry uses the two products differently. In *Deutsche Bank AG v. AMBAC Credit Prod., LLC,* there were three parties involved in the CDS transaction.[163] Deutsche Bank ("DB") was the protection buyer, AMBAC Credit Products ("ACP") was the CDS protection seller and Ambac Assurance Corporation (AAC) sold the financial guarantee.[164] In this transaction, AAC insured ACP so that ACP would be able to make any payments necessary under the CDS contract to DB.[165] AAC used a financial guarantee to support ACP's CDS contractual obligations with DB. Here, the parties used the two products separately in the same transaction.

The fact that these companies used CDSs and financial guarantees as two separate components in the same transaction does not weigh heavily against taxing CDS as guarantees given the nature of the deal. Even though the deal formally treated these products as two separate instruments, the basic function these products played in the deal was the same. In this transaction DB agreed to make payments to ACP in exchange for protection should the reference obligation default.[166] This was the CDS portion of the agreement. The financial guarantee portion of the agreement involves ACP and AAC's relationship.[167] AAC issued a financial guarantee that promised to cover any payments made from ACP to DB.[168] At their most basic level, these two transactions perform the same function in this transaction: they both guarantee that the expected cash flow will arrive. The CDS portion of the agreement guaranteed that the cash flow from the bonds would be there and the guarantee portion of the deal guaranteed that the cash flow from the CDS agreement would continue to arrive should ACP be unable to make the payments.[169] Both portions of the deal acted as a backstop that ensured a

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[163] Deutsche Bank AG v. AMBAC Credit Prod., LLC, No. 04 CIV. 5594 (DLC), 2006 WL 1867497 (S.D.N.Y. Jul. 6, 2006).
[164] *Id.* at 4.
[165] *Id.* at 4-5.
[166] *Id.* at 4.
[167] *Id.*
[168] *Id.*
[169] *Id.*

continuing cash flow. Even though the parties treated these products as separate, the fact that the product's main objective was similar argues for treating them similarly for tax purposes. If the goal is to backstop a financial transaction, then CDS and guarantees are quite similar indeed.

VI. Conclusion

The basic CDS transaction is a complex yet useful tool for creating liquidity in the market because it allows financial institutions to engage in transactions that they otherwise might avoid were the CDS backstop unavailable. Likewise, guarantees provide liquidity and serve a backstop function by allowing obligors to complete transactions that the obligee would not want to engage in were it not for the presence of a guarantor. On this similarity rests the basic premise of this note. The similarity between these instruments supports an argument for a similar tax structure. Guarantees have an able tax structure in place that policy makers could use to either apply directly to CDSs or use as a guide in crafting a specific tax treatment for CDSs. Certain aspects of the guarantee taxation scheme do not clearly apply in the CDS context. Naked CDSs disrupt the analogy between CDSs and guarantees by removing the holder of the instrument from the reference obligation. Furthermore, although CDSs seem to be more similar to guarantees than any other financial instrument, other instruments compete for attention. A comprehendsive analysis of the similarities between CDSs for practical and tax purposes might prove to be an interesting topic. Likewise, a closer look at the naked CDS arrangement and its tax implications also could prove useful in solving the CDS tax riddle. One thing seems certain, however: applying the guarantee tax model to CDS contracts would remove some uncertainty from the market by providing practitioners with a way to capture the vast payments that flow between the companies who use these instruments.