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MEMORANDUM

Re: Future Tax Guidance on Credit Default Swaps — Treasury and the Internal Revenue Service Request Information

From: Susan J. Hotine

Date: July 23, 2004

With the issuance of Notice 2004-52, the Treasury Department and the Internal Revenue Service requested information on credit default swaps (“CDS”), generally referring to contractual arrangements in which one party (the protection buyer) buys from a counter-party (the protection seller) protection against default by a particular obligor (the reference entity) with respect to a particular obligation (the reference obligation). A simpler description of a CDS is a contractual agreement in which one party purchases protection against the debtor’s default on a certain obligation.

Treasury and the IRS’ request for information is a consequence of several taxpayers and industry groups asking guidance on the tax treatment of CDSs and the taxpayers that enter into them. Questions raised include:

- 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 I.R.C. § 4371 insurance premium excise tax;
- Whether a protection seller could be considered to be engaged in a trade or business in the U.S. by virtue of entering into CDS agreements;

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- Whether a CDS agreement 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 the expense for the protection buyer.

The notice discusses suggestions and arguments that have been made. With respect to whether a CDS can be analogized to a form of insurance, the notice says that some commentators have distinguished CDSs from insurance on the basis that no actual loss need be sustained in order to give rise to an obligation under a CDS. The notice provides several ways in which comments may be submitted, but provides no particular date for submitting the comments.

Some questions and comments: What is the difference between a CDS and financial guaranty insurance? If no actual loss need be sustained in order to give rise to an obligation under a CDS, does that mean that the protection buyer need have no financial interest in the reference obligation? Is that like allowing a person to buy insurance on an event without an insurable interest? It should be noted that the notice requesting information was issued by the Office of the Associate Chief Counsel (International) and not the Office of the Associate Chief Counsel (Financial Institutions & Products). Are the issues involved only foreign tax issues?