

# ISDA

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Courier's Desk  
Internal Revenue Service  
Attn: CC:ITA:RU (Notice 2002-22)  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20224

**Re: Withholding Taxes on Credit Default Swaps**

Re: Withholding Taxes on Credit Default Swaps

This letter summarizes the views of the International Swaps and Derivatives Association, Inc. (*ISDA*) concerning withholding taxes (including insurance excise taxes) on payments made to a non-U.S. person pursuant to an over-the-counter contract in the form of a Credit Default Swap, that shifts credit risk among the parties on one or more reference entities or reference obligations (which may be changed over the term of the contract) (such a contract, a *CDS*, as more fully defined below). ISDA concurs in the suggestion, made in a letter, dated July 2, 2002, from Capitol Tax Partners, that the Internal Revenue Service (the *IRS*) issue guidance providing that there is no withholding tax (including any insurance or reinsurance excise taxes) on payments made to a non-U.S. counterparty on a CDS. (A copy of that letter is attached.)

ISDA is global trade association in the privately negotiated derivatives industry with more than 575 member institutions from over 44 countries throughout the world. ISDA's members include most of the world's leading dealers in swaps and other off-exchange derivatives transactions (collectively, *OTC derivatives*). The membership of ISDA also includes many of the businesses, financial institutions, governmental entities, and other end users that rely on OTC derivatives to manage the financial, commodity and other risks inherent in their core economic activities with a degree of efficiency and effectiveness that would not otherwise be possible. A list of ISDA's members is attached to this letter and additional information with respect to ISDA and its programs is available on the ISDA website at [www.isda.org](http://www.isda.org).

The market for credit derivatives is rapidly expanding. Positions in these instruments expanded from \$108 billion in notional principal amount as of June 30, 1998 to \$1.6 trillion as of June 30, 2002.<sup>1</sup> Credit derivatives play an important role in reducing risk in the bank and financial sector and are credited with having prevented severe distress in the wider financial system arising from a significant number of bankruptcies in the telecom sector and the defaults by Enron, Global Crossing, Railtrack, WorldCom, and Swissair.<sup>2</sup>

While virtually all tax practitioners believe that there are no U.S. federal withholding taxes on payments made in either direction on a CDS, the IRS has never provided any direct guidance on the point and, in light of the current size of the market and its rate of growth, such guidance would be most welcome.

As an approach to providing guidance in the area, Capitol Tax Partners suggested issuing a revenue ruling that would provide for no withholding taxes (including no excise taxes) on payments made to a non-U.S. counterparty under the following set of facts: (1) a securities dealer subject to section 475 enters into a CDS in the ordinary course of its business, (2) the CDS is documented on standard ISDA documentation that does not require a loss on the part of the credit protection buyer as a condition to collection, and (3) the Reference Entity is not related under section 267(b) or 707(b) to either the credit protection buyer or seller. Capitol Tax Partners suggested that the ruling describe the terms of a CDS, but leave flexibility as to whether there were Deliverable Obligations other than the Reference obligation, whether there were Credit Events other than a payment default, and whether settlement were in cash or through physical delivery. Capitol Tax Partners suggested that the ruling hold that a CDS is a financial instrument and that payments thereunder are not subject to withholding under either section 1441 or 1442 or the insurance or reinsurance excise tax provisions.<sup>3</sup>

We concur in the approach suggested by Capitol Tax Partners but suggest the following minor clarifications.

#### Clarification of the Definition of CDS:

Many CDSs in the market do not have just a single reference obligation but rather, have a “pool” of reference obligations. The composition of these pools is often not static but may be changed over time.<sup>4</sup> A CDS with dynamic pooled reference obligations presents no additional withholding tax issues than a CDS with a single reference obligation and, therefore, we believe

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<sup>1</sup> For a more detailed view of the growth in this market, see the surveys collected at [www.isda.org/statistics/index.html](http://www.isda.org/statistics/index.html).

<sup>2</sup> Remarks by Chairman Alan Greenspan at Lancaster House, London, U.K., September 25, 2002.

<sup>3</sup> References to sections herein are to the Internal Revenue Code of 1986.

<sup>4</sup> Although transactions vary, in a typical *synthetic* collateralized debt obligation transaction, instead of acquiring and securing the collateralized debt obligations (*CDOs*) with a managed pool of high yield bonds, the CDO issuer acquires (and uses as collateral) Treasury securities (or other high quality, low yield) debt instruments and enters into a managed pool of CDSs.

that any guidance should cover CDSs with single or multiple, static or dynamic reference obligations.

Clarification of the First Premise:

Although the terms “seller” and “buyer” are used in the CDS market, both dealers and end users enter into both sides of CDS transactions and, therefore, can assume the role of either the “credit protection seller” or “credit protection buyer.” Thus, the revenue ruling should set forth facts whereby a taxpayer that is a “dealer in securities” within the meaning of section 475(c) enters into either side of a CDS (that is, as either a credit protection buyer or credit protection seller).

Clarification of the Second Premise:

While market participants often document a CDS under a contract that is governed by an ISDA Master Agreement, the confirmation relating any particular CDS will be individually negotiated and will reflect the particular characteristics of the CDS or circumstances of the counterparties. Therefore, we suggest that the second condition should be phrased solely to provide that to qualify as a CDS, an agreement must be documented as an over-the-counter contract that is governed by an ISDA Master Agreement.

Dealers often enter into a CDS either as a hedge of another CDS or as a hedge of a long position in a debt instrument. Accordingly, as a practical matter, a protection buyer may have a loss on its offsetting position. The fact that a dealer or investor hedges or uses its CDS as a hedge should not affect whether payments made under such CDS are subject to withholding or insurance excise taxes. Thus, the second factual assertion on which Capitol Tax Partners asks guidance to be based should make clear that a loss is not required *under the terms of the CDS*.

Requested Guidance; Suggested Approach:

Accordingly, we respectfully request guidance that a CDS is a financial instrument and payments thereunder are not subject to withholding tax under section 1441 or 1442 or the insurance excise taxes. For this purpose, as described above, we suggest setting forth a factual scenario whereby a CDS is defined as a contract pursuant to which, for valuable consideration, one party transfers credit risk to another party with respect to one or more reference obligations (or obligations of a reference obligor), which may be changed over the life of the contract, wherein: (1) at least one party to the contract is a “dealer in securities” within the meaning of section 475(c) that enters into a CDS, (2) the agreement is documented as an over-the-counter contract that is governed by an ISDA Master Agreement that does not by its terms require a loss on the part of the credit protection buyer as a condition to payment, and (3) the reference obligor(s) or the obligor(s) on any reference obligation are not the credit protection buyer or seller and are not related to either one under section 267(b) or section 707(b).

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ISDA respectfully requests the opportunity to discuss the withholding tax issues surrounding CDSs with representatives of the Department of Treasury and the IRS and stands ready to respond to any questions that may arise in connection with their review of these comments.

Sincerely,



Thomas Prevost  
Chair, North American Tax Committee

cc: Ms. Pamela Olson  
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