SOCIETY OF ACTUARIES

Article from:

Taxing Times

May 2009 – Volume 5 – Issue No. 2

T³: *TAXING TIMES* TIDBITS

SECTION 988 HEDGING IMPACTED BY ECONOMIC PROBLEMS

By Biruta P. Kelly and Peter H. Winslow

Lending or borrowing in foreign currency subjects a U.S. company to foreign currency risk, which can be reduced or eliminated using a hedge. For tax purposes, the debt instrument and the hedge usually are two separate properties and the usual tax rules that are applicable to the debt instrument and the hedge may result in timing and character mismatches. To eliminate these issues, a company may designate the hedging instrument or instruments and the debt as a section 988 hedging transaction. A section 988 hedging transaction integrates the hedge with the debt instrument to create a synthetic debt instrument denominated in a currency other than the debt's currency. For example, a bond that pays in Euros may be turned into a synthetic U.S. dollar bond when it is integrated with an appropriate pay Euro/receive U.S. dollars swap contract.

The effect of the section 988 hedging transaction is to treat for federal income tax purposes the transactions as if they were a single synthetic debt instrument issued in another currency. This treatment is for the taxpayer that has entered into the transaction and does not affect the tax treatment of any of the other parties to the transactions. In addition to coordinating timing and character, other benefits of a section 988 hedging transaction are that neither the qualifying debt instrument nor the hedge will be subject to the section 1092 straddle rules, the section 1256 mark-to-market rules, or the section 263(g) capitalization rules.

To qualify as a section 988 hedging transaction, the rules of the Treasury regulations[1] must be met, including a requirement that the transaction be identified as a qualified hedging transaction before the close of the day that the hedge is entered into. The synthetic debt instrument will remain in place so long as the qualifying debt and the hedge remain in place.

The current economic crisis has caused problems where section 988 hedging transactions have terminated due to counterparty credit issues and new hedging transactions are substituted. The first consequence is that when the initial hedge is terminated, the taxpayer is considered as "legging out" of the integrated treatment and any gain or loss on all of the positions making up the synthetic debt instrument from the date it was identified as a section 988 hedging transaction to the legging-out date is realized and recognized for tax purposes.[2] Second, the regulations provide that the part of the qualified hedging transaction that has not been terminated can never be part of a qualified hedging transaction for any period after the legging-out date.[3] Thus, the taxpayer cannot identify the qualifying debt instrument and the new hedge as a section 988 hedging transaction and continue receiving integrated treatment. This rule is particularly harsh where the prior integration was with a capital asset. In such case, a replacement hedge may not qualify as a tax hedging transaction under section 1221(b)(2). Therefore, the inability to identify the substituted hedge as part of a new section 988 hedging transaction could cause the straddle rules to come into play with a subsequent deferral of loss recognition.

There appears to be no sound tax policy reason to deny integrated treatment for succeeding hedging transactions at least where the legging-out was by reason of counterparty credit risk exposure. Our understanding is that the IRS National Office has this situation under consideration. A change in the rule prohibiting further integration should not require a change in the regulations because the regulations already provide that the Commissioner may treat transactions as integrated.[4] Thus, guidance could take the form of a ruling or notice, which could be welcome relief if the IRS chooses to address this problem.

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END NOTES

1. Treas. Reg. § 1.988-5(a) provides rules for section 988 hedging transactions relating to debt instruments. Treas. Reg. § 1.988-5(b) provides similar rules for integrating a hedge with an executory contract.
2. Treas. Reg. § 1.988-5(a)(6)(ii).
3. Treas. Reg. § 1.988-5(a)(6)(ii)(D).
4. Treas. Reg. § 1.988-5(a)(8)(iii).

IRS FOREIGN INSURANCE EXCISE TAX – AUDIT TECHNIQUES GUIDE PRESENTS QUESTIONABLE POSITIONS

By Peter H. Winslow and Biruta P. Kelly

Section 4371 imposes an excise tax on a policy of insurance or reinsurance issued by a foreign insurer or reinsurer. The tax is four percent of premiums paid for direct insurance of U.S. property/casualty risks or one percent of premiums paid for a life or accident and health policy or annuity with respect to a U.S. citizen or resident or for reinsurance of U.S. risks. The tax does not apply when the insurer or reinsurer is engaged in a U.S. business and is subject to U.S. income tax. The persons liable for the tax include any person who makes, signs, issues or sells the policy of insurance or reinsurance. Many tax treaties with foreign countries contain provisions that eliminate the excise tax liability under certain circumstances.

In October 2008, the Internal Revenue Service (IRS) added to its Web site a guide for IRS agents to follow when auditing foreign insurance excise tax liability. An introduction to the guide cautions that it is not an official pronouncement of the law or of the IRS's position, but it undoubtedly reflects input from the IRS personnel who administer the excise tax and audit compliance.

The guide is detailed, containing 12 chapters. Chapter 7 contains an extensive discussion of the controversial cascading excise tax issue. In Rev. Rul. 2008-15,[1] the IRS set forth its position that the excise tax can apply to the same risks more than once—once to insurance (or reinsurance from a U. S. insurer) of U.S. risks by a foreign insurer, and again if the foreign insurer reinsures the risks with another foreign reinsurer. According to the IRS, this conclusion applies whether or not the foreign reinsurance treaty has a nexus with the United States other than the fact that the reinsured risks found their origin in the United States. In Announcement 2008-18,[2] the IRS set forth a voluntary compliance program which, when followed, provides excise tax audit protection for premiums paid before Oct. 1, 2008. Major insurance trade associations jointly submitted comments on Rev. Rul. 2008-15, explaining several legal and practical reasons why the IRS's cascading excise tax theory is suspect.[3] Undoubtedly, the issue will be litigated if the IRS declines to withdraw the ruling.

The portion of the audit guide added to the IRS Web site on the cascading excise tax issue does not break new ground beyond what has been stated in prior IRS pronouncements. The same cannot be said for the discussion in Chapter 4 of the timing of "premium paid," on which the excise tax is based. The audit guide says:

> **Cash vs. Accrual Method of Accounting**
> In determining when premiums are paid, and thus subject to the tax, the accrual method of accounting, not the cash-basis method of accounting applies. Revenue Ruling 77-453, 1977-2 C.B. 237, and G.C.M. 37, 201 (July 26, 1977) support an interpretation of the term "amounts paid for reinsurance" under I.R.C. § 832(b)(4) as including amounts accrued as well as amounts actually paid. Ceded premiums are considered paid to the reinsurer when all events have occurred that fix the reinsurer's right to the premiums and the amount of such premiums is reasonably ascertainable.

The guide's position that an accrual method of accounting applies to the excise tax is in apparent conflict with the statute which refers to "premium paid"—a cash concept. The regulations confirm this by stating that the excise tax attaches "at the time the premium payment is transferred to the foreign insurer or reinsurer."[4]

That the excise tax attaches only to actual payments of premiums, rather than on accrued premiums, also is supported by the legislative history. Prior to amendment by the Excise Tax Reduction Act of 1965,[5] section 4371 imposed the tax with respect to "the premiums charged on the policy of reinsurance." Section 804 of the 1965 Act provided for

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the payment of the tax by return and added a sentence to the statute to make it clear that the excise tax would no longer be based on premiums charged.

The audit guide cites authorities which, it says, hold that "premiums paid on reinsurance" in the context of determining underwriting income under section 832(b)(4) for property/casualty insurers is based on an accrual method of accounting.[6] However, this analogy to the income tax accounting rules under section 832 is no more relevant than the many other tax provisions where the term "paid" or "payment" refers to a cash method of accounting.[7]

This cash vs. accrual accounting issue has arisen in IRS audits most frequently in the context of funds withheld reinsurance. In this type of indemnity reinsurance, instead of paying a portion of the gross premium to the reinsurer, the ceding company withholds the funds and makes a promise to pay the reinsurer's share of profits in the future. If experience is adverse, the reinsurer reimburses the ceding company. If the experience is favorable, the ceding company pays a fee to the reinsurer to compensate for its assumption of risk. Taxpayers have taken the position that the excise tax attaches only when actual payments are made to the reinsurer in funds withheld reinsurance, pointing out the basic tax principle that a mere promise to pay does not constitute a payment, even if such promise is evidenced by a written agreement.[8] In support of its position, the IRS relies on rulings and case law that suggest that the term "premium paid" is measured by gross amounts due to the reinsurer and is not reduced by obligations to the ceding company that are netted against the premiums otherwise due the reinsurer.[9] But, under the tax law, when an actual netting occurs a payment has been constructively made. Thus, the netting principle does not depart from a cash concept for implementing the excise tax and does not support an accrual accounting for determining the timing of premiums paid.

The problem with the audit guide analysis is that it fails to appreciate the fundamental difference between an excise tax that is imposed on the manufacture, use or sale of a commodity (in this case an insurance policy) and an income tax. An excise tax typically is imposed on an event or a thing. The proper inquiry is to determine when the excise tax attaches and the measurement of the tax at that point in time. Methods of accounting for determining taxable income over a multi-year period have little relevance.

This brings us back to the cascading excise tax. Here again, the IRS may be overreaching perhaps because it interprets Code provisions that impose an excise tax using income tax notions. With respect to the income tax, the United States taxes its citizens on worldwide income and the applicable Code provisions presume that all income from whatever source is taxable. By contrast, an excise tax, by definition, is imposed on a transaction within the jurisdiction of the taxing authority. In Rev. Rul. 2008-15 the IRS seems to be forgetting this basic principle in its attempt to impose an excise tax on a foreign transaction.

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END NOTES

1 2008-12 I.R.B. 633.
2 2008-12 I.R.B. 667.
3 Letter of Brenda Viehe-Naess, Washington Advocates Group, dated July 9, 2008.
4 Treas. Reg. § 46.4374-1(b).
5 Pub. L. 89-44, 89th Cong., 1st Sess. (1965).
6 It is questionable whether the IRS would continue to contend that the accrual method of accounting always applies under section 832 for premiums paid on reinsurance in light of its departure from the accrual method for at least some gross premiums written in Treas. Reg. § 1.832-4.
7 *E.g.*, Treas. Reg. § 1.461-4(g)(1)(ii)(A); Treas. Reg. § 1.404(a)-1(c); Treas. Reg. § 31.3402(a)-1(b).
8 *See, e.g., Helvering v. Price,* 309 U.S. 409 (1940); *Foley v. Commissioner,* T.C. Memo. 1976-60; Rev. Rul. 76-135, 1976-1 C.B. 114.
9 Rev. Rul. 79-138, 1979-1 C.B. 359.

APPEALS COURT AFFIRMS TEXTRON (OR NOT)

By Samuel A. Mitchell and Peter H. Winslow

In what some characterized as a significant taxpayer victory, the First Circuit Court of Appeals initially upheld a lower court ruling that Textron Inc.'s tax accrual workpapers are subject to protection under the work product doctrine.[1] Under that doctrine, documents that are prepared in anticipation of litigation are protected from disclosure unless the party seeking the documents can demonstrate a compelling need for the materials and cannot obtain the information any other way. The doctrine is designed to enhance an attorney's ability to represent clients without fear that an opponent in current or anticipated litigation will use the work product to the disadvantage of the attorney's client. Typically, the important sticking points for parties claiming work product protection are whether the documents were prepared in anticipation of litigation and whether the client has waived the protection by disclosing the work product to a potentially adverse third party.[2]

On March 25, 2009, the First Circuit vacated the ruling and scheduled an *en banc* hearing for June 2, 2009.

On appeal, the IRS argues that the tax accrual workpapers were not prepared in anticipation of litigation because tax disputes with the IRS are not "litigation," and because Textron had a business purpose related to financial reporting that was not related to litigation. In its vacated opinion, the Appeals Court panel rejected both of these arguments, holding that not all "dealing with the IRS during an audit is 'litigation'," but that resolutions of disputes through the adversary administrative process, including administrative appeals, meets the definition of litigation. The panel's reference to the IRS Appeals process as an adversarial process is not how IRS Appeals Officers typically view their role. Most Appeals Officers attempt to provide an independent review of the IRS's proposed adjustments seeking what they perceive to be a fair resolution based on an evaluation of the litigating hazards. Nevertheless, the Appeals process can be viewed as adversarial because the IRS Exam team is provided an opportunity to make its case prior to the commencement of the taxpayer/Appeals settlement negotiation.

Regarding the second IRS argument, the panel held that Textron prepared the tax accrual workpapers "because of" litigation, in spite of the fact that the taxpayer had other business reasons (*e.g.*, financial reporting) for preparing the documents. According to the panel, there would be no reason for the financial reporting "but for" the prospect of litigation. The panel held that the documents, because they were designed to assist the taxpayer to establish financial reporting reserves taking into account the risk of tax litigation with the IRS, would not have been prepared "but for" the prospect of litigation.

The panel also dealt with the waiver issue. The work product doctrine is designed with fundamental fairness in mind; it is unfair for an opponent in litigation to take advantage of its adversary's preparation for the litigation. With this in mind, courts have recognized that the protection is waived if the party that created the work product discloses it to a party which is in an adversarial position. Here, Textron disclosed its tax accrual workpapers to its independent auditors, with the stipulation that the auditors had to return the documents to Textron. On appeal, the IRS recognizes that Textron and its auditors were not adversaries, but argues that the auditors may be a potential adversary or at least a "conduit" to a potential adversary. The panel rejected the notion that the auditors were potential adversaries, but nevertheless ordered a remand of the issue to the district court to determine whether the auditors were, in effect, a conduit to a potential adversary. Specifically, the panel recognized

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that a disclosure to a non-adversary that significantly increases the risk of disclosure to an adversary or potential adversary can result in a waiver. The panel recognized that the auditing firm used the Textron workpapers to create its own workpapers analyzing Textron's tax reserves. Because the auditor's workpapers may be discoverable by the IRS through a third-party summons, the panel recognized that the auditor's workpapers may disclose Textron's tax analysis. If this were the case, the disclosure to the auditor could be considered a waiver because it resulted in a substantial risk of disclosure to an adversary, the IRS, albeit indirectly.

Tax department's celebration of the *Textron* decision was premature. There is a possibility that the full court in its *en banc* review will find that the auditor's workpapers are discoverable and that they reveal Textron's thoughts and analysis from its own workpapers, even though those workpapers were only shown to the auditor and not retained by the auditor. If this is the case, the full Court of Appeals could find that a waiver occurred and the IRS could obtain the documents. Thus, taxpayers may not be able to prevent disclosure by simply requiring that the auditors not copy the tax accrual workpapers. The waiver issue, presumably, will turn on the level of detail in the auditor's workpapers. More fundamentally, the full court could rethink the entire reasoning of the panel's original position and hold that the panel misapplied the "because of" litigation test.

A key fact in the Textron case is that the IRS was seeking Textron's internal workpapers. The reasoning of the panel indicates that it may not have been troubled if the IRS sought discovery of the outside auditor's workpapers. In a FIN 48 context, where taxpayers are required to do a more rigorous tax provision analysis and a more robust disclosure, we would expect the outside auditors' workpapers underlying tax positions to contain significantly more detail than the auditor's workpapers from pre-FIN 48 years, such as those in Textron. Therefore, regardless of the outcome, the opinion may not apply in a FIN 48 environment.

As noted in our May 2008 article, however, the standard for FIN 48 disclosure turns on what would occur regarding an issue in litigation (*i.e.*, is it more likely than not that the taxpayer would prevail in litigation). Therefore, it could be argued that all FIN 48 workpapers are attorney work product because anticipation of litigation is an integral part of the recognition process. For this reason, the waiver issue and the disclosure of outside auditors' workpapers probably will be the primary focus of FIN 48 workpaper disputes.

As of now, the IRS has not changed its policy of restraint regarding tax accrual workpapers, except when the taxpayer has engaged in tax shelters. This disclosure issue will become much more important if the IRS ever changes its policy.

END NOTES

1. *United States v. Textron*, No. 07-2361 (1st Cir. Jan. 21, 2009).
2. We discussed this doctrine and its requirements in the May 2008 issue of *TAXING TIMES. See* "What Does Textron Mean for Preserving the Confidentiality of Tax Accrual Workpapers?", Vol. 4, Issue 2 at 20 (May 2008).

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REMIC IMPAIRMENTS MAY QUALIFY AS WORTHLESS BAD DEBTS

By Samuel A. Mitchell and Peter H. Winslow

In the September 2008 issue of *TAXING TIMES* we discussed the general tax rules that apply to write-downs of impaired investment assets.[1] In the prior article, we explained the different tax treatment for instruments treated as securities versus other debt instruments. In summary, "securities" are not eligible for a worthlessness deduction until the security is wholly worthless, and the worthlessness deduction is capital in character. A "security" is defined as a stock, subscription right or bond, debenture, note or certificate or other evidence of indebtedness with interest coupons or in registered form issued by a corporation, government or a political subdivision thereof.[2] Classification of an investment asset as a security is a double disadvantage, in that it delays the timing of the deduction and, in some instances, may limit the ability to realize any benefit because capital losses can be used only against capital gains and the carry-over of capital losses is limited to five years. In the current economic environment, there is no certainty that capital gains will be available to offset capital losses. For these reasons, non-security treatment is preferable because the instruments potentially are eligible for partial bad debt deductions as the instruments become worthless and the deductions are ordinary in character, meaning they can be used to offset ordinary operating income and can be carried forward for a longer period of time.[3]

The issues discussed in our prior article have come up frequently with respect to impairments of investments in Real Estate Mortgage Investment Conduits ("REMICs"). A regular interest in a REMIC entitles the certificate holder to a portion of the cash flows from underlying residential mortgages packaged as securities by financial institutions. Regular interest REMICs along with other asset types have experienced dramatic declines in value as the result of the mortgage crisis and insurance companies have recorded impairments for statutory accounting purposes. Many taxpayers assume that the contingent nature of the cash flows from REMIC regular interests suggests that they would be classified as securities and ineligible for bad debt treatment. However, for federal income tax purposes, REMIC regular interests are treated as debt instruments under section 860B of the Internal Revenue Code.[4] Importantly, moreover, they typically are issued by a trust rather than a corporation or government entity. This means that REMIC regular interests should not be treated as "securities" for purposes of the bad debt rules.[5] Thus, statutory impairments of REMIC regular interests potentially may be eligible for a partial bad debt deduction under section 166 of the Code if the impairment satisfies the partial worthlessness standard for tax purposes. Taxpayers may be able to demonstrate that an impairment, or at least a portion of the impairment, represents a wholly worthless portion of the instrument under the tax standard (*i.e.*, that collection of that portion is hopeless).[6] To the extent the amount of partial worthlessness of a REMIC regular interest is difficult to prove, insurance companies may want to contend that the conclusive presumption of worthlessness under Treas. Reg. § 1.166-2(d) applies. For a company to take advantage of the presumption, its state regulators would need to provide a letter verifying that the impairment was required.

This issue will become increasingly important in tax year 2009, when Statement of Statutory Accounting Principles (SSAP) 98 is adopted. SSAP 98 amends SSAP 43, essentially requiring statutory impairments for structured securities similar to the GAAP impairments.[7] As the impairments become more common, it will be important for companies to be able to evaluate each impairment to determine the portion that satisfies the tax standard of worthlessness and, moreover, to keep in contact with their state regulators in the annual statement examination process if reliance on the conclusive presumption is contemplated.

END NOTES

1. "Tax Aspects of Nonperforming Assets," *TAXING TIMES,* Vol. 4, Issue 3 at 28 (Sept. 2008).
2. I.R.C. § 165(g).
3. Non-life insurance companies can carry Net Operating Losses back two years and forward 20 years. I.R.C. § 172(b)(1)(A)(i)-(ii). Life insurance companies can carry their operations losses back three years and forward 15 years. I.R.C. § 810(b)(1)(A)-(B).
4. Residual Interests, on the other hand, essentially are the equity interests in the REMIC and are not treated as debt. *See* I.R.C. § 860C.
5. A debt instrument must be issued by a corporation or government in order to qualify a security for purposes of a worthlessness deduction under I.R.C. § 165(g)(2)(C). See Treas. Reg. § 1.165-5(a). Commentators agree that regular interest REMICs are not securities. *See, e.g.*, James A. Peaslee, *The Federal Income Taxation of Mortgage-Backed Securities at 270 n.* 147, Probus Publishing (1994).
6. *See TAXING TIMES, supra* note 1.
7. The SSAP requires an impairment to reflect the discounted value of expected future cash flows if that amount is less than book value.

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THE CHARACTERIZATION OF CREDIT DEFAULT SWAPS IS UNDER REVIEW BY NEW YORK INSURANCE REGULATORS AND THE IRS

By Emanuel Burstein

New York's insurance department concluded in September 2008 that "covered" credit default swaps (CDSs), defined here, are insurance contracts under New York Insurance Law. The insurance department's interest in the characterization and regulation of CDSs stems from huge losses realized by CDS sellers from sudden and substantial increases in their CDS obligations, which are a significant source of the current financial problems facing the economy.[1] A CDS arrangement that qualifies as insurance under state law does not necessarily qualify as insurance under the federal income tax, however. Commentators conclude that few, if any, CDS arrangements are insurance under the federal income tax.

Credit Default Swaps

The IRS stated in Notice 2004-52[2] that:

> A credit default swap (CDS) generally refers to a contractual arrangement in which one party (the protection buyer) buys from a counterparty (the protection seller) protection against default by a particular obligor (the reference entity) with respect to a particular obligation (the reference obligation). Typically the protection buyer either pays a single lump sum, or it pays periodical regular fees either until a defined credit event occurs or until the maturity of the CDS if no credit event occurs. Following the occurrence of a credit event, the protection seller typically either pays the protection buyer an amount reflecting the reference obligation's loss in value from the date the CDS was established or purchases from the protection buyer at a pre-determined price an obligation (the deliverable obligation) that is expected to approximate the post-credit-event value of the reference obligation.[3]

A "covered" CDS is a CDS that offsets much or all of the risk of loss from default by a bond issuer or borrower on a bond or loan that the CDS owner holds. Speculators that do not hold related bonds or loans purchase "naked" CDSs to gain from expected increases in their value.

When Are Credit Default Swaps Insurance Under New York Insurance Law?

Section 1101(a)(1) of the New York Insurance law defines an insurance contract as:

> any agreement or other transaction whereby one party, the "insurer", is obligated to confer benefit of pecuniary value upon another party, the "insured" or "beneficiary", dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.[4]

In his statement for a Congressional hearing on the role of credit derivatives in the U.S. economy, New York Insurance Superintendent Dinallo indicated that in September 2008 the New York insurance department concluded that covered CDSs qualify as insurance under New York State Insurance Law. Superintendent Dinallo reasoned that:

> the covered swap, is insurance. The essence of an insurance contract is that the buyer has to have a material interest in the asset or obligation that is the subject of the contract. . . . With insurance, the buyer only has a claim after actually suffering a loss. With the covered swaps, if the issuer of a bond defaults, then the owner of the bond has suffered a loss and the swap provides some recovery for that loss.[5]

Federal Income Tax Treatment

The IRS and tax professionals are examining the tax characterization of CDS arrangements. The federal income tax applies standards to determine whether a contract qualifies as insurance that differ from those that apply under New York's insurance law. An insurance transaction must involve both risk transfer and risk distribution and satisfy other requirements to qualify as insurance for federal tax purposes. New York Insurance Law section 1101(a)(1) does not require an entity that assumes an insurance risk to distribute it with risks from others for the transaction to qualify as an insurance contract, for example.

The characterization of CDSs under the federal income tax is uncertain. The IRS states in Notice 2004-52 that "some possible analogies for a CDS include a derivative financial instrument such as a contingent option or notional principal contract, a financial guarantee or standby letter of credit and an insurance contract," presumably financial guaranty insurance.[6]

The IRS indicated that to determine whether a CDS contract qualifies as insurance, some commentators scrutinize whether the CDS satisfies traditional factors, such as whether it involves the shifting and distribution of insurance risks. It states, for example, "[s]ome 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[.]"[7] In addition, commentators argue that CDS protection buyers cannot know "how its counterparty manages risk with respect to a particular CDS;"[8] that is, it cannot know if the CDS counterparty distributes the risk in order to determine whether the arrangement involves insurance.

One commentator also concludes that CDS transactions generally do not qualify as insurance for tax purposes but applies an alternative approach to characterize a CDS. Edward Kleinbard, in an article that predates the IRS

Notice, recommends a "functional approach that considers the credit protection seller's risk management strategy as well as the formal terms of the contract in question"[9] in place of the "normative" approach applied by others to determine whether a CDS qualifies as insurance. He argues, in part, that the contention that a CDS does not require the CDS buyer to suffer a loss "is not factually satisfying when applied to the normal case of a protection buyer that in fact is obtaining practical indemnification through that contract."[10] Commentators' arguments distort the intent of the risk shifting test, which is to distinguish insurance from "synthetic investment contacts" such as the arrangement in *Le Gierse*[11] or from self insurance reserves.

Kleinbard's functional approach also diminishes commentators' concerns that CDS participants cannot discern whether its counterparty distributes assumed risks. An element of his approach is a presumption that "in the world of financial services firms, what can be hedged at reasonable cost, is hedged, because market hedging generally is more efficient than relying on the law of large numbers."[12] Kleinbard concludes that CDSs generally are not insurance contracts. His understanding is that CDS counterparties generally use market hedging to manage default risks.[13]

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Convergence of Insurance and Other Financial Products

Many CDS arrangements provide risk management benefits that are similar to benefits provided by insurance contracts, such as financial guaranty coverage, but involve different federal tax treatment of the CDS holders and insurance purchasers. In addition, different tax treatment applies to CDS counterparties and financial guaranty insurers. Differences in the tax treatment of contracts that provide similar risk management benefits can influence one's decision to use a given product, and therefore raise important tax neutrality concerns. This issue has been getting increasingly more important as insurance and other risk management markets have tended to converge in recent years.[14]

CONCLUSION

The New York State Insurance Department concludes that covered CDSs qualify as insurance contracts under New York's insurance law. CDSs that qualify as insurance under state law do not necessarily qualify as insurance under the federal income tax. Commentators conclude that few, if any, CDS arrangements qualify as insurance for tax purposes. Tax-based distortions can arise when insurance, such as financial guaranty coverage, and other financial products, such as CDSs, that address similar risk management goals are subject to different tax rules.

END NOTES

1 House Committee on Agriculture, Hearing to review the role of credit derivatives in the U.S. economy at 5 (November 2008) (Statement of New York Insurance Superintendent Eric Dinallo) (Retrieved from *http://www.ins.state.ny.us/speeches/pdf/sp0811201.pdf* on February 2, 2009). [Hereinafter cited as statement of Superintendent Dinallo.] The value of a CDS issuer's obligation is marked to market so that a very significant number of default events in a short time period can result in significant losses. This can trigger sizeable collateral calls and force issuers with limited liquid assets to sell other assets, also at a loss, and further weaken the issuer's financial condition. Dinallo indicated that a ratings downgrade of AIG in September 2008 resulted in immediate collateral calls, for which AIG did not have enough liquid assets.

2 2004-32 I.R.B. 168 (Aug. 9, 2004). [Hereinafter cited as *Service Notice on CDSs*.] In this Notice, the Service requests information on the tax treatment of credit default swaps.

3 *Id.*

4 New York Insurance Law section 1101(a)(1)(McKinney 2009).

5 *Statement of Superintendent Dinallo*, at 3.

6 *Service Notice on CDSs* at 168.

7 *Id.* at 169.

8 *Id.* But *see* a "functional" approach that can address this concern at note 12 and accompanying text.

9 E. Kleinbard, "Competitive Convergence in the Financial Services Markets," 81 *Taxes-The Tax Magazine* 225, 248 (vol. 81 #3). [Hereinafter cited as *Convergence of Financial Markets Article*]

10 *Id.* at 247.

11 312 U.S. 53 (1941).

12 *Convergence of Financial Markets Article* at 248.

13 *Id.* at 245 and 249.

14 *See*, *Convergence of Financial Markets Article*, D. Miller, "Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace," 55 Tax Lawyer 481 (Winter 2002); E. Burstein, *Federal Income Taxation of Insurance Companies* (2nd edition), at 5 (2007).

POINT OF INTEREST

We want to make our Taxation Members aware of a recent article that appeared in the March 2009 Issue of the newsletter Risk Management of the Joint Risk Management Section.

John Manistre's article, "An ERM Approach to Income Tax Risk," explores ERM issues and the impact of income tax on a fair value accounting system. The tax issues raised in this article should be of interest to our members.

Check it out at *www.soa.org* under the Joint Risk Management newsletter Web page.