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#### ACCOUNTING AND TAXATION OF DERIVATIVES

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Thorough description of the Taiwan derivatives taxation system. Comprehensive coverage of the legal and regulatory framework and of the practice of the tax administration.

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## COMPARATIVE SURVEY

### THE TAX TREATMENT OF CREDIT DEFAULT SWAP PROCEEDS

Credit derivatives are the last generation of DFI. The fast development of the market of these products represents a challenge for tax systems and creates many problems for tax administrations, practitioners and taxpayers. Most of the tax systems, in fact, do not explicitly provide for the tax treatment of these products. Tax people are therefore compelled to make an effort in checking whether credit derivatives can be regarded as encompassed and subjected to tax by rules referring to other contracts such as, for example, the other derivatives or the insurance contract. But, even the conclusion that the proceeds from a credit derivative are brought to charge within the existing categories of income would, however, be only a first step in the resolution of the problem. It would, in fact, be necessary to check whether the treatment provided for the already regulated items of income (i.e. determination of the taxable basis, timing of the deduction of the losses etc.) can actually be applied to the credit derivatives cash flows, this particularly in order to avoid inconsistencies that could be especially dangerous in financial markets which need speed and certainty of the (contractual) relationships. Aim of this comparative survey is providing a guidance in solving these problems. We publish now the second part of the comparative survey. In the last issue Greece, Malta, Portugal, Switzerland and the United Kingdom have been dealt with.

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## UNITED STATES

## THE TAX TREATMENT OF CREDIT DEFAULT SWAP PROCEEDS

Viva Hammer and Frank Kuriakuz, Jr<sup>1</sup>

## I. INTRODUCTION

Broadly defined, a credit derivative is a contract which requires one party to make payments or perform certain actions based on a credit event or the credit performance of a specified credit-sensitive instrument or instruments. A credit derivative can take the form of a swap, an option, a note, or a hybrid product.

This article will outline the major US federal income tax considerations in analysing credit derivatives, focusing on the taxation of total return swaps and credit put options. Before turning to the tax issues relating to these products, a brief comparison of credit derivatives and traditional credit risk management tools will be discussed.

## II. TRADITIONAL CREDIT RISK MANAGEMENT TOOLS

Prior to the development of credit derivatives,<sup>2</sup> lenders hedged credit risk by obtaining letters of credit, requiring guarantees, or purchasing insurance. With credit derivatives, a lender is able to achieve the same credit risk management objectives as obtained from the traditional methods, but with greater accuracy and at lower cost, while at the same time preserving client relations.

Letters of credit, guarantees, and insurance all place the lender in the same financial position as if a default had not occurred. For instance, a standard letter of credit is an instrument issued by a bank guaranteeing the payment of a customer's draft for a specified period up to a stated amount. The letter of credit effectively substitutes the buyer's credit with the bank's, greatly reducing the seller's risk. In the event that the buyer does not make good with its commitment, the bank will see that the seller is put in the position that it would have been had the buyer not defaulted.

A credit default swap also ensures that a lender is made whole by transferring the credit risk to another party. In a credit default swap, one party receives periodic payments or an up-front fee in exchange for agreeing to make a payment to another party if a particular, predetermined credit event occurs. The swap allows the lender to eliminate its exposure to the debtor's credit risk while keeping the loan on its balance sheet and maintaining client relations.

## III. TAXATION OF TOTAL RETURN SWAPS

A total return swap is a contract where one party (hereinafter: the receiver) receives the total positive return<sup>3</sup> on a security or basket of securities (hereinafter: the reference obligation) from another party (hereinafter: the payer).<sup>4</sup> In exchange, the payer receives periodic fixed or floating-rate payments on the reference obligation plus any depreciation in capital value. (See Diagram 1, below.) The most relevant guidance with respect to the taxation of total return swaps is contained within the rules governing notional principal contracts.<sup>5</sup>

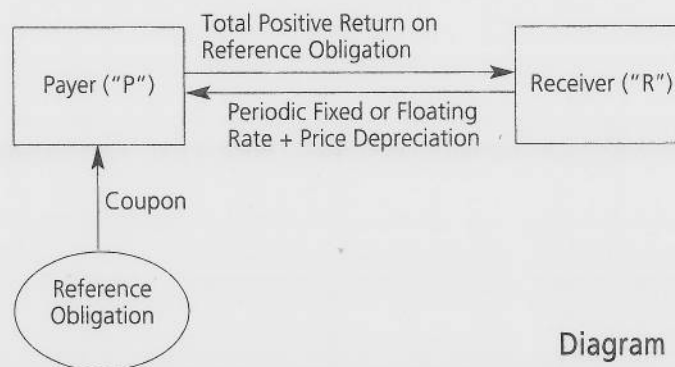


Diagram 1

## IV. NOTIONAL PRINCIPAL CONTRACTS

A notional principal contract is defined as a financial instrument that provides for payments by one party to another at specified intervals, calculated by reference to a specified index upon a notional principal amount, in exchange for a promise to pay similar amounts or other specified consideration.<sup>6</sup> A "specified index" can be any of the following:

- fixed rate, price, or amount (or a combination thereof);
- index based on objective financial information;<sup>7</sup> or

1. Capital Markets Group, PricewaterhouseCoopers, New York.

2. Credit derivatives were first introduced in 1992 at the International Swaps and Derivatives Association annual meeting in Paris; Tanya Styblo Beder and Frank Iacono, "The Good, The Bad - And The Ugly?", *Risk* (July 1997), at 30.

3. Coupons plus any appreciation in capital value.

4. The payer does not necessarily own the reference obligation.

5. The rules governing notional principal contracts are contained in Treas. Reg. Sec. 1.446-3.

6. Treas. Reg. Sec. 1.446-3(c)(1)(i). Note that an agreement between a taxpayer and a "qualified business unit" or among qualified business units is not a notional principal contract, as a taxpayer cannot enter into a contract with itself.

7. "Objective financial information" is any current, objectively determinable financial or economic information that is not within the control of any of the contracting parties and is not unique to one of the parties' circumstances. A notional principal amount may be based on a broadly based equity index or the outstanding balance of a pool of mortgages, but not on the value of a party's stock, dividends or profits. Treas. Reg. Sec. 1.446-3(c)(4)(ii).

- interest rate index regularly used in normal lending transactions between a party to the contract and unrelated persons.<sup>8</sup>

A notional principal amount is a specified amount of money or property that, when multiplied by the specified index, measures a party's rights and obligations under the contract, but is not loaned or borrowed between the parties.<sup>9</sup>

Most total return swaps will be considered notional principal contracts for tax purposes. In a simple total return swap arrangement (such as the one described above), the payer's

periodic payments of coupon plus the net change in capital value of the reference obligation (i.e. notional principal amount) and the receiver's periodic fixed or floating rate payments are all considered payments at "specified intervals" and calculated by reference to a "specified index" (i.e. LIBOR and coupon payments). (See Diagram 2, below). If the total return swap only calls for bullet payments by each party at maturity, the swap is not a notional principle contract, as there are no payments being made at specified intervals.<sup>10</sup>

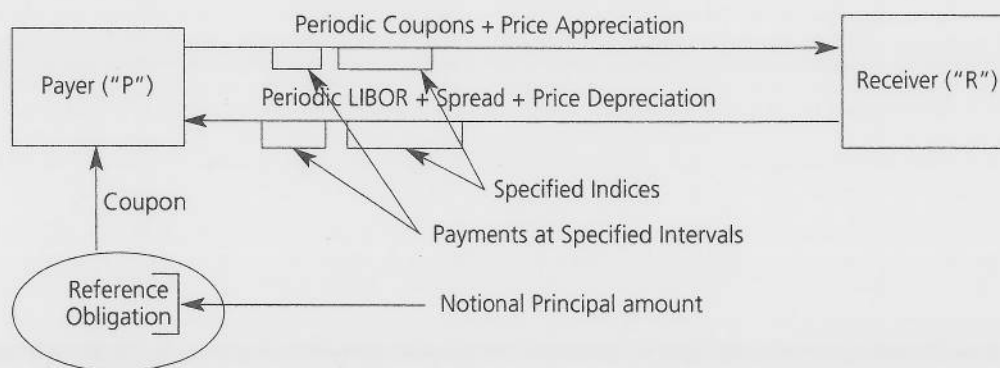


Diagram 2

## V. TIMING

Timing rules determine when the parties making and receiving payments are required to report their income or deduction to determine their federal tax liability. There are three types of payments that the Internal Revenue Service (hereinafter: IRS) considers when determining the income or loss of a counterparty to a notional principal contract for a particular taxable year. The three types are "periodic", "non-periodic", and "termination" payments.<sup>11</sup>

*Periodic payments* are payable at intervals of one year or less during the entire term of the contract. Periodic payments are based on a specified index and on either a single principal amount or a notional principal amount that varies in the same proportion as the notional principal amount that measures the other party's payments.<sup>12</sup> Every taxpayer, whether on a cash or accrual basis accounting method, must recognize income equal to the ratable daily portion of a periodic payment for the taxable year to which that portion relates.<sup>13</sup> The ratable daily portion of a periodic payment is determined by netting such payment due by each party and then dividing by the number of days in the payment period. The daily portion is then multiplied by the number of days of the periodic payment period that is within the taxable year. It should be noted that this method does not necessarily generate an income or loss amount for a swap party as the change in the mark-to-market value of the swap calculated for accounting or performance evaluation purposes.

The following example illustrates periodic payments. On 1 April 1998, a payer (hereinafter: P) enters into a total return

swap with a receiver (hereinafter: R) where the reference obligation is a five year, 10 per cent annual coupon, USD 1,000,000 XYZ Inc note. Under the swap agreement, P is required to make annual payments in the amount of USD 100,000 (the annual coupon of XYZ Inc note) to R starting on 1 April 1999 and every year thereafter until 1 April 2003. In exchange, R is obligated to make a payment to P every 1 April, beginning 1 April 1999 and ending 1 April 2003, in an amount equal to LIBOR, as determined on the immediately preceding 1 April, plus 4 per cent multiplied by the USD 1,000,000 face value of XYZ Inc note (i.e. the notional principal amount). P and R are calendar year taxpayers which use the accrual method of accounting. On 1 April 1998, LIBOR is 5.7 per cent.

All of the payments to be made by P and R are periodic payments since each party's payments are based on a specified index and are payable at periodic intervals of one year or less throughout the term of the contract, and are based on a single notional principal amount.

Though no payments were exchanged in 1998, P and R must recognize the ratable daily portion of the 1 April 1999 pay-

8. Treas. Reg. Sec. 1.446-3(c)(2).

9. Treas. Reg. Sec. 1.446-3(c)(3).

10. See Satyajit Das (ed.), *Credit Derivatives: Trading & Management of Credit & Default Risk*, (Singapore: John Wiley & Sons (Asia) Pte Ltd, 1998), Chapter 14 sec. 10, p. 512.

11. Treas. Reg. Sec. 1.446-3(d).

12. Treas. Reg. Sec. 1.446-3(e).

13. Treas. Reg. 1.446-3(e)(2).



ments that are attributable to their taxable years ending 31 December 1998. On 1 April 1999, P is obligated to make a payment to R of USD 100,000 (10 per cent coupon times USD 1,000,000) and R is obligated to make a payment to P of USD 97,000 (9.7 per cent times USD 1,000,000). The ratable daily portion of the 10 per cent fixed leg is USD 75,342 (275 days divided by 365 days times USD 100,000), and the ratable daily portion of the floating leg is USD 73,082 (275 days divided by 365 days times USD 97,000). The net amount for the taxable year is the difference between the ratable daily portions of the two periodic payments, or USD 2,260 (USD 75,342 minus USD 73,082). For 1998, R has net income of USD 2,260 and P has a corresponding net deduction of USD 2,260.<sup>14</sup>

A *termination payment* is one made or received to extinguish or assign all or a proportionate part of the remaining rights and obligations of any party. Such payments include payments made between the original parties to the contract (an extinguishment), payments made between one contracting party and a third party (an assignment), and any gain or loss realized on the exchange of one contract for another. In an assignment, the original non-assigning party realizes gain or loss if the assignment results in a deemed exchange of contracts and a realization event.<sup>15</sup> A termination payment is generally recognized in the year the contract is extinguished, assigned, or exchanged.<sup>16</sup>

*Non-periodic payments* are payments which are not periodic payments or termination payments.<sup>17</sup> As with periodic payments, all taxpayers must recognize the ratable daily portion of non-periodic payments for the taxable year to which that portion relates. Examples of non-periodic payments include premiums paid for a cap or floor, the prepayment of part or all of one leg of a swap, and premiums paid for an option to enter into a swap if and when the option is exercised. Such payments must be included in income over the term of the contract and in a manner that reflects the economic substance of the contract. Generally, the payments must be allocated over the term of the contract in accordance with forward rates of a series of cash-settled forward contracts that reflect the specified index and the notional principal amount.<sup>18</sup>

## VI. INTEGRATION OF REFERENCE OBLIGATION AND TOTAL RETURN SWAP

If the party receiving the return on a bond also owns the reference obligation (the bond), that party may be able to integrate the reference obligation and the total return swap for tax purposes.<sup>19</sup> In order to qualify for integration treatment, the total return swap must be a hedge as defined in Treasury Regulation Section 1.1275-6. Treasury Regulation Section 1.1275-6 states that a hedge is any financial instrument, including a notional principal contract,<sup>20</sup> where the combined cash flows of the qualifying debt instrument and the financial instrument permit the calculation of a yield to maturity,<sup>21</sup> or the right to the combined cash flows qualify as a variable rate debt instrument<sup>22</sup> that pays interest at a qualified floating rate or rates.<sup>23</sup> Furthermore, the resulting synthetic debt instru-

ment must have the same term as the remaining term of the qualifying debt instrument.<sup>24</sup>

Thus, to qualify for integration treatment, the combined cash flows to the receiver in the swap (party receiving the return on a bond) must permit the calculation of a yield to maturity. This can be accomplished by structuring the swap agreement so that the payments to the receiver are based on a fixed or interest-like rate and the term of the total return swap coincides with the maturity of the reference obligation.<sup>25</sup>

Integration permits the receiver to treat, for tax purposes, the total return swap and the reference obligation as a single combined debt obligation.<sup>26</sup> The character and timing of the receiver's income is treated as if the receiver continued to own the reference obligation with the yield adjusted to the return promised by the payer. Furthermore, integration will ensure that the straddle rules do not apply (straddle rules are discussed below).<sup>27</sup>

## VII. SPECIAL TIMING RULES

Hedge timing rules are special timing rules which apply to taxpayers who enter into notional principal contracts in order to hedge exposure to the underlying reference asset.<sup>28</sup> The rules allow the taxpayer to match the timing of income of the notional principal contract and the item hedged (underlying reference asset). The rules impact the timing of recognition of income of the notional principal contract, as well as the character of that income.

To qualify under the hedge timing rules, the property being hedged must be a non-capital asset in the hands of the hedger. The underlying reference obligation in a total return swap is a capital asset in the hands of a non-dealer, thereby precluding the application of the rules. Furthermore, a dealer who holds the underlying reference obligation in inventory (hence a non-capital asset) is specifically excluded from the rules

14. Assuming there are no other reasons to deny or defer the loss, such as the application of the straddle rules.

15. Treas. Reg. Sec. 1.446-3(h)(1).

16. Treas. Reg. Sec. 1.446-3(h)(2).

17. Treas. Reg. Sec. 1.446-3(f)(1).

18. Treas. Reg. Sec. 1.446-3(f)(2)(i)-(ii).

19. Assuming the total return swap is treated as a notional principal contract.

20. Treas. Reg. Sec. 1.1275-6(b)(3).

21. Under the principles of Internal Revenue Code (hereinafter: IRC) Sec. 1272.

22. Under Treas. Reg. Sec. 1.1275-5, except for the requirement that the interest payments be stated as interest.

23. Treas. Reg. Sec. 1.1275-6(b)(2)(i). Treas. Reg. Sec. 1.1275(b) states that a "variable rate is a qualified floating rate if variations in the value of the rate can reasonably be expected to measure contemporaneous variations in the cost of newly borrowed funds in the currency in which the debt instrument is denominated".

24. Treas. Reg. Sec. 1.1275-6(b)(2)(i).

25. If the parties intend on including more than one reference obligation into their total return swap agreement, it is recommended that separate total return swap agreements be entered into for each reference obligation. This will avoid the netting of a payment due by the payer, thus avoiding a problematic yield to maturity computation.

26. Treas. Reg. Sec. 1.1275-6(f).

27. Treas. Reg. Sec. 1.1275-6(f)(1).

28. Treas. Reg. Secs. 1.446-4 and 1.1221-2.

(see dealer character rules, below).<sup>29</sup> Integrated transactions are also excluded.

An example of how the hedge timing rules apply to credit derivatives would be an option on credit spread (hereinafter: OCS). An issuer of yet to be issued notes can hedge any increases in the credit risk premium that may occur prior to the issuance. The notes being hedged are not capital assets in the hands of the issuer and are thus subject to the hedge timing rules. Under the rules, the issuer would be able to offset the gain or loss on the OCS with gain or loss on the notes over the life of the notes.

## VIII. STRADDLE RULES

Total return swaps may constitute "offsetting positions" for tax law purposes and are thus subject to special treatment.<sup>30</sup> The IRS does not allow a loss to be taken on one of the positions in a straddle to the extent of unrecognized gain in any other offsetting position.<sup>31</sup> The straddle rules effectively prevent the recognition of loss on the sale of one position until an offsetting position with unrecognized gain is recognized.

A "straddle" is defined as offsetting positions with respect to personal property.<sup>32</sup> An "offsetting position" is a position that is held and substantially diminishes the taxpayer's risk of loss with respect to another position.<sup>33</sup> "Personal property" is any property of a type which is actively traded.<sup>34</sup> A total return swap (notional principal contract) constitutes personal property if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market.<sup>35</sup> An "established financial market" includes:

- a national securities exchange;
- an inter-dealer quotation system;
- a domestic board of trade;
- a foreign regulated securities exchange or board of trade;
- an inter-bank market; and
- an inter-dealer market.

Over the past few years, an inter-bank market in credit derivatives has developed. Products such as total return and credit default swaps are now traded by institutional brokers such as Prebon Yamane Inc. As this market is fairly new, the question as to whether such trading is sufficient to constitute "active trading" for purpose of the straddle rules has not arisen. If credit derivatives are considered actively traded property, the taxpayer would also have to hold an offsetting position (e.g. another credit derivative or a debt instrument) with property that is also actively traded in order for the straddle rules to apply.<sup>36</sup>

## IX. DEALERS IN SECURITIES

"Dealers in securities" are generally taxed in a different manner than other taxpayers. Securities held by dealers are subject to mark-to-market treatment.<sup>37</sup> A "dealer" is broadly defined as a taxpayer which (1) regularly purchases securities from or sells securities to customers in the ordinary course of

a trade or business or (2) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business.<sup>38</sup> In this context, a security includes stock, evidence of indebtedness, swap, or any other derivative financial instrument.<sup>39</sup> As a credit derivative is within the definition of a security under the mark-to-market rules, a dealer holding a credit derivative at the close of the taxable year must recognize gain or loss on the derivative as if it were sold for its fair market value,<sup>40</sup> unless the derivative is held for investment or is a hedge of a security held for investment.<sup>41</sup>

## X. CHARACTER

The character rules determine whether income or loss is treated as ordinary or capital. Generally, capital gains earned by non-corporate taxpayers on capital assets held for more than 12 months are subject to a maximum tax rate of 20 per cent.<sup>42</sup> Ordinary income earned by non-corporate taxpayers is subject to the maximum tax rate of 39.6 per cent. Corporate taxpayers are subject to a marginal tax rate of 35 per cent. Furthermore, non-corporate taxpayers may deduct up to USD 3,000 annually of excess capital losses from ordinary income, while corporations cannot use capital losses to offset ordinary income.<sup>43</sup>

### A. Dealers in securities

A dealer treats gain or loss as ordinary gain or loss under the mark-to-market rules.<sup>44</sup> Unless one of the exceptions described below applies, a dealer also treats as ordinary the gain or loss recognized on disposition of a security before the close of the taxable year when the security, if held at year-end, would have been treated as ordinary income or loss.<sup>45</sup> Ordinary income treatment does not apply during the period that a security is:

- a hedge of an investment security or an ordinary course of business debt instrument (i.e. securities not marked-to-market);
- a hedge of a position, right to income, or a liability which is not a security in the hands of the taxpayer and thus not marked-to-market;

29. Treas. Reg. Sec. 1.446-4(a)(2).

30. Straddle rules contained in IRC Sec. 1092.

31. IRC Sec. 1092(a)(1)(A).

32. IRC Sec. 1092(c)(1).

33. IRC Sec. 1092(c)(2)(A).

34. IRC Sec. 1092(d)(1).

35. Treas. Reg. Sec. 1.1092(d)-1(c)(1).

36. Many exceptions to the straddle rules exist, such as identified straddle elections and mixed straddles.

37. IRC Sec. 475. Traders in securities may elect to subject themselves to mark-to-market treatment under IRC Sec. 475(f).

38. IRC Sec. 475(c)(1).

39. IRC Sec. 475(c)(2).

40. IRC Sec. 475(a)(2).

41. IRC Sec. 475(b)(1).

42. IRC Sec. 1(h).

43. Treas. Reg. Sec. 1.1211-1(a).

44. IRC Sec. 475(d)(3)(A)(i).

45. IRC Sec. 475(d)(3)(A)(ii).



- a security held by the taxpayer other than in connection with its activities as a dealer; or
- a security that is improperly identified as qualifying for the exceptions under the mark-to-market rules.<sup>46</sup>

If a total return swap gets ordinary income treatment (i.e. the exceptions listed above do not apply), the character of payments of the swap in the hands of a dealer<sup>47</sup> does not pose a mismatch issue.<sup>48</sup> For example, a gain on a reference obligation will offset a loss incurred under the total return swap, as gains and losses on both securities will be ordinary. However, if ordinary income treatment is not available to a dealer's total return swap, the dealer will be in the same boat as other taxpayers, with a potential character mismatch.

## B. Character of payments under total return swaps

The character of total return swap payments is uncertain with respect to non-dealers and dealers for whom ordinary income treatment is not available. Payments under total return swaps will generally be treated as ordinary income unless a "sale or exchange" has taken place. Section 1234A of the Internal Revenue Code provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to any property that is or on acquisition would be a capital asset in the taxpayer's hands is treated as gain or loss from the sale of a capital asset.<sup>49</sup> A total return swap is "property"; however, it is not clear whether all payments under a total return swap are subject to capital treatment.

## C. Special character rules

Special character rules apply to a total return swap which contains a reference obligation denominated in a foreign currency. If the total return swap requires payments to be made or received in, or determined by reference to the value of "nonfunctional currency", gains and losses attributable to foreign currency (from exchange rate fluctuations) are generally treated as ordinary in character.<sup>50</sup> "Functional currency" is the currency of the economic environment in which a significant part of the activities of a business unit are conducted and which is used by the unit in keeping its books and records. For US persons, the functional currency is usually the US dollar.<sup>51</sup> Accordingly, where the reference debt instrument is denominated in non-functional currency, the gain or loss attributable to the foreign currency will be accounted for separately from the total return swap gain or loss and the foreign currency gain or loss will be ordinary in character.

## XI. SOURCE RULES

Determining the source of income from a total return swap is necessary, amongst other reasons, in order to determine whether a withholding obligation exists.<sup>52</sup> The source of income is generally determined by reference to the residence of the income recipient.<sup>53</sup> For instance, if the payer in a total return swap makes a net payment to a non-US receiver, the

payment would be considered sourced outside the US and thus no withholding obligation will exist. In contrast, if the receiver is a US resident and the payer a non-US resident, the payment would be considered US source and not subject to withholding tax, as the receiver is already subject to US taxation. If the income is effectively connected to the conduct of a US trade or business (i.e. the total return swap was entered into in connection with that business), the income is generally considered US source.<sup>54</sup>

The source of foreign currency gain or loss on a total return swap where the payments are denominated in or determined by reference to a foreign currency is determined by reference to the residence of the taxpayer upon whose books the gain or loss is reflected.<sup>55</sup> The foreign currency gain or loss is treated separately from the gain or loss of the underlying transaction (the total return swap).<sup>56</sup>

US withholding rules can be quite complex. Fortunately, the issue of withholding is resolved by an applicable tax treaty for most taxpayers.<sup>57</sup>

## XII. CONSTRUCTIVE SALE RULES

If the payer in a total return swap owns the underlying reference obligation, the question arises as to whether the payer has constructively disposed of the reference asset and thus realized a taxable event.

A constructive sale is a transaction that offsets an "appreciated financial position" and has the effect of substantially eliminating the taxpayer's risk of loss and chance for further gain on the position.<sup>58</sup> An appreciated financial position is defined as any position with respect to any stock, debt instrument, or partnership interest if there would be gain if such a position were sold, assigned, or otherwise terminated at fair market value.<sup>59</sup> However, an appreciated financial position does not include positions that are marked-to-market (e.g. inventories of dealers in securities) or any position with regard to "straight debt".<sup>60</sup> Straight debt is debt that unconditionally entitles the holder to receive a specified principal

46. IRC Sec. 475(d)(3)(B).

47. If the swap were in the hands of a trader, the outcome may be different.

48. The total return swap would be marked-to-market under IRC Sec. 475(a) and Treas. Reg. Sec. 1.475(b)-1(c), and losses and gains treated as ordinary under IRC Sec. 475(d)(3) and Treas. Reg. Sec. 1.475(d)-1(b).

49. IRC Sec. 1234A.

50. IRC Sec. 988(a)(1)(A); Treas. Reg. Secs. 1.998-1(a)(1)(i), 1.988-1(a)(2)(iii)(B)(1), and 1.446-3(c)(1)(iv).

51. IRC Sec. 985(b) and Treas. Reg. Sec. 1.988-1(c). A non-functional currency may also be a currency of the economic environment where a qualified business unit conducts activities and such currency is used in keeping its books and records.

52. The source of income also affects the tax liability of foreign corporations and non-resident aliens and the use of foreign tax credits by residents and domestic parties.

53. Treas. Reg. Sec. 1.863-7(b)(1).

54. Treas. Reg. Secs. 1.863-7(b)(3) and 1.864-4(c).

55. IRC Sec. 988(a)(3)(A).

56. HR Rep. No. 841, 99th Cong., 2d Sess. II-663 to II-664 (1986).

57. The US Model Income Tax Convention of 20 September 1996.

58. IRC Sec. 1259.

59. IRC Sec. 1259(b)(1).

60. IRC Sec. 1259(b)(2).

amount, provides for interest payable based on a fixed or variable rate,<sup>61</sup> and is not convertible into stock of the issuer or any related person.<sup>62</sup>

Constructive sale transactions include short sales, offsetting notional principal contracts, futures or forward contracts, or similar transactions with respect to the same or substantially identical property.<sup>63</sup> For purposes of the constructive sale rules, an offsetting notional principal contract is defined as an agreement which requires a payment (or provides credit) for all or substantially all of the investment yield (including appreciation) on the position for a specified period and provides reimbursement for (or receives credit for) all or substantially all of any decline in the value of such property.<sup>64</sup>

Thus, the payer in a total return swap who owns the underlying reference obligation will not trigger the constructive sale rules if the reference asset is straight debt or the swap agreement does not cover all of the economic risk relating to the debt instrument.

### XIII. TAXATION OF CREDIT OPTIONS

Credit options are over-the-counter contracts between counterparties which are customized to meet the specific credit related hedging or investment objectives of the user. There are many varieties of credit options<sup>65</sup>. For the purposes of this article, we will focus on credit put options.

Under a credit put option, the purchaser pays the writer a fixed premium in a lump sum or periodically. The put purchaser acquires the right, exercisable upon a predetermined credit event (e.g. credit downgrading or default), to sell the put writer the reference asset for its face amount plus any accrued and unpaid interest.

#### A. Timing

At the time an option is purchased, the purchaser cannot deduct the cost of entering into the option and the writer cannot include in income the gain from selling the option.<sup>66</sup> The taxable events occur at the time the option is sold, exchanged, exercised, or allowed to expire.<sup>67</sup>

If the put purchaser exercises the option, the cost of the option is reduced from the amount realized upon sale of the underlying property. On exercise, the put writer decreases its basis in the security purchased by the amount of the premium received in the opening sale.<sup>68</sup> If the put purchaser allows the option to expire, the option is deemed to be sold or exchanged on the date of expiration; at this time the purchaser is allowed to deduct the premium and transaction costs paid to acquire the option, and the writer recognizes income equal to the net premium received.<sup>69</sup>

#### B. Integration of underlying security and credit put option

If the purchaser of the put option owns the underlying debt instrument, it may be possible to integrate the two instru-

ments for timing and character purposes. Integration can be accomplished if the put is exercisable upon a default, thus allowing a yield-to-maturity calculation.<sup>70</sup>

#### C. Character

The character of income or loss associated with the sale, exchange, exercise, or lapse of an option takes on the character of the property to which the option relates.<sup>71</sup> If the debt to which the option relates is a capital asset in the hands of the taxpayer, then the gain or loss from the option will also be capital. Thus, traders and investors who allow an option to expire will have a capital loss in the amount of the premium paid for the option. Gain or loss from a credit put option will be ordinary in character to dealers for which the option is a "security" in its hands, or a hedge of ordinary property held by the dealer.<sup>72</sup>

### XIV. CONCLUSION

As lenders and other investors increase their use of credit derivatives to manage credit risk or to synthetically invest in existing debt instruments, it becomes increasingly important that the US federal tax system resolve any uncertainties with respect to the taxation of credit derivatives. The rules governing credit derivatives tend to be quite complex. Tax issues such as timing, character, and source of income should be carefully considered before entering into a credit derivative contract. Overlooking tax implications of certain terms of any financial product could jeopardize the contracting parties' ability to achieve their intended financial goals. Financial practitioners should consult a tax professional when designing or investing in complex forms of financial products.

61. IRC Sec. 860G(a)(1)(B).

62. IRC Sec. 1259(b)(2)(A).

63. IRC Sec. 1259(c)(1).

64. IRC Sec. 1259(d)(2).

65. Such as options on credit loss, options on credit spread, and credit risk options.

66. Rev. Rul. 58-234, 1958-1 CB 279, clarified by Rev. Rul. 68-151, 1968-1 CB 363; *Hollingsworth v. Commissioner*, 27 BTA 621 (1938), acq. XII-1 CB 6.

67. Rev. Rul. 78-182, 1978-1 CB 265. Unless the option is so deep-in-the-money at the time it is written that is certain to be exercised, see Rev. Rul. 85-87, 1985-1 C.B. 269 and Rev. Rul. 82-150, 1982-2 C.B. 110.

68. Rev. Rul. 78-182, 1978-1 CB 265, citing Rev. Rul. 58-234, 1958-1 CB 279.

69. IRC Sec. 1234(a)(2) and Treas. Reg. Sec. 1.1234-1(b).

70. Treas. Reg. Sec. 1.1275-6(b)(2).

71. IRC Sec. 1234(a)(1).

72. IRC Sec. 1221, Treas. Reg. Sec. 1.1221-2.