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September 9, 2005

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3112 MT
1500 Pennsylvania Avenue, N.W.
Washington D.C. 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington D.C. 20224

Re: Notice 2004-52 (Credit Default Swaps)

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1095 (the "Report") responding to a request for comments on the taxation of credit default swaps made in Notice 2004-52. The Notice requests comments on, among other things, credit default swap contractual terms, credit default swap pricing and price dissemination, credit default swap hedging practices, and the regulatory capital and GAAP treatment of credit default swaps. The Notice also requests any other comments market participants may have. The Report responds to the request for factual information and then urges the Treasury Department and Internal Revenue Service to issue guidance addressing the U.S. federal income taxation of credit default swaps.

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There are two broad tax issues raised by credit default swaps. The first is how to determine when a credit default swap may appropriately be taxed as a derivative financial instrument, as compared to possible taxation under the rules applicable to traditional forms of credit protection, most notably insurance. The second is how those instruments that qualify as derivative financial instruments should be taxed. We recommend that Treasury and the Service issue guidance that addresses both of these questions. The need for guidance is most pressing with respect to cross-border transactions, because of the deal-breaking effect of the application of withholding tax or U.S. net-basis income tax to payments made to foreign persons.

Our recommendations fall broadly into three categories. First, we recommend that Treasury and the Service provide a safe harbor under which qualifying credit default swaps are characterized for U.S. federal income tax purposes as a type of financial instrument for which there is a well-developed body of law, such as a notional principal contract, rather than as an insurance policy, guarantee, letter of credit or similar contract, subject to certain conditions. We suggest that a qualifying credit default swap be defined as a single-name or portfolio credit default swap with conventional market terms (as more fully described in the Report) that states that the protection buyer is not required to have suffered a loss on, or to have owned, the underlying reference obligation at any time in order to receive payment. A credit default swap should, however, be outside the safe harbor if the reference obligation is the only available measure of settlement value and is effectively immobilized in the hands of, or for the benefit of, one of the parties.

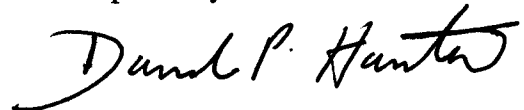
The premise of the recommendation above is that it is possible to identify a class of credit default swaps that should *not* be taxed as an insurance policy, guarantee, letter of credit or similar contract. There should be no implication that credit default swaps other than qualifying credit default swaps are properly taxed as an insurance policy, guarantee, letter of credit or similar contract. Accordingly, our second recommendation is that either presumptions or factors should be provided for assessing whether credit default swaps other than qualifying credit default swaps should be excluded from insurance, guarantee or similar treatment and should be treated as derivative financial instruments. Such presumptions or factors should include, as determinative or highly probative indications, (a) the lack of an insurable interest and (b) the lack of risk distribution. Furthermore, credit default swaps

treated as derivative financial instruments, whether or not they are qualifying credit default swaps, should be subject to the same section 864(b) trade or business rules and sourcing (and therefore withholding tax) rules as notional principal contracts.

The last part of the Report addresses the timing and character of payments on credit default swaps that are treated as derivative financial instruments. The Report recommends that such credit default swaps be subject to the timing rules applicable to notional principal contracts, with some modifications. The proposed regulations on notional principal contracts with contingent nonperiodic payments should be modified to provide that such credit default swaps are outside their scope. Accordingly, subject to anti-abuse rules, periodic payments on such credit default swaps should be treated as periodic payments required to be deducted and included currently, with no accrual of income or expense with respect to potential settlement payments under the credit default swaps. (A significant minority of our members believes that this general timing rule should not apply to credit default swaps as to which the risk of a settlement payment is high.) Finally, with respect to character, we believe that if rules were being written on a clean slate there would be a compelling case for treating settlement payments on credit default swaps treated as derivative financial instruments as giving rise to capital gain or loss. We reluctantly conclude, however, that if Treasury and the Service continue to take the position that payments on other notional principal contracts determined by reference to the change in value of a capital asset constitute ordinary income or expense, it is preferable for such credit default swaps to be subject to the same rules as other notional principal contracts rather than to a special regime of their own.

We appreciate your consideration of our recommendations and comments. Please feel free to contact us if you have any questions regarding this Report. As always, we would be happy to discuss them with you.

Respectfully submitted,



David P. Hariton
Chair

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