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Cross-border credit default swaps

Scenario 1

H Co. Protection Buyer is a Host Country financial institution that enters into a credit default swap with F Co. Protection Seller, a Country X investment bank that does not have an office or fixed place of business in H Co.

Under the credit default swap, H Co. Protection Buyer agrees to pay F Co. Protection Seller annual premiums equal to the LIBOR interest rate on five-year obligations multiplied by a notional principal amount calculated by reference to the principal amount of an actual loan (the "Reference Instrument"), which may or may not be held by H Co. Protection Buyer.

In turn, F Co. Protection Seller agrees that, in the event of an actual default on the payment of principal or interest on the Reference Instrument or certain other events, including the bankruptcy or insolvency of the obligor on the Reference Instrument or its failure to satisfy certain net worth covenants under the Reference Instrument documents (each such occurrence is a "Credit Event"), F Co. Protection Seller agrees to pay H Co. Protection Buyer the diminution in value of the Reference Instrument from the date of issuance to the date of the Credit Event.

The credit default swap terminates after the earlier of five years or upon the occurrence of a Credit Event with respect to the Reference Instrument.

F Co. Protection Seller is interested in the answers to the following questions:

Taking into account the Host Country domestic law characterisation and treatment of credit default swaps and payments thereunder:

- Will F Co. Protection Seller's participation in the credit default swap cause it to be subject to Host Country net income taxation by virtue of doing business in Host Country and, if a tax treaty applies, having a Host Country permanent establishment?
- If F Co. Protection Seller is subject to Host Country net income taxation with respect to the credit default swap, how will H Co. Protection Buyer's payments to it and its payment to H Co. Protection Buyer be taken into account in calculating its actual or potential Host Country tax liability?
- If F Co. Protection Seller is not subject to Host Country net income taxation with respect to the credit default swap, will H Co. Protection Buyer's payments be subject to Host Country withholding, VAT or excise tax?

Scenario 2

F Co. Protection Buyer, a Country X financial institution with no office or fixed place of business in Host Country, enters into a credit default swap with H Co. Protection Seller, a Host Country investment bank, with terms similar to those set forth in Scenario 1.

F Co. Protection Buyer is interested in answers to the following questions:

Taking into account the Host Country domestic law characterisation and treatment of credit default swaps and payments thereunder:

- Will F Co. Protection Buyer's participation in the credit default swap cause it to be subject to Host Country net income taxation by virtue of doing business in Host Country and, if a tax treaty applies, having a Host Country permanent establishment?
- If F Co. Protection Buyer is subject to Host Country net income taxation with respect to the credit default swap, how will its payments to H Co. Protection Seller and H Co. Protection Seller's payment to it be taken into account in calculating its actual or potential Host Country tax liability?
- If F Co. Protection Buyer is not subject to Host Country net income taxation with respect to the credit default swap, will H Co. Protection Seller's payment be subject to Host Country withholding, VAT or excise tax?

Host Country FRANCE

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This article examines the tax treatment of credit default swaps (CDS) in a cross-border situation where either the seller or the buyer is located in France, in relation to corporate tax (and more specifically potential permanent establishment (PE) issues), withholding tax and value added tax (VAT). Before addressing the tax treatment of CDS in a cross-border context, an attempt is made to analyse how such instruments would be treated in a purely domestic context.

A CDS is a credit derivative contract under which the protection buyer under the CDS makes periodic fixed payments to the protection seller in consideration for protection against a defined default risk relating to an asset or a basket of assets. Under the agreement, the protection seller makes a payment to the protection buyer if a credit instrument – typically a bond or a loan – goes into default or the issuing company undergoes restructuring or bankruptcy or even just has its credit rating downgraded. The quantum of the payment is (broadly) a function of the diminution in value of the nominated reference obligation underlying the contract.

The regime applicable to CDS is not defined by law and there are no specific rules governing the tax treatment applicable to such instruments.

The French tax treatment of a transaction primarily depends on its legal analysis. Unless a specific tax rule provides otherwise, the tax treatment of a transaction follows the accounting treatment under French GAAP, which happens also to be largely influenced by the legal analysis. Unlike in some other countries, the economic analysis is not the prime factor in determining how a transaction, the classification of which is clear from a legal perspective, should be treated for tax purposes, although in most situations one would expect the legal and accounting treatment to be consistent with the economic analysis. However, the French tax administration has the right to challenge the tax treatment of a transaction in some situations, when the transaction has been wrongly analysed (i.e. it has been given a designation that is incompatible with its precise legal nature) or when the nature of a transaction has been disguised or the transaction has been entered into for the sole purpose of avoiding tax. How the various legal, accounting, economic and tax classifications are reconciled is an interesting subject, but one on which it is not proposed to go into in any further detail here because, as will become clear, there are as yet no clear legal or accounting rules applicable to all CDS on the basis of which the appropriate tax treatment can be determined.

The legal nature of CDS remains open to debate, although it seems probable that they should be treated as derivatives (*instruments financier à terme*) under Articles L 211-1 and D 211 1 A of the French Monetary Code. It could be argued that a CDS should instead be compared to a contractual guarantee or to insurance, but there seems to be a large consensus to the effect that such a classification should be avoided (classifying a CDS as an insurance transaction would give rise to regulatory difficulties and insurance premium tax issues and would not be consistent with the economic character of the transaction, which relates to financial credit risk). Even if it is accepted that a CDS is a financial derivative, it is uncertain whether a CDS should be treated as an option or as a swap.

The general guidance with respect to the proper accounting treatment of a CDS is not much clearer than that with respect to the legal nature of a CDS. Most CDS are organised as bilateral over-the counter (OTC) transactions on the market, can be used as hedging or trading instruments and can be cash-settled or physically settled. It is not necessary for the buyer to own the underlying credit instrument. In the absence of a clear legal regime, the accounting treatment of a CDS largely depends on the economic analysis of the particular agreement and each party's situation.

The above is not meant to suggest that it is not possible to determine how such a sui generis transaction should be treated for tax purposes, but it will suffice to indicate that the analysis that follows cannot cover all possible situations and, even subject to that limitation, is open to debate.

I. Tax treatment of credit default swaps

A. Tentative analysis of the corporate tax treatment

Notwithstanding the caveats in the introduction above, the issues surrounding the tax treatment of CDS are, in practice, relatively circumscribed.

There are currently very few circumstances in which French tax law provides that income generated by a transaction effected by a corporate entity does not fall within the scope of ordinary income. The long-term capital gain regime (which provides for a 95 percent exemption) only applies to disposals of qualified investment portfolios (shares) and some intangible assets (patents). Apart from such long-term capital gains, there are no other special baskets of income. Thus, the only question that arises concerning the tax treatment of CDS is the timing of the recognition of income/gains and expenses/losses in determining the total net basis subject to the normal corporate tax rate (currently 34.4 percent, including the social contribution on corporate tax).

As already noted, the French tax treatment of a CDS should largely follow its accounting treatment. In practice, the likely treatment is that, as in the case of a swap, the income from and expenses incurred in relation to a CDS (the premium) will be recorded on an accrual basis and it will be possible to deduct unrealised losses by way of transfer to a reserve. Were the CDS to be regarded as an option rather than a swap, the treatment of the premium could be different (i.e. the premium could be taxed/deducted on maturity, instead of on an accrual basis).

Banks, however, are subject to specific rules: trading portfolios must be marked to market as must swaps that are used as part of a trading activity or for hedging other portfolios that themselves must be marked to market.[1]

Also, derivative financial instruments are subject to specific tax rules that are not entirely in keeping with the accounting rules and that may give rise to additional difficulties (which will be relevant if the CDS in question is indeed categorised as a derivative). The most important departures from the accounting treatment are as follows:

- Independently of their accounting treatment, unrealised gains and losses of any company (not just a bank) are taxed on a mark to market basis when the instruments giving rise to them are traded on an organised market.[2] Most CDS are OTC instruments and should not be subject to this rule. However, the recent creation of organised markets for CDS could give rise to some doubt as to whether CDS should not be subject to the mark to market rule. In some cases, the administration assimilates an OTC instrument to a listed instrument, when the OTC can be compared to a listed instrument. However, the recent crisis has shown that the liquidity attached to organised markets is relative and that the supposedly objective mark to market value of an instrument is disputable and highly influenced by the counterparty risk.
- In situations in which a CDS is entered into to hedge an asset, the accounting treatment normally allows a mismatch to be avoided where the gain and the loss on each position are not taken into account at the same time. Should this occur, however, because the transaction is not recorded as a hedge for accounting purposes, Article 38.6.3 of the French Tax Code provides that a realised or unrealised loss cannot be deducted when a gain on a symmetrical position exists and has not yet been taxed. Moreover, such symmetrical transactions must be declared for tax purposes.

B. Withholding

French law provides for an 18 percent withholding tax on interest payments, but a large number of exemptions from the tax are provided for under both domestic law (for example, for interest on loans) and under France's tax treaties. French tax law also provides for a 33.33 percent withholding on certain payments made for the supply of services used in France; this tax never applies in a treaty context, however, since invariably France will be prevented from imposing it by either the "Business income" Article or, where this does not apply, by the "Other income" Article.

Based on the analysis of CDS in I.A., above, it seems doubtful that payments made under a CDS would be within the scope of these withholding taxes, even in a non-treaty context. Also, the French Administration has recently confirmed that no withholding tax should apply to swaps and other futures.[3] Although this statement did not explicitly refer to CDS, it seems unlikely that the French Administration would take a different position with regard to CDS. A general, official clarification on this point would, of course, still be welcome.

C. Value added tax

Credit derivatives are "financial" in nature and, like other financial derivatives, should be exempt from VAT under Article 135-1 of the EC VAT Directive. Whether a CDS is cash-settled or physically settled should have no impact on this exemption, since the underlying asset transactions would also be exempt. It is not entirely clear whether the premium received by the protection seller would remain exempt were the seller to elect to be subject to VAT on the provision of financial services, but it seems very likely that, like other swaps and options, such payments would remain exempt despite such an election, which has in practice been made by a few French financial entities.

If, as seems very likely, CDS are exempt from VAT, there will be no right to recover the related input VAT, except in the case of transactions entered into with non-EU counterparties. There is some doubt as to how the income received on CDS should be taken into account in computing the VAT recovery ratio, but there is relatively well-established case law to the effect that income from swaps should be taken into account on a net basis. The position taken by the Administration in 2006 in relation to banks confirms that income from a swap should be taken into account on a net basis and provides specific rules allowing banks to compute the amount of profit by reference to a basket of transactions.[4] There are three baskets of financial instruments encompassing swaps, futures and options. A bank can choose either to retain the profit of each basket computed by taking into account only profitable transactions, or to take into account the net amount of all profits and losses for all three baskets. Which of the three baskets a CDS falls into should be determined on a case-by-case basis.

II. Scenario 1: Treatment of F Co. Protection Seller under F Co. Protection Seller-H Co. Protection Buyer credit default swap

A. Host Country net income taxation of F Co.?

F Co.'s provision of credit protection to H Co. should not cause F Co. to be subject to French taxes.

A non-resident is subject to French tax only where it is trading in France through a PE and profit is directly attributable to the activities undertaken by that PE. French domestic law, as interpreted by some relatively old case law, also allows a company to be taxed in France when it performs a "full commercial cycle in France." The case law is somewhat ambiguous as to the level of autonomy required for such a "commercial cycle" organised in France to attract taxation and how it can be isolated from the rest of a company's home activity. The "commercial cycle" criterion is not relevant where a tax treaty applies (in which case no PE will exist unless the company concerned has a fixed place of business or a dependant agent in France) and is seldom referred to.

If F Co. has negotiated the CDS from its home jurisdiction and the obligations thereunder are booked in its home jurisdiction, provided nothing further remains to be done by F Co. in relation to the CDS in France, F Co. cannot be taxed in France, notwithstanding the presence of its counterparty in France. This result is in line with OECD principles.

B. Other Host Country taxes

For the reasons stated above, no withholding should apply to H Co.'s payments to F Co. under the CDS.

The CDS will be VAT-exempt and the payments under it by H Co. will not be subject to VAT.

III. Scenario 2: Treatment of F Co. Protection Buyer under H Co. Protection Seller-F Co. Protection Buyer credit default swap

The treatment of F Co. where it is the protection buyer under the CDS will be the same as that outlined above in relation to the situation where it is the protection seller, in the sense that F Co., as a foreign protection buyer, cannot be regarded as becoming subject to French corporate tax for the sole reason that it enters into a CDS transaction with a French protection seller.

No withholding tax and no VAT will apply.

Thierry Pons is an expert in finance tax, including the provision of tax advice for French and cross-border banking, capital markets and derivatives transactions. Thierry covers all tax issues, including litigation, in the banking, finance and capital market industries, concerning both corporate and indirect taxes. He has wide experience in advising corporate clients on international tax issues.

NOTES

[1] French Tax Code (FTC), Article 38 *Bis* C, which follows the accounting treatment applicable to banks.

[2] FTC, Article 38.6.1.

[3] SP. 5 I-1-08 of January 24, 2008.

[4] SP. 3 L 1-06 of January 17, 2006.

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