

Tax Naked Credit Default Swaps for What They Are: Legalized Gambling

James Blakey

8 U. MASS L. REV. 136

ABSTRACT

Credit default swaps (CDSs) gained notoriety for their role in the global financial crisis. In late 2011, the IRS proposed new regulations that would classify CDSs bought by someone who does not own the credit, known as “naked” CDSs, as “financial instruments” and thereby qualify them for the highly beneficial capital gains tax treatment. This classification is incorrect.

Naked CDSs, which constitute about 80% or more of all CDSs, are not financial instruments at all. Rather, this article argues, they are gambling wagers—the winnings on which are taxable at the ordinary income tax rate. This is not the radical suggestion it may seem. In fact, Congress acknowledged that certain derivatives, including CDSs, might constitute gambling when it exempted them from “any State or local law that prohibits or regulates gaming.” While the exemption decriminalized Naked CDSs, it made no change to their tax status.

Under *existing* law, this tax rate would apply to the winnings of hedge funds and hedge fund managers through their so-called carried interests. The 20% difference on perhaps hundreds of billions of dollars of income is highly significant to a financially strapped U.S. Treasury. In addition, as gambling income, Naked CDS winnings of hedge fund managers are subject to the 2.9% Medicare tax, and most Naked CDSs are also subject to a 2% federal excise tax on gambling.

AUTHOR

A.B., Dartmouth College; J.D., Boston University. The author would like to thank JoAnne Blakey, for her enduring support, as well as Michael Burns, Joseph Hellman, Stephen Gardner and Mary Voce for their close reading and appraisal of early drafts, and Andrew Mark, Maureen Herbert, Ian Stock, Bruce Herzfelder and Bill Maddix for their encouragement. The article benefits significantly from the excellent work of the members of The University of Massachusetts Law Review, for which the author is also grateful.

- I. INTRODUCTION..... 138
- II. A NAKED CDS IS GAMBLING..... 144
- III. A NAKED CDS IS TAXABLE JUST LIKE ANY OTHER GAMBLING 151
 - A. Federal Excise Tax on Wagers 151
 - B. Ordinary Income, Not Capital Gain..... 154
 - C. Medicare Taxes..... 157
 - D. Limitations on Use of Losses..... 158
 - E. State Income Taxes and Federal Withholding Taxes..... 159
- IV. CONCLUSION 161

I. INTRODUCTION

Credit default swaps (CDSs), arcane “financial products” developed in the mid-1990s, are widely regarded as a significant contributing factor to the global financial crisis that followed barely a decade later.¹ While disastrous for some participants,² the CDS “market” was immensely profitable for others.³

In August 2004, the IRS sought information in connection with requests from “taxpayers and industry groups” for guidance on the proper tax treatment for CDSs.⁴ After more than seven years of waiting, the IRS issued its proposed regulation.⁵ The fine print of the proposed regulation provides a tax giveaway that amounts to perhaps hundreds of billions of dollars to the very investment banks, hedge fund managers, and others that made vast fortunes helping to bring about that crisis.

A CDS is a contract under which a “protection buyer” agrees to make payments, the “premium,” to a “protection seller” in exchange for a larger lump-sum payment if a third-party borrower, known as a “reference entity,” defaults on its obligation, the “reference obligation.”⁶ The CDS identifies a “notional amount” of the reference obligation covered, upon which the reciprocal payments are computed, and the duration for which the coverage will last, usually five years.⁷

In a hypothetical example, suppose hedge fund *A* agrees to pay insurance company *B* a \$2.50 (2.5%) per year premium on a \$100

¹ See, e.g., John Grgurich, *Credit Default Swaps: Still Here, Still Able to Wreak Havoc*, DAILY FINANCE (May 11, 2012), <http://www.dailyfinance.com/2012/05/11/jpmorgan-credit-default-swaps-still-wreaking-havoc/>.

² See, e.g., Michael Lewis, *The Man Who Crashed the World*, VANITY FAIR, Aug. 2009, at 98, 98–99.

³ See, e.g., Gary Weiss, *The Man Who Made Too Much*, UPSTART BUS. J. (Jan. 7, 2009, 8:00 AM), <http://upstart.bizjournals.com/executives/features/2009/01/07/John-Paulson-Profits-in-Downturn.html>.

⁴ I.R.S. Notice 2004-52, 2004-2 C.B. 168.

⁵ See Prop. Treas. Reg. § 1.446-3, 76 F.R. 57684 (Sept. 16, 2011) (proposing to treat CDSs as notional principal contracts under I.R.C. § 1256(b)(2)(B)).

⁶ *Product Descriptions and Frequently Asked Questions*, INT’L SWAPS AND DERIVATIVES ASS’N, <http://www.isda.org/educat/faqs.html#26> (last visited Sept. 22, 2012), cited in Lawrence Lokken, *Taxation of Credit Derivatives 3*, (Univ. of Fla. Col. Of Law Research Paper Series, Paper No. 2009-39), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1509681.

⁷ Lokken, *supra* note 6, at 3–4.

notional amount of a debt owed by investment bank *C* to lender *D*, and if *C* defaults on that debt, *B* agrees to pay *A* \$100. *C* and *D* are not parties to the CDS transaction or even necessarily aware of the CDS transaction.

In a real life example, on October 21, 2008, a notional amount of \$360 billion in CDSs on reference obligations of a single borrower, Lehman Brothers, came home to roost.⁸ One CDS on Lehman Brothers debt was bought by a hedge fund for \$22 million and is said to have returned \$1 billion to the buyer⁹—almost fifty to one—far in excess of the highest odds at a roulette table.¹⁰ Apparently, CDSs bought on Lehman Brothers debt and sold by American International Group, Inc. (“AIG”) triggered AIG’s financial collapse and the massive U.S. government bailout that followed.¹¹

As the CDS market developed, the total notional amount of CDSs far exceeded the amount of debt that could possibly go into default.¹² A small percentage of CDS buyers may actually have owned the reference obligation and had a legitimate financial risk to hedge; however, most CDS buyers had nothing at stake and were simply

⁸ See Kim A. Olsen, *Pay-up Time for Lehman Swaps*, ASIA TIMES ONLINE (Oct. 22, 2008), http://www.atimes.com/atimes/Global_Economy/JJ22Dj03.html; see also Louise Armitstead & Peter Koenig, *Market Holds Breath as \$360bn Lehman Swaps Unwind*, THE TELEGRAPH (UK), Oct. 18, 2008, <http://www.telegraph.co.uk/finance/financialcrisis/3224615/Markets-hold-breath-as-360bn-Lehman-swaps-unwind.html>.

⁹ See Weiss, *supra* note 3.

¹⁰ CATALIN BARBOIANU, ROULETTE ODDS AND PROFITS: THE MATHEMATICS OF COMPLEX BETS 20 (2007) (demonstrating that the highest pay out on a roulette wheel, from “the straight up” bet, is thirty-five to one and that the odds of winning the straight up bet are thirty-seven to one).

¹¹ See Lokken, *supra* note 6, at 1–2. See generally, MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010), for a fascinating and highly readable explanation of how the massive growth in CDSs helped to fuel the U.S. real estate mortgage bubble, the popping of which in 2008 sent the world financial markets into collapse and the world economy into recession.

¹² See Gretchen Morgenson, *Arcane Market is Next to Face Big Credit Test*, N.Y. TIMES, Feb. 17, 2008, at A1, available at <http://www.nytimes.com/2008/02/17/business/17swap.html> (“Since 2000, [the CDS market] has ballooned from \$900 billion to more than \$45.5 trillion—roughly twice the size of the entire United States stock market.”); see also Lokken, *supra* note 6, at 2 (estimating that the notional amounts of outstanding CDSs exceeded \$60 trillion at the end of 2007).

piling on side bets, so-called “Naked CDSs,” hoping to profit vicariously from the random misfortune of a stranger.¹³

The 2004 IRS Notice indicates that a variety of taxation theories for CDSs had been advanced by analogy to exotic financial devices.¹⁴ According to the Notice, “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.”¹⁵ More recently, certain academics have argued that, for tax purposes, CDSs do not fit correctly into any of those classifications. One author, for example, has argued that CDSs belong in his own newly-invented classification, “annuity-paid deep out-of-the-money derivative contracts.”¹⁶ Another has argued that taxation of CDSs should be addressed with new legislation.¹⁷

¹³ See, e.g., Richard Beales, *Uncertain Road Ahead for Delphi*, FIN. TIMES, Nov. 7, 2005, available at <http://www.ft.com/intl/cms/s/0/f6a5d3e4-4fb6-11da-8b72-0000779e2340.html> (noting that when Delphi, General Motors’ parts supplier, went bankrupt in 2005, “the notional amount of credit derivatives referencing the company was more than 10 times the \$2 [billion] or so of bonds outstanding”); see also Lokken, *supra* note 6, at 4–5 (discussing how the industry was forced to migrate from its original standard form swap contracts, which contemplated the physical delivery of the actual reference obligation by the protection buyer to the protection seller, to forms that provided either for settlement in cash, optionally or exclusively, whereby the protection seller simply writes a check if the obligation defaults, but nothing is transferred by the protection buyer in return).

¹⁴ See I.R.S. Notice 2004-52, 2004-2 C.B. 168, 168–169.

¹⁵ *Id.*

¹⁶ See Ari J. Brandes, *A Better Way to Understand the Speculative Use of Credit Default Swaps*, 14 STAN. J.L. BUS. & FIN. 263, 263–267 (2009).

¹⁷ See Lokken, *supra* note 6, at 14–15 (“A solution that might ultimately become the best alternative—marking credit default swaps to market [But a] mark-to-market regime for credit default swaps could only be instituted by a statutory change”). Professor Lokken’s proposal appears to have been rejected, at least insofar as Congress in 2010 amended I.R.C. § 1256(b) expressly to exclude credit default swaps from its mark-to-market provisions. Dodd-Frank Wall Street Reform and Consumer Protection Act, sec. 1601(a), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at I.R.C. § 1256(b)(2)(B) (Supp. IV 2011)). Under proposed regulations, CDSs would be taxed instead as “notional principal contracts.” Prop. Treas. Reg. § 1.446-3, 76 F.R. 57684–85 (Sept. 16, 2011).

It is often said, however, that the simplest explanation is usually the right one.¹⁸ Whether some exotic analogy is necessary to understand how to tax a CDS where the buyer actually *has* a legitimate financial risk to hedge,¹⁹ the simple explanation as to a Naked CDS is that it is gambling. “A person engages in gambling when he stakes or risks something of value upon the outcome of a contest of chance or a future contingent event not under his control or influence, upon an agreement or understanding that he will receive something of value in the event of a certain outcome.”²⁰ Naked CDSs should be taxed the same way as any other gambling.

This is not the radical suggestion it might seem.²¹ In fact, Congress confirmed that certain derivatives, including CDSs, constitute

¹⁸ See R. H. Helmholz, *Ockham's Razor in American Law*, 21 TUL. EUR. & CIV. L.F. 109, 110–11 (2006) (“[C]omplex explanations of observed phenomena should not ordinarily be accepted without proof of their necessity. Simpler explanations are to be preferred.”) (citing *Pluralitas non est ponenda sine necessitate*, Ordinatio I, d. 30 q. 2, in 4 WILLIAM OF OCKHAM, OPERA THEOLOGICA 322 (G.I. Etzkorn & Francis Kelly eds., 1979)).

¹⁹ The scope of the IRS Notice is not limited to Naked CDSs, and it recognizes that “[a] relevant factor [in the consideration of analogs] may be how much of the CDS protection-buying market consists of persons who do not have or expect to be exposed to credit risk.” I.R.S. Notice 2004-52, 2004-2 C.B. at 169. For tax purposes, the difference between hedging transactions and those entered into for speculation is well recognized. *E.g.*, Treas. Reg. § 1.446-3(f)(2)(v) (1994) (setting out specific rules for transactions “entered into primarily to reduce risk with respect to a specific debt instrument or group of debt instruments held or issued by the taxpayer”); Treas. Reg. § 1.1221-2(b)(1)–(3) (2007) (specifying different tax treatment for hedging and non-hedging transactions and defining the former as “any transaction that a taxpayer enters into in the normal course of the taxpayer’s trade or business primarily—(1) to manage risk of price changes or currency fluctuations with respect to ordinary property . . . that is held or to be held by the taxpayer, (2) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or (3) to manage such other risks as the Secretary may prescribe in regulations . . .”).

²⁰ N.Y. PENAL LAW § 225.00(2) (McKinney 2012).

²¹ See Mark Sunshine, “*Stupid is as Stupid Does*”, THE SUNSHINE REP. (Dec. 27, 2008), <http://www.thesunshinereport.net/marksunshine/?p=223> (“[W]hen the speculator doesn’t have an underlying economic interest . . . it’s high stakes gambling at its best.”); Jane Hamsher, *Geitner Endorses Naked Credit Default Swaps*, FIREDOGLAKE.COM (Mar. 26, 2009, 9:35 AM), <http://firedoglake.com/2009/03/26/geithner-endorses-naked-credit-default-swaps/> (quoting Dean Baker in reference to naked CDSs: “We tax gambling in Las Vegas”); DEAN BAKER, CENTER FOR ECON. & POL’Y RES., THE BENEFITS OF

gambling when in 2000, to allay industry fears that CDSs were *illegal* gambling,²² it exempted them from “any State or local law that prohibits or regulates gaming.”²³ While the exemption decriminalized Naked CDSs,²⁴ it made no change to their tax status.

By contrast, the proposed regulations incorrectly categorize *every* CDS as a “notional principal contract” (NPC), a kind of financial instrument entitled to special, highly favorable capital asset tax treatment.²⁵ That categorization is a product of rogue agency action; Congress never authorized this for Naked CDSs.²⁶

The proposed regulations would provide a massive tax windfall to some of the nation’s wealthiest taxpayers,²⁷ at a time when the

A FINANCIAL TRANSACTIONS TAX 3 (2008) (arguing in favor of a tax on financial speculation and noting that taxing transactions that are most comparable to gambling could result in their cessation). *But see* Kristin N. Johnson, *Things Fall Apart: Regulating the Credit Default Swap Commons*, 82 U. COLO. L. REV. 167, 197–98 (2011) (arguing against the application of gambling as an analogy to CDSs).

²² *See, e.g., Hearing to Review the Role of Credit Derivatives in the U.S. Economy: Hearing Before H. Comm. on Agriculture*, 110th Cong. 81 (2008) (statement of Eric Dinallo, Superintendent of New York State Ins. Dept.) (“With the growth of various kinds of derivatives in the late 20th Century, there was legal uncertainty as to whether certain derivatives, including credit default swaps, violated state bucket shop and gambling laws. [The Commodity Futures Modernization Act of 2000] created a ‘safe harbor’ by . . . preempting state and local gaming and bucket shop laws”); *see also* 7 U.S.C. § 16(e)(2) (2000), *amended by* Commodity Futures Modernization Act of 2000, sec. 117, Pub. L. No. 106-554, 114 Stat. 2763.

²³ 7 U.S.C. § 16(e)(2) (2006).

²⁴ *Id.* It remains unlawful to buy insurance on the life of a stranger. *See, e.g.,* N.Y. INS. LAW § 3205(b)(2) (McKinney 2012). That is, at least, until the day an enterprising financial professional similarly persuades Congress to legalize “health default swaps.”

²⁵ *See* Prop. Treas. Reg. § 1.446-3, 76 F.R. 57684, 57685–86. (Sept. 16, 2011).

²⁶ *See* Lokken, *supra* note 6, at 14.

²⁷ *See* Gretchen Morgenson, *It’s Time for Swaps to Lose Their Swagger*, N.Y. TIMES, Feb. 27, 2010, <http://www.nytimes.com/2010/02/28/business/economy/28gret.html> (“United States commercial banks . . . held \$13 trillion in notional value of credit derivatives at the end of the third quarter [of 2009], according to the Office of the Comptroller of the Currency. The biggest players in this world are JP Morgan Chase, Citibank, Bank of America and Goldman Sachs.”).

government doesn't have a nickel to spare.²⁸ Meanwhile, the Occupy Wall Street movement, Warren Buffett, and the typical American wage earner are already outraged that "the 1%" pays taxes at a much lower rate than "the 99%."²⁹ The difference to the U.S. Treasury between tax-advantaged financial instruments and the less friendly treatment of gambling, which reflects the predictable divide between how the moneyed and non-moneyed classes are taxed, is very significant, potentially involving hundreds of billions of dollars of lost tax revenue if Naked CDSs are misclassified.

After the introduction in Part I, this article argues in Part II that Naked CDSs constitute gambling wagers, not financial instruments. Part III discusses the current tax treatment of gambling and how it should apply to Naked CDSs. Throughout Part III, comparisons are drawn between gambling wagers and Naked CDSs to illustrate the implications that would follow from the federal treatment proposed in this article. These implications include the federal excise tax of up to 2% on wagers,³⁰ the treatment of profits on wagers as ordinary income rather than capital gains,³¹ the 2.9% Medicare tax imposed on income earned from a trade or business,³² and the limitations on deductions for gambling losses.³³ Since gambling income is taxable in the jurisdiction in which bets are placed rather than in the jurisdiction in which the taxpayer resides, like capital gains, there are also significant state income tax and foreign withholding tax implications that are discussed in Part III.³⁴

²⁸ See Jackie Calmes, *Geithner Asks Congress to Raise U.S. Debt Limit Quickly*, N.Y. TIMES, Jan. 7, 2011, <http://www.nytimes.com/2011/01/07/business/economy/07debt.html>.

²⁹ See, e.g., James Kwak, *Occupy Wall Street's Top Priority Should Be to Kill the Bush Tax Cuts*, ATLANTIC MONTHLY, Oct. 17, 2011, <http://www.theatlantic.com/business/archive/2011/10/occupy-wall-streets-top-priority-should-be-to-kill-the-bush-tax-cuts/246817/>; Steve Jordan, *Warren Watch: Buffett Tax Idea Moves Omaha Native*, OMAHA.COM (Oct. 9, 2011), <http://www.omaha.com/article/20111009/MONEY/710099929>; Sarah Dutton, *Polls Show Longtime Support for Tax Hikes on Rich*, CBS NEWS (Oct. 12, 2011, 12:16 PM), http://www.cbsnews.com/8301-503544_162-20119267-503544/polls-show-longtime-support-for-tax-hikes-on-rich/.

³⁰ See discussion *infra* Part III.A.

³¹ See discussion *infra* Part III.B.

³² See discussion *infra* Part III.C.

³³ See discussion *infra* Part III.D.

³⁴ See discussion *infra* Part III.E.

While “taxpayers and industry groups” might find it a nasty surprise to have Naked CDSs taxed as gambling,³⁵ in view of the cost to the U.S. Treasury of bailing out the financial system from a collapse caused at least in part by Naked CDSs,³⁶ it seems only appropriate that those transactions and the very large profits made thereon be taxed for what they are.³⁷

II. A NAKED CDS IS GAMBLING

The regulations proposed in 2011³⁸ arises from a classic flaw in logic. In 2010, Congress amended the Internal Revenue Code (the Code) to add CDSs to a list of transactions that are not so-called § 1256 contracts.³⁹ The IRS concluded that by this action Congress intended also to add CDSs to a similar list of what are NPCs.⁴⁰ If not

³⁵ The imposition of taxes coming as a nasty surprise to a large class of taxpayers who thought they were just doing what everybody else was doing is not at all unprecedented. For example, see I.R.S. Treas. Dir. 04-0407-036, IRM 4.51.5 (June 15, 2007), which discusses hundreds of U.S. corporations issuing thousands of what they claimed were “incentive stock options” with very favorable deferred tax treatment, before it was determined that the options had all been cleverly backdated to place them immediately in the money, and thus were immediately taxable. There were so many option holders who had not timely paid the tax on the options before that party ended that the IRS had to designate the matter an “LMSB Tier I issue” (Large and Mid-Size Business Division) and establish a formal program to administer the retroactive tax collections. *See id.*

³⁶ See Richard Simon & Nicole Gaouette, *Approval of Bailout Comes Amid Signs That a Steep Recession is Just Beginning*, L.A. TIMES, Oct. 4, 2008, available at <http://articles.latimes.com/2008/oct/04/business/fi-bailout4/2>.

³⁷ This is not to suggest that any wrongdoing is afoot. In fact, during the seven year absence of requested guidance from the IRS, whatever reporting position a taxpayer may have taken with respect to Naked CDS transactions may be perfectly reasonable, even if it is ultimately determined on audit not to be the correct one. *See* Treas. Reg. § 1.6664-4(b) (2003).

³⁸ Prop. Treas. Reg. § 1.446-3, 76 F.R. 57684 (Sept. 16, 2011).

³⁹ Dodd-Frank Wall Street Reform and Consumer Protection Act, sec. 1601(a), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at I.R.C. § 1256(b)(2)(B) (Supp. IV 2011)).

⁴⁰ *See* Prop. Treas. Reg. § 1.446-3, 76 F.R. at 57684–85 (“Congress incorporated into section 1256(b)(2)(B) a list of swaps that parallels the list of swaps included under the definition of a notional principal contract in § 1.446-3(c) with the addition of credit default swaps. The parallel language suggests that Congress

A, then *B*, is a propositional fallacy; it presumes that there is only one alternative to *A*, which is not the case.⁴¹ In fact, the term “notional principal contract” is entirely an invention not of Congress, but of the IRS in its regulations.⁴² The term does not appear in the § 1256 amendment or, for that matter, anywhere else in the Code. In the § 1256 amendment, Congress only said what a CDS is not, never what it is. As the Conference Report to the amendment stated, “The title contains a provision to address the *recharacterization* of income as a result of increased exchange-trading of derivatives by clarifying that section 1256 of the Internal Revenue Code does not apply to certain derivatives contracts transacted on exchanges.”⁴³

Section 1256 contracts are taxed at a hybrid 40% short-term, 60% long-term capital gains rate.⁴⁴ The intent of the § 1256 amendment was to deny this lower capital gains rate to CDSs.⁴⁵ Under the IRS regulations on NPCs, a premium payment is taxable as ordinary income to the protection seller, but a reciprocal payment made on the termination or assignment of an NPC, which is what normally happens when a default occurs under a CDS, is taxable to the protection buyer as capital gain.⁴⁶ If the premium was paid more than one year earlier, the reciprocal payment is taxed as long-term capital gain.⁴⁷ As the proposed regulations pertain to Naked CDSs, their effect would thus be the exact opposite of what Congress intended. Treating a Naked CDS as an NPC disregards the Congressionally recognized

was attempting to harmonize the category of swaps excluded under section 1256(b)(2)(B) with swaps that qualify as notional principal contracts under § 1.446-3(c) . . .”).

⁴¹ See THE CAMBRIDGE DICTIONARY OF PHILOSOPHY 316–17 (Robert Audi ed., 2d ed. 1999) (defining formal fallacy).

⁴² See Treas. Reg. § 1.446-3(c)(1)(i) (1994) (defining notional principal contracts).

⁴³ Prop. Treas. Reg. § 1.446-3, 76 F.R. at 57685 (quoting H.R. REP. NO. 111-517, at 879 (2010) (Conf. Rep.)) (emphasis added).

⁴⁴ See I.R.C. § 1256(a)(3) (2006).

⁴⁵ See Dodd-Frank Wall Street Reform and Consumer Protection Act, sec. 1601(a)(2)(B), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended at I.R.C. § 1256(b)(2)(B) (Supp. IV 2011)).

⁴⁶ See Lokken, *supra* note 6, at 28–29 (recommending against treating a CDS as a NPC because capital asset treatment on a sale or termination of a NPC lets the buyer take an ordinary deduction on CDSs that do not pay off and selectively realize capital gain on the ones that do).

⁴⁷ I.R.C. § 1222 (2006) (defining long-term capital gain).

characterization of Naked CDSs as gambling.⁴⁸ Moreover, this treatment affirmatively enables the “recharacterization” of the ordinary income from a winning Naked CDS bet into capital gain, something Congress expressly sought to prevent.⁴⁹

An NPC is “a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay *similar* amounts.”⁵⁰ A typical NPC would be something like an interest rate swap, where a party paying interest on a floating interest rate loan gets rate protection by finding a third party who will take monthly payments at a fixed rate in exchange for making monthly payments at the floating rate.

By contrast, with a Naked CDS, a party makes one or more small payments in exchange for a *huge* payment if a financial instrument he *does not own* goes into default.⁵¹ This is indistinguishable from gambling. It is no different from any other bet placed in exchange for a payback upon “a future contingent event not under [the bettor’s] control or influence.”⁵²

A fifty-to-one jackpot on a Naked CDS hardly involves the “similar amounts” contemplated by the NPC definition.⁵³ Moreover, the key term, which may be appropriate for a CDS hedging a legitimate financial risk, is “financial instrument.”⁵⁴ If that key term is ignored, and attention is given only to reciprocal payment obligations rather than the substance of the transaction, the rest of the NPC definition equally describes not only a Naked CDS, but also a lottery ticket or a World Series bet.⁵⁵ Would anyone, except perhaps an

⁴⁸ See 7 U.S.C. § 16(e)(2) (2006).

⁴⁹ See Lokken, *supra* note 6, at 19; Dodd-Frank Act sec. 1601(a).

⁵⁰ Treas. Reg. § 1.446-3(c)(1)(i) (1994) (emphasis added).

⁵¹ See Lokken, *supra* note 6, at 8.

⁵² N.Y. PENAL LAW § 225.00(2) (McKinney 2012).

⁵³ See Treas. Reg. § 1.446-3(c)(1)(i) (1994).

⁵⁴ See *id.*

⁵⁵ To qualify, the lottery ticket or World Series bet would technically have to be paid for in at least two installments. This is because the proposed regulations include a “new ‘two-payment rule’ for delineating between Section 1256 contracts, such as futures and foreign currency contracts, and notional principal contracts.” See Prop. Treas. Reg. § 1.446-3, 76 F.R. 57684, 57687 (Sept. 16, 2011); see also N.Y. BAR ASS’N, REPORT ON PROPOSED AND TEMPORARY

investment banker on the receiving end of a large payout, have the audacity to suggest that those latter items are also “financial instruments” deserving capital gain treatment rather than ordinary income treatment?⁵⁶ As the Supreme Court observed in a leading income tax case involving a professional gambler, “[a] test that everyone passes is not a test at all.”⁵⁷

What is it that singles out a Naked CDS from every other garden-variety bet for celebration as a “financial instrument”? That it is made on an institutional “trading desk,”⁵⁸ rather than in a back alley? That it is written on an International Swaps and Derivatives Association form,⁵⁹ rather than a bookie’s notepad? That it looks to the outcome of

REGULATIONS UNDER SECTION 871(M), 34–35 (Apr. 25, 2012) (discussing the “two-payment rule” in the context of tax treatment of accrual amounts).

⁵⁶ See generally Luc Sante, *Goldman: All Con, No Artist*, POLITICO (Apr. 26, 2010, 11:07 PM), <http://www.politico.com/news/stories/0410/36369.html> (suggesting that the creation and sale of “booby-trapped” wagers by boastful investment bankers constitutes a confidence game).

⁵⁷ *Comm’r v. Groetzinger*, 480 U.S. 23, 34 (1987).

⁵⁸ See Philip R. Cleary, *Predicting the Taxation of Prediction Markets*, 27 VA. TAX REV. 953, 956–57 (2008) (noting that transactions, including bets on presidential elections, that “might strike many tax professionals as gambling” can now be effected through so-called “prediction markets”). Attorney Cleary argues that something new and exciting that everyone is doing by a different name shouldn’t be gambling, even if that’s what an old-fashioned Code section expressly calls it, saying “[i]t is hard to imagine classifying prediction derivatives as gambling for income tax purposes merely because gambling for purposes of an excise tax written in 1954 includes wagering pools based on election outcomes.” *Id.* at 980. He concedes, however, that the IRS has stated that it sees “no reason why the income tax meaning of a wager should differ from the explanation put forth in the Regulations under the excise tax,” and that “if some or all prediction markets are a form of gambling, then there are relatively severe tax consequences.” *Id.* at 978, 980. See also Stephen Zorn, *Federal Tax Treatment of Gambling: Fairness or Obsolete Moralism?*, 49 TAX LAW. 1, 1–2 (1995) (arguing that gambling has become so widespread and accepted that it should no longer be taxed disadvantageously).

⁵⁹ See *An Introduction to the Documentation of OTC Derivatives*, ALLEN & OVERY, at 3–4 (May 2002), http://www.isda.org/educat/pdf/documentation_of_derivatives.pdf. The International Swaps and Derivatives Association (“ISDA”) defines “credit derivative” as “a privately negotiated agreement that explicitly shifts credit risk from one party to the other.” ISDA, *supra* note 6. The ISDA defines “credit default swap” as “a credit derivative contract in which one party (*protection buyer*) pays an [sic] periodic fee to another party (*protection seller*) in return for compensation for default (or similar *credit event*) by a *reference entity*.” *Id.* In the case of a Naked CDS, there is, by definition, no risk

a random event involving a corporate security rather than perhaps a roll of the dice or the pull of a slot machine handle?⁶⁰

The Wall Street figures who achieved great success buying Naked CDSs no doubt studied hard and worked with great ingenuity to improve their odds.⁶¹ But so do the people pouring over the *Daily Racing Form* looking for long shots at the track. A recent article in *Harper's Magazine* discusses the remarkable "luck" of a Texas scratch-ticket lottery player who won three jackpots of more than a million dollars each during the last decade.⁶² The odds of doing this by random selection are astronomical. The article speculates that the winner, a sixty-three-year-old, Stanford University-educated math professor, who specialized in statistics, might have discovered an angle.⁶³ But nobody would argue that her lottery winnings were perhaps instead a tax-exempt stipend for academic research.⁶⁴ The fact that a particular player can improve her gambling odds through personal effort and skill does not alter the fact that she is gambling.⁶⁵

An IRS spokesperson with responsibility for the proposed regulations stated to this author that while all derivatives could be looked at as gambling to some degree, the IRS would not tax them as such without express congressional action.⁶⁶ However, this view misses the point that Congress has acted. By preempting the application of state gaming laws on certain derivatives, Congress

to shift from the buyer, so a Naked CDS does not fall within the ISDA definition of credit derivative.

⁶⁰ See Treas. Reg. § 44.4421-1(b)(1) (2008) (including within the definition of "lottery" numbers games in which the winning numbers are published in "United States Treasury balance reports, or the reports of a stock or commodity exchange").

⁶¹ See Weiss, *supra* note 3 (discussing how one hedge fund carefully selected those reference obligations which were most likely to default); see also LEWIS, *supra* note 11, at 202 (describing a credit default swap devised by Morgan Stanley trader Mike Edman that, through the use of "some fine print," provided the buyer with the equivalent of "flood insurance that, if a drop of water so much as grazed any part of the house, paid them the value of the entire house").

⁶² Nathaniel Rich, *The Luckiest Woman on Earth: Three Ways to Win the Lottery*, HARPER'S MAG., Aug. 2011, at 58, 62–63.

⁶³ *Id.* at 58.

⁶⁴ See I.R.S. Pub. 970, at 6 (2011).

⁶⁵ See *Baxter v. United States*, 633 F. Supp. 912, 917 (D. Nev. 1986) (recognizing a distinction between active and passive gambling in relation to the tax code).

⁶⁶ Telephone interview with K. Scott Brown, I.R.S. Spokesperson (Jan. 30, 2012).

recognized that at least *some* derivatives are gambling, not financial instruments.⁶⁷ Despite this recognition, Congress did not act to recharacterize income from any derivatives, let alone income from whichever ones Congress was protecting from state gambling laws.

A “short seller” of stock may not own the stock on the date of the short sale, but the short seller typically has borrowed it.⁶⁸ And because short sales only account for a tiny fraction of the overall market,⁶⁹ they can be covered, or physically delivered upon,⁷⁰ if necessary, even by a naked short seller. Certain other kinds of swaps, such as those on interest rates or equity indexes, may also be “naked” in some respects, but they are surrogates for securities that could be bought in the market.⁷¹ By contrast, there is typically an insufficient supply of reference obligations to enable most Naked CDS buyers to cover,⁷² and often the terms of a Naked CDS do not contemplate or even permit physical delivery.⁷³

⁶⁷ See *supra* notes 25–27 and accompanying text.

⁶⁸ See *Short Selling Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/s/shortselling.asp> (last visited Dec. 20, 2012) (“The selling of a security that the seller does not own, or any sale that is completed by the delivery of a security borrowed by the seller.”).

⁶⁹ See, e.g., Press Release, New York Stock Exchange Euronext, NYSE Group Inc. Issues Short Interest Report (July 12, 2011) (<http://www.nyse.com/press/1310464193322.html>) (stating that in the year ending June 30, 2011, monthly short interest on the New York Stock Exchange averaged less than 4% of total shares outstanding).

⁷⁰ See *Physical Delivery Definition*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/physicaldelivery.asp> (last visited Dec. 20, 2012) (“Term in an options or futures contract which requires the actual underlying asset to be delivered upon the specified delivery date, rather than being traded out with offsetting contracts.”).

⁷¹ See Kevin Dolan & Carolyn DuPuy, *Equity Derivatives: Principles and Practice*, 15 VA. TAX REV. 161, 164 (1995) (describing equity derivatives).

⁷² See Lewis, *supra* note 11, at 28–29 (“The bonds were impossible to sell short. To sell a stock or bond short, you needed to borrow it, and these tranches of mortgage bonds were tiny and impossible to find. You could buy them or not buy them, but you couldn’t bet explicitly against them . . .”).

⁷³ See Lokken, *supra* note 6, at 4, 5 n.17 (suggesting that multiple Naked CDSs on a single reference obligation could in theory physically settle one by one, with the same reference obligation transferred repeatedly through successive transactions, but conceding this would likely result in market chaos even if physical settlement was allowed in the contract).

And, most importantly, by far, from the buyer's standpoint, a Naked CDS is uniquely *not* a surrogate for any actual security.⁷⁴ The buyer of a Naked CDS has no relationship with the reference entity, no interest in the reference obligation, no control over the default event, and no risk to guard against.⁷⁵ The buyer of a Naked CDS is not investing for market appreciation of an asset over time, the *sine qua non* of a capital asset.⁷⁶ The "buyer" is not actually buying anything at all; the buyer is not even trying to mimic the market appreciation of an asset that could be bought. Rather, the Naked CDS buyer is betting that a future event not under his control will come along and destroy the value of *someone else's* capital asset. The reference obligation is the *last* thing the Naked CDS buyer would want to invest in.⁷⁷

It may very well be that "covered" CDSs, where the buyer is actually at risk on an underlying bond or other financial instrument, are themselves properly characterized as some kind of financial instrument for tax purposes, but there is simply nothing "financial" about a Naked CDS.⁷⁸ To the holder of a Naked CDS, the reference obligation has no economic significance and is a complete abstraction.⁷⁹

If a Naked CDS is not *the* derivative that required preemption from state gambling laws, it is hard to imagine the transaction more

⁷⁴ See Lokken, *supra* note 6 at 8; Johnson, *supra* note 24, at 197 ("[I]nnovators created a credit default swap agreement that did not require the protection buyer to own the reference asset mentioned in the credit default swap agreement. Market participants describe these agreements as 'uncovered' . . . or naked credit default swaps").

⁷⁵ See, e.g., Gregory Zuckerman, *A Daring Trade Has Wall Street Seething*, WALL ST. J., June 11, 2009, at C1, available at <http://online.wsj.com/article/SB124468148614104619.html> (discussing bets of \$130 million made by J.P. Morgan, Royal Bank of Scotland Securities, Bank of America, and others on the performance of around \$27 million in securities issued by Lehman Brothers in 2005 where the Texas protection seller who took the bets cleverly bought up all the particular bonds in question, ensuring that no default would occur).

⁷⁶ See *infra* Part III.B.

⁷⁷ See Sunshine, *supra* note 24.

⁷⁸ The IRS has suggested that Naked CDSs serve a useful function, providing "liquidity" in the marketplace. Brown, *supra* note 66. Whether true, however, it is irrelevant to how Congress intends them to be taxed.

⁷⁹ See, e.g., LEWIS, *supra* note 11, at 77 ("The original home mortgage loans on whose fate both sides were betting played no role. In a funny way, they existed only so that their fate might be gambled upon.").

distanced from legitimate financial activity that Congress had in mind when it enacted the preemption.⁸⁰

III. A NAKED CDS IS TAXABLE JUST LIKE ANY OTHER GAMBLING

While the Commodity Futures Modernization Act of 2000 “legalized” Naked CDSs under state gaming laws,⁸¹ it did nothing to suggest that Naked CDSs should be treated differently *for tax purposes* than any other form of gambling under either federal or state law.⁸² Taxing Naked CDSs as gambling has a number of significant tax implications.

A. Federal Excise Tax on Wagers

Wagers accepted in states where wagers are not authorized by state law, such as New York, are subject to a 2% federal excise tax.⁸³ In states where wagers are legal, a 0.25% federal excise tax applies.⁸⁴ “A person is engaged in the business of accepting wagers if he makes it a practice to accept wagers with respect to which he assumes the risk of profit or loss depending on the outcome of the event or the contest with respect to which the wager is accepted.”⁸⁵ It is not necessary that “a person must be either so engaged to the exclusion of all other activities or even primarily so engaged.”⁸⁶

⁸⁰ *Cf.*, *Jacobellis v. Ohio*, 378 U.S. 184, 197 (1964) (Stewart, J. concurring) (“I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description But I know it when I see it”).

⁸¹ 7 U.S.C. § 16(e)(2) (2000), *amended by* Commodity Futures Modernization Act of 2000, sec. 117, Pub. L. No. 106-554, 114 Stat. 2763.

⁸² In determining that the I.R.C. § 4401 wagering excise tax applies to wagering that itself had been authorized by federal law on an Indian reservation, the Supreme Court specifically cited the interpretive canon “that warns us against interpreting federal statutes as providing tax exemptions unless those exemptions are clearly expressed.” *Chickasaw Nation v. United States*, 534 U.S. 84, 95 (2001).

⁸³ I.R.C. § 4401(a)(2) (2006). New York law prohibits wagers, so wagers there are subject to the 2% federal excise tax. *See* N.Y. PENAL LAW § 225.00 (McKinney 2011).

⁸⁴ I.R.C. § 4401(a)(1) (2006).

⁸⁵ Treas. Reg. § 44.4401-2 (b) (2008).

⁸⁶ *Id.*

“The amount of the wager is the amount risked by the bettor . . . [not] the amount which he stands to win.”⁸⁷ In the case of a Naked CDS, the wager would thus be the premium, the periodic payments paid for the Naked CDS by the protection buyer to the protection seller, not the entire notional amount.⁸⁸

The excise tax must be paid even if the person initially accepting wagers “lays off all or part of the wagers placed with him with another person.”⁸⁹ Thus, the tax would be paid even when the person accepting the wager hedges the Naked CDS sold with a Naked CDS purchased from a different protection seller. However, the person initially accepting a wager may apply for a refund if the lay-off is to another person subject to the excise tax who certifies that he will pay the tax.⁹⁰

Notably, the wagering excise tax is a joint and several obligation of both the entity accepting the wager and the individual accepting the wager on behalf of the entity, for example, an individual employee on a trading desk, unless that individual has previously personally registered with the IRS as a wager taker.⁹¹

Consider this proposed tax treatment in the context of a real example. According to The Securities and Exchange Commission 2010 securities fraud complaint (the “SEC Complaint”) against Goldman, Sachs & Co. (“Goldman”) and Fabrice Tourre, a Goldman Vice President in charge of its “structured product correlation trading desk,” the Goldman office in New York sold a Naked CDS to hedge fund Paulson & Co. (“Paulson”).⁹² If the Naked CDS is considered a wager, then Paulson’s premium payments to Goldman would be subject to a 2% excise tax.⁹³ Payment of that excise tax would be a joint and several liability of Goldman and any individual Goldman employee who accepted the wager on behalf of Goldman unless the individual was himself personally registered as a wager taker.⁹⁴

⁸⁷ Treas. Reg. § 44.4401-1 (b)(2)(i) (2008).

⁸⁸ See Lokken, *supra* note 6 at 3.

⁸⁹ Treas. Reg. § 44.4401-2(c) (2008).

⁹⁰ *Id.* at § 44.6419-2(b)

⁹¹ I.R.C. § 4401(c) (2006).

⁹² Complaint at 2, SEC v. Goldman Sachs & Co., 790 F. Supp.2d 147 (S.D.N.Y. 2011) (No. 1:10CV03229) [hereinafter Complaint].

⁹³ See I.R.C. § 4401(a)(2) (2006).

⁹⁴ *Id.* § 4401(c) (2006).

Following along with the analysis, Goldman would be said to have laid off the bet it made with Paulson by buying matching Naked CDSs from ACA Capital Holdings, Inc. and ABN AMRO Bank N.V. for a total of sixty-seven basis points (0.67%) per year.⁹⁵ The SEC Complaint doesn't state what Goldman charged Paulson for the Naked CDSs it sold, but if Goldman were, for example, collecting 250 basis points (2.50%) from Paulson on the notional amount of Naked CDSs it sold,⁹⁶ and paying only sixty-seven basis points (0.67%) on an equivalent notional amount of Naked CDSs it bought, it would thereby have laid off the entire bet, while netting almost three quarters, 183 basis points (1.83%), of the amount wagered for itself.

If the notional amount of the Naked CDSs sold to Paulson were \$1 billion, as suggested by what Paulson eventually collected on its bet,⁹⁷ the amount of the wager at 2.5% would have been \$25 million per year, and a 2% excise tax on that would be \$500,000 per year.

While the entire \$500,000 excise tax would have to be paid each year by Goldman (or by an unregistered individual wager taker who accepted the Naked CDS on Goldman's behalf), Goldman (or such individual) would be entitled to apply for a refund to the extent that the entities to which Goldman laid off the bet certified they would pay it; that is, the net liability could be less if ACA and ABN AMRO took responsibility for the excise tax on the portions laid off.⁹⁸ However, wagers are only subject to the excise tax if they have sufficient U.S. ties.⁹⁹ So, if the lay-off to ABN AMRO, a large foreign bank, were accepted off-shore, it would not appear to be subject to the excise tax and able to give rise to a refund to Goldman.¹⁰⁰

Extrapolating the proposed tax treatment from this single \$1 billion CDS transaction to a perhaps \$60 trillion total CDS market, of which perhaps 80%,¹⁰¹ \$48 trillion, is "naked," an average premium of 2.5%

⁹⁵ See Complaint, *supra* note 92, at 2.

⁹⁶ See, e.g., LEWIS, *supra* note 11, at 75–76 (providing an example of one Naked CDS sold by Goldman at a 2.5% premium, although this may not be representative).

⁹⁷ See *id.* at 237–38.

⁹⁸ See Treas. Reg. § 44.4401–2 (2008); Treas. Reg. § 44.6419-2(b) (2008).

⁹⁹ Treas. Reg. § 44.4404-1(a) (2008).

¹⁰⁰ See *id.*

¹⁰¹ See Andrew Leonard, *Credit Default Swaps: What Are They Good For?*, SALON.COM, (Apr. 20, 2010, 4:21 PM), http://www.salon.com/2010/04/20/naked_credit_default_swaps.

of the notional amount would represent a possible total of \$1.2 trillion of wagers that could be subject to a 2% excise tax. That would generate a possible \$24 billion per year in tax revenue. However, the actual number is difficult to estimate because an indeterminate but probably large portion of that \$60 trillion total market may represent bets laid off multiple times, premiums vary depending on the perceived risk of default, and some portion of the market is offshore.¹⁰² But the number would nevertheless represent a large amount of tax revenue.¹⁰³

B. Ordinary Income, Not Capital Gain

Gambling income is taxed as ordinary income.¹⁰⁴ A wager is not a capital asset for tax purposes.¹⁰⁵ This is so despite the broad “property held” language of the Code’s definition of capital asset and the absence of any express exclusion from that definition for wagers.¹⁰⁶ In rejecting a taxpayer’s argument that the sale of a winning lottery ticket held by the taxpayer qualifies for capital gain treatment, the Ninth Circuit stated that *Maginnis*, the taxpayer:

(1) did not make any underlying investment of capital in return for the receipt of his lottery right, and (2) the sale of his right did not reflect an accretion in value over cost to *any underlying asset Maginnis held*.

....

Maginnis does not—and cannot—argue that the purchase of a lottery ticket is a “capital investment,” the return from which should be treated as a capital gain. . . . The lottery prize would have been taxed at ordinary income rates, reflecting the Revenue Code’s general position that gambling winnings are not treated as

¹⁰² Gerald P. Dwyer & Thomas Flavin, *Credit Default Swaps on Government Debt: Mindless Speculation?*, CENT. FOR FIN. INNOVATION & STABILITY (Sept. 2010), available at http://www.frbatlanta.org/documents/cenfis/pubscf/nftv_0910.pdf (showing that CDSs premiums on debt issued by Greece skyrocketed as it faced default beginning as early as 2010).

¹⁰³ See I.R.C. § 4401(c) (2006).

¹⁰⁴ See, e.g., *United States v. Maginnis*, 356 F.3d 1179, 1183 (9th Cir. 2004); *Watkins v. Comm’r*, 447 F.3d 1269, 1273 (10th Cir. 2006). *But see* *Robida v. Comm’r*, 460 F.2d 1172, 1174 (9th Cir. 1972) (“Gambling receipts have been considered . . . more clearly akin to return on capital . . . than earned compensation for services performed.”).

¹⁰⁵ See *Maginnis*, 356 F.3d at 1184; *Watkins*, 447 F.3d at 1273.

¹⁰⁶ See *Maginnis*, 356 F.3d at 1182; *Watkins*, 447 F.3d at 1271-72.

capital gains. Therefore, the purchase of a lottery ticket is no more an underlying investment of capital than is a dollar bet on the spin of a roulette wheel.¹⁰⁷

A Naked CDS fits squarely into the Ninth Circuit's description of what is not a capital asset. There is no underlying investment of capital, no underlying asset held, just "a dollar bet on the spin of a roulette wheel."¹⁰⁸ Congress, by the § 1256 amendment, expressly denied CDSs even a hybrid 40%-short-term, 60%-long-term capital gains tax rate.¹⁰⁹ Accordingly, and whether a Naked CDS wager "pays off" by settlement or termination payment from the protection seller or by a sale of the Naked CDSs to a third party, it must give rise to ordinary income, not capital gain.¹¹⁰

Much has been made in the perennial debate over income tax reform of the need to change the law providing special tax treatment for so-called carried interests of hedge fund managers, under which a significant part of their compensation can come to them as a share of the long-term capital gains of the hedge fund, taxable at low long-term capital gains rates rather than much higher ordinary income rates, even though it is paid in exchange for their services.¹¹¹ By contrast with a

¹⁰⁷ *Maginnis*, 356 F.3d at 1183–84 (emphasis added). The *Maginnis* court based its holding largely on an earlier Supreme Court case that said that capital asset treatment would not be available "when there is no evidence of a sale of an underlying capital investment," and the transaction is "manifestly not of the type which gives rise to the hardship of the realization in one year of an advance in *value over cost* built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions." *Id.* at 1183 (quoting *Comm'r v. Gillette Motor Transport, Inc.*, 364 U.S. 130, 135 (1960)); accord *Watkins*, 447 F.3d at 1272 (quoting *Comm'r v. P.G. Lake, Inc.*, 356 U.S. 260, 265 (1958) ("capital gains treatment of the lump sum is inappropriate. This is so because the 'consideration was paid for the right to receive future income, not for an increase in the value of income-producing property'")).

¹⁰⁸ *Maginnis*, 356 F.3d at 1184.

¹⁰⁹ I.R.C. § 1256(a)–(b) (2006 & Supp. IV 2011).

¹¹⁰ See *Maginnis*, 356 F.3d at 1183.

¹¹¹ See Laura Saunders, 'Carried Interest' in the Crosshairs, WALL ST. J., Aug. 6, 2011, <http://online.wsj.com/article/SB10001424053111903885604576486541761322496.html>. A carried interest is a share of the profits of a partnership allocated to a partner that is disproportionately large relative to the partner's contribution of capital to the partnership, typically in consideration of services provided by the partner. *Id.* The taxation of hedge fund managers' carried interests has long been a contentious issue in tax reform discussions because, to the extent the profits so allocated consist of long-term capital gains, the partner,

fund manager's share of true capital gains made by a hedge fund, however, a hedge fund manager's carried interest allocation of gambling income must always be ordinary income, under *existing* law.¹¹²

John Paulson, the named principal of the hedge fund involved in the Naked CDS transaction with Goldman that is the subject of the SEC Complaint, reportedly earned \$3.7 billion in 2007 by predicting the downfall of Wachovia, Washington Mutual, Lehman Brothers, and certain other institutions:

Since all that toxic waste on the balance sheet imperiled the survival of the banks, Paulson wanted to be sure he was prepared. So he bought credit default swaps, like the \$22 million he bet against Lehman—essentially an insurance policy that paid off when Lehman's bonds defaulted. Even though Paulson didn't actually own any Lehman bonds, he made more than \$1 billion on that bet. It's as though he'd bought insurance policies on houses he didn't own along the Indian Ocean just moments before the tsunami hit.¹¹³

Mr. Paulson's tax return is not in the public record, of course,¹¹⁴ so there is no way to know how he characterized income from Naked CDSs. But on a pay out of \$3.7 billion, the difference between a 15% long-term capital gain tax and a 35% top bracket ordinary income tax is \$740 million for that single year.¹¹⁵ And Mr. Paulson is not alone in

who could be earning millions or even billions of dollars a year, gets a paycheck exempt from payroll taxes and subject to only a 15% federal income tax rate. See Jenny Anderson, *Scrutiny on Tax Rates That Fund Managers Pay*, N.Y. TIMES, June 13, 2007, at C3, available at <http://www.nytimes.com/2007/06/13/business/13tax.html>.

¹¹² See I.R.C. § 165 (2006); *Maginnis*, 356 F.3d at 1183.

¹¹³ Weiss, *supra* note 3. The SEC Complaint notes that Paulson was actively involved in selecting the particularly vulnerable reference obligation portfolio as to which it bought the Naked CDSs from Goldman. See Complaint, *supra* note 92, at 2–3, 25. In the aftermath of the financial crisis, one expert on structured finance observed, “[W]hen you buy protection against an event you have a hand in causing, you are buying fire insurance on someone else's house and then committing arson.” Gretchen Morgenson & Louise Story, *Banks Bundled Mortgage Related Debt, Bet Against It and Won*, N.Y. TIMES, Dec. 24, 2009, at B4.

¹¹⁴ I.R.C. § 6103(a) (2006).

¹¹⁵ See I.R.S. Pub. 17 at 104, 115, 274 (2011).

having made large profits on Naked CDSs.¹¹⁶ *The Big Short* recounts the stories of several different hedge funds and their managers that made tens to hundreds of millions of dollars on Naked CDSs,¹¹⁷ and great success by other hedge fund managers has also been reported.¹¹⁸

The same potential 20% federal income tax rate differential would apply to Naked CDS income allocated by a hedge fund not only to its general partner-managers, but also to its limited partner-investors. In other words, the remaining typically 80% of the fund's income not allocated as carried interest to the general partner would be reportable as ordinary income, not capital gain, by its limited partners.¹¹⁹

C. Medicare Taxes

Income earned through a trade or business, either directly or by allocation from a partnership, is generally considered net earnings from self-employment¹²⁰ and subject to federal self-employment taxes.¹²¹

Capital gains are excluded from the definition of net earnings from self-employment.¹²² Further, “[t]he character of any item of income . . . included in a partner’s distributive share . . . shall be determined as if such item were realized directly from the source from which realized by the partnership”¹²³ As a result, even though

¹¹⁶ See LEWIS, *supra* note 11, at 105–06 (Whitebox, The Baupost Group, Passport Capital, Elm Ridge, Elliot Associates, Cedar Hill Capital Partners, QVT Financial, Hayman Capital, and Pennant Capital are among those listed by the author as having profited by betting against subprime mortgages).

¹¹⁷ *Id.*

¹¹⁸ See, e.g., Chris Serres, *From Iron Range hockey hero to Wall Street star*, MINNEAPOLIS STAR TRIBUNE, July 6, 2008, available at <http://www.startribune.com/business/22949299.html> (reporting that Philip Falcone of Harbinger Capital Partners, who bet against the housing market in 2006, bought hundreds of millions of dollars of CDSs that yielded \$1.5 billion by the year’s end).

¹¹⁹ See *supra* note 111.

¹²⁰ I.R.C. § 1402(a) (2006) (stating that a taxpayer’s net earnings from self-employment include “gross income derived by an individual from any trade or business . . . plus his distributive share . . . of income or loss . . . from any trade or business carried on by a partnership of which he is a member . . .”).

¹²¹ *Id.* § 1401 (2006) (net earnings from self-employment are subject to self-employment taxes).

¹²² *Id.* § 1402(a)(3) (2006).

¹²³ *Id.* § 702(b) (2006).

managing an investment fund is a trade or business for tax purposes,¹²⁴ much of an investment fund manager's income typically comes as an allocation of capital gains of the fund, which retains that character in the hands of the manager and does not typically bear self-employment taxes.¹²⁵

Gambling income, however, is not excluded from the definition of net earnings from self-employment.¹²⁶ Accordingly, by contrast with an allocation of partnership capital gains, an allocation of Naked CDS winnings by a partnership to its general partner-manager would be subject to self-employment taxes.¹²⁷

Although the self-employment 12.4% Social Security tax only applies to the first approximately \$100,000 of income, there is no limit to the applicability of the 2.9% Medicare tax.¹²⁸ Thus, for example, if all of hedge fund manager John Paulson's \$3.7 billion of income in 2007 were attributable to Naked CDS winnings taxed as gambling income, a Medicare tax on that amount would be more than \$100 million.

D. Limitations on Use of Losses

Gambling losses are deductible for federal tax purposes, but only to the extent of gambling income.¹²⁹ Since a deduction in excess of gambling losses is not allowed, gambling losses also do not give rise to a net operating loss that can be carried back or forward.¹³⁰

Limiting the use of losses on Naked CDSs to same tax year profits on Naked CDSs could have significant implications for sellers who made large profits in the years leading up to the 2008 financial crisis and then incurred large losses in that single year.¹³¹ For example,

¹²⁴ See *Dagres v. Comm'r*, 136 T.C. 263, 283–85 (2011).

¹²⁵ See I.R.C. § 1402(a)(3) (2006); see also Anderson, *supra* note 111.

¹²⁶ I.R.C. § 1402(a)(2)–(5) (2006).

¹²⁷ Limited partner-investors are not, by contrast, engaged in a trade or business, so income allocated to them would not be subject to self-employment taxes, regardless of character. See I.R.C. § 1402(a)(13) (2006).

¹²⁸ I.R.S. Pub. 334, at 9 (2010).

¹²⁹ See I.R.C. §§ 162(a) (2006); *id.* § 165(d) (2006); see also *Boyd v. United States*, 762 F.2d 1369, 1372–73 (9th Cir. 1985) (“[A] gambling loss, although it may be a business expense, is deductible only to the extent of gambling gains.”).

¹³⁰ See I.R.C. § 172(c) (2006) (defining “net operating loss” as “the excess of the deductions allowed by this chapter over the gross income”).

¹³¹ See Lokken, *supra* note 6 at 14.

Ambac Financial Group, Inc., the holding company for a now bankrupt CDS seller, recovered a reported \$700 million of tax refunds for the years 2003–2008 by carrying back more than \$3 billion of losses arising from its subsidiary's CDS business in subsequent years.¹³² To the extent the later year losses were attributable to Naked CDSs, that carryback is improper and the refund by the U.S. Treasury should not have been paid.¹³³ Given the size of the Naked CDS market and the massive losses resulting from the financial crisis, it is likely that Ambac is not an isolated case,¹³⁴ and there is a good chance that a much larger amount of Naked CDS losses has been improperly carried back to shelter prior year income from the up to 35% federal income tax rate that should have applied.

These limitations also have post-financial crisis relevance. For example, JP Morgan/Chase announced a disastrous loss, \$2 billion and counting, on CDSs in 2012.¹³⁵ To the extent these losses are attributable to Naked CDSs, they similarly should not be used to offset JP Morgan/Chase's regular banking income in 2012 or carried back or forward to other years.

E. State Income Taxes and Federal Withholding Taxes

A detailed discussion is beyond the scope of this article, but it bears noting that gambling income characterization of Naked CDS profits also has state and cross-border tax implications.

¹³² See Tiffany Kary, *Ambac Sues U.S., Seeks Shield for \$700 Million Refund*, (Nov. 9, 2010), <http://www.bloomberg.com/news/2010-11-09/ambac-sues-u-s-seeks-shield-for-700-million-refund-update1-.html>; see also Tiffany Kary, *Ambac Financial Files Third Amended Plan of Reorganization*, (Feb. 27, 2012) <http://www.bloomberg.com/news/2011-09-22/ambac-files-amended-reorganization-plan-after-reaching-wisconsin-agreement.html>.

¹³³ See I.R.C. § 172(c) (2006); see also I.R.S. Pub. 550, at 41 (2011) (discussing loss carryback election for NPCs).

¹³⁴ See Erika W. Nijenhuis, *New Tax Issues Arising From the Dodd Frank Act and Related Changes to Market Practices for Derivatives*, 2 COLUM. J. TAX L. 1, 90–91 (2011) (“When Ambac decided to[apply for carryback adjustments] . . . it did so on the basis of an opinion from one of the ‘Big Four’ accounting firms, KPMG.”).

¹³⁵ See Mary Childs & Shannon D. Harrington, *JPMorgan Losses Spark Frenzy In Swaps Indexes: Credit Markets*, Bloomberg.com (May 14, 2012, 9:09 AM), <http://www.bloomberg.com/news/2012-05-14/jpmorgan-losses-spark-frenzy-in-swaps-indexes-credit-markets.html>.

Capital gains on intangibles such as investment securities are generally taxable in the jurisdiction of the taxpayer's residence, without regard to where the gain may have been generated; for example, buying and selling stock through a broker in California does not create California taxable income for a non-resident.¹³⁶ The aggregate capital gains of a partnership located in one state are allocated to individual partners who may reside in other states and may only be taxed on the gains there,¹³⁷ and U.S.-derived capital gains of non-resident foreigners are generally not subject to U.S. taxes.¹³⁸

By contrast, the locus of gambling taxation is where the bet is accepted.¹³⁹ Some states tax non-residents on in-state gambling income,¹⁴⁰ some states do not.¹⁴¹ And some states, like New York, where a significant amount of the CDS market was centered, tax non-resident gambling income only if it is sufficient to rise to the level of a trade or business.¹⁴² Thus, depending on the circumstances, some or all of the partners could be liable for state income tax on their distributive shares of a partnership's Naked CDSs income in the state where the partnership's Naked CDSs are accepted, without regard to where any of the individual partners live. And, while for federal purposes gambling winnings can be netted against gambling losses in the same tax year, some states tax gross gambling winnings and limit or deny entirely any gambling loss offset.¹⁴³

¹³⁶ State of Cal. Franchise Tax Board, FTB Pub. 1100, at 5 (2012), *available at* <https://www.ftb.ca.gov/forms/misc/1100.pdf>.

¹³⁷ David M. Halbfinger, *Fund Managers' Profits Are Ripe for a New Tax*, N.Y. TIMES, June 29, 2010, at A28, http://www.nytimes.com/2010/06/30/nyregion/30hedge.html?_r=0 (discussing a New York proposal to tax the profits of nonresident hedge fund managers).

¹³⁸ I.R.C. § 871(a)(1), (b) (2006) (imposing a 30% tax on a litany of U.S. source income categories earned by non-resident aliens, but only on capital gains to the extent that the taxpayer is present in the United States for 183 or more days).

¹³⁹ *See id.* § 4401(a) (2006); *see also id.* § 4404(a)(1) (2006); Treas. Reg. § 44.4421-1 (2008).

¹⁴⁰ *See, e.g.*, Minn. Stat. § 270.17(2)(d) (West 2012) ("Income from winnings on a bet made by an individual while in Minnesota is assigned to this state").

¹⁴¹ *See, e.g.*, Conn. Dep't of Rev. Serv., IP 2011(27), at 2, *available at* <http://www.ct.gov/drs/cwp/view.asp?A=1510&Q=493764>.

¹⁴² N.Y. State Dep't of Taxation & Fin., Pub. 88, at 12, 15 (2010), *available at* <http://www.tax.ny.gov/pdf/publications/income/2010/pub88.pdf>.

¹⁴³ *See* I.R.C. § 63(d) (2006); *id.* § 165(d) (2006); Mass. Dep't. of Revenue, Directive 03-3, Factors For Determining When Gambling is a Trade or Business

Similarly, the Naked CDS winnings of a non-resident foreigner on Naked CDSs accepted in the United States could be subject either to income tax on a U.S. trade or business¹⁴⁴ or to backup withholding,¹⁴⁵ and the foreign taxpayer's right to offset losses against winnings could depend upon the presence and precise terms of a tax treaty between the United States and the foreign taxpayer's jurisdiction of residence.¹⁴⁶

IV. CONCLUSION

Insofar as Naked CDSs are concerned, the Proposed Regulations are inconsistent with existing tax law, and would erroneously reduce applicable tax rates on a massive volume of gambling transactions. A Naked CDS is not, and should not be taxed as an NPC.

It should not come as a surprise to "taxpayers and industry groups" that Naked CDSs are taxable as gambling. Congress may in 2000 have made Naked CDSs *legal* gambling, but Congress never said Naked CDSs were also *tax-advantaged* gambling. The U.S. government has been driven deeply into debt as a result of a financial crisis precipitated at least in part by Naked CDSs. It can hardly afford not to aggressively

(2003), n. 1 ("For federal tax purposes, gambling losses may be deducted from adjusted gross income to the extent of gambling winnings, if the taxpayer itemizes his or her deductions. Massachusetts does not adopt this federal deduction."); *Busch v. Comm'r of Revenue* 713 N.W.2d 337, 345 n.7 (Minn. 2006) ("Minnesota incorporates the federal AMT calculation method, but changes it somewhat The effect of this approach is to use the federal AMT laws for calculating the gross income subject to the Minnesota AMT, but to apply Minnesota's own curtailed list of itemized deductions . . . [which excluding gambling losses].").

¹⁴⁴ See I.R.S. Notice 2004-52, 2004-2 C.B. 168, 169. The IRS Notice states that "insuring risks [from the CDS seller side, if a CDS were deemed to be insurance] from within the United States could constitute engaging in a trade or business within the United States," but does not mention the possibility that *buying* Naked CDSs within the United States could also constitute engaging in a trade or business, including gambling, within the United States. *Id.* "Nonresident aliens are taxed at graduated rates on net gambling income won in the U.S. that is effectively connected with a U.S. trade or business." I.R.S. Pub. 515, at 27 (2011).

¹⁴⁵ I.R.C. § 871(a)(1) (2006) (imposing a 30% withholding tax on any "amount [of income] received from sources within the United States by a nonresident alien individual . . . not effectively connected with the conduct of a trade or business within the United States").

¹⁴⁶ See *Park v. Comm'r*, 136 T.C. 569, 575 (2011).

pursue tax collections from those who profited so handsomely while the game was on.