Taxation of Financial Instruments and Transactions

Georgetown University Law Center

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COURSE DESCRIPTION

The course will explore selected federal income tax issues relating to financial instruments and transactions. Major topics will include the legal and economic characteristics of equity, indebtedness, derivatives, and the fundamentals of the original issue discount (“OID”) rules, market discount and bond premium, variable rate and contingent payment debt instruments. The course also will address the tax rules applicable to derivatives, hedging transactions, and various anti-abuse rules that were enacted to address straddles, wash sales, constructive sales, and constructive ownership transactions.

COURSE OBJECTIVES

The course has two objectives. First, it seeks to help students understand the legal framework for the federal income tax rules that apply to the issuance and ownership debt, equity, and derivatives. Second, it seeks to help students in the practical applications of these rules.

CLASS FORMAT AND ATTENDANCE

Class sessions will consist primarily of lectures, but group discussions also will be encouraged. There will be seven classes, with the first class on Thursday, May 26 from 6pm - 9:20pm, and the remaining classes on Mondays from 6pm – 9:20pm (June
6, 13, 20, 20, and July 11, 18). Dates are subject to change depending on weather and other scheduling conflicts.

**GRADING AND REQUIREMENTS**

**Grade:** The course will have a final exam. Student grades will be based on a combination of classroom participation and the final exam, with a heavy emphasis on the final exam.

**READING MATERIAL**

Reading is highly encouraged for students to gain an understanding of the subjects covered in class. Reading should be done in advance of the relevant class.

**Sources:**


2. Yoram Keinan, “Is there a Mark-to-Market in Your Future? – Rethinking the Recent Ways and Means Committee’s Proposal to Mark Derivatives to Market” (“Keinan 1”)


SESSION 1: DEBT INSTRUMENTS

1. What Is Indebtedness
   a. Overview
   b. Debt vs. equity
   c. Upstream loans
   d. Nonrecourse debt
   e. Debt contrasted with certain other financial arrangements

2. Whose Debt Is It?
   a. Shareholder guarantees
   b. Co-obligors

3. Basic Debt Instrument Terminology and Economics
   a. Compound interest
   b. Present and future value
   c. Yield to maturity
   d. Discount and premium

Reading:

1. Garlock, up to page 29
2. Garlock, Chapter 1
SESSION 2: DEBT INSTRUMENTS AND THE OID RULES

4. **Overview and History of the OID Rules**

5. **Determining Whether a Debt Instrument Has OID**
   a. Stated redemption price at maturity and qualified stated interest
   b. Issue price
   c. *De minimis* OID
   d. Pay-in-kind ("PIK") interest

6. **How OID Accrues**
   a. Accrual periods
   b. Allocation of OID to accrual periods
   c. Daily portions of OID
   d. Special cases
      i. Stepped interest rates
      ii. Puts and calls
      iii. Convertibles and investment units

7. **The OID Anti-abuse Rule**
   a. Statement of the Rule
   b. Potential applications

Reading:

1. Garlock, Ch. 2, ¶¶ 201, 202, 203, 204.01
2. Garlock, Ch. 5, ¶¶ 501, 502, 503, 504, 505, 506, 508, 510, 511
SESSION 3: INTEREST IMPUTATION, MARKET DISCOUNT AND BOND PREMIUM

8. The Imputed Interest Rules – Sections 1274, 483, 7872 and 482
   a. Historical background
   b. Applicable federal rates and adequate stated interest
   c. Imputation of interest

9. Market Discount
   a. Definition of market discount
   b. *De minimis* rule
   c. Basic market discount rules
   d. Computing accrued market discount
   e. Recognition of market discount
   f. Deferral of interest deductions allocable to accrued market discount

10. Bond Premium
    a. Basic rules adopt OID principles
    b. Acquisition premium
    c. Different rule for holders and issuers

Reading:

1. Garlock, Ch. 3, ¶¶ 301, 302, 303, 304
2. Garlock, Ch. 11, ¶¶ 1101, 1102, 1103.01 and .02, 1104.01 and .02, 1105.01 and .03
3. Garlock, Ch. 12, ¶¶ 1201, 1202.01, 1202.02, 1203
SESSION 4: SPECIAL TYPES OF DEBT INSTRUMENTS

11. Variable Rate Debt Instruments (“VRDIs”)
   a. Definition of VRDI and qualified floating rate (QFR)
   b. Accrual of interest and OID on a VRDI

12. Contingent Payment Debt Instruments (“CPDIs”)
   a. Historical background
   b. The noncontingent bond method
   c. Contingent convertible debt instruments
   d. Contingent debt issued for property

13. Short-Term Obligations
   a. Government obligations
   b. Nongovernmental obligations
   c. Interest deferral rules

Reading:
1. Garlock, Ch. 8, ¶¶ 801, 802, 803, 804, 805, 806
2. Garlock, Ch. 9, ¶¶ 901, 902, 903.01 and .02, 904.01 through .04, 905.01 through .05
3. Garlock, Ch. 7, ¶ 701 through 704

SESSION 5: LIMITATION ON INTEREST DEDUCTIONS AND DEBT MODIFICATIONS

14. Limitations on Interest Deductions
   a. Debt incurred or continued to purchase or carry tax-exempt bonds
   b. Applicable high yield discount obligations (“AHYDOs”)
   c. Section 163(l)
   d. Straddle interest (section 263(g))

15. Debt Modifications
   a. Historical background – early cases and Cottage Savings
   b. Modifications
   c. Significant modifications

Reading:
1. Garlock, Ch. 6, ¶¶ 601, 602, 606, 607, 608
2. Garlock, Ch. 5, ¶ 515
3. Garlock, Ch. 14, ¶¶ 1401, 1402, 1403, 1404, 1405
SESSION 6: TAXATION OF DERIVATIVES AND HEDGING TRANSACTIONS – PART 1

16. An Overview of Taxation of Derivatives
   a. Types of derivatives
   b. Taxation based on –
      i. Type of financial instrument (option, swap, forward, etc.)
      ii. Use of the financial instrument (e.g., hedging)
      iii. Identify of the taxpayer (e.g., dealers)

17. The Taxation Rules for Options, Forwards, Futures and Notional Principal Contracts
   a. Wait-and see: forwards and options
   b. Sections 475 and 1256: mark-to-market taxation
   c. Notional principal contracts
   d. Embedded loans in derivatives

18. Taxation of Hedging Transactions
   a. Definition and qualification for tax hedging treatment
   b. Hedge accounting

19. Integration of Debt Instrument and Hedge
   a. Definitions and qualification
   b. Taxation of integrated transaction
   c. Call spreads

Reading:

1. Garlock, Ch. 17, ¶¶ 1701 and 1702
2. Garlock, Ch. 17, ¶¶ 1703 and 1704
3. Keinan 1, pages 1 - 35
4. Keinan 2, pages 1 - 28
SESSION 7: DERIVATIVES – PART 2

20. Short Sales

21. Stock Loans and Section 1258

22. Anti-Abuse Rules
   a. Straddles
   b. Wash sales
   c. Constructive sales (section 1259)
   d. Constructive ownership transactions
   e. Conversion transactions

23. Variable Prepaid Forward Contracts
   a. Economics
   b. Posting collateral and stock lending
   c. Anschutz case

24. Debt/forward contract investment units (Feline PRIDES)

25. Legislative Proposals to Reform Taxation of Derivatives (Mark to Market)

Reading:

1. Garlock ¶ 901-905, 907
2. Keinan 1, pages 36 - end