I. INTRODUCTION AND OVERVIEW OF COURSE ORGANIZATION, DEVELOPMENT AND FINANCIAL PRODUCTS

A. Approach is to analyze legal and economic characteristics of each major derivative product and then evaluate applicable tax rules. Consider combinations of derivatives. Recognize how derivatives can be combined or disaggregated in various ways to form economic equivalents. Understand and evaluate tax policy regarding derivatives and financial products, including importance of economic equivalence as compared to legal rights and obligations. Basic tax principles of concern relate to timing, character and source.

II. STOCK AND SHORT SALES

A. Mechanics of, and rights and obligations created by, short sales and short-against-the-box transactions. Application of basic tax principles to short sales as well as specific, anti-abuse rules. Most of the tax themes and issues to be encountered in the taxation of derivatives throughout the course will be discussed in the context of short sales.

III. DEBT

A. How are interest rates determined? The forward rate and yield curves. Common types of debt, including zero-coupon bonds, and applicable tax concepts. Repurchase agreements. Exchanges of debt instruments. Comparison of, and distinctions between, debt and equity. The primary focus in this topic is on concepts needed to understand and evaluate other derivative products.

IV. FORWARDS, FUTURES, OPTIONS (PUTS AND CALLS)

A. Legal and economic characteristics of forward contracts, including cost of carry pricing model. Two common types of contracts are foreign currency forwards and forward rate agreements. Features of futures contracts, which reduce credit risk and improve liquidity. Forward contracts are
taxed under general principles with some modifications while futures contracts are subject to mark-to-market treatment with special character treatment. Options characteristics include equivalency to half of a forward contract — either a right but not an obligation or an obligation but not a right. Options taxation is governed by a number of special rules, including mark-to-market treatment in the case of dealers and non-equity options.

V. SWAPS, CAPS, FLOORS, COLLARS AND SWAPTIONS

A. Swaps (notional principal contracts) evolved in 1981 from parallel loans as companies sought ways to manage foreign currency exposures. Legal and economic characteristics of swaps. Application of settled tax principles caused perceived abuses leading to promulgation of Treasury regulations governing timing of payments under swaps, caps, floors and collars. Treatment of forward contracts on swaps and options to enter swaps (swaptions).

VI. CONTINGENT DEBT AND OTHER HYBRID PRODUCTS

A. How should a product that embodies a combination of equity and debt features be taxed? The Treasury’s four different proposals regarding the treatment of contingent debt obligations (debt obligations with embedded equity features) embody the various approaches that could be taken.

VII. PORTFOLIO COMBINATIONS OF PRODUCTS

A. Straddles are combinations of derivatives that offset the economic, market risk created by each component and leave the holder with little or no market risk. The basic tax rules allowed straddles to be used to defer income and convert ordinary income into capital gains. Congress responded with a variety of anti-abuse rules including mark-to-market treatment of futures contracts and nonrecognition of losses from a straddle while there were unrecognized gains in the straddle.

B. Business hedging involves straddles entered into in the normal course of a trade or business to offset price, currency or interest rate risks. The straddle anti-abuse rules excepted hedges, which continued to be taxed under normal tax rules. Supreme Court’s decision in Arkansas Best had the effect of making almost all business hedges fail to qualify for the straddle anti-abuse rules exception, resulting in gross income taxation of hedges. Treasury reacted by promulgating specific rules governing character and timing of business hedges.
VIII. DEVELOPMENT OF THEMES INHERENT IN CURRENT TAX RULES RELATING TO CONSIDERATIONS OF TIMING, CHARACTER AND SOURCE

A. Effect of difference in treatment of debt and equity

B. Effect of realization concept for equity and the accrual concept for debt

C. Extent to which the tax system recognizes that derivatives can be combined into synthetics
   1. What is the paradigm — the “real” thing, the synthetic, or the economic components of each?

D. Effect of tax rules generally having been developed in the context of a very different financial marketplace
   1. Blurring of traditional distinctions

E. Effect of a tax regime consisting of anti-abuse rules

Reference material:


Garlock, Federal Taxation of Debt Instruments (2000 with supplements)

Keyes, Federal Taxation of Financial Instruments and Transactions (1997 with supplements)


http://www.investorguide.com/ (Good description of many financial products and other investing information)