

Introduction to the Taxation of Financial Products Summer 2016

LAWT 992/491 - LL.M --- TaxA 692/185 M.S. --- LAW 992/512 J.D.

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Course Materials

All students are expected to have current copies of the Internal Revenue Code & regulations. Online subscriptions to Bloomberg Law (free for enrolled students) will be necessary for students to access assignment reading materials. Reading assignments include sections from BNA Tax Management Portfolio (#s 186 to 189), a report by the Joint Committee on Taxation dealing with financial instruments and products (JCX-56-11) and a few revenue rulings. Enrolled students are strongly encouraged to activate Bloomberg Law accounts before the first class.

Class Time and Location

Tuesday evenings: 6:00 - 9:10 p.m.
Location: Room 608

Course Overview

This course will explore the basic financial building blocks (equity, debt, options and forward contracts) and their various combinations, with a special emphasis on notional principal contracts. In addition to the familiar stocks and bonds, students will explore the taxation of instruments in the derivatives and hedging markets. Various instruments can be used for investment, speculation, insurance, monetization or basic business hedging purposes.

Financial instruments are used to change the timing, character and source of income. Upon completion of the course, students should be able to recognize the widely varying uses of financial products by businesses, investors, speculators, traders and dealers and to recognize the use of different financial instruments to achieve nearly identical financial and business goals, but with varying tax results.

Financially equivalent products and derivative instruments are taxed under widely varying tax regimes. Thus, gaps in existing rules will be studied as well as the rules themselves. A review of the basic financial building blocks will be followed by discussions of how complex financial instruments can be disaggregated in more than one manner and how identical building blocks can be aggregated to create different financial instruments governed by different tax regimes. Along with the interaction among different Code sections, students will learn to recognize the effects of an increasing convergence in the financial services markets, *e.g.*, insurance, securitization and credit protection.

Because the market produces a steady stream of new products, the course will focus on developing an understanding of existing rules plus the varying means of combining or disassembling them to reach the desired new tax or financial reporting results. Given an understanding of the existing rules and regulations and the areas in which tax law continues to evolve, students can provide practical tax advice for clients needing to hedge recurring business risks as well as clients seeking to profit from the assumption of other taxpayers' risks, *e.g.*, interest rate, credit, commodity pricing, currency fluctuations or even the changing weather.

During the initial lectures, students are to develop an understanding the development of tax rules governing the financial instruments. Alternative tax regimes will be discussed.

Attendance:

Class attendance is a primary obligation of each J.D. student whose right to continued enrollment in the course and to take the examination is conditioned upon a record of attendance satisfactory to the professor ([General Attendance Policy](#)). A J.D. student who exceeds the maximum allowable absences may be compelled to withdraw from the course, or may be barred from sitting for the final exam. A student who is compelled to withdraw or is barred from sitting for the final exam may receive an "F" in the course. Attendance will be taken at the beginning of each class. A student who is present but unprepared for class may be treated as absent.

While LL.M. and M.S. students should endeavor to attend each class, there is no attendance policy applying to these students.

Grading, Class Participation, Computers and Final Examination

Ninety percent of the final grade will be based on a final examination and ten percent will be based on class participation. Class participation includes a willingness and ability to analyze and discuss problems, examples and the assigned reading materials. Meaningful participation presupposes regular attendance (either live or online) and a working familiarity with reading assignments.

Students may use laptop computers for class related purposes. If students elect to use a computer for the final examination, designated software must be used to temporarily disable most computer functions and convert the laptop into a basic word processor.

A three hour examination will include a combination of multiple choice, fill in the blank and essay questions. The Internal Revenue Code and regulations may be used during the examination.

Class Cancellation

If the instructor must cancel a class, notices will be sent to students via email and posted on the classroom door. If there is inclement weather, students should visit the University of Baltimore web page or call the University's Snow Closing Line at (410) 837-4201. If the University is not closed, students should presume that classes are running on the normal schedule.

Academic Integrity

Students are obligated to refrain from acts that they know or, under the circumstances, have reason to know will impair the academic integrity of the University and/or the School of Law. Violations of academic integrity include, but are not limited to: cheating; plagiarism; misuse of library materials; use of another's book or study materials without consent; unapproved multiple submissions; material misrepresentation of one's academic history or standing; misrepresentation of any academic matter; intentionally giving another student false or inaccurate information about class requirements; inappropriate discussion of exams; and misrepresenting or falsifying class attendance reports.

Disability Policy

If you are a student with a documented disability who requires an academic accommodation, please contact Leslie Metzger, Director for Student Support in the Office of Academic Affairs at 410-516-5623 or via email at lmetzger@ubalt.edu.

Miscellaneous

No advanced math is required. A familiarity with basic addition, subtraction, multiplication, division, percentages and fractions will suffice. Individual questions can be addressed via telephone or email. Email inquiries received by 8:00 p.m. on weekdays will be answered that same evening.

First Class Assignment:

Segment # 1 and a portion of segment # 2 will be discussed during the first class session.

Segment # 1: Code § 1001; Treas. Reg. § 1.1001-1
JCX-56-11, pp. 1-8, 14-30, 42-43; scan pp. 30-42

Segment # 2: Code §§ 1058, 1233, 1259, 1258 & 1234
JCX-56-11, pp. 36-39, 69-70, 72, 78-79
TMP # 186, §§ II.A.; B.; C.1.a.
TMP # 186, §§ III.A.; B.
TMP # 187, §§ III.A.2.; B.2.
TMP # 188, §§ II.D.1. – 3., scan 4

Both JCX-56-11 and instructions for setting up a Bloomberg account will be sent via email to each enrolled student's U.B. email account. If you have not received these materials, send a message to AEstrada@ubalt.edu. Tax Management Portfolios (TMPs) are available via Bloomberg. If you are unable to access Bloomberg before the first class, you can read the TMP materials before the second class session.

Assignments for the entire semester are set forth below. Students should generally prepare for **two segments** per class session unless instructed otherwise.

Introduction to the Taxation of Financial Products

Class Topics & Reading Assignments - Summer 2016

** Students should generally prepare for **two segments** per class session unless instructed otherwise.

1. Basic Concepts and Financial Products Overview

Realization v. mark to market	Code § 1001; Treas. Reg. § 1.1001-1
Debt v. equity	Code § 385
Basic financial instruments	JCX-56-11, pp. 1-8, 14-30, 42-43; scan 30-42
Time Value of Money	

2. Short Sales

JCX-56-11, p. 72 ; Rev. Rul. 72-478;
TMP # 187, §§ III.A.2.; B.2.
TMP # 188, §§ II.D.1. – 3., scan 4
Code § 1058; Prop. Treas. Reg. § 1.1058-1
Code § 1233; Treas. Reg. § 1.1233-1(a)

Short Against the Box

Constructive Sales

Code § 1259; JCX-56-11, pp. 69-70
TMP # 186, §§ III.A.; B.

Conversion Transactions

Code § 1258; TMP # 186, §§ II.A.; B.; C.1.a.

3. Options

Code §§ 1234, 1234A; JCX-56-11, pp. 32-35
TMP # 187, §§ V.A. (skip Black-Scholes);
B.1.a. – c., 2.a. – c.; 3
Rev. Rul. 78-182 / Options Taxation

4. Forward Ks, Futures Ks, Forward K Variations,

JCX-56-11, pp. 36-39, 78-79
TMP # 187, §§ IV.A.; B.1.a., b.; 2.a. - c.; 3

VPFC, Feline Prides

TMP # 188, § III.C.1.a. – d., 2.
Rev. Rul. 2003-7 / VPFC v. Constructive Sale
Rev. Rul. 2003-97 / Feline Prides

5. Notional Principal Contracts

History, basic economics, examples	JCX-56-11, pp. 39-42; Treas. Reg. §§ 1.446-3(a) - (d), (e)(1), (2), (f)(1), (2)(i), (ii)
Significant nonperiodic payments	TMP # 189, §§ I.A. – E.; II.A.; B.1., 4., 5., 6.a.;
Equity / total return swaps	II.A.; B.1., 4., 5., 6.a.; C. 1., 2.a., b.(1), (2), (3)(a), 3.;
Variations (floaters, inverse floaters weather derivatives, etc.)	D.1., 3.a. III.A.; B.1.a.
Credit Default Swaps	

6. Debt Instruments

Overview	TMP # 187, §§ II.A.1. – 5. ; JCX-56-11, pp. 30-32
Market discount and OID	Code §§ 163(d) & (e); JCX-56-11, pp. 68-69 Skim Code §§ 1271 – 1275; 1276 – 1278
Debt/Equity / MIPs VRDI (Variable Rate Debt Instruments)	
Stripped bonds	Code 1286
Debt v. other financial instruments	

7. Debt / Equity

& Debt / Derivative Hybrids

Preferred Stock	Code § 385; JCX-56-11, pp. 62-66
Convertible / Exchangeable Debt	
Contingent Debt (Interest & Principal)	Treas. Reg. § 1.1275-4
Integrating Qualifying Debt Instruments	Skim Treas. Reg. § 1.1275-6
Modifications of Debt Instruments	Skim Treas. Reg. § 1.1001-3

8. Mark to Market Taxation

§ 1256 contracts	Code § 1256; JCX-56-11, pp. 80-83 TMP # 187, §§ IV.C.1., 2., 3.a.
§ 475 Dealers in securities	Code § 475

9. Straddles

Loss deferral	TMP # 187, §§ VII.A.; B.; C.1.a. – d.; 2.a., c.1. – 2; D.1. – 3., 4. (up to a.), 5. – 6.
Mark to market	Code § 1092
Interest capitalization	Code § 1256; JCX-56-11, pp. 80-83 (review) Code § 263(g)

10. Hedging Transactions

Code § 1221(b)(2); Treas. Reg. §§ 1.446-4, 1.1221-2
TMP # 187, §§ VI.A.; B; C.1. – 2.; D; E.1.,2.a. – d.

11. Securitization

Code §§ 671, 677, 1286, 7701(a)(2)
Skim §§ 860A – 860G (REMIC)
Treas. Reg. §§ 301.7701-(a)(4) (4 examples),
301.7701-4(c)(2)

12. Tax v. Legal Ownership

§ 1260 Constructive ownership	Code § 1260; JCX-56-11, pp. 84-86 TMP # 186, §§ IV.A.; B.1. – 5.; C.1.
§ 1259 Constructive sales – review	Code § 1259; TMP # 186, §§ III.A.; B. (review)
§ 1091 Wash sales	Code § 1091; JCX-56-11, pp. 70-71 TMP # 186, §§ I.A.; B.; C.1.a., b.; 2.a. – c.
Short sales – review	Code § 1233
§ 1258 Conversion Transactions	Code § 1258; TMP # 186, §§ II.A.; B.; C.1.a. (review)
Sale v. Loan	
Substantially Identical Stock & Securities	

13. Amorphous Timing, Character & Source

Integrating separate instruments	JCX-56-11, pp. 44-47, 65-66, 75-76
Disaggregating complex instruments	TMP # 187, §§ VIII.A.; B.; C.3. – 4.
Put-call parity	
Credit Default Swaps -- Alternatives	TMP # 189, §§ I.D.7; E.3, 4., skim 5.
Convergence of financial markets	

JULY 12, 2016 (FINAL EXAM)