TAXATION OF FINANCIAL INSTRUMENTS
LAW T 527

PROFESSOR MEDLEAU SPRING QUARTER 2013

SYLLABUS
Class 1 – Introduction and Fundamentals

Summary: We will discuss the five basic financial instruments, “put-call parity”: how one financial instrument can be expressed in terms of other instruments, and the problems for financial instruments caused by a realization-based taxation system.

Code: Review §§ 1234; 1234A. Skim §§ 1233(a)-(d) & (h); 1256(a), (b), (g)(1) & (7); 475(a), (b)(1)(A), (b)(2) & (c)(1).

Regs: Review § 1.1234-1 & -3. Skim §§ 1.446-3(c)(1)-(3); 1.1233-1(a), (c) & (d)(1).


Classes 2 and 3 – Fixed and Variable Rate Debt

Summary: The tax treatment of original issue discount including the time value of money principles, OID definitions and special OID issues and a comparison of the tax treatment of fixed and variable rate debt.

Code: Study §§ 163(e)(1) & (2); 1271(a)(except (a)(2)), (b) & (d); 1272(a)(except (a)(6)), (c) & (d); 1273(a)-(b)(1); 1275(a)(1)(A), (a)(2)(A), (a)(3), (a)(4) & (d).

Regs: Review §§ 1.148-1(b) (“Issue Price” definition); 1.163-7(a) & (b); 1.1275-1(f)(1); 1.1272-1(a), (b), (g) & (j)(Exs. 1(i)-(iv), 2(i)-(iii) & 9); 1.1272-2(a)-(c)(Ex. 1); 1.1272-3; 1.1273-1(a)-(d)(2), (d)(5), (f) (Exs. 1-3), -2(a), (j) & (m); 1.1273-2(a) & (e); 1.446-5(a)-(b)(2); 1.1275-1(b); 1.1275-5.

Materials: Review PowerPoint Handouts; Midland Ross.

Problem 1 – Fixed Rate Debt

On January 2, Year 1 Corporation X wants to borrow $100 million by issuing $100 million of its ten-year notes (“Notes”), due December 31, Year 10. Each Note will have a ten percent interest rate (payable annually on December 31) and a $1,000 principal
amount. Corporation X to borrow and issue Notes to the public as follows: (i) $10 million are issued (sold) on January 2, Year 1 at a price of $990 per $1,000 Note and (ii) $50 million are issued (sold) on January 3, Year 1 at a price of $930 per $1,000 Note. Corporation X is unable to issue (sell) any more Notes – i.e., $40 million of Notes.

(i) What is the issue price of a Note?

(ii) What amount can Corporation X deduct as interest, including original issue discount, on a Note in the Year 1 taxable year?

(iii) What amount must an individual holder of a Note who purchased the Note on January 2, Year 1 for a price of $930 include in its gross income for Year 1?

(iv) Would it make a difference if the interest on the Notes were only paid to holders every two years (on an annual compounded basis)?

(v) How, if at all, would your answers change in Parts (i)-(iii) (i.e., annual payment of 10% interest coupon) if instead of directly issuing (selling) the Notes to the public, Corporation X uses an underwriter (“Underwriter”) who agrees to do their best to sell the issues to the public (i.e., Best Efforts Underwriting) for a fee of 2% for each $1,000 face amount Note sold? What if instead it was a Firm Commitment Underwriting and the underwriter purchased all the Notes on January 2, Y1 for $980 per $1,000 face amount Note (or $98 million for all the Notes)?

Problem 2 - Variable Rate Debt

On January 1, Year 1 Corporation X issues $10 million of three-year floating rate notes ("Notes"). The Notes provide for interest payable quarterly (March 31, June 30, September 30, December 31) at a rate equal to the London Interbank Offered Rate ("LIBOR") on three-month deposits in effect on such date. The Notes are sold to the public for a price of $970 per $1,000 Note. On the issue date LIBOR was 7%.

(i) What amount is Corporation X entitled to deduct in Year 1 on the Notes?

(ii) What amount must an individual who purchased a Note on January 1, Year 1 and held it throughout Year 1 include in gross income for Year 1?

(iii) Would your answer change if the Note provided for interest at a rate equal to 2 x LIBOR?
Summary: The federal income tax treatment of contingent debt including its treatment under the contingent payment debt regulations.

Code: None

Regs: Review §§ 1.1275-4(a)-(b) & (e)-(f). Skim § 1.1272-1(c).


Problem 1 – Contingent Debt -- Contingent Interest

F, a financial services corporation, issues $100 million of debt instruments ("Notes") on January 1, Year 1. The issue price for each $1,000 Note is $1,000. The Notes mature on December 31, Year 3. On that date, the holder is entitled to receive $1,000 plus the Indexed Amount. The Indexed Amount equals $1,000 multiplied by the percentage increase in the value of the S&P 500 stock index ("S&P Index") from January 1, Year 1 to December 31, Year 3. Assume that on January 1, Year 1 the S&P Index has a value of 100. At the same time it issues the Notes, F enters into a hedge of the Note interest rate with an investment bank ("Bank"). The hedge is a notional principal contract structured as follows (i) F will pay Bank semi-annually an amount equal to 6% per year times a $100 million notional principal amount and (ii) Bank will pay F the Indexed Amount times a $100 million notional principal amount on December 31, Year 3 (i.e., the amount necessary to pay the Indexed Amount on all the Notes).

a. A, an individual, purchased a Note on January 1, Year 1 for $1,000 and holds it for the entire year. What is the treatment of holder A during Year 1?

b. Assume that on December 31, Year 3 the S&P Index has a value of 400. On that date A receives a payment of $4,000 on her Note i.e., A’s original $1,000 plus 300 percent times $1,000. What are the federal income tax consequences to A in Year 3?

c. Assume, instead, that on December 31, Year 1 the S&P Index has a value of 150. Assume further that A sells her Note for $1,500 to B, an unrelated party, on that date. What are the tax consequences to A?

d. Would your answers change if the Note provided that at maturity the minimum amount a holder was entitled to receive was $900?

Problem 2 – Contingent Debt -- Contingent Principal

A U.S. banking institution ("Bank") has a portfolio of $100 million composed of ten bank loans ("Loans"). The Loans bear interest at LIBOR plus spreads ranging from 100 to 200 basis points. They have maturities ranging from five to 10 years. Bank believes the
U.S. will go through a depression in Year 2 that will be worse than the Great Depression. It believes the depression will last four years. Accordingly, Bank wants to minimize the risk of losses on the Loans during that time. To do so, on January 1, Year 1 Bank will sell credit-linked notes ("CLN"s) to public investors in the U.S. The CLNs will have a $100 million face amount. They will pay interest annually at 7 percent, i.e., a 7% coupon each year (Bank, a high quality creditor, would normally borrow at 6 percent). The CLNs will mature in five years. At that time, Bank is obligated to pay the CLN holders the $100 million face amount, except if there has been a "credit event" with respect to one or more of the Loans. If a credit event has occurred (making the Loan a "Credit Event Loan"), then with respect to a portion of the CLN equal to the Credit Event Loan’s original face amount ("Original Amount"), Bank will only be obligated to pay back 50% of the Original Amount. (Fifty percent is the anticipated recovery, based on 50 years of statistics, by a creditor when a corporate loan goes into default.) A credit event is any event of default on a Loan, other than an event of default that is cured within 30 days. Bank is free to transfer the Loans at any time.

As an example, assume that one of the Loans has a $20 million face amount. During the five-year period, that Loan defaults. Bank would be obligated to pay $90 million to the CLN holders at maturity. Thus, because a $20 million Loan defaulted, Bank's obligation with respect to $20 million of the CLN's $100 million face amount (i.e., the Original Amount corresponding to the Credit Event Loan) is to repay $10 million, i.e., 50% of the Original Amount.

(a) What amount, if any, must holder A, an individual cash basis taxpayer, who purchases a CLN on January 1, Year 1 for $1,000, include in income in year 1 with respect to her CLN?

(b) What amount, if any, is Bank, an accrual basis taxpayer, entitled to deduct on the CLNs in year 1?

Class 5(a) – Secondary Market Transactions

Summary: The federal income tax treatment of secondary market purchases of debt instruments.

Code: Study §§ 1276(a) & (b); 1277; 1278; 171; 1272(a)(7) & (c)(1). Skim § 1016(a)(5).

Regs: Review §§ 1.171-1(a)(1), (c), (d)(1), (e)(1)(i), -2(a)-(c)(Ex. 1), -3(a), -4; 1.1272-2(a)-(b)(3). Skim §§ 1.446-2(a); 1.61-7(c); 1.1016-5(b).

Problem – Market Discount and Premium

On July 1, Year 1, individual A purchases a $1,000 face amount 10 percent bond issued by X, a corporation. The Bond was originally issued on January 1, Year -10 (i.e., ten years ago) for an issue price of $1,000. Interest on the Bond is payable and paid each year on December 31st. It matures on December 31, Year 10. Because market interest rates on July 1, Year 1, are higher than 10 percent, A purchases the Bond for $800 (i.e., $750 plus $50 of accrued interest).

A. What amount must A include in income with respect to the Bond in Year 1?

B. What are the federal income tax consequences to A if A sells the Bond in the market for $850 on December 31, Year 1? Assume A received $100 on the bond (i.e., the bond coupon) before selling the bond.

C. Assume that A incurred $750 in indebtedness to purchase the Bond and that in Year 1 A incurred $50 of interest expense on the borrowing. Can A deduct the $50?

Assume that on July 1, Year 1, interest rates were lower than 10 percent. Assume further that A purchased the Bond for $1,100.

D. What amount must A include in income with respect to the Bond in Year 1?

E. What are the federal income tax consequences to A if A sells the Bond in the market for $1,000 on December 31, Year 1?

Class 5(b) – Stripped Debt

Summary: The federal income tax treatment of stripped debt including basis allocation and OID treatment.

Code: Study § 1286(a)-(b) & (e)-(g). Skim § 305(e).

Regs: None


Problem – Stripped Debt

On July 1, Year 1, F purchased a non-prepayable bond from Corporation Y with interest coupons attached for $100. Interest of $10 was payable every June 30 for 5 years (as evidenced by 5 separate coupons). Principal of $100 was payable on June 30, Year 6,
in full redemption of the bond. A few hours after she purchased the bond, F, in an unrelated transaction, sold all five interest coupons to P, an unrelated individual, for $40.

a. What are the tax consequences to F in Year 1 as a result of acquiring the bond and selling the interest coupons while continuing to hold the principal portion of the bond?

b. What is the amount and character of any income that P, a cash method taxpayer, must report in Year 1 and Year 2 (assuming the Year 2 coupon is paid when due)?

C. What effect, if any, does the sale of the interest coupons by F have on Corporation Y?

Class 6 – Notional Principal Contracts

Summary: Definition of notional principal contract ("NPC"). Illustrations of interest rate swaps and equity swaps, which are common types of NPCs. Discuss the federal income tax treatment (i.e., timing, character and source) of the three types of payments under a NPC; periodic, nonperiodic and termination payments.

Code: None

Regs: Review § 1.446-3 (but regarding the examples, only review the examples in -3(e)(3), Ex. 5 in -3(f)(4), Ex. 3 in -3(g)(6) and Ex. 1 in -3(h)(5)); Prop. Reg. §§ 1.162-30(a); 1.212-1(q); 1.1234A-1(a) & (b).


Problem – Notional Principal Contracts Interest Rate Swaps.

Company is a domestic industrial firm desiring to borrow on a fixed-rate, long-term basis to fund a construction project. The Company can obtain a 20-year term loan at a fixed rate of 10.00% per annum, compounded semiannually (a relatively high rate), or at a floating rate of six-month LIBOR + 0.25% (a relatively low rate). The Company asks its investment banker to arrange an interest rate swap. The banker finds a foreign financial institution ("FFI") that has access to fixed rate long-term funds at a rate of 8% per annum, compounded semiannually, and floating rate long-term funds at the rate of six-month LIBOR - 0.25%. FFI is interested in borrowing on a long-term basis at a floating rate. The parties agree as follows: Company will borrow locally $10,000,000 for 20 years at six-month LIBOR + 0.25% (redetermined semiannually). FFI will borrow $10,000,000 in the Euromarket for 20 years at a fixed rate of 8.00% per annum,
compounded semiannually. Each loan will have balloon payments of principal at maturity. At the end of each six-month period, Company will pay to FFI the excess of (i) interest at 8.75% on a notional principal amount of $10,000,000 over (ii) interest at six-month LIBOR on the same notional principal amount over the same period (or, if (ii) is greater than (i), the Company will receive the difference from FFI). How should Company account for the swap for federal income tax purposes?

Class 7 – Transactions in Common Stock-Equity Derivatives

Summary:  Why hedging is so important to investors today. Stock loans and short sales, short sales against the box, §1259 and the constructive sale rules. Straddle rules and interest capitalization rules.

Code: Study §§ 263(g); 1259. Review §§ 1001(a)-(c); 1092(a)-(b)(1), (c)(1) & (2), (d)(1)-(4), (e) & (g); 246(c). Skim §§ 1233(a)-(d).

Regs: Skim §§ 1.1092(b)-1T(a)-(g)(Exs. 1-8), 1.1092(b)-2T(a)-(b)(1), (c)(1) & (f)(Exs. 1 & 4); 1.1233-1(a), (c) & (d)(1); Proposed Reg. § 1.263(g)-1(a), -2, -3(a)-(b), -5.


Problem – Constructive Sales

Corporation X is in the newspaper publishing business. In early Year -5, X acquired 1 million shares of the stock of Corporation Y, a maker of wireless application software. X paid $1 million for the Y shares (i.e., $1 per share). During Year -5, Y went public in an enormously successful public offering. Today, Y’s stock trades at $100 per share. X’s 1 million shares, therefore, are worth $100 million.

X is afraid the Y shares will decline in value. If X sells the Y shares, however, X will recognize a $99 million gain. X would like to monetize its position without selling the Y shares.

Investment Banker A proposes that X enter into a "short sale against the box" with a portion ($10 million) of the Y shares. (While X would like to sell the entire 1 million share position short, A advises that there is insufficient trading in Y shares and that such a sale would disrupt the market). In the short sale, X would sell 100,000 Y shares in the market for $10 million. X would borrow the 100,000 Y shares from Investment Banker and deliver those shares. X intends to close out the borrowing in the future by delivering shares from its position. As collateral for the loan of Y shares, X would be required to deliver the short sale proceeds to A. A will split earnings on the $10,000,000 cash collateral with X. X is also required to pay an annual fee to A for borrowing the shares.
Investment Banker B proposes that X sell a debt instrument (“Note”) to the public. The Note would be sold in a registered public offering for $100 million in the aggregate, $100 per Note. It would have a three-year maturity. It would pay interest at a rate of 4 percent per year. At maturity, X would be required to pay to the holder (i) if the price of Y stock is less than $100 per share, 1 share of Y stock per Note (or the cash equivalent), (ii) if the price of Y stock is greater than $120 per share, .833 shares of Y stock per Note (or the cash equivalent), and (iii) if the price of Y stock is between $100 and $120 per share, then a fractional share per Note with a value equal to $100 (or the cash equivalent).

Investment Banker C proposes that a trust (“Trust”) be set up as follows: The Trust will sell 1 million units to the public for $100 per unit. The Trust will invest $10,000,000 of the proceeds in U.S. Treasury STRIPS maturing semi-annually for the next three years with a $2 million face amount per semi-annual period. The remaining proceeds ($90,000,000) will be paid to X as a prepayment under a forward contract (“Forward”) that the Trust will enter into with X. Pursuant to the Forward X will agree to deliver to the Trust (i) if the price of Y stock is less than $100 per share, 1 share of Y stock (or the cash equivalent) per unit, (ii) if the price of Y stock is greater than $120 per share, .833 shares of Y stock per unit (or the cash equivalent), and (iii) if the price of Y stock is between $100 and $120 per share, then a fractional share with a value equal to $100 (or the cash equivalent) per unit.

X asks you to describe the federal income tax treatment of each of the proposals. In particular, X asks when it will be required to recognize gain on the Y shares and whether it can deduct interest, if any, in the proposed transactions.

Class 8 – Mark to Market Accounting

Summary: Who is a “dealer in securities” for purposes of §475? What is a “security” for purposes of §475 and what are the exceptions from mark to market accounting.

Code: Study § 475.

Regs: Review §§ 1.475(b)-1(a)-(b)(2), -2(a)-(b); 1.475(c)-1(a)-(a)(2), (b), (c)(1)-(2), -2(a)(1)-(2); 1.475(d)-1.


Problem – Dealer Issues

BD is a registered broker dealer under the Securities Act of 1934. BD regularly buys and sells stock and securities from customers in the ordinary course of business. It also
regularly enters into options with respect to stock and securities with customers. Additionally, it enters into interest rate and equity notional principal contracts with customers. BD also regularly enters into credit derivatives with customers.

Describe the federal income tax treatment to BD if it holds the following positions on December 31, Year 1; the end of its taxable year:

1. Stock held for sale to customers with a basis of $100 and a FMV of $150.
2. Stock held as an investment with a basis of $100 and a FMV of $50.
3. Stock in a corporation in which BD owns 51% of the vote and value.
4. An “on market” interest rate swap entered into during the year obligating BD to pay 7% times a $100 million notional principal amount and entitling it to receive LIBOR plus 100 basis points times such NPA (the FMV of BD’s position is $1,000,000).
5. An option to buy a publicly traded debt instrument, and the option has a basis of $10 and a FMV of $5.
6. A loan commitment to loan $10 million to an unrelated third party; BD received $50,000 for entering into the commitment; it would receive $100,000 if it entered into a similar commitment today.
7. An instalment note received on the sale of stock in a closely held company.
8. A credit derivative with a customer (the value of BD’s position is $1,000,000).