

Law 7931: Taxation of Financial Instruments

Credit Hours. 2

Course Prerequisites. This course has no prerequisites for LLM students. Other students may enroll with permission of the instructor.

Course Description. From the UF Website:

This course covers the U.S. taxation of financial instruments. The first part of the course is about debt instruments, beginning with an examination of interest and the time value of money and continuing with the tax consequences of issuing or holding a debt instrument that is issued or purchased at a price differing from the instrument's face value. Subsequent topics include the tax treatment of options, futures, forwards, swaps and other "derivatives."

Course Objectives/Learning Outcomes.

Students successfully completing the course will gain an understanding of:

- The economics of, and federal income tax rules applicable to, debt instruments.
- The U.S. federal income tax rules applicable to the holding and trading of non-U.S. currencies.
- The U.S. federal income tax rules applicable to virtual currencies, such as Bitcoin.
- The U.S. federal income tax rules applicable to many "derivative" transactions, including futures, forwards, swaps and contingent-payment debt instruments.
- The U.S. federal income tax rules applicable to certain tax avoidance transactions, including wash sales, straddles and hedging transactions.

More generally, a principal objective of the course is to understand the financial aspects of these arrangements as well as their U.S. federal income tax aspects.

Required Materials.

IRC and Treasury Regulations. These materials are available online.

Texts. There is no required textbook to purchase for this course. Instead, we will read from portions of Bittker and Lokken, Federal Taxation of Income, Estates & Gifts (B&L). It is available on Westlaw. The path on Westlaw is Home > Secondary Sources > Tax > WG&L > Business Entities Treatises.

Slides. PowerPoint Slides from John Hull, Options, Futures and Other Derivatives (11th ed.) serve as background to some of the material as indicated on the schedule. The slides are available at no cost [here](#).

Financial Calculator. You also should have and be able to use a financial calculator or an app, such as Excel, that enables you to calculate present and future values, amortization and other financial items. Websites that offer financial calculators include:

<https://www.mortgagecalculator.org/calcs/bonds.php>
<https://www.fncalculator.com/financialcalculator?type=bondCalculator>

Statement on Workload.

Students should expect to spend, on average, at least two full hours preparing for every 55 minutes of class, and often more.

Readings.

The attached schedule lists readings. In addition, from time to time you may need to read other Code or Regulations sections to understand the material.

Problems.

A set of problems is typically assigned for class. These problems will be posted on the course's Canvas web page under the Assignments tab at least one week before the class for which they are due. You are required to prepare the problems for class. You are NOT required to turn in your answers. We will spend a significant portion of class time doing assigned problems.

Attendance and Final Exam.

You are expected to attend class. It is strongly recommended, but not required, that you take notes by hand.

You are on call every class unless you notify me before class by email that you would like to pass. Each student may take one pass at no penalty during the semester without offering any reason ("free pass"). There is no need to let me know your reason for taking the free pass. If you believe that you need to pass more frequently or on an extended basis, please see me outside of class or email me. Students who are excused on the basis of a free pass are effectively present as visitors and may not participate in the discussion.

The final will be a limited open-book, in-class exam of approximately two hours on a fixed date. The final will consist of multiple choice questions, possibly one or more short essay questions, or both.

Exam delays: The Law School policy on exam delays and accommodations can be found [here](#).

Grading.

Grades will be awarded in accordance with the College of Law's posted grading policy (available at <https://www.law.ufl.edu/life-at-uf-law/office-of-student-affairs/current-students/academic-policies>). Grades are based primarily on performance on the final exam, but your grade may be adjusted upward or downward up to two steps (e.g., B+ to A, or B to C+) based on class participation. In addition, more than two unexcused absences or excessive passes can result in a reduction in your grade, and unexcused absences from more than six hours of class (i.e., three full class meetings) will result in your being disallowed from taking the final exam and receiving a grade of E for the course.

Letter grades correspond to grade points as follows:

Letter Grade	Point Equivalent
A (Excellent)	4.0
A-	3.67
B+	3.33
B (Good)	3.0
B-	2.67
C+	2.33
C (Satisfactory)	2.0
C-	1.67
D+	1.33
D (Poor)	1.0
D-	0.67
E (Failure)	0.0

Note that the mandatory Law School mean does not apply to LLM students.

Office Hours.

Thursdays, 1:05 to 2:45, and by appointment. I strongly encourage you to see me if you have questions about the material. I am also happy to discuss any aspect of tax law or tax practice with you.

Course Policies.

1. Accommodations. Students requesting accommodation for disabilities must first register with the Dean of Students Office (<http://www.dso.ufl.edu/drc/>). The Dean of Students Office will provide documentation to the student, who must then provide this documentation to Student Affairs (Dean Rachel Inman) when requesting accommodation. You must submit this documentation prior to submitting assignments or taking the quizzes or exams. Accommodations are not retroactive. Therefore, students should contact the office as soon as possible in the term for which they are seeking accommodations.
2. University Policy on Academic Misconduct. Academic honesty and integrity are fundamental values of the University community. Students should be sure that they understand and comply with the UF Student Honor Code, available at: <https://www.dso.ufl.edu/%20sccr/process/student-conduct-honor-code>. Failure to comply can result in sanctions, as described in the UF Student Honor Code.
3. Netiquette: Common Courtesy. All members of the class are expected to follow rules of common courtesy in all email messages, threaded discussions and chats. They also are advised to adhere to the guidelines and rules set forth in the University's policy, available at <http://teach.ufl.edu/wp-content/uploads/2012/08/NetiquetteGuideforOnlineCourses.pdf>. Students who consistently or intentionally fail to follow these rules may be subject to discipline, including but not limited to grade reduction and referral to the Law School or University for further disciplinary action.

4. Recordings of Class. All classes will be recorded via Mediasite in case students must miss class for health reasons. The Office of Student Affairs will work with faculty to determine when students may have access to these recordings, and the recordings will be password protected. It is the student's responsibility to contact the Office of Student Affairs as soon as possible after an absence.
5. Online Course Evaluation. Students are expected to provide feedback on the quality of instruction in this course by completing online evaluations at <https://evaluations.ufl.edu>. Evaluations are typically open during the last two or three weeks of the semester, but students will be given specific times when they are open. Summary results of these assessments are available to students at <https://evaluations.ufl.edu/results/>.
6. UF Law respects students' observance of religious holidays. Students, upon prior notification to their instructors, shall be excused from class or other scheduled academic activity to observe a religious holy day of their faith.
7. Students shall be permitted a reasonable amount of time to make up the material or activities covered in their absence.
8. Students shall not be penalized due to absence from class or other scheduled academic activity because of religious observances.

SCHEDULE

Date	Unit	Topics	Assignment
Week 1 (first day of class)	I II.A	Introduction: debt and derivatives Interest, OID, dispositions of debt instruments	Unit I: B&L ¶¶53.1, 53.2, 57.1; Hull slides: Chapters 1, 4 (slides 1-17 only) Unit I: all problems Unit II: §§1272, 1273(a), (b), 1275(c), 6041(a), (c), (d) Reg. §§1.1272-1(a), (b)(1), (j) <i>Examples 1 & 2</i> , 1.1273-1(b), (c)(1)(i), 1273-2(a) B&L ¶¶53.3—53.6 Unit II.A: Problems 1 and 2

See below for 2 separate problem sets.

Problems: Unit I¹

1. Ed deposits \$1,000 in a bank account bearing interest at an annual rate of 5 percent. What is the balance in Ed's account after three years if Ed makes no withdrawals from the account and, alternatively,

- a) Interest compounds annually?
- b) Interest compounds semiannually?
- c) Interest compounds continuously?

The formula for continuous compounding is:

$$Ae^{Rn} = \text{future value}$$

where

A is the principal sum (present value)

e is 2.71828

¹ Most of the problems assigned in this course were designed, and are copyrighted © 2019, by Lawrence Lokken.

SCHEDULE

R is the annual interest rate

n is the number of years

- d) At an interest rate of 5 percent compounded semiannually, what is the present value of \$1,160 in three years? (That is, what is the present value of a right to receive \$1,160 in three years?)
2. X Corp. issues a debt instrument for \$1,000 that calls for a single payment of \$1,160 in three years. Assume semiannual compounding in answering the following questions.
- a) What is the instrument's yield to maturity?
 - b) How should X Corp.'s interest expense be computed for each of the years the instrument is outstanding?
 - c) Edie purchases the instrument at original issue and holds it until maturity. How should her interest income be computed for each of the years during which she holds it?
3. Ron borrows \$1,000 from Last National Bank and agrees to repay the bank with five equal annual payments of principal and interest (at 6 percent compounded annually) of \$237.40 each.
- a) How is interest computed for the first year? The second year?
 - b) What is the present value of five equal annual payments of \$237.40 each, determined with a discount rate of 6 percent compounded annually?
4. What is each of the following?
- a) Regulated investment company (RIC).
 - b) Hedge fund.
 - c) Real estate investment trust (REIT).
 - d) Real estate mortgage investment conduit (REMICs).
 - e) Collateralized debt obligation (CDO)
 - f) Derivative financial instrument.
 - g) Futures contract.
 - h) Forward contract.
 - i) Option (including calls and puts).
 - j) Swap.
 - k) Short position; long position.
 - l) Arbitrage.

SCHEDULE

Dianne's stock broker told her that options are a wonderful way to leverage investments in stocks. For example, if a stock is trading at \$30, Dianne could, by holding a call option on the stock, capture the entire amount by which the price might rise above \$30 by investing only a fraction of \$30. Do you have any words of caution?

Problems: UNIT II.A²

For class of 1/18/24: Problems 1 and 2

For class of 1/25/23: Problems 3 through 8

For class of 2/1/24: Problems 9 through 15

INTEREST AND THE TIME VALUE OF MONEY

A. INTEREST, OID, AND DISPOSITIONS OF DEBT INSTRUMENTS READ:

Code: §§61(a), 163(a), 163(e), 163(f), 1271, 1272, 1273, 1275 Regs: §§1.446-2, 1.1272-1, 1.1273-1
B&L: ¶¶52.1.1–52.1.4, 53.3–53.6

PROBLEMS:

1. X Corp. issues a \$1,000 note to Harry, an investor. The note bears no interest and matures in two years. Harry pays \$854.80 to X for the note. What are the income tax consequences for X and Harry resulting from the issuance, holding, and payment of the note? Determine the following:

1. (a) The instrument's "stated redemption price at maturity." See IRC §1273(a)(2); Reg. §1.1273-1(b),(c).
2. (b) The instrument's "issue price." See IRC §1273(b).
3. (c) The original issue discount (OID) on the instrument. See IRC §§1273(a)(1), (3).
4. (d) The accrual period. See IRC §1272(a)(5); Reg. §1.1272-1(b)(1)(ii).
5. (e) The instrument's "adjusted issue price." See IRC §1272(a)(4).
6. (f) The instrument's "yield to maturity." See Reg. §1.1272-1(b)(1)(i).
7. (g) The "daily portion" of OID for each day during the two years the instrument is outstanding. See IRC §1272(a)(3); Reg. §1.1272-1(b)(1)(iv). See also IRC §163(e). Assume the instrument is issued on March 1 of year 1, and Harry, whose taxable year is the calendar year, holds the instrument until it matures.
8. (h) Harry's adjusted basis for the instrument. See IRC §1272(c)(2).

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SCHEDULE

9. (i) Does Harry have to use a financial calculator to do his income tax return? See IRC §§1275(c), 6041.
2. Harry sells the X note to Holly for \$900 six months after the issue date. What are the resulting consequences to Harry and Holly? Does Holly have to use a financial calculator to do her income tax return? How would the calculations change if the sale occurred five months after the issue date?
3. Y Corp. issues a 10-year, \$1,000, 6 percent note to Helen. Y is required to pay interest on the note semiannually. The note is issued at the beginning of the fourth month of the taxable year of both Y and Helen, Y uses the accrual method of accounting, and Helen uses the cash method of accounting. What are the income tax consequences for Y and Helen in the following alternative cases?
- (a) The issue price is \$1,000.
 - (b) The issue price is \$928.94.
 - (c) The issue price is \$985.
 - (d) The issue price is \$1,077.95. See IRC §171; Reg. §1.163-13.
4. BigBank lends \$1,000 to Laura under a five-year note bearing interest at 7 percent, which generally requires Laura to pay interest semiannually, but requires her to pay the interest for the first 18 months in advance when the loan is made. When Laura signs the note, the bank credits to her checking account at the bank \$895 (\$1,000, less prepaid interest of \$105). What are the resulting income tax consequences to BigBank and Laura? See Reg. §1.1273-2(g)(2)(i). Hint: The yield to maturity is 7.17 percent.
5. I Corp. issues a \$1,000, 6 percent, 10-year bond for \$1,000. Interest is normally payable semiannually in cash, but I may, in lieu of making a particular interest payment in cash, issue to each holder a \$30 note bearing interest, payable semiannually, at 125 basis points in excess of the yield on 10-year U.S. Treasury notes on the date that the interest payment is due. Each of these notes is payable on the maturity date of the bond. What are the tax consequences to I Corp. and holders of the bonds?
6. Ben purchases a condominium apartment for \$120,000, paying \$20,000 down and financing the remaining \$100,000 with a 20-year mortgage loan from Last National Bank. The interest rate on the loan is 6 percent. The bank charges two points. (A “point” is a fee charged by the bank equal to one percent of the principal amount of the loan.) At the closing of the purchase, (1) Ben signs a mortgage note for \$102,040.82, which he agrees to pay in 240 equal monthly installments of \$731.05 each, and (2) the bank disburses \$100,000 to the seller of the condominium. The difference between the principal amount of the mortgage note and the amount disbursed to the purchaser is the bank’s fee (points). How should Ben and the Bank treat the points for income tax purposes if, alternatively,

SCHEDULE

1. (a) Ben immediately makes the condominium his principal residence?
2. (b) Ben uses the condominium, which is located in a mountain community in North Carolina, as a vacation home?

See IRC §§163(h), 461(g); Rev. Proc. 94-27, 1994-1 CB 613.

7. D Corp. issues a 10-year, \$1,000 note under which interest is payable semiannually at a rate equal to 75 basis points in excess of the six-month Secured Overnight Financing Rate (SOFR) in effect on the first day of the particular interest period. The issue price is \$1,000.

1. (a) If the SOFR is 2.43 percent on a particular determination date, how is interest for the period computed under the note?
2. (b) Does the note have OID?

See Reg. §1.1275-5(a), (b), (d) Exs. 1, 2, (e)(2). For the SOFR, see Young & Humphreys, *Breaking Up With LIBOR*, 164 Tax Notes Fed. 1719 (Sept. 9, 2019).

8. X Corp. issues a 10-year, \$25,000 debt note for \$25,000. Interest on the note is payable every 28 days. The interest rate for the first 28 days is 5 percent. On the 21st day of each interest period, a bank acting as agent for the issuer holds an auction. Every holder of one of the notes may enter his or her note in the auction. The auction is open to all interested buyers, who bid for particular quantities of the notes at particular interest rates. The interest rate for the succeeding period is the lowest yield at which all notes submitted in the auction find buyers for \$25,000 each (the “clearing rate”). How is OID determined? See Reg. §1.1275-5(f).

9. Helen owns a \$1,000, 6 percent bond that she purchased at original issue for \$1,000. Ten days before the due date of a semiannual interest payment, Helen sells the bond to Herman for \$1,030. The issuer of the bond pays that interest payment to Herman when due. What are the tax consequences to Helen and Herman? See Reg. §1.61-7(d).

10. The board of directors of X Corp., on September 1, declares a dividend of \$1 per share on the corporation’s common stock, payable on November 1 to shareholders of record on October 15. The stock is traded on NASDAQ. The ex-dividend date is October 13. (A person buying stock on or after the ex-dividend date does not receive the dividend because the purchase is recorded on the shareholder records after the record date.)

1. (a) Harvey, who has owned 100 shares of the stock for several years, sells the stock on October 12.
2. (b) Harold purchases 100 shares of X stock on October 12.

See Reg. §1.301-1(b).

SCHEDULE

11. The City of Gainesville issues a 10-year, \$1,000 note, which bears no interest. Henry purchases the note at original issue for \$672.97 and sells the note three years later. Compute and characterize Henry's gain or loss on the sale assuming, alternatively, that the selling price is

1. (a) \$758.
2. (b) \$784.
3. (c) \$732.

In each of these cases, what is the buyer's yield to maturity? How is the buyer's basis for the note determined and adjusted? See IRC §§103, 1288. See also IRC §265(a)(2).

12. D Corp., a Delaware corporation, issues a \$1,000, zero coupon bond, payable in five years, to F Corp., which is organized under the laws of foreign country X.

The issue price is \$744. What is the U.S. tax treatment of OID accruals for D and F if, alternatively,

1. (a) F is D's only shareholder?
2. (b) D is F's only shareholder?

In either case, does the answer depend on whether the United States has an income tax treaty with country X? See IRC §163(e)(3), 881(a)(3). See also IRC §267(a)(3); B&L ¶53.5.3.

13. I Corp., issues a \$1,000, zero coupon bond, payable in 10 years to H for \$342.73. When the bond is issued, the long-term AFR is 5 percent, compounded semiannually. What is the bond's yield to maturity? What is the U.S. tax treatment of OID accruals on the bond? See IRC §§163(e)(5), 163(i); B&L ¶53.5.4.

14. BigBank lends \$5 million to X Corp. It thereafter sells the loan to a hedge fund. What is the character of BigBank's gain or loss on the sale? Does the answer depend on how often BigBank makes such sales? See IRC §§1221(a)(1), 1221(a)(4); Federal National Mortgage Ass'n v. CIR, 100 TC 541 (1993); Burbank Liquidating Corp. v. CIR, 39 TC 999 (1963), modified as to other issues, 335 F2d 125 (9th Cir. 1964); B&L ¶47.5.

15. Y Corp. issues \$4 million of 10-year, 6 percent \$1,000 bonds to a group of investors at par. Interest on the bonds is payable semiannually. Y incurs costs of \$50,000 in issuing the bond. How are these costs treated for income tax purposes? See Reg. §§1.263(a)-5(a)(9), 1.263(a)-5(b)(1), 1.446-5; B&L ¶52.8.5.