

University of Florida College of Law
Taxation of Financial Instruments

LAW7931

Two credits

Spring 2018

Professor Lawrence Lokken

Course Syllabus

As of 7 December 2017

This course is about U.S. taxation of financial instruments, including debt instruments, options, futures, forwards, swaps, and other “derivatives.” Classes meet only for the first seven weeks of the semester, beginning on 10 January and ending on 22 February. The final examination for the course will be given on the weekend following the last class.

Roughly the half 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. For example, the issuer of a \$1,000 zero coupon bond (a debt instrument on which the issuer pays no interest) receives less than \$1,000 on issuing the bond because investors have to be given a reason to buy this instrument, rather than one on which interest is paid. In the tax law, the difference is called original issue discount, and it accrues over the instrument’s term and is treated as interest income for the holder and interest income for the issuer.

The course also covers debt securitizations. In a securitization, an organizer (e.g., an investment bank) creates a special purpose entity and transfers many mortgages or other debt instruments to the entity, which capitalizes itself by issuing debt instruments with varying rights and priorities and a very thin slice of equity. All payments on the securitized debt are transmitted to the securitization entity, which distributes its cash receipts to the holders of the debt instruments that it issued. The equity holder gets whatever is left, if anything, after the entity has paid all of the debt instruments. Debt securitizations began with residential mortgages several decades ago, but other forms of debt, including commercial mortgages, car loans, student loans, loans financing private equity transactions, and credit card debt, have been securitized more recently. Debt instruments issued by securitization entities (e.g., mortgage-backed securities) played a prominent role in the 2007–2009 financial crisis.

The other major topic of the course is derivatives. A derivative is a financial instrument whose value depends on the value of other property (the underlying), a reference rate (e.g., an interest rate), or an index (e.g., a stock index). Options are a common type of derivative. Assume Wendy grants Hal an option to purchase 100 shares of *X* Corp. six months after the option is granted (written) for \$10 per share; Hal pays Wendy \$15 for the option when it is written (the option premium). The option (a call) has a value, even if *X* shares trade at \$10 or less when it is written, because it gives Wendy the opportunity to capture any amount by which the stock’s value may exceed \$10 on the option exercise date. (Robert C. Merton and Myron S. Scholes won the Nobel prize in economics in 1997 for their work in quantifying this value; the process of measuring the value of options is often called the Black-Scholes Model.) The option is a

derivative because its value, when granted and thereafter, depends on the value of X stock. Other types of derivatives include:

1. Futures and forwards, which are essentially contracts to buy and sell property, typically a fungible commodity, currency, or financial instrument, for a designated price at a designated time in the future. When traded on an exchange, such a contract is known as a “futures contract”; when made outside an exchange, in an over-the-counter market, such a contract is a “forward contract.”
2. Swaps, which are bilateral contracts to exchange payments, computed with reference to some reference rate or index, at set intervals over a stipulated period of time. An example is an interest rate swap—an agreement by which A agrees to make quarterly payments to B equal to interest at 5 percent on a notional principal amount, such as \$1 million; and B agrees to make contemporaneous payments to A equal to interest on the same notional principal at a variable rate, such as the 90-day U.S. dollar LIBOR (London Inter-Bank Offered Rate).

Investment banks have also developed contingent-payment debt instruments, which, in essence, typically consist of a debt instrument with a derivative embedded within it. For example, a company might issue a \$1,000 note, payable in three-years without interest, but the amount payable on maturity is \$1,000, plus or minus the product of \$1,000 and the percentage change in the S&P 500 (a stock index) over the note’s term. The essence of this instrument is a zero coupon bond, coupled with a cash-settled forward contract on the S&P 500.

Over the last several decades, derivatives have become a large presence in financial markets. Exchanges specializing in derivative transactions have grown to be among the largest securities exchanges in the world. Daily trading volumes in derivative instruments are in the hundreds of billions of dollars. One type of swap agreement— credit default swaps—figured prominently in the 2007–2008 financial crisis.

Derivatives are used for many purposes. For example, a business incurring a liability in a foreign currency (e.g., for a purchase of goods) may not want to add a currency exchange risk to the risks ordinarily arising in its business; it can use a derivative (e.g., a currency forward) to eliminate the currency risk. During a period when the stock market seems to be going nowhere, a mutual fund may use derivatives to enhance its otherwise unexciting yield (e.g., by writing calls on stocks it owns). A gambler finding the highest stakes available in Las Vegas casinos to be too modest can find everything he or she may desire in derivatives markets. The bedrock of these markets is, however, companies and investors using derivatives to manage financial risk, not to gamble.

The course focuses on financial aspects of derivatives, as well as their tax consequences. It is assumed that students have no prior knowledge of or background in the financial or tax aspects of derivatives. For example, the coverage of options will begin with a discussion of what options are, what people use them for, how they are traded, etc. However, a willingness to tackle rather complex financial abstractions is essential to success in the course.

The course makes extensive use of TWEN. On the TWEN website for the class, you will

find all of the assignments and problems for the course and various items of course materials. Before the first class, each student should register for the course on TWEN and download at least the first problem set and the materials assigned for the first classes.

To aid the study of financial aspects, the assignments include a series of PowerPoint files by John C. Hull, intended for use with his book, *Options, Futures, and Other Derivatives* (Pearson 10th ed. 2018). You can download the files for free at <http://www-2.rotman.utoronto.ca/~hull/ofodslides/>. The files are also posted on the TWEN website for this course. The files are referred to in the assignments as Hull slides. Only some of the files are assigned. You are welcome to view them all, but many of them are much more advanced than the level of coverage in this course. You can purchase an e-copy of the Hull book for about \$130, but it is not needed for the course.

The assignments include portions of Boris I Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts (B&L)*. This treatise may be found online on WestLaw and CheckPoint. A hardcopy of the treatise is available in the law library

Although you are not required to purchase any books for the course, you must either have a financial calculator with a capability to compute present values or have (and be able to use) a computer program (e.g., Excel) that can compute present values. Two relatively inexpensive calculators that will serve this purpose are the HP 10bII, which is produced by Hewlett-Packard, and the Texas Instruments BAII Plus. Both of them cost about \$30 for basic models (which is all you will need) and are available both online and at bricks-and-mortar outlets. You must also have current volumes of the Internal Revenue Code and Treasury Regulations. "Selected Federal Taxation: Statutes and Regulations," published by Thompson/West, or the corresponding CCH publication, will serve for this purpose, but must occasionally be supplemented with electronic downloads.

The classes will consist almost entirely of discussions of problems. Students should expect to spend, on average, approximately two hours preparing for every hour of class. Students are expected to attend all classes, but no attendance record will be kept.

The assignments below for classes more than two weeks beyond the date of this version of the syllabus are tentative. The syllabus will be amended periodically during the semester to correlate it with our actual progress. Also, some of the problems for Units after Unit I may be changed before we cover them in class. You should check TWEN a day or so before each class to make sure that you have the most recent version of the problems to be covered in that class.

On completing the course, a student should have a basic understanding of the financial concepts underlying the principal forms of derivatives and should, using the Internal Revenue Code, Treasury regulations, and other authorities, be able to solve practical problems of the taxation of financial instruments.

The exam for the course is an six-hour take home examination. You must take the exam on either Saturday, 24 February, or Sunday, 25 February. Grades will be based largely on the final examination, but one or more short quizzes may be given during the course, and up to 15 percent of the course grade may be based on the quizzes. Grades will be assigned under the usual

letter-grade system.¹

Date Assignment

January 10	Unit I: Introduction
	Unit II: Interest and the Time Value of Money
	A. Interest, OID, and Dispositions of Debt Instruments
	Problems 1, 2
January 11	Unit II: Interest and the Time Value of Money
	A. Interest, OID, and Dispositions of Debt Instruments
	Problems 3–8
January 17	Unit II: Interest and the Time Value of Money
	A. Interest, OID, and Dispositions of Debt Instruments
	Problems 9–15
January 18	Unit II: Interest and the Time Value of Money
	B. Market Discount
	Problem 1–4

¹ The official grading scale is as follows:

Letter Grade	Point Equivalent
A (Excellent)	4.0
A-	3.67
B+	3.33
B	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

Of course, as applied to LL.M. courses, the foregoing description is misleading because a GPA of at least 3 is required to obtain the degree, and any grade below B can jeopardize a student's chances of receiving the degree. The instructor's general rule-of-thumb is that a B paper should be at least half as good as an A paper.

- January 24 Unit II: Interest and the Time Value of Money
 C. Short-Term Obligations
 D. Stripped Bonds
- January 25 Unit II: Interest and the Time Value of Money
 E. Debt Instruments Received in Exchange for Property
 F. Below-Market Loans
- January 31 Unit II: Interest and the Time Value of Money
 G. Debt Securitizations
- February 1 Unit III: Short Sales and Related Issues
- February 7 Unit IV: Options
- February 8 Unit V: Futures and Forward Contracts
- February 14 Unit VI: Notional Principal Contracts (Swaps)
- February 15 Unit VI: Notional Principal Contracts (Swaps)
- February 21 Unit VII: Contingent Payment Debt Instruments, Wash Sales, and Straddles
- February 22 Unit VIII: Hedging Transactions

The instructor's office hours are Tuesdays and Wednesdays, noon to 1 p.m. The instructor's email address is lokken@ufl.edu and office is Room 312J.

Academic honesty and integrity are fundamental values of the University community. Students should be sure that they understand the UF Student Honor Code at <http://www.dso.ufl.edu/students.php>.

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 the 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.