

Taxation of Financial Instruments and Transactions

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By

Felix I. Lessambo

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LIST OF ACRONYMS

- CFC: Controlled Foreign Corporations
- DRD: Dividends Received Deduction
- E&P: Earnings and Profits
- ECI: Effectively Connected Income
- ED: Extraordinary Disposition
- FBCI: Foreign Base Company Income
- FC: Foreign Corporation
- FOGEI: Foreign Oil and Gas Extraction Income
- FPHCI: Foreign Personal Holding Company Income
- GILTI: Global Intangible Low-Taxed Income
- HAD: Hybrid Deduction Account
- IRC: Internal Revenue Code
- IRS: Internal Revenue Service
- PFIC: Passive Foreign Investment Company
- PTEP: Previously Taxed Earning & Profits
- REIT: Real Estate Investment Trust

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- *Bank One Corp. v. Commissioner of Internal Revenue*, Nos. 5759–95 5956–97, United States Tax Court, May 2, 2003.
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- *Century Wood Preserving Co. v. Commissioner*, 69 F.2d 967 (3d Cir. 1934).
- *Compaq vs. Commissioner*, 277 F.3d 778, 781 (5th Cir. 2001).
- *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981).
- *IES Indus, Inc. vs. US*, 253 F.3d 350 (8th Cir. 2001).
- *McKelvey v. Commissioner*, 148 T.C. No. 13 Docket No. 26830-14. 04-19-2017
- *Muhich v. Commissioner*, 238 F.3d 860, 863 (7th Cir. 2001).
- *Noble v. Commissioner*, 368 F.2d 439, 442 (9th Cir. 1966).
- *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91-92 (4th Cir.1985)

PART I

TAXATION OF FINANCIAL INSTRUMENTS

CHAPTER 1

OVERVIEW OF FINANCIAL PRODUCTS, INSTRUMENTS AND TRANSACTIONS

Abstract: Debt and equity are taxed differently. Interest on debt is generally a deductible expense of the payer and taxed at ordinary rates in the hands of the payee. Dividends, or other equity returns, on the other hand, are generally not deductible and are typically subject to some form of tax relief (an exemption, exclusion, credit, etc.) in the hands of the payee.

1.1 General

Financial products have increased significantly the recent decades. Their increasing complexity, sophistication and aggressiveness make them more difficult to analyze. Financial products are instruments utilized in the global marketplace. They include, but are not limited to, conventional financial instruments such as: Stocks, bonds, mortgages, foreign currency, and physical commodities. Financial products also include derivatives of conventional financial instruments, such as (i) Forward Contracts, (ii) Option Contracts, (iii) Futures Contracts, (iv) Notional Principal Contracts (swaps), (v) Stripped Mortgage-Backed Securities, (vi) Structured Notes, (vii) Hybrid and/or Synthetic Securities. Financial product tax issues involve the determination of their Character, Amount, Timing, Source, and Debt or equity determinations on hybrid financial instruments. A bunch of new financial instruments have emerged in the markets in recent decades. These instruments include contingent debt, contingent swaps, contingent convertibles, prepaid forwards, and so on. These financial instruments raise novel tax questions while offering taxpayers new ways to reduce tax liability.

1.2 Development of financial products and instruments

Financial products are contracts that are bought and sold on a marketplace. The most commonly used forms of retail financial products are bank accounts, accident and life insurance, credit cards, and mortgages. Financial

products have distinct characteristics: they cannot be prototyped and are easy to imitate¹. A financial instrument refers to any asset which holds capital and can be traded in the market. The OECD defines financial instruments as:

Financial instruments are public policy instruments such as subsidised loans, credit guarantees and equity finance schemes designed to overcome market failures experienced by small and medium-sized enterprises to promote productive investments in a way that would not result though market interactions alone².

Common examples of financial instruments include stocks, exchange-traded funds (ETFs), mutual funds, real estate investment trusts (REITs), bonds, derivatives contracts (such as options, futures, and swaps), checks, certificates of deposit (CDs), bank deposits, and loans. Financial Products and instruments promote economic growth through capital accumulation and technological progress by increasing the savings rate, mobilizing and pooling savings, producing information about investment, facilitating and encouraging the inflows of foreign capital, as well as optimizing the allocation of capital³. They play a major role in economic development particularly in emerging economies. Financial institutions are continually developing and marketing new financial products⁴. It is estimated that revenue from sustainable trade finance and cash management products will grow by 15 to 20 percent annually to total combined revenues of \$28 billion to \$35 billion in 2025⁵.

¹ Hidenori Sato, Takahiro Fujimoto (2013): New Product Development in Financial Industries, *Annals of Business Administrative Science* 12(2):63-70, DOI:10.7880/abas.12.63.

² OECD (2017): The theory and practice of financial instruments for small and medium-sized enterprises, pp. 1-42, https://www.oecd.org/cfe/regionaldevelopment/Brown_When-to-use-financial-instruments.pdf.

³ <https://www.worldbank.org/en/publication/gfdr/gfdr-2016/background/financial-development>.

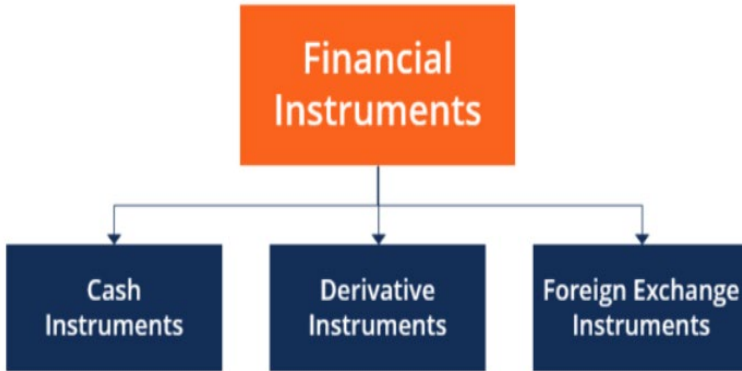
⁴ John Armour, Dan Awrey, Paul Davies, Luca Enriques, Jeffrey N. Gordon, Colin Mayer, Jennifer Payne (2016): *Principal of Financial Regulations*, Chapter 12- Financial Products, pp. 245–272, <https://doi.org/10.1093/acprof:oso/9780198786474.003.0012>.

⁵ <https://www.mckinsey.com/industries/financial-services/our-insights/sustainability-in-global-transaction-banking-a-market-imperative>.

1.3 Types of financial instruments

There are typically three types of financial instruments: cash instruments, derivative instruments, and foreign exchange instruments.

Figure 1.1 Types of financial instruments



- Cash instruments

Cash instruments are financial instruments whose values are ascertained directly by markets. Within cash instruments, there are two types; securities and deposits, and loans. A security is a financial instrument that has monetary value and is traded on the stock market. When purchased or traded, a security represents ownership of a part of a publicly-traded company on the stock exchange. Both deposits and loans are considered cash instruments because they represent monetary assets that have some sort of contractual agreement between parties. Securities are readily transferable whereas loans and deposits can be transferred only if both the lender and borrower agree.

- Derivatives instruments

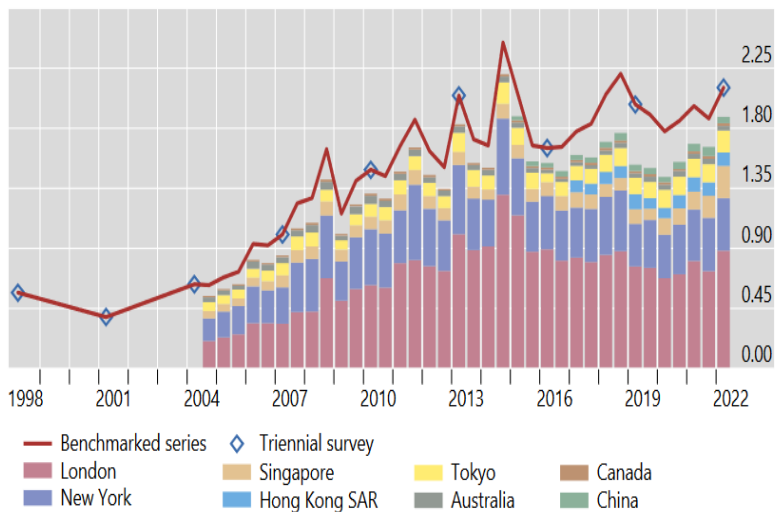
Derivatives contracts generally represent agreements between parties either to make or receive payments or to buy or sell an underlying asset on a certain date (or dates) in the future. OTC derivatives are riskier exactly because they are traded outside regulated exchanges. The five most common examples of derivatives instruments are synthetic agreements, forwards, futures, options, and swaps.

- Foreign Exchange instruments

Foreign exchange instruments are transactions that are concluded on the currency market. These include, for example: Spot transactions. Outright Forwards. Currency swaps. In terms of currency agreements, they can be broken into three categories.

- Spot: A currency agreement in which the actual exchange of currency is no later than the second working day after the original date of the agreement. It is termed “spot” because the currency exchange is done “on the spot” (limited timeframe). According to the latest Triennial, daily trading volume in the global spot FX market averaged \$2.11 trillion in April 2022⁶.

Figure 1.2: FX Market- daily transaction



- Outright Forwards: Is a transaction between a purchaser and the bank to purchase one currency against selling another currency at a fixed price for delivery on an agreed date in the future. It is a currency agreement in which the actual exchange of currency is done “forwardly” and before

⁶ Alain Chaboud, Dagfinn Rime and Vladyslav Sushko (2023): The foreign exchange market, BIS- Monetary and Economic Department, pp. 1-28, <https://www.bis.org/publ/work1094.pdf>.

the actual date of the agreed requirement. It is not to confuse with FX swap. The key difference between the two lies on the fact that an FX swap requires multiple payments in the future, whereas an FX forward leads to a single future payment. Outright Forwards is beneficial in cases of fluctuating exchange rates that change often.

- Currency Swap: A currency swap refers to the act of simultaneously buying and selling currencies with different specified value dates. A currency swap involves exchange of principal and interest payments in two different currencies between two parties⁷. FX swap markets are vulnerable to funding squeezes⁸.

1.4 Financial instruments categorization

There is currently no definition in the Code or Treasury regulations that can be used to determine whether an interest in a corporation constitutes debt or equity for tax purposes. The characterization of an instrument as debt or equity for Federal income tax purposes is determined by the substance of the investor's investment. An instrument's characterization depends upon the terms of the instrument and all the surrounding facts and circumstances analyzed in terms of economic and practical realities. Neither the form of the instrument nor the taxpayer's characterization of the interest is necessarily determinative of the instrument's treatment for Federal income tax purposes. The determination of whether an interest constitutes debt or equity is generally made by analyzing and weighing the relevant facts and circumstances of each case⁹. Section 385 authorizes the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation should be characterized as debt or equity (or as in part debt and in part equity) for Federal income tax purposes. The two asset classes of financial instruments are debt-based financial instruments and equity-based financial instruments:

⁷ Sivaprakasam Sivakumar and Anita Mathew (1996): Currency Swaps: An Instrument of International Finance, Sage Publication, Vol. 21, No. 2, pp. 1-12.

⁸ Claudio Borio, Robert McCauley, Patrick McGuire (2022): Dollar debt in FX swaps and forwards: huge, missing and growing, BIS, pp. 1-7, https://www.bis.org/publ/qtrpdf/r_qt2212h.pdf.

⁹ John Kelley Co. v. Commissioner, 326 U.S. 489 (1943).

1.4.1 Debt-Based Financial Instruments

In general, a debt instrument requires a fixed obligation to pay a certain amount at a specified date. In addition to the tax benefits of interest deductibility, debt permits owners of business or investment assets to extract cash or to obtain a higher basis in the leveraged asset without an additional equity investment¹⁰. Debt instruments are assets that require a fixed payment to the holder, usually with interest. Debt-based financial instruments are categorized as mechanisms that an entity can use to increase the amount of capital in a business. Examples include bonds, debentures, mortgages, U.S. treasuries, credit cards, and line of credits (LOC). Debt-based financial instruments are a critical part of the business environment because they enable corporations to increase profitability through growth in capital. Interest on debt is taxed to a taxable individual or corporate holder at the ordinary income tax rate of the holder (currently, up to 35 percent).

1.4.2 Equity-Based Financial Instruments

Equity-based financial instruments are categorized as mechanisms that serve as legal ownership of an entity. Examples include common stock, convertible debentures, preferred stock, and transferable subscription rights. They help businesses grow capital over a longer period of time compared to debt-based but benefit in the fact that the owner is not responsible for paying back any sort of debt. A business that owns an equity-based financial instrument can choose to either invest further in the instrument or sell it whenever they deem necessary.

Notes

- Hidenori Sato, Takahiro Fujimoto (2013): New Product Development in Financial Industries, *Annals of Business Administrative Science* 12(2):63-70, DOI:10.7880/abas.12.63.
- OECD (2017): The theory and practice of financial instruments for small and medium-sized enterprises, pp. 1-42, https://www.oecd.org/cfe/regionaldevelopment/Brown_When-to-use-financial-instruments.pdf.

¹⁰ US Joint Committee on Taxation (2011): Present Law and Background Relating to Tax Treatment of Business Debt, pp. 1-147, <https://www.finance.senate.gov/imo/media/doc/JCT%20Business%20Debt%207-11-11.pdf>.

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CHAPTER 2

STOCK DISTRIBUTIONS UNDER SECTION 305 AND CONSTRUCTIVE DIVIDENDS

Abstract: Under IRC section 305, a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock is not included in gross income except as provided in section 305(b) and the regulations promulgated under the authority of section 305(c). A constructive dividend occurs when a corporation confers an economic benefit upon a shareholder without any expectation that the shareholder will reimburse the corporation.

2.1 General

A stock represents an ownership in a company. Stocks offer one of the highest potential returns on one's money, while simultaneously exposing the owner to the highest level of risk. Under IRC section 305, a distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock is not included in gross income except as provided in section 305(b) and the regulations promulgated under the authority of section 305(c). A distribution made by a corporation to its shareholders in its stock or rights to acquire its stock which would not otherwise be included in gross income by reason of section 305 shall not be so included merely because such distribution was made out of Treasury stock or consisted of rights to acquire Treasury stock.

2.2 Stock distribution treated as property distribution

where a distribution of stock or rights to acquire stock of a corporation is treated as a distribution of property to which section 301 applies by reason of section 305(b), the amount of the distribution, in accordance with section 301(b) and § 1.301-1, is the fair market value of such stock or rights on the date of distribution.

Example 1

(i) Corporation X declared a dividend payable in additional shares of its common stock to the holders of its outstanding common stock on the basis of two additional shares for each share held on the record date but with the provision that, at the election of any shareholder made within a specified period prior to the distribution date, he may receive one additional share for each share held on the record date plus \$12 principal amount of securities of corporation Y owned by corporation X. The fair market value of the stock of corporation X on the distribution date was \$10 per share. The fair market value of \$12 principal amount of securities of corporation Y on the distribution date was \$11 but such securities had a cost basis to corporation X of \$9.

(ii) The distribution to all shareholders of one additional share of stock of corporation X (with respect to which no election applies) for each share outstanding is not a distribution to which section 301 applies.

(iii) The distribution of the second share of stock of corporation X to those shareholders who do not elect to receive securities of corporation Y is a distribution of property to which section 301 applies, whether such shareholders are individuals or corporations. The amount of the distribution to which section 301 applies is \$10 per share of stock of corporation X held on the record date (the fair market value of the stock of corporation X on the distribution date).

(iv) The distribution of securities of corporation Y in lieu of the second share of stock of corporation X to the shareholders of corporation X whether individuals or corporations, who elect to receive such securities, is also a distribution of property to which section 301 applies.

(v) In the case of the individual shareholders of corporation X who elects to receive such securities, the amount of the distribution to which section 301 applies is \$11 per share of stock of corporation X held on the record date (the fair market value of the \$12 principal amount of securities of corporation Y on the distribution date).

(vi) In the case of the corporate shareholders of corporation X electing to receive such securities, the amount of the distribution to which section 301 applies is \$9 per share of stock of corporation X held on the record date (the basis of the securities of corporation Y in the hands of corporation X).

Example 2

On January 10, 1970, corporation X, a regulated investment company, declared a dividend of \$1 per share on its common stock payable on February 11, 1970, in cash or in stock of corporation X of equivalent value determined as of January 22, 1970, at the election of the shareholder made on or before January 22, 1970. The amount of the distribution to which section 301 applies is \$1 per share whether the shareholder elects to take cash or stock and whether the shareholder is an individual or a corporation.

Such amount will also be used in determining the dividend paid deduction of corporation X and the reduction in earnings and profits of corporation X.

Under IRC § 1.305-2(b), where a corporation which regularly distributes its earnings and profits, such as a regulated investment company, declares a dividend pursuant to which the shareholders may elect to receive either money or stock of the distributing corporation of equivalent value, the amount of the distribution of the stock received by any shareholder electing to receive stock will be considered to equal the amount of the money which could have been received instead.

IRC 305 (c) provides that the amount of the distribution where certain transactions, such as changes in conversion ratios or periodic redemptions, are treated as distributions.

- Adjustment in purchase price

A transfer of stock (or rights to acquire stock) or an increase or decrease in the conversion ratio or redemption price of stock which represents an adjustment of the price to be paid by the distributing corporation in acquiring property (within the meaning of section 317(a)) is not within the purview of section 305 because it is not a distribution with respect to its stock.

Example 3

Assume that on January 1, 2010, pursuant to a reorganization, corporation X acquires all the stock of corporation Y solely in exchange for its convertible preferred class B stock. Under the terms of the class B stock, its conversion ratio is to be adjusted in 2016 under a formula based upon the earnings of corporation Y over the 6-year period ending on December 31, 2015. Such an adjustment in 2016 is not covered by section 305.

2.3 Constructive dividends

A constructive dividend occurs when a corporation confers an economic benefit upon a shareholder without any expectation that the shareholder will reimburse the corporation¹. The corporation need not formally declare a dividend for a constructive dividend to exist². Like a cash dividend, a constructive dividend is not deductible by the corporation and is taxable to the shareholder³. Constructive dividends generally occur in three ways:

- When the corporation pays the personal expenses of the shareholder⁴;
- When the shareholder directs one corporation to distribute assets or transfer funds to another corporation the shareholder owns⁵; and
- When the shareholder receives money as a tax-free transaction (such as a loan) from the corporation and has no intention of paying it back⁶.

Notes

- *Muhich v. Comm'r*, 238 F.3d 860, 863 (7th Cir. 2001).
- *Noble v. Comm'r*, 368 F.2d 439, 442 (9th Cir. 1966).
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- *Benson v. Comm'r*, T.C. Memo. 2004-272; *Menard, Inc. v. Comm'r*, T.C. Memo. 2004-207.
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¹ *Muhich v. Comm'r*, 238 F.3d 860, 863 (7th Cir. 2001).

² *Noble v. Comm'r*, 368 F.2d 439, 442 (9th Cir. 1966).

³ *Muhich v. Comm'r*, 238 F.3d at 863.

⁴ *Ali v. Comm'r*, T.C. Memo. 2004-284; *Benson v. Comm'r*, T.C. Memo. 2004-272; *Bruecher v. Comm'r*, T.C. Summ. Op. 2005-52; *Delaware Corp. v. Comm'r*, T.C. Memo. 2004-280; *Lenzen v. Comm'r*, T.C. Memo. 2005-120; *Noble v. Comm'r*, 368 F.2d 439; *Strong v. Comm'r*, T.C. Memo. 2005-125.

⁵ *Benson v. Comm'r*, T.C. Memo. 2004-272; *Menard, Inc. v. Comm'r*, T.C. Memo. 2004-207.

⁶ See *Bussell v. Comm'r*, T.C. Memo. 2005-77; *Gowni v. Comm'r*, T.C. Memo. 2004-54; and *Moran v. Comm'r*, T.C. Memo. 2005-66.