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DEPARTMENTS

book reviews

edited by Robert J. Wells

Taxation of Financial Instruments

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Taxation of Financial Instruments, edited by Reuven Avi-Yonah, David B. Newman, and Diane M. Ring. Published by Clark Boardman Callaghan, 1996 (Updated). Price: $145. To order, call (800) 328-4880.

Anyone compiling a work on the taxation of financial transactions will have to consider which dimension of the subject matter to focus on, for example: participants (brokers, dealers, hedgers, investors); transactions (debt, equity, forwards, options, and their progeny); and tax concepts (realization, deferral, mark to market, accrual, bifurcation, integration). The difficulty with *Taxation of Financial Instruments* is that it does not appear to have chosen any particular theme. Rather, the editors compiled nine articles on disparate topics that are loosely connected with finance. Certainly, this is not the book to go to with a specific question on the taxation of forwards or options, or a number of other topics normally associated with financial instruments, although it does provide a valuable overview of some of the topics that the editors have chosen to focus on.

The first chapter, written by Thomas A. Humphreys of Brown & Wood, discusses asset securitization. Considering the excellent but extremely detailed books on this subject (such as Peaslee, *Federal Taxation of Mortgage Backed Securities*), no doubt the chapter author wished to provide the outsider a first look at the topic. This he does in a straightforward and easily assimilable fashion. He describes the various securitization vehicles, such as partnerships and trusts, and then goes into some detail as to the requirements for establishing and maintaining a real estate mortgage investment conduit (REMIC), although he does not discuss the real estate investment trust (REIT). The author then describes the financial asset securitization investment trust (FASIT), the new vehicle that will allow taxpayers to securitize assets other than real estate mortgages. There is a short mention of the state tax implications of asset securitization that, although clearly inadequate, is a welcome reminder to taxpayers to consider these issues as well.

The chapter entitled Eurobond Transactions surveys the U.S. federal income tax treatment of foreign portfolio debt investments in the U.S., most particularly the portfolio interest rules. The following chapter provides an introduction to contingent debt instruments, including variable rate instruments, instruments that provide for an alternative payment schedule upon the occurrence of a contingency, and other contingent instruments. The subject matter is so broad here that the author can give only a brief review of the regulations. It would have been helpful, however, if the chapter author had provided a little more substance, for example, in discussing the definition of a debt instrument. At the very least, he could have footnoted the rich literature on this and other subjects, which are only touched on in the chapter, to which the author has made significant contributions.

The chapter on notional principal contracts is probably the most comprehensive treatment of the subject in print. The author, Erika W. Nijenhuis of Cleary, Gottlieb, publishes frequently on the taxation of financial instruments. Nijenhuis begins with the definition of notional principal contract (NPC), explaining each of the clauses of the definition in the regulations. She then goes into the general timing rules for taking into account payments under an NPC, and includes a discussion of other regulations that may override the general timing regulations, such as the straddle rules. That is followed by a discussion of the character of payments under NPCs; tax ownership questions; the effect of an NPC on a particular stock on the ability to claim a dividends received deduction with respect to that stock; withholding on payments under an NPC and source rules; treaty issues; characterization of swap income for subpart F and foreign tax credit purposes; and other ancillary issues. Nijenhuis includes excellent footnotes detailing some of the complexity and uncertainty that is glossed over in the text, and her references are comprehensive and extremely useful. Two areas that she does not discuss and I believe do deserve some mention are NPCs, tax-exempt entities, and the unincorporated business tax, and the treatment of those contracts that are labeled swaps by the financial community, but do not fit within the tax definition of NPC.

The chapter on foreign currency transactions also attempts to address a massive subject matter in a small space, and so we are left with a guide to the regulations, with little embellishment. It would have been useful had the author addressed the issues raised by the interaction between the mixed straddle rules and the foreign currency rules; the proper treatment of individuals engaging in foreign currency transactions;

and the intersection between the interest equivalent rules of reg. section 1.861-9T and the foreign currency rules.

The taxation aspects of securities lending transaction is one that has received relatively little attention in the financial literature, and so Linda Swartz's chapter is a welcome introduction to the subject. After briefly outlining the business transactions that gave impetus to the legislative regime, she leads us through the tax rules, describing their application to those transactions. It would have been useful if there had been some references to finance texts that provide greater detail on the legal and transactional aspects of securities loans and repos, given the brevity of the Swartz introduction, and considering that many novices would be using Swartz's chapter as their first introduction to the subject.

In the next chapter, Limitations on Loss Recognition, Peter Canellos of Wachtell, Lipton describes some of the exceptions to the U.S. federal realization-based tax system. He discusses wash sales and the straddle rules, as well as judicially developed loss limitation doctrines. It will be interesting to see if this chapter is expanded to include mandatory gain recognition rules if the Clinton constructive sales rules make it through the legislative process, or if the author will add other exceptions to realization-based tax accounting, such as the dealer mark-to-market regime.

The last two chapters of the book deal with recent statutory and regulatory changes relating to preferred stock, and debt restructuring transactions. The former subject is very topical in light of the Internal Revenue Service's crackdown on stripping transactions. The latter is a brief summary of a difficult subject that has been well covered in the literature.

Taxation of Financial Products has an index of code and regulations references, as well as cases. There is also a subject matter index, which is disappointingly brief. It is a mystery why, in this era of computer word searches, there cannot be very long and detailed indices dealing with every topic discussed in a book. For example, although the index has one reference to REMICs, it does not have any entry for REITs at all, even though REITs are mentioned a number of times in the chapter on asset securitization.

Overall, this is a motley collection of articles at different depths on subjects varying from very basic to quite specialized. I hope that the authors continue collecting such pieces, and eventually sort them thematically in a multi-volume collection on this new, and multi-faceted, area of tax law.

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