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Legal Update
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Out-of-the-Money: The IRS Designates Basket Options as Listed Transactions and Transactions of Interest

It's been a long hard road for barrier options. In 2010, the Internal Revenue Service (the "IRS") issued a legal advice memorandum that challenged the characterization of certain option transactions, alternately known as "basket option contracts," "barrier options" or "accreting strike price options," as options for federal income tax purposes.[1] Since such time, the IRS has attacked these transactions through a variety of challenges.[2] A Congressional Subcommittee also issued an unflattering report on the use of these financial products.[3] On July 8, 2015, the IRS took its disagreement one step further: It designated these transactions, and similarly structured transactions, as "listed transactions" and "transactions of interest" in Notice 2015-47 and Notice 2015-48, respectively. These designations create significant reporting obligations for holders of the options, writers of the options and persons who provided tax advice on these transactions.

Basket Option Contracts Have Been Designated as Listed Transactions

Notice 2015-47 describes affected basket options. These transactions typically involve a hedge fund ("taxpayer") entering into a contract denominated as an option with a counterparty, commonly a financial institution, to receive a return based on the performance of a notional basket of actively traded personal property ("reference basket"). The taxpayer either identifies the assets to place in the reference basket or selects a trading algorithm that determines the assets. Additionally, during the term of the contract, which typically exceeds one year, the taxpayer often retains the right to request changes to the assets in the reference basket or the trading algorithm.[4] The Notice appears to capture basket transactions even if the option holder accounts for each component as a separate option.

The taxpayer generally makes an upfront cash payment to the counterparty of between 10 and 40 percent of the value of the assets in the reference basket. An open issue is whether the IRS intends to treat collateral deposits as though they were upfront payments for this purpose. The counterparty (option writer), in turn, typically acquires substantially all of the assets in the reference basket and thereafter acquires or exchanges the assets that parallel changes to the reference basket made in response to requests by the taxpayer. The terms of the contract permit either party to terminate the contract upon the occurrence of certain events.[5] Commonly, the contracts will terminate automatically if the value of the assets in the reference basket approach the amount of the taxpayer's upfront payment. Other provisions may further minimize the risk exposure of both the taxpayer and the counterparty.

The assets in the reference basket typically would generate ordinary income if held directly by the taxpayer, and short-term trading gains and losses if purchases and sales of the assets

were carried out directly by the taxpayer. However, taxpayers take the position that short-term gains and interest, and other periodic income from the performance of the reference basket is deferred until the contract terminates. Moreover, if the basket option contract is held for more than one year, the entire gain is treated as long-term capital gain. The IRS disagrees with this reporting, instead suggesting that taxpayers "are using basket option contracts to inappropriately defer income recognition and convert ordinary income and short term capital gain into long –term capital gain."

The IRS also posits four arguments it intends to use in challenging the taxpayers' characterizations of the basket option contracts. Those arguments include: (1) that the counterparty financial institutions, in substance, hold the assets in the reference baskets as agents of the taxpayers and, as such, the taxpayers are the true beneficial owners of the assets for tax purposes; (2) that the basket option contracts are not options for tax purposes; (3) that changes to the assets in the reference baskets during the year materially modify the basket option contracts and result in taxable dispositions of the contracts under Code § 1001[6] throughout the term of the contracts; and (4) that taxpayers actually own separate contractual rights with respect to each asset in the reference baskets such that each change to the assets in the baskets results in a taxable disposition of a contractual right under Code § 1001 with respect to the assets affected by the change.

Notice 2015-47, which characterizes basket option contracts and "substantially similar transactions" as listed transactions, applies to transactions that were in effect on or after January 1, 2011, regardless of when the transaction was entered into.[7] This effective date rule is a snapshot. If a taxpayer was a party to a basket option transaction on or after such date, it will be affected by the Notice.

The Notice does not provide a carve-out if a holder of a basket option is using mark-to-market accounting or if the holder employs realization accounting for each change in the composition of the basket. Taxpayers using these accounting methods would not seem to pose the perceived abuse that the IRS is trying to curtail. It would be helpful if the IRS provided that transactions with option holders using these accounting methods are outside the scope of the Notice.

Basket Contracts More Generally Have Been Designated as Transactions of Interest

Basket contracts are defined in Notice 2015-48 as a larger category of similarly structured basket transactions that include options, notional principal contracts, forward contracts, and other derivative contracts. The IRS expressed the same concerns with basket contracts as those with basket option contracts; however, basket contracts are separately identified as "transactions of interest" in the new reporting regime. The Notices clarify that to the extent a transaction can be characterized as both a basket option contract and basket contract, the basket option contract characterization will control for tax reporting purposes.

The rules for basket contracts apply to transactions entered into on or after November 2, 2006 if such transaction was outstanding on or after January 1, 2011.[8] Accordingly, in contrast to the rules for basket option transactions, in order for a transaction to be treated as a basket transaction it must meet both date tests. This double testing will exempt basket contracts entered into before November 2, 2006 from being treated as a transaction of interest.

General Observations

One could surmise that the Notices are premised on the conclusion that there is a very high "delta" between the performance of the basket option or transaction with the underlying securities (although this is not stated in either Notice). Delta is the relationship between

changes in the value of the reference assets and the derivative itself. In the proposed regulations governing transactions that could be subject to Code § 871(m), the IRS carved out transactions that had a delta of less than 0.70. As is the case with Code § 871(m) transactions, a carve-out for low delta transactions seems appropriate.

In addition, the Notices apply even when the holders of the basket options and basket transactions are held by non-U.S. persons not in connection with the conduct of a U.S. trade or business. Such persons would not have an incentive to convert short-term capital gains into long-term capital gains. It is worth noting that the basket transactions could be used as a method of avoiding withholding on dividends, assuming that Code § 871(m) does not capture the transaction. If this is the IRS's concern, then the inclusion of basket transactions issued to non-U.S. persons makes sense to the extent that the underlying assets would give rise to payments subject to withholding but are not encompassed by an explicit withholding tax rule.

The Notices apply to transactions even if the property underlying the basket option or basket transaction are subject to Code § 1256. Code § 1256 provides for so-called "60/40" treatment, that is 60% long-term capital gain or loss and 40% short-term capital gain or loss, regardless of actual holding period. A taxpayer that would have received this treatment if it held that underlying property directly is unlikely to have entered into the basket transaction for tax-motivated reasons.

It is also unclear as to when a basket option or a basket transaction that references an index comprised of publicly-traded securities will be considered to be "actively traded personal property." In the proposed regulations that were promulgated under Code § 871(m), the IRS took an extremely narrow view of when an index will be considered to be publicly-traded. In the context of the basket option Notice, no parameters were offered as to when an index transaction will be considered to relate to actively traded personal property.

A very significant issue is whether options over partnership interests are encompassed by the Notice 2015-47. Specifically, hedge funds are frequently formed as entities taxable as partnerships and substantially all of their assets may be comprised of actively-traded personal property. An option over a partnership interest (or a number of partnership interests) could be treated as an option over actively-traded personal property under the aggregate theory of partnership taxation. Under the entity theory, options over non-traded partnership interests would be excluded from the Notice 2015-47. The position of the IRS on this issue is not clear.

Reporting Requirements and Penalties

Hedge funds and counterparty financial institutions that engaged in affected basket option contracts, basket contracts, or substantially similar transactions must file a Form 8886 disclosure with the Office of Tax Shelter Analysis under Treasury Regulation §1.6011-4 for each taxable year in which the party participated in the transaction. The information required to be disclosed in that Form includes: (1) the amount and nature of the expected tax treatment and expected tax benefits generated by the transaction for all affected years; (2) facts of each step of the transaction that relate to the expected tax benefits (including the amount and nature of the investment); and (3) the parties' participation in the transaction and all related transactions regardless of the year in which they were entered.

The original Notices required that all disclosures be filed by November 5, 2015 (120 days from the date of the Notices). The IRS, however, failed to recognize in the original Notices that Treasury Regulation § 1.6011-4(e) would have required an earlier filing deadline for transactions that should have been included on 2014 returns. The IRS, to allow taxpayers that have 2014 transactions to take advantage of the November

5, 2015 deadline, reissued both Notices on July 22, 2015 to treat 2014 transactions disclosed no later than November 5, 2015 as being timely disclosed.[9]

The counterparty financial institutions disclosure requirement is a significant detail in both Notices. In most circumstances, counterparties to reportable transactions generally have no reporting obligations under the disclosure regime. Applicable regulations, however, specifically permit the IRS to identify broader classes of parties required to file such disclosures. Here, both Notices specifically provide that counterparties will be subject to the reporting requirements. Accordingly, financial institutions must now assess their inventory of transactions from the affected years, make certain judgments regarding the characterization of those transactions, and file disclosures within a relatively short period of time. Open issues include whether synthetic prime brokerage arrangements, such as direct market access, and whether credit default swaps treated as options, constitute basket transactions.

Pursuant to the Notices, both hedge funds and counterparty financial institutions will also be subject to the reportable transaction penalty regime. The penalty for failing to make the requisite disclosures is 75 percent of the decrease in tax as a result of the transaction.[10] The maximum penalty under this regime for each listed transaction is $200,000 ($100,000 in the case of a natural person) and for other reportable transactions (including transactions of interest) is $50,000 ($10,000 in the case of a natural person). There is also a minimum penalty of $10,000 ($5,000 in the case of a natural person) per transaction.[11] Applicable rules require disclosure of payment of a penalty for participating in listed transactions.[12]

Certain counterparty financial institutions that quality as "Material Advisors" under Code § 6111 may have separate obligations under the reportable transaction regime. The Notices specify that Material Advisors who make a tax statement on or after January 2, 2011, with respect to transactions in effect on or after that date, have additional disclosure and list maintenance responsibilities for the transactions under Code §§ 6111 and 6112. The failure to make those disclosures or maintain lists of relevant advisees may also subject the Material Advisors to penalties.[13]

More Controversies on the Horizon

Historically, the IRS has used the reportable transaction disclosure regime not only as a warning to taxpayers (and material advisors) who are considering engaging in the transactions, but also as a means to collect preliminary information to aid in the future examination of taxpayers that have already implemented the structures. The disclosures, therefore, ultimately serve as a roadmap to IRS audits and controversies.

As noted above, Notice 2015-47 also identifies several substance-over-form based arguments that the IRS may assert in the future to challenge taxpayers' characterizations of basket option contracts. The IRS arguments are all derived from the notion that the taxpayer was the beneficial owner of the assets in the reference basket during the term of the option contract. Taxpayers should take note and, accordingly, anticipate increased IRS scrutiny of these transactions during future audits.

If you have any questions or need any assistance with the reporting responsibilities introduced by Notice 2015-47 and Notice 2015-48, please contact any of the following lawyers.

Brian W. Kittle
+1 212 506 2187
bkittle@mayerbrown.com

Mark H. Leeds
+1 212 506 2499
mleeds@mayerbrown.com

Shawn R. O'Brien
+1 713 238 2848
sobrien@mayerbrown.com

Brendan J. Sponheimer
+1 212 506 2489
bsponheimer@mayerbrown.com

Endnotes

[1] A.M. 2010-005

[2] See C.C.A. 201426025 (Jan. 14, 2014); C.C.A. 201432016 (Apr. 20, 2014).

[3] US Senate Permanent Subcommittee on Investigations, *Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits* (July 22, 2014).

[4] The IRS has been quoted as saying that the right to request variations in the basket is a crucial fact. If this fact is not present, a transaction should not be encompassed by the Notice. There does not seem to be any requirement that the party that is short the basket option be acting as an agent of the option holder.

[5] The IRS has been quoted as saying that this feature is not an essential fact to the conclusions in the Notice.

[6] All "Code §" references are to the Internal Revenue Code of 1986, as amended.

[7] Provided the statute of limitations for the year in which the basket option was open has not expired.

[8] Provided the statute of limitations for the year in which the basket contract was open has not expired.

[9] Taxpayers engaging in these transactions prospectively must also report the transactions on returns in the manner specified in Treas. Reg. §1.6011-4. This includes reporting the transactions on any amended return. Treas. Reg. §1.6011-4(e)(1).

[10] Code §6707A .

[11] These penalties apply on top of any accuracy-related penalties imposed under Code§§ 6662 or 6662A.

[12] *See* Code §6707A(e).

[13] Code §6707(a) and Code §6708(a). Promoter penalties may also apply to counterparty financial institutions in certain circumstances. *See* Code § 6700.