Sharpened Knives: US Internal Revenue Service Continues Slicing Through Barrier Options with CCA 201547004

By Mark Leeds

The efforts of the US Internal Revenue Service (the "IRS") to broadly challenge the purported federal income tax consequences of barrier and basket options has been gathering steam over the past few years.[1] In early November 2015, the IRS released Notice 2015-73 and Notice 2015-74.[2] These Notices refined the circumstances under which certain basket options would be considered to be listed transactions and transactions of interest and extended the deadlines for disclosure until January 19, 2016.[3]

The most recent development occurred on November 20, 2015, with the IRS release of CCA 201547004. In this Chief Counsel Advisory, the IRS has set forth its view of the proper federal income tax treatment of basket option transactions. The analysis provided by CCA 201547004 dovetails with the parameters set forth in Notice 2015-73 and Notice 2015-74. Under this analysis, if the taxpayer, or the taxpayer's designee, exercised discretion to vary the basket of assets underlying the option, the IRS will assert that the option holder was the owner of the underlying basket for federal income tax purposes.

Background

The facts provided in CCA 201547004 were as follows. A partnership (the "Taxpayer") comprised of the taxpayer, his wife and his wholly owned corporation (presumably an S corporation), purchased a long-dated cash-settled equity barrier call option (the "Option")[4] from "Bank." The property subject to the Option was a portfolio of various hedge fund limited partnership interests that could be, and were, changed over the life of the Option. The Option premium (not specified in the CCA) was deducted from the Option strike price, which increased periodically by a time value of money factor (LIBOR plus a spread). In addition, the Bank had the option to provide additional leverage to the Option (re-leveraging), which increased the strike price, and to remove leverage (de-leveraging), which decreased the strike price. If the value of the property subject to the Option approached the premium (referred to as the "barrier"), the Bank had the right to cancel the Option. The Taxpayer had the ability to prevent the Option from being cancelled by paying additional premium.[5] It is clear that Option was outstanding for at least eight years before it was terminated.

The basket of hedge funds that was the subject of the Option was determined by a portfolio manager ("Corporation 2"). Corporation 2 recommended various changes and the Bank made such changes to the composition of hedge funds over the duration of the Option transaction. Corporation 2 was owned by a business partner of the owner of the Taxpayer, who worked from offices in the home of the owner of the Taxpayer. During the initial year of the Option, Corporation 2 was not paid a fee for

its services. In the second year of the Option, the arrangement was amended and Taxpayer paid Corporation 2 a fee for its services. All changes that were recommended by Corporation 2 were approved by the Taxpayer. The Bank approved most (but not all) changes recommended by Corporation 2.

Apart from changes to the reference basket, two other changes were made to the Option. In the second year that the Option was outstanding, the Option was amended to provide for the payment of a portfolio management fee. In the fifth year that the Option was outstanding, it was amended to reduce the LIBOR spread payable to the Bank.

The hedge funds that were the subject of the Option were aware of the fact that Bank held interests in the hedge funds subject to the Option.

Beginning in the fourth year that the Option was outstanding, the Taxpayer made cash withdrawals from the Option. The withdrawals were not treated as partial terminations. The Taxpayer did not report any tax consequences from the withdrawals. Certain of the hedge funds invested in illiquid transactions (referred to as "side pockets"). The Taxpayer removed certain of these hedge funds from the Option. Given that Bank did not receive cash in respect of the side pockets in connection with its termination of its interest in the hedge fund (held as a hedge of its position in the Option), the Taxpayer maintained a continuing interest in that hedge fund until the side pocket was liquidated.

The Taxpayer obtained a tax opinion that the Option would be respected as an Option for federal income tax purposes and that the constructive ownership rules of Section 1260 of the Internal Revenue Code of 1986, as amended (the "Code") would not apply to the Option. The opinion erroneously assumed that the Option premium was payable in respect of the option privilege and was not deducted from the Option strike price.

The IRS Attack on the Treatment of the Option as an Option for Tax Purposes

The IRS first attacked the treatment of the Option as an option for federal income tax purposes by asserting that the Option was a disguised ownership arrangement in which the Taxpayer was the owner-in-fact of the hedge fund limited partnership interests. The IRS launched a two-prong attack in support of this position. First, the IRS found that there was no continuous offer and so the Taxpayer was economically compelled to exercise the Option. Second, the IRS found that "Taxpayer's ability to alter the Basket, through Corporation 2 … is not consistent with the notion that an option on property must reference specific property as a specified strike price."

Once the IRS found that these two factors supported the conclusion that the Option should not be treated as an option for federal income tax purposes, it concluded that the Taxpayer possessed the "benefits and burdens of ownership" of the hedge fund limited partnership interests. This conclusion supported the assertion that the Taxpayer should be treated as the owner of the underlying assets. Importantly, the IRS specifically held the fact "[t]hat Taxpayer was exposed to Bank's credit risk under the [Option] is not a significant countervailing factor." The IRS based this conclusion on its understanding that a bailor of securities to a deposit broker bears the risk of the deposit broker's solvency.

Of course, if the Bank did not hold a particular hedge fund referenced in the Option, it would have been anomalous to conclude that the Bank was acting as an agent of the Taxpayer in holding such asset. Accordingly, the IRS held that to the extent that Bank did not hold a hedge fund limited partnership interest referenced in the Option as a hedge, the Taxpayer would be

considered to have entered into a constructive ownership transaction under Code § 1260 with respect to such asset.

The IRS also asserted that there were other adverse federal income tax consequences from the Option transaction. First, it asserted that the changes to the Option in the second and fifth years (to add a portfolio management fee and reduce the spread) were material modifications to the Option. Even if the Option was respected as an option for federal income tax purposes, these material modifications triggered a deemed exchange of the pre-modified Option for the post-modified Option. This deemed exchange would have triggered recognition of all gain or loss inherent in the Option. The IRS also asserted that all changes to the reference hedge fund limited partnership interests also resulted in deemed taxable exchanges. Last, the IRS held that the cash withdrawals from the Option were taxable and "Taxpayer has offered no explanation as to how it could withdraw cash from its appreciated positions in the contracts without realizing taxable income."

As a closing matter, the IRS held that the change in treatment from deferral under an Option to deemed ownership under a custodial arrangement is a change in accounting method. Based upon prior similar assertions, it appears that the IRS is treating this change as such in order to avoid statute of limitations defenses that the Taxpayer may otherwise have enjoyed. In our prior writings, we have raised the issue as to whether this is a correct interpretation of the change in accounting method rules.[6]

Concluding Observations

It is clear that the IRS believes that the barrier/basket option transactions that it has uncovered in tax audits are abusive transactions that do not justify the tax reporting that taxpayers have employed in connection with these transactions. It is unusual to find such an extensive trail of IRS deliberations on a decision to draw a "line in the sand" to fight taxpayers (mostly individuals) who have engaged in such transactions. Taxpayers who have engaged in barrier/basket options transactions with features that closely resemble those in CCA 201547004 should consider changing their tax reporting pursuant to the provisions of Notice 2015-73 and Notice 2015-74 or prepare themselves for a protracted fight with IRS.[7]

For more information about the topics raised in this article, contact any of the following lawyers or your regular Mayer Brown contact.

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

Brian W. Kittle
+1 212 506 2187
bkittle@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. We chronicled these IRS efforts in October 2014 in the Mayer Brown Legal Update, "Like a Hot Knife Through Butter: the US Congress and Internal Revenue Service Pierce Straight Through Barrier Options," available at: https://www.mayerbrown.com/Like-a-Hot-Knife-Through-Butter-The-US-Congress-and-Internal-Revenue-Service-Pierce-Straight-Through-Barrier-Options-10-07-2014/

2. These Notices replaced and superseded Notice 2015-47 and Notice 2015-48, respectively.

3. Our initial observations on Notice 2015-47 and Notice 205-48 can be seen here: https://www.mayerbrown.com/Out-of-the-Money-The-IRS-Designates-Basket-Options-as-Listed-Transactions-and-Transactions-of-Interest-07-16-2010/

[4] In fact, there were two Options. The description in text will be simplified to refer to only one Option.

[5] These provisions are indeed complex. They are explained in more detail in our earlier writings.

[6] See footnote 1 above.

[7] Notice 2010-46.

Mayer Brown is a global legal services organization advising many of the world's largest companies, including a significant portion of the Fortune 100, FTSE 100, DAX and Hang Seng Index companies and more than half of the world's largest banks. Our legal services include banking and finance; corporate and securities; litigation and dispute resolution; antitrust and competition; US Supreme Court and appellate matters; employment and benefits; environmental; financial services regulatory & enforcement; government and global trade; intellectual property; real estate; tax; restructuring, bankruptcy and insolvency; and wealth management.

Please visit our web site for comprehensive contact information for all Mayer Brown offices. www.mayerbrown.com

IRS CIRCULAR 230 NOTICE. Any advice expressed herein as to tax matters was neither written nor intended by Mayer Brown LLP to be used and cannot be used by any taxpayer for the purpose of avoiding tax penalties that may be imposed under US tax law. If any person uses or refers to any such tax advice in promoting, marketing or recommending a partnership or other entity, investment plan or arrangement to any taxpayer, then (i) the advice was written to support the promotion or marketing (by a person other than Mayer Brown LLP) of that transaction or matter, and (ii) such taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

Mayer Brown comprises legal practices that are separate entities (the Mayer Brown Practices"). The Mayer Brown Practices are: Mayer Brown LLP and Mayer Brown Europe-Brussels LLP, both limited liability partnerships established in Illinois USA; Mayer Brown International LLP, a limited liability partnership incorporated in England and Wales (authorized and regulated by the Solicitors Regulation Authority and registered in England and Wales number OC 303359); Mayer Brown, a SELAS established in France; Mayer Brown Mexico, S.C., a sociedad civil formed under the laws of the State of Durango, Mexico; Mayer Brown JSM, a Hong Kong partnership and its associated legal practices in Asia; and Tauil & Chequer Advogados, a Brazilian law partnership with which Mayer Brown is associated. Mayer Brown Consulting (Singapore) Pte. Ltd and its subsidiary, which are affiliated with Mayer Brown, provide customs and trade advisory and consultancy services, not legal services.

This Mayer Brown publication provides information and comments on legal issues and developments of interest to our clients and friends. The foregoing is not a comprehensive treatment of the subject matter covered and is not intended to provide legal advice. Readers should seek specific legal advice before taking any action with respect to the matters discussed herein.

© 2015 The Mayer Brown Practices. All rights reserved.