

LB&I Virtual Library Transaction Unit

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Shelf		Crossover Considerations
Volume	73	Financial Instruments
Part	73.5	Financial Transactions
Chapter	73.5.8	Basket Transactions
Subchapter		

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Issue and Transaction Overview

Basket Transactions Notices 2015-73 and 2015-74

A Basket Transaction is a type of structured financial transaction in which a taxpayer attempts to defer and treat ordinary income and short-term capital gain as long-term capital gain through a contract denominated as an option, notional principal contract, forward contract or other derivative contract. Basket Transactions typically involve a hedge fund or a high net-worth individual.

Taxpayers take the position that if the Basket Transaction is held for more than one year, that the gain realized upon the disposition of the Basket Transaction is treated as long-term capital gain. Taxpayers effectively defer reporting income from the performance of the reference basket until the transaction terminates. Also, the character of the income generated by the reference basket, such as, short-term capital gain, interest income, dividend, and other ordinary periodic income from the performance of the reference basket is purportedly converted to long-term capital gain.

The IRS is concerned that taxpayers may be using Basket Transactions to inappropriately defer income recognition or convert ordinary income or short-term capital gain into long-term capital gain. In some cases, taxpayers also may be mischaracterizing the form of the transaction to avoid application of IRC 1260.

The IRS may challenge the taxpayer's position taken as part of these transactions under judicial doctrines, such as substance over form, or under IRC 1260, 1001, or other provisions of the Code, including, whether the taxpayer's method of accounting is permissible under IRC 446, and whether a 481(a) adjustment may be warranted. In addition, the IRS may challenge claimed tax benefits under IRC 871, 881 and 882 or other provisions of the Code, and assert failures to comply with reporting obligations associated with investments in passive foreign investment companies and withholding and reporting obligations under Chapters 3 and 4 of the Code.

The Treasury Department and the IRS issued two notices in 2015 to address these transactions, Notice 2015-73 and Notice 2015-74. The term "Basket Transaction" is used in this Practice Unit and refers to a transaction to which either Notice 2015-73 or Notice 2015-74 applies. The difference between the two notices is the type of contract used and the assets in the reference basket.

Issue and Transaction Overview (cont'd)

Basket Transactions Notices 2015-73 and 2015-74

Notice 2015-73 identifies a contract denominated as an option referencing actively traded personal property as a listed transaction.

Notice 2015-74 identifies a contract denominated as an option, notional principal contract, forward contract, or other derivative contract as a "Transaction of Interest." The referenced asset (or "reference basket") of the contract described in Notice 2015-74 may include:

1. Interests in entities that trade securities, commodities, foreign currency or similar property ("hedge fund interest"),
2. Securities,
3. Commodities,
4. Foreign Currency, or
5. Similar property (or positions in such property).

This Practice Unit describes the Basket Transaction. The Practice Unit also addresses the factual development needed and arguments to consider in developing the issue. The specific legal arguments that will apply in each case will depend on the facts and circumstances. We recommend consultation with Counsel.

Transaction and Fact Pattern

Basket Transactions Notices 2015-73 and 2015-74

Diagram of Transaction	Facts
<p style="text-align: center;">Basket Transaction</p> <p>The diagram illustrates the components and interactions of a basket transaction. It features three main entities: a Taxpayer (represented by a rectangle), a Counterparty (e.g., Bank) (represented by a pentagon), and a Reference Basket (e.g., Basket of Securities) (represented by a rounded rectangle). The Taxpayer provides an Upfront Cash Payment to the Counterparty and receives a Contract in return. Dashed arrows indicate that Managerial Decisions by either Taxpayer or Designee and the Taxpayer's Designee influence the composition of the Reference Basket. A vertical line connects the Counterparty to the Reference Basket, indicating its management of the assets.</p>	<ul style="list-style-type: none"> ▪ Taxpayer enters into a contract denominated as a derivative with a Counterparty (typically a bank) to receive a return based on the performance of the reference basket. ▪ Taxpayer (or Taxpayer's Designee) will determine the assets that comprise the reference basket. Taxpayer has the right to change the assets in the reference basket or request that Counterparty change the assets in the reference basket. ▪ Counterparty generally accepts all or nearly all of the changes requested by Taxpayer. ▪ When the basket contract is entered into, Taxpayer typically makes an upfront cash payment to Counterparty of between 10 and 40 percent of the value of the assets in the reference basket. ▪ Counterparty typically acquires substantially all of the assets in the reference basket and acquires and disposes of assets during the term of the contract when instructed by Taxpayer (or Designee). ▪ Counterparty generally supplies the additional cash required to purchase the assets in the reference basket.

Transaction and Fact Pattern (cont'd)

Basket Transactions Notices 2015-73 and 2015-74

Facts

- The assets in the reference basket would typically generate ordinary income if held directly by Taxpayer, and short-term gains and losses if purchases and sales of the assets were carried out directly by Taxpayer.
- The basket contract has a stated term of more than one year (or overlaps two of the taxpayer's taxable years).
- The amount that Taxpayer receives upon settlement of the basket contract is based on the performance of the assets in the reference basket.
- A common payout formula on the basket contract entitles Taxpayer to a return equal to the upfront payment, plus net basket gain or minus net basket loss.
- The net basket gain or net basket loss includes net changes in the values of the assets in the reference basket, together with interest, dividend, and other periodic income on the assets, reduced by Counterparty's fee (which includes counterparty's expenses and interest incurred in holding the assets in the reference basket) for its role in the transaction.
- The basket contract typically includes a provision automatically terminating the contract if the amount of the net basket loss reaches the amount of the upfront payment, giving Taxpayer a cash settlement amount of zero.
- The basket contract also may permit or require taxpayer to provide additional collateral or otherwise reduce risk in the reference basket if a specified level of risk is reached.
- The basket contract typically contains other safeguards to minimize the risk of loss to Counterparty. For example, Counterparty may terminate the basket contract if Taxpayer violates investment guidelines that are part of the contract.
- Counterparty may hold the rights associated with legal title to the assets and positions in the reference basket, including voting rights and the right to commingle, lend, pledge, transfer, or otherwise use the assets in the basket without notice to Taxpayer.
- Taxpayer takes the position that its short-term trading gains and interest, dividend, and other ordinary periodic income from the performance of the reference basket are deferred until the basket contract terminates and, if the basket contract is held for more than one year, that the entire gain is treated as long-term capital gain.

Summary of Potential Issues

Basket Transactions Notices 2015-73 and 2015-74

<u>Issue 1</u>	Whether the Basket Transaction is properly characterized as an option or other derivative (in accordance with the form and substance of the transaction) for federal income tax purposes?
<u>Issue 2</u>	If the contract is not properly characterized as an option or other derivative, whether the taxpayer is the beneficial owner of the reference basket for tax purposes?
<u>Issue 3</u>	If the taxpayer is not the beneficial owner of the reference basket, whether IRC 1260 applies to determine that the taxpayer had gain from constructive ownership of the reference basket?
<u>Issue 4</u>	Whether changes to the assets in the reference basket during the year result in taxable dispositions under IRC 1001 throughout the term of the contract?
<u>Issue 5</u>	Whether a change in accounting method under IRC 446 occurs when the Basket Transaction is no longer treated as an option or another derivative?

All Issues, Step 1: Initial Factual Development

Basket Transactions Notices 2015-73 and 2015-74

Taxpayers enter into derivative transactions with a reference basket for various reasons. If the taxpayer enters into the derivative with a reference basket and defers income recognition and converts short-term capital gain and ordinary income to long-term capital gain, the transaction may be a Basket Transaction. All relevant facts and circumstances must be considered when determining whether the form of a transaction is consistent with its substance.

Fact Element	Resources
<ul style="list-style-type: none"> ▪ Did the taxpayer disclose the transaction? 	<ul style="list-style-type: none"> ▪ Form 8886, Reportable Transaction Disclosure Statement (per Notice 2015-73 or Notice 2015-74)
<ul style="list-style-type: none"> ▪ Evidence that the taxpayer has participated in a Basket Transaction (e.g., derivative transactions that result in character conversion and income deferral and taxpayer exercises control over the reference basket). 	<ul style="list-style-type: none"> ▪ Form 8949, Sales and Other Dispositions of Capital Assets ▪ Schedule D ▪ Financial statements ▪ Other assets schedule ▪ Other investments schedule ▪ Facts developed during exam (including IDR and interviews)
<ul style="list-style-type: none"> ▪ Evidence that the taxpayer is not reporting income or losses from derivative transactions with a reference basket. 	<ul style="list-style-type: none"> ▪ Schedule D ▪ Facts developed during exam (including IDR and interviews)

Issue 1, Step 2: Review Potential Issues

Basket Transactions Notices 2015-73 and 2015-74

Issue 1

Whether the Basket Transaction is properly characterized as an option or other derivative (in accordance with the form and substance of the transaction) for federal income tax purposes?

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ An option has two characteristics:<ol style="list-style-type: none">1. a continuing offer to do an act, or to forebear from doing an act, which does not ripen into a contract until it is accepted; and2. an agreement to leave the offer open for a specified period of time.▪ The purpose of an option that references property is to provide the holder the opportunity to buy or sell specified property in the future at a defined price without the potential liability inherent in being obligated to buy or sell.▪ Situations where a contract does not function like an option:<ul style="list-style-type: none">– A contract that imposes a high cost upon an offeree (taxpayer) for failing to accept an offer will not be deemed an option if the cost effectively compels the offeree (taxpayer) to exercise.– If the terms of the contract (e.g., premium, cash settlement amount, other provisions) places the taxpayer in the same economic position as a party obligated to exercise the option or ensure from inception that the purported option would be "exercised."	<ul style="list-style-type: none">▪ GLAM AM 2010-005▪ CCA 201547004▪ <i>Saviano v. Commissioner</i>, 80 T.C. 955 (1983), aff'd 765 F.2d 643 (7th Cir. 1985)▪ <i>United States Freight Co. v. United States</i>, 422 F.2d 887 (Ct.Cl. 1970)▪ <i>Halle v. Commissioner</i>, 83 F.3d 649 (4th Cir. 1996)▪ Rev. Rul. 82-150

Issue 1, Step 2: Review Potential Issues (cont'd)

Basket Transactions Notices 2015-73 and 2015-74

[Issue 1](#)

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ Situations where a contract does not function like an option:<ul style="list-style-type: none">- If any Knock-Out provision ensures that the contract would never lapse unexercised.- Taxpayer's ability to alter the reference basket, while the contract remains open is inconsistent with the notion that an option on property must reference specific property at a defined price	

Issue 1, Step 3: Additional Factual Development

Basket Transactions Notices 2015-73 and 2015-74

[Issue 1](#)

Fact Element	Resources
<ul style="list-style-type: none">Analyze the terms of the Basket Transaction to determine whether they are consistent with the form of the transaction.	<ul style="list-style-type: none">Contracts, such as, confirmations, International Swap and Derivatives Association, Inc. (ISDA) Master Agreement, guarantees, relevant prime brokerage agreements, etc.
<ul style="list-style-type: none">Develop facts about the pricing of the Basket Transaction to determine whether it is consistent with the form of the transaction.	<ul style="list-style-type: none">Information Document RequestTaxpayer InterviewThird Party Contacts
<ul style="list-style-type: none">Determine whether the taxpayer (or the taxpayer's designee) has the ability to alter or control the basket of securities.	<ul style="list-style-type: none">ContractsInformation Document RequestTaxpayer Interview
<ul style="list-style-type: none">The parties' treatment of the transaction for book (if relevant) and tax purposes.	<ul style="list-style-type: none">Tax ReturnsInformation Document RequestFinancial StatementsThird Party Contacts

Issue 1, Step 3: Additional Factual Development

Basket Transactions Notices 2015-73 and 2015-74

[Issue 1](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Determine whether there was a deferral of income reporting and/or conversion of the character of the income reported.	<ul style="list-style-type: none">▪ Tax Returns▪ Information Document Request▪ Financial Statements▪ Third Party Contacts

Issue 1, Step 4: Develop Arguments

Basket Transactions Notices 2015-73 and 2015-74

[Issue 1](#)

Explanation of Adjustment	Resources
<p>The relevant considerations to determine the substance of the transaction will vary depending on the derivative at issue in the case, and may include (but are not limited to):</p> <ul style="list-style-type: none"> ▪ Does the contract provide the opportunity to a party to buy or sell specified property in the future at a defined price without being obligated to buy or sell? ▪ Does the contract holder control the specified property? ▪ Is the contract holder compelled to exercise rather than allowing the contract to lapse? ▪ Do the changes in the contract's value track the changes in value of the referenced assets at or near dollar for dollar? 	<ul style="list-style-type: none"> ▪ <i>Saviano v. Commissioner</i>, 80 T.C. 955 (1983), aff'd 765 F.2d 643 (7th Cir. 1985) ▪ <i>United States Freight Co. v. United States</i>, 422 F.2d 887 (Ct.Cl. 1970) ▪ <i>Halle v. Commissioner</i>, 83 F.3d 649 (4th Cir. 1996) ▪ <i>Progressive Corp. v. United States</i>, 970 F.2d 188 (6th Cir. 1992) ▪ <i>Commissioner v. Baertschi</i>, 412 F.2d 494 (6th Cir. 1969) ▪ GLAM AM 2010-005
<ul style="list-style-type: none"> ▪ Is the transaction priced according to the methodology typically used for the specific type of derivative? <ul style="list-style-type: none"> – Or, in contrast, is the transaction's price a fixed percentage of the reference basket? <p> CONSULTATION: Counsel should be consulted when determining whether the transaction is properly characterized as an option.</p>	<ul style="list-style-type: none"> ▪ GLAM AM 2010-005

Issue 2, Step 2: Review Potential Issues

Basket Transactions Notices 2015-73 and 2015-74

Issue 2

If the contract is not properly characterized as an option or other derivative, whether the taxpayer is the beneficial owner of the reference basket for tax purposes?

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ Whether the taxpayer has the benefits and burdens of ownership of the reference basket is determined based on the facts and circumstances of the case and no one factor is determinative. Factors that establish the taxpayer has the benefits and burdens of ownership of the reference basket include:<ul style="list-style-type: none">- Taxpayer bears the expenses- Taxpayer has the right to receive income from the referenced assets (such as, dividend income).- Taxpayer has the opportunity for gain and bears the loss from the Basket Transaction.- Taxpayer alters the reference basket including deciding which assets are bought and sold while the Basket Transaction remains open.- Taxpayer has voting rights over the assets within the reference basket.	<ul style="list-style-type: none">▪ GLAM AM 2010-005▪ CCA 201547004▪ <i>Pac. Coast Music Jobbers v. Comm'r</i>, 55 T.C. 866 (1971), aff'd 457 F.2d 1165 (5th Cir. 1972)▪ <i>Frank Lyon Co. v. United States</i>, 435 U.S. 561 (1978)▪ <i>Webber v. Comm'r</i>, 144 T.C. 324 (2015)▪ <i>Christoffersen v. United States</i>, 749 F.2d 513 (8th Cir. 1984)

Issue 2, Step 3: Additional Factual Development

Basket Transactions Notices 2015-73 and 2015-74

[Issue 2](#)

Fact Element	Resources
<ul style="list-style-type: none"> ▪ Consider the following factors (described in part on the previous slide) to determine if the taxpayer is the beneficial owner of the reference basket. This determination is based on the facts and circumstances and no one factor is determinative. <ul style="list-style-type: none"> – Which party bears the expenses? Which expenses are assumed by each party? What type of expenses are incurred? – Which party has the right to receive income from the referenced assets (such as, dividend income)? – Which party has the opportunity for gain from the Basket Transaction? – Which party bears the risk of loss related to the Basket Transaction? – Which party controls the activities within the reference basket? – Which party has the right to sell the assets within the reference basket? – Which party acquires an equity interest in the assets? – Which party has the right of possession of the reference basket? – Which party has voting rights over the assets within the reference basket? 	<ul style="list-style-type: none"> ▪ Contracts, such as, confirmations, ISDA agreements, guarantees, relevant prime brokerage agreements, etc. ▪ Information Document Request ▪ Taxpayer interview ▪ Third party contacts
<ul style="list-style-type: none"> ▪ Compensation received by each of the parties. <ul style="list-style-type: none"> – Was compensation received by each of the parties consistent with the form of the transaction? 	<ul style="list-style-type: none"> ▪ Contracts ▪ Information Document Request ▪ Taxpayer interview ▪ Third party contacts

Issue 2, Step 4: Develop Arguments

Basket Transactions Notices 2015-73 and 2015-74

[Issue 2](#)

Explanation of Adjustment	Resources
<ul style="list-style-type: none"> ▪ Determine whether the taxpayer is the beneficial owner of the reference basket for tax purposes. <ul style="list-style-type: none"> – Courts have held that an “deep in the money” option transfers ownership for tax purposes. – Courts have considered numerous factors indicative of the burdens and benefits of ownership. No one factor is determinative; courts accord varying weight to each factor depending on the type of property and transaction at issue. – Evaluate economics of transaction to determine if taxpayer obtained benefits and bore burdens from the Basket Transaction. Consider the factors listed under Step 3 for Issue 2 in this Practice Unit. 	<ul style="list-style-type: none"> ▪ GLAM AM 2010-00 ▪ <i>Halle v. Comm’r</i>, 83 F.3d 649 (4th Cir. 1996) ▪ <i>Progressive Corp. v. United States</i>, 970 F.2d 188 (6th Cir. 1992) ▪ <i>Calloway v. Comm’r</i>, 135 T.C. 26 (2010), aff’d 691 F.3d 1315 (11th Cir. 2012) ▪ <i>Anschutz v. Comm’r</i>, 135 T.C. 78 (2010), aff’d 664 F.3d 313 (10th Cir. 2011) ▪ <i>Webber v. Comm’r</i>, 144 T.C. 324 (2015) ▪ <i>Christoffersen v. United States</i>, 749 F.2d 513 (8th Cir. 1984)
 <p>CONSULTATION: Counsel should be consulted when determining whether the taxpayer is the beneficial owner.</p>	

Issue 3, Step 2: Review Potential Issues

Basket Transactions Notices 2015-73 and 2015-74

Issue 3

If the taxpayer is not the beneficial owner of the reference basket, whether IRC 1260 applies to determine that the taxpayer had gain from constructive ownership of the reference basket?

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ Constructive ownership transactions include but are not limited to:<ul style="list-style-type: none">- Taxpayer holds a long position under a notional principal contract with respect to the financial asset.- Taxpayer effectively enters into a forward or futures contract to acquire the financial asset.- Taxpayer is the holder of a call option and is the grantor of a put option with respect to a financial asset. Both the call and the put options have a substantially equal strike price and a substantially contemporaneous maturity dates.	<ul style="list-style-type: none">▪ IRC 1260▪ CCA 201547004

Issue 3, Step 3: Additional Factual Development

Basket Transactions Notices 2015-73 and 2015-74

[Issue 3](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ If the taxpayer is not the beneficial owner of the reference basket, do the facts support the application of IRC 1260?<ul style="list-style-type: none">– Does the taxpayer hold a long position under a notional principal contract with respect to the financial asset?– Did the taxpayer effectively enter into a forward or futures contract to acquire the financial asset?– If the taxpayer has gain from a constructive ownership transaction with respect to any financial asset and such gain would be treated as a long-term capital gain (without the application of IRC 1260), what amount of such gain exceeds the net underlying long-term capital gain?	<ul style="list-style-type: none">▪ IRC 1260▪ CCA 201547004
<ul style="list-style-type: none">▪ Were positions marked to market? If so, IRC 1260 does not apply.	<ul style="list-style-type: none">▪ IRC 1260(d)(2)

Issue 3, Step 4: Develop Arguments

Basket Transactions Notices 2015-73 and 2015-74

[Issue 3](#)

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ If the taxpayer is not the beneficial owner of the reference basket, does the taxpayer hold future or forward contracts or a position under a notional principal contract with respect to the assets underlying the reference basket?<ul style="list-style-type: none">▪ If so, and the referenced assets are “financial assets,” then IRC 1260 may apply.▪ Perform IRC 1260 analysis to determine whether, absent IRC 1260, the gains generated by the transaction would be treated as long-term capital gains.▪ Gains that are not attributable to net underlying long-term capital gains shall be treated as ordinary income by IRC 1260 and will be subject to an interest charge.	<ul style="list-style-type: none">▪ IRC 1260▪ CCA 201547004
 CONSULTATION: Counsel should be consulted when determining whether IRC 1260 applies to the Basket Transaction.	

Issue 4, Step 2: Review Potential Issues

Basket Transactions Notices 2015-73 and 2015-74

Issue 4

Whether changes to the assets in the reference basket during the year result in taxable dispositions under IRC 1001 throughout the term of the contract?

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ If the taxpayer can be viewed as having a series of separate contractual rights for each security within the reference basket, then each trade executed while the Contract is open is treated as a taxable sale under IRC 1001.▪ Alternatively, material amendments to a Basket Transaction and fundamental changes to the Basket Transaction's reference basket are deemed exchanges of the entire Basket Transaction.	<ul style="list-style-type: none">▪ IRC 1001▪ <i>Cottage Savings Ass'n v. Comm'r</i>, 499 U.S. 554 (1991)▪ GLAM AM 2010-005▪ Treas. Reg. 1.446-3(c)(1)(i) (last sentence)▪ CCA 201547004▪ Rev. Rul. 90-109

Issue 4, Step 3: Additional Factual Development

Basket Transactions Notices 2015-73 and 2015-74

[Issue 4](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Develop relevant facts to determine whether the taxpayer has separate contractual rights for each security within the reference basket.	<ul style="list-style-type: none">▪ Contracts▪ Information Document Request▪ Third party contacts
<ul style="list-style-type: none">▪ Develop relevant facts to determine whether there were material modifications to the reference basket.	<ul style="list-style-type: none">▪ Contracts▪ Information Document Request▪ Third party contacts
<ul style="list-style-type: none">▪ Analyze changes to the reference basket.	<ul style="list-style-type: none">▪ Detailed list of assets underlying the reference basket, including acquisitions and dispositions of assets underlying the reference basket

Issue 4, Step 4: Develop Arguments

Basket Transactions Notices 2015-73 and 2015-74

[Issue 4](#)

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ A sale is generally a taxable event. If the facts support that the Basket Transaction granted to the taxpayer a series of separate contractual rights for each asset underlying the reference basket, then an adjustment for each change to the separate contractual right within the reference basket may be a distinct taxable event pursuant to IRC 1001.	<ul style="list-style-type: none">▪ IRC 1001▪ GLAM AM 2010-005▪ <i>Cottage Savings Ass'n v. Comm'r</i>, 499 U.S. 554 (1991)▪ Treas. Reg. 1.446-3(c)(1)(i) (last sentence)
<ul style="list-style-type: none">▪ If there are material amendments and changes to the reference basket, the entire contract may be deemed exchanged in each year of the taxpayer's holding period of the Basket Transaction and result in an annual recognition event. <p> CONSULTATION: Counsel should be consulted when determining whether an IRC 1001 argument is applicable.</p>	<ul style="list-style-type: none">▪ CCA 201547004▪ <i>Cottage Savings Ass'n v. Comm'r</i>, 499 U.S. 554 (1991)

Issue 5, Step 2: Review Potential Issues

Basket Transactions Notices 2015-73 and 2015-74

Issue 5

Whether a change in accounting method under IRC 446 occurs when the Basket Transaction is no longer treated as an option or another derivative?

Explanation of Issue	Resources
<ul style="list-style-type: none"> ▪ If no accounting method has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income. 	<ul style="list-style-type: none"> ▪ IRC 446 ▪ Treas. Reg. 1.446-1(b)(1)
<ul style="list-style-type: none"> ▪ A change in method of accounting includes a change in the overall plan of accounting and/or a change in the treatment of a material item. ▪ A material item is any item that involves the proper time for inclusion of the item in income or the taking of a deduction. In determining whether a practice involves the proper time for inclusion of an item in income and/or taking of a deduction, the relevant question is generally whether the practice permanently changes the amount of taxable income over a taxpayer's lifetime or merely changes the tax year in which taxable income is reported. ▪ A method of accounting is adopted by a consistent pattern of treatment. A taxpayer adopts a permissible method of accounting by using it on the first return that reflects the overall method or the material item. A taxpayer adopts an impermissible method of accounting by using it on two or more consecutively-filed returns. 	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.446-1(e)(2)(ii)(a) ▪ Rev. Proc. 2002-18 ▪ <i>Primo Pants Co. v. Comm'r</i>, 78 T.C. 705 (1982) ▪ <i>General Motors Corp. v. Comm'r</i>, 112 T.C. 270 (1999) ▪ Rev. Proc. 91-31 ▪ Rev. Proc. 2015-13, Sec. 2.01(1) ▪ <i>Knight-Ridder Newspapers, Inc. v. U.S.</i>, 743 F.2d 781 (11th Cir. 1984)

Issue 5, Step 2: Review Potential Issues (cont'd)

Basket Transactions Notices 2015-73 and 2015-74

[Issue 5](#)

Explanation of Issue	Resources
<ul style="list-style-type: none">An examining agent who determines that a taxpayer's method of accounting is impermissible, or that a taxpayer changed its method of accounting without obtaining the consent of the Commissioner, may propose an adjustment with respect to that method only by changing the taxpayer's method of accounting.	<ul style="list-style-type: none">IRM 4.11.6.7. <i>Examining Officer's Guide, Procedures for Implementing Involuntary (Service-imposed) Change</i>Rev. Proc. 2002-18
<ul style="list-style-type: none">An examining agent changing a taxpayer's accounting method will ordinarily make the change in the earliest tax year under examination, or, if later, the first tax year the method is considered impermissible.	<ul style="list-style-type: none">CCA 201426025Rev. Proc. 2002-18, Sec. 5.04(1)

Issue 5, Step 2: Review Potential Issues (cont'd)

Basket Transactions Notices 2015-73 and 2015-74

[Issue 5](#)

Explanation of Issue	Resources
<ul style="list-style-type: none">▪ The IRC 481(a) adjustment shall be taken into account for those adjustments which are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.▪ The IRC 481(a) adjustment can include amounts attributable to tax years that are closed by the statute of limitations.▪ The net IRC 481(a) adjustment, whether positive or negative, is taken into account entirely in the year of change.	<ul style="list-style-type: none">▪ IRC 481(a)▪ <i>Suzy's Zoo v. Comm'r</i>, 114 T.C. 1 (2000), aff'd 273 F.3d 875 (9th Cir. 2001)▪ Treas. Reg. 1.481-1(a)▪ Rev. Proc. 2002-18, Sec. 5.04(3)

Issue 5, Step 3: Additional Factual Development

Basket Transactions Notices 2015-73 and 2015-74

[Issue 5](#)

Fact Element	Resources
<ul style="list-style-type: none">▪ Develop relevant facts to determine whether the taxpayer has a change in method of accounting. Reconcile proposed adjustment to lifetime income from the transaction.<ul style="list-style-type: none">- Is the adjustment a timing difference?	<ul style="list-style-type: none">▪ Information Document Request▪ Taxpayer's interview▪ Detailed list of assets underlying the reference basket, including acquisitions and dispositions
<ul style="list-style-type: none">▪ Determine the year of change.<ul style="list-style-type: none">- This should generally be the earliest year under examination.	
<ul style="list-style-type: none">▪ Determine the amount of 481(a) adjustment that is appropriate to recognize income that should be reported in the year of change.	<ul style="list-style-type: none">▪ Detailed list of assets underlying the reference basket, including acquisitions and dispositions since inception of the transaction

Issue 5, Step 4: Develop Arguments

Basket Transactions Notices 2015-73 and 2015-74

[Issue 5](#)

Explanation of Adjustment	Resources
<ul style="list-style-type: none">▪ A change in method of accounting occurs when the Basket Transaction is no longer treated as a derivative and the gains, losses, income or deductions associated with the Basket Transaction are no longer deferred.▪ The computation and recognition of an appropriate adjustment under IRC 481(a) is needed to eliminate the distortion that occurs when amounts are omitted or duplicated because of the accounting method change resulting from the IRS's proposed adjustments to properly report the Basket Transaction.	<ul style="list-style-type: none">▪ IRC 446▪ CCA 201426025▪ IRC 481(a)▪ <i>Suzy's Zoo v. Comm'r</i>, 114 T.C. 1 (2000), aff'd 273 F.3d 875 (9th Cir. 2001)▪ <i>Greiner v. United States</i>, 122 Fed.Cl. 139 (2015)
 CONSULTATION: Counsel should be consulted when proposing a change in method of accounting adjustment in a Basket Transaction case.	

Index of Referenced Resources

Basket Transactions Notices 2015-73 and 2015-74

IRC 481(a)

IRC 1001

IRC 1260

Treas. Reg. 1.446-1(e)(2)(ii)(a)

Treas. Reg. 1.446-3(c)(1)(i)

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CCA 201547004

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Rev. Rul. 82-150

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Rev. Proc. 2015-13, Sec. 2.01(1)

IRM 4.11.6.7. *Examining Officer's Guide, Procedures for Implementing Involuntary (Service-imposed) Change*

Anschutz v. Comm'r, 135 T.C. 78 (2010), aff'd 664 F.3d 313 (10th Cir. 2011)

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Index of Referenced Resources (cont'd)

Basket Transactions Notices 2015-73 and 2015-74

Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984)

Commissioner v. Baertschi, 412 F.2d 494 (6th Cir. 1969)

Cottage Savings Ass'n v. Comm'r, 499 U.S. 554 (1991)

Frank Lyon Co. v. United States, 435 U.S. 561 (1978)

General Motors Corp. v. Comm'r, 112 T.C. 270 (1999)

Greiner v. United States, 122 Fed.Cl. 139 (2015)

Halle v. Commissioner, 83 F.3d 649 (4th Cir. 1996)

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Pac. Coast Music Jobbers v. Comm'r, 55 T.C. 866 (1971), aff'd 457 F.2d 1165 (5th Cir. 1972)

Primo Pants Co. v. Comm'r, 78 T.C. 705 (1982)

Progressive Corp. v. United States, 970 F.2d 188 (6th Cir. 1992)

Saviano v. Commissioner, 80 T.C. 955 (1983), aff'd 765 F.2d 643 (7th Cir. 1985)

Suzy's Zoo v. Comm'r, 114 T.C. 1 (2000), aff'd 273 F.3d 875 (9th Cir. 2001)

United States Freight Co. v. United States, 422 F.2d 887 (Ct.Cl. 1970)

Webber v. Comm'r, 144 T.C. 324 (2015)

Training and Additional Resources

Basket Transactions Notices 2015-73 and 2015-74

Type of Resource	Description(s)
Articles	<ul style="list-style-type: none">▪ The U.S. Senate Permanent Subcommittee on Investigations (PSI) released a report titled <i>Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits</i> on July 22, 2014.
Databases / Research Tools	<ul style="list-style-type: none">▪ IRM 21.7.4.4.20.2 <i>Basket Option Contracts</i>▪ IRM 21.7.9.3.2 <i>Amended Return Filed Under Notice 2015-73 and Notice 2015-74</i>

Glossary of Terms and Acronyms

Term/Acronym	Definition
CCA	Chief Counsel Advice
Financial Asset	For purposes of the application of IRC 1260, “financial asset” means— (A) any equity interest in any pass-thru entity, and (B) to the extent provided in regulations— (i) any debt instrument, and (ii) any stock in a corporation which is not a pass-thru entity.
Forward Contract	Any contract to acquire in the future (or provide or receive credit for the future value of) any financial asset.
GLAM	Generic Legal Advice Memorandum
ISDA	International Swap and Derivatives Association, Inc.
Net Underlying Long-term Capital Gain	The aggregate net capital gain that the taxpayer would have had if the financial asset had been acquired for fair market value on the date such transaction was opened and sold for fair market value on the date such transaction was closed, and only gains and losses that would have resulted from the deemed ownership were taken into account.
Taxpayer’s Designee	Any person who is: (1) taxpayer’s agent under principles of agency law; (2) compensated by taxpayer for suggesting, requesting, or determining changes in the assets in the reference basket or the trading algorithm; or (3) selected by taxpayer to suggest, request, or determine changes in the assets in the reference basket or the trading algorithm.

Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
1441.00-00 1442.00-00	FDAP Withholding under Chapter 3	RPW/CU/P_08.1_03(2016)