

Part III – Administrative, Procedural, and Miscellaneous

Listing Notice – Basket Option Contracts

Notice 2015-47

The Treasury Department and the Internal Revenue Service (the “IRS”) are aware of a type of structured financial transaction, described below, in which a taxpayer attempts to defer income recognition and convert short-term capital gain and ordinary income to long-term capital gain using a contract denominated as an option contract. The Treasury Department and the IRS believe this transaction (the “basket option contract”) is a tax avoidance transaction. This notice identifies the basket option contract and substantially similar transactions as listed transactions for purposes of § 1.6011-4(b)(2) of the Income Tax Regulations and §§ 6111 and 6112 of the Internal Revenue Code (“the Code”). This notice also alerts persons involved in these transactions about certain responsibilities that may arise from their involvement with the basket option contract.

SECTION 1. BACKGROUND

In a basket option contract, a taxpayer (“T”), typically a hedge fund or a high net-worth individual, enters into a contract that is denominated as an option with a counterparty (“C”), typically a bank, to receive a return based on the performance of a notional basket of referenced actively traded personal property (the “reference basket”).

T or a designee named by T will either determine the assets that comprise the reference basket or design or select a trading algorithm that determines the assets. While the basket option contract remains open, T¹ has the right to request changes in the assets in the reference basket or the specified trading algorithm.² The terms of the basket option contract also permit C to reject certain changes requested by T to the assets in the reference basket. C, however, generally accepts all or nearly all of the changes requested by T.

When the basket option contract is entered into, T typically makes an upfront cash payment to C of between 10 and 40 percent of the value of the assets in the reference basket. To manage its risk under the basket option contract, C typically acquires substantially all of the assets in the reference basket at the inception of the contract and acquires and disposes of assets during the term of the contract either when T changes the assets in the reference basket or the trading algorithm provides for such changes. C generally supplies the additional cash required to purchase the assets in the reference basket. The assets in the reference basket would typically generate ordinary income if held directly by T, and short-term trading gains and losses if purchases and sales of the assets were carried out directly by T.

¹ When used in this sentence and subsequently with respect to identifying the assets in the reference basket or the trading algorithm, references to “T” include T’s designee.

² For purposes of this Notice, a change in the assets in the reference basket as a result of events outside of the control of T (such as a change in the notional securities in the reference basket due to a stock split or a merger of existing companies) is not treated as a change requested by T.

The basket option contract has a stated term of more than one year but contains provisions that in effect allow either party to terminate the contract at any time with proper notice. The amount that T receives upon settlement of the basket option contract is based on the performance of the assets in the reference basket. A common payout formula on the basket option contract entitles T to a return equal to its 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 a fee paid to compensate C for participating in and financing the transaction. The basket option contract typically includes a provision automatically terminating the contract if the value of the reference basket approaches the amount of the upfront payment. The basket option contract also may permit or require T to provide additional collateral or otherwise reduce risk in the reference basket if the reference basket reaches a specified level of risk.

The basket option contract typically contains other safeguards to minimize the economic risk to C. For example, C may terminate the basket option contract if T violates investment guidelines that are part of the contract. C typically holds rights associated with the legal title to the assets and positions in the reference basket, including voting rights and the rights to commingle, lend, or otherwise use those assets without notice to T.

T takes the position that short-term gains and interest, dividend, and other ordinary periodic income from the performance of the reference basket are deferred

until the basket option contract terminates and, if the basket option contract is held for more than one year, that the entire gain is treated as long-term capital gain.

The Treasury Department and the IRS are concerned 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. In some cases, taxpayers are mischaracterizing a transaction as an option to avoid application of § 1260, U.S. tax liability under §§ 871 and 881, and withholding and reporting obligations under Chapters 3 and 4 of the Code. Therefore, the Treasury Department and the IRS are identifying basket option contracts and substantially similar transactions as listed transactions.

The IRS may assert one or more arguments to challenge the parties' tax characterization of a basket option contract, including: (1) that C, in substance, holds the assets in the reference basket as an agent of T and that T is the beneficial owner of the assets for tax purposes; (2) that the basket option contract is not an option for tax purposes; (3) that changes to the assets in the reference basket during the year materially modify the basket option contract and result in taxable dispositions of the contract under § 1001 throughout the term of the contract; and (4) that T actually owns separate contractual rights with respect to each asset in the reference basket such that each change to the assets in the basket results in a taxable disposition of a contractual right under § 1001 with respect to the asset affected by the change. The IRS may assert other arguments supporting the conclusion that T is the beneficial owner of the assets in the reference basket for tax purposes.

SECTION 2. LISTED TRANSACTIONS

.01 Transactions Identified as Listed Transactions

A transaction is the same as, or substantially similar to, the transaction identified in this notice if (1) the transaction is denominated as an option contract; (2) substantially all of the assets in the reference basket primarily consist of actively traded personal property as defined under § 1.1092(d)-1(a); (3) the purchaser of the option or the purchaser's designee either have the right to (a) determine the assets in the reference basket both at the inception of the transaction and periodically over the term of the transaction or (b) select or use a specified trading algorithm under its control to determine the assets in the reference basket; and (4) the purchaser of the option, the purchaser's designee, or the specified trading algorithm actually changes one or more of the assets in the reference basket during the term of the basket option contract.

.02 Effective Date

Transactions in effect on or after January 1, 2011, that are the same as, or substantially similar to, the transaction described in this notice are identified as "listed transactions" for purposes of § 1.6011-4(b)(2) and §§ 6111 and 6112 effective July 8, 2015.

Persons engaged in transactions in effect on or after January 1, 2011, must disclose the transactions as described in § 1.6011-4 for each taxable year in which the taxpayer participated in the transactions, provided that the period of limitations for assessment of tax had not ended on or before July 8, 2015. Material advisors who make a tax statement on or after January 1, 2011, with respect to transactions in effect

on or after January 1, 2011, have disclosure and list maintenance obligations under §§ 6111 and 6112. See §§ 301.6111-3, 301.6112-1.

Independent of their classification as listed transactions, transactions that are the same as, or substantially similar to, the transaction described in this notice may already be subject to the requirements of §§ 6011, 6111, or 6112, or the regulations thereunder. If a transaction is identified as a listed transaction under section 2.01 of this notice and as a transaction of interest in Notice 2015-48, the transaction is identified as a listed transaction. Persons satisfying the disclosure requirements for a listed transaction under this notice are deemed to have satisfied the disclosure requirements under Notice 2015-48.

.03 Participation

Under § 1.6011-4(c)(3)(i)(A), for each year in which a transaction described in this notice (basket option contract) is open, the following parties are treated as participating in the listed transaction identified in this notice: (i) the purchaser of the basket option contract, (ii) if the purchaser of the basket option contract is a partnership, any general partner of the purchaser, (iii) if the purchaser of the basket option contract is a limited liability company, any managing member of the purchaser, and (iv) the counterparty to the basket option contract.

.04 Time for Disclosure

For rules regarding the time for providing disclosure of a transaction described in this notice, see § 1.6011-4(e) and § 301.6111-3(e). For purposes of the transactions described in this notice, the 90-day period provided in § 1.6011-4(e)(2) for certain disclosures is extended to 120 days. However, if, under § 1.6011-4(e), a taxpayer is

required to file a disclosure statement with respect to the listed transaction described in this notice after July 8, 2015, and prior to November 5, 2015, that disclosure statement will be considered to be timely filed if the taxpayer alternatively files the disclosure with the Office of Tax Shelter Analysis by November 5, 2015.

.05 Material Advisor Threshold Amount

For the threshold amounts necessary to become a material advisor to a listed transaction, see § 301.6111-3(b)(3)(i)(B).

.06 Penalties and Period of Limitations

Persons required to disclose these transactions under § 1.6011-4 who fail to do so may be subject to the penalty under § 6707A. Persons required to disclose these transactions under § 6111 who fail to do so may be subject to the penalty under § 6707(a). Persons required to maintain lists of advisees under § 6112 who fail to do so (or who fail to provide such lists when requested by the IRS) may be subject to the penalty under § 6708(a). In addition, the IRS may impose other penalties on parties involved in these transactions or substantially similar transactions, including the accuracy-related penalty under §§ 6662 or 6662A. Persons required to disclose these transactions under § 1.6011-4 who fail to do so may be subject to an extended period of limitations under § 6501(c)(10).

The Treasury Department and the IRS recognize that some taxpayers may have filed tax returns taking the position that they were entitled to the purported tax benefits of the type of transaction described in this notice. These taxpayers should take appropriate corrective action and ensure that their transactions are disclosed properly.

SECTION 3. DRAFTING INFORMATION

The principal authors of this notice are Anna H. Kim and Robert A. Martin of the Office of Associate Chief Counsel (FIP). For further information regarding this notice, contact Ms. Kim at (202) 317-4431 or Mr. Martin at (202) 317-4455 (not a toll-free call).