

## PART III – Administrative, Procedural, and Miscellaneous

### Transaction of Interest - Basket Contracts

#### Notice 2015-48

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 may attempt to convert short-term capital gain and ordinary income to long-term capital gain through a contract denominated as an option, notional principal contract, forward contract, or other derivative contract. The Treasury Department and the IRS believe this transaction (the “basket contract”) has a potential for tax avoidance or evasion but lack enough information to determine whether the transaction should be identified specifically as a tax avoidance transaction. This notice identifies the basket contract and substantially similar transactions as transactions of interest for purposes of § 1.6011-4(b)(6) 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 these transactions.

#### SECTION 1. TRANSACTION OF INTEREST

##### .01 Description

In a basket contract, a taxpayer (“T”) enters into a contract with a counterparty (“C”) to receive a return based on the performance of a notional basket of referenced

assets (the “reference basket”). The assets that comprise the reference basket may include (1) interests in entities that trade securities, commodities, foreign currency, or similar property (“hedge fund interests”), (2) securities, (3) commodities, (4) foreign currency, or (5) similar property (or positions in such property). 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 contract remains open, T<sup>1</sup> has the right to request changes in the assets in the reference basket or the specified trading algorithm.<sup>2</sup> The terms of the basket 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 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 contract, C typically acquires all or 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

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<sup>1</sup> 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.

<sup>2</sup> 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.

income if held directly by T, and short-term gains and losses if purchases and sales of the assets were carried out directly by T.

The basket contract has a stated term of more than one year or overlaps two of T's taxable years but contains provisions that in effect allow either party to terminate the contract at any time during the stated contract term with proper notice. The amount that T receives upon settlement of the basket contract is based on the performance of the assets in the basket. A common payout formula on the basket contract entitles T to receive back 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 basket, together with interest, dividend, and other periodic income on the assets, reduced by C's fee for its participation 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 T a cash settlement amount of zero. The basket contract also may permit or require T to provide additional collateral or otherwise reduce risk in the basket if a specified level of risk is reached.

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

T takes the position that T's short-term trading gains and interest, dividend, and other ordinary periodic income from the performance of the 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.

The Treasury Department and the IRS are concerned that taxpayers may be using a basket contract to inappropriately defer income recognition and convert ordinary income and 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 § 1260, to avoid U.S. tax liability under §§ 871, 881, and 882, to avoid tax or reporting obligations associated with investments in passive foreign investment companies, and to avoid withholding and reporting obligations under Chapters 3 and 4 of the Code. Therefore, the Treasury Department and the IRS are identifying the basket contract and substantially similar transactions as transactions of interest. The Treasury Department and the IRS believe that the use of a basket contract to claim the tax treatment specified herein may be improper.

.02 Effective Date

Transactions entered into on or after November 2, 2006, that are the same as, or substantially similar to, the transactions described in this notice, and in effect on or after January 1, 2011, are identified as transactions of interest for purposes of § 1.6011-4(b)(6) and §§ 6111 and 6112 effective July 8, 2015. Persons engaged in transactions entered into on or after November 2, 2006, and 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 transactions of interest, 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 Notice 2015-47, and as a transaction of interest under this notice, the transaction is identified as a listed transaction. Persons satisfying the disclosure requirements for a listed transaction under Notice 2015-47 are deemed to have satisfied the disclosure requirements under this notice.

When the Treasury Department and the IRS have gathered enough information to make an informed decision as to whether these transactions are a tax avoidance type of transaction, the Treasury Department and the IRS may take one or more administrative actions, including removing the transactions from the transactions of interest category in published guidance, designating the transactions as a listed transaction, or providing a new category of reportable transactions. In the interim, in appropriate situations, the IRS may challenge the taxpayer's position taken as part of these transactions under §§ 1260, 1001, or other provisions of the Code or under judicial doctrines, such as substance over form.

### .03 Participation

Under § 1.6011-4(c)(3)(i)(E), for each year in which a transaction described in this notice (basket contract) is open, the following parties are treated as participating in the transaction of interest identified in this notice: (i) the purchaser of the basket

contract, (ii) if the purchaser of the basket contract is a partnership, any general partner of the purchaser, (iii) if the purchaser of the basket contract is a limited liability company, any managing member of the purchaser, and (iv) the counterparty to the basket 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 transaction of interest 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

The threshold amounts are the same as those for listed transactions. See § 301.6111-3(b)(3)(i)(B).

.06 Penalties

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.

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 2. 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).