

PART III – Administrative, Procedural, and Miscellaneous

Transaction of Interest - Basket Contracts

Notice 2015-74

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. Notice 2015-48, 2015-30 I.R.B. 77, identified 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”). Notice 2015-48 also alerted persons involved in these transactions about certain responsibilities that may arise from their involvement with these transactions.

Commenters expressed concern that difficulty in identifying transactions that are the same as, or substantially similar to, the transaction described in Notice 2015-48 may cause taxpayers to file disclosures for transactions that are not intended to be treated

as transactions of interest at this time. This notice revokes Notice 2015-48. Section 2 of this notice provides additional details on the types of transactions that are the same as or substantially similar to the transaction described in this notice, and thus transactions of interest for purposes of § 1.6011-4(b)(6) and §§ 6111 and 6112 of the Code. Section 3.06 of this notice provides procedures for taxpayers to change their method of accounting for transactions within the scope of this notice.

Section 2.04 of this notice more specifically describes the tax benefits that identify the transaction described in this notice as a transaction of interest. No inference is intended regarding the appropriate treatment of transactions not described in this notice. The IRS may challenge, including by asserting judicial doctrines, claimed tax benefits under §§ 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.

SECTION 1. BACKGROUND

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, T¹ has the right to change the assets in the reference basket, request that C change the assets in the reference basket, change the trading algorithm, or request that C change the trading algorithm (collectively, discretion).² The terms of the basket contract may permit C to reject certain changes requested by T to the assets in the reference basket or the trading algorithm. 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 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 reference basket. A common payout formula on the basket contract

¹ When used in this sentence and subsequently with respect to changing or requesting changes to the assets in the reference basket or the trading algorithm, references to "T" include T's designee as defined in section 2.02 of this notice.

² See also section 2.03 of this notice.

entitles T 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 C's fee 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 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 reference 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 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 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 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.

The Treasury Department and the IRS are concerned that taxpayers may be using a basket contract 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 § 1260.

Therefore, the Treasury Department and the IRS are identifying transactions described in section 2 of this notice 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.

SECTION 2. TRANSACTIONS OF INTEREST

.01 Transactions Identified as Transactions of Interest

A transaction is the same as, or substantially similar to, the transaction of interest identified in this notice only if: (1) T enters into a contract with C to receive a return based on the performance of the reference basket; (2) the basket contract has a stated term of more than one year or overlaps two of T's taxable years; (3) T or T's designee (as defined in section 2.02 of this notice) has exercised discretion (as defined in section 2.03 of this notice) to change (either directly or through a request to C) the assets in the reference basket or the trading algorithm; and (4) T's tax return for a taxable year ending on or after January 1, 2011,³ reflects a tax benefit described in section 2.04 of this notice. Notwithstanding any other provision in this notice, a transaction is not the same as, or substantially similar to, the transaction of interest identified in this notice if the transaction is described in section 2.05 of this notice.

.02 Designee

For purposes of this notice, any reference to T having the right to change or request changes to the assets in the reference basket or the trading algorithm includes T's designee as defined in this section 2.02. T's designee is any person who is: (1) T's agent under principles of agency law; (2) compensated by T for suggesting, requesting,

³ See section 3.01 for disclosure requirements.

or determining changes in the assets in the reference basket or the trading algorithm, or (3) selected by T to suggest, request, or determine changes in the assets in the reference basket or the trading algorithm. A person will not, however, be treated as compensated or selected by T as a result of: (1) the person's position as an investment advisor, officer, or employee of an entity, such as a mutual fund, when the entity's publicly offered securities are included in the reference basket; or (2) the person's use of, the person's payment of a licensing fee for the right to use, or the person's authority to suggest, request, or determine changes in the assets included in (y) a widely used and publicly quoted index that is based on objective financial information or (z) an index that tracks a broad market or a market segment.

.03 Discretion

For purposes of this notice, T will not be treated as having discretion to change (either directly or through a request to C) the assets in the reference basket or the trading algorithm if changes in the assets in the reference basket or the trading algorithm are made according to objective instructions, operations, or calculations that are disclosed at the inception of the transaction (the rules) and T does not have the right to alter or amend the rules during the term of the transaction or to deviate from the assets in the reference basket or the trading algorithm selected in accordance with the rules. For these purposes, T will not be treated as having authority to alter or amend the rules solely because T has the authority to: (1) exercise routine judgment in the administration of the rules provided, however, that such routine judgment does not include deviations or alteration to the rules that are designed to improve the financial performance of the reference basket; (2) correct errors in the implementation of the

rules or calculations made pursuant to the rules; or (3) make an adjustment to respond to an unanticipated event outside of T's control, such as a stock split, merger, listing or delisting, nationalization, or insolvency of a component of a basket, a disruption in the financial markets for specific assets or in a particular jurisdiction, regulatory compliance requirement, force majeure, or any other unanticipated event of similar magnitude and significance.

.04 Tax Benefit

For purposes of this notice, a tax benefit is a deferral of income into a later taxable year or a conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss.

.05 Excluded Contracts

A transaction is not the same as, or substantially similar to, the transaction described in this notice if: (1) the contract is traded on (a) a national securities exchange that is regulated by the Securities and Exchange Commission or a domestic board of trade regulated by the Commodity Futures Trading Commission, or (b) a foreign exchange or board of trade that is subject to regulation by a comparable regulator; or (2) the contract is treated as a contingent payment debt instrument under § 1.1275-4 (including a short-term contingent payment debt instrument) or a variable rate debt instrument under § 1.1275-5. With respect to T, a transaction is not the same as, or substantially similar to, the transaction described in this notice unless T's tax return for a taxable year ending on or after January 1, 2011,⁴ reflects a tax benefit of the transaction that is described in section 2.04 of this notice. With respect to C, a transaction is not

⁴ See section 3.01 for disclosure requirements.

the same as, or substantially similar to, the transaction described in this notice if: (1) T represents to C in writing under penalties of perjury that T's tax return has not and will not reflect a tax benefit described in section 2.04 of this notice in any taxable year ending on or after January 1, 2011,⁵ or (2) C has established that T is a nonresident alien that is not engaged in a U.S. trade or business or a foreign corporation that is not engaged in a U.S. trade or business by obtaining a valid withholding certificate from the beneficial owner of the payments made or to be made under the basket contract (W-8BEN, W-8BEN-E, or W-8EXP), or in the case of payments made outside of the U.S. on offshore obligations, by obtaining documentary evidence as described in Treas. Reg. § 1.1441-1(c)(17).

SECTION 3. RULES OF APPLICATION

.01 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 as of October 21, 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 October 21, 2015. Material advisors who make a tax statement on or after January 1, 2011, with respect to

⁵ See section 3.01 for disclosure requirements.

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 2015-73, 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 2015-73 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.

.02 Participation

Under § 1.6011-4(c)(3)(i)(E), for each year in which a transaction described in this notice (basket contract) is open, only the following parties are treated as participating in the transaction of interest identified in this notice: (1) the purchaser of

the basket contract, (2) if the purchaser of the basket contract is a partnership, any general partner of the purchaser, (3) if the purchaser of the basket contract is a limited liability company, any managing member of the purchaser, and (4) the counterparty to the basket contract.

.03 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). 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 October 21, 2015, and prior to January 19, 2016, 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 January 19, 2016.

.04 Material Advisor Threshold Amount

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

.05 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.

.06 Requests for a Change in Method of Accounting

(1) Background. Section 446(e) and § 1.446-1(e) provide that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446-1(e)(3)(i) provides that, to obtain the Commissioner's consent to an accounting method change, a taxpayer must file a Form 3115, Application for Change in Accounting Method, during the taxable year in which the taxpayer desires to make the proposed change. Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e).

Rev. Proc. 2015-13, 2015-5 I.R.B. 419, as clarified and modified by Rev. Proc. 2015-33, 2015-24 I.R.B. 1067, provides the procedures for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes. Under the non-automatic change procedures of Rev. Proc. 2015-13, a taxpayer generally must file a Form 3115 during the year of change.

When a taxpayer computes its taxable income using a method of accounting that differs from the method of accounting used during the preceding taxable year, a § 481(a) adjustment is required to prevent the duplication or omission of taxable income. Except as otherwise provided in Rev. Proc. 2015-13, a letter ruling to the taxpayer, or in other guidance published in the Internal Revenue Bulletin, section 7.03 of Rev. Proc. 2015-13 provides that a positive § 481(a) adjustment is taken into account ratably over four taxable years, and a negative § 481(a) adjustment is taken into account in one taxable year. A taxpayer that timely files a Form 3115 under Rev. Proc. 2015-13 generally receives audit protection for taxable years prior to the year of change, as provided in section 8 of Rev. Proc. 2015-13.

Section 11.02 of Rev. Proc. 2015-13 states that the national office will deny any Form 3115 requesting consent to make a change in method of accounting in any situation in which the national office determines that permitting the requested change in method of accounting would not clearly reflect income or would otherwise not be in the interest of sound tax administration. As part of this determination, the national office will consider whether the change in method of accounting would clearly and directly frustrate compliance efforts of the IRS in administering the income tax laws. The national office will consider all the facts and circumstances and exercise discretion under §§ 446(e) and 481(c) in a manner that generally minimizes distortions of income across taxable years, as well as on an annual basis.

Rev. Rul. 90-38, 1990-1 C.B. 57, provides that, if a taxpayer uses an erroneous method of accounting for two or more consecutive taxable years, the taxpayer has adopted a method of accounting. The ruling further provides that a taxpayer may not,

without the Commissioner's consent, retroactively change from an erroneous to a permissible method of accounting by filing an amended return. See also Rev. Proc. 2015-13, section 2.03(1).

(2) In general.⁶

(a) Deferral transaction. A taxpayer that wants to change a method of accounting for a transaction described in this notice, for a transaction from which the taxpayer's only tax benefit is a deferral of income into a later taxable year (a "deferral transaction") may change its method of accounting for the deferral transaction by either: (1) filing amended returns in accordance with section 3.06(3) of this notice, or (2) if eligible, requesting a change in method of accounting under the non-automatic change procedures of Rev. Proc. 2015-13 subject to the rules provided in section 3.06(4) of this notice.

(b) Conversion transaction. The IRS has determined that it is not in the interest of sound tax administration to permit a prospective change in method of accounting for a transaction within the scope of this notice that involves the conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss (a "conversion transaction"). Accordingly, the IRS will not process applications for any changes in method of accounting filed under the non-automatic change procedures of Rev. Proc. 2015-13 for a conversion transaction within the scope of this notice. A taxpayer may, however, change its method of accounting for a conversion transaction within the scope of this notice by filing an amended return in accordance with section 3.06(3) of this notice.

⁶ Nothing in this notice may be construed as identifying whether the taxpayer's treatment of any particular aspect of a transaction described in this notice is a method of accounting.

(3) Change in method of accounting by filing amended returns.

(a) In general. In accordance with § 1.446-1(e)(3)(ii) and Rev. Rul. 90-38, consent is hereby granted for any taxpayer that has engaged in a transaction within the scope of this notice, to file amended returns to retroactively change from an impermissible method of accounting to a permissible method of accounting for the transaction. This consent is granted only if the taxpayer files such amended returns using a permissible method of accounting for such transactions for the first taxable year in which the taxpayer used the impermissible method of accounting for any such transaction (or if the period of limitations has expired for such taxable year, for the first taxable year for which the period of limitations has not expired) and for each subsequent taxable year in which the taxpayer's use of the impermissible method of accounting for these transactions affected the taxpayer's taxable income. If the period of limitations has expired for the first taxable year in which a taxpayer used the impermissible method of accounting for these transactions and the taxpayer files amended returns pursuant to this notice, the amended return for the first taxable year for which the period of limitations has not expired must include the entire amount of the § 481(a) adjustment, whether positive or negative, attributable to the change in accounting method as ordinary in character. The terms, conditions, and administrative procedures of Rev. Proc. 2015-13, as clarified and modified by Rev. Proc. 2015-33, do not apply to a taxpayer changing its method of accounting by amending its Federal income tax returns under section 3.06(3) of this notice.

(b) Manner of making change.

A taxpayer filing amended returns under this notice must comply with the requirements of § 1.6011-4 including, but not limited to, attaching to the amended return any disclosure statements that may be required in accordance with § 1.6011-4(a) and (e). In addition, a taxpayer filing an amended return under this section 3.06(3)(b) must write “FILED UNDER NOTICE 2015-74” at the top of any amended paper return or, with respect to any amended return submitted electronically, must indicate “FILED UNDER NOTICE 2015-74.”

(4) Filing Form 3115 under Rev. Proc. 2015-13 for a deferral transaction. A taxpayer that wants to change its method of accounting under Rev. Proc. 2015-13 for a deferral transaction described in this notice, must use the non-automatic change procedures in Rev. Proc. 2015-13. Consistent with the discretion granted to the National Office under sections 7.01 and 7.03 of Rev. Proc. 2015-13, a taxpayer making a change in method of accounting under Rev. Proc. 2015-13 to the method described in this notice must take into account the entire amount of a positive § 481(a) adjustment in the taxable year of change.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Notice 2015-48 is revoked.

SECTION 5. DRAFTING INFORMATION

The principal authors of this notice are Orla J. O’Connor and Robert A. Martin of the Office of the Associate Chief Counsel (Financial Institutions and Products). For further information regarding this notice, contact Ms. O’Connor at (202) 317-6367 or Mr. Martin at (202) 317-4455 (not a toll-free call).