

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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to: Area Counsel (Heavy Manufacturing & Transportation)
(Large Business & International)
Attn: Philip Yarberough

from: Associate Chief Counsel
(Financial Institutions & Products)

subject: Section 475(f) and Basket Transactions

This Chief Counsel Advice responds to your request for assistance dated January 16, 2014. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
Trading Entity Y	=
Entity Z	=
Person 1	=
Year 1	=
Year 2	=
Years 3-through 6	=
Year 7	=
Year 8	=
Bank	=
basket transactions	=
Date 1	=
Date 2	=
<u>x</u> percent	=
<u>y</u> percent	=

IDR Response	=
CCA 1	=
amount 1	=
amount 2	=
amount 3	=
amount 4	=
amount 5	=
amount 6	=
amount 7	=
amount 8	=

ISSUES

1. Whether the basket transactions at issue were subject to a mark-to-market method of accounting under section 475(f)? If so, please address how section 475 would apply under the following alternative arguments.

(a) Please address this issue under the primary theory of this case in which the basket transactions are recharacterized and not treated as options, but rather the Taxpayer is treated as the beneficial owner of the underlying securities in the baskets.

(b) In the alternative, if for example a court were to find that the recharacterization of the option treatment is not appropriate, please address how the “options” would be treated under section 475.

(c) Also, if a court were to find under the primary argument or the alternative argument that neither position resulted in a change in method of accounting, can the character of the gains and losses reported by Taxpayer under the open transaction method be treated as ordinary under sections 475(d) and (f)(1)(d)?

CONCLUSIONS

1. As discussed in the previously issued CCA 1, the change for Taxpayer under the recharacterized basket transactions (going from option transactions to the underlying securities traded under the basket transaction agreement), results in Taxpayer going from an open transaction method of accounting to a section 475 method of accounting. This is a change in method of accounting for Taxpayer, and a section 481(a) adjustment is appropriate. We also think that same rationale applies to the method change for the alternative argument raised in Issue 1(b). Taxpayer had a whole class of securities (i.e., “options”) that should have been marked under section 475 and it did not mark any of these basket transactions under section 475. This is a material item, not a correction of an error, and therefore a method change. Discussed

below is the application of the section 475 method of accounting to the various scenarios described in Issues 1(a)-(c).

(a) Taxpayer made a section 475(f) election so it must report all of its securities described in section 475(c)(2) under the section 475 mark-to-market method of accounting. The recharacterized basket transactions have underlying securities that are subject to section 475. Taxpayer has not established that the basket transactions or the recharacterized transactions were excepted from marking under section 475(f)(1)(B). Therefore, section 475(f) is the appropriate method of accounting to be used for the recharacterized basket transactions, and all gains and losses are ordinary.

(b) We note that it is Service position that these transactions are not “options” and should not be treated as such. That said, you have now asked what the results would be under section 475 if the basket transactions were not recast. The tax treatment would be the same under section 475 for the recharacterized transactions or if these securities were treated as “options.” Because these “options” are securities under section 475(C)(2)(E), they are required to be marked to market. Taxpayer has not established that these securities are not held in connection with its trading business therefore they are not excepted from marking under section 475(f)(1)(B).

(c) If a court rejects our change in method of accounting argument, another alternative argument can be used to treat the reported long term capital gains as ordinary. Because section 475 is the appropriate method of accounting to be used for these transactions, under section 475(d)(3)(A) and section 475(f)(1)(D), any gains or losses reported under the open transaction method can be recharacterized as ordinary gains or losses. However, we cannot say for certain that the Service will get all of the gains and losses that would have been reported under a mark-to-market calculation with a section 481(a) adjustment. Therefore, this position should only be used as an alternative to the other two positions discussed above.

FACTS

Taxpayer is a limited liability company treated as a partnership for tax purposes. Taxpayer conducts hedge fund activities. Taxpayer and other affiliated limited liability companies were controlled by common members, including Person 1, who is a member manager of Taxpayer. Person 1 holds its majority interest in Taxpayer through Entity Z. Taxpayer through its wholly owned disregarded entity, Trading Entity Y, made a section 475(f) (1) election as a trader in securities. This election was made with Taxpayer’s Year 1 tax return and effective for Year 2 and forward. For the years at issue, Taxpayer conducted trading activity through Trading Entity Y. Trading Entity Y generally purchases and sells positions in securities on a daily basis.

During Years 3 through 6, Taxpayer entered into several different basket transactions with Bank. The basket transactions were styled as a call option on a

basket of securities held in specified prime brokerage accounts with Bank. Taxpayer controlled the basket of securities while the “option” was open. The baskets were comprised of U.S. equity securities divided into long and short positions. In a typical basket transaction, Taxpayer makes an upfront payment of x percent of the notional amount referenced in the basket transaction. Bank provides the remaining y percent, the total amount which is used to acquire a basket of securities that is actively traded and managed by Entity Z and other affiliates of Taxpayer. The contract between Taxpayer and Bank describes Taxpayer’s upfront payment as a “premium” that gives Taxpayer an “option” to receive a cash settlement amount from Bank when the contract expires or is otherwise terminated. The premium amount is determined by Bank’s finance department rather than through option valuations formulas typically used when pricing standard options. The cash settlement amount is determined by a formula that reflects (i) the increase or decrease in the value of the securities held and traded within the basket transactions, (ii) expense and income payments made or received with respect to the securities, and (iii) the interest and fees payable to Bank for its services and capital.

For tax purposes, Taxpayer treated the basket transactions as options under section 1234. As a result, Taxpayer did not recognize gains, losses income or deductions as it held and traded the securities within the basket transaction. Instead it deferred recognition of any tax consequences until the basket transaction expired or otherwise terminated, when Taxpayer recognized gain equaling the difference between the cash settlement amount and the upfront payment made.

On its Year 7 return, Taxpayer reported that basket 1 was purchased on Date 1 and sold on Date 2 for amount 1. Taxpayer had a basis in Basket 1 of amount 2. Taxpayer had reported long term capital gain in amount 3. On its Year 8 return, Taxpayer reported a combined sales price of amount 7 for Baskets 7- 10. These same transactions had a cost basis of amount 5. Taxpayer reported a combined long term capital gain in amount 6.

Taxpayer’s federal tax returns for Years 7 and 8 are currently under examination. Exam has determined that the basket transactions lack the requirements to be treated as options for tax purposes. It has also been determined by Exam that Taxpayer has the benefits and burdens of ownership of the securities underlying the basket transactions, and thus was the beneficial ownership of these securities for tax purposes.¹ Exam has challenged Taxpayer’s deferral of gains and losses, income or deductions associated with the Basket transactions. Exam intends to place Taxpayer on the correct method of accounting consistent with its ownership of securities. It also intends to impose an adjustment under section 481(a) in the first year of the tax examination.

¹ The Service addressed this issue in Generic Legal Advice. See AM-2010-005.

For book purposes, Taxpayer marked to market its securities, including the basket transactions. For tax purposes, Taxpayer did not account for any of its basket transactions under section 475, but it did mark to market other trading securities held by Trading Entity Y. By not marking the basket transactions, Taxpayer left out a whole class of securities from its proper method of accounting for securities subject to section 475. Taxpayer had stated in its IDR Response that it misread section 475(f)(3), which provides for separate elections for a trader in securities and a trader in commodities. Taxpayer claims that they originally thought they could make separate section 475(f) elections for each line of trade or business it owns, and that it had not made an election for the basket transactions. Taxpayer argues that if they cannot make separate elections, that this is not a change in method of accounting, but rather a correction of an error. The Service's position is that the treatment of the basket transactions is a material item, and as such, any adjustment that conforms to the practice of Taxpayer's existing method of accounting is an accounting method change, rather than an error correction.

Advice has previously been sought by LB&I as to whether this change from a deferral reporting (open transaction method) to reporting the gains and losses currently is a change in Taxpayer's method of accounting and whether this change allows for a section 481(a) adjustment. Chief Counsel Advice was issued stating that this is a change in method of accounting and that a section 481(a) adjustment is appropriate. See CCA 1. Chief Counsel Advice was also sought on the effect of section 734(b) basis adjustments as a result of a section 754 election on the issue of whether this is a change in method of accounting. The Service determined that the basis adjustments do not change its conclusion that this is a change in method of accounting. This Chief Counsel Advice addresses section 475 implications.

LAW AND ANALYSIS

Whether the Basket Transactions Are Subject to a Mark-to-Market Method of Accounting under Section 475(f)

Section 475(f)(1) provides that a person who is engaged in a trade or business as a trader in securities can elect to have the mark to market rules of section 475 apply to such trade or business. If the mark-to-market rules apply, such person shall recognize gain or loss on any security held in connection with its trade or business at the close of any taxable year, as if such security were sold for its fair market value on the last business day of such taxable year. Any such gain or loss shall be taken into account for such taxable year.

The general rule that the character of the gains and losses under section 475 are ordinary also applies to a trader in securities that has made an election under section 475(f). See section 475(d)(3)(A)(i) and section 475(f)(1)(D). See also Proposed Treas.

Reg. § 1.475(f)(5)(b). Section 475(d)(3)(B) also applies to traders and provides exceptions to the automatically ordinary rule under section 475(d)(3)(A). If a taxpayer can establish that it held securities as hedges, or that the securities were not held in connection with its trading business or that a security is improperly identified as described in section 475(d)(2), then gains and losses are not automatically ordinary. Section 475(d)(3)(B)(i), (ii) and (iii). Character must then be determined by other relevant Code sections.

Any securities held by the trader are subject to marking unless they fall within the exception to marking under section 475(f)(1)(B). In the case of traders there is only one exception to marking. Under that exception, two requirements must be met. First, it must be established to the satisfaction of the Secretary that the security has no connection to the activities of such person as a trader. See section 475(f)(1)(B)(i). Second, any such security must be clearly identified in such person's records as being described in section 475(f)(1)(B)(i) before the close of the day on which it was acquired, originated or entered into (or such other time as the Secretary may by regulations prescribe). See section 475(f)(1)(B)(ii). An identification that a security is held for investment for financial reporting purposes is not sufficient for section 475 purposes. See Rev. Rul. 97-39, 1997-2 C.B. 62, Issue 4. This is even more so in the case of a trader who has to establish more than that a security is held for investment, but that the security is not held in connection with its trading business.

In the case of traders, the legislative history makes it clear that Congress was concerned about issues of taxpayer selectivity in making identifications out of marking. It did not want a taxpayer to selectively mark to market some securities, and then to selectively identify other securities as exempt from the mark-to-market treatment. Congress especially did not want a taxpayer to be able to do that using hindsight. To address this concern, Congress placed a higher burden of proof for electing securities traders to identify securities as not subject to section 475 than is applicable to securities dealers. Another concern is that it is more difficult for the Service to distinguish trading securities from investment securities than it is to distinguish dealer securities from investment securities. See Conf. Report 105-220, 105th Cong., 1st Sess., July 30, 1997, 1997-4 C.B. 1457, 1985; General Explanation of Tax Legislation Enacted in 1997, (Blue Book), JCS 23-97, Dec. 17, 1997, p. 182, 1997-3 C.B. 89, 292. See also Preamble to REG-104924-98, 1999-10 IRB 47,49. Under the proposed regulations, a taxpayer must be able to demonstrate by clear and convincing evidence that a security bears no relation to its activities as a trader in order to be identified as not subject to the mark-to-market rules of section 475. See Proposed Reg. §1.475(f)-2(a)(2).

The proposed regulation also provides a special rule for the situation where a taxpayer may identify securities as not held in connection with its trading business when the electing trader also trades the same or substantially similar securities that it uses in its trade or business. In this situation, a taxpayer can only meet the requirements of section 475(f)(1)(B)(i) if the security is held in a separate, non-trading account maintained by a third party. See Proposed Reg. §1.475(f)-2(a)(3)

Under Proposed Reg. § 1.475(f)-2(a)(4), if an electing trader holds a security that is not held in connection with its trading business and fails to identify the security in a manner that satisfies the requirements of section 475(f)(1)(B)(ii), then section 475(d)(2) applies (i.e., the security is marked to market and any losses realized with respect to the security prior to its disposition are recognized only to the extent of gain previously recognized with respect to that security) and the character of the gain or loss is ordinary.

The election under section 475(f) is made on an entity by entity basis, not a separate trade or business basis. Only in the case of separate commodities and securities businesses can a taxpayer make separate elections. Section 475(f)(3) provides that separate elections must be made for a trader in securities election under (f)(1) and a trader in commodities election under (f)(2).

(a) Application of Section 475 if Basket Transactions Not Treated as Options

Under LB&I's primary theory for this case, the basket transactions contracts should be recharacterized, such that they are not treated as options under section 1234, but instead as though Taxpayer directly owned each security in the baskets.² The result is that taxpayer is to be taken off the open transaction method of accounting it was using and will be placed on a mark-to-market method of accounting for these securities. Taxpayer had previously made an election under section 475(f) and that election applies to any trading conducted by itself and any trading conducted by its disregarded entity, Trading Entity Y. All securities subject to section 475(c)(2) must be marked to market unless they fall within the exception to marking under section 475(f)(1)(B).

In this case, there does not appear to be any question that a section 475(f) election was made and that it applies to Taxpayer. In IDR Response, Taxpayer explains that it originally thought that under section 475(f)(3) it could make separate elections for different lines of trading businesses, but even within that IDR it acknowledges that is not what section 475(f)(3) provides. In that same IDR Response, it does not appear that Taxpayer's position is that these securities are not held in connection with their trading business. Rather, Taxpayer is asserting that since they were already on a mark-to-market method under section 475(f), that this is not a change in a method of accounting, but a correction of an error. As stated above, CCA 1 addresses this issue thoroughly. It remains our position that this treatment of the

² The primary theory in this case is therefore consistent with the conclusions reached in AM 2010-005. This Chief Counsel Advice (CCA) does not address the correctness of this position to this taxpayer, that issue has been previously addressed. This CCA assumes that position is correct. This CCA also does not address the change in accounting method issue and the appropriateness of the section 481 adjustment in depth as that it has been thoroughly discussed in a CCA 1. This CCA is addressing the application of section 475 to the recharacterized transactions and the alternative arguments raised by your incoming request.

underlying basket of securities as subject to section 475 is a change in its method of accounting, and a section 481(a) adjustment is appropriate.

Although it is not clear from your incoming request whether Taxpayer is actually asserting that these securities meet the exception to marking under section 475(f)(1)(B), we are assuming that you have asked us to address this issue in case Taxpayer raises it later in the exam, in the Appeals process or in litigation.

As discussed above, there are two requirements that must be met to except any securities from marking under section 475(f)(1)(B): (1) Taxpayer must establish securities are not held in connection with its trading business; and (2) there must be timely and specific section 475 identification made in its books and records. Taxpayer has not asserted that the basket transactions contracts were not held in connection with its trading business. In addition, there have been no facts presented to us that suggest these contracts were not held in connection with Taxpayer's trading business. The facts seem to support the conclusion that these securities were held in connection with its trading business. The trading strategies used for Taxpayer and the basket transactions were nearly identical to the trading strategies used for the individual securities traded through Taxpayer's disregarded entity, Trading Entity Y, in its other brokerage account with Bank. Taxpayer conducted its non-basket transactions through Trading Entity Y's brokerage account. Both Taxpayer's basket transactions and its individual security positions owned by Trading Entity Y were held in the accounts with Bank. Gains from Taxpayer's basket transactions upon termination were used to pay the liabilities incurred in Trading Entity Y's trading account. It is also our understanding that the sheer volume of securities trading that occurred in each basket on a daily basis makes it very difficult to find that these securities were not held in connection with its trading business.

Taxpayer did record the basket transactions in their month-ending trial balances under the title "Investment in Barrier Option." Taxpayer also noted in its financial statements that the basket transaction securities cannot be offered or sold because of other arrangements, restrictions or conditions applicable to the instruments or to the Company. Taxpayer recorded the x premium payment on its balance sheet. On its financial statements it reported the fair value of the total cash settlement amount from the baskets. The fact that Taxpayer did record the basket transactions on its monthly ending trial balances as an investment in options does not necessarily support a finding that these securities were not held in connection with its trading business. In addition, Taxpayer did not make any specific references to section 475(f) identifications. Taxpayer didn't make any same day identifications in its books and records regarding section 475(f) identifications. Taxpayer's only type of identification of the basket transactions appears on the month-end trial balances and balance sheet, and as stated above, these notations are not specific to section 475, and they do not occur on acquisition dates, but are noted at month end.

Taxpayer has not established by clear and convincing evidence that these basket transactions or the underlying securities in the basket transactions are not held in connection with its trading business and no timely or proper section 475(f) identifications have been made. Therefore, the recharacterized “option” transactions, the underlying basket of securities, are marked to market under section 475(f) and all gains or losses are ordinary.

Because this is a change in method of accounting, going from the open transaction method to a section 475 mark-to-market method for these recharacterized basket transaction, a section 481 adjustment is appropriate. As thoroughly discussed in CCA 1, a change in method of accounting occurs when Taxpayer no longer treats certain securities transactions as options and stops deferring the gains, losses, income and deductions associated with those transactions. The computation and recognition of an appropriate section 481(a) adjustment is needed to eliminate any distortion (duplication or omission of income or deductions) caused by the accounting method change.

Taxpayer’s argument that this is not a method change but a correction of an error is incorrect. As also discussed in CCA 1, the fact that Taxpayer was already on a section 475 method of accounting for its securities does not preclude a change in method of accounting when Taxpayer has left out a whole class of securities (basket transaction securities) from that method. A taxpayer is generally required to apply the same accounting method to all instances of a particular item. In this case, Taxpayer is required to apply the same accounting method for all securities subject to section 475 and not identified out of marking. On occasion, however, a taxpayer purports or attempts to report an item using the accounting method that it has adopted, established, or elected, but fails to apply the accounting method with perfect consistency. As a result, the taxpayer treats the item in two different ways; part of the item is reported under the primary accounting method, while the remainder of the item is reported using a treatment that diverges from the primary accounting method (divergent treatment).

When the divergent treatment is discovered by the taxpayer or Exam, the issue arises whether adjustments to conform the divergent treatment to the primary accounting method should be treated as the correction of errors in open tax years or as a change in accounting method under sections 446 and 481. Under current law, we believe that the key to deciding whether an accounting method change occurs is whether the divergent treatment is a timing practice that is used on a consistent basis. If so, then the divergent treatment is a material item, and conforming the divergent treatment to the primary accounting method is a change in the treatment of a material item that constitutes an accounting method change. See Treas. Reg. § 1.446-1(e)(2)(ii)(a). In contrast, if the divergent treatment is not a timing practice and/or is not a consistent practice, it will have a permanent impact on lifetime taxable income, and the divergent treatment is an error (or series of errors). In this case, Taxpayer’s treatment of the basket transactions is a material item, a timing practice that was employed by Taxpayer consistently over many years. Therefore, any adjustment that

conforms the practice to its existing accounting method would be an accounting method change, rather than an error correction.

(b) Alternatively, Application of Section 475 if the Service Fails in Challenging Taxpayer's Treatment of the Basket Transactions as Options

The incoming request raises an alternative question as to how these transactions would be treated under section 475 if the "option" form of these transactions were somehow not recharacterized. As noted above, the recharacterization of the basket transactions should be our primary argument. We are addressing this alternative argument in case a court disagreed with our primary argument. Because a section 475(f) election was made by this Taxpayer, all of its securities must be marked to market. An option other than a section 1256 contract is a section 475(c)(2)(E) security. The options in this case do not appear to be section 1256 contracts. The same analysis discussed above would apply for determining whether Taxpayer meets the exception to marking under section 475(f)(1)(B). Based upon the facts we know to date, we do not think Taxpayer can establish that the basket transactions were not held in connection with Taxpayer's trading business securities. Taxpayer also did not make an identification specific to section 475 as required by section 475(f)(1)(B)(ii). Therefore the section 475 method of accounting applies and all gains or losses are ordinary.

The same analysis discussed above regarding a change in method of accounting and a section 481(a) adjustment also applies under this argument. Taxpayer's failure to mark the "options" when it was subject to section 475 is a material item and a timing practice that was consistently done. Therefore any adjustment that conforms the practice to its section 475 method would be an accounting method change, rather than an error correction. A section 481(a) adjustment would be appropriate in this case.

(c) Alternative Argument if a court were to find under the primary argument (a) or the alternative argument (b) that neither position resulted in a change in method of accounting, can the character of the gains and losses reported by Taxpayer under the open transaction method be treated as ordinary under sections 475(d) and (f)(1)(d)?

The incoming request also raises another alternative argument as to whether the character of the long term capital gains can be treated as ordinary under sections 475(d) and (f)(1)(D), assuming a court does not agree with our conclusion that this is a change in method of accounting with a section 481(a) adjustment applying. For example, Basket 1 was sold on Date 3 for Amount 1. Taxpayer had a cost basis in Basket 1 of amount 2.³ Taxpayer treated the sale of Basket 1 as triggering a long term capital gain in amount 3. Exam wants to assert that Taxpayer has ordinary income on Basket 1 in Amount 3. For Baskets 7-10, at year end for Year 7, Taxpayer still owned the baskets and the collective cash settlement amount of Baskets 7-10 was reported on

³ This includes an increase to the original premium that is attributable to section 734(b) adjustments from gain recognized by partners on the liquidation of their partnership interests.

the Basket Performance Reports generated by Bank as Amount 4. As of the end of Year 7, Taxpayer had an adjusted basis in the Baskets 7-10 of Amount 5. Exam wants to assert that for Year 7 Taxpayer had ordinary gains in Amount 6. For Year 8, when Taxpayer terminated Baskets 7-10 for the cash settlement amount of Amount 7, Exam wants to assert that Taxpayer has ordinary gains in Amount 8.

Only if we are unable to get a section 481(a) adjustment for closed years do we think we should use this argument as an alternative argument. In that case, we agree that sections 475(d) and (f)(1)(D) can be asserted to find the gains and losses are ordinary. We note also that Proposed Treas. Reg. § 1.475(f)-2(a)(5)(b) also provides that the character of securities subject to marking under section 475(f)(1)(A) is ordinary.

However, we are not sure that under this argument the Service would pick up all the income that should be recognized under a mark-to-market method with a section 481(a) adjustment picking up the income that arose during the closed years. Because of the closed years involved, and because different securities could be and were traded in and out of the baskets on a daily basis, we are uncertain that this argument picks up the appropriate amount of gains and losses under section 475. It is not clear that all the appropriate values for the sold securities are reflected in the basis of the basket or are all part of the deferred gains or losses realized upon termination of the basket. Because the basket transactions do not reference specific properties at a defined price, using the gains or losses from the open transaction method may not be sufficient.

Before this type of argument could be applied, it must be established that section 475 applies to the securities at issue and that the automatic ordinary treatment under sections 475(d)(3)(A) and (f)(1)(D) applies and that none of the exceptions to automatic ordinary treatment under section 475(d)(3)(B) apply. As discussed above in the primary argument and the first alternative argument, section 475 applies in this case because of the election made by the Taxpayer. Based upon the facts that have been presented to us so far, none of the exceptions to automatic ordinary treatment under sections 475(d)(3)(B) and (f)(1)(D) apply in this case. Taxpayer is not using the basket transactions as hedges identified under section 475(b)(1)(C), the basket transactions are held in connection with the Taxpayer's trading business or at least Taxpayer has not established that they are not held in connection with its trading business, and these basket transactions have not been improperly identified as described in section 475(d)(2)(A). Therefore sections 475(d) and (f)(1)(D) would make any gains or losses ordinary.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS



[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

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