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July 2015

New Guidance Regarding Basket Derivatives

On July 8, the Internal Revenue Service (the IRS) issued two new pieces of guidance regarding certain derivatives on baskets of assets. One is old wine in new bottles; the other is an expansion of the category of transaction under IRS scrutiny.

1. Current Guidance

Notice 2015-47 (the First 2015 Notice) states that transactions (basket option contracts) similar to the transaction described in AM 2010-005 (the 2010 Guidance) will be treated as "listed transactions" for purposes of Code sections 6111 and 6112 and Treas. Reg. 1.6011-4(b)(2). Notice 2015-48 (the Second 2015 Notice) states that a somewhat broader category of similar transactions (basket contracts) will be treated as "transactions of interest" for purposes of Treas. Reg. 1.6011-4(b)(6).[1]

[1] Very briefly, “listed transactions” and “transactions of interest” are two types of “reportable transactions.” Treas. Reg. §1.6011-4(b). Absent adequate disclosure, understatements due to tax benefits afforded by reportable transactions are subject to penalties under Sections 6662A and 6707. In order to make adequate disclosure, every party that has “participated” in a reportable transaction is required to attach a disclosure statement about the transaction to its return for the applicable tax year. Treas. Reg. §1.6011-4(a). In order to be complete, the disclosure statement must describe the expected tax treatment and all potential tax benefits expected to result from the transaction, describe any tax result protection (as defined in Treas. Reg. §301.6111-3(c)(12)) with respect to the transaction, and identify and describe the transaction in sufficient detail for the IRS to be able to understand the tax structure of the reportable transaction and the identity of all parties involved in the transaction. Treas. Reg. §1.6011-4(d). In the case of a transaction of interest, the IRS has discretion to identify which parties “participated” in the transaction. Treas. Reg. §1.6011-4(e).

The treatment of basket option contracts as reportable transactions is not really news. Taxpayers were put on notice about these transactions when the 2010 Guidance came out, and most of these transactions were shut down then. However, the expansion of the scope of IRS scrutiny to basket contracts is significant.

2. Notice 2010-005

a. **Facts**. On Day One of the transaction at issue in the 2010 Guidance, the taxpayer, a hedge fund, paid its counterparty, a foreign bank, 10 percent of the value of a reference portfolio consisting of a basket of publicly-traded, liquid stocks. The contract matured more than one year after Day One. At maturity, the taxpayer had the right to a return of the 10 percent "premium" paid on Day One, plus any increase in the value of the reference portfolio over the life of the contract, less any decrease therein, and less a financing charge. The taxpayer had the right to order changes to the composition of the portfolio over the life of the contract, and the counterparty had the right to refuse any of these requested changes. If the value of the portfolio at any time fell below 90 percent of its Day One value, the taxpayer would lose its 10 percent "premium" and the contract would terminate (the knock-out provision). As the value of the portfolio approached 90 percent, the counterparty was required to modify the portfolio in such a way as to reduce portfolio risk. The counterparty calculated the financing charge deducted from the final pay-out with reference to financing rates for loans, rather than by using an option pricing formula. From the perspective of both the taxpayer and the counterparty, the arrangement was economically similar to a non-recourse purchase money loan for 90 percent of the value of the reference portfolio.

   Although not required to do so under the terms of the contract, the counterparty hedged its position under the contract by purchasing the portfolio on Day One. The taxpayer (through its manager) placed frequent orders to change the portfolio. It appears that the orders placed by the fund manager were similar to orders that would have been placed pursuant to an actively-managed trading strategy. Whenever an order to change the reference portfolio was made, the counterparty would adjust its hedge to match the reference portfolio. The counterparty never exercised its right to refuse a change to the portfolio. The transaction was not terminated early under the knock-out provision.

b. **Is It an Option?** The taxpayer in the 2010 Guidance took the position that the contract was an option. Accordingly, it did not recognize gain or loss with respect to the contract until the maturity date, and gain, when recognized, was treated as long-term capital gain.[2] The IRS found that the transaction was not an option, and that the taxpayer in substance owned the reference portfolio. Because the reference portfolio was actively traded, this meant that the IRS required the taxpayer to recognize gain or loss recognized with respect to changes made in the reference portfolio currently.

   In holding that the transaction was not an option, the IRS cited two factors. First, it said that the up-front premium was so big as to compel the taxpayer to exercise its rights under the contract. This is a familiar argument; courts and the IRS have previously held that entry into a deep-in-the-money call option should be treated as a current sale of the underlying property because the payment of a big enough premium by the holder of the option to the writer of the option ensures that the holder has enough "skin in the game" to guarantee that she will exercise her rights under the option.[3] That said, there is no "bright line" to measure when an option is so deep in the money as to constitute a current sale. Although the option in the 2010 Guidance was styled an at-the-money option with refundable premium equal to 10 percent of the Day One reference portfolio value, it was

[2] See, e.g. Rev. Rul. 78-182, 1978-1 C.B. 265 (absent application of a special timing rule, "wait-and-see" accounting for gain and loss from option transactions applies to both issuers and owners).

[3] See, e.g., Rev. Rul. 82-150, 1982-2 C.B. 110 (deep ITM call option treated as current sale of underlying stock for purposes of the foreign personal holding company rules); Rev. Rul. 80-238, 1980-2 C.B. 96 (sale of OTM covered call not treated as a "short sale" for purposes of tolling the DRD holding period rules); *Halle v. Commissioner, 83 F.3d 649 (4th Cir., 1996)*; *Commissioner v. Baerstchi, 412 F.2d 494 (6th Cir., 1969)* (similar).

economically identical to a 10 percent in-the-money option with a nonrefundable premium and a strike price equal to 90 percent of the Day One reference portfolio value.[4] Options that are 70 percent[5] or 29 percent[6] in-the-money have been found to constitute current sales of their underliers; however, query whether a 10 percent discount is sufficient to support this position.[7]

In addition to holding that the contract was not an option because it was certain to be exercised, the IRS also held that the fact that the taxpayer's ability to change the composition of the reference portfolio prior to the contract's maturity was inconsistent with option characterization.

c. **Beneficial Ownership.** After the IRS found that the contract in the 2010 Guidance was not an option, it found that the taxpayer was the beneficial owner of the reference portfolio and that the counterparty was effectively a broker who had extended a margin loan to the taxpayer. Generally, the two features that courts and the IRS look to in determining whether a taxpayer is the beneficial owner of an asset are whether the taxpayer has economic exposure to the asset (the benefits and burdens test) and whether the taxpayer has the power to dispose of the asset.[8] The IRS held that economic exposure rested solely with the taxpayer because the taxpayer stood to benefit from all increases in value in the reference portfolio, and all loss therein up to the 10 percent knock-out barrier. There was a remote chance that the counterparty could suffer loss if the value of the reference portfolio fell below 90 percent of its Day One value before the counterparty could terminate the option pursuant to the knock out provision and sell its hedge, but the breadth of the knock out band and the risk mitigation requirements made this unlikely. The IRS held further that the fact that the taxpayer had (and exercised) the right to modify the reference portfolio indicated that the taxpayer had effective control over the hedge securities held by the counterparty.

d. **The Specter of Section 1260**. One type of economically equivalent transaction that the IRS did <u>not</u> examine in the 2010 Notice was barrier options on partnership interests. These are similar to the basket option contracts described in the 2010 Guidance, except that in these transactions, the taxpayer obtains exposure to an interest in a hedge fund partnership that actively trades a portfolio of securities, while in the 2010 Guidance, the hedge fund itself obtained exposure to an actively traded portfolio. To the extent that derivatives on hedge fund interests are respected as options, they provide the same tax benefit as those claimed by the taxpayer in the 2010 Guidance with respect to basket option contracts. However, to the extent that these transactions are treated as actual ownership of the partnership interests, or as "constructive ownership" transactions under Section 1260, the twin benefits of income deferral and long-term capital gain rates evaporate.

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[4] The 2010 Notice assumes that Day One portfolio value is $100, premium is $10, and the strike price is $100. At maturity, the taxpayer receives a refund of its premium, plus any appreciation over the strike price, minus any depreciation below the strike price, less a financing fee. The same result would obtain if the taxpayer paid $10 on Day One, and received or paid at maturity an amount equal to the difference between a strike price of $90 and the value of the reference portfolio at maturity, less a financing fee.

[5] Rev. Rul. 82-150, <u>supra</u>.

[6] Baerstchi, <u>supra</u>.

[7] Although existing authority has cited the percentage of underlier value represented by an option's intrinsic value on Day One as the most important factor in determining whether an option constitutes a sale, the Service has begun to explore the possibility that an option's "delta," or sensitivity to changes in the value of the underlier, is a better measure of whether a holder of an option should be treated as an owner of the underlier for purposes of Section 871(m). Prop. Reg. 1.871-15. While a test that makes reference to option "Greeks" may be a more accurate test than the current "in the money" test, the more complicated test may not lend itself to administrative simplicity.

[8] The benefits and burdens test tends to be more important in determining beneficial ownership of illiquid, non-fungible assets, and the power to segregate and dispose of the asset tends to be more important in determining beneficial ownership of liquid, fungible assets. This is because there can be infinitely many "long" positions in a liquid, fungible asset, but there can only be one tax owner. <u>See, e.g.</u> *Provost v. United States, 269 U.S. 443, 455 (1926)* (stock lender not owner of shares loaned to short seller because purchaser has control over the shares); Richardson v. Commissioner, 121 F.2d 1 (2d Cir. 1941) (short seller owner of shares purchased to cover short position until shares actually delivered; basis in shares delivered not determinable until actual shares were identified and delivered); Rev. Rul. 80-135, 1980-1 C.B. 18 ("interest equivalent" payments received by lender of municipal bond not interest entitled to exemption under Section 103).

By way of background - Section 1260 treats as ordinary income, and imposes an interest charge on, deemed late payment of gain received by holders of certain derivatives on interests in pass-thru entities to the extent that amounts attributable to this gain would have been treated as other than long-term capital gain had the taxpayer owned the interests directly. Generally, gain is recharacterized as ordinary and the late-payment interest charge is assessed to the extent that gain from a constructive ownership transaction with respect to a financial asset exceeds net underlying long term capital gain.[9] For these purposes, a financial asset is an interest in certain pass-thru entities (including partnerships).[10] Net underlying long term capital gain is the portion of gain attributable to the constructive ownership transaction that would have been long-term capital gain had the taxpayer owned the financial asset herself.[11] A constructive ownership transaction is (i) a long position under a notional principal contract with respect to the financial asset, (ii) entry into a forward or futures contract to acquire the financial asset, (iii) entry into a "synthetic forward" option combination to purchase the financial asset, or (iv) a similar transaction with substantially the same effect as specified by the Secretary in (as-yet unpromulgated) regulations.[12] A position in a single option contract is generally not a constructive ownership transaction.[13] However, a taxpayer is treated as holding a long position with respect to a financial asset under a notional principal contract if he or she (i) has the right to be paid (or receive credit for) all or substantially all of the investment yield (including appreciation) on the financial asset, and (ii) is obligated to reimburse (or provide credit for) all or substantially any decline in the value of the financial asset.[14]

The analysis in the 2010 Guidance would seem to indicate that the IRS could take the position that barrier options on hedge fund interests ought to be treated as outright ownership of the hedge fund interests. In addition, in light of the IRS's conclusion that the transactions in the 2010 Guidance were in fact "delta one" derivatives, rather than true options, there is a significant risk that barrier options on hedge fund interests could be treated as long positions in notional principal contracts with respect to hedge fund interests for Section 1260 purposes. However, neither of these issues was directly addressed in the 2010 Guidance.

3. Expansion of Scope

The Second 2015 Notice expands the scope of governmental scrutiny in three ways:

a. **Scope of Derivatives**. First, it expands the scope of derivatives that are under scrutiny. While the 2010 Guidance and the First 2015 Notice are limited to transactions denominated as option transactions that are substantially similar to the transaction described in the 2010 Guidance, the Second 2015 Notice applies to contracts denominated as options, notional principal contracts, forwards, *or any other derivative* on an applicable basket.

b. **Scope of Underliers.** Second, it expands the scope of underliers. While the 2010 Guidance applied only to options on baskets of actively traded securities, the Second 2015 Notice applies to reference baskets of assets including "(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)."

   i. **Limited to Actively-Traded Baskets.** Notwithstanding the expansion of the scope of assets that may be included in applicable baskets, the Second 2015 Notice specifies that, in order for a basket to be within its scope, the taxpayer must have the right to request changes in the assets in the reference basket or the specified trading algorithm. A derivative on a single, static underlier, or a derivative on a static portfolio,

[9] Section 1260(a).
[10] Section 1260(c).
[11] Section 1260(e).
[12] Section 1260(d)(1).
[13] Id.
[14] Section 1260(d)(3). Note that this definition of "notional principal contract" is broader than the definition found in certain other areas of the Code, because it defines a notional principal contract with regard to the exposure that it grants to the underlier, rather than the timing of the schedule of payments. See, e.g. Treas. Reg. §1.446-3(c)(i).

therefore, would not appear to be within the scope of the Notice.

c. **Reporting Parties.** Finally, it specifies a broad range of parties who are required to file a disclosure statement with respect to transactions under scrutiny. The Second 2015 Notice states that, in the case of basket contracts, the purchaser of the contract, any general partner of the purchaser (if the purchaser is a partnership), any managing member of the purchaser (if the purchaser is a limited liability company), and the counterparty to the contract are required to provide a disclosure statement. The Notice further states that disclosure statements must be filed with respect to all transactions that were entered into on or after Nov. 2, 2006 and that were in effect on or after Jan. 1, 2011.

   This is a significant expansion of the scope of transactions under scrutiny. It is also an expansion of the responsibility of sell-side institutions to help the government do the government's due diligence – and to provide the government with their customers' identity. This could be burdensome for banks and other sell-side institutions that have hitherto provided synthetic exposure to hedge fund interests to their clients. To the extent that exposure of this type dries up, it might also decrease hedge funds' pool of potential equity investors.

4. Whither Options?

Despite the tightening of the noose, there does appear to be some room for market participants to continue to provide derivative exposure to hedge fund interests and other assets without being caught under either Section 1260 or the relevant Notices. Generally, in order to qualify, it is likely that a contract would need to have the following characteristics:

a. **True Optionality.** First, it would need to be a true option. In order for this to be the case, the contract would need to have a "delta" of less than 1, and the counterparty would have to be able to show that they priced it using option pricing methods, rather than loan pricing methods. True option status ought to remove a contract from the scope of Section 1260 and the 2010 Guidance, and it might prevent it from being treated as a listed transaction under the First 2015 Notice.

b. **No Right to Vary.** Second, the option should not allow the holder to vary the composition of the underlying asset or portfolio of assets. To the extent that the holder would like to change the underlying assets, the holder should be required to terminate the option and enter into a new contract, on new underliers. This ought to address the power-to-vary requirement specified in both the First 2015 Notice and the Second 2015 Notice.

Because the guidance is still new, and because questions of this type are fact-specific, taxpayers should consult with legal counsel prior to entering into or amending a business of this type. That said, there seems to still be some (albeit less) opportunity for this type of activity.

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