



LISTED TRANSACTIONS: A LOOK AT BASKET OPTION CONTRACTS, PART II

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This post continues our coverage of basket option contracts, which were recently designated as listed transactions. See Notice 2015-73, 2015-46 I.R.B. 660 (Nov. 16, 2015). As [discussed](#), the IRS designated these contracts as listed transactions because it is concerned that the basket option contract has been used by taxpayers to defer the recognition of income and to convert ordinary income and short-term capital gain or loss into long-term capital gain or loss. 2015-46 I.R.B. at 661.

[A recent Chief Counsel Advice Memorandum](#) offers further insight into the arguments that the IRS will likely offer in challenging the tax treatment of these transactions. See I.R.S. Chief Couns. Advice Mem. 201547004, 2015 IRS CCA LEXIS 118 (Aug. 11, 2015). The arrangement at issue in CCAM 201547004 was labeled as a “Cash-Settled Equity Barrier Call Option,” *Id.* at *4 n.4, but it had the same basic features described in the listing notice for basket option contracts. These included the use of a notional “basket” of assets, the practice of the counterparty acquiring the assets that comprise the basket, and the taxpayer having discretion over the composition of the basket. *Id.* at *8-*15.

CCAM 201547004 first concluded that the relevant contracts did not function as options. Specifically, Chief Counsel focused on the fact that the contracts imposed costs upon the taxpayer that were consistent with the costs a committed buyer would absorb. Chief Counsel also noted the fact that the contracts were structured to assure that they would never expire unexercised: the economics of the contracts dictate that either the buyer would exercise or the bank would terminate

the contract. *Id.* at *20-*21. This concern was reinforced by the fact that the contracts did not appear to employ normal option pricing methods. *Id.* at *21. In addition, Chief Counsel noted that the taxpayer's ability to change the composition of the basket was inconsistent with the structure of an option contract, which provides one party with the right to purchase or to sell specified property at a set price within a designated period. *Id.* at *22-*23.

Next, Chief Counsel addressed whether the taxpayer was the beneficial owner of the assets in the basket. *Id.* at *23-*24. Here, the analysis focused upon the economic benefits and burdens of ownership. Chief Counsel concluded that the taxpayer was the beneficial owner of the assets because it enjoyed the economic benefits of owning the assets in the basket, bore the economic burdens associated with the assets, and enjoyed the power to direct the counterparty to purchase new assets or close existing positions. *Id.* at *25-*26. In this context, Chief Counsel placed particular emphasis on the taxpayer's ability to determine the assets that comprise the basket. *Id.* at *31-*32.

In light of the fact that the contract structure assured that the taxpayer would exercise the option and it enjoyed all of the incidents of ownership of the relevant assets, Chief Counsel readily concluded that the contractual arrangement represented a sale of the referenced assets for tax purposes. *Id.* at *34-*35.

As an alternative ground, Chief Counsel concluded that the contractual arrangements represented forward contracts to purchase pass-through entities and consequently were governed by Section 1260 of the Code as a constructive ownership transaction. *Id.* at *38-*39. Indicating that this analysis should be conducted on an asset by asset basis, Chief Counsel recognized the possibility that some assets would be directly owned by the taxpayer and others would represent constructive ownership transactions under Section 1260. *Id.* at *39.

After reviewing the mechanics of how Section 1260 would apply, CCAM 201547004 closed with a discussion of the appropriate treatment for situations in which the taxpayer either owned the assets for tax purposes, or engaged in a taxable cash withdrawal or exchange of the contracts. *Id.* at *45-*46. First, Chief Counsel reasoned that the manner in which the taxpayer reported its income or losses associated with the relevant contracts was an accounting method, subject to adjustment by the IRS under Section 481 of the Code because it affected the timing of when income is recognized. *Id.* at *46-*47. Next, Chief Counsel opined that the taxpayer's method of accounting was incorrect and indicated that the taxpayer should adjust its tax treatment for prior years, including years that ordinarily be closed under the assessment statute of limitations. *Id.* at *48-*49. This position is consistent with prior case law. See *Comm'r v. Welch*, 345 F.2d 939, 950 (5th Cir. 1965).

One other recent development is relevant here: at the same time it issued a listing notice for basket option contracts, the IRS designated basket contracts as a "transaction of interest." See Notice 2015-74, 2015-46 I.R.B. 663 (Nov. 16, 2015). The notice indicates that the Department of Treasury and the IRS believe that these types of contracts have potential for abuse but lack sufficient information to make a determination that they should be designated as listed transactions. *Id.*

A "transaction of interest" is a reportable transaction. See Treas. Reg. § 1.6011-4(b)(6). Consequently, participating taxpayers will have disclosure obligations. See Treas. Reg. § 1.6011-

4(a). Material advisors will also have obligations to disclose their involvement and maintain lists of participants, but the dollar threshold for their reporting obligation is higher than in the case of a listed transaction. See Treas. Reg. § 301.6111-3(b)(3)(i)(B).

The outlines of the basket contract arrangement described in the notice appear to be substantially similar to the basket option contract. See Notice 2015-74, 2015-46 I.R.B. at 664. The main difference appears to be a broader class of counterparties. In describing basket option contracts, Notice 2015-73 indicated that banks were usually the counterparty, while Notice 2015-74 is silent on the nature of the counterparties for basket contracts. See Notice 2015-73, 2015-46 I.R.B. at 660; see also Notice 2015-74, 2015-46 I.R.B. at 664. The other difference is nomenclature; Notice 2015-73 indicated that the contracts at issue were “denominated as an option.” 2015-46 I.R.B. at 660.

Taxpayers and advisors who were involved in either type of transaction should carefully assess their obligations, as the failure to make required disclosures can result in significant penalties.



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