LISTED TRANSACTIONS: A LOOK AT BASKET OPTION CONTRACTS

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The IRS recently issued a notice formally designating basket option contracts as a listed transaction, which means that the IRS views these arrangements as tax avoidance transactions. *See* Notice 2015-73, 2015-46 I.R.B. 660 (Nov. 16, 2015). Notice 2015-73 supersedes Notice 2015-47, 2015-30 I.R.B. 76 (July 27, 2015).

The designation of a transaction as a listed transaction has a variety of adverse consequences. *First*, a taxpayer who has participated in a listed transaction has an obligation to make disclosures on her tax return. Treas. Reg. § 1.6011-4(a), (b)(2). *Second*, material advisors are required to report their involvement in the listed transaction, and must maintain lists of their clients and provide those lists to the IRS upon demand. I.R.C. §§ 6011, 6012. *Third*, since the IRS has concluded that the transactions are abusive, taxpayers who entered into them are likely to be subject to audit.

What Is a Basket Option Contract?

A basket option contract is a contractual arrangement between a taxpayer and a counterparty that is denominated as an option contract. It has several salient features:

- The taxpayer is to receive a return based upon the performance of a notional “basket” of actively traded securities;
- The taxpayer or her designee can determine either the components of the basket or select a trading algorithm that will determine the components of the basket;
- The taxpayer retains discretion over the composition of the basket over the duration of the contract and can (directly or through a designee) either change the components of the basket or alter the trading algorithm that determines the components;

- While the form of the contract may permit the counterparty to reject requested changes in the basket, that power is almost never exercised.

Notice 2015-73, 2015-46 I.R.B. at 660.

At the inception of the basket option contract, the taxpayer makes an initial payment to the counterparty of ten to forty percent of the value of assets comprising the basket. The counterparty will generally acquire the assets referenced in the basket and execute trades as the composition of the basket is changed over the life of the contract to manage its risk. The assets that comprise the basket would generate ordinary income if they were held by the taxpayer directly, and would generate short-term capital gains and losses if traded by the taxpayer directly. *Id.*

The contractual structure provides for a duration in excess of one year, although it may be terminated earlier. On settlement, the taxpayer receives a return derived from the performance of the assets that comprised the basket; a typical arrangement provides for the taxpayer to receive a payout equal to the amount of its initial deposit plus net basket gain or minus net basket loss, which reflect changes in asset values over the life of the contract, net of the counterparty's fee. *Id.*

Why Is the IRS Concerned with Basket Option Contracts?

The IRS 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.

In the government's view, the basket option contract structure does not reflect the economic realities of the arrangement. Notice 2015-73 indicates that the IRS will offer a variety of arguments to recast the structure, including the following:

- The counterparty is holding the assets that comprise the basket as an agent for the taxpayer, who is the beneficial holder for tax purposes;
- The basket option contract should not be treated as an option contract for tax purposes;
- The changes to the composition of the basket result in a taxable disposition of the contract under Section 1001 of the Code because the contract was materially modified;
- The taxpayer has separate contractual rights as to each of the assets in the basket, which means that each change in the assets in the basket represents a taxable disposition of her contractual rights under Section 1001 of the Code.

Id. The notice specifically indicates that the IRS will offer other arguments to fit the circumstances of particular contractual arrangements.
Certain contracts are excluded, including contracts that trade on a national securities exchange that is regulated by the SEC or on a domestic board of trade regulated by the CFTC. *Id.*

What Tax Years Are Effected?

The notice indicates that it will be applied to taxpayers who file a return for any tax year ending on or after January 1, 2011 that incorporates a tax benefit (defined as either deferral of income or conversion of ordinary income of short-term capital gain into long-term capital gain or loss) derived from a basket option contract. *Id.*

Disclosures will be required from participants for each taxable year in which a basket option contract was in effect on or after January 1, 2011 unless the assessment statute of limitations had expired by October 21, 2015. *Id.* at 662.

Material advisors will have disclosure and list maintenance obligations if they make a tax statement on or after January 1, 2011 relating to a transaction that was in effect on or after that date. *Id.*

What Are the Potential Consequences?

There are penalties that will apply to taxpayers who entered into basket option contracts and derived tax benefits if they fail to meet their disclosure obligations. Similarly, penalties will apply to material advisors who fail to comply with their disclosure and list maintenance obligations. *Id.*

In addition, taxpayers may be subject to accuracy related penalties.

Two cautionary notes on the relevant limitations period are in order:

- *First*, a taxpayer who fails to comply with the disclosure obligations of Section 6011 of the Code will be subject to an extended assessment limitations period. *See* I.R.C. § 6501(c)(10).
- *Second*, the Notice contains provisions indicating that the IRS views this situation as one in which the chosen method of accounting for the contracts is incorrect. This creates the potential for adjustments to be made in any future year. Under Section 481(a)(2) of the Code, once the IRS determines that the taxpayer applied an improper method of accounting, it can make adjustments in *any* future year; the only limitation is that “no pre-1954 adjustments shall be made.” *Comm’r v. Welch*, 345 F.2d 939, 950 (5th Cir. 1965).

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