Client Alert.

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IRS Characterizes Unique "Knock-Out" Option Contract as Direct Ownership of Underlying Property

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On November 12, 2010, the Internal Revenue Service ("IRS") released an advice memorandum – AM 2010-005, dated October 15, 2010 – in which it concluded that a contract styled as an option should in substance be characterized for federal income tax purposes as direct ownership of the underlying property.

FACTS

Taxpayer, a hedge fund ("HF") without any employees, was organized as a Delaware limited partnership and managed by its general partner ("GP"). HF entered into a call option contract ("Contract") with a foreign bank ("FB") on a basket of securities ("Reference Basket") held in an account administered by FB. The Reference Basket was funded with $1x, the premium paid by HF to FB, and $9x paid by FB.[1] Pursuant to the terms of the Contract, HF had the right to terminate the Contract at any time during its two-year term upon which it would receive the "Cash Settlement Amount." This amount equaled the greater of (i) zero, or (ii) the reimbursement of the $1x premium, plus "Basket Gain" or less "Basket Loss." Basket Gain or Loss equaled (i) trading gains, unrealized gains, interest, dividends, or other current income, less (ii) trading losses, unrealized losses, interest, dividend, or other current expenses, less (iii) commissions and other trading costs incurred in acquiring or disposing of the securities and positions, and less (iv) financing charges on the $9x provided by FB. The terms of the Contract included a "knock-out" provision, pursuant to which the Contract would automatically terminate at any time the Basket Loss reached 10%, and gave FB the right to require HF to enter into risk-reducing trades.

FB entered into an investment management agreement with GP setting forth certain investment guidelines and pursuant to which GP conducted trading of the securities included in the Reference Basket.[2] In addition, GP had the power to make corporate action decisions with respect to the Reference Basket securities.[3] Pursuant to the investment management agreement, FB paid GP a fixed annual fee of less than 0.1% of $10x.[4]

IRS ANALYSIS

Contract Not an Option

The IRS concluded that the terms of the Contract, and in particular the Cash Settlement Amount, ensured one of two outcomes: (i) HF would exercise if the Reference Basket increased in value, or decreased by less than 10%, in order to recoup at least a portion of its premium, or (ii) the Reference Basket would fall in value by 10% and the knock-out

[1] According to the IRS memorandum, the amount of the premium was not determined using option-pricing standards.
[2] GP selected the initial securities to be included in the Reference Basket and GP conducted the trading by instructing FB to execute its trading decisions.
[3] For example, addressing tender offers, mergers, and other decisions offering a choice of considerations of cash or shares.
[4] The IRS memorandum indicates that GP was compensated by the investors in HF through a fee structure equal to 2% of the net asset value of the Reference Basket and 20% of specified levels of Basket Gain.

provision would terminate the Contract and HF would receive nothing. As a result, in the IRS's view, the Contract imposed on HF costs similar to those of an obligated buyer and precluded any possibility of lapse and therefore lacked the requisite characteristics of an option.[5]

Further, the IRS concluded that the Contract did not function like an option because HF (through GP acting on its behalf) actively traded the securities included in the Reference Basket, whereas an option on property allows the holder to accept an offer to buy or sell specified property at a defined price.[6]

Ownership of Reference Basket

Citing case law,[7] the IRS concluded that HF should be treated as the owner of the Reference Basket for federal income tax purposes because HF had (i) opportunity for full trading gain and current income, (ii) substantially all of the risk of loss related to the Reference Basket, and (iii) complete dominion and control of the Reference Basket.

In concluding that HF bore substantially all of the risk of loss related to the Reference Basket, the IRS acknowledged that FB could suffer a loss if a Basket Loss were incurred that would breach the knock-out level and FB would not be able to timely liquidate the Reference Basket to limit the loss to 10%. The IRS, however, noted that this possibility was remote and that FB also had rights to force HF into risk-reducing trades under the investment guidelines.

SIMILAR CASES

Finally, the IRS noted that it considers the nature of the above-described transaction particularly aggressive and it encourages its agents to develop cases with respect to this and similar transactions. In addition, the IRS stated that it may be appropriate to argue that changes in a contract's reference basket causes a taxable exchange of either the contractual rights within the reference basket or of the contract itself.

COMMENT

An advice memorandum ("AM") is a memorandum from the IRS National Office to the IRS field that sets out a stylized set of facts and the IRS's view of the applicable law. One assumes, however, that the facts here are based on an actual taxpayer that is under audit.[8] While the facts in this AM are unique, it does contain some important insights into the IRS's view on current derivatives tax issues. The first is the analysis of the knock-out provision. After Section 1260[9] was enacted in 1999, a number of market participants migrated toward option contracts with knock-out features. The notion was that Section 1260 does not apply to an option where the taxpayer is not exposed to all the downside risk with respect to the underlying. In the classic case, a 25% knock-out was included. Once the underlying declined by more than 25%, the contract "knocked out" and was terminated. In the AM, the IRS concludes that the 10% knock-out feature effectively gave the taxpayer full downside risk, even though the taxpayer could lose no more than its premium if the underlying declined in value by more than 10%.

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[5] In addition, the IRS noted that the premium was a fixed percentage of the Reference Basket and was not based on an option-pricing formula (e.g., the Black-Scholes model). The IRS therefore considered the premium more akin to collateral for a nonrecourse margin loan.

[6] Importantly, the IRS noted that HF could be viewed as having a series of separate contractual rights for each security included in the Reference Basket with the result that each trade executed by HF would cause a taxable sale or exchange. However, because the IRS concluded that HF owned the securities included in the Reference Basket for federal income tax purposes, it need not (and did not) address this issue further.

[7] Among other cases, the IRS cites *Anschutz v. Commissioner*, 135 T.C. 5 (2010) and *Calloway v. Commissioner*, 135 T.C. 3 (2010). For a discussion of these cases please see our prior client alert and MoFo Tax Talk at http://www.mofo.com/files/Uploads/Images/100723TaxCourt.pdf and http://www.mofo.com/files/Uploads/Images/100716TaxTalk.pdf.

[8] According to the AM, the reason the taxpayer structured the arrangement in this fashion was twofold: first, to defer income and second, to get long-term capital gain treatment. Had it owned the basket of securities directly, it would have been taxed currently on short-term trading gains.

[9] All Section references are to the Internal Revenue Code of 1986, as amended, and Treasury regulations promulgated thereunder.

In the AM, the IRS also speculates that the taxpayer's control of the index may result in continuous recognition of gains and losses. GP's trading of the underlying securities "calls into question whether the Reference Basket constitutes specific property apart from its components; … HF could be viewed as having a series of separate contractual rights for each security within the Reference Basket such that each trade HF executes while the Basket Contract is open would generate a taxable event attributable to the trade under [Section] 1001."

Finally, the AM implies that an option must be based on "objective financial information." Because GP traded the underlying securities, the IRS implies that the price of the underlying was not objective financial information. This definition is important not only in this context, but also, for example, in the context of notional principal contracts.[10] However, no such requirement appears in the case law defining an option for federal income tax purposes.

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[10] Section 1.446-3(c)(4)(ii).

