

# IRS designates certain basket contracts as listed transactions or transactions of interest

On July 8, 2015, the Internal Revenue Service (IRS) published [Notice 2015-47](#), which alerts taxpayers and their representatives that certain “basket option contracts” have been designated as **listed transactions**, and [Notice 2015-48](#), which alerts taxpayers and their representatives that certain “basket contracts” have been designated as **transactions of interest**.

## Overview of the transactions

Generally, the IRS has identified certain contracts, including basket options, as having the potential for tax avoidance because such investments are viewed as having the potential to improperly result in (1) the deferral of income and (2) long-term capital gain. The contracts typically provide a return based on the performance of multiple underlying securities or assets. The IRS has focused on those contracts with reference property that is not static during the life of the contract (that is, the composition of the reference property is subject to change). Further, the IRS has focused more specifically on situations where the taxpayer (or its designee) has some level of control over the components underlying the contract. The IRS is concerned that even though the reference assets vary during the term of the contract, the taxpayer does not recognize current gain or loss relating to changes in the underlying assets and does not recognize currently any income produced by such assets (such as dividends or interest). Instead, the taxpayer takes the position that if the contract is held open for more than one year, the taxpayer simply recognizes long-term capital gain upon the closing of the contract.

Taxpayers who have entered into transactions described in the Notices, or substantially similar transactions, are now subject to certain reporting requirements under Reg. § 1.6011-4. **Participation in these transactions must be disclosed by taxpayers no later than November 5, 2015 on Form 8886, Reportable Transaction Disclosure Statement.** In addition, advisors to those taxpayers may be subject to registration and list maintenance requirements under IRC §§ 6111 and 6112, respectively.

## Notice 2015-47

In Notice 2015-47, the IRS described a basket option transaction designed to defer income and gain recognition, while the assets within the basket are determined by the taxpayer. Notice 2015-47 is specifically concerned with transactions used to (i) defer income recognition and convert what would be short term capital gain or ordinary income into long term capital gain, (ii) avoid application of § 1260, (iii) avoid withholding taxes, and/or (iv) avoid certain other tax reporting requirements. In Notice 2015-47, the IRS states that it may assert one or more arguments to challenge the tax characterization of a basket option contract, including:

1. The counterparty (typically a bank) in substance holds the assets in the reference basket as an agent for the taxpayer, and that the taxpayer is the beneficial owner of the assets for tax purposes;
2. The basket option contract is not an option for tax purposes;
3. Changes to the assets in the reference basket during the year materially modify the contract and result in taxable dispositions of the contract; and

4. The taxpayer actually owns separate contractual rights with respect to each asset in the reference basket such that each change to the assets in the basket results in a taxable disposition of a contractual right with respect to the assets affected by the change.<sup>1</sup>

A transaction is deemed to be the same as, or substantially similar to, the listed transaction identified in Notice 2015-47 if:

1. The transaction is denominated as an option contract;
2. Substantially all of the assets in the reference basket primarily consist of actively traded personal property as defined under Reg. § 1.1092(d)-1(a);
3. The purchaser of the option or the purchaser's designee either have the right to (a) determine the assets in the reference basket both at the inception of the transactions and periodically over the term of the transaction or (b) select or use a specified trading algorithm under its control to determine the assets in the reference basket; and
4. The purchaser of the option, the purchaser's designee, or the specific trading algorithm actually changes one or more of the assets in the reference basket during the term of the basket option contract.

The following parties are treated as participating in the listed transaction identified in Notice 2015-47: (i) the purchaser of the basket option contract, (ii) if the purchaser of the basket option contract is a partnership, any general partner of the purchaser, (iii) if the purchaser of the basket option contract is a limited liability company, any managing member of the purchaser, and (iv) the counterparty to the basket option contract.

Transactions in effect on or after January 1, 2011, that are the same as, or substantially similar to, the transaction described in Notice 2015-47, are identified as "listed transactions" for purposes of Reg. § 1.6011-4(b)(2) and §§ 6111 and 6112 effective July 8, 2015. Persons engaged in transactions in effect on or after January 1, 2011, must disclose the transactions for each taxable year in which the taxpayer participated in the transactions, provided that the period for limitations for assessment of tax had not ended on or before July 8, 2015.

### Notice 2015-48

Notice 2015-48 casts a wider net as the IRS describes certain basket contracts that may be designated as options, notional principal contracts, forward contracts or other derivative contracts. Notice 2015-48 goes further than Notice 2015-47 by describing reference assets in a basket to include interests in entities that trade financial instruments ("hedge fund interests"), as well as securities, commodities, foreign currencies, or similar property. Notice 2015-48 indicates that Treasury and the IRS believe that such basket contracts have the potential for tax avoidance or evasion, but they lack enough information to determine whether such transactions should be identified specifically as tax avoidance transactions. To that end, when the US Treasury Department and the IRS have gathered enough information to make an informed decision as to whether these transactions are a tax avoidance type of transaction, the US Treasury Department and the IRS may take one or more administrative actions, including removing the transactions from the transactions of interest category in published guidance, designating the transactions as a listed transaction, or providing a new category of reportable transactions. In the meantime, such transactions should be disclosed in the taxpayer's tax returns as transactions of interest on Form 8886, *Reportable Transaction Disclosure Statement*, in the same manner in which other reportable transactions are disclosed, although subject to different effective dates as discussed below.

Transactions entered into on or after November 2, 2006, that are the same as, or substantially similar to, the transaction described in Notice 2015-48, and in effect on or after January 1, 2011, are identified as transactions of interests for purposes of Reg. § 1.6011-4(b)(6) and §§ 6111 and 6112 effective July 8, 2015. Persons engaged in transactions entered into on or after November 2, 2006, and in effect on or after January 1, 2011, must disclose the transactions for each taxable year in which the taxpayer participated in the transactions, provided that the period for limitations for assessment of tax had not ended on or before July 8, 2015. The same type of participants as described in Notice 2015-47 must disclose their participation in the transactions of interest described in Notice 2015-48.

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<sup>1</sup> The IRS reserves the right to make other arguments supporting the conclusion that the taxpayer is the beneficial owner of the assets in the reference basket for tax purposes.

## Timing of disclosure

For purpose of transactions described in either Notice 2015-47 or Notice 2015-48, the 90-day period for taxpayers to disclose listed transactions or transactions of interest set forth in Reg. § 1.6011-4(e)(2) is extended to 120 days from the notice date of July 8, 2015, therefore they are due by November 5, 2015. For a taxpayer that participated in a transaction described in either Notice and for which the tax return is due between July 8, 2015 and November 5, 2015, that disclosure statement will be considered timely filed if the taxpayer files the disclosure with the Office of Tax Shelter Analysis by November 5, 2015.

Notices 2015-47 and 2015-48 represent the first financial product transactions designated as listed transactions or transactions of interest in years. A transaction that meets the requirements of both Notices is identified as a listed transaction under Notice 2015-47 and as a transaction of interest under Notice 2015-48 need only be reported once. Rules impacting material advisors to such transactions have also been described in the Notices.

## Contacts

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