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Investment Management Tax Alerts

Senate investigates use of barrier option baskets

On July 22, 2014, the Senate Permanent Subcommittee on Investigations ["PSI"] held a hearing in Washington D.C. to discuss the use of certain financial products purported to avoid both federal income taxes and regulatory leverage limits. In conjunction with this hearing, the PSI issued the report: Abuse of structured financial products: Misusing basket options to avoid taxes and leverage limits**.**

The report describes in detail the specific transaction the PSI is concerned with, which may be summarized as follows:

A hedge fund ["taxpayer"] entered into a basket option transaction with a counterparty bank ["bank"]. Taxpayer paid a 10 percent upfront premium to the bank, and bank provided the remaining 90 percent of the funds needed to acquire a basket of securities under the terms of the option contract. The contract provided for a "barrier" provision which would allow the bank to terminate the contract and liquidate the securities in the portfolio if there was greater than 10 percent depreciation in the value of the securities. Taxpayer was entitled to cash settlement of the option when the contract expires or is otherwise terminated. Typically the maturity of the contract was in excess of one year. The cash settlement amount was determined by a formula which generally reflected the net increase in the value of the securities in the basket, plus any dividends earned on the underlying stocks and less expenses charged by the bank including financing costs. While the option contract provided for a few basic parameters, the general partner of taxpayer had wide discretion to trade the securities in the basket despite the fact that the securities were held in the name of the bank. In many cases the securities in the basket were held for a very short period of time; the PSI report indicates that in the contracts they reviewed, 97 percent of the securities in the option baskets were held for six months or less.

Taxpayer typically cash settled the option after the contract had been outstanding for 12 months, and claimed long term capital gain treatment upon termination.

The PSI report made reference to an IRS Generic Legal Advice Memorandum ["GLAM"][1] issued in 2010 which considered the same type of option transaction. In that GLAM, the IRS concluded that:

1. The contract did not function like an option, and should not be treated as such, and
2. The taxpayer should be treated as the owner of the underlying securities because it had control over the securities, had the full opportunity for gain, and bore the risk of loss.

The GLAM observed that in considering who is the true owner of stock, the most relevant factors courts have considered are the ability to sell shares, the power to vote, the right to receive dividends, and the opportunity for gain and risk of loss. The IRS concluded that the hedge fund had most of these attributes and should be treated as the tax owner of the securities in the basket.

In summarizing its concern, the PSI report stated that:

> "In the end, the trading conducted by the hedge funds using the basket option accounts was virtually indistinguishable from the trading conducted by hedge funds using their own brokerage accounts, and provided no justification for treating the resulting short-term trading profits as long term capital gains."

Using data supplied by several banks and hedge funds, the PSI estimated that billions in trading profits had

[1] AM2010-005

been classified as long term capital gains, and the taxation of such gains had been deferred, improperly by 13 hedge funds.

The PSI recommends that the IRS audit the hedge funds that entered into these barrier option transactions, as well as the financial institutions that acted as counterparties.

For additional information or questions, please contact:

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