

Service Denies Tax Deferral and Long-Term Capital Gains Through Basket Option Transaction

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Advice Memorandum 2010-005, released on November 12, 2010, sets out the Internal Revenue Service's position on whether the purchased call option described therein should be respected as an option; treated as another form of a derivative transaction; or recast as, in substance, tax ownership of the underlying basket of securities.

In a recent Chief Counsel's Advice Memorandum, the Internal Revenue Service (Service) challenged the availability of tax deferral and long-term capital gains pursuant to a basket option transaction by disregarding the form of the transaction and treating the option purchaser as having made a leveraged investment directly in the underlying securities.

Advice Memorandum 2010-005, released on November 12, 2010, sets out the Service's position on whether the purchased call option described therein should be respected as an option; treated as another form of a derivative transaction; or recast as, in substance, tax ownership of the underlying basket of securities (Reference Basket). The Service noted that the option purchaser "sought two tax advantages in characterizing the Basket Contract as an option," namely, (1) deferral of taxable income with respect to gains, interest and dividends earned within the Reference Basket until the option either was exercised or was earlier terminated and cash-settled, and (2) conversion of short-term capital gains and ordinary income (interest and dividends) with respect to the Reference Basket into long-term capital gains if the option remained open for more than one year before termination and cash settlement.

Description of the Basket Option

According to the Advice Memorandum, the option purchaser was a tax partnership that operated as a hedge fund (HF). In consideration of an option premium of \$1x, HF purchased a two-year call option from a foreign financial institution (FB) relating to the Reference Basket. FB apparently held the securities making up the Reference Basket in a prime brokerage account. At the time the option was entered into, the Reference Basket had an aggregate value of \$10x. The Advice Memorandum states that \$9x of the funds used to purchase the Reference Basket were provided by FB. The Service also found no indication that normal option pricing was involved in setting HF's \$1x premium, and it instead viewed HF's premium as collateral for a nonrecourse margin loan from FB.

HF had the right to terminate the option at any time during its two-year term. Upon earlier termination, HF was entitled to receive the "Cash Settlement Amount" from FB. The Service described the Cash Settlement Amount as an amount reflecting the aggregate economic performance (dividends, interests, gains and losses) derived from the

securities making up the Reference Basket over the option term, reduced by commissions and other trading costs incurred by FB in acquiring or disposing of the securities, and further reduced by financing charges on the \$9x of funding provided by FB (collectively, the Basket Gain or Basket Loss).

The option contained a “Knock-Out” feature that automatically terminated the transaction prior to its scheduled maturity if the Basket Loss reached the amount of HF’s initial premium of \$1x. If the Knock-Out provision was triggered, HF would receive a Cash Settlement Amount of zero. Although no details were provided, FB apparently had the right to require HF to enter into risk-reducing trades (hedges) before losses on the Reference Basket reached the Knock-Out threshold.

The Service also noted the existence of an investment management agreement with HF’s general partner (GP) that provided GP with control over the composition of the Reference Basket. According to the Service, while FB was not contractually obligated to follow GP’s instructions, the Reference Basket would be valued based on GP’s instructions and “FB in fact executed all of GP’s trading instructions, which could entail numerous trades per day.” GP also had the authority to vote the securities held in the Reference Basket.

Tax Ownership Versus Derivative Taxation

The Service disregarded the form of the transaction and concluded that, in substance, HF was the tax owner of the Reference Basket based on its view that HF had the entire opportunity for gain and the risk of loss on, as well as “complete dominion and control over,” the Reference Basket.

In considering the economics of the transaction, the Service noted that HF had full opportunity for income and gains, and focused on HF’s risk of loss, noting that the determination of the Cash Settlement Amount, coupled with the Knock-Out feature, resulted in the full risk of loss inherent in the Reference Basket being borne by HF. The Service concluded that FB could suffer a loss only if the value of the Reference Basket declined so quickly that FB was unable to liquidate the Reference Basket fast enough to prevent losses beyond HF’s \$1x premium. The Service believed FB’s risk of loss was remote, however, considering its right to require HF to enter into risk-reducing trades against the Reference Basket and its right to cause an early termination before losses reached the Knock-Out threshold.

The second component of the Service’s tax ownership analysis focused on its view that HF, through GP, had “complete dominion and control” over the securities making up the Reference Basket. GP apparently instructed FB to execute numerous trades on a daily basis. This control, coupled with GP’s authority to vote the securities in the Reference Basket, led the Service to conclude that HF, rather than FB, acted as an owner of the Reference Basket. The Service considered FB’s right to loan or rehypothecate the securities without HF’s knowledge but concluded that

this right was akin to the customary powers that a broker has over assets under custodial arrangements with prime brokerage customers. According to the Service, “HF’s ability to trade any security within the Reference Basket or terminate the Basket Contract at any time and receive the Cash Settlement Amount further places HF in a similar position to an owner of a prime brokerage account and limits FB’s ability to lend or rehypothecate the securities.”>

If the Service is ultimately successful in recharacterizing the option transaction described in the Advice Memorandum, or potentially similar transactions, as resulting in HF having beneficial (tax) ownership of the underlying securities, such recharacterization will have a number of important tax consequences to the option purchaser, including potential acceleration of recognition of income and loss of long-term capital gains treatment in the case of U.S. taxable investors. If a transaction of this type is determined to be, in substance, an investment in securities through margin loans in the equivalent of a prime brokerage account, debt-finance property issues under Code §514 could arise for a tax-exempt investor participating directly, or indirectly through a tax partnership, in such a transaction. Non-U.S. persons participating in such transactions could also be affected to the extent that certain income generated by the securities maintained in the basket are viewed as generating, for example, U.S. source dividend or other income potentially subject to a U.S. withholding tax, whereas “gains” from an option may not have been subjected to such withholding taxes. Finally, non-U.S. investors would also need to consider whether the deemed ownership of an actively managed portfolio of securities results in income effectively connected with the conduct of a U.S. trade or business and the potential availability of the “trading” safe harbors.

Constructive Ownership Issues (Code §1260)

Although the Service ultimately concluded that the transaction at issue should not be respected as an option and that HF had beneficial (tax) ownership of the Reference Basket from its inception, it briefly considered whether the transaction could be classified as a forward contract rather than an option. This comment is interesting in that the Service essentially acknowledged that if the transaction were to be recharacterized as a forward contract, the general tax result to HF (deferral and long-term capital gains) would have been largely the same as a tax option. It appears that the Service may have included the forward contract discussion to note its view on the potential application of the constructive ownership rules of Code §1260 in the event that the particular transaction, or variations on the transaction, cannot be successfully recast by the Service as resulting in immediate tax ownership. For Code §1260 purposes, this distinction is important because a forward contract relating to equity interests in certain “pass-thru” entities (regulated investment companies, real estate investment trusts, S corporations, tax partnerships, trusts, common trust funds, certain passive foreign investment companies and REMICs) potentially results in adverse tax timing and character implications under Code §1260, whereas an at-the-market stand-alone option generally would not be subject to Code §1260.

Without engaging in an extensive analysis, the Service concluded that option characterization was not appropriate for the transaction at issue. In reaching this conclusion, the Service focused on the economics of the transaction, along with HF's apparent ability to alter the composition of the Reference Basket, and concluded that these factors were contrary to option classification.

As to the economics, the Service determined that the terms of the transaction ensured one of two outcomes:

- If the Reference Basket increased in value, or decreased by less than 10 percent, HF would exercise the option in order to recoup at least a portion of its investment.
- If the Reference Basket fell in value by 10 percent, the Knock-Out provision would terminate the option, and HF would receive nothing. "Thus, the Cash Settlement Amount placed HF in the same economic position as a party obligated to buy the Reference Basket, while the Knock-Out provision ensured that the Basket Contract would never lapse unexercised."

The Service's conclusion that the transaction did not perform like a traditional option was also based on its determination that HF—through GP's actions under the Investment Management Agreement—could alter the composition of the Reference Basket during the term of the transaction. Based on its view that a typical option provides the holder with the choice of accepting the option seller's offer, for the term of the option, to buy or sell specified property at defined price, the Service concluded that HF's ability to alter the composition of the Reference Basket contradicted option characterization.

Observations

The Advice Memorandum reflects the Chief Counsel's views on a particular transaction and is intended to provide guidance to examining agents in the field. There are no assurances, however, that the positions expressed by the Service in the Advice Memorandum will ultimately be sustained. Nevertheless, the Advice Memorandum is important in that it potentially sheds additional light on the factors that are, at least from the Service's viewpoint, most likely to cause it to attempt to recharacterize a derivative as resulting in a transfer of ownership of the reference property. As such, the discussions in the Advice Memorandum may be of interest in considering the tax ownership implications of other derivative transactions.

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