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## IRS Attacks “Barrier Options” and Treats Optionholder as Owning the Underlying Securities

The Internal Revenue Service (IRS) recently released Advice Memorandum 2010-005 (the AM), in which it held that a so-called barrier option or “knock-out option,” as described below, would not be respected as an option for U.S. federal income tax purposes and would cause the optionholder to be treated as the owner of the “optioned” securities.

Generally, when a taxpayer acquires an option, it is not treated as the owner of the securities underlying the option and is not required to recognize gain or loss until the option settles or expires. At the time of settlement, if the asset underlying the option is a capital asset, the optionholder will generally recognize long-term capital gain if it held the option for longer than one year. The IRS’s holding in the AM would require a “barrier” optionholder to accelerate recognition of income and gain, and may cause the optionholder to recognize short-term capital gain or ordinary income rather than long-term capital gain.

Although the AM has limited precedential weight, it reflects the view, and directive to area counsels, of a senior IRS lawyer, and its implications should be carefully considered by any taxpayer who entered into a barrier option or another derivative referencing an interest in a managed account or a variable basket of securities (whether held directly or in the form of a private fund, including a hedge fund).

### Facts

In the scenario addressed in the AM, the taxpayer, a hedge fund (HF), entered into an option with a foreign bank (FB) on a basket of securities (the Reference Basket). The premium paid by HF for the option was 10% of the initial value of the Reference Basket.

The terms of the option provided that upon the settlement date, HF was entitled to receive the greater of (i) zero, and (ii) the sum of (a) all gains and income realized on the securities in the Reference Basket and (b) the option premium less the sum of (x) any losses or costs incurred in connection with purchasing, holding and selling the securities in the Reference Basket, and (y) a finance charge on 90% of the initial value of the Reference Basket.

The option contained a “knock-out” feature whereby it would immediately settle if the value of the underlying securities in the Reference Basket decreased by 10% relative to the initial value of the Reference Fund. FB also had the right to require certain risk mitigating

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investment strategies to be implemented if the value of the securities in the Reference Basket decreased, even by less than 10%, and certain other conditions were satisfied.

FB also entered into an agreement with HF's general partner (GP) to manage the securities that comprised the Reference Basket. GP, as investment manager of the securities that comprised the Reference Basket, was required to follow various investment guidelines. FB had the right to terminate the option if GP violated these guidelines.

Although not contractually obligated to follow GP's specific trading instructions, as long as GP's instructions complied with the investment guidelines, FB in fact always did execute upon GP's trading instructions. In addition, GP also had the power to make corporate decisions (i.e., to exercise voting rights) relating to the securities in the Reference Basket.

FB's rights with respect to the securities in the Reference Basket were similar to the rights FB had as pledgee with respect to assets in margin securities accounts of its brokerage customers.

Finally, GP was paid management fees by FB for its investment management services to FB. However, such fees were significantly less than the fees GP ordinarily charged other third parties for its services.

## IRS Holding

The AM concluded that the terms of the "option" caused HF to have all the upside potential and bear all the downside risk of the securities in the Reference Basket. Specifically, the "knock-out" feature of the option effectively ensured that HF (rather than FB) would bear all the downside risk of the Reference Basket. In addition, because GP was relying mainly on the compensation it was receiving from HF and not from FB, the AM concluded that GP was in essence working for HF. Thus, HF (through GP) was controlling the securities in the Reference Basket.

Based on the above, the AM advised that the option should not be respected as such, and that HF should be treated for U.S. federal income tax purposes as owning the securities in the Reference Basket throughout the term of the option.

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