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Chief Counsel Advice Memoranda 201547004

Subject Matter

Cash-Settled Barrier "Call ***Options***"

[*1]

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Core Terms

basket, hedge, portfolio, ownership, tax purposes, terminate, accounting method, barrier, premium, liquidity, capital gains, cash settlement, partnership, hoist, buy, redact, long-term, investor, entity, redeem, terms of the contract, financial assets, cash withdrawal, deferral, withdraw, pocket, spread, tax year, maturity, buyer's

Text

This Chief Counsel Advice responds to your request for assistance dated March 18, 2015, as supplemented by your request for assistance dated July 10, 2015. This advice may not be used or cited as precedent.

ISSUES

To obtain exposure to hedge funds (both U.S. and non-U.S. entities [1] , the "referenced assets") Taxpayer, a U.S. person, entered into contracts with a counterparty bank ("Bank") referencing an index specific to the transactions in issue, composed of the referenced assets (the "***Basket***"). [2] You have asked for advice on the following:

(1) Whether the contracts should be treated as ***options*** held by Taxpayer to purchase the referenced assets or, if not, whether Taxpayer should be treated as the owner of the referenced assets for tax purposes;

(2) If Bank (and not Taxpayer) is treated as the owner of the referenced assets for tax purposes, whether Taxpayer should be treated **[*2]** as the constructive owner of the referenced assets under *section 1260*;

(3) Whether, to the extent the contracts are not treated as transferring ownership of the referenced assets for tax purposes, (a) withdrawals from the contracts are income of Taxpayer to the extent of any gain on the

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[1] The ″passive foreign investment company″ (″PFIC″) rules are set forth at sections 1291 through 1298 of the Internal Revenue Code (the ″Code″). Some or all of the non-U.S. hedge funds may meet the definition of PFIC under section 1297. This memorandum does not address the application of the PFIC rules.

[2] The contract refers to the Basket as an ″index″.

contracts as of the date cash was received, and (b) changes to the ***Basket*** or amendments to the contracts are taxable exchanges of Taxpayer's contracts under section 1001; and

(4) Whether Taxpayer's deferral of gains, losses, income or deductions arising from the contracts under its current accounting method (a "deferral accounting method") clearly reflects Taxpayer's income under section 446 (b) and, if not, whether the Internal Revenue Service (the "Service") may change Taxpayer's deferral accounting method to a method that does clearly reflect Taxpayer's income and make an adjustment under section 481 (a), in both cases only as relates to the non-PFIC referenced assets. [3]

CONCLUSIONS

(1) Although the contracts are labeled as ***options***, the contracts do not function as ***options***, or have the economic characteristics of ***options***, and therefore we conclude they are not ***options*** for tax purposes. To the extent that **[*3]** Bank in fact held the referenced assets in connection with the contracts, we conclude that Taxpayer owns the referenced assets for all purposes of the Code.

(2) To the extent Taxpayer is not treated as the owner for tax purposes of a referenced asset and the referenced asset is a "pass-thru" entity, we conclude that under section 1260 Taxpayer is the constructive owner of the referenced asset.

(3) To the extent Taxpayer is not treated as the owner of the referenced assets for tax purposes, (a) Taxpayer's cash withdrawals from the contracts are taxable, (b) amendments to the contracts to include a portfolio management fee and to reduce Bank's spread are taxable exchanges of Taxpayer's contracts that result in recognition of any net gain or loss on the contracts, and (c) Taxpayer's discretion to make changes to the composition of the ***Basket***, combined with the resulting number of changes to the ***Basket*** based on that discretion, may be economically significant such that, within a given tax year, the changes are cumulatively a "fundamental change" to the contracts resulting in taxable exchanges of Taxpayer's contracts.

(4) To the extent Taxpayer is treated as the owner of any referenced asset **[*4]** for tax purposes or if there is a taxable cash withdrawal or taxable exchange of Taxpayer's contracts, then the deferral accounting method does not clearly reflect Taxpayer's income and therefore the Service may change Taxpayer's deferral accounting method to a method that does clearly reflect its income and may compute the necessary adjustment under section 481 (a), in both cases only as relates to the non-PFIC referenced assets.

FACTS

Bank marketed various products to investors seeking hedge fund exposure. Taxpayer, a U.S. person, purchased several contracts styled as "call ***options***" from Bank, including the two contracts that are the subject of this advice. [4] The contracts designate a portfolio manager, Corporation 2, to manage the ***Basket*** while the "***options***" remain open. As described below under "Corporation 2's Management of the Portfolio," Corporation 2 is a company formed at Individual 1's request and operated by Individual 2, who was Taxpayer's former employee. The transaction documents state that Bank "will not recommend any [***Basket***] Component to [Taxpayer] that should be included in the [***Basket***]," that Bank is not acting as an advisor to Taxpayer, and that Taxpayer and its advisors **[*5]** are solely responsible for determining the composition of the ***Basket***.

The tax years under examination are Years 4 and 5. Several of Taxpayer's call ***option*** contracts were terminated in prior years; the two that have not been terminated (Contract 1 and Contract 2 and collectively, the "contracts") are the subject of this memorandum.

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[3] This memorandum does not address whether an adjustment under section 481 (a) is required related to Taxpayer's deferral of gains, losses, income or deductions arising from any non-U.S. referenced assets that are PFICs.

[4] Although each contract bears the title "Cash-Settled Equity Barrier Call ***Option***," the general terms of each contract specify a "Number of ***Options***" of T.

Taxpayer is a State A partnership. During the years in issue, Individual 1 and his wife owned A percent of Taxpayer and Corporation 1 owned B percent. [5] Taxpayer is on the cash receipts and disbursements accounting method but has not included any gains or losses from Contract 1 and Contract 2 in its taxable income through Year 5.

Contract Terms. In each contract the "premium" is K percent of the contract's initial notional amount. [6] The "strike price" is (100 - K) percent of the initial notional amount, as adjusted for an annualized LIBOR and spread amount (i.e., interest-like charges and fees imposed by Bank), and as modified by the "barrier provisions" (i.e., adjusted upward to the extent Bank contributes additional capital to re-leverage Taxpayer's position, and adjusted downward to the extent Bank withdraws capital to de-leverage Taxpayer's position, as **[*6]** described further below). The "cash settlement amount" payable to Taxpayer at maturity or early termination equals the value of the portfolio [7] minus the strike price, subject to a floor of zero. [8] The barrier provisions, however, are intended to prevent the floor from being reached.

The barrier provisions provide a framework for maintaining Bank-provided leverage at or near the initial (100 - K) percent level. If the value of the portfolio increases, Taxpayer may request that Bank contribute "additional capital." The barrier provisions also provide for termination of the contract if the value of the portfolio decreases more than a specified percentage. Specifically, if the value of the portfolio drops by more than approximately L percent from its starting value (representing less than half of Taxpayer's "premium"), Taxpayer is required to pay "additional premium" to reset the ratio (i.e., buy down the over-leverage). Otherwise, Bank has the right to either "deduct capital" from the portfolio by adjusting the valuation of the portfolio downward, or terminate the contract. Capital may be "deducted" **[*7]** either by withdrawing cash, or by allocating to Bank a share in gains from the portfolio.

The contracts do not explicitly permit Taxpayer to withdraw cash from the contracts while the contracts remain open, except for partial terminations as discussed below.

Each of the contracts has an L-year term. However, Taxpayer is permitted to terminate a contract in whole or in part on D days' notice.

Amendments to Contracts. Contract 1 was amended in Year 2 to provide for a portfolio management fee and both Contract 1 and Contract 2 were amended in Year 5 to reduce to the spread payable to Bank. There were other less relevant amendments to the contracts as well, which we have not discussed in this advice.

Cash Withdrawals. In Year 4, Taxpayer began to make cash withdrawals from the contracts. Between Years 4 and 8, Taxpayer withdrew cash on Q separate occasions for Contract 1 and R separate occasions for Contract 2. Although the contracts provide for partial terminations at Taxpayer's election, Taxpayer's cash withdrawals were not treated by either party as a partial termination event. [9]

The Portfolio. The contracts define the "portfolio" as the ***Basket*** referenced in the contract, and then, in a **[*8]** section called "Portfolio Description," provide that the portfolio "shall consist of notional interests in (1)

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[5] Corporation 1 is the general partner of Taxpayer and the legal entity referenced in the contracts. Corporation 1 is owned by Individual 1 and relatives of Individual 1. Individual 1 is also the president of Corporation 1.

[6] We note that the premium is a fixed percentage of the initial notional amount, and therefore not priced using the Black-Scholes, or any other accepted methodology for determining the fair market value of an ***option***.

[7] As described further below in the discussion of "The Portfolio" and "Corporation 2's Management of the Portfolio," the "portfolio" is defined by the contracts as the ***Basket***.

[8] Accordingly, each contract, at the outset, was in-the-money by an amount equal to Taxpayer's "premium" payment. The value of the portfolio under the contract is the "aggregate USD value of the net asset values of the components which comprise the [***Basket***]. . . less any fees and expenses associated with the maintenance of the [***Basket***]. . ." Bank's fees and expenses in the form of the LIBOR and spread amounts, alternatively, affect the strike price.

[9] In particular, the amounts withdrawn do not correspond to the fixed number of ***options*** referenced by each contract (for example, cash withdrawn in an amount corresponding to the cash settlement value of one or more out of the T total ***options***).

investment vehicles, managed accounts, and indices thereof, (2) cash, and (3) other assets or securities." The ***Basket*** in fact referenced hedge fund interests and cash. Although Bank was not required by the contracts to purchase the referenced assets in amounts sufficient to support its obligations to Taxpayer, the following facts (as described further below) indicate that Bank held the referenced assets: (a) the type of referenced assets, (b) the focus of the parties on the management of liquidity risk, and (c) Bank's "division of the ***Basket***" in Years 3 and 4.

First, the referenced assets, hedge fund interests, are not publicly traded and, unlike publicly traded securities, such interests do not have a readily ascertainable value. Because the value of a particular hedge fund is not available to the public, Bank would have needed to own some interest in each of the underlying hedge funds in order to determine the value of a contract's referenced assets.

Second, the contracts treated failure to maintain sufficient "liquidity" in the ***Basket*** as a "market disruption event." Absent **[*9]** such a "market disruption event," the contracts require C percent of the cash settlement amount to be paid within D days of termination or maturity, with the remainder payable within E days. However, Bank did not meet this timeline on Taxpayer's terminated contracts on account of illiquid "side pocket" investments made by the referenced hedge funds. [10] This fact indicates that Bank needed to redeem its investment in the referenced hedge funds before paying a cash settlement to Taxpayer and, because of the "side pocket" investments that may have delayed Bank's ability to redeem its investment, the payment to Taxpayer was delayed. Moreover, Bank's "***basket*** reports" provided to Taxpayer show transfers to "side pockets," which is indicative of the fact that Bank owned an interest in the underlying hedge fund and needed to track the illiquid "side pocket" investments of the hedge fund. In other words, the tracking of these "side pockets" would not typically be of concern for those with merely notional interests in a hedge fund.

Third, the same ***Basket*** referenced by Contract 1 and Contract 2 was initially referenced by other contracts held by Individual 1's friends and family. [11] However, in **[*10]** Years 3 and 4, Bank "divided the ***Basket***" as between its various counterparties. Bank would not have had to do this if Bank did not need to rely on redeeming the referenced assets it held to respond to a cash settlement request.

Bank "divided the ***Basket***" because the performance of the ***Basket*** had been affected by a relatively high cash balance in the ***Basket*** created by the requests of certain counterparties for cash settlements of their contracts. In response to a counterparty's request that Bank cash settle the counterparty's contract, Bank would redeem interests in hedge funds (which would not have been required if Bank did not in fact hold the referenced assets). Redemption of such interests could only take place at certain pre-specified times when the hedge funds processed redemption requests, and could take a number of months to complete. While hedge fund interests were being redeemed, the ***Basket*** would consequently include a relatively high proportion of cash, resulting in lower yields on all contracts referencing the ***Basket***. To prevent this result, Bank "divided the ***Basket***." After the ***Basket*** was divided, Bank maintained a separate ***Basket*** for each contract.

Corporation 2's Management **[*11]** of the Portfolio. As explained above, the ***Basket*** was managed by Corporation 2, a company owned by Individual 2. Individuals 1 and 2 had an existing working relationship that predated the contracts in issue in this case. Individual 2 was a former Taxpayer employee; several years prior to Year 1, Individual 1 hired Individual 2 to work for Individual 1 at Taxpayer. Individual 2 worked out of an office in Individual 1's home, and lived there for several years while he worked for Taxpayer. Individual 1 requested that Individual 2 form Corporation 2 for the purpose of managing Taxpayer's contracts with Bank, such as Contracts 1 and 2.

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[10] A hedge fund "side pocket" is an account that separates a hedge fund's illiquid investments from its more liquid investments. Although the creation of a side pocket generally does not affect the fund's net asset value, "once an investment is made in a side pocket . . . funds associated with the investment may not be withdrawn from the partnership until the particular investment is sold, even if an investor redeems out of the hedge fund before the side pocket investment has been liquidated . . . ." David S. Miller & Jean Bertrand, "Federal Income Tax Treatment of Hedge Funds, Their Investors, and Their Managers," 65 Tax Lawyer 309, 322 (2012).

[11] Individual 2 stated that two contracts referencing the ***Basket*** were held by "friends" of Individual 1.

Corporation 2 was selected by, compensated by, and acted on behalf of Taxpayer. Corporation 2 did not earn any fees or other compensation under the contracts for performing advisory functions until Contract 1 was amended in Year 2. Corporation 2's portfolio management activities included recommending changes to the ***Basket***, requesting the addition of new hedge funds to Bank's platform (enabling them to be added to the ***Basket***), and communicating with hedge fund managers to negotiate waivers of redemption fees (which were otherwise borne by Taxpayer under the **[*12]** contracts).

All changes to the ***Basket*** were requested by Corporation 2. The contracts do not require Individual 1 to approve changes to the ***Basket***, but Individual 1 in fact approved all changes. The contracts require Bank's consent to changes to the ***Basket***, and allow Bank to make its own changes for "risk management" reasons. Bank in fact rejected, at most, only P requests to change the ***Basket***, yet there were F, G, H, I, and J changes to the ***Basket*** in Years 1 through 5, respectively. [12] The transaction documents include multiple statements that Bank "will not recommend any [***Basket***] Component to [Taxpayer] that should be included in the [***Basket***]," that Bank is not acting as an advisor to Taxpayer, and that Taxpayer and its advisors are solely responsible for determining the composition of the ***Basket***.

Expenses Associated with Bank's Holdings of Referenced Assets. Although the contracts refer to Bank's potential positions in the referenced assets as "hedges," the contracts' valuation of the portfolio ensured that Taxpayer bore any expenses associated with maintaining these positions to the extent Corporation 2 was unable to negotiate fee reductions with hedge fund managers. These expenses **[*13]** were generally created when hedge fund interests were acquired and redeemed and as described above in "Corporation 2's Management of the Portfolio," Taxpayer, through Corporation 2, controlled these decisions.

Taxpayer's Relationship with Hedge Fund Managers. Although hedge fund interests were held in the name of Bank, hedge fund managers were generally aware of Bank's relationship with Taxpayer (as described in more detail above under "Corporation 2's Management of the Portfolio"), and knew that interests were held on behalf of Taxpayer. Additionally, Taxpayer consented in the contracts to the "disclosure to any [h]edge fund . . . the identity of [Taxpayer], the amount of exposure [Taxpayer] has, or is proposed to have, to such [h]edge fund, the amount of any change in exposure [Taxpayer] has to such [h]edge fund or any other information requested by such [h]edge fund . . . with respect to [Taxpayer]." Taxpayer was also required to represent in the contracts with Bank that it met various eligibility requirements to be an investor in the hedge funds, including its status as a "qualified purchaser" under the Investment Company Act of 1940, and that it is not a "benefit plan investor" **[*14]** for purposes of the ERISA rules.

Bank's Contractual Protections. In addition to the barrier provisions, the contracts include the following provisions, which may have the effect of protecting Bank from loss by indirectly requiring the portfolio to meet certain diversification and liquidity requirements.

The contracts treat the following as "market disruption events," which result in a delay of up to S years of a cash settlement upon termination or maturity of a contract: (1) "the [portfolio] contains an insufficient amount of liquidity to meet [Bank's] hedging requirements"; and (2) "the portfolio is insufficiently diversified, or the portfolio would be insufficiently diversified as a result of [Bank] altering its hedge, if any, to effect a termination of any portion of the ***options***." Bank's "hedging" requirements are not set out in the contracts, nor is the diversification standard for the portfolio. However, according to Bank's marketing materials, portfolios typically include the following attributes: "a minimum of M different hedge funds; a minimum of N different strategies; annualized historical volatility less than N percent (standard deviation); and all funds must have annual liquidity **[*15]** or better." The portfolio in fact included over O different hedge funds at one point.

Taxpayer in fact sought the most favorable liquidity terms possible for the referenced assets, directing that positions be taken in non-U.S. hedge funds when available. According to Individual 2, this liquidity was the primary reason why Individuals 1 and 2 selected non-U.S. hedge funds for the ***Basket***. Onshore hedge funds (typically

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[12] Thus, Bank rejected, at most, 0.N percent of the requested changes.

structured as State A partnerships) limit investors' ability to redeem to certain timeframes, typically upon opinion of counsel, to avoid "publicly traded partnership" status, which would result in entity level taxation. [13] Offshore hedge funds (typically structured as non-U.S. corporations) are not subject to these restrictions, and therefore are able to offer more frequent redemptions.

Taxpayer's Position. An entity related to Taxpayer (specifically, a partnership for which Corporation 1 was also a general partner) initially entered into the contracts in Year 1. At the end of Year 1, Taxpayer obtained limited scope tax opinions for the contracts. On Date 1, Year 2, Taxpayer purchased the contracts from the related party. As explained above, Taxpayer has deferred reporting **[*16]** for federal income tax purposes all income, gain, loss and deduction from the contracts through Year 5.

The tax opinion, which was provided to Corporation 1 (in its capacity as Taxpayer's general partner) concluded as follows: (1) the contracts are ***options***; (2) the ownership of the referenced assets for tax purposes is not transferred by the contracts; (3) the ***options*** are not constructive ownership transactions under *section 1260*; and (4) upon sale or exchange of the ***options***, capital gain will be realized, except for the portion of any gain or loss attributable to "unrealized receivables" of hedge funds "to the extent required by *[section 751 of the Code*]." [14] To reach these conclusions the opinion assumes that there is a reasonable possibility that the final ***option*** value will be less than the strike price, in which case the opinion concludes the ***options*** will expire "out of the money." The opinion appears to give weight to the L-year term of the contracts, and in particular the accretion of interest and spread payable to the Bank over this term. The opinion erroneously assumes that the contracts' premiums were set using the Black-Scholes ***option*** pricing methodology. The opinion also **[*17]** relies on a representation from Bank that "several other investors unrelated to [Taxpayer]" held contracts using the ***Basket***. [15]

LAW AND ANALYSIS

Taxpayer entered into contracts labeled "cash-settled equity barrier call ***options***" to purchase components of the ***Basket*** cross-referenced by the contracts. The ***Basket*** is made up of a diversified pool of domestic and foreign hedge fund interests and varying amounts of cash. As described above in Contract Terms, if the value of the portfolio decreases by more than a specified percentage, the contracts require Taxpayer to contribute additional "premiums" and permit the Bank to withdraw capital or terminate the contract, effectively limiting both parties' risk of loss (Bank's to zero, Taxpayer's to its "premium"). The effect of the contracts is to transfer the economic gain or loss associated with ownership of the referenced assets to Taxpayer.

1. We conclude the contracts are not ***options*** and, to the extent Bank holds the referenced assets on Taxpayer's behalf, the contracts transfer ownership of the referenced assets for tax purposes.

a. Although labeled "***options***," the contracts lack the essential economic and legal characteristics of ***options***.

Case **[*18]** law defines an ***option*** as having two characteristics: (1) a continuing offer to do an act, or to forebear from doing an act, which does not ripen into a contract until it is accepted; and (2) an agreement to leave the offer open for a specified period of time. *Saviano v. Commissioner, 80 T.C. 955, 970 (1983)*, aff'd, *765 F.2d 643 (7th Cir. 1985)*. The purpose of an ***option*** that references property is to provide a party the opportunity to buy or sell specified property in the future at a defined price without the potential liability inherent in being obligated to buy or

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[13] SeeMiller & Bertrand, supra, note 10, at 327 (explaining that hedge funds typically avoid treatment as publicly traded partnerships).

[14] The opinion implicitly assumes that the referenced assets are partnerships and does not address any PFIC-related issues. The opinion advises that market discount bonds and short-term obligations of hedge funds could be considered "unrealized receivables" and that gain on the ***options*** could be treated as ordinary income to the extent of any ordinary income Taxpayer would have realized if it held the hedge funds directly.

[15] The opinion does not specify the meaning of "unrelated" in this context. Corporation 2 only managed contracts for Taxpayer and Individual 1's friends and family. Thus, we assume that the opinion's reference to "unrelated" investors is referring to friends of Individual 1.

sell. See *United States Freight Co. v. United States, 422 F.2d 887, 894-95, 190 Ct. Cl. 725 (Ct.Cl. 1970)*. Thus, an ***option*** only makes sense economically if the ***option*** holder's cost of failing to exercise is lower than the holder's potential liability had he or she instead entered into and breached a contract to buy or sell the underlying property. See *Halle v. Commissioner, 83 F.3d 649, 655-56 (4th Cir. 1996)* (comparing potential buyer's liquidated damages with seller's expected damages in event of buyer's default to determine whether an "***option***" is likely to be exercised and therefore treated as a sale).[16] A contract that **[*19]** imposes a high cost upon an offeree for failing to accept an offer will not be deemed an ***option*** if the cost effectively compels the offeree to exercise. See *Progressive Corp. v. United States, 970 F.2d 188, 193 (6th Cir. 1992)* (explaining that certain "***options***" may be disguised sales because "the exercise of such ***options*** may be virtually guaranteed"); *Commissioner v. Baertschi, 412 F.2d 494, 498 (6th Cir. 1969)* (noting buyer's high cost of breach equal to 29% of property value is indication of sale rather than ***option***).

Upon applying these principles to the contracts between Taxpayer and Bank, it is clear that the contracts, despite their use of ***option*** terminology, lack the requisite characteristics of ***options***. In particular, two elements of the contracts between Taxpayer and Bank are contrary to the typical functioning of an ***option***: (a) the interplay between the contracts' premiums, cash settlement amounts, and the barrier provisions, which imposed upon Taxpayer costs similar to an obligated buyer and preclude any possibility of lapse; and (b) Taxpayer's ability to alter the ***Basket***, through Corporation 2, while the contracts remained open, which is inconsistent with the notion that **[*20]** an ***option*** on property must reference specific property at a specified strike price.

i. The contracts imposed costs upon Taxpayer similar to an obligated buyer, and did not allow for any possibility of lapse, which is inconsistent with treatment of the contracts as ***options***.

The contracts did not function as ***options*** because the terms of the contracts imposed costs upon Taxpayer similar to the costs that would be borne by an obligated buyer and the imposition of these costs would compel Taxpayer to exercise rather than allow the ***options*** to lapse. As noted by the courts in United States Freight and Halle, a call ***option*** should function so that the holder has a real choice to allow the ***option*** to lapse; if the contract imposes a cost for failure to exercise that places the holder in a similar economic position to a party obligated to buy, then the holder lacks the choice not to buy and the contract is not an ***option***. In the instant case, the cash settlement provisions ensured that Taxpayer would lose its premiums investment-dollar-for-investment-dollar until the ***Basket*** fell in value by an amount sufficient to terminate the contracts under the barrier provisions, with Taxpayer losing its entire **[*21]** investment. Accordingly, the terms of the contracts ensured one of two outcomes: (1) if the ***Basket*** increased in value or decreased by less than the requisite amount under the barrier provisions, Taxpayer would exercise to reap its profits or to recoup at least a portion of its investment; or (2) the ***Basket*** would fall in value by the requisite amount under the barrier provisions and the barrier provisions would permit Bank to terminate the ***option***. Thus, the cash settlement provisions placed Taxpayer in the same economic position as a party obligated to buy each component of the ***Basket*** and the barrier provisions ensured that the contracts would never lapse unexercised. In this manner, the contracts did not function as ***options***.

Moreover, there is no indication that Taxpayer and Bank employed recognized ***option*** pricing methodologies to determine the premium. Rather, the premiums that Taxpayer paid were merely a fixed percentage of the contracts' notional value. Thus, the premiums under the contracts are more akin to collateral for a nonrecourse loan than to ***option*** premiums. The similarity between Taxpayer's premium and loan collateral is consistent with the other terms of the contracts, **[*22]** which, again, imposed potential costs upon Taxpayer that were more like those imposed upon an owner or a party obligated to buy than upon a party with the mere ***option*** to buy.

ii. Taxpayer's ability (through Corporation 2) to alter the ***Basket*** undermines ***option*** treatment.

The contracts did not function like ***options*** insofar as they referenced the ***Basket***, which Taxpayer (through Corporation 2) could and did alter by changing the ***Basket***'s components. Corporation 2 acted on Taxpayer's behalf. Individual 2's relationship with Taxpayer, the contracts' failure until the amendment in Year 2 to provide for

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[16] In terms of pricing and risk, call ***options*** generally allocate risk of loss between ***option*** writers and holders such that the ***option*** writers/sellers bear the risk of price decreases in the underlying asset while the ***option*** holders/buyers enjoy the benefits of price increases while also bearing the risk that they may lose their premium. See Halle, 83 F.3d at 657.

payment of a fee to Corporation 2 for its services, Corporation 2's management of similar contracts with Bank only for Taxpayer's friends and family (and not Bank's other clients), and, as discussed above in "Corporation 2's Management of the Portfolio," the fact that Corporation 2 did not make a single recommendation to Bank without first obtaining Individual 1's consent all indicate that Corporation 2 has acted on behalf of Taxpayer.

Taxpayer's control over the ***Basket*** caused the contracts to operate unlike an ***option***. As explained by the court in Saviano, an ***option*** provides one party with the **[*23]** choice of accepting an offer, while the other party is obligated to keep the offer open for a specified period of time. ***Options*** on property allow the holder to accept an offer to buy or sell specified property at a defined price. In this case, the contracts purport to identify the ***Basket*** as specific property subject to an ***option***, yet the contracts contradict that characterization by allowing Taxpayer (through Corporation 2) to alter the ***Basket*** while the contracts remained open.

It was feasible for Bank to permit Taxpayer to have this control because the terms of the contracts ensured that Bank was protected from Taxpayer's investment decisions; as noted above in Section 1.a.i., the contracts imposed potential costs upon Taxpayer that were more consistent with a party that had an obligation to buy than upon a party with a mere ***option*** to buy. The contracts were neither priced like ***options*** nor did the contracts apportion costs like a typical ***option*** because Taxpayer's power to control and alter the ***Basket*** was contrary to the essential function and nature of an ***option***. [17]

For all of the reasons discussed above, we conclude that the contracts are not ***options*** for Federal income tax purposes.

b. To the extent Bank held the referenced assets on behalf of Taxpayer, we conclude that the contracts transfer ownership of the referenced assets for tax purposes to Taxpayer.

We **[*24]** now turn to the question of whether Taxpayer, in substance, owns the referenced assets. [18] Although the contracts function economically as if Taxpayer owns the referenced assets, to treat the contracts as transferring ownership for tax purposes of a particular referenced asset, Bank must in fact hold the referenced asset in connection with the contracts. [19]

To determine whether a taxpayer holds the beneficial ownership of assets for tax purposes, courts have considered numerous factors indicative of the benefits and burdens of ownership. No one factor is determinative; courts accord varying weight to each factor, depending on the type of property and transaction at issue. See *Pac. Coast Music Jobbers v. Commissioner, 55 T.C. 866, 874 (1971)* (employing multi-factor test to determine ownership of stock and according less weight to attributes that are formalistic and "not useful"), aff'd, *457 F.2d 1165 (5th Cir. 1972)*.

Ownership for tax purposes of property that is not freely transferrable, such as hedge fund interests, has generally been evaluated by courts using an analysis of the economic benefits and burdens of ownership. For example, in *Frank Lyon Co. v. United States, 435 U.S. 561, 98 S. Ct. 1291, 55 L. Ed. 2d 550 (1978)*, **[*25]** the Supreme Court

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[17] The Treasury Regulations governing notional principal contracts also recognize this principle by prohibiting parties to a contract from controlling indexes that are used as referenced assets. Treas. Reg. § 1.446-3 (c) (4) (ii).

[18] We have already concluded that the contracts are not ***options***. A remaining question is whether Taxpayer owned each of the referenced assets during its holding period, or whether Taxpayer was merely obligated to purchase the assets in the future, i.e., through a forward contract. Forward contracts are typically treated as open transactions, and parties obligated to buy under forward contracts are not taxed as though they are current owners of the asset for tax purposes. See Lucas v. N. Texas Lumber Co., 281 U.S. 11, 13, 50 S. Ct. 184, 74 L. Ed. 668, 1930-1 C.B. 294 (1930) (agreement to sell land in 1916 was not a closed sale for tax purposes until price paid and title transferred in 1917). As discussed below in Section 2, in certain circumstances, however, taxpayers holding forward contracts may be treated as constructively owning the underlying asset. Seesection 1260 (d) (1) (B) (treating taxpayers as constructively owning financial assets referenced by certain forward contracts).

[19] It is unclear if Bank in fact owned each referenced asset in an amount sufficient to support its obligations to Taxpayer under the contracts; these facts require further development.

set out the "general and established principles" for evaluating the substance of a transaction, and also determined that a lessor was the owner of property. In reaching its conclusion, the Court considered twenty-seven factors largely looking at the economics of the real property transaction. For example, the Court considered the substantiality of the purchase price, the lack of certainty as to whether a purchase ***option*** would be exercised, and the lessor's risks with respect to depreciation of the property. Courts have generally determined that ownership for tax purposes of property that is not freely transferrable, like hedge fund interests, is transferred when the economic benefits and burdens of ownership are transferred, regardless of when legal title is transferred. See *Commissioner v. Union Pac. Railroad Co., 86 F2d 637 (2d Cir. 1936)* (holding that a sale happened even though the deed and title to real property, respectively, did not transfer until a later date); *Baird v. Commissioner, 68 T.C. 115 (1997)* (same).

As discussed below in Sections 1.b.i.-iii., it is clear that Taxpayer should be treated as the owner for tax purposes of the referenced assets because **[*26]** Taxpayer had (i) the opportunity for full gain and current income from the referenced assets (i.e., the economic benefits), (ii) substantially all of the risk of loss and the burden associated with the referenced assets' lack of liquidity (i.e., the economic burdens), and (iii) the effective power to direct Bank to acquire and redeem the referenced assets. Moreover, as discussed below in Section 1.b.iv., courts and the Service have treated certain ***options*** that are "in-the-money" at the contract's outset as transferring ownership for tax purposes.

That Taxpayer was exposed to Bank's credit risk under the contracts is not a significant countervailing factor. Persons using custodians are exposed to real credit risk of the custodian yet such persons are the owners of deposited assets. [20] We do not find Taxpayer's exposure to Bank's credit risk a compelling reason to treat Bank (the custodian) as the owner for tax purposes of the securities or other investments that Bank holds on behalf of another party, including Taxpayer. Nor is the contracts' failure to require Bank to own the referenced assets sufficient reason to retain ownership of the assets with Bank for tax purposes. As explained **[*27]** below in Section 1.b.i-iv., to the extent Bank "hedged" its portfolio by holding the referenced assets, Taxpayer was the owner of the referenced assets for tax purposes.

i. The economic benefits of owning the referenced assets were Taxpayer's.

Taxpayer had full opportunity for gain and income from the performance of the referenced assets. Cash settlement amounts include a refund of Taxpayer's premium and the positive or negative total return in the value of the portfolio, as adjusted for expenses, including interest and spread payable to Bank. Because Taxpayer could exercise its right to receive a cash settlement at any time, Taxpayer was at all times free to take full advantage of its opportunity for gain and income. Moreover, while the contracts remained open, Taxpayer could lock in gain in any single position within the ***Basket*** by instructing that the interest in the referenced asset be redeemed and that the referenced asset be deleted from the ***Basket***.

ii. The economic burdens of owning the referenced assets were Taxpayer's.

Taxpayer had substantially all of the risk of loss of the referenced assets. As explained in Section 1.a.i., the contracts' cash **[*28]** settlement provisions reduced Taxpayer's ability to recoup its investment to the extent of any losses on the referenced assets. Taxpayer had the risk of loss, dollar-for-dollar, up to any point at which Bank might terminate the contracts under the barrier provisions. Moreover, due to the barrier provisions, the full risk of loss inherent in the contracts was the initial premium paid by Taxpayer. Bank did indeed bear a theoretical risk; Bank could possibly suffer a loss if the diversified pool of the referenced assets decreased in value so quickly that Bank was unable to redeem hedge fund interests quickly enough to prevent losses beyond the threshold created by the barrier provisions, and such losses were sustained beyond the two-year delay in payment of any cash settlement

[20] See Office of the Comptroller of the Currency, Dept. of the Treasury, OCC Bull. No. 2002-39, Investment Portfolio Credit Risks (2002) (cautioning banks that they may lose "investment portfolio assets" deposited with third party "deposit brokers" who subsequently fail).

amount triggered by a "market event." That possibility was remote, however. [21] Thus, the barrier provisions merely reflected the typical arrangement between a broker and an investor who purchases securities through margin loans in a prime brokerage account, i.e., the investor's risk of loss is limited to the amount of the purchase price the investor itself funded, while the broker has rights to liquidate the securities **[*29]** or take other actions to ensure that losses will not exceed the amount funded by the investor.

In addition to the barrier provisions, the contracts protected Bank from loss through provisions designed to require the portfolio to meet certain diversification and liquidity requirements. As noted above in the Facts Section, the contracts treat the following as "market disruption events," which result in a delay of up to two years of a cash settlement upon termination or maturity: (1) "the [portfolio] contains an insufficient amount of liquidity to meet [Bank's] hedging requirements"; and (2) "the portfolio is insufficiently diversified, or the portfolio would be insufficiently diversified as a result of [Bank] altering its hedge, if any, to effect a termination of any portion of the ***options***."

Taxpayer also bore the economic burdens associated with ownership of the referenced assets by bearing all fees and liquidity risk associated with their ownership. Although interests in hedge funds generally cannot be transferred, a holder may redeem hedge fund interests at specified intervals for then "net asset value" (subject to certain fees, for example, if the owner's holding period is considered **[*30]** short-term or otherwise). Absent a "market disruption event," the contracts require C percent of the cash settlement amount to be paid within D days of termination or maturity, with the remainder payable within E days; Bank did not meet this timeline on Taxpayer's terminated contracts on account of illiquid "side pocket" investments made by the referenced hedge funds, demonstrating that it was Taxpayer and not Bank that bore liquidity risks associated with the ownership of the referenced assets. Furthermore, under the contracts Taxpayer bore any and all fees associated with the subscription for and redemption of the referenced assets. [22]

iii. Taxpayer's control over the ***Basket*** indicates its ownership of the referenced assets for tax purposes.

Taxpayer, through Corporation 2, had complete dominion and control over the ***Basket***. Acting at Taxpayer's direction, Corporation 2 instructed a large number of changes to the ***Basket***, which Bank executed with only very few exceptions. Bank initiated no changes to the ***Basket*** on its own.

The Tax Court recently addressed whether a taxpayer owned investments in start-up companies that were nominally owned by an insurance company that used the investments **[*31]** to fund variable life insurance policies owned by grantor trusts that the taxpayer established. See *Webber v. Commissioner, 144 T.C. No. 17 (June 30, 2015)*. In determining whether the taxpayer owned the assets underlying the policies, the court explained that "[t]he core 'incident of ownership' *is the power to select investment assets by directing the purchase, sale, and exchange of particular securities*." *Webber, 2015 U.S. Tax Ct. LEXIS 27. at *66* (emphasis added) (citing *Griffiths v. Commissioner, 308 U.S. 355, 357-58, 60 S. Ct. 277, 84 L. Ed. 319, 1940-1 C.B. 136 (1939))*. [23] The court then noted that the taxpayer "enjoyed the unfettered ability to select investments" for the account by directing the investment manager (who nominally had independent discretion) to buy, sell, and exchange assets in which the taxpayer wanted to invest, and that "such facts support a finding that [the taxpayer] retained significant incidents of ownership over those assets." *Webber, 2015 U.S. Tax Ct. LEXIS 27. at *73* (citing *Helvering v. Clifford, 309 U.S.*

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[21] Likewise, we do not view as a "reasonable possibility" the risk that Taxpayer's cash settlement at maturity (but for the barrier provisions) would be less than zero through accretion of interest and the spread, as assumed by Taxpayer's counsel in rendering its opinion of the transaction.

[22] Individual 2's level of communication with hedge fund managers (on behalf of Taxpayer) in seeking waivers of redemption fees is an indication of Taxpayer's ownership of referenced assets for tax purposes.

[23] The court also noted that other "incidents of ownership" include the power to vote securities and exercise other rights with respect to the investments and the power to obtain "effective benefit" from the assets by extracting money from the account. Webber, 2015 U.S. Tax Ct. LEXIS 27 at *60-*61.

331, 60 S. Ct. 554, 84 L. Ed. 788, 1940-1 C.B. 105 (1940)). [24] The court concluded that the taxpayer was the owner of the assets, despite the formalities, because the taxpayer maintained essentially the same rights of ownership over **[*32]** the assets that he would have retained had he chosen to title the assets in his own name. Webber, 2015 U.S. Tax Ct. LEXIS 27. at *79.

iv. Courts and the Service have held that "in-the-money" ***options*** transfer ownership for tax purposes.

As noted above in Section 1.a., courts have treated ***options*** that are likely to be exercised as sales. See Halle, 83 F.3d at 655-56 (comparing potential buyer's liquidated damages with seller's expected damages in event of buyer's default to determine whether an "***option***" is likely to be exercised and therefore treated as a sale). A contract that imposes a high cost upon an offeree for failing to accept an offer will be deemed a sale if the cost effectively compels the offeree to exercise. See Progressive Corp., 970 F.2d at 193; Baertschi, 412 F.2d at 498.

The court in Progressive adopted language from Rev. Rul. 80-238, 1980-2 C.B. 96, which held that that writing a call ***option*** on a stock does not generally diminish a stockholder's risk of loss for purposes of claiming the dividends received deduction under section 246 of the Code, but distinguished an in-the-money call ***option***. In distinguishing in-the-money ***options***, the court in Progressive explained:

> . . .[S]uch considerations, **[*33]** however, are not applicable to "in-the-money" call ***options***, that is, call ***options*** that are sold with a [strike] price below the market price of the underlying stock on the date that the ***option*** is written, since in such a situation the exercise of such ***options*** may be virtually guaranteed and the element of risk is either greatly reduced or eliminated.

Progressive, 970 F.2d at 193-94. Likewise, the Service in Rev. Rul. 82-150, 1982-2 C.B. 110, held that a sale of a deep-in-the-money ***option*** was, in substance, not an ***option*** but a completed sale of the referenced stock for purposes of the foreign personal holding company rules. Rev. Rul. 82-150 cited Commissioner v. Court Holding Company, 324 U.S. 331, 65 S. Ct. 707, 89 L. Ed. 981, 1945 C.B. 58 (1945) (for "substance over form" principles), John Kelley Co. v. Commissioner, 326 U.S. 521, 530, 66 S. Ct. 299, 90 L. Ed. 278, 1946-1 C.B. 191 (1946) (for, in characterizing an instrument for tax purposes, the relevance of whether it is a "risk investment" in corporate stock), Zilkha and Sons, Inc. v. Commissioner, 52 T.C. 607, 613 (1969) (same), and Tenn. Natural Gas Lines v. Comm'r, 71 T.C. 74, 84 (1978) (for factors to be weighed in determining **[*34]** ownership for tax purposes, weighting payment of property taxes heavily in determining the earlier of two possible sale dates).

As noted above, each of Taxpayer's "***options***" was "in-the-money" not only at the outset of the contract but, under the contract's terms, on every day of the contract. This is because, as described in the Facts Section above in "Contract Terms," the cash settlement amount equals the fair market value of the portfolio minus the "strike price," and the "strike price" equals Bank's upfront contribution [25] plus the interest paid to the Bank and the spread paid to the Bank to compensate it for its participation in the contracts.

This factor, along with the factors discussed in Section 1.b.i.-iii. indicates that the contracts transfer ownership of the reference assets for tax purposes. We therefore conclude that, to the extent Bank held a particular referenced asset on behalf of Taxpayer in connection with the contracts, Taxpayer was the owner of the referenced asset for tax purposes. To the extent Taxpayer is treated as the owner of the referenced assets for tax purposes, Taxpayer must also accrue gross items of income and loss for the referenced assets that are partnerships **[*35]** as reported annually on Schedules K-1 by the U.S. partnerships to their partners. [26] Additionally, Taxpayer may be entitled to claim deductions annually for interest and other expenses incurred, subject to applicable limitations under the

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[24] The court explained that the investment manager merely acted as a "rubber stamp" for the taxpayer's "recommendations," which the court deemed as equivalent to "directives." Webber, 2015 U.S. Tax Ct. LEXIS 27 at *60.

[25] (100 - K) percent of the initial notional amount.

[26] We note that the K-1 items are realized by Taxpayer in addition to any gains or losses Taxpayer realizes from Taxpayer's disposition of any referenced assets; similarly, Taxpayer must accrue flow-through gross items of income or loss in respect of any referenced assets that are non-U.S. partnerships.

Code.
2. If Taxpayer is not the owner of any referenced asset for tax purposes, and the referenced asset is a "pass-thru" entity, we conclude that Taxpayer is the constructive owner of the referenced asset under section 1260.

We concluded above that the contracts are not ***options***. Particularly, in Section 1.a.i, we concluded that the contracts imposed costs upon Taxpayer similar to those imposed upon an obligated buyer. Consequently, if Taxpayer is not deemed to own the contracts' referenced assets, Taxpayer will be treated as holding forward contracts with respect to the referenced assets that Taxpayer is not deemed to own. [27] Forward contracts to purchase interests in hedge funds raise the "constructive ownership" provisions of section 1260.
a. Section 1260 applies to the contracts.

Section 1260 was enacted in response to taxpayers' use of derivatives to avoid tax consequences associated with owning certain property, in particular, ordinary income and **[*36]** short-term capital gains passed through to holders by hedge funds structured as partnerships. [28] Section 1260 limits the amount of long-term capital gain realized by taxpayers entering into certain derivative contracts, called "constructive ownership transactions," over certain "financial assets." Section 1260 also increases the tax on the amount of ordinary income that a taxpayer is treated as having deferred by an interest charge calculated on a constant yield basis.

A "constructive ownership transaction" includes a forward or futures contract to acquire a "financial asset." The definition of "forward" in section 1260 is broad, including "any contract to acquire in the future (or provide or receive credit for the future value of) any financial asset." Section 1260 (d) (4). A "financial asset" includes "any equity interest in any pass-thru entity." Section 1260 (c) (1) (A). A "pass-thru entity" includes a partnership. [29] Section 1260 (c) (2) (D), (G). The Senate Report, explaining the provision, states as follows:

> The Committee is concerned with the use of derivative contracts by taxpayers in arrangements that are primarily designed to convert what otherwise would be ordinary income **[*37]** and short-term capital gain into longterm capital gain. Of particular concern are derivative contracts with respect to partnerships and other pass-thru entities. The use of such derivative contracts results in the taxpayer being taxed in a more favorable manner than had the taxpayer actually acquired an ownership interest in the entity. [Text omitted].
>
> One example of a conversion transaction involving a derivative contract is where a taxpayer enters into an arrangement with a securities dealer whereby the dealer agrees to pay the taxpayer any appreciation with respect to a notional investment in a hedge fund. In return, the taxpayer agrees to pay the securities dealer any depreciation in the value of the notional investment. The arrangement lasts for more than one year. The taxpayer is substantially in the same economic position as if he or she owned the interest in the hedge fund. However, the taxpayer may treat any appreciation resulting from the contractual arrangement as long-term capital gain. Moreover, any tax attributable to such gain is deferred until the arrangement is terminated.

S. Rep. No. 106-201, at 32-33 (1999) (footnote omitted).

If the contracts in the present case do **[*38]** not transfer ownership of particular referenced assets for tax purposes to Taxpayer, as discussed above in Section 1.b., the contracts are forward contracts to purchase pass-thru entities, and are therefore constructive ownership transactions under section 1260. The deferral and character conversion inherent in the contracts is precisely the type of avoidance that Congress sought to address when it enacted section 1260. We further note that the Service, in Rev. Rul. 85-87, 1985-1 C.B. 268, held that a "put ***option***" in form was a forward contract; the Service disregarded the form of the ***option*** because at the time written there was "no

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[27] Whereas the holder of a call ***option*** has the ***option***, but not the obligation, to purchase the contract's referenced assets, the holder of a forward contract has the obligation to purchase the referenced assets at a certain future time. See John C. Hull, ***Options***, Futures, and Other Derivatives, at 3 (7th ed. 2009).

[28] S. Rep. No. 106-201, at 32 (1999).

[29] Pass-thru entities also include PFICs, which are not addressed in this memorandum.

substantial likelihood that the put would not be exercised." [30]
b. The mechanics of applying section 1260 to the contracts.

Section 1260 (d) (1) provides that a taxpayer "shall be treated as having entered into a constructive ownership transaction with respect to any financial asset if the taxpayer [holds the relevant derivative with respect to the] financial asset." The determination as to whether a transaction is a "constructive ownership transaction" is therefore made on a "financial asset" by "financial asset" basis. Taxpayer may directly own some of **[*39]** the contracts' referenced assets as discussed above in Section 1.b. and constructively own other referenced assets under *section 1260*.

When realized, any gains from Taxpayer's constructive ownership transactions must be analyzed to determine whether, absent *section 1260*, those gains would be treated as long-term capital gains. For example, if Taxpayer recognized ordinary income prior to termination or maturity of the contracts on account of cash withdrawals (as discussed below in Section 3), that income would not be taxed using the principles of *section 1260* because that income would not otherwise treated as long-term capital gains. However, any gains realized by Taxpayer upon termination or maturity of the contracts may be gains that, absent *section 1260*, would be treated as long-term capital gains and would therefore require further analysis under *section 1260*. [31]

Next, Taxpayer determines the amount of any "net underlying long-term capital gain." Gain that is not attributable to net underlying long-term capital gain will be treated as ordinary income by *section 1260 (a) (1)* and will be subject to an interest charge, determined on a constant yield basis, by *section 1260 (b)*. *Section 1260 (e)* **[*40]** defines "net underlying long-term capital gain" as the aggregate net capital gain Taxpayer would have had if it had acquired the "financial asset" for fair market value on the date the constructive ownership transaction was opened and sold the "financial asset" for fair market value on the date the constructive ownership transaction was closed. To perform this calculation, Taxpayer must disaggregate the ***Basket*** and consider gains it would have realized upon its redemption of, and throughout its holding period for, each referenced asset (including any gains reported to holders by the referenced assets that are partnerships).

Section 1260 (e) requires Taxpayer to demonstrate by "clear and convincing evidence" the amount of any net underlying long-term capital gain. This subsection defaults the characterization of constructive gains under *section 1260* to ordinary for taxpayers who may not have access to information regarding the tax characteristics of the underlying referenced assets (e.g., Schedules K-1 or, to the extent relevant, information regarding the underlying assets held by any pass-thru entities). [32] Evidence submitted by Taxpayer to substantiate the amount of any net underlying **[*41]** long-term capital gains must also substantiate the tax year or years to which the gains are allocable so that tax may be calculated using the rates in effect for those years, as required by *section 1260 (a) (2)*.
3. Taxpayer may have other taxable events in respect of the contracts.

An ***option*** holder generally does not realize gain or loss until the ***option*** is exercised, terminated, or lapses unexercised. *Rev. Rul. 78-182, 1978-1 C.B. 265*. You have asked whether, to the extent the contracts are not treated as transferring ownership of the referenced assets for tax purposes, (a) withdrawals from the contracts are

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[30] We note that this ruling deals with a classic put ***option*** (the strike price was determined at the outset with respect to a future exercise date) and the difference between treating the contract as a transfer of ownership for tax purposes as opposed to a forward contract was not relevant to the wash sale conclusion.

[31] In addition to any maturity or termination event under the contracts, gain from Taxpayer's constructive ownership of the referenced assets may be recognized under section 1001 upon any taxable exchange of the contracts, or of a particular referenced asset. Additionally, if Taxpayer argues that its withdrawals from the contracts, as discussed further in Section 3, would (absent section 1260) result in Taxpayer recognizing long-term capital gains, then section 1260 would likewise apply to Taxpayer's gains from withdrawals at the time they are realized.

[32] The legislative history contemplates that Taxpayers may have difficulty establishing the amount of net underlying long-term capital gain, particularly "[t]o the extent that the economic positions of the taxpayer and the counterparty do not equally offset each other. . . ." S. Rep. No. 106-201, at 34 n.20.

income of Taxpayer to the extent of any gain on the contracts as of the date cash was received, and (b) changes to the ***Basket*** or amendments to the contracts are taxable exchanges of Taxpayer's contracts under *section 1001*.
a. Taxpayer's cash withdrawals from the contracts are realization events.

First, we consider Taxpayer's cash "withdrawals." As noted in the Facts Section above under "Cash Withdrawals," the cash withdrawals have been treated by Taxpayer as extra-contractual withdrawals of cash from the contracts, and not partial terminations. [33] However, if the contracts are not **[*42]** treated as transferring ownership of the referenced assets for tax purposes, then Taxpayer would realize gain from the contracts to the extent of any cash received "under a claim of right and without restriction as to disposition." See*section 61* (including as gross income "all income from whatever source derived"); *Boyce v. United States, 405 F.2d 526, 186 Ct. Cl. 420 (1968)* (holding that where taxpayer withdrew amounts awarded to it for seizure of land from an escrow account, and which were subject to contest proceedings, the withdrawn amounts were taxable to taxpayer in the year withdrawn, and not later). Taxpayer has offered no explanation as to how it could withdraw cash from its appreciated positions in the contracts without realizing taxable income. Any income Taxpayer realizes on account of its cash withdrawals would be ordinary income, because Taxpayer has not sold or exchanged a capital asset.
b. The contracts may be deemed exchanged in each year of Taxpayer's holding period because of material amendments to the contracts and changes to the ***Basket***.

Section 1001 provides rules for the computation of gain or loss from the sale or other disposition of property. *Treas. Reg. §1.1001-1 (a)* **[*43]** provides, as relevant here, that gain or loss is realized upon an exchange of property for other property differing materially in kind or in extent. See *Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554, 566, 111 S. Ct. 1503, 113 L. Ed. 2d 589 (1991)* ("Under [the Court's] interpretation of *[section] 1001 (a)*, an exchange of property gives rise to a realization event so long as the exchanged properties are 'materially different' -- that is, so long as they embody legally distinct entitlements."). *Treas. Reg. § 1.1001-3* provides specific guidance addressing when the exchange or amendment of a debt instrument will be considered a significant modification that results in an exchange of the original debt instrument for a modified instrument that differs materially in kind or in extent. With respect to financial instruments other than debt instruments, the "fundamental change" doctrine described in *Rev. Rul. 90-109, 1990-2 C.B. 191*, continues to apply. See*Rev. Rul. 90-109* (concluding that the substitution of one employee for another as the party insured by a life insurance contract held by an employer was a "fundamental change" that resulted in the recognition by the employer of gain or loss on its contract); see also*T.D. 8675* **[*44]** (*Treas. Reg. §1.1001-3* debt modification regulation preamble stating that the final regulations do not limit or otherwise affect the application of the "fundamental change" concept articulated in *Rev. Rul. 90-109*). [34]

There were two amendments to the terms of the contracts: (1) a provision for portfolio management fees for Contract 1 in Year 2, and (2) a reduction of the spreads payable to Bank under both contracts in Year 5. The first change is "fundamental" (and therefore material) if the contracts are respected as ***options*** because it reduces Taxpayer's return on the contracts by a fixed amount regardless of whether there is gain on the contracts (and recovery of Taxpayer's "premiums" beyond that). Likewise, the modification to reduce Bank's spread also fundamentally changes Taxpayer's return on the contracts and should be considered material.

We now turn to the question of whether changes to the referenced ***Basket*** constitute taxable exchanges of Taxpayer's contracts. No fewer than J and up to H changes to the referenced ***Basket*** have been made in each year of the contracts' holding period, per request of Taxpayer or Corporation 2. A derivative contract where one or both of the parties **[*45]** have the discretion to change the referenced assets and one or both of the parties use that discretion to change the referenced assets raises the question of whether the parties have terminated the

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[33] If the cash withdrawals had been partial terminations gain or loss would have been realized on the proportionate number of ***options*** deemed terminated.

[34] The Service in ***Rev. Rul. 78-408, 1978-2 C.B. 203***, held that the substitution of "X corporation" stock for "Y corporation" stock in warrants issued pursuant to X corporation's acquisition of Y corporation resulted in taxable gain or loss under section 1001 even though the warrants' terms and conditions otherwise remained identical (including the number of shares and price per share).

derivative and entered into a new one. In the present case, Taxpayer's discretion to make changes to the composition of the ***Basket***, combined with the resulting number of changes to the ***Basket*** based on that discretion, may have been economically significant such that, within a given tax year, the changes are cumulatively a "fundamental change" to the contracts resulting in taxable exchanges of Taxpayer's contracts. That the changes to the ***Basket*** were made pursuant to the terms of the contracts does not alter this result. See, e.g., *Rev. Rul. 90-109*. Given the factual nature of this determination, we discuss this issue further in the "Case Development, Hazards, and Other Considerations" Section.

4. To the extent Taxpayer is treated as the owner for tax purposes of any referenced asset, or there is a taxable cash withdrawal or exchange of Taxpayer's contracts, Taxpayer's deferral accounting method for the gains, losses, income, or deductions arising from the contracts fails to clearly reflect income. The Service may change Taxpayer's deferral accounting method to a method that does clearly reflect its income and may compute the necessary adjustment under *section 481 (a)* only as relates to the non-PFIC referenced assets.

An **[*46]** accounting practice that involves the timing of when an item is included in income or when it is deducted is considered an accounting method. *General Motors Corp. v. Commissioner, 112 T.C. 270, 296 (1999)*; *Color Arts, Inc. v. Commissioner, T.C. Memo 2003-95*.

An "item" is any recurring element of income or expense. For example, the Court of Appeals for the Second Circuit determined that a local tax is an "item," and that the treatment it is given qualifies as an accounting method. *American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963)*. Likewise, the Court of Appeals for the Fourth Circuit determined that a vacation pay accrual is an "item," and the treatment it is given qualifies as an accounting method. *Capital One Fin. Corp. v. Commissioner, 130 T.C. 147, 159-61 (2008)*, aff'd, *659 F.3d 316 (4th Cir. 2011)*. See also *Color Arts, Inc. v. Commissioner, T.C. Memo 2003-95*.

Treas. Reg. § 1.446-1 (e) (2) (ii) (a) provides that a change in accounting method includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item used in such overall plan. A "material item" includes "any item that involves the proper time **[*47]** for the inclusion of the item in income or the taking of a deduction."

In determining whether timing is involved, generally the pertinent inquiry is whether the accounting practice permanently affects the taxpayer's lifetime taxable income or merely changes the tax year in which taxable income is reported. See*Section 2.01 of Rev. Proc. 2002-18, 2002-1 C.B. 678, 681*; *Rev. Proc. 91-31, 1991-1 C.B. 566*; *Knight-Ridder Newspapers, Inc. v. United States, 743 F.2d 781, 798 (11th Cir. 1984)*; *Peoples Bank & Trust Co. v. Commissioner, 415 F.2d 1341, 1344 (7th Cir. 1969)*; *Huffman v. Commissioner, 126 T.C. 322, 343 (2006)*; *Primo Pants Co. v. Commissioner, 78 T.C. 705, 723-4 (1982)*.

Taxpayer's current deferral of gains, losses, income, or deductions arising from the contracts qualifies as an accounting method. For the reasons discussed above in Sections 1 and 3, we conclude that this accounting method is impermissible. Thus, as Taxpayer's accounting method is not permissible, the Service has broad discretion in selecting a new accounting method that properly reflects the income of Taxpayer. The selected method must be a permissible accounting method. A taxpayer may challenge the selected method **[*48]** only upon showing an abuse of discretion. See *Wilkinson-Beane, Inc. v. Commissioner, 420 F.2d 352, 353 (1st Cir. 1970)*; *Stephens Marine, Inc. v. Commissioner, 430 F.2d 679, 686 (9th Cir. 1970)*; *Standard Paving Co. v. Commissioner, 190 F.2d 330, 332 (10th Cir. 1951)*.

Changing from Taxpayer's current deferral accounting method to the accounting method that has been selected by the Service is an accounting method change. This change does not permanently affect Taxpayer's lifetime taxable income.

Section 481 (a) provides that in computing the taxpayer's taxable income for any tax year (the year of change), if such computation is under an accounting method different from the method under which the taxpayer's taxable income for the preceding tax year was computed, then there shall be taken into account those adjustments which

are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. See also *Treas. Reg. § 1.448-1 (a)*.

Once the Commissioner has imposed a change in accounting method, the application of *section 481 (a)* to such change is mandatory. *Primo Pants Co. v. Commissioner, 78 T.C. 705, 723-4 (1982)*. An adjustment under *section 481 (a)* **[*49]** can include amounts attributable to tax years that are closed by the statute of limitations. *Rankin v. Commissioner, 138 F.3d 1286 (9th Cir. 1998)*; *Weiss v. Commissioner, 395 F.2d 500 (10th Cir. 1968)*; *Spang Indus., Inc. v. United States, 6 Ct. Cl. 38, 46 (1984)*, rev'd on other grounds, *791 F.2d 906 (Fed. Cir. 1986)*; *Suzy's Zoo v. Commissioner, 114 T.C. 1, 13 (2000)*, aff'd, *273 F.3d 875, 884 (9th Cir. 2001)*. See also *Earthquake Sound Corp. v. Commissioner, T.C. Memo. 2000-112* (*section 481 (a)* adjustment to eliminate duplicated deductions resulting from accounting method change could be imposed even though related years in which duplicate deductions were taken have been closed by the statute of limitations).

The *section 481 (a)* adjustment in this case should reflect relevant amounts from any tax years preceding the year of change, even if such years are closed by the statute of limitations. Thus, if, under Taxpayer's current deferral accounting method, Taxpayer earned amounts in Year 1 but did not report any income on the Year 1 tax return, then positive amounts (increases to taxable income) will be recognized under *section 481 (a)* to eliminate the omission that would otherwise result, **[*50]** despite Year 1 now being closed under the statute of limitations. Since the adjustment proposed by the Service is for income earned in Year 4, the *section 481 (a)* adjustment will ensure that all gains, losses, income, or deductions arising from the contracts in all years prior to Year 4, including Year 1, are accounted for.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

The conclusions that we reach in the memorandum are subject to change if facts come to light that are inconsistent with the facts described herein. We recommend further development of the following facts:

1. [TEXT REDACTED]
2. [TEXT REDACTED]
3. [TEXT REDACTED]
4. [TEXT REDACTED]
5. [TEXT REDACTED]

[TEXT REDACTED]

[TEXT REDACTED]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Orla J. O'Connor at (202) 317-6367 if you have any further questions.

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Office of Associate Chief Counsel

(Financial Institutions and Products)

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[TEXT **[*51]** REDACTED]

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This document is not to be relied upon or otherwise cited as precedent by taxpayers.

Office of Chief Counsel Internal Revenue Service Memorandum