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IRS Clarifies Transactions that are Basket Options (Listed Transactions) and Basket Contracts (Transactions of Interest) and Extends the Date by which Disclosure is Required

On October 21, 2015, the IRS released Notice 2015-73 (involving basket options) and Notice 2015-74 (involving basket contracts). Notice 2015-73 revokes Notice 2015-47, 2015-30 I.R.B. 76, but continues to treat certain basket options as listed transactions that must be disclosed by participants and material advisors. Notice 2015-74 revokes Notice 2015-48, 2015-30 I.R.B. 77, but continues to treat certain basket contracts as transactions of interest that must be disclosed by participants and material advisors. Each notice provides greater detail than the respective earlier notice about transactions within the scope of each notice, including clarifying that a taxpayer must have reflected on a tax return a “tax benefit” described in the notice. Further, each notice describes when a person is treated as the taxpayer’s “designee” and when the taxpayer or its designee would not be treated as having “discretion” to change the assets in the reference basket or the trading algorithm and lists certain contracts that are excluded from each notice, including when a counterparty would not have to disclose a transaction. Finally, the notices provide special rules for taxpayers that want to change their method of accounting for transactions within their scope and generally require applicable transactions to be disclosed by January 19, 2016, the date that is 90 days after the issuance of these notices.

Some of the clarifications provided by the notices include the following:

- (1) Each notice lists the facts that are necessary for a transaction to be described in the notice (that is, the same as, or substantially similar to). Thus, Notice 2015-74 provides a list of factors that the earlier notice did not.

- (2) The taxpayer must have claimed a “tax benefit” as defined in the notices – deferral of income into a later tax year or a conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss (both notices). Thus, for example, a taxpayer using mark-to-market method of tax accounting for a contract would not have claimed a tax benefit under the definitions in the notices. Also, tax benefit no longer includes benefits related to other areas, such as withholding taxes and information reporting.
- (3) The taxpayer (or the taxpayer’s designee) must have exercised “discretion” as defined in the notices to change (either directly or through a request to the counterparty) the assets in the reference basket or the trading algorithm. This means that an actual exercise of discretion (as opposed to a power that remains unexercised) is required to bring a transaction within the notices.
- (4) The notices define what is meant by a taxpayer’s “designee” and provides certain safe harbors. The taxpayer’s designee is a person who (a) is the taxpayer’s agent under principles of agency law or (b) is compensated or selected by the taxpayer for suggesting, requesting, or determining changes in the assets in the reference basket or the trading algorithm. A person will not be treated as compensated or selected by the taxpayer as a result of the following: (1) the person’s position as an investment advisor, officer, or employee of an entity, such as a mutual fund, when the entity’s publicly offered securities are included in the reference basket or (2) the person’s use of, the person’s payment of a licensing fee for the right to use, or the person’s authority to suggest, request, or determine changes in the assets included in (y) a widely-used and publicly-quoted index that is based on objective financial information or (z) an index that tracks a broad market or a market segment.
- (5) The notices provide that the taxpayer (or its designee) will not be treated as having discretion to change (either directly or through a request to the counterparty) the assets in the reference basket or the trading algorithm if changes in the assets in the reference basket or the trading algorithm are made according to objective instructions, operations, or calculations that are disclosed at the inception of the transaction (the “Rules”) and the taxpayer does not have the right to alter or amend the Rules during the term of the transaction or to deviate from the assets in the reference basket or the trading algorithm selected in accordance with the rules. The notices also provide safe harbors to describe when a taxpayer will not be treated as having authority to alter or amend the Rules solely because of certain rights that the taxpayer has under a contract.
- (6) The notices provide that the following contracts are not within the scope of either notice: (1) contracts traded on a (a) national securities exchange regulated by the SEC or a domestic board of trade regulated by the CFTC; or (b) a foreign exchange or board of trade subject to regulation by a comparable regulator, (2) a contingent payment debt instrument (including a short-term contingent payment debt instrument) under Reg. § 1.1275-4, or (3) a variable rate debt instrument under Reg. § 1.1275-5.
- (7) With respect to the counterparty, the notices also provide that a transaction is not within their scope if (1) the taxpayer represents to the counterparty in

writing under penalties of perjury that the taxpayer's tax return will not reflect a "tax benefit" in any taxable year ending after the effective date of the notice or (2) the counterparty has established that the taxpayer is a nonresident alien not engaged in a U.S. trade or business or a foreign corporation not engaged in a U.S. trade or business by obtaining a valid withholding certificate from the beneficial owner of the payments made or to be made under the contract (W-8BEN, W-8BEN-E, or W-8EXP), or in the case of payments made outside of the U.S. on offshore obligations, by obtaining documentary evidence as described in Reg. § 1.1441-1(c)(17). Because neither notice references Form W-8IMY (Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or certain U.S. Branches for U.S. Tax Withholding), a counterparty apparently could not exclude a transaction if the other party is a partnership, absent receiving a representation from the partnership.

Special rules for method of accounting changes for transactions within the scope of either notice.

Each notice provides rules for a taxpayer that wishes to change its method of accounting for a transaction within the scope of the notice. For transactions within the scope of Notice 2015-73, the IRS will not permit a prospective change in method of accounting and will not process applications for such transactions under the non-automatic change procedures of Rev. Proc. 2015-13 (as clarified and modified by Rev. Proc. 2015-33). Instead, a taxpayer must change its method of accounting by following the notice's procedures, which generally require the taxpayer to file amended returns to retroactively change its method of accounting.

For transactions within the scope of Notice 2015-74 that the notice defines as deferral transactions (i.e., transactions whose only tax benefit is a deferral of income into a later tax year), a taxpayer may change its method of accounting either by (1) filing amended returns in accordance with the notice or (2) if eligible, requesting a change in method of accounting under the non-automatic procedures of Rev. Proc. 2015-13.

For transactions within the scope of Notice 2015-74 that the notice defines as conversion transactions (i.e., transactions that involve the conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss), the IRS will not permit a prospective change in method of accounting and will not process applications for such transactions under the non-automatic change procedures of Rev. Proc. 2015-13. Instead, a taxpayer must change its method of accounting by following the notice's procedures, which generally require the taxpayer to file amended returns to retroactively change its method of accounting.

Effective Dates

Notice 2015-73 is effective October 21, 2015, for transactions in effect on or after January 1, 2011, and that are the same as, or substantially similar to, the transaction described in Notice 2015-73. In general, disclosure of participation in such transactions must be made by January 19, 2016.

Notice 2015-74 is effective October 21, 2015, for transactions entered into on or after November 2, 2006, and in effect on or after January 1, 2011, that are the same as, or substantially similar to, transactions described in Notice 2015-74. In general, disclosure of participation in such transactions must be made by January 19, 2016.

Notice 2015-73 is available at <https://www.irs.gov/pub/irs-drop/n-15-73.pdf>.

Notice 2015-74 is available at <https://www.irs.gov/pub/irs-drop/n-15-74.pdf>.

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