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IRS Notices impose disclosure obligations on persons that participated in either a basket option contract or a basket contract

On July 8, 2015, the IRS identified basket options as a listed transaction (Notice 2015-47) and basket contracts (derivative transactions including swaps and forwards as well as call options) as a transaction of interest (Notice 2015-48), thereby imposing disclosure requirements on persons that participated in those transactions. These types of derivatives are designed to provide the purchaser with a return based on the performance of a notional basket of referenced property. The IRS and Treasury Department are concerned that taxpayers are using these types of derivatives (1) to defer income recognition, (2) to convert ordinary income and short-term capital gain into long-term capital gain, and (3) to avoid the withholding of tax on U.S. sourced dividends paid to non-U.S. persons.

Basket Option Contracts and Basket Contracts

Both types of derivatives are executed between a purchaser (“T”) and a counterparty (“C”), usually a bank. A basket option is denominated as an option and substantially all of the reference property is actively traded personal property. A basket contract is denominated as an option, a swap (notional principal contract), forward contract, or other derivative contract, and the reference property may include (1) interests in entities, such as hedge funds, that trade securities, commodities, foreign currency, or similar property, (2) securities, (3) commodities, (4) foreign currency, or (5) similar property or positions in such property. Under these types of derivatives, T has the ability to determine the assets that compose the reference basket or select the trading algorithm that determines the assets, and the ability to change (subject to C’s approval) those assets or the trading algorithm for the term of the derivative. If T

holds the derivative for longer than one year, T takes the position that gain on the derivative is long-term capital gain.

Participants

The notices treat the following persons as having participated in a basket option or a basket contract: (1) the purchaser (T in the above description); (2) if the purchaser is a partnership, such as a hedge fund, any general partner of the purchaser; (3) if the purchaser is a limited liability company, any managing member of the purchaser; and (4) the counterparty to the derivative.

Effective Date

The basket option notice (Notice 2015-47) applies to basket options and transactions that are the same as, or substantially similar to basket options, in effect on or after January 1, 2011. The basket contract notice (Notice 2015-48) applies to basket contracts and transactions that are the same as, or substantially similar to basket contracts, that were entered into on or after November 2, 2006 and in effect on or after January 1, 2011.

Disclosure Requirement

Persons that have participated in either type of basket derivative transaction to which the respective notice applies must disclose the transaction to the IRS on Form 8886 (by November 5, 2015, 120 days after July 8, 2015) for each tax year in which the taxpayer participated in the transaction, provided that the period of limitations for assessment of tax had not ended on or before July 8, 2015. The disclosure requirement also applies to persons that have already filed a return (including an amended return) reflecting the taxpayer's participation in either transaction. For any transaction that is both a basket option and a basket contract, the transaction is treated as a listed transaction and a proper disclosure of the basket option is deemed to have satisfied the disclosure requirements for the basket contract. Participants may also have disclosure requirements under reportable transaction rules enacted by a number of states.

Penalties

Participants required to disclose a transaction but who fail to do so may be subject to certain penalties, some of which are strict liability penalties. Further, participants required to disclose basket options but who fail to do so may be subject to an extended statutory period of limitations.

KPMG Observations

The reach of the basket contract, Notice 2015-48, is particularly broad and transactions entered into in the ordinary course of business can still be within its scope, especially because nothing defines or limits the phrase "the same as, or substantially similar to." Furthermore, it appears that the notices cover transactions for which a purchaser never claimed the identified type of tax benefit; for example, where the contract was terminated within one year of having been entered into, and the purchaser reported short-term capital gain.

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