End-Run Around Constructive Ownership Rules Fails—But Could Tweaks to Transaction Change Tax Result for Investor?

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In AM 2010-005, the IRS has taken a firm substance-over-form position to derail an "option transaction" designed to create deferred long-term capital gains. Once characterization of the investment as an option or some type of derivative was rejected, the investor—a hedge fund—faced taxation as the owner of securities.

Introduction

In AM 2010-005 the IRS stated that certain contracts labeled as options should not be treated as options for federal income tax purposes and that the option holder should be considered the owner of the underlying portfolio.[1]

The facts under the memorandum were the following. A hedge fund entered into an "option" contract with a foreign bank that referenced a basket of securities (Basket) held in a brokerage account administered by the bank. The hedge fund's general partner was hired by the bank to trade the securities in the account. The hedge fund was hoping that the option would be respected, that no taxable event would be triggered when the portfolio changed, and that all gains would be realized only upon sale of the option 12 or more months hence, creating only long-term capital gains. The contract referenced an amount that imposed all of the costs, as if the hedge fund had purchased a leveraged changing underlying basket.

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[1] AM 2010-005 (Oct. 15, 2010, released Nov. 12, 2010), 2010 TNT 218-16, available at http://www.irs.gov/pub/irs-utl/am2010005.pdf.

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Investor's Goals

The investor entered into this transaction hoping to achieve both (1) the deferral of gains and (2) the conversion of those gains into long-term gains. It should be noted that, in the past, an investor could have accomplished these goals by entering into such a contract based upon the returns generated by the hedge funds. However, in 1999 Congress put forth the "constructive ownership rules" of IRC Section 1260, which put an end to the strategy. Here the hedge fund tried to resurrect the desired treatment by having the fund buy a derivative on the portfolio instead of having the investor buy a derivative on the fund.

The terms of the options were as follows:

- The cost of the option was equal to 10 percent of the value of the underlying account.
- If the account's losses reached 10 percent, the contract would terminate and the hedge fund would not be entitled to receive anything.
- The option's strike price was equal to the initial value of the securities in the account.
- The Cash Settlement Amount was equal to the greater of (1) zero or (2) the reimbursement of the premium plus or minus the Basket Gain or Basket Loss, as the case may be. (Basket Gain or Loss is comprised of the following: realized and unrealized gains, interest, dividends, or other current income *less* (1) realized and unrealized losses, interest, short dividend expenses, or other current expenses; (2) commissions and other trading costs incurred in acquiring or disposing of the positions; and (3) financing costs on 90 percent of the initial value of the Basket. This replicates the P+L on a leveraged managed account.)

The general partner of the hedge fund even got to exercise voting rights on the referenced shares.

IRS Analysis

An Obligation, Not an Option. In analyzing the option, the IRS looked to the substance of the transaction and not its form to determine the federal income tax consequences of the transaction. The Service stated that under case law the purpose of an option that references property is to provide a party the opportunity to buy or sell the property in the future at a defined price without the potential liability inherent in being obligated to buy or sell the property.[2]

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[2] U.S. Freight Co. v. U.S., 422 F.2d 887 (Ct. Cl. 1970).

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The Service concluded that under its terms the contract should not be treated as an option. The investor retained all of the upside on the Basket and suffered all losses on a dollar for dollar basis up to 10 percent. As long as the Basket's value didn't drop by more than 10 percent, there would be a final settlement amount—and, if the Basket ever decreased by 10 percent, the contract would terminate. Therefore, the Service held, the hedge fund had incurred the burdens and benefits of an obligated buyer. Further, the hedge fund's ability to alter the make-up of the underlying property was inconsistent with the notion that an option on property must reference specific property at a defined price. Therefore, the IRS held that the contract was not an option.

Investor Treated as Owner of Securities. Once the IRS found that the contract was not an option it had to decide what the contract should be treated as. It could have been re-characterized as a different type of derivative, which might still have the effect of deferring income and converting all income into long-term capital gains, or the contract could have been ignored and the hedge fund treated as the owner of the underlying property.

The IRS stated that for ownership of stock for tax purposes the following factors are the most relevant: ability to sell the shares, power to vote, right to receive dividends, and the opportunity for gain and the risk of loss in the value of the shares.[3] The IRS also made reference to two other recently decided cases that focused on these rights (*Anschutz Co*. and *Calloway*).[4] However, reliance on these two cases appears to be inappropriate because there were other significant factors that the Tax Court took into consideration in coming up with its conclusions. More on point is the Eighth Circuit's 1984 decision in *Christoffersen v. United States*.[5] In *Christoffersen*, the taxpayers purchased a variable annuity contract. The amount of the annuity was based upon the value of six mutual fund shares held by the selling insurance company. The investor had the right to direct which mutual funds should be purchased, and could reallocate the investment among the funds at any time. Upon seven days' notice the investor had the right to withdraw funds, surrender the contract, or apply the accumulated value of the funds to provide annuity payments. The court held that the investor bore the full investment risk of the mutual funds, and that the investor had immediate access to the funds. The court held that the investor should be treated as the owner of the mutual funds and not the owner of an annuity contract.

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[3] Ragghianti v. Comm'r, 71 TC 346 (1978).

[4] Anschutz Co. v. Comm'r, 135 TC No. 5 (July 22, 2010); Calloway v. Comm'r, 135 TC No. 3 (July 8, 2010).

[5] 749 F.2d 513 (8th Cir. 1984).

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In the Advice Memorandum, the Service finally held that the taxpayer should be treated as the owner of the underlying securities because it had all of the opportunity for gain, bore substantially all of the risk of loss from the securities, could change the make-up of the Basket, and had complete dominion and control of the securities. Therefore, each time a position was closed in the underlying account a gain or loss was triggered and the nature of the income and expenses received and incurred retained their nature as opposed to being rolled up into the settlement payment.

Conclusion

The Advice Memorandum is not surprising to us. The IRS concluded that there are various forms of the contract described being offered in the marketplace, and that there may be different legal analyses applied to these other contracts.

It would appear that the key factors that would differentiate other fact patterns from this case would be the economic differences derived from the contract and the underlying Basket, and the amount of control that the investor has in reformulating the make-up of the Basket. Often an investor will instruct a counterparty to follow a specific algorithm in trading the portfolio. In such a case, the investor can't change the investment decisions during the life of the transaction and has no actual control over the trades in the underlying account. If the counterparty is also allowed to vote the shares in the account, a different analysis and outcome might occur. This should be analogous to changes in the portfolio of an index, such as the S&P 500. To our knowledge, the IRS has never asserted that a derivative on the S&P 500 should have gain or loss triggered due to a change in the underlying index. A similar issue arises if the portfolio could be changed by someone unrelated to the investor but not under a strict algorithm.

It will be interesting to see how these issues will be dealt with.

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