Proposed Regulations Issued on Reporting Obligations for Basket Contract Transactions

Tax Talks on **August 21, 2024**

1. **Introduction.**

On July 12, 2024, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS") issued proposed regulations that would classify "basket contract transactions", which are derivatives (i) with a term of more than a year (or that spans two taxable years), (ii) that reference a basket of assets, and (iii) where the taxpayer or an agent of the taxpayer exercises discretion to change the assets in the basket or the trading algorithm for the basket as "listed transactions" under the reportable transaction rules. Taxpayers engaging in basket contract transactions as described in the proposed regulations will face potentially significant penalties for failing to properly report such transactions—and taxpayers (and their tax advisors) would need to file reports even for transactions entered into prior to the date of the issuance of, or finalization of, these regulations.

2. **Background.**

Section 6011(a)[1] and Treasury Regulations Section 1.6011-4 provide that a taxpayer must disclose to the IRS if such taxpayer has participated in certain types of transactions, such as “listed transactions,” transactions with losses in excess of certain amounts (which are not exempted by other guidance), and “transactions of interest.” Additionally, material advisors to taxpayers with respect to such transactions must also report their involvement to the IRS.[2] The intent of these reporting requirements is to provide information to Treasury and the IRS to allow them to investigate transactions that Treasury and the IRS suspect may be causing inappropriate tax avoidance or evasion. Treasury and the IRS had previously flagged certain types of “basket contracts”, including contracts structured as options, and contracts structured as other financial instruments such as notional principal contracts or forward contracts, as listed transactions or transactions of interest in previous notices.[3] Basket contract transactions are generally structured so that a taxpayer, using a contract such as an option, notional principal contract, forward contract, or other derivative contract, receives a return based on the performance of a reference basket of assets. Treasury and the IRS are concerned that taxpayers are using these types of transactions to defer ordinary income and to inappropriately convert what would be short-term capital gain or ordinary income, to long-term capital gain recognized later.

3. **The Proposed Regulations.**

Treasury and the IRS had concluded, based on their analysis of transactions reported under the prior notices, that basket contracts of all types identified in those notices inappropriately deferred income and/or inappropriately converted ordinary income or short-term capital gain into long-term capital gain. As such, and also likely to protect their reporting requirements from being set aside as violative of the Administrative Procedure Act[4], Treasury and the IRS issued the proposed regulations to classify all such “basket contracts” as listed transactions. In particular, the proposed regulations list the various attributes that will cause a transaction to fall under the reporting requirements: (1) the taxpayer enters into a contract with a counterparty to receive a return based on the performance of a reference basket of assets, (2) the contract has a stated term of more than one year or overlaps two or more of the taxpayer’s taxable years, (3) the taxpayer has exercised discretion to change the assets in the reference basket or trading algorithm,[5] (4) the taxpayer’s tax return reflects a tax benefit with respect to the transaction, and (5) the transaction is not subject to the exceptions of paragraph (d) of the proposed regulations.[6] These exceptions include contracts that are traded on a national securities exchange, contracts that are treated as contingent payment debt instruments, and, with respect to the counterparty, if the taxpayer represents that none of its tax returns ending on or after January 1, 2011 will reflect a benefit with respect to the transaction, or if the counterparty has established that the taxpayer is a nonresident alien that is not engaged in a U.S. trade or business or a foreign corporation that is not engaged in a U.S. trade or business.[7]

Because Treasury and the IRS are classifying these basket contracts as “listed transactions” in the proposed regulations, the more onerous reporting rules relating to such transactions will apply to taxpayers and their material advisors upon the finalization of the regulations. In particular, taxpayers will be subject to (1) reporting requirements for prior open tax years as well as any year going forward in which they participate in such a transaction,[8] (2) increased penalties for failing to properly report,[9] (3) an extended period of limitations with respect to assessment of the tax,[10] and (4) possible financial statement reporting.[11]

Treasury and the IRS also discuss the various potential challenges they planned to bring against taxpayers who had engaged in “basket contracts” that meet the requirements of the proposed regulations. These include the argument that the counterparty in the transaction holds the assets in the reference basket as an agent of the taxpayer and that the taxpayer is actually the beneficial owner of the assets for tax purposes, the argument that changes to the assets in the reference basket materially modify the contract and therefore result in a taxable event under Section 1001, and the argument that the taxpayer is mischaracterizing the transaction as an option or other derivative to avoid the application of Section 1260 (with respect to constructive ownership transactions) or Section 1291 (with respect to passive foreign investment companies), or both. Note that just because a basket contract is a listed transaction does not mean Treasury or the IRS will win any challenge under the grounds they list—it merely triggers the reporting requirements discussed above. However, the identification of a transaction as a “listed transaction” is a strong signal that Treasury and the IRS are highly suspicious of the transactions and could pursue audits with intensity and may indicate a lower willingness to provide favorable settlement terms.

4. **Conclusion.**

As stated previously, the IRS’s and Treasury’s chief concern is that basket contracts represent tax ownership of the underlying basket because the taxpayer has control over its assets, and secondarily, that changes to the basket give rise to taxable events. Taxpayers and their material advisors should be aware of the proposed regulations, and ensure that if they participate in the transactions described, they are able to comply with the disclosure requirements. As stated above, listed transactions involve more onerous reporting requirements, including the need to look back to past tax years, as well as more significant penalties for failure to comply.

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[1] All references to “Section” are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

[2] In the proposed regulations, material advisors will be required to report transactions for prior years if they have made a tax statement on or after the date that is six years prior to the date of publication of the final regulations.

[3] Notice 2015-73 (basket contracts structured as options, when certain other requirements are met, are listed transactions); Notice 2015-74 (other basket contracts, when certain other requirements are met, are transactions of interest).

[4] *See e.g.*, *Mann Construction, Inc., v. United States*, 27 F.4th 1138 (6th Cir. 2022) and *CIC Servs., LLC v. IRS*, No. 3:17-cv-110, 2022 BL 97539 (E.D. Tenn. Mar. 21, 2022).

[5] This control requirement is the key feature which distinguishes basket contract transactions from other more common financial derivatives, such as swaps on the S&P 500.

[6] Proposed Regulation Section 1.6011-16(c).

[7] Proposed Regulation Section 1.6011-16(d).

[8] Treasury Regulations Sections 1.6011-4(d) and (e).

[9] Section 6707A and Sections 6662A(a) and (c).

[10] Section 6501(c)(10).

[11] Section 6707A(e).

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