

Index Derivatives and Current “Basket Option” Guidance

By Brennan W. Young and Remmelt A. Reigersman

Many companies are in the business of index creation and maintenance (in other words, the index sponsorship business). Several household names, such as S&P Global, Nasdaq, Bloomberg, and MSCI, each sponsor hundreds of indices with strategies focused on different categories of assets, geographic regions, company size, company sector, and environmental and societal factors.¹ There are many other index sponsors in the market (including some financial institutions).

For the last decade, institutions structuring index-linked derivatives (and their tax advisors) contended with the application of Internal Revenue Service (IRS) reportable transaction notices with respect to “basket options” and substantially similar transactions, found in Notice 2015-73 and Notice 2015-74 (the “Notices”),² to such index-linked derivatives. On July 12, 2024, the U.S. Treasury and the IRS released proposed regulations on “basket option contracts” (the “Proposed Regulations”).³ The Proposed Regulations, which do not substantively differ from the Notices in any way that is helpful to the index-linked derivatives market, are the heir to the Notices and will become effective once published as final in the federal register. As such, taxpayers currently live in a world governed by the Notices but with the impact of the final version of the Proposed Regulations looming ahead.

We will start with an overview of how the current basket option contract guidance can apply to an index-linked derivative, then discuss some of the mechanical ambiguities found in the current basket contract guidance that currently (maybe unintentionally?) broaden the scope of the guidance, and finally discuss the potential U.S. federal tax characterizations of an index-linked derivative that is a “listed transaction.”

I. An Index-Linked Derivative as a Reportable Transaction

When is an index-linked derivative captured? Mechanically, the Notices and Proposed Regulations are scoped broadly enough to cover most traditional index-linked derivatives (*e.g.*, total return swaps, forward contracts, put and

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call options, *etc.*), some of which are then excluded from being treated as a reportable transaction through key exceptions. Much of the actual wording in the Proposed Regulations defining the substance of what transactions are captured by the basket option transaction guidance (including the key exceptions) is substantively unchanged from the Notices. Captured as a “listed transaction” is any transaction that meets the following criteria (and any transaction substantially similar to a transaction meeting these criteria)⁴:

- i. Taxpayer (T) enters into a contract (including a contract denominated as an option, notional principal contract, forward contract, or other derivative contract) with counterparty (C) to receive a return based on the performance of the reference basket⁵;
- ii. the basket contract has a stated term of more than one year or overlaps two of T’s taxable years;
- iii. T or T’s designee has exercised discretion to change (either directly or through a request to counterparty) the assets in the reference basket or the trading algorithm;
- iv. T’s tax return reflects a deferral of income into a later taxable year or a conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss⁶; and
- v. the transaction is not otherwise excepted.⁷

There are three key potential exceptions for index-linked derivative transactions falling within the broad stroke of the above criteria, which can be analyzed with the three questions below.

1. Is the contract excluded based on the parties or tax characterization?

Several transactions are entirely excepted under both the Notices and the Proposed Regulations, including (1) contracts traded on a national securities exchange that is regulated by the Securities and Exchange Commission or a domestic board of trade regulated by the Commodity Futures Trading Commission, or a foreign exchange or board of trade that is subject to regulation by a comparable regulator, (2) contracts treated as contingent payment debt instruments or variable rate debt instruments, and (3) with respect to the counterparty, T represents to C in writing under penalties of perjury that none of T’s tax returns for taxable years ending on or after January 1, 2011 has reflected or will reflect a tax benefit with respect to the transaction and C has established that T 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 by obtaining a valid Form W-8BEN or W-8BEN-E upon which it may rely under the requirements of Reg. §1.1441-1 from T as the beneficial owner

of the payments made or to be made under the basket contract.⁸

These exclusions are fact dependent, but if a transaction is excluded, no further analysis is required. Note that the issuer of an index-linked derivative sold to multiple investors is only excepted from reportable transaction reporting if the contract is excluded with respect to all investors.

For the last decade, institutions structuring index-linked derivatives (and their tax advisors) contended with the application of Internal Revenue Service (IRS) reportable transaction notices with respect to “basket options” and substantially similar transactions, found in Notice 2015-73 and Notice 2015-74 (the “Notices”), to such index-linked derivatives.

2. Is there impermissible discretion in the index methodology or maintenance rules?

The definition of “discretion” provides the second key exception, this one excluding rules-based changes from amounting to “discretion” with respect to a particular derivative. The Notices and Proposed Regulations generally define “discretion” to include T’s right to change, either directly or through a request to C, the assets in the reference basket or the trading algorithm, even if the terms of the transaction permit C to reject certain changes requested by T to the assets in the reference basket or the trading algorithm.⁹ There are a number of permissible amendments, including (1) 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 (rules), and T 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, (2) exercising routine judgment in the administration of the rules, which does not include deviations or alterations to the rules that are designed to improve the financial performance of the reference basket, (3) correcting errors in the implementation of the rules or calculations made pursuant to the rules,

and (4) making an adjustment to respond to an unanticipated event outside of T's control, such as a stock split, merger, listing or delisting, nationalization, or insolvency of a component of a basket, a disruption in the financial markets for specific assets or in a particular jurisdiction, a regulatory compliance requirement, force majeure, or any other unanticipated event of similar magnitude and significance.

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Analyzing whether there is impermissible discretion generally leads to a review of the index methodology for the particular index to analyze when, and under what circumstances, an index sponsor is permitted amendments to the index or index methodology. Index methodologies can sometimes give an index sponsor an auxiliary right to make any amendments necessary for the index to properly pursue its objectives, and it may not always be clear that these maintenance rights to not constitute "discretion." Although the basket contract guidance technically applies only when the party with "discretion" (here, the index sponsor) has actually exercised that discretion, parties to index-linked derivatives and their material advisors may generally assume that any impermissible discretion will be exercised in deciding whether a particular transaction is reportable.

3. Is the index sponsor directly or indirectly being "compensated" by the taxpayer to alter the index?

The definition of "designee" contains the first key exception for index-linked derivative transactions because the definition excludes a person who is otherwise a "designee" if the person is being compensated for managing certain indices. Specifically, under the Notices and Proposed Regulations, the term designee, with respect to T having discretion or having exercised discretion, means any person who is: (1) T's agent under principles of agency law; (2) compensated by T for suggesting, requesting, or determining changes in the assets in the reference basket or the trading algorithm; or (3) selected by T to suggest, request, or determine changes in the assets in the reference

basket or the trading algorithm.¹⁰ Compensation does not include (1) a 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 a widely used and publicly quoted index that is based on objective financial information, or an index that tracks a broad market or a market segment. Index sponsors commonly receive a fee for the use of their index as an underlying in a derivative transaction, and where an investor economically bears that fee, the index sponsor may be viewed as the investor's "designee."

In the context of an index-linked derivative, the ambiguous meanings of a "widely used and publicly quoted index" and a "broad market or market segment" have made it difficult in some cases to conclude that an index sponsor is not an investor's "designee" without some level of uncertainty.

II. Narrowing the Scope

As discussed, the architecture of the current basket contract guidance (including the Proposed Regulations) does not draw clear lines for falling within key definitional exceptions. The preamble's request for examples of indices that should qualify as a "widely used and publicly quoted index that is based on objective financial information," or that "tracks a broad market or market segment" demonstrates that the IRS and Treasury are aware that these definitional ambiguities make for a less than straightforward application of the rules. Each of the New York State Bar Association (NYSBA) Tax Section, Securities Industry and Financial Markets Association (SIFMA), and the North American Tax Working Group of the International Swaps and Derivatives Association, Inc. (ISDA) provided the IRS and Treasury with comment letters on the Proposed Regulations requesting clarity for the ambiguous elements of the definitional exceptions (along with other changes).¹¹ The following reviews some of the key uncertainties addressed by the industry comment letters.

A. Remove the "Substantially Similar" Standard

In a departure from the Notices, the Proposed Regulations capture as a "listed transaction" any transaction that meets the five criteria set forth in Part I above, but also "any substantially similar" transactions (which were previously

“transactions of interest.” All three comment letters ask that the final basket option reportable transaction guidance be limited only to transactions that meet the five criteria (and not substantially similar transactions). The comment letters express the agreeable sentiment that for reputational reasons taxpayers and their material advisors could be reluctant to have any part in a transaction that can reasonably be viewed as a “listed transaction,” and that therefore the overly broad inclusion of “any substantially similar” transaction could stop a swath of non-abusive derivatives from being issued.

B. Provide Certainty to Index Sponsors

As discussed, the key exceptions contain some ambiguities that are particularly troubling when applied to index-linked derivatives. An index sponsor is not treated as “compensated by” an investor (and therefore outside the definition of “designee”) if the index is (1) “widely used and publicly quoted” and “based on objective financial information,” **or** (2) an index that tracks “a broad market or market segment.”¹² In the alternative, purely rules-based changes do not amount to “discretion,” but the scope of that exception is not entirely clear.

1. Objective-Based Maintenance Amendments

The “objective financial information” standard in the designee exception, and the exception for rules-based amendments in the discretion exception, do not address all modern index methodologies (*e.g.*, environmental, social, and governance (ESG) index methodology may look to non-financial that is nonetheless objective). All three comment letters ask that the exception permit all objective information, not just objective financial information. The letters also, with some deviation, ask that the discretion exception for mechanical amendments be expanded to include any rights of the index sponsor to make maintenance amendments pursuant to the published guidelines of the index aimed at ensuring the index achieves its theme or objective.

2. Compensation and a “Meaningful Relationship”

In some situations, it may be possible to conclude with certainty that the index sponsor and investor are completely removed from one another, such the treatment of the index sponsor as a “designee” of the investor does not reflect reality (*e.g.*, a single option over the S&P 500). The ISDA letter asks that the direct or indirect payment of a fee to an index sponsor of the ordinary course pursuant to an index license or similar arrangement be excluded from

the meaning of “compensated by the taxpayer” without limitation.

As currently written, an index sponsor could be treated as a taxpayer’s designee even if the two do not have contact or a relationship other than the index licensing transaction. The SIFMA and ISDA letters ask for the following specific revisions to the definition of a designee, aimed at excluding index-linked derivatives referencing an index where there is no meaningful relationship between the investor and the index sponsor:

- The term designee, with respect to a T having discretion or having exercised discretion, is defined in Proposed Reg. §1.6011-16(b)(3) as any person who is: T’s agent under principles of agency law; compensated by T for suggesting, requesting, or determining changes in the assets in the reference basket or the trading algorithm; or acting in concert with T to suggest, request, or determine changes in the assets in the reference basket or the trading algorithm.

3. “Broad Market or Market Segment”

Another exception to treatment of the index sponsor as the “designee” of an investor in an index-linked derivative contract is for indices that track a “broad market or market segment.” As discussed, this term is undefined, which makes this exception difficult to use as a source of certainty. The NYSBA letter recommends borrowing from the Commodity Exchange Act of “tracking a broad market.”¹³ Another approach would be for the IRS to create a new definition, starting with the pertinent components of the definition of a “qualified index” in the regulations under Code Sec. 871(m).¹⁴

C. Sales to Non-U.S. Holders

The Proposed Regulations provide an exception for transactions where the non-U.S. tax status of the counterparty has been verified through the receipt of an IRS Form W-8BEN or Form W-8BEN-E, in each case because such holders are not taxable on capital gain or loss and therefore do not have a “tax benefit.” All three comment letters, in similar words, point out that IRS Form W-8EXP and Form W-8IMY (with only Forms W-8BEN, BEN-E, and EXP attached, or with an allocation statement with no allocation to an underlying Form W-9 or W-8ECI) could also provide verification that a derivative is held by an investor who would not expect to recognize a “tax benefit.”

In addition, the SIFMA and NYSBA comment letters ask that the issuers of structured products and securities sold to non-U.S. investors under Regulation S be excluded from being a basket option reportable

transaction, since those products and securities may not be marketed or sold to any “U.S. Person” as defined for such purposes, which generally includes individual residents of the United States, legal entities incorporated under U.S. law, and U.S. branches or agencies of foreign entities.

III. What Happens to Index-Linked Derivatives that Are Reported?

What does the status of an index-linked derivative that is required to be reported as a “listed transaction” mean for the U.S. federal tax characterization of the transaction? In the preamble to the Proposed Regulations, the IRS clearly states its view on the possible characterizations:

“[t]he IRS may assert one or more arguments to challenge the parties’ tax characterization of a basket contract, including:

- (1) that C, in substance, holds the assets in the reference basket as an agent of T and that T is the beneficial owner of the assets for tax purposes;
- (2) that the basket contract is not an option or other derivative contract for tax purposes;
- (3) that changes to the assets in the reference basket during the year materially modify the basket contract and result in taxable dispositions of the contract under section 1001 of the Code throughout the term of the contract;
- (4) that T actually owns separate contractual rights with respect to each asset in the reference basket such that each change to assets in the basket results in a taxable disposition of a contractual right under section 1001 with respect to the asset affected by the change;
- (5) that T is mischaracterizing the transaction as an option or certain other derivatives in an effort to avoid application of section 1260 (with respect to constructive ownership transactions), section 1291 (with respect to passive foreign investment companies), or both;
- (6) that a change from accounting for basket contracts as derivative contracts with respect to the referenced assets to accounting for the contracts in a manner consistent with T’s beneficial ownership of the referenced assets results in one or more accounting method changes within the meaning of section 446; and

- (7) any accounting method change generally will be implemented with a section 481(a) adjustment that takes on the character of the item to which the adjustment relates.

The IRS may also assert other arguments supporting the conclusion that T is the beneficial owner of the assets in the reference basket for tax purposes.”¹⁵

This menu of options points to at least two possible distinct tax recharacterizations for an index-linked derivative that is a “basket contract.”¹⁶ First, a taxpayer could be viewed as owning multiple financial instruments (*i.e.*, the equity or other financial instruments that make up the assets included in the index). In this case, the taxpayer is the U.S. federal income tax owner of each component included in the index, with a tax basis in each component, and the taxpayer would expect to recognize gain or loss for each change in an index component or other rebalancing. Second, a taxpayer could be treated as owning a single financial instrument that undergoes a deemed exchange upon each “material modification” to the index. In this case, a U.S. taxpayer could be expected to recognize gain or loss upon each “material modification.” Both options are a departure from the current U.S. federal income tax position taken with respect to common index-linked derivatives. It is also unclear the extent to which these recharacterizations could apply to index-linked derivative transactions that fall outside the scope of the Notices and Proposed Regulations but are otherwise factually identical to transactions that are captured.¹⁷

All three comment letters, with some deviation in wording, ask that the IRS issue additional guidance (separate from the final basket contract regulations) on the U.S. federal income tax treatment of financial contracts that reference recalculating indices or baskets, including under Code Sec. 1001.¹⁸ The request is for this guidance to also address any transactions that the IRS believes might be outside the scope of the Proposed Regulations but also treated as ownership by the investor of the assets underlying the transaction (*e.g.*, the components of an index).

While anything new issued by the IRS in response to the request in the comment letters for separate guidance under Code Sec. 1001 for index-linked derivative transactions could bring some certainty for some types of modifications, guidance that is too broad and difficult to administer may disrupt current U.S. federal income tax treatment of these instruments.

ENDNOTES

- ¹ See the S&P Global Index tool, available at www.spglobal.com/spdji/en/index-finder/, for more particular index flavors.
- ² See Notice 2015-73, IRB 2015-46, 660 and Notice 2015-74, IRB 2015-46, 663. For a summary of the Notices and the related reportable transaction consequences and considerations, see Thomas A. Humphreys, Remmelt A. Reigersman, and Brennan W. Young, *New Notices for "Basket Contracts" Revoke and Replace July Notices*, JOURNAL, Volume 13, Issue 3 (2015). All references to "Code Sec." are to the Internal Revenue Code of 1986, as amended and all reference to "Reg. S" are to the regulations issued thereunder.
- ³ Proposed Reg. §1.6011-16 (REG-102161-23).
- ⁴ Under the Notices, transactions that were the same as, or substantially similar to, transactions under the specific definition of an option contract were treated as "transactions of interest," with only the specified option contracts being treated as "listed transactions." Under the Proposed Regulations, both transactions meeting the specified criteria and substantially similar transactions would be listed transactions. Failing to report either type of reportable transaction may lead to penalties. The elevation to "listed transaction" treatment generally means higher penalties for failure to disclose, enhanced underpayment penalties, and an extended statute of limitations.
- ⁵ A "reference basket" is defined to be any notional basket of assets that may include securities, commodities, foreign currency, digital assets as defined in Code Sec. 6045(g)(3)(D), interests in entities that any of the above, actively traded personal property as defined under Reg. §1.1092(d)-1(a), and similar property (or positions in similar property). Proposed Reg. §1.6011-16(b)(6). The Proposed Regulations tweaked the definition of "reference basket" to include actively traded personal property as defined under Reg. §1.1092(d)-1(a) and digital assets (and positions in such property).
- ⁶ This is the definition for "tax benefit" under Proposed Reg. §1.6011-16(b)(5).
- ⁷ Proposed Reg. §1.6011-16(c).
- ⁸ Proposed Reg. §1.6011-16(d).
- ⁹ Proposed Reg. §1.6011-16(b)(4).
- ¹⁰ Proposed Reg. §1.6011-16(b)(3).
- ¹¹ See NYSBA Tax Section, Report on Proposed Regulations Identifying Basket Contract Transactions as Listed Transaction (September 10, 2024); SIFMA, 2024 Proposed Regulations for the Identification of Basket Contract Transactions; and ISDA, Comments on 2024 Proposed Regulations Identifying Certain Basket Contract Transactions as Listed Transactions (September 10, 2024). Each of the comment letters is available on the Treasury regulation website at www.regulations.gov/document/IRS-2024-0032-0001/comment.
- ¹² Proposed Reg. §1.6011-16(b)(3).
- ¹³ The Commodity Exchange Act analogies referred to look at whether an index has numerous components, whether any component or group of components is too heavily weighted, and other factors.
- ¹⁴ See Reg. §1.871-15(l).
- ¹⁵ The preamble also states that the IRS may challenge, including by asserting judicial doctrines, claimed tax positions under Code Secs. 871, 881, and 882 or other provisions, and may assert failures to comply with reporting obligations associated with investments in passive foreign investment companies and withholding and reporting obligations under chapters 3 and 4 of the Code.
- ¹⁶ Notice 2015-74, IRB 2015-46, 663, has a much shorter list of recharacterizations, including only "challenge[s] the taxpayer's position taken as part of these transactions under Code Sec. 1260, 1001, or other provisions or under judicial doctrines, such as substance over form." The preamble to the Proposed Regulations is not specific as to whether the possible recharacterizations of "basket contracts" were intended to apply similarly to "basket contracts" under the Notice, but the retroactive reporting required for "substantially similar" transactions indicates that is a possibility.
- ¹⁷ For example, two index-linked derivatives could have the same terms in every respect except that one index sponsor's index amendment/maintenance rights was excepted from the definition of "discretion."
- ¹⁸ The ISDA comment letter attached a separate SIFMA comment letter to the IRS in September 2020 that includes detailed recommendations on any potential Code Sec. 1001 guidance for derivatives.

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