**US**
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# Knock-out option treated as direct ownership of underlying

Towards the end of last year, the IRS released an advice memorandum in which it concluded that a contract styled as an option should in substance be characterized for federal income tax purposes as direct ownership of the underlying property. The facts described in the memorandum were as follows: Taxpayer, a hedge fund (HF) without any employees, was organised as a Delaware limited partnership and managed by its general partner (GP).

HF entered into a call option contract (contract) with a foreign bank (FB) on a basket of securities (reference basket) held in an account administered by FB. The reference basket was funded with $1x, the premium paid by HF to FB, and $9x paid by FB. Pursuant to the terms of the contract, HF had the right to terminate the Contract at any time during its two-year term upon which it would receive the cash settlement amount. This amount equaled the greater of (i) zero, or (ii) the reimbursement of the $1x premium, plus basket gain or less basket loss.

Basket Gain or Loss equaled (i) trading gains, unrealized gains, interest, dividends, or other current income, less (ii) trading losses, unrealized losses, interest, dividends, or other current expenses, less (iii) commissions and other trading costs incurred in acquiring or disposing of the securities and positions, and less (iv) financing charges on the $9x provided by FB. The terms of the Contract included a knock-out provision, pursuant to which the contract would automatically terminate at any time the basket loss reached 10%, and gave FB the right to require HF to enter into risk-reducing trades.

FB entered into an investment management agreement with GP setting forth certain investment guidelines and pursuant to which GP conducted trading of the securities included in the reference basket. In addition, GP had the power to make corporate action decisions with respect to the Reference Basket securities. Pursuant to the investment management agreement, FB paid GP a fixed annual fee of less than 0.1% of $10x.

The IRS concluded that the terms of the contract, and in particular the cash settlement amount, ensured one of two outcomes: (i) HF would exercise if the reference basket increased in value, or decreased by less than 10%, in order to recoup at least a portion of its premium, or (ii) the reference basket would fall in value by 10% and the knock-out provision would terminate the contract and HF would receive nothing.

As a result, in the IRS's view, the contract imposed on HF costs similar to those of an obligated buyer and precluded any possibility of lapse and therefore lacked the requisite characteristics of an option.

Further, the IRS concluded that the contract did not function like an option because HF (through GP acting on its behalf) actively traded the securities included in the reference basket, whereas an option on property allows the holder to accept an offer to buy or sell specified property at a defined price.

Citing case law, the IRS concluded that HF should be treated as the owner of the reference basket for federal income tax purposes because HF had (i) opportunity for full trading gain and current income, (ii) substantially all of the risk of loss related to the reference basket, and (iii) complete dominion and control of the reference basket.

In concluding that HF bore substantially all of the risk of loss related to the reference basket, the IRS acknowledged that FB could suffer a loss if a basket loss were incurred that would breach the knock-out level and FB would not be able to timely liquidate the reference basket to limit the loss to 10%. The IRS, however, noted that this possibility was remote and that FB also had rights to force HF into risk-reducing trades under the investment guidelines.

Finally, the IRS noted that it considers the nature of the above-described transaction particularly aggressive and it encourages its agents to develop cases with respect to this and similar transactions. In addition, the IRS stated that it may be appropriate to argue that changes in a contract's reference basket cause a taxable exchange of either the contractual rights within the reference basket or of the contract itself.

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