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Accounting

Switch From Treating Basket Transactions As Options an Accounting Change, CCA Says



June 30 — The Internal Revenue Service Office of Chief Counsel in a chief counsel advice memorandum said that when a taxpayer stops treating certain securities transactions as "options," and thus no longer defers associated gains, losses, income or deductions, it is a change in accounting method under tax code Section 446.

Section 481(a) applies in such a situation, the office said in CCA 201426025, released June 30, so computation and recognition of an appropriate adjustment is needed to eliminate any distortions in income or deductions caused by the accounting method change.

The CCA considered a situation where a limited liability company, treated as a partnership for federal tax purposes, conducts daily trading in securities positions, mainly through various basket transactions with a broker and investment bank. Typically, the taxpayer makes an up-front payment of 10 percent of the notional amount of the basket of securities and the bank provides the remaining 90 percent. The year-plus contract describes the LLC's investment as a "premium" giving the LLC the "option" to receive a cash settlement from the bank when the contract expires or is terminated.

The cash settlement amount is determined by formula and generally reflects the increase or decrease in the securities' value, less expenses, interest and fees payable to the bank for its services and capital.

The taxpayer doesn't recognize gains, losses, income or deductions as it trades the securities within the basket, instead deferring recognition until the contract is ended. The taxpayer recognizes gain equaling the difference between the cash settlement received and the up-front payment made.

On examination, the IRS field agent determined the transactions lack the requirements to be treated as options for tax purposes—that the LLC should be treated as beneficial owner of the basket of securities for tax purposes and shouldn't defer reporting of the resulting income. The CCA didn't examine those conclusions and assumed that result is correct.

Change in Timing Versus Total

The Office of Chief Counsel said the field agent's adjustment constitutes a change in accounting method under Section 446 and Section 481 "because it impacts the timing (amounts and tax years) of taxable income, but does not change the total amount of taxable income recognized over the lifetime of Taxpayer."

The amount of taxable income recognized by the LLC under its current practice when a basket transaction expires or otherwise terminates is the same as the cumulative amount of taxable income recognized for the basket over multiple taxable years under the practice imposed by the IRS field agent, the office explained. "Accordingly, a change between these practices is an accounting method change."

The office rejected the taxpayer's argument that the change creates a permanent difference in lifetime taxable income because the adjustments require it to recognize amounts it never intended to recognize—like gains and losses on individual securities transactions within the basket. The taxpayer argues the issue is "whether" such amounts are taxable, rather than "when" they are taxable.

The office said the taxpayer's argument "elevates form over substance and places undue significance on the labeling of amounts."

Different Labels

"While it may be strictly true that Taxpayer never intended to recognize gains, losses, income, or deductions from Basket Transactions, Taxpayer did intend to recognize an option gain (loss)

whenever a Basket Transaction ended, and such gain (loss) effectively included the gains, losses, income, and deductions asserted in adjustment by Field Operations. Thus, Taxpayer intended to include (and actually did include) these amount in gross income, albeit under a different label," it said.

In addition, it said, the adjustment includes the corresponding removal of gains recognized by the taxpayer when the basket transaction has ended. "Thus, when seen in its overall context, the adjustment merely impacts the time when taxable income would be recognized; it does not propose to recognize amounts that Taxpayer never intended to recognize."

The office also rejected treating the change as an error correction.

The CCA was dated Jan. 17.

For More Information

Text of CCA 201426025 is in TaxCore.

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