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to: Area Counsel (Financial Services)
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subject: Hedge Fund Basket Option Contracts

This memorandum addresses certain contracts styled as options in form but acting like direct ownership of the underlying property in substance. This memorandum should not be used or cited as precedent.

ISSUES

Where the taxpayer, a partnership, entered into a contract styled as an option to purchase a basket of securities that the taxpayer's general partner also actively managed and controlled while the contract remained open, and with respect to which the taxpayer had opportunity for full gain and income and substantially all of risk of loss: (1) whether the contract should be treated as an option for tax purposes; and (2) whether the taxpayer should be treated as the tax owner of the securities.[1]

CONCLUSIONS

(1) The contract does not function like an option, and should not be treated as such.

(2) A contract that provides a taxpayer with dominion and control over a basket of securities, the opportunity for full gain and income, and substantially all of the risk of loss, provides to the taxpayer beneficial ownership of the securities for tax purposes.

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[1] To simplify the discussion, this memorandum refers to both long and short positions in securities as "securities."

Thus, the taxpayer must currently recognize the trading gains, losses, income, or expense resulting from trading and holding the securities in the basket.

FACTS

Taxpayer and affiliated entities. The taxpayer is a Delaware limited partnership that operates as a hedge fund (the taxpayer is hereinafter referred to as "HF"). During the relevant tax years, HF and other affiliated limited partnerships ("Other Hedge Funds") had common partners that were Delaware limited partnerships ("Feeder Funds"), one of which was GP. GP was the general partner of HF and the Other Hedge Funds. GP also served as the Investment Manager for the Other Hedge Funds. Among these entities, only GP had employees, and the individuals who owned interests in GP also owned interests in the Feeder Funds.

Basket Contract. HF entered into a contract ("Basket Contract") with Foreign Bank ("FB"), which is a U.K. public limited company.[2] The Basket Contract was styled as a call option on a basket of securities ("Reference Basket") held in a specified prime brokerage account administered by FB. The value of the securities in the Reference Basket was $10x when the parties entered into the Basket Contract, and the Reference Basket was funded with $1x in "premium" paid by HF and $9x paid by FB. FB determined HF's $1x premium through its finance department, rather than through option valuation formulas typically used when pricing standard options. HF had the right to terminate the Basket Contract at any time during a two-year term and receive a specified "Cash Settlement Amount," which was based on the performance of the Reference Basket.

The Basket Contract provided for a strike price equal to the initial value of the Reference Basket ($10x). The Cash Settlement Amount that HF was entitled to receive upon termination of the contract equaled the greater of (1) zero or (2) the reimbursement of the $1x premium, plus "Basket Gain" or less "Basket Loss." Basket Gain or Loss comprised:

> (1) trading gains, unrealized gains, interest, dividends, or other current income; minus: (2)(a) trading losses, unrealized losses, interest, dividend, or other current expenses; (b) commissions and other trading costs incurred in acquiring or disposing of the securities and positions; and (c) financing charges on the $9x provided by FB.

Accordingly, Basket Gain or Loss fully reflected all of the net economic return or loss on the performance of the Reference Basket, including the financing charges on $9x.

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[2] This memorandum will not consider whether FB or any investors in HF have income that is effectively connected with a trade or business within the United States pursuant to I.R.C. §§ 864(b)-(c), 871(b), and 882(a).

Moreover, the Cash Settlement Amount allowed HF to receive back its $1x premium investment, reduced by any Basket Loss. Specifically, the Cash Settlement Amount would be reduced, dollar-for-dollar, for any Basket Losses up to $1x (i.e., 10% of the initial amount in the basket).

The Basket Contract contained a "Knock-Out" provision that automatically terminated the contract at any time that Basket Losses reached 10%, which was the same amount as HF's initial premium investment.[3] Thus, if Basket Losses breached the Knock-Out barrier, the contract would terminate and HF would receive a Cash Settlement Amount of zero. FB also had the right to require HF to enter into risk reducing trades even before losses in the Reference Basket reached the 10% barrier. Consequently, HF bore the risk of loss, dollar-for-dollar, for Basket Losses up to the amount of its investment. The Knock-Out provision protected FB against additional Basket Losses by allowing FB to terminate the Basket Contract and obtain control over the assets in the Reference Basket.

Investment Management Agreement. Related to its Basket Contract with HF, FB entered into an Investment Management Agreement ("IMA") with GP. In accordance with the IMA, GP conducted short-term trading (including acquisition of the initial make-up of the Reference Basket) of both short and long positions in exchange traded and over-the-counter securities as permitted by Investment Guidelines incorporated by reference into the IMA. GP conducted such short-term trading by instructing FB to execute GP's trading decisions. The Investment Guidelines limited the aggregate trading positions in the Reference Basket based on the value of any one security, business sector, or types of issuers; FB could terminate the Basket Contract if GP violated the Investment Guidelines, regardless of whether the value of the Reference Basket was near the Knock-Out barrier.

Although not contractually obligated to follow GP's specific trading instructions as long as the net value of the Reference Basket nevertheless reflected GP's instructions, FB in fact executed all of GP's trading instructions, which could entail numerous trades per day. In addition to making every trading decision, GP also had power to make corporate action decisions over the securities, addressing tender offers, mergers, and other decisions that offer a choice of consideration of cash or shares.

Nothing in the agreements between HF and FB contractually prohibited FB from commingling, lending or otherwise using the securities in the Reference Basket without notice to HF. These are customary rights a pledgee has over the assets of its brokerage customers.

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[3] A contract that is subject to a knock-out contingency is part of a broader category of contracts referred to as "barrier options." See Emanuel Derman and Iraj Kani, The Ins and Outs of Barrier Options: Part 2, Derivatives Quarterly, Spring 1997, at 73, 77. As this memorandum explains, infra, the Basket Contract's particular Knock-Out provision caused the contract to function in a manner unlike options generally.

GP Management Fee Arrangement. Under the IMA, FB paid GP a fixed annual fee of less than 0.1% of $10x, which was described as a compensation and incentive fee for trading management of the Reference Basket. This is significantly less than GP received from HF's partners and beneficial owners of HF (Feeder Funds) for providing the same service. The Feeder Funds' partnership agreements provided GP with 2% of the net asset value of the Reference Basket and 20% of specified levels of Basket Gain. These fees from the Feeder Funds were consistent with the standard industry fees for trading and management services.

LAW AND ANALYSIS

HF in form owned a call option to purchase the Reference Basket, which contained securities held by FB. It has long been a principle of federal tax law, however, that the substance of a transaction and not its form will determine the federal income tax consequences of the transaction. Commissioner v. Court Holding Company, 324 U.S. 331 (1945); Gregory v. Helvering, 293 U.S. 465, 470 (1935). If the Basket Contract was not, in substance, an option contract, then HF must treat the transaction for tax purposes in accordance with its actual substance. This memorandum first addresses whether the Basket Contract qualifies as an option for tax purposes, and then addresses whether HF, in substance, is the tax owner of the Reference Basket.[4]

1. The Basket Contract Is Not an Option

Although labeled as an option, the Basket Contract lacks the essential economic and legal characteristics of an option.

Case law defines an option as having two characteristics: (1) a continuing offer to do an act, or to forebear from doing an act, which does not ripen into a contract until it is accepted; and (2) an agreement to leave the offer open for a specified period of time. Saviano v. Commissioner, 80 T.C. 955, 970 (1983), aff'd, 765 F.2d 643 (7th Cir. 1985). The purpose of an option that references property is to provide a party the opportunity to buy or sell specified property in the future at a defined price without the potential liability inherent in being obligated to buy or sell. See United States Freight Co. v. United States, 422 F.2d 887, 894-95 (Ct.Cl. 1970). Thus, an option only makes sense economically if the option holder's cost of failing to exercise is lower than the holder's

[4] Hedge Funds typically own directly the assets they manage by using prime brokerage accounts offered by investment banks and securities firms. In this case, HF sought two tax advantages in characterizing the Basket Contract as an option to purchase the Reference Basket rather than as direct ownership of basket assets through a prime brokerage account: (1) Basket Gains, including short term gains, interest, and dividends earned within the Reference Basket, would not be taxable to HF until HF exercised the option, since unexercised options on property are typically treated as "open transactions" pursuant to Rev. Rul. 58-234, 1958-1 C.B. 279; and (2) Basket Gains, including short term gains, interest, and dividends, would taxable at the low rate applicable to long-term capital gains if HF received the Cash Settlement Amount after holding the Basket Contract for more than one year, pursuant to I.R.C. §§ 1221; 1234(a)(1), (c)(2).

potential liability had he or she instead entered into and breached a contract to buy or sell the underlying property. See Halle v. Commissioner, 83 F.3d 649, 655-56 (4th Cir. 1996)(comparing potential buyer's liquidated damages with seller's expected damages in event of buyer's default to determine whether contract is option versus sale).[5] A contract that imposes a high cost upon an offeree for failing to accept an offer will not be deemed an option if the cost effectively compels the offeree to exercise. See Progressive Corp. v. United States, 970 F.2d 188, 193 (6th Cir. 1992) (explaining that certain "options" may be disguised sales because "the exercise of such options may be virtually guaranteed"); Commissioner v. Baertschi, 412 F.2d 494, 498 (6th Cir. 1969) (noting buyer's high cost of breach equal to 29% of property value is indication of sale rather than option).[6]

Upon applying these principles to the agreements between HF and FB, it is clear that the Basket Contract, despite its option terminology, lacks the requisite characteristics of an option. In particular, two elements of the agreements between HF and FB are contrary to the typical functioning of an option: (a) the interplay between the Basket Contract's premium, Cash Settlement Amount, and Knock-Out provision, which imposed upon HF costs similar to an obligated buyer and preclude any possibility of lapse; and (b) HF's ability to alter the Reference Basket, through GP, while the Basket Contract remained open, which is inconsistent with the notion that an option on property must reference specific property at a defined price.

a. Costs Imposed upon HF and the Possibility of Lapse

The Basket Contract did not function like an option insofar as its terms imposed costs upon HF that compelled HF to exercise rather than allow it to lapse. As noted by the courts in United States Freight and Halle, a call option should function so that the holder has a real choice to allow the option to lapse; if the contact imposes a cost for failure to exercise that places the holder in a similar economic position to a party obligated to buy, then the holder lacks the choice not to buy and the contract is not an option. In the instant case, the Cash Settlement Amount ensured that HF would lose its premium investment dollar-for-dollar for Basket Losses until the Reference Basket fell in value by the full amount of HF's premium investment (i.e., 10%), and the Knock-Out provision would terminate the contract with HF losing its entire investment. Accordingly, the terms of the Basket Contract ensured one of two outcomes: (1) if the Reference Basket increased in value, or decreased by less than 10%, HF would exercise in order

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[5] In terms of pricing and risk, call options generally allocate risk of loss between option writers and holders such that the option writers/sellers bear the risk of price decreases in the underlying asset while the option holders/buyers enjoy the benefits of price increases while also bearing the risk that they may lose their premium. See Halle, 83 F.3d at 657.

[6] The court in Progressive adopted language from Rev. Rul. 80-238, 1980-2 C.B. 96, which held that a purported stock option is actually a sale if it is deep "in-the-money" at the time it is issued, i.e., the holder can purchase the stock at below current market price such that the holder is almost certain to exercise. Likewise, the Service in Rev. Rul. 82-150, 1982-2 C.B. 110, held that a sale of a deep-in-the-money option was, in substance, not an option but a completed sale of the referenced stock.

to recoup at least a portion of its investment; or (2) the Reference Basket would fall in value by 10% and the Knock-Out provision would force HF to terminate the option and receive nothing. Thus, the Cash Settlement Amount placed HF in the same economic position as a party obligated to buy the Reference Basket, while the Knock-Out provision ensured that the Basket Contract would never lapse unexercised. In this manner, the Basket Contract did not function like an option.

Moreover, there is no indication that HF and FB employed recognized option pricing methodologies to determine the premium. Rather, the premium that HF paid was merely a fixed percentage of the Reference Basket (i.e., 10%), which is also equal to the loss required to trigger the Knock-Out barrier. Thus, the premium under the Basket Contract is more akin to collateral for a nonrecourse margin loan than to an option premium. The similarity between HF's premium and margin loan collateral is consistent with the other terms of the Basket Contract, which, again, imposed potential costs upon HF that were more like those imposed upon an owner or a party obligated to buy than upon a party with the mere option to buy.

b. <u>The Effect of HF's Ability (Through GP) to Alter the Reference Basket</u>

The Basket Contract did not function like and option insofar as it referenced a basket of assets that HF (through GP and the IMA) can and did alter by actively trading the underlying securities. Though the IMA in form was a management agreement between GP and FB, which permitted GP to trade assets within the Reference Basket, GP in substance acted on HF's behalf. GP was the only entity among HF's affiliates that had employees, and GP served as the investment manager for Other Hedge Funds that had common partners with HF. Since the Basket Contract provided HF with full opportunity for gain and risk of loss up to the first 10% of losses, GP's management of the Reference Basket served to benefit HF more than FB. This is evident in the manner in which FB and HF compensated GP; the fee that FB paid to GP was a fixed annual fee of less than 0.1% of $10x, whereas the fee that HF's partners and beneficial owners (the Feeder Funds) paid to HF for comparable services was much larger, equal to 2% of the net asset value of the Reference Basket and 20% of specified levels of Basket Gain. The fees that the Feeder Funds paid to GP were consistent with the standard industry fees for trading and management services. Thus, the facts and circumstances indicate that GP was trading within the Reference Basket on behalf of HF, rather than FB.

HF's control over the Reference Basket caused the Basket Contract to operate unlike an option. As explained by the court in <u>Saviano</u>, an option provides one party with the choice of accepting an offer, while the other party is obligated to keep the offer open for a specified period of time. Options on property allow the holder to accept an offer buy or sell specified property at defined price. In this case, the Basket Contract purports to identify the Reference Basket as specific property subject to an option, yet the IMA contradicts that characterization by allowing HF (through GP) to alter the Reference Basket while the Basket Contract remained open. HF's ability to trade component securities within the Reference Basket calls into question whether the Reference Basket constitutes specific property apart from its components; thus, rather than having the right to buy the Reference Basket, HF could be viewed as having a series of separate contractual rights for each security within the Reference Basket such that each trade HF executes while the Basket Contract is open would generate a taxable event attributable to that trade under sec. 1001.[7] FB permitted HF to have this control because the terms of the Basket Contract ensured that FB was protected from HF's investment decisions; as noted above, the Basket Contract imposed potential costs upon HF that were more consistent with a party that had an obligation to buy than upon a party with a mere option to buy. Not surprisingly, the Basket Contract was neither priced like an option nor did it apportion costs like a typical option because HF's power to control and alter the Reference Basket was contrary to the very notion of what an option is.[8]

Having applied the principles set forth in the relevant authorities to the terms of the Basket Contract, we conclude that the Basket Contract is not an option for Federal income tax purposes.

2. HF Had Tax Ownership of the Reference Basket

We now turn to the question of whether HF, in substance, owns the Reference Basket.[9]

To determine whether a taxpayer holds the beneficial ownership of assets for tax purposes, courts have considered numerous factors indicative of the burdens and benefits of ownership.[10] No one factor is determinative; courts accord varying weight to

[7] See generally James M. Peaslee, Modifications of Nondebt Financial Instruments as Deemed Exchanges, Tax Notes, April 29, 2002, at 766-67 (discussing whether options referencing baskets of generate deemed exchanges under sec. 1001 when basket is changed in accordance with terms of the contract). Given the conclusion in Part 2 of this memorandum's "Law and Analysis" section that HF actually owned the component securities within the basket for tax purposes, this memorandum need not address whether the Reference Basket should be disaggregated into a series of contractual rights.

[8] The Treasury Regulations governing notional principal contracts also recognize this principle by prohibiting parties to a contract from controlling indexes that are used as referenced assets. Treas. Reg. § 1.446-3(c)(2)(iii), (c)(4)(ii).

[9] We have already concluded that the Basket Contract was not an option because HF is compelled to exercise; thus, the remaining question is whether HF owned the assets in the Reference Basket during the period in issue, or whether HF was merely obligated to purchase the assets in the future, i.e., through a forward contract. Forward contracts are typically treated as open transactions, and parties obligated to buy under forward contracts are not taxed as though they are current owners of the asset. See Lucas v. N. Texas Lumber Co., 281 U.S. 11, 13 (1930) (agreement to sell land in 1916 was not a closed sale for tax purposes until price paid and title transferred in 1917). In certain circumstances, however, taxpayers holding forward contracts may be treated as constructively owning the underlying asset. See I.R.C. § 1260(d)(1)(B) (treating taxpayers as constructively owning financial assets subject to certain forward contracts).

[10] In Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221 (1981), the Tax Court applied an eight factor test to determine whether taxpayer owned cattle, including: (1) Whether legal title passes; (2) how

each factor, depending on the type of property and transaction at issue. See Pac. Coast Music Jobbers v. Commissioner, 55 T.C. 866, 874 (1971) (employing multi-factor test to determine ownership of stock and according less weight to attributes that are formalistic and "not useful"), aff'd, 457 F.2d 1165 (5th Cir. 1972). For example, in determining the ownership of stock for tax purposes, the following factors are most relevant: (1) the ability to sell the shares; (2) the power to vote, especially as a means of controlling the board of directors and managing the underlying business; (3) the right to receive dividends; and (4) the opportunity for gain and the risk of loss in the value of the shares. See, e.g., Ragghianti v. Commissioner, 71 T.C. 346, 350 (1978) (sharing in profit and loss, and participating in shareholder meetings); Pac. Coast Music, 55 T.C. at 876-77 (dividends and voting proxies); Hall v. Commissioner, 15 T.C. 195, 200 (1950), aff'd,194 F.2d 538 (9th Cir. 1952) (noting that right of sale is "one of the most important attributes of ownership").

Tax Court has recently issued two opinions in which it addressed whether taxpayers were owners of fungible securities -- the type of securities in the Reference Basket. In each case, the court employed an analysis that was consistent with the principles described above. In Anschutz v. Commissioner, 135 T.C. No. 5 (July 22, 2010), the taxpayer received a nonrefundable upfront cash payment in exchange for transferring stock subject to a purported forward sale of the same stock (with variable number of shares to be delivered) and a purported share lending agreement of the same stock. The Tax Court held that the taxpayer had transferred its beneficial ownership of the stock because the taxpayer: (1) transferred most of the opportunity for gain; (2) eliminated its risk of loss; and (3) the party to whom the taxpayer loaned the stock had the right to dispose of the shares. Anschutz, slip op. at 46-47.

In Calloway v. Commissioner, 135 T.C. No. 3 (July 8, 2010), the taxpayer likewise received a nonrefundable upfront cash payment in exchange for transferring stock, in this case subject to a purported loan. The Tax Court held that the taxpayer had transferred its beneficial ownership because the taxpayer: (1) could not sell the shares during the three year term of the purported loan; (2) eliminated its risk of loss; and (3) the purported stock borrower was authorized to sell the stock immediately after receiving it from the taxpayer. Calloway, slip op. at 13-18.

The Court of Appeals for the Eighth Circuit focused on the same three factors employed by the Tax Court and Anschutz and Calloway in holding that a taxpayer had beneficial ownership of mutual fund shares that supported a variable annuity contract held by the taxpayer. In Christoffersen v. United States, 749 F.2d 513 (8th Cir. 1984), the taxpayers purchased a variable annuity contract that provided the taxpayers the full

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the parties treat the transaction; (3) whether an equity interest in property is acquired; (4) whether the contract creates a present obligation on the seller to transfer ownership and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. 77 T.C. at 1237-38.

investment return and risk of loss of mutual fund shares held in an account of the issuing insurance company. The taxpayers had the right to direct that their premium payments be invested in any one of six publicly traded mutual funds, and the taxpayers could reallocate their investment among the funds at any time. The taxpayers also had the right upon seven days notice to withdraw funds, surrender the contract, or apply the accumulated value under the contract to provide annuity payments. The court noted that the taxpayer bore full investment risk and had immediate access to the funds, and that the policy's limitations upon the taxpayer's control of the mutual fund shares were no different than the limits imposed by traditional brokerage accounts. Id. at 516.[11]

Upon application of the factors set forth by the authorities discussed above to the terms of the agreements between HF and FB, it is clear that HF should be treated as the tax owner of the Reference Basket because HF had: (a) opportunity for full trading gain and current income; (b) substantially all of the risk of loss related to the Reference Basket, and (c) complete dominion and control over the Reference Basket.

a. HF's Opportunity for Gain and Income

HF had full opportunity for gain and income from the Reference Basket performance. The Cash Settlement Amount included the refund of HF's premium investment and Basket Gain or Loss, which was defined to include all trading gains and losses, net current income or expenses, trading costs, and a financing charge for the funding of $9x provided by FB. Basket Gain or Loss reflected all of the economic return or loss on the performance of the Reference Basket. Because HF could also exercise its right to receive the Cash Settlement Amount at any time, HF was at all times free to take full advantage of its opportunity for gain and income.[12] Moreover, HF could lock in gain in any single position within the Reference Basket by instructing its disposition, while the Basket Contract remained open.

b. HF's Risk of Loss

HF had substantially all of the risk of loss of the Reference Basket. As explained in Part 1.a. of this memorandum's "Law and Analysis" section, the Basket Contract's Cash Settlement Amount reduced HF's ability to recoup its investment to the extent of any Basket Loss. HF had the risk of loss, dollar-for-dollar, up to the full amount of its premium investment, which was equal to 10% of the Reference Basket's initial value.

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[11] The IRS has declined to treat policyholders as the owner of mutual fund shares supporting variable life and annuity contracts if the shares are only available to the insurer's policyholders, and not to the general public, thus indicating that the policyholders lacked control over the mutual funds. Rev. Rul. 2003-91, 2003-2 C.B. 347; Rev. Rul. 81-225, 1981-2 C.B. 12.

[12] See Calloway, slip op. at 31 (taxpayer has full opportunity for gain "only if the taxpayer is able to effect a sale of the security in the ordinary course of the relevant market (e.g., by calling a broker to place a sale) whenever the security is in-the-money." (quoting Samueli v. Commissioner, 132 T.C. 37, 48 (2009)).

Moreover, due to the Knock-Out provision, the full risk of loss inherent in the Basket Contract was the 10% borne by HF.

FB did indeed bear a theoretical risk; FB could possibly suffer a loss if Basket Losses were incurred so quickly that FB was unable to liquidate the Reference Basket timely enough to prevent losses beyond the 10% threshold created by the Knock-Out. That possibility was remote, however, and FB also had rights through the Investment Guidelines to force HF into risk reducing trades or cause an early termination (and liquidation) of the Basket Contract even before Basket Losses reached the 10% barrier. Thus, the Knock-Out provision (and FB's additional risk-reduction rights) merely reflected the typical arrangement between a broker and an investor who purchases securities through margin loans in a prime brokerage account, i.e., the investor's risk of loss is limited to the amount of the purchase price the investor itself funded, while the broker has rights to liquidate the securities or take other actions to ensure that losses will not exceed the amount funded by the investor.[13]

c. HF's Control over the Reference Basket

HF, through GP, had complete dominion and control over the Reference Basket. As HF's agent, GP instructed numerous trades per day, which FB executed without exception. GP also had the power to make corporate action decisions over the securities in the Reference Basket. FB arguably had some control over the Reference Basket, as FB could have (and may have) lent or rehypothecated the securities without HF's knowledge. Nevertheless, these are customary powers that a broker-pledgee has over assets under custodial arrangement with prime brokerage customers. In this regard, HF's ability to trade any security within the Reference Basket or terminate the Basket Contract at any time and receive the Cash Settlement Amount further places HF in a similar position to an owner of a prime brokerage account and limits FB's ability to lend or rehypothecate the securities.

Accordingly, HF had: (a) opportunity for full trading gain and current income; (b) all of the risk of loss inherent in the Basket Contract; and (c) complete dominion and control of the Reference Basket. We conclude that HF is the beneficial owner of the Reference Basket for tax purposes.

[13] Furthermore, courts have respected the debt character of nonrecourse debt used in leveraged purchases of property (and thus the debtor's ownership of the leverage purchased property), despite the lender's bearing the risk of loss if the property decreases in value below the amount owed on the loan. For example, the Court of Appeals for the Fourth Circuit in Odend'hal v. Commissioner, 748 F.2d 908 (4th Cir. 1984) recognized that a nonrecourse obligation constitutes genuine indebtedness "so long as the fair market value of the property is at least equal to the amount of the nonrecourse debt at the time it was incurred, because the taxpayer, even though he has no personal liability at stake, has an economic incentive to pay off the debt rather than to lose the collateral." Id. at 912.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

You have informed us that there are variations to the contract described above. We encourage you to develop those cases, and stand ready to assist with legal analysis and alternative arguments. For example, in some cases it may be appropriate to assert that changes in a contract's reference index generate taxable exchanges of either contractual rights within the reference index, or of the entire contract; these would be alternative arguments to direct ownership of the underlying securities. We also suspect that this transaction is not confined to large hedge funds. Lastly, given the particularly aggressive nature of this transaction, we further encourage you to gather information about similar cases so that the Service can determine whether to resolve this issue case-by-case or through the formal programs in place for addressing potentially abusive transactions.

Please call Robert A. Martin or Anna H. Kim at (202) 622-3900 if you have any further questions.

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