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Report No. 1499
September 10, 2024

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Re: NYSBA Tax Section Report No. 1499 - Report on Proposed Regulations Identifying Basket Contract Transactions as Listed Transactions

Dear Mses. Aron-Dine and Rollinson, and Mr. Werfel:

Please see attached Report No. 1499 of the Tax Section of the New York State Bar Association, which discusses proposed regulations identifying certain basket contract transactions as listed transactions.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

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Respectfully submitted,

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Report No. 1499

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS IDENTIFYING BASKET CONTRACT TRANSACTIONS AS LISTED TRANSACTIONS

September 10, 2024

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Report No. 1499

Report on Proposed Regulations Identifying Basket Contract Transactions as Listed Transactions

I. INTRODUCTION

The New York State Bar Association Tax Section is submitting this report (the "***Report***")[1] in response to a request for comments on proposed regulations (the "***Proposed Regulations***") issued by the United States Department of the Treasury ("***Treasury***" including, as applicable, the Internal Revenue Service (the "***IRS***")) on July 12, 2024 that would designate certain basket contract transactions and basket option transactions, and substantially similar transactions ("***SSTs***"), as "listed transactions" under section 6011.[2] Under this designation, which is reserved for transactions that the government has determined to be abusive tax avoidance transactions,[3] participants and material advisors in such transactions are, among other things, required to file disclosures with the IRS and are subject to penalties for failure to disclose.

In many respects, the Proposed Regulations closely follow Notice 2015-74[4] (the "***Final Basket Contract Notice***") and Notice 2015-73[5] (the "***Final Basket Option Notice***," and together with the Final Basket Option Notice, the "***Final Basket Notices***"), which designated basket contract SSTs as "transactions of interest" and basket option SSTs as "listed transactions." We commend Treasury for reintroducing the substance of the Final Basket Notices in the form of the Proposed Regulations, providing taxpayers with the opportunity formally to comment on the designation of basket transactions as reportable transactions. The IRS first designated basket transactions as reportable transactions more than nine years ago in Notice 2015-48[6] (the "***Original Basket Contract Notice***") and Notice 2015-47[7] (the "***Original Basket Option Notice***," and together with the Original Basket Contract Notice, the "***Original Basket Notices***"). The Original

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[1] The principal drafters of this Report are Lorenz Haselberger and Elena Romanova. Substantial contributions were made by Tyler Arbogast. Helpful comments were provided by Robert Cassanos, Peter Connors, Geoff Goldman, Edward Gonzalez, Robert Kantowitz, Jiyeon Lee-Lim, John Lutz, Andrew Meiser, Vadim Novik, Larry Salva, David Schizer, Michael Schler, Aliza Slansky, Wade Sutton, Linda Swartz, Matthew Williams and Libin Zhang. The authors thank Anna Armao and Kavya Rajasekar for helpful research assistance. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or House of Delegates of the New York State Bar Association.

[2] Notice of Proposed Rulemaking and Notice of Public Hearing, *Identification of Basket Contract Transactions as Listed Transactions*, REG-102161-23; 89 F.R. 57111-57120; 2024-33 I.R.B. 502. All references to sections are to the Internal Revenue Code of 1986, as amended (the "***Code***"), and to treasury regulations promulgated under the Code.

[3] Treas. Reg. § 1.6011-4(b)(2); IRS Announcement 2023-11, 2023-17 I.R.B. 798.

[4] 2015-46 I.R.B. 663.

[5] 2015-46 I.R.B. 660.

[6] 2015-30 I.R.B. 77.

[7] 2015-30 I.R.B. 76.

Basket Notices were ultimately withdrawn and significantly revised by the Final Basket Notices, which narrowed the scope of reporting based on informal comments from taxpayers and tax practitioners by implementing a broad but exclusive four-factor test for SST status intended to avoid targeting non-abusive transactions and facilitate compliance.[8]

We endorse Treasury's continued efforts to identify and scrutinize abusive basket transactions of the kind that precipitated the issuance of the Original Basket Notices, which typically featured taxpayers entering into contracts styled as options in respect of actively managed securities portfolios in an attempt to defer realization of income and convert ordinary income or short-term capital gain into long-term capital gain.[9] However, we have significant concerns that the elevation of basket contract SSTs to listed transaction designation, when coupled with the definitional uncertainties that arise in determining whether a transaction is a basket contract SST, could have the effect of significantly curtailing portions of the market for financial contracts linked to indices or rules-based baskets, which do not result in impermissible tax benefits under current law and are not tax avoidance transactions. We do not believe the Proposed Regulations are intended to achieve this result, and accordingly, our recommendations in this Report aim to ensure that the final regulations ("***Final Regulations***") narrow the scope of listed transaction designation to tax avoidance transactions.

The Report is divided into three parts: (1) a summary of our proposed recommendations (Part II), (2) a summary of the Original Basket Notices, Final Basket Notices, Proposed Regulations and other relevant background (Part III) and (3) a detailed discussion of each of our recommendations (Part IV).

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8 While we understand that the IRS received a significant number of comments on the Original Basket Notices and reflected some of those comments in the Final Basket Notices, these comments generally were made informally and are not publicly available. *See generally* Lee Sheppard, News Analysis: Hubbard Addresses Basket Contract Notices and Other Developments, 148 Tax Notes 255 (July 20, 2015); Lee Sheppard, ABA Meeting: Basket Contract Notices to Be Clarified, 2015 TNT 182-8 (Sept 21, 2015).

9 The origins of the Original Basket Notices can be traced to 2010, when the IRS issued a generic legal advice memorandum describing a contract between a bank and a hedge fund that was styled as an option on a basket of securities, but structured to provide the hedge fund full opportunity for gain and substantially all opportunity for loss on each of the positions in the basket and complete dominion and control over the referenced securities in the basket. *See* Generic Legal Advice Memorandum 2010-005 (Oct. 15, 2010). In the memorandum, the IRS concluded that the option should be disregarded as a separate financial contract, that the hedge fund beneficially owned the reference assets, and that it was accordingly required to recognize the resulting trading gains, losses, income and expense on a current basis. The memorandum also noted, as an alternative argument, that changes to the reference basket could give rise to a realization event in respect of the option, if the option were respected as such. A Congressional subcommittee report released in connection with a July 2014 hearing identified two hedge funds as the most significant users of the option structure. *See* Staff of S. Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, *Abuse of Structured Financial Products: Misusing Basket Options to Avoid Taxes and Leverage Limits* (Sept. 30, 2014) at 26-34. One of the hedge funds has since entered into a $7 billion settlement agreement with the IRS for its use of basket options, while the other hedge fund is currently engaged in litigation with the IRS.

II. SUMMARY OF RECOMMENDATIONS

This Report's recommendations are summarized as follows:

A. The government should consider issuing additional substantive guidance regarding the federal income tax treatment of financial contracts that reference non-static indices or baskets, including under section 1001. Although such guidance would be particularly helpful if provided prior to or in connection with finalizing the Proposed Regulations, we recognize that it would be a significant guidance project separate and apart from the Final Regulations.

B. The Final Regulations should restore the broad but exclusive four-factor SST Test set forth in the Final Basket Notices (modified as recommended below) as the sole determinant of SST status (that is, exclude from listed transaction designation transactions that do not meet the SST Test but are "substantially similar" to transactions that meet the test). Alternatively, if this recommendation is not adopted, the government should explain which abusive transactions it intends to capture that are not covered by the existing SST Test, and the Final Regulations should (x) supplement or modify the existing SST Test to identify such transactions, rather than mandating an open-ended "substantially similar" inquiry and (y) clarify that transactions that fall within a specific exception (such as the Index Exception or Objective Rules Exception, as defined below) do not need to be re-tested under a general "substantially similar" inquiry. In addition, any reformulated SST inquiry should apply solely on a prospective basis to transactions entered into after the publication of the Final Regulations.

C. Both the Final Basket Notices and the Proposed Regulations exclude contracts referencing indices that (x) are "widely used and publicly quoted" and "based on objective financial information" or (y) "based on a broad market or market segment" (the "***Index Exception***"). The Final Regulations should expand and clarify the application of the Index Exception to ensure that it covers common types of index-linked contracts that do not result in impermissible tax benefits under current law and are not tax avoidance transactions, including by:

   1. Removing the requirement for a "widely used and publicly quoted" index to be "based on objective financial information."

   2. Alternatively, if Recommendation C.1 is not adopted:

      a. Specifying that the composition of a "widely used and publicly quoted" index may be based on any "objective information" (for example, environmental, social and governance ("***ESG***") criteria or Shariah law), rather than on "objective *financial* information," and

      b. Specifying that the composition of a "widely used and publicly quoted" index may be based on discretionary determinations (rather than solely on objective information) to the extent such determinations are either (x) made by the index sponsor, index

administrator or similar person pursuant to publicly available index guidelines with a principal purpose of ensuring that the index properly represents the economic reality or theme it is intended to reflect or (y) made by a rating agency, data provider or similar person in the ordinary course of business for purposes that are not specific to any particular financial contract that may reference such determinations.

3. Defining a "broad market" index to include any index that, with respect to the particular contract in question, is not a narrow-based security index within the meaning of the Commodity Exchange Act, as amended by Title VII of the Dodd-Frank Act (the "***CEA***"),[10] determined as if the contract were a swap for purposes of the CEA.

4. Specifying that if a base index qualifies for the Index Exception as modified above (that is, as "widely used and publicly quoted" as defined in Recommendation C.1 or C.2 or as "based on a broad market or market segment" as defined in Recommendation C.3), an adjusted index that differs from the base index solely due to the addition of thematic index selection criteria (for example, ESG criteria or Shariah law) will also qualify for the Index Exception, provided that the thematic selection criteria are either (x) based on objective rules (for example, a kick-out for any issuer that derives more than a specified percentage of its revenue from thermal coal or controversial weapons) or (y) based on discretionary determinations (A) made by the index sponsor, index administrator or similar person pursuant to publicly available index guidelines with a principal purpose of ensuring that the adjusted index properly represents the economic reality or theme it is intended to reflect or (B) made by a rating agency, data provider or similar person in the ordinary course of business for purposes that are not specific to any particular financial contract that may reference such determinations.

D. Both the Final Basket Notices and the Proposed Regulations exclude basket contracts "if 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 (the rules) and [the taxpayer and/or its designee] 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" (the "***Objective Rules Exception***"). The Final Regulations should expand and clarify the Objective Rules Exception by:

1. Specifying that the ability of an index sponsor, index administrator or similar person periodically to amend the rules that govern an index's construction and rebalancing will not prevent the index rules from

[10] *See* 7 U.S.C. §1, et seq.

qualifying for the Objective Rules Exception, provided that the amendments are made pursuant to publicly available index guidelines and with a principal purpose of ensuring that the index properly represents the economic reality or theme it is intended to reflect.

2. Specifying that it is permissible for the "rules" to reference discretionary determinations made by a rating agency, data provider or similar person in the ordinary course of business for purposes that are not specific to any particular financial contract that may reference such determinations.

E. The Final Regulations should expand the types of tax certifications that may be provided to establish the absence of a Tax Benefit by:

1. Reinstating Form W-8EXP as a tax form that can be used to establish the absence of a Tax Benefit.

2. Permitting a foreign partnership to establish the absence of a Tax Benefit by providing a Form W-8IMY along with a statement certifying that the partnership has no direct or indirect partners that are U.S. net income taxpayers (even if such form is not accompanied by a withholding statement or flow-through IRS forms for partners).

3. Permitting a foreign qualified derivatives dealer ("***QDD***") to establish the absence of a Tax Benefit by providing a Form W-8IMY that certifies the dealer's QDD status.

F. The Final Regulations should specify (x) that all instruments treated as indebtedness for federal income tax purposes are excluded from SST treatment, whether or not they qualify as contingent payment debt instruments ("***CPDIs***") or variable rate debt instruments ("***VRDIs***") and regardless of their term and (y) that the foregoing debt exclusion applies *as to the issuer* if it has disclosed to holders that it intends to treat the instrument as indebtedness for federal income tax purposes and actually treats the instrument as indebtedness for all applicable tax years while the instrument remains outstanding, and *as to holders* if they actually treat the instrument as indebtedness for all applicable tax years while the instrument remains outstanding.

G. The Final Regulations should exclude contracts with a stated term of no more than one year from SST treatment, regardless of whether they overlap two of a taxpayer's tax years.

H. The Final Regulations should exclude contracts that are hedging transactions as defined in Treasury regulations section 1.1221-2(b) from SST treatment.

I. The Final Regulations should exclude securities issued under Regulation S from SST treatment *as to the issuer*, provided that the securities are issued and held in book-entry form through a clearing organization.

J. The Final Regulations should clarify that entering into multiple derivative transactions under a single master agreement does not, in and of itself, give rise to a "basket contract."

K. The Final Regulations should provide that taxpayers that have already reported basket contract SSTs as transactions of interest pursuant to the Final Basket Contract Notice in prior open tax years are not required to re-report such transactions as listed transactions pursuant to the Final Regulations.

L. The government should clarify that the Final Basket Contract Notice remains in effect until Final Regulations are published.

III. BACKGROUND

A. The Basket Notices

On July 8, 2015, the IRS issued the Original Basket Notices. In general, the Original Basket Notices designated as a reportable transaction any transaction in which a taxpayer ("***T***") enters into an option or other financial contract with a counterparty ("***C***"), the contract references a basket of assets whose composition is actively managed on a discretionary basis by T or a designee named by T, and T takes the position that for federal income tax purposes, the contract is a unitary financial derivative that is not disposed of during its term (with the result that short-term trading gains and ordinary periodic income from the performance of the reference basket are deferred until the basket contract terminates and, if the basket contract is held for more than one year, all economic gain is treated as long-term capital gain).

Although the Original Basket Notices described the foregoing features of basket transactions in substantially the same manner, the Original Basket Option Notice designated basket contracts denominated as options that reference actively traded personal property and have a term of more than one year as listed transactions, whereas the Original Basket Contract Notice designated all other basket contracts, regardless of the legal form and regardless of whether the referenced property is actively traded, as transactions of interest.

The Original Basket Notices applied not just to the basket transactions specifically described in the notices, but to any "substantially similar" transactions. However, the Original Basket Notices did not specify how to determine whether a particular contract or transaction is "substantially similar" for these purposes. As a consequence, taxpayers and tax practitioners informally expressed concern to the government that the Original Basket Notices could be interpreted as requiring reporting in respect of financial contracts linked to indices and rules-based baskets, which do not result in impermissible tax benefits under current law and therefore should not fall within the ambit of reportable transaction designation.[11]

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[11] The Final Basket Notices observe that "[c]ommenters expressed concern that difficulty in identifying transactions that are the same as, or substantially similar to, the transaction described in [the Original Basket Notices] may cause taxpayers to file disclosures for transactions that are not intended to be treated as [listed transactions or transactions of interest] at this time."

In response to these comments, the IRS issued the Final Basket Notices on October 21, 2015, which revoked the Original Basket Notices and set forth a broad but exclusive four-factor test for purposes of determining whether a transaction is an SST. More specifically, under the Final Basket Contract Notice, a transaction is an SST (and therefore a reportable transaction of interest) *if and only if* it meets each of the following four requirements (the "***SST Test***"):

1. T enters into a contract with C to receive a return based on the performance of a reference basket;

2. The basket contract has a stated term of more than one year or overlaps two of T's tax years;

3. T or its "designee" has exercised "discretion" to change the assets in the reference basket or the trading algorithm; and

4. T's tax return for a tax year reflects a tax benefit, defined as the deferral of income into a later tax year or a conversion of ordinary income or short-term capital gain or loss into long-term capital gain or loss (a "***Tax Benefit***").

The Final Basket Option Notice contains a substantially identical definition of "basket option contract," as well as a substantially identical SST Test, except that among other things, basket option SSTs must be denominated as options and must reference actively traded property.

For purposes of the SST Test, the Final Basket Notices provide that a person is a "designee" of a taxpayer if it is (a) the taxpayer's agent under principles of agency law; (b) compensated by the taxpayer for suggesting, requesting, or determining changes in the assets in the reference basket or the trading algorithm; or (c) selected by the taxpayer to suggest, request or determine changes in the assets in the reference basket or the trading algorithm.

However, as noted above, the Final Basket Notices provide the Index Exception under which a person will not be treated as compensated or selected by a taxpayer (and thus will not be treated as a "designee" of the taxpayer for purposes of prong 3 of the SST Test) as a result of 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 (i) a "widely used and publicly quoted index that is based on objective financial information" or (ii) an "index that tracks a broad market or a market segment."

The Final Basket Notices also provide the Objective Rules Exception, under which a taxpayer or its designee will not be treated as having "discretion" to change the composition of an underlying basket of reference assets or the trading algorithm "if 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 (the rules) and [the taxpayer and/or its designee] 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."[12]

Lastly, the Final Basket Notices specifically exclude the following types of contracts from being treated as SSTs:

- A contract traded on a national securities exchange regulated by the Securities and Exchange Commission ("***SEC***"), a domestic board of trade regulated by the Commodity Futures Trading Commission ("***CFTC***") or a foreign exchange or board of trade that is subject to regulation by a comparable regulator;

- A contract "treated as a contingent payment debt instrument under [Treasury regulations section] 1.1275-4 (including a short-term contingent payment debt instrument) or a variable rate debt instrument under [Treasury regulations section] 1.1275-5";

- With respect to T, a contract with respect to which no tax return of T reflects a Tax Benefit; and

- With respect to C, a contract with respect to which (x) T represents to C in writing under penalties of perjury that T's tax return has not and will not reflect a Tax Benefit for any tax year ending on or after January 1, 2011 or (y) 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 withholding certificate from the beneficial owner of the payments made or to be made under the contract (IRS Form W-8BEN, W-8BEN-E or W-8EXP)."

B. The Proposed Regulations

In most respects, the Proposed Regulations closely follow the Final Basket Notices. However, they depart from the Final Basket Notices in several respects:

- The Proposed Regulations elevate all SSTs to listed transaction designation, whereas the Final Basket Contract Notice designated basket contract SSTs as transactions of interest.

- Whereas the Final Basket Notices limit the scope of reportable SSTs to transactions that meet the SST Test, the Proposed Regulations provide that SSTs include transactions that

[12] The Final Basket Notices further clarify that for purposes of the Objective Rules Exception, a taxpayer or its designee "will not be treated as having authority to alter or amend the rules solely because [it] has the authority to: (1) exercise routine judgment in the administration of the rules provided, however, that such routine judgment does not include deviations or alteration to the rules that are designed to improve the financial performance of the reference basket; (2) correct errors in the implementation of the rules or calculations made pursuant to the rules; or (3) make an adjustment to respond to an unanticipated event outside of [the taxpayer and/or designee'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, regulatory compliance requirement, force majeure, or any other unanticipated event of similar magnitude and significance."

do not meet the SST Test but are "substantially similar" to transactions that meet the test (although it is unclear whether this change was intended).

- The Proposed Regulations remove Form W-8EXP from the type of form that can establish the absence of a Tax Benefit.[13]

The Proposed Regulations would become effective only upon publication of Final Regulations. The Proposed Regulations anticipate that once Final Regulations are published, the listed transaction designation for basket contract SSTs, and concomitant reporting obligations would apply retroactively to all tax years of a taxpayer for which the statute of limitations has not ended on or before the date of the publication of the Final Regulations.

In addition, as published in the Federal Register, the Proposed Regulations provide that "[t]his document obsoletes [the Final Basket Contract Notice] as of July 12, 2024," but that it "do[es] not obsolete, revoke, or modify the Final Basket Option Notice."

C. The Reportable Transaction Regime

The reportable transaction regime is a mandatory disclosure framework established by Congress to assist the IRS in identifying, monitoring and deterring certain types of transactions that may be used for tax avoidance or evasion.[14] This regime requires taxpayers and their material advisors to disclose to the IRS transactions designated as reportable by the IRS, thereby promoting transparency and aiding the IRS in identifying for examination and challenge potentially abusive tax strategies.[15] The categories of reportable transactions include, in relevant part, listed transactions and transactions of interest. Failure by either the taxpayer or a material advisor to disclose a reportable transaction can result in significant penalties, including monetary fines and potential criminal charges.[16]

The reportable transaction regime plays a central role in the IRS's efforts to combat tax avoidance and ensure compliance with tax laws. By requiring disclosure of listed transactions and transactions of interest, this regime enhances the IRS's ability to detect and address potentially abusive tax strategies, thereby promoting fairness and integrity within the tax system. Even where

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[13] In addition, the Proposed Regulations would expand the list of underlying reference assets that can give rise to a basket transaction SST to include digital assets.

[14] The regime is codified under sections 6011, 6111, and 6112 of the Code and is further developed in the Treasury regulations thereunder.

[15] Taxpayers who participate in listed transactions or transactions of interest are required to disclose their involvement to the IRS using Form 8886, Reportable Transaction Disclosure Statement. This disclosure must include information identifying and describing the transaction, any potential tax benefits expected to result from the transaction, and any other information as prescribed by the Treasury. *See* section 6111(a).

[16] Civil penalties for taxpayers or material advisors can be substantial. *See* Treas. Reg. § 301.6707A-1(a). Taxpayers that willfully fail to disclose reportable transactions in order to evade or defeat tax may also be subject to criminal penalties or federal incarceration. For example, the federal tax evasion statute imposes a corporate fine of up to $500,000 and an individual fine of up to $100,000 plus five years of imprisonment. *See* section 7201.

disclosure is made on a protective basis (for example, due to uncertainty as to the application of the disclosure requirement), disclosure increases the likelihood that a transaction will be examined by the IRS, which may require the taxpayer to bear certain financial and reputational costs associated with defending an IRS audit.

In designating transactions as reportable transactions, Treasury and the IRS generally are required to comply with the procedural notice-and-comment rulemaking requirements of the Administrative Procedure Act ("***APA***").[17] This requirement is confirmed by several recent court cases addressing the validity of IRS notices designating listed transactions or transactions of interest and the IRS's obligations under the APA. These cases highlight the importance of the IRS following the APA procedural requirements, including providing an opportunity for comment, on the designation of reportable transactions.[18]

Reportable transactions are categorized as listed transactions or transactions of interest depending on their abuse potential. More specifically:

- Listed transactions are transactions that the IRS has designated as abusive tax avoidance transactions.[19] The identification of a transaction as a listed transaction serves as a clear signal to taxpayers and their advisors that the IRS considers the transaction to be abusive and subject to heightened scrutiny.

- A transaction of interest, in contrast, is "a transaction that the IRS and Treasury believe has a potential for tax avoidance or evasion, but for which the IRS and Treasury lack sufficient information to determine whether the transaction should be identified specifically as a tax avoidance transaction."[20] By designating a transaction as a transaction of interest, the IRS aims to gather more information to determine whether the transaction should be elevated to listed transaction designation or addressed through other measures. The decision to elevate the status of a transaction of interest to listed transaction designation is based on the transaction's potential to undermine the tax system and the need for heightened

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17 The APA governs the process by which federal agencies develop and issue regulations. It includes requirements for publishing notices of proposed and final rulemaking in the Federal Register and for providing opportunities for the public to comment on notices of proposed rulemaking. *See* 5 U.S.C. §§ 551–559, 701–706, 1305, 3105, 3344, 5372, 7521 (2012).

18 The IRS continues to disagree with recent court decisions holding that listed transactions cannot be identified by notice or other sub-regulatory guidance but has indicated that it will no longer take the position that transactions of interest can be identified without complying with APA notice-and-comment procedures. *See* IRS Announcement 2023-11, 2023-17 I.R.B. 798. Courts have distinguished between legislative rules, which require notice-and-comment rulemaking, and interpretive rules, which do not. Legislative rules are those that create new rights or obligations, whereas interpretive rules clarify existing laws or regulations. *See e.g., Mann Constr., Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022); *Green Valley Investors, LLC v. Comm'r*, 159 T.C. No. 5 (2022); *Green Rock LLC v. Internal Revenue Serv.* 104 F.4th 220 (11th Cir. 2024).

19 Treas. Reg. § 1.6011-4(b)(2); IRS Announcement 2023-11, 2023-17 I.R.B. 798.

20 Preamble to the 2007 amendment to Treas. Reg. § 1.6011-4. Treasury and the IRS have not published any policies, procedures or guidelines describing the process or criteria for elevating transactions of interest to listed transactions or for removing transactions that have been previously designated as reportable (including transactions of interest) from such designation.

scrutiny. It is also possible that after examining the disclosed information, the IRS and Treasury may conclude that no tax avoidance or evasion potential exists and remove a particular transaction from the list of reportable transactions.[21]

- In both cases, the form, manner and substance of the disclosure a taxpayer is required to make in respect of the listed transaction or transaction of interest (as the case may be) is substantially the same.[22] However, the penalties for a failure to disclose are more severe in the case of listed transactions.[23]

As a matter of managing tax, financial accounting, regulatory and reputational risks, we understand that many sophisticated institutional taxpayers, including many regulated financial institutions, have adopted internal policies that prohibit them from entering into or offering to customers transactions that are designated as listed transactions, including because engaging in listed transactions may attract scrutiny from non-tax regulators. Similarly, we understand that certain leading accounting and law firms have internal policies that preclude them from advising on listed transactions. These policies tend to interpret available guidance in a conservative manner and steer the institution or advisor to avoid involvement if there is any reasonable likelihood of a transaction being viewed as a listed transaction. In addition, it is common to require contractual counterparties to represent that they have not participated in any listed transactions, including for example in transaction agreements for mergers and acquisitions, minority equity investments, fund investments and capital markets transactions. We understand that most taxpayers and advisors do not have such far-reaching policies with respect to transactions of interest, which are viewed with less prejudice. Therefore, as a practical matter, the designation of a transaction as a listed transaction (or even uncertainty about such designation) may be tantamount to the elimination of the transaction from the market, particularly in the context of financial transactions that generally are offered or entered into only by regulated financial institutions.

IV. DISCUSSION

A. Tax Treatment of Contracts Referencing Non-Static Indices or Baskets

1. Background

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[21] Similarly, the IRS and Treasury may conclude that a transaction previously designated as a listed transaction does not warrant the designation, or any reportable transaction designation, and remove such designation. For example, Notice 2002-70 originally designated certain micro-captive insurance transactions as listed transactions. *See* Notice 2002-70, 2002-2 C.B. 1. Notice 2004-65 was subsequently issued reversing that decision and removing the designation after examinations revealed fewer abusive transactions than anticipated. *See* Notice 2004-65, 2004-2 C.B. 599.

[22] *See* Treas. Reg. § 1.6011-4(d); Form 8886 (rev. Dec. 2019).

[23] The penalty for failure to include information with respect to any reportable transaction is 75 percent of the decrease in tax shown on the return as a result of the transaction or the decrease that would have resulted from the transaction if it were respected for Federal tax purposes. The maximum penalty for failure to include information with respect to a listed transaction is $100,000 for a natural person and $200,000 for all other persons. For any other reportable transaction, the maximum penalty is between $5,000 to $10,000 for a natural person and $10,000 to $50,000 for all other persons. Treas. Reg. § 301.6707A-1(a).

As discussed in Part III of this Report, the prototypical basket transaction targeted by the Proposed Regulations and the Final Basket Notices is a transaction in which T enters into a financial contract with C that references a non-static basket of securities whose composition is actively managed on a discretionary basis by T or its designee, with T taking the position that for federal income tax purposes, short-term trading gains and ordinary periodic income from the performance of the reference basket are deferred until the basket contract terminates.

In such cases, the basket contract may provide the taxpayer with economic results that are virtually indistinguishable from the results of trading through a prime brokerage or custodial account. Because T directly or indirectly controls the composition of the basket at any given time, under general tax ownership principles, the basket contract may not be respected as a separate derivative contract but may instead be characterized as beneficial ownership of the underlying securities by T.[24] Alternatively, even if the contract is respected as a derivative, it may be argued that each material change to the composition of the underlying securities in the reference basket gives rise to a deemed taxable disposition of the basket contract.

In other cases, however, financial contracts may reference non-static indices or baskets whose composition may vary based on (x) discretionary determinations by index committees who make such determinations independently of any particular financial contract whose payout is determined by reference to the index or (y) predetermined, objective rules. In these cases, it may be appropriate to respect the financial contract as a derivative separate from the referenced securities that comprise the index or basket, and a change in the composition of the index or basket may not give rise to a taxable event under section 1001 for the contract holder, because the index value is either itself objective financial information not within the control of any particular party to a financial contract referencing the index or changes to the composition of underlying securities referenced by the contract occur pursuant to the terms of predetermined, objective rules.[25] In other words, in such cases, even though the treatment of the financial contract as a unitary derivative may be viewed as resulting in a tax deferral or character conversion benefit relative to a hypothetical case in which the taxpayer owns each of the components of the index or basket outright, from a substantive federal income tax perspective, this hypothetical alternative may be the incorrect point of comparison in determining whether the taxpayer has achieved an impermissible tax benefit under current law.

In the case of index-linked swaps, the foregoing conclusion is implicit in the definition of a notional principal contract ("***NPC***") in Treasury regulations section 1.446-3, which defines an NPC as "a financial instrument that provides for the payment of amounts by one party to another

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24 However, we observe in this regard that any argument that T is the tax owner of the securities under general tax ownership principles may be undermined by the fact that (i) C may or may not own the underlying physical securities and (ii) even if C does own the securities, (A) T may have no ability to exercise voting or information rights in respect of the securities and (B) T will bear C's credit risk in respect of payments on the basket contract, which would not be the case if C were T's agent or broker.

25 For a general discussion of the application of section 1001 to derivatives including basket contracts, see Michael Shulman and Nate Tasso, *Changes to Derivatives 'Pursuant to Their Terms' (Part 1)*, 155 Tax Notes 653 (May 1, 2017), Michael Shulman and Nate Tasso, *Changes to Derivatives 'Pursuant to Their Terms' (Part 2)*, 155 Tax Notes 805 (May 8, 2017) and James Peaslee, *Modifications of Nondebt Financial Instruments as Deemed Exchanges*, 95 Tax Notes 737 (April 29, 2002).

at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts" and provides that both the specified index and the notional principal amount may vary over the terms of a single NPC if the variation is "based on objective financial information."[26] For these purposes, "objective financial information" is defined as "current, objectively determinable financial or economic information that is not within the control of any of the parties to the contract and is not unique to one of the parties' circumstances (such as one party's dividends, profits, or the value of its stock)."[27] Thus, for example, it appears clear that a total return swap referencing the Dow Jones Industrial Average ("***DJIA***") is based on objective financial information and can therefore qualify as an NPC, since the value of the DJIA is publicly quoted and not within the control of, or unique to, any particular party to a financial contract, even though the composition of the DJIA from time to time is determined in the discretion of an index committee rather than pursuant to objective rules, as discussed in further detail below. Although not explicitly stated, it is clear that variations permitted by the NPC rules — including variations in the composition of the specified index — do not result in the deemed exchange of the existing NPC for a new NPC for purposes of section 1001, or in the treatment of the long party to the NPC as the tax owner of each underlying stock included in the DJIA. It follows that the holder of an index-linked instrument of this kind does not enjoy an impermissible tax benefit under current law merely because the underlying index composition may change over time (and although this rationale presumably is the basis for the Index Exception, the Index Exception in its current form may not cover a sufficiently broad variety of index-linked products, as discussed in Part IV.C below).

However, aside from the NPC regulations, there is scant guidance on the tax treatment of financial contracts that reference non-static indices or baskets. Taxpayers and industry groups have formally and informally urged the government to provide such guidance — and in particular, to address whether and to what extent changes in the underlying reference assets that occur pursuant to the terms of a derivative contract give rise to a taxable disposition for the long party under section 1001.[28] The government, however, has yet to provide such guidance. Even without the benefit of such additional guidance, it appears clear that the scope of the listed transaction designation in the Proposed Regulations is significantly broader than the scope of transactions that generate impermissible tax benefits under current law. In particular, the definition of Tax Benefit in the Proposed Regulations could be understood to create an inference that the only appropriate point of reference for the comparison of the tax treatment of a derivative transaction referencing a basket of assets is to ownership of such assets outright by the taxpayer (at least absent availability of the Index Exception or Objective Rules Exception, discussed in more detail in Part IV.A.3). Under this interpretation of the Proposed Regulations, any deviation in tax treatment from the treatment that would obtain under the outright ownership construct may produce a Tax Benefit that results in listed transaction designation, as that term is currently defined in the Proposed

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[26] Treas. Reg. §§ 1.446-3(c)(1)(i); -3(c)(3).

[27] Treas. Reg § 1.446-3(c)(4)(ii); *see also* Treas. Reg. § 1.1275-5(c) (providing that an "objective rate" for purposes of the VRDI rules "does not include a rate based on information that is within the control of the issuer . . . or that is unique to the circumstances of the issuer.")

[28] *See, e.g.*, International Swaps and Derivatives Association, *Comments on the Treatment of the Modification of Non-Debt Derivatives Under Section 1001* (Sept. 18, 2020), *available at* https://www.isda.org/a/TpHTE/ISDA-1001-Letter-September-18-2020.pdf.

Regulations. In many instances, such a divergence in tax treatment may reflect a reasonable application of current law rather than evidencing a tax avoidance transaction.

Accordingly, and as described in the remainder of this Report, if the Proposed Regulations are finalized in their current form, we believe there would be a significant class of financial contracts linked to indices or rules-based baskets that are not abusive and do not result in impermissible tax deferral or character conversion under current law but would nonetheless potentially fall within the ambit of listed transaction designation, including both due to the broad scope of the SST designation and the lack of substantive guidance on the tax treatment of such transactions. As a consequence, we anticipate taxpayers may no longer enter into such transactions, given that most financial institutions and accounting firms have policies prohibiting participation in or advising on transactions that are (or may be) listed transactions.

2. Recommendations

Based on the foregoing discussion, we recommend that Treasury consider issuing additional guidance on the federal income tax treatment of financial contracts that reference non-static indices or baskets, including under section 1001. Although such guidance would be particularly helpful to taxpayers if provided prior to or in connection with finalizing the Proposed Regulations, we recognize that it would be a significant guidance project separate and apart from the Final Regulations, which merely designate certain transactions as listed transactions.[29] Providing such guidance could clarify the circumstances in which a financial contract is deemed to be disposed of upon a change in the composition of the underlying reference assets or treated as tax ownership of such assets, and thereby help ensure that the listed transaction designation in the Final Regulations is limited to tax avoidance transactions (or, if provided after the Final Regulations are published, help interpret their scope).

We observe in this regard that the preamble to the Proposed Regulations notes that the government made the decision to designate basket contract SSTs as listed transactions based on disclosures received under the Final Basket Contract Notice.[30] However, our understanding based on discussions with market participants is that in many cases, disclosures under the Final Basket Contract Notices related to transactions that were not tax motivated but rather where the application of the SST Test could not be conclusively determined, including due to the definitional uncertainties regarding the application of the Index Exception, Objective Rules Exception and Tax Benefit determination (as described in greater detail in the remainder of this Report). We

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[29] We would be glad to assist in such a project if helpful. Although this Report does not make any specific recommendations as to the substance of such guidance, we note that at least one leading industry group and a number of leading tax practitioners have previously provided comments and recommendations in this regard. *See* sources cited *supra* notes 25 and 28; *see also* Thomas Brennan and David Schizer, *Transaction-Specific Tax Reform in Three Steps: The Case of Constructive Ownership*, 15 Columbia Tax J. 1 (2024).

[30] *See* Proposed Regulations (preamble), 89 F.R. 57114 (noting that "disclosures filed in response to [the Basket Contract Notice] have clarified the Treasury Department's and the IRS's understanding of basket contracts identified in [the Basket Contract Notice]," that the "information received indicates that basket contracts . . . have been used to inappropriately defer income recognition or inappropriately convert ordinary income or short-term capital gain into long-term capital gain" and that this information informed the government's decision to elevate basket contract SSTs to listed transaction designation).

accordingly recommend that to the extent the government believes that some of the disclosed transactions are tax avoidance transactions, it would be helpful if the preamble to the Final Regulations explain the relevant facts of the disclosed transactions and why such transactions resulted in impermissible tax benefits under current law.

B. SST Test

1. Background

The Final Basket Notices provide that a transaction is an SST if and only if it meets each of the four prongs of the SST Test, as set forth in Part III.A above. The Proposed Regulations would instead apply to transactions that do not meet the SST Test but are "substantially similar" to transactions that meet the test.

It is unclear whether this change is intentional. As described in Part III.A above, the broad but exclusive four-factor SST Test in the Final Basket Notices was developed by the government in response to taxpayer and practitioner comments regarding the perceived overbreadth of the Original Basket Notices. In contrast to the SST Test articulated in the Final Basket Notices, the Original Basket Notices described basket contract transactions and basket option transactions in more general terms and applied to all transactions "substantially similar" to such transactions. Commentators on the Original Basket Notices expressed concern that this open-ended "substantially similar" inquiry would be challenging for taxpayers to apply and would cause voluminous reporting in respect of transactions that are not tax avoidance transactions, including in the case of financial contracts referencing indices or rules-based baskets that are properly characterized for federal income tax purposes as derivatives but that could in theory be viewed as generating a tax deferral and character conversion benefit relative to a hypothetical case in which the long party owns the referenced securities outright (as described in Part IV.A.1).[31] We understand that the development of the SST Test reflected a deliberate decision on the part of the government to give taxpayers more certainty regarding the scope of the reporting requirement. This history suggests that the reformulation of the SST inquiry in the Proposed Regulations may be inadvertent. In any event, it appears inconsistent with the history of the Final Basket Notices for the government to revive an open-ended "substantially similar" inquiry of the kind initially required by the Original Basket Notices and rejected by the Final Basket Notices while at the same time elevating basket contract SSTs from transactions of interest to listed transactions.

We acknowledge in this regard that section 6707A(c)(2) defines a "listed transaction" as "a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011." In addition, Treasury regulations section 1.6011-4(c)(4) describes the "substantially similar" standard broadly as follows:

> The term substantially similar includes any transaction that is expected to obtain the same or similar types of tax consequences and that is either factually similar or based on the same or similar tax strategy. Receipt of an opinion regarding the tax consequences of the transaction is not relevant to the determination of whether the transaction is the same as or

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[31] *See supra* note 11.

substantially similar to another transaction. Further, the term substantially similar must be broadly construed in favor of disclosure. For example, a transaction may be substantially similar to a listed transaction even though it involves different entities or uses different Internal Revenue Code provisions.

However, we believe it is in keeping with these statutory and regulatory definitions — and within the government's regulatory authority — to specify discrete factors that must be present in order for a particular type of transaction to be "substantially similar" within the meaning of section 6707A(c)(2) and "expected to obtain the same or similar types of tax consequences" within the meaning of Treasury regulations section 1.6011-4(c)(4), as the government did in promulgating the Final Basket Notices and withdrawing the Original Basket Notices. This is particularly true in a case where an open-ended "substantially similar" inquiry has the potential to substantially curtail a large class of investment transactions that are not tax avoidance transactions. In this regard, we observe that the government historically has emphasized that the listed transaction regime is intended "not only to identify improper tax shelters, but also to protect taxpayers that engage in legitimate business transactions" and that "[t]he IRS wants to ensure that transactions are not labeled as improper tax shelters merely because they are novel or complex."[32]

2. Recommendations

We recommend that the Final Regulations reinstate the SST Test as the exclusive determinant of SST status, rather than also requiring a general "substantially similar" inquiry of the kind set forth in the current Proposed Regulations.

If the Final Regulations retain the reformulated SST inquiry, it could create considerable uncertainty for taxpayers in respect of common financial products that do not result in impermissible tax benefits under current law and therefore are not tax avoidance transactions, including contracts linked to indices or rules-based baskets. For example, under the existing SST Test, it appears clear that a financial contract linked to a widely used and publicly quoted or broad-based equity index generally should not be in scope under the Index Exception. The Index Exception operates by providing that the index administrator of a qualifying index is not a "designee" of the noteholder, such that prong 3 of the SST Test is not satisfied (as discussed in more detail in Part IV.C.1 below). Under the reformulation of the SST inquiry in the Proposed Regulations, however, a taxpayer would also be required to determine whether the index-linked note is "substantially similar" to a transaction that satisfies the SST Test. Given that indices typically are rebalanced on a quarterly or annual basis in a manner that could, in theory, be viewed as generating a tax deferral or character conversion benefit (at least relative to a comparison case in which the taxpayer owns each of the component equity securities referenced by the index outright), it potentially may be challenging for tax practitioners and taxpayers to conclude at a high level of comfort that such index-linked contracts are not listed transactions, given that Treasury regulations section 1.6011-4(c)(4) generally requires broad construction in favor of disclosure. Since many financial institutions and advisors have internal policies prohibiting participation in or advising on listed transactions, a possible practical effect of such an approach would be to

32 Treasury Acting Assistant Secretary for Tax Policy, Jonathan Talisman, Testimony before Senate Finance Committee, March 8, 2000.

adversely affect all or some portion of the market for products linked to indices or rules-based baskets.

In addition, since the Proposed Regulations would require retroactive listed-transaction reporting for all basket contract SSTs issued in open return years, the reformulated SST inquiry would appear to require taxpayers systematically to revisit the treatment of transactions predating the issuance of the Proposed Regulations, with the odd result that transactions that were viewed as non-reportable prior to the Proposed Regulations because they did not satisfy the SST Test becoming potential listed transactions simply because they might be viewed as substantially similar to transactions that do satisfy the SST Test (including transactions that previously were not subject to material analysis because they unambiguously fell within an exception under the SST Test, such as the Index Exception). Taxpayers have relied on the SST Test for almost a decade in order to arrange their affairs, including to obtain advice on whether a transaction is or is not reportable. We believe it would be unduly burdensome to require such taxpayers to retroactively apply the reformulated SST inquiry to existing transactions for all open return years.

We note in this regard that the existing SST Test is very broad, as described in detail in the remainder of this Report, and we have not been able to identify transactions that result in impermissible tax benefits under current law (that is, tax avoidance transactions) and that reasonably could be determined to fall outside of the scope of the SST Test but that nonetheless are "substantially similar" to transactions that satisfy the SST Test. Accordingly, setting aside the potential chilling effect the reformulated SST inquiry would have on financial contracts linked to indices and rules-based baskets and the significant administrative burden it would impose on taxpayers to retroactively apply such a reformulated inquiry to prior open tax years, we are not aware of any tax policy or tax administration benefit that would be achieved by mandating the more ambiguous listed transaction designation.

If the change to an open-ended "substantially similar" inquiry reflects the government's deliberate determination that expanding the scope of listed transaction designation beyond the SST Test is necessary, we recommend that (a) the government explain the basis for this determination in the preamble to the Final Regulations, including by providing examples of transactions that would not fall within the scope of the SST Test but nevertheless result in impermissible tax benefits under current law and are tax avoidance transactions of a kind for which listed transaction designation is appropriate, (b) the Final Regulations add to or otherwise modify the factors of the existing SST Test to identify such transactions, rather than applying an open-ended "substantially similar" inquiry and (c) the Final Regulations clarify that any transaction that meets a specific exception set forth in the Proposed Regulations, such as the Index Exception or Objective Rules Exception (modified as recommended in this Report), does not need to be retested under any reformulated variation of the SST inquiry.

Finally, if the Final Regulations either retain the new, broader SST inquiry of the Proposed Regulations or accept our recommendation to modify the existing SST Test as described above, we recommend that the reformulated SST determination should apply solely on a prospective basis to transactions entered into after the publication of the Final Regulations. Prospective application of regulations provides taxpayers with the certainty and predictability needed to plan their activities, make informed decisions, and allocate their resources. In addition, the retroactive application of listed transaction designation creates particularly troublesome issues for taxpayers,

as it may cause taxpayers unintentionally to become participants in listed transactions that were properly determined not to be reportable in reliance on the Final Basket Contract Notice (which may cause taxpayers to be in breach of contractual representations provided to third parties and in violation of internal policies that may be subject to regulatory scrutiny).

C. Index Exception

1. Background

The broad definition of "designee" in the Final Basket Notices and Proposed Regulations includes not just common law agents or persons compensated by T for suggesting, requesting or determining changes in the composition of the securities referenced by a contract, but also any person "selected by T to suggest, request or determine changes in" the securities referenced by a contract. Since the phrase "selected by" is not defined, it is unclear whether the mere investment decision to purchase a financial contract on a take-it-or-leave-it basis (for example, a structured note or other financial contract linked to an ESG index) is sufficient to render the index administrator, or any rating agency or other data provider whose determinations are referenced directly or indirectly by the contract, as "designees" of the investor.[33]

In the case of index-linked products, this uncertainty presumably is intended to be addressed by the Index Exception. Under the Index Exception, a person will not be treated as compensated or selected by a taxpayer (and thus will not be treated as a "designee" of the taxpayer for purposes of prong 3 of the SST Test) as a result of 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 (i) a "widely used and publicly quoted index that is based on objective financial information" or (ii) an "index that tracks a broad market or a market segment."

The Index Exception appears to reflect an understanding that the long party to a financial contract that references an index of the kind described above generally should not have a realization event under section 1001 each time the index is rebalanced, because the index value is either itself objective financial information not within the control of any party to the contract or the composition of the index is based on objective rules.[34] Indeed, the phrase "based on objective financial information" in the Final Basket Notices and in the Proposed Regulations appears to trace its origin to the NPC rules, which define an NPC to include a contract with a payout that varies "based on objective financial information" and implies that such variations do not give rise to a realization event for the holder of the NPC (as described in more detail in Part IV.A.1 above).[35] Critically, however, the NPC rules define "objective financial information" as any objectively determinable information that is not within the control of, or unique to, any of the *parties to the contract* rather than requiring the methodology by which such information is determined to be

[33] There is a persuasive argument that the phrase "selected by" logically cannot have such a broad meaning, because in such case the term "designee" is so broad that it essentially becomes meaningless.

[34] *See supra* notes 25 through 28 and accompanying text.

[35] *See* Treas. Reg. § 1.446-3(c)(1)(iv)(3).

objective.[36] By contrast, the Index Exception appears to require the *underlying index's composition and rebalancing mechanism* to be "based on objective financial information."

In practice, this difference in wording gives rise to a significant disparity between the current scope of the Index Exception and the scope of transactions that ought to fall within the Index Exception because they do not generate impermissible tax benefits. As an example, although commonly used equity indices like the DJIA and the S&P 500 are widely used and publicly quoted, and thus ought to qualify as "objective financial information" within the meaning of the NPC rules vis-à-vis any particular parties to a financial contract referencing these indices, it is not entirely clear whether the index selection processes determining the composition of the index *themselves* are "based on objective financial information." In the case of the DJIA, we understand that the composition of the index is determined by a committee on a discretionary basis without pre-determined criteria, pursuant to a general directive that the components should be established U.S. companies that are leaders in their respective industries.[37] In the case of the S&P 500, although the universe of eligible stocks is selected based on relatively objective financial criteria (for example, a minimum market capitalization), we understand that the index components are selected out of the eligible universe by a committee based in part on discretionary determinations.[38] In both cases, then, the composition of the indices arguably is based in part on the exercise of discretion by the index committees.

Similar interpretive difficulties may arise in determining whether an index "tracks a broad market or market segment." The government has not defined the term "broad market" or "market segment" for these purposes. Although we are not aware of any commonly accepted financial definition of the term "broad market" index, at least one financial dictionary defines the term "broad market" index to refer to an index that consists of many stocks in many different industries.[39] Presumably this definition would include the S&P 500 and DJIA indices, both of which include issuers from all or most major U.S. economic sectors. However, this conclusion is not entirely free from doubt with respect to the DJIA, which has only 30 components.

We note in this regard that in colloquial financial usage, the term "broad-based security index" is commonly used to refer to an index that is not a "narrow-based security index" within the meaning of the CEA. Accordingly, it may be reasonable to look to that definition in

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[36] The NPC rules are not unique in this regard — the rules for variable rate debt instruments apply a similar test in determining whether a contract referencing a variable rate qualifies as a variable rate debt instrument, providing that an objective rate "does not include a rate based on information that is within the control of the issuer . . . or that is unique to the circumstances of the issuer." Treas. Reg. § 1.1275-5(c).

[37] S&P Dow Jones Indices, *Dow Jones Averages Methodology* (April 2024) at 5, *available at* https://www.spglobal.com/spdji/en/documents/methodologies/methodology-dj-averages.pdf (stating that "stock selection is not governed by quantitative rules" and that "a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth and is of interest to a large number of investors.")

[38] *See* S&P Global, *Icons: The S&P 500 and the Dow* (last accessed on Aug. 22, 2024), *available at* https://www.spglobal.com/spdji/en/research-insights/index-literacy/the-sp-500-and-the-dow/.

[39] *See* Farlex Financial Dictionary (2012 ed.) (defining "broad market" as "[a]n index that consists of many stocks or stocks in many different industries," and noting that "[a]n example of a broad market is the Wilshire 5000," which tracks approximately 5000 stocks of issuers in different industries).

determining whether an index "tracks a broad market." Under the CEA, generally there are two paths by which an index may qualify as a broad-based security index. Path A, which derives from Section 1a(25)(A) of the CEA,[40] requires that:

- The index has ten or more component securities;
- No single component security comprises more than 30 percent of the index's weighting;
- The five highest weighted component securities together comprise no more than 60 percent of the index's weighting; and
- The lowest weighted component securities comprising, in the aggregate, 25 percent of the index's weighting have an aggregate dollar value of average daily trading volume of $50 million or more (or in the case of an index with 15 or more component securities, $30 million or more).

Path B, which derives from Section 1a(25)(B) of the CEA, requires that:

- The index has nine or more component securities;
- No single component security comprises more than 30 percent of the index's weighting;
- All of the component securities are registered under Section 12 of the Securities Exchange Act of 1934; and
- Each component security is one of the 750 securities with the largest market capitalization and one of the 675 securities with the largest dollar value of average daily trading volume.[41]

In addition to these statutory requirements, the CFTC and the SEC have jointly promulgated regulations intended to distinguish between broad-based and narrow-based indices in the context of derivatives, since the categorization of the index affects which agency has jurisdiction over the product under Title VII of the Dodd-Frank Act.[42] Under the joint guidance, for purposes of Title VII, where a swap contract references a securities index that might otherwise satisfy the CEA's statutory requirements to qualify as a broad-based securities index, and a swap counterparty either directly or indirectly (for example, through an investment adviser or through the third-party index provider) retains discretionary authority to change the composition of the security portfolio (including, for example, by adding or removing securities in the security

[40] 7 U.S.C. § 1a(25)(A).

[41] The CFTC maintains a list of those securities that meet both the market capitalization and trading volume requirements.

[42] In general, under Title VII, an over-the-counter swap referencing an index that is a broad-based security index (as defined by reference to the CEA) is subject to the CFTC's regulatory oversight, and an over-the-counter derivative referencing a narrow-based security index (as defined in the CEA) is a "security-based-swap" subject to the SEC's regulatory oversight. For definitions of swap and security-based swap for these purposes, see 77 F.R. 48208-48366 (Aug. 13, 2012); 12 U.S.C. §§ 5301-5641.

portfolio on an "at-will" basis during the term of the instrument), the index will be treated as a narrow-based security index, rather than as a broad-based security index.[43]

Contracts referencing the S&P 500 and the DJIA should qualify as referencing broad-based security indices for these purposes, since the indices should meet the relevant CEA diversification and weighting requirements and since no particular market participant or contractual counterparty would be expected to have any influence over the manner in which the indices are constructed and rebalanced from time to time. In practice, however, since the term "broad market" is not defined, taxpayers may be reluctant to rely solely on the fact that an index is a broad-based security index for these purposes to conclude that a particular transaction is not reportable.

In recent years, the application of the Index Exception has been further complicated by the growing popularity of indices with thematic "filters," which generally have the aim of preserving the attributes of the underlying index (for example, the nature of the S&P 500 as a broad-based, large cap U.S. equity index) while eliminating, substituting or adding index components in a manner that reflects the relevant theme. For example, the S&P 500 ESG index, which was launched in 2019, uses the S&P 500 as its starting point and applies an exclusionary methodology to filter out issuers that, among other things, (x) derive a specified percentage of revenue from controversial weapons, thermal coal or tobacco products or (y) have an ESG "score" within the bottom 25 percent of their industry group.[44] A company's ESG "score" is computed by S&P based on a variety of factors, which are separately computed and weighted by reference to the industry group to which a particular company belongs.[45] S&P currently computes the ESG score of over 13,000 companies across 25 industry groups.[46] Although S&P may use the ESG scores for purposes of index construction, S&P also markets its ESG scores in a variety of other ways including to allow companies to benchmark their ESG performance over time.[47] Other index sponsors have developed similar ESG indices, although in many cases relevant ESG scoring determinations are made by ESG rating agencies that are independent of the index sponsor or administrator. Another example of an index with a thematic filter is the S&P 500 Shariah Index, which was launched in 2006 and removes Shariah-noncompliant components of the S&P 500.[48]

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[43] *Id.* at 48258.

[44] *See* S&P Dow Jones Indices, S&P ESG Index Series Methodology (May 2024), *available at* https://www.spglobal.com/spdji/en/documents/methodologies/methodology-sp-esg-index-series.pdf.

[45] *See* S&P Global, ESG Scores Methodology (March 2024), *available at* https://portal.s1.spglobal.com/survey/documents/spglobal_esg_scores_methodology.pdf.

[46] S&P Global, Global Industry Classification Standard, *available at* https://www.spglobal.com/spdji/en/landing/topic/gics/.

[47] S&P Global, *ESG Scores and Raw Data* (last accessed on Aug. 22, 2024), *available at* https://www.spglobal.com/esg/solutions/esg-scores-data.

[48] *See* S&P Dow Jones Indices, S&P Shariah Indices Methodology (April 2024), *available at* https://www.spglobal.com/spdji/en/documents/methodologies/methodology-sp-shariah-indices.pdf. Shariah-based filters may eliminate issuers with significant involvement in business activities prohibited by Shariah law, including conventional financial services, alcohol, gaming and most conventional media.

In many cases, there are strong arguments that indices with thematic filters of the kinds described above should fall within the scope of the Index Exception, either because they are "widely used and publicly quoted" or because they track a "broad market" or a "market segment" (for example, the segment of the market with favorable ESG or Shariah characteristics). However, this conclusion is not free from doubt, both because ESG criteria, Shariah law and similar thematic index criteria may not be "objective *financial* information" and because as noted above, the terms "broad market" and "market segment" are not defined.

Under the Final Basket Notices (and prior to the issuance of the Proposed Regulations), the stakes for taxpayers of favorably resolving these interpretive difficulties were significantly mitigated by the fact that most common financial contracts linked to indices or rules-based baskets are not denominated as options and therefore do not fall within the scope of the Final Basket Option Notice's listed transaction designation. Accordingly, in cases of uncertainty, it was possible for financial institutions and taxpayers to disclose the relevant financial contracts as transactions of interest under the Final Basket Contract Notice on a protective basis. However, because under the Proposed Regulations, basket contract SSTs would be designated as listed transactions, many financial institutions would be required to forego entering into such transactions due to internal policies prohibiting participation in or advising on listed transactions, and protective reporting may no longer be a practical solution to these definitional uncertainties.

2. <u>Recommendations</u>

We recommend that the Final Regulations expand and clarify the application of the Index Exception to apply to common types of index-linked contracts that do not result in impermissible tax benefits under current law and therefore are not tax avoidance transactions. In particular we recommend the following changes:

The Final Regulations should remove the requirement for a "widely used and publicly quoted" index to be based on "objective financial information." As discussed above, the publicly quoted value of such an index inherently should qualify as "objective financial information" within the meaning of the NPC rules vis-à-vis the *parties to any particular contract referencing the index*, because it is current, objectively determinable financial information that is not within the control of, or unique to, the parties to the contract (regardless of whether the index selection methodology is partially or principally discretionary rather than based on objective rules). It follows that a contract that references such an index is properly treated for federal income tax purposes as a unitary derivative that is not deemed to be disposed of under section 1001 in connection with an index rebalancing, and accordingly should not give rise to an impermissible tax deferral or character conversion benefit under current law.[49]

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[49] Under this recommendation, an index could be based entirely on discretionary determinations or on non-financial information and still be eligible for the Index Exception, provided that it is "widely used and publicly quoted." Thus, it would be possible, although practically unlikely, that a non-traditional index based on discretionary financial determinations (such as a prominent investor's stock picks) or on non-financial information (such as weather, catastrophe, or other potentially speculative events) could qualify for the Index Exception if the index gains sufficiently wide acceptance within the market to qualify as "widely used and publicly quoted."

Alternatively, if the recommendation in the preceding paragraph is not accepted, the Final Regulations should specify:

- That the composition of a "widely used and publicly quoted" index may be based on any "objective information" (for example, ESG criteria or Shariah law), rather than solely on "objective *financial* information." Thus, for example, a widely used and publicly quoted index should not fail to qualify for the Index Exception merely because the underlying index rules include an ESG kick-out for any issuer that derives more than a specified percentage of its gross revenue from thermal coal or controversial weapons.[50]

- That the composition of a "widely used and publicly quoted" index may be based on discretionary determinations (rather than solely on objective information) to the extent such determinations are either (x) made by the index sponsor, index administrator or similar person pursuant to publicly available index guidelines with a principal purpose of ensuring that the index properly represents the economic reality or theme it is intended to reflect or (y) made by a rating agency, data provider or similar person in the ordinary course of business for purposes that are not specific to any particular financial contract that may reference such determinations. Thus, for example, a "widely used and publicly quoted" index should not fail to qualify for the Index Exception merely because the index's composition from time to time is based in part on discretionary determinations by the index committee or by an ESG rating agency.

The Final Regulations should define a "broad market" index to include any index that, with respect to the particular contract in question between T and C, is not a narrow-based security index within the meaning of the CEA, determined as if the contract were a swap for purposes of the CEA. As described above, to qualify as a broad-based security index for these purposes in respect of a particular financial contract, the index must not only meet the weighting and diversification requirements of the CEA, but also cannot give any party to the contract discretionary authority to change (either directly or indirectly) the composition of the referenced securities during the term of the instrument. We believe these CEA and Title VII limitations make it unlikely that such index-linked contracts would be tax avoidance transactions and offer a solution that would be relatively easy for financial institutions to administer given their familiarity in applying CEA and Title VII limitations for non-tax purposes.

Lastly, the Final Regulations should specify that if a base index (for example, the S&P 500) qualifies for the Index Exception as modified above (that is, as "widely used and publicly quoted" or as "based on a broad market or market segment"), an adjusted index that differs from the original index solely due to the addition of thematic index selection criteria (for example, ESG criteria or Shariah law) will also qualify for the Index Exception, provided that the thematic selection criteria are either (x) based on objective rules (for example, a kick-out for any issuer that derives more than a specified percentage of its revenue from thermal coal or controversial weapons) or (y) based on discretionary determinations (A) made by the index sponsor, index

[50] *Cf.* Proposed Treasury regulations section 1.446-3(c)(2)(ii) (REG-111283-11) (defining a "specified non-financial index" as "any objectively determinable information that is not within the control of any of the parties to the contract and is not unique to one of the parties circumstances; is not financial information; and cannot be reasonably expected to front-load or back-load payments accruing under the contract.").

administrator or similar person pursuant to publicly available index guidelines with a principal purpose of ensuring that the adjusted index properly represents the economic reality or theme it is intended to reflect or (B) made by a rating agency, data provider or similar person in the ordinary course of business for purposes that are not specific to any particular financial contract that may reference such determinations. Thus, for example, an index that derives from a "widely used and publicly quoted" index by eliminating or substituting issuers based on their ESG "score," as determined by an ESG rating agency, would also qualify for the Index Exception even if the adjusted index is not itself "widely used and publicly quoted."

D. Objective Rules Exception

1. Background

In view of the definitional uncertainty surrounding the Index Exception, taxpayers may rely on the Objective Rules Exception to determine that products linked to algorithmic, rule-based indices are not reportable under the Final Basket Contract Notice. As described above, the Objective Rules Exception provides that a taxpayer or its designee will not be treated as having "discretion" to change the composition of an underlying basket of reference assets or the trading algorithm (and thus will not be treated as satisfying prong 3 of the SST Test) "if 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 (the rules) and [the taxpayer and/or its designee] 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." Since index sponsors typically publish the rules pursuant to which their indices are constructed and periodically rebalanced, there may be persuasive arguments that contracts referencing such indices fall within the Objective Rules Exception, depending on the objectivity of the underlying rules. However, index sponsors typically retain the ability to make periodic amendments to index rules, generally to improve the ability of the index to track the economic reality or theme it is intended to track over time.[51] Accordingly, it is not entirely clear whether taxpayers may rely on the Objective Rules Exception in respect of contracts tied to indices, as the index sponsor arguably may retain "the right to alter or amend the rules" during the term of a contract that references the index (even where the alterations or amendments are intended simply to maintain the exposure targeted by the index).[52]

Taxpayers may also rely on the Objective Rules Exception to conclude that financial contracts linked to customized, rules-based baskets are not reportable transactions. In certain cases, however, such contracts may reference determinations that, though objective vis-à-vis the parties to the contract, are not based strictly on defined rules. For example, a contract might reference an otherwise static basket of equities but kick out a reference equity if the relevant

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[51] The European Union imposes certain restrictions on index methodology changes. *See* Benchmarks Regulation (Regulation (EU) 2016/1011 of the European Parliament and of the Council of 8 June 2016); Principles for Financial Benchmarks published by the International Organization of Securities Commissions in July 2013 (FR07/13). We are not aware of any similar U.S. restrictions.

[52] As discussed above in note 12, although the requirement that T or its designee cannot have the power to alter or amend the rules is subject to certain narrow exceptions, it is not clear that an index sponsor's ability to amend index rules would fall within these exceptions.

issuer's credit rating (as determined by a credit rating agency) falls below a specified level. In general, we believe that rules-based basket contracts that reference such objective third-party determinations do not result in impermissible tax benefits under current law and therefore are not tax avoidance transactions of the kind that are the intended target of the Final Basket Notices, given that it is implausible that any particular investor could directly or indirectly control or influence the determinations of a third-party credit rating agency or similar determinations. However, given that such determinations may not always be based on strictly defined rules, but may involve an element of discretionary judgment and qualitative decision-making, it may not be entirely clear whether such contracts are based on "objective instructions, operations or calculations" within the meaning of the Objective Rules Exception.

2. Recommendations

We recommend that the Final Regulations clarify that the ability of an index sponsor, index administrator or similar person periodically to amend the rules that govern an index's construction and rebalancing will not prevent the index rules from qualifying for the Objective Rules Exception, provided that the amendments are made pursuant to publicly available index guidelines with a principal purpose of ensuring that the index properly represents the economic reality or theme it is intended to reflect.

In addition, we recommend that the Final Regulations specify that under the Objective Rules Exception, it is permissible for the "rules" to reference discretionary determinations made by a rating agency, data provider or similar person in the ordinary course of business for purposes that are not specific to any particular financial contract that may reference such determinations. Thus, for example, if T purchases a basket contract from C that references an otherwise static basket of equities but kicks out issuers whose credit rating falls below a specified level, as determined by X in the ordinary course of its business as a credit rating agency, the fact that X's credit rating determinations may involve an element of discretionary, subjective judgment should not cause the contract to be an SST.

E. Tax Forms to Establish Absence of Tax Benefit

1. Form W-8EXP

Under the Final Basket Notices, T and C may establish the absence of a Tax Benefit in respect of a basket contract by, among other things, establishing that T is a beneficial owner that is a non-U.S. person and that does not hold the contract in connection with a U.S. trade or business. The Final Basket Notices indicate that T and C may establish such facts by causing T to provide a Form W-8BEN, W-8BEN-E or W-8EXP.

The Proposed Regulations remove Form W-8EXP from the list of IRS forms that can be used to establish the absence of a Tax Benefit. Although the government does not explain the basis for this change, it is possible that the change was made because in certain limited circumstances, non-U.S. persons can provide Form W-8EXP in order to claim an exemption in respect of income treated as effectively connected with a U.S. trade or business ("***ECI***").[53]

[53] For example, gain from stock in a United States real property holding corporation (treated as ECI under section 897) may be exempt under section 892 in the hands of a foreign sovereign; gain from the disposition

However, even in such cases, a Form W-8EXP requires the person providing the form to certify under penalties of perjury that the relevant income item is exempt from U.S. federal income tax, which establishes the absence of a Tax Benefit.

Accordingly, we recommend that the Final Regulations reinstate Form W-8EXP as a form that can be used to establish the absence of a Tax Benefit.

2. Form W-8IMY From Foreign Partnership with No U.S. Partners

Broker dealers may offer over-the-counter basket contracts to foreign partnerships. Under the Proposed Regulations, it appears that the only manner in which a broker dealer can establish the absence of a Tax Benefit through IRS forms in such cases is to obtain a Form W-8IMY for the partnership along with a withholding statement and Forms W-8BEN or W-8BEN-E for each ultimate foreign partner.

In some cases, payments on such contracts may not derive from U.S. sources or otherwise be subject to U.S. withholding tax, and accordingly, a nonwithholding foreign partnership that acquires such contracts may (absent the requirements created by the Final Basket Notices or the Proposed Regulations) provide the broker dealer with an IRS Form W-8IMY without attaching a withholding statement or flow-through tax certifications for its ultimate partners.[54] In other cases, the foreign partnership may have entered into an agreement with the IRS to be a withholding foreign partnership, in which case the foreign partnership itself assumes responsibility to withhold U.S. taxes in respect of its partners and is not required to provide flow-through documentation for its direct or indirect partners. In many of the foregoing cases, providing flow-through documentation in respect of ultimate partners is impracticable or not commercially desirable (for example, because of confidentiality or client retention reasons).

Accordingly, we recommend that the Final Regulations permit foreign partnerships to certify the absence of a Tax Benefit by providing a written statement with their Form W-8IMY certifying that the partnership has no direct or indirect partners that are United States persons as defined in section 7701(a)(30). Together with the other certifications required by the Form W-8IMY, which may not be provided in connection with income treated as ECI for federal income tax purposes, we believe such a statement should be sufficient to establish the absence of a Tax Benefit and avoid listed transaction designation (provided that as to T, such a statement should only insulate T from listed transaction designation if the statement is correct).

3. Form W-8IMY From Qualified Derivatives Dealer

A U.S. broker dealer may issue over-the-counter basket contracts to foreign broker dealers that are QDDs and therefore hold the contracts as a *principal* rather than as an intermediary in their capacity as derivatives dealers (that is, beneficially own the contracts). In such cases, obtaining a

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of any United States real property interest (treated as ECI under section 897) may be exempt under section 897(l) in the hands of a qualified foreign pension fund; and ECI allocable to a foreign tax-exempt organization may be exempt under sections 512 and 513. *See* IRS Form W-8EXP (rev. 2003), Part II, Lines 13 and 15.

[54] Although a Form W-8IMY may not be required for chapter 3 withholding purposes in such cases, it may be requested and provided for FATCA account documentation purposes.

Form W-8IMY from a foreign broker dealer that certifies QDD status with respect to the contract in question should be sufficient to establish the absence of a Tax Benefit, since the certification can only be given by a foreign beneficial owner that is not subject to U.S. net income tax in respect of the contract.[55]

Accordingly, we recommend that the Final Regulations permit foreign derivatives dealers to certify the absence of a Tax Benefit with respect to a contract by providing a Form W-8IMY with a QDD certification. We note in this regard that even if the non-U.S. broker dealer holds the contract to hedge a separate, identifiable client-facing basket contract (which typically cannot be determined given that broker dealers generally hedge their derivatives books on a net basis), the client-facing basket contract would be a listed transaction as to the non-U.S. broker dealer and the client if it otherwise qualifies as an SST.

F. Debt Exception

1. Background

Like the Final Basket Notices, the Proposed Regulations would exclude a contract from the SST Test if "[t]he contract is treated as a contingent payment debt instrument under §1.1275-4 (including a short-term contingent payment debt instrument) or a variable rate debt instrument under §1.1275-5" (the "***Debt Exception***"). Presumably, the basis for this exception is that sections 1271 through 1275 and the Treasury regulations thereunder provide detailed rules requiring holders of CPDIs and VRDIs to accrue ordinary interest income on a projected basis, with adjustments as necessary to account for actual payouts, making CPDIs and VRDIs poor vehicles for tax deferral or character conversion.

Although it appears clear that short-term debt instruments are intended to qualify for this exception, the quoted language could be interpreted in a contrary manner. Specifically, Treasury regulations section 1.1275-4(a)(2)(vi) excludes from the application of the CPDI rules "any debt instrument (other than a tax-exempt obligation) described in section 1272(a)(2)." The exception in section 1272(a)(2) includes, among other instruments, obligations with a fixed maturity date of not more than one year from issue. Thus, short-term taxable obligations arguably cannot be CPDIs, creating a technical ambiguity regarding the intended meaning of the parenthetical reference to a "short-term contingent payment debt instrument."

In addition, although certain prepaid, asset-linked instruments may properly be characterized as CPDIs or VRDIs for federal income tax purposes, this characterization may not be free from doubt (for example, if the issuer does not have an unconditional obligation to repay the entire amount invested). Under the issuer-holder consistency rules for debt instruments, however, holders generally are required to follow the issuer's determinations in this regard, including for purposes of computing income accruals on a CPDI and for purposes of determining the issue price and original issue discount (if any) of a VRDI.[56] To take an inconsistent position, a

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[55] A Form W-8IMY with a QDD certification may not be provided in respect of a contract held as part of a U.S. trade or business, in which case Form W-8ECI generally is the appropriate form.

[56] *See* section 385(c)(1); Treas. Reg. §§ 1.1275-4(b)(4)(iv); 1.1273-2(f)(9).

holder must explicitly disclose such position on a statement attached to their federal income tax return.

2. Recommendations

To resolve the ambiguity identified above regarding the treatment of short-term debt instruments, we recommend that the Final Regulations clarify that the Debt Exclusion applies to all instruments that are indebtedness for federal income tax purposes (irrespective of whether the debt instrument is a CPDI, VRDI or short-term or long-term fixed rate debt instrument).

In addition, to provide certainty to issuers, we recommend that the Final Regulations provide that the Debt Exception applies *as to C* (the issuer of the applicable instrument) in any case where C takes the position that the instrument is indebtedness for federal income tax purposes, discloses this treatment to potential holders and actually treats the instrument as indebtedness for all applicable tax years while the instrument remains outstanding, and *as to T* as long as T actually treats the instrument as indebtedness for all applicable tax years while the instrument remains outstanding. In such cases, we believe the issuer-holder consistency rules described above minimize the possibility that T would claim an impermissible Tax Benefit contrary to C's treatment of the instrument as indebtedness. In addition, this exception would not apply to T if T reports a tax treatment other than indebtedness, in which case T would be required to report the contract as a listed transaction if the contract otherwise qualifies as an SST.

G. Short-Term Contracts

Under the definition of Tax Benefit in the Final Basket Notices and the Proposed Regulations, basket contracts with a term of one year or less may give rise to a Tax Benefit because they overlap two of T's tax years. In such cases, the only Tax Benefit that can be obtained (even assuming that the proper comparison in determining whether a Tax Benefit exists is outright ownership of the reference assets) is deferral of tax for one year, in which case the Proposed Regulations would designate the contracts as listed transactions.

We recommend that the Final Regulations exclude contracts that have a stated term of no more than one year, regardless of whether they overlap two of T's tax years. In such cases, the Tax Benefit derived from no more than one year of tax deferral is relatively insignificant and the comparative costs of entering into such transactions to obtain such a small tax benefit render it unlikely that they are tax motivated. As a practical matter, the exclusion of such short-term contracts would significantly reduce the administrative burden that broker dealers currently face in determining whether short-term contracts overlap a counterparty's tax year and therefore need to be reviewed for SST status, particularly for fiscal year counterparties. Accordingly, we believe that any benefit to the fisc and the integrity of the administration of tax law in mandating disclosure of such short-term contracts as listed transactions is outweighed by the administrative burdens it imposes on taxpayers.

H. Hedging Transactions

Taxpayers may enter into basket transactions that are treated as "hedging transactions" within the meaning of Treasury regulations section 1.1221-2(b).[57] One example of such a transaction is a contract entered into by a taxpayer to hedge the taxpayer's obligations under a non-qualified deferred compensation plan.[58]

Hedging transactions generally have no potential for abuse because they give rise to ordinary income and the timing of any income, deduction, gain, or loss is matched to the timing of the corresponding amounts realized in respect of the hedged item to ensure clear reflection of income.[59] In view of their low abuse potential, hedging transactions historically have been excluded from other anti-abuse rules and reportable transaction designations.[60] We accordingly recommend that the Final Regulations exclude from SST treatment any transaction that a taxpayer accounts for as a hedging transaction under Treasury regulations section 1.1221-2(b).

I. Cleared Notes Issued Under Regulation S

Broker dealers may offer structured securities to foreign investors under Regulation S, which generally are not treated as indebtedness for federal income tax purposes and therefore do not qualify for the Debt Exception described above. Such securities typically are held in book-entry form through a clearing organization, and accordingly, it is not practicable for the issuer to obtain IRS forms directly from ultimate beneficial owners of the securities, as is required under the Final Basket Notices and Proposed Regulations to establish the absence of a Tax Benefit.

However, under Regulation S, such securities may not be marketed or sold to any "U.S. person" as defined in 17 C.F.R. section 230.902(k), which generally includes individual residents of the United States, legal entities incorporated under U.S. law and U.S. branches or agencies of

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[57] A hedging transaction is any transaction entered into in the normal course of the taxpayer's trade or business primarily to (i) manage risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer, or (ii) to manage the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer. Treas. Reg. § 1.1221-2(b).

[58] As long as derivative contracts meet the risk management requirements of section 1221(b)(2)(A) and Treas. Reg. § 1.1221-2(b), and the identification requirements of Treas. Reg. § 1.1221-2(f), those derivative contracts qualify as hedging transactions for purposes of section 1221(a)(7). *See* I.R.S. Priv. Ltr. Rul. 200415009 (Apr. 9. 2004).

[59] With respect to character, an identified hedging transaction is treated as giving rise to ordinary gain or loss. *See* Treas. Reg. § 1.1221-2. In addition, an anti-abuse rule for unidentified hedging transactions treats gain (but not loss) from such transactions as ordinary if the taxpayers has "no reasonable grounds for treating the transaction as other than a hedging transaction." *See* Treas. Reg. § 1.1221-2(g)(2)(iii). With respect to timing, the taxpayer's method of accounting in respect of a hedging transaction must reasonably match the timing of income, deduction, gain, and loss on the hedge with the corresponding income, deduction, gain, and loss on the hedged item, regardless of whether or not the taxpayer has identified the transaction as a hedging transaction. *See* Treas. Reg. § 1.446-4.

[60] *See* section 1092(e) (excluding hedging transactions from the application of the straddle rules); Rev. Proc. 2013-11, § 4.03(5) (excluding hedging transactions from transactions that give rise to a reportable loss under Treas. Reg. § 1.6011-4(b)(5)).

foreign entities.[61] Because such selling restrictions are not technically sufficient to establish the absence of a Tax Benefit under the Final Basket Notices, we understand that some issuers have filed protective disclosures identifying certain securities sold under Regulation S as a transaction of interest.

However, because under the Proposed Regulations, basket contract SSTs would be designated as listed transactions, many financial institutions would be required to forego issuing such securities due to internal policies prohibiting participation in listed transactions, and protective reporting may no longer be a practical solution. Accordingly, we recommend that the Final Regulations specify that financial instruments issued under Regulation S are not SSTs *as to C* provided that the securities are issued and held in book-entry form through a clearing organization. We note in this regard that if a U.S. taxpayer acquires such a security notwithstanding the Regulation S selling restrictions, and the security is, in fact, an SST, the holder would still have the obligation to report the security as a listed transaction.

J. Master Swap Agreements

Under both the Final Basket Notices and the Proposed Regulations, the first prong of the SST Test requires T to enter into a "basket contract" — defined as a contract "to receive a return based on the performance of a reference basket." The Final Basket Notices and the Proposed Regulations also include an example in which T "enters into a contract . . . to receive a return based on the performance of a notional basket of reference assets." This definition of "basket contract" has given rise to concerns among taxpayers that entering into multiple separate derivatives under a single master agreement could give rise to a basket contract, even though in substance there is no relevant distinction between entering into multiple standalone swap agreements or multiple transactions under a master agreement, and both should be treated the same way for U.S. federal income tax purposes.

Under a typical master swap agreement, the long party may enter into any number of "transaction portions" on underlying reference assets, each of which is accounted for separately and can be terminated separately, in whole or in part, without affecting the other transaction portions under the same master swap agreement.[62] In such cases, the only meaningful difference between entering into multiple transaction portions under a master swap agreement and entering

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[61] Regulation S is a set of rules promulgated by the SEC that exempts securities offered and sold outside of the United States from registration requirements under the Securities Act of 1933. The definition of a "U.S. person" for purposes of Regulation S is not in all cases coextensive with the types of persons that may be subject to U.S. federal income tax in respect of a security — for example, it generally would not include a Cayman partnership with U.S. partners. In addition, Regulation S only applies to the initial issuance and marketing of securities, rather than their acquisition on the secondary market.

[62] The master swap agreement may include a covenant requiring both the long party and the short party to treat the transaction portions under the master agreement as separate financial contracts for federal income tax purposes. However, even absent such a covenant, there would not appear to be a plausible substantive basis for a contrary federal income tax treatment.

into multiple separate swaps generally is that the master swap agreement provides for netting of payment flows and margin requirements as a matter of administrative convenience.[63]

In contrast, a basket contract of the kind that is the intended target of the Final Basket Notices and in the Proposed Regulations references a single, notional *basket* rather than various different notional amounts of different shares that functionally operate as separate derivatives. Accordingly, the long party can only terminate the basket contract on a proportionate basis with respect to each underlying stock. However, the long party also either directly or indirectly retains the power to vary the shares referenced by the basket, potentially enabling it to take the position that changes to the securities in the underlying reference basket do not give rise to a realization event under section 1001 in respect of the basket contract.[64]

In substance, then, master swap agreements are not basket contracts and should not fall within the ambit of the Final Basket Notices or the Proposed Regulations. Accordingly, we recommend that the Final Regulations clarify the definition of a "basket contract" to specify that entering into multiple component transactions under a master swap agreement of the kind described above does not, in itself, give rise to a "basket contract" provided that none of the component transactions (when separately analyzed) is an SST.

K. Retroactive Re-Reporting of Open-Year Basket Contract SSTs

As described in the introduction to this Report, the Proposed Regulations anticipate that after the Final Regulations are issued, taxpayers that have already reported basket contract SSTs as transactions of interest pursuant to the Final Basket Contract Notice in prior open tax years will be required to re-report such transactions as listed transactions pursuant to the Final Regulations. We believe it is unduly burdensome to require taxpayers to re-report information they have already provided to the government, and are not aware of any benefits to sound tax policy or tax administration from requiring duplicative reporting, particularly as the information taxpayers are required to provide in respect of reportable transactions is substantially the same regardless of whether the transaction is designated as a transaction of interest or as a listed transaction.[65] Accordingly, we recommend that the Final Regulations apply only to basket contract SSTs entered into after the Final Regulations are published.

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[63] For example, consider a taxpayer that enters into four long transaction portions under a master swap agreement: $100 of Stock A, $100 of Stock B, $100 of Stock C and $100 of Stock D. If, after eleven months, the aggregate value of the notionally referenced stocks has increased to $500, with each stock position now worth $125, and the long party terminates its transaction portion in respect of Stock D and enters into a new transaction portion referencing $125 of new Stock E, the long party would treat the termination of the transaction portion and realize $25 of short-term capital gain.

[64] Revisiting the facts of the example in note 63, suppose that a basket contract reference $400 notional of Basket X, which initially is comprised of $100 of each of Stock A, Stock B, Stock C and Stock D. If the value of Basket X has increased to $500 after eleven months, with each underlying stock position now worth $125, Stock D could be removed from the basket in exchange for $125 of new Stock E, and yet the long party may claim that it has no realization event under section 1001 since the basket swap still references Basket X.

[65] *See* Treas. Reg. § 1.6011-4(d); Form 8886 (rev. Dec. 2019).

L. Obsolescence of Basket Contract Notice

As published in the Federal Register, the Proposed Regulations provide that "[t]his document obsoletes [the Basket Contract Notice] as of July 12, 2024," but that it "do[es] not obsolete, revoke, or modify the Basket Option Notice." It is unclear whether this language revokes the Basket Contract Notice *as of the date of the publication of the Proposed Regulations* (that is, as of July 12, 2024) or whether it is only intended to apply as of the date that Final Regulations are published. It is accordingly unclear whether or how taxpayers who enter into transactions that may be basket contract SSTs are required to disclose those transactions between July 12, 2024 and the date the Final Regulations are promulgated.

We recommend that the government clarify that the Final Basket Contract Notice remains in effect until Final Regulations are published. This approach would ensure that the government continues to receive reporting in respect of transactions that are potentially tax avoidance basket contract SSTs that are not denominated as options and therefore do not fall within the scope of the Final Basket Option Notice, while at the same time avoiding confusion and uncertainty on the part of taxpayers about their reporting obligations prior to the publication of Final Regulations.