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U.S. Tax Court: Contracts were not "options" under sections 1234 and 1234A because taxpayer in substance owned underlying securities

The U.S. Tax Court yesterday held that 10 contracts entered into between the taxpayer and a third-party bank regarding various securities were not call option contracts under sections 1234 and 1234A—as labeled and characterized by the taxpayer—and the substance of the transactions was that the taxpayer owned the underlying securities.

The court thus upheld the IRS' adjustments to the taxpayer's income based on the determination that the taxpayer owned the securities for federal income tax purposes.

The case is*: GWA, LLC v. Commissioner*, T.C. Memo. 2025-34 (April 16, 2025). Read the Tax Court's **opinion**

Summary

The payout under each contract entered into between the taxpayer and the third-party bank depended on the value of the securities referenced therein on the expiration date. The securities were nominally owned by an affiliate of the third-party bank, but the taxpayer directed trading in the securities on a daily or hourly basis, employing the same complex strategies it used in its other portfolios.

The taxpayer realized large trading gains in the securities, but it took the position that these profits were not taxable on an annual basis as short-term capital gains. Rather, it contended that tax on its profits must be deferred until it exercised or terminated the "option." Each "option" had a term of more than 12 years, so the tax deferral could continue for some time, and the profits ultimately would be taxed as long-term capital gains.

The IRS on December 3, 2018, issued petitioner a notice of final partnership administrative adjustment (FPAA) for 2009 and 2010 determining that, for federal income tax purposes, the contracts were not "options" and that the taxpayer was, in substance, the owner of the securities. The FPAAs determined total ordinary income adjustments in excess of $500 million for 2009 and 2010, plus accuracy-related penalties for each year.

The taxpayer on May 1, 2019, petitioned the Tax Court for review of the IRS' determinations, but the court ultimately sustained the IRS' determinations.

The court did reject the IRS' contention that the taxpayer had made a "mark-to-market" election requiring the taxpayer to mark to market the securities on an annual basis under section 475(f)(1) and the IRS' determination of a $337,170,142 section 481 adjustment on that ground. The court also sustained the taxpayer's argument that the IRS' determination that the taxpayer was the owner of the securities effected a change in the taxpayer's method of accounting, necessitating a section 481 adjustment to prevent amounts of the taxpayer's income from being duplicated or omitted and accordingly directed the parties to compute an appropriate section 481 adjustment.

KPMG observation

In Notice 2015-73, the Treasury Department and IRS identified the contracts addressed in this case ("basket option contracts"), and substantially similar transactions, in effect on or after January 1, 2011, as listed transactions for purposes of sections 6111 and 6112 and Treas. Reg. § 1.6011-4(b)(2). More recently, in July 2024, the Treasury Department and IRS released proposed regulations (REG-102161-23) identifying certain "basket contract" transactions and substantially similar transactions as listed transactions for tax years ending on or after January 1, 2011. Read *TaxNewsFlash*

Then just a few days ago, on April 14, 2025, the IRS released Notice 2025-22 obsoleting nine items of "extraneous and unnecessary" guidance, including Notice 2015-73. The IRS stated that it will no longer defend Notice 2015-73 in accordance with Action on Decision 2024-1, which announces the IRS' acquiescence to *Green Rock LLC v. IRS*, 104 F.4th 220 (11th Cir. 2024), in which the 11th Circuit found Notice 2017-10, which identifies certain syndicated conservation easement arrangements as listed transactions, invalid under the Administrative Procedures Act (APA) because it was issued without following notice-and-comment rulemaking procedures. Thus, it seems that the IRS will no longer defend the validity of treating basket option contracts as listed transactions at least until the proposed regulations may be finalized. However, there is no indication that the IRS will cease to challenge these transactions on the merits.

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