Estate of McKelvey v. Commissioner of Internal Revenue, 148 T. C. No. 13 (2017)

In a significant ruling on variable prepaid forward contracts (VPFCs), the U. S. Tax Court held that extending settlement dates in VPFCs does not trigger taxable events under IRC sections 1001 and 1259. This decision clarifies the tax treatment of VPFCs, affirming that open transaction status persists until the delivery of underlying stock, impacting how taxpayers and financial institutions structure these complex financial instruments.

Parties

The Estate of Andrew J. McKelvey, represented by Bradford G. Peters as Executor, was the petitioner. The Commissioner of Internal Revenue was the respondent. The case was appealed to the United States Tax Court after a notice of deficiency was issued by the IRS.

Facts

Andrew J. McKelvey, the deceased, entered into variable prepaid forward contracts (VPFCs) with Bank of America (BofA) and Morgan Stanley & Co. International plc (MSI) in September 2007. Under these contracts, McKelvey received upfront cash payments in exchange for his obligation to deliver a variable number of Monster Worldwide, Inc. (Monster) shares or their cash equivalent on specified future dates in September 2008. In July 2008, McKelvey extended the settlement dates of both VPFCs until February 2010 for BofA and January 2010 for MSI, paying additional consideration for these extensions. McKelvey died in November 2008, before the extended settlement dates. The estate settled the VPFCs by delivering Monster shares in 2009.

Procedural History

The IRS issued a notice of deficiency to McKelvey’s estate in August 2014, asserting a $41,257,103 deficiency in federal income tax for 2008. The IRS argued that the VPFC extensions constituted taxable exchanges and constructive sales of the pledged Monster stock. The estate disputed this determination and filed a petition with the U. S. Tax Court. The case was submitted fully stipulated and without trial under Tax Court Rules 50(a) and 122(a).

Issue(s)

Whether the extensions of the VPFCs in 2008 resulted in taxable exchanges under IRC section 1001?

Whether the extensions of the VPFCs in 2008 resulted in constructive sales of the pledged Monster stock under IRC section 1259?

© 2025 SCOTUSreports.com. All rights reserved.

Rule(s) of Law

Under IRC section 1001, gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis. IRC section 1001(c) mandates recognition of the entire amount of gain or loss on the sale or exchange of property unless otherwise provided. IRC section 1259 treats certain transactions as constructive sales of appreciated financial positions, including entering into a forward contract to deliver substantially fixed amounts of property for a substantially fixed price. Revenue Ruling 2003-7 holds that VPFCs meeting specific criteria are open transactions, with no immediate recognition of gain or loss until the delivery of the underlying stock.

Holding

The Tax Court held that the extensions of the VPFCs did not constitute taxable exchanges under IRC section 1001 nor constructive sales under IRC section 1259. The court determined that the original VPFCs were open transactions under Revenue Ruling 2003-7, and the extensions merely postponed the settlement dates without altering the open transaction status. Thus, no taxable event occurred upon the execution of the extensions.

Reasoning

The court's reasoning was multifaceted. Firstly, it determined that the VPFCs were not "property" to McKelvey at the time of extension; they were obligations to deliver. The court rejected the IRS's argument that McKelvey possessed valuable rights in the VPFCs, such as the right to cash prepayments, settlement method choice, and collateral substitution, finding these to be procedural mechanisms rather than property rights.

Secondly, the court upheld the open transaction treatment of the original VPFCs under Revenue Ruling 2003-7. The extensions did not change the uncertainty regarding the amount and nature of the property to be delivered at settlement, which is the rationale behind open transaction treatment. The court analogized VPFCs to options, noting that the option premium's tax treatment remains uncertain until exercise or expiration.

Thirdly, the court addressed the constructive sale argument under IRC section 1259. It noted that the original VPFCs did not trigger constructive sales because they involved the delivery of stock subject to significant variation. Since the extensions did not constitute a new contract or an exchange under section 1001, they could not trigger a constructive sale.

The court emphasized the importance of maintaining the open transaction status until the actual delivery of stock, consistent with the principles of tax fairness and accuracy in determining gain or loss. It also considered the legislative intent behind

© 2025 SCOTUSreports.com. All rights reserved.

section 1259, which aimed to prevent tax avoidance through complex financial transactions, but found that the VPFC extensions did not fall within the scope of this concern.

Disposition

The Tax Court entered a decision for the petitioner, affirming that no taxable event occurred upon the VPFC extensions and that the open transaction treatment continued until the delivery of Monster shares.

Significance/Impact

This case is doctrinally significant as it provides clarity on the tax treatment of VPFC extensions, affirming that they do not constitute taxable events or constructive sales. It reinforces the open transaction doctrine as applied to VPFCs under Revenue Ruling 2003-7, which is crucial for taxpayers and financial institutions engaging in such contracts. The decision impacts the structuring of VPFCs, allowing for extensions without triggering immediate tax liabilities. Subsequent courts have referenced this case when addressing similar financial instruments, and it continues to guide tax planning and compliance in the realm of complex financial transactions.

© 2025 SCOTUSreports.com. All rights reserved.