Estate of Andrew J. McKelvey v. Commissioner of Internal Revenue, 161 T. C. No. 9 (2023)

The U. S. Tax Court ruled that Andrew J. McKelvey's estate realized $71. 6 million in short-term capital gains in 2008 from the termination of variable prepaid forward contracts (VPFCs). The court held that the exchange of original VPFCs for new ones constituted a taxable termination under Section 1234A, impacting how similar financial instruments are taxed and clarifying the tax treatment of derivative obligations.

Parties

Estate of Andrew J. McKelvey, Deceased, with Bradford G. Peters as Executor (Petitioner) v. Commissioner of Internal Revenue (Respondent). The case was heard in the U. S. Tax Court and later appealed to the U. S. Court of Appeals for the Second Circuit, with subsequent remand to the Tax Court.

Facts

In 2007, Andrew J. McKelvey, the founder of Monster Worldwide, Inc. , entered into two variable prepaid forward contracts (VPFCs) with Bank of America (BofA) and Morgan Stanley & Co. International plc (MSI). Under these contracts, McKelvey received cash prepayments in exchange for agreeing to deliver a variable quantity of Monster shares or their cash equivalent on specific future dates in 2008. In 2008, before the original settlement dates, McKelvey paid additional consideration to extend the settlement dates of these contracts to 2010. He passed away later that year. The IRS determined that the exchanges of the original VPFCs for the amended ones resulted in taxable gains for the year 2008.

Procedural History

The case was initially decided by the U. S. Tax Court in *Estate of McKelvey v. Commissioner*, 148 T. C. 312 (2017), where the court held that the exchanges did not result in taxable gains under Sections 1001 and 1259. The Commissioner appealed to the U. S. Court of Appeals for the Second Circuit, which reversed the Tax Court's decision in *Estate of McKelvey v. Commissioner*, 906 F. 3d 26 (2d Cir. 2018), determining that the exchanges resulted in constructive sales under Section 1259 and remanded the case for further proceedings on the application of Section 1234A. On remand, the Tax Court found that the exchanges constituted a taxable termination under Section 1234A, resulting in short-term capital gains.

Issue(s)

Whether the exchange of the original VPFCs for amended VPFCs in 2008 constituted a taxable termination of obligations under Section 1234A, resulting in short-term capital gains?

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Rule(s) of Law

Section 1234A of the Internal Revenue Code provides that gain or loss attributable to the termination of a right or obligation with respect to property, which is a capital asset, shall be treated as gain or loss from the sale of a capital asset. The Second Circuit's decision established that the exchanges of the VPFCs were treated as if the original contracts were exchanged for new ones, invoking Revenue Ruling 90-109's concept of a "fundamental or material change" in contractual terms.

Holding

The Tax Court held that the exchange of the original VPFCs for the amended VPFCs in 2008 constituted a taxable termination of obligations under Section 1234A, resulting in $71,668,034 of short-term capital gain for the estate in the tax year 2008.

Reasoning

The Tax Court reasoned that the exchanges of the original VPFCs for the amended ones were treated as if the original contracts were actually exchanged for new ones, following the Second Circuit's application of Revenue Ruling 90-109. This treatment was akin to an option repurchase, resulting in the termination of McKelvey's obligations under the original VPFCs. The court applied Section 1234A, which governs the tax treatment of the termination of obligations with respect to capital assets, and found that the Monster shares, to which the VPFCs related, were capital assets. The court rejected the application of the open transaction doctrine, as the values of the assets exchanged were ascertainable at the time of the exchange. The court calculated the gain using the Black-Scholes option pricing formula, which was stipulated by both parties, to determine the value of McKelvey's ongoing obligations under the new VPFCs immediately following the exchange.

Disposition

The Tax Court's decision resulted in a finding of $71,668,034 in short-term capital gains for the estate for the tax year 2008, and the case was to be entered under Rule 155 for the computation of the tax liability.

Significance/Impact

The decision clarifies the tax treatment of VPFCs and similar financial instruments, establishing that the exchange of such contracts, when resulting in a fundamental change, can be treated as a taxable termination under Section 1234A. This ruling may impact how taxpayers and financial institutions structure and report gains or losses from derivative contracts. It also underscores the importance of the underlying property in determining the tax treatment of derivatives, even when the taxpayer's position is not classified as property. The decision has implications for tax planning and compliance in the realm of financial derivatives, particularly in the

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context of variable prepaid forward contracts.

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