Estate of McKelvey v. Commissioner—Tax Planning Opportunity or a Trap for the Unwary?

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In a highly unexpected result, the Tax Court in Estate of McKelvey v. Commissioner *ruled that the extension in maturity of a profitable prepaid variable forward contract (PPVF) was not a taxable event. If this case could be relied upon, a hedger who is rolling over a profitable PPVF could avoid realizing gain on the PPVF by simply extending the maturity of the contract. Although tempting, the authors think this procedure could turn out to be disastrous if the case is overturned. Commenters have speculated that this decision could also delay the crystallization of profits on an option that one had sold, though this avenue may carry much less bite if the Tax Court is reversed.*

Introduction

In *Estate of McKelvey v. Commissioner*,[1] Andrew McKelvey, the founder of Monster Worldwide Inc. (Monster), entered into prepaid variable forward contracts (PPVFs) with both Bank of America (B of A) and Morgan Stanley (MS) on a total of 6.5 million shares of Monster during September 2007. The original maturity dates of the contracts were all September 2008. Prior to their maturity, after Monster's share price had declined, McKelvey "extended" the expiration dates to January and February of 2010. As a result, the floor of the PPVFs was now considerably above the market price.

The IRS contended that the extensions of the contracts created taxable events under Internal Revenue Code Section 1001. The taxpayer contended

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[1] 148 TC No. 13 (2017).

that Section 1001was inapplicable to the transactions because (1) Section 1001 applies to gains realized from the disposition of property, and (2) at the time of the modifications the PPVFs were obligations, not property, that the taxpayer had.

The Tax Court, surprisingly, agreed with the taxpayer. The court reasoned that McKelvey only had an obligation under the PPVF contract once he received the payment from the investment bank. The court ruled that a modification of an obligation was not a taxable event, and that only the satisfaction of the obligation would trigger a taxable event.

The implications of this case could be enormous. It appears that the extension of time of any option that was sold would not be treated as giving rise to a taxable event. Once taxpayers sell an option, the only thing left for them to do is to fulfill an obligation either to sell or to buy. By their nature, listed options can't be extended. However, over-the-counter (OTC) options, which are contracts between two parties, could be extended. This case would seem to give OTC options superior tax planning opportunities versus exchange traded options.

The IRS also argued that the modifications to the contracts created new PPVFs that resulted in a constructive sale under Section 1259. However, once the court ruled that the modifications were not taxable events, this argument became moot.

In order to make sense of the Tax Court decision one should read the case of *Iber v. United States*.[2] In *Iber*, the facts and findings of which are irrelevant to our case, a federal court in the Southern District of Illinois stated that the taxpayer believed the question to be answered by the court in order to reach its decision was question "A." The court stated that the U.S. believed that the question to be answered was question "B." The court decided that neither litigant was correct and came up with question "C." The key was that if the court agreed with either litigant as to what the proper question was, that litigant would have won the case.

In our case, the taxpayer's counsel convinced the Tax Court that the taxpayer's interpretation of both the economics behind the transactions and the issue to be decided was correct. McKelvey's counsel did an outstanding job. Once the judge accepted the economic analysis and the issue presented by the taxpayer, the contest was over. Because of this, the court never got to the point where it had to weigh in on whether constructive sales under Section 1259 had occurred.

The PPVFs at Issue

As noted, McKelvey entered into PPVFs with both B of A and MS with respect to Monster. As Monster's founder, McKelvey owned a considerable amount

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[2] 286 F. Supp. 114 (S.D. Il. 1968).

of Monster stock with zero basis. The combined PPVFs covered approximately 6.5 million shares. At the time the contracts were entered into, Monster was trading at approximately $33 per share. The PPVFs were to expire in approximately one year. The number of shares that were to be delivered under both contracts varied depending on the price of Monster on the delivery dates. Both contracts used a similar formula to determine the number of shares to be delivered. The floor and cap on the B of A contracts were $30.46 and $40.58, respectively; and the floor and cap on the MS contracts were $30.89 and $35.77, respectively. Based on a price of $33 (which is approximate), the B of A PPVF had a 92 percent floor–123 percent ceiling, and the MS PPVF had a 93.6 percent floor–108.4 percent ceiling. At the time the contracts were entered into, McKelvey received approximately $193.5 million from the two investment banks.

Economics of the Transactions. The first thing McKelvey's attorneys successfully did was explain the economics of the transactions to the court. The court understood each transaction as one whereby McKelvey received an upfront payment in exchange for the obligation to return a variable number of shares at the maturity of the contract. The number of shares would vary depending on the price of Monster on the date of delivery. Short, simple, sweet.

However, the investment bankers pricing the transactions looked at them quite differently. They knew that while each PPVF looks like a single contract, it really is three contracts "smushed" (technical term) into one. According to the bankers, McKelvey actually (1) bought a put contract on the shares with a strike price set at the floor and an expiration date coinciding with the expiration of the PPVF, (2) wrote a call contract with a strike price set at the cap and an expiration date coinciding with the expiration of the PPVF, and (3) received cash equal to the present value of the floor price plus or minus the cost or proceeds of the options.

The investment bankers' pricing methodology truly represented the economics of the transactions. McKelvey wanted to protect the value of his shares, so he purchased puts. In order to lower the cost of the puts he was willing to forgo some of the appreciation on the stock, so he sold calls. He wanted access to cash, so he received prepayments of the discounted value of the put strike prices. The banks were willing to make the prepayments because the banks were ultimately responsible for making the payments under the puts. McKelvey posted the shares as collateral with the banks so they were assured of receiving them at the expiration of the contracts.

If the court had looked at the economics of each transaction through the eyes of the bankers, and the true economic substance of the transaction, it would have seen three separate transactions combined into one.

Understanding the Contract Extensions. Prior to the expiration of the PPVFs, McKelvey asked the banks to extend the contracts for two years. At the time the extensions were requested, Monster had decreased in value.[3]

As one would expect, the IRS contended that each extension was, in reality, a closing of the original PPVF and the opening of a new PPVF. As such, the IRS claimed that McKelvey recognized approximately $88 million of short-term capital gain from the extinguishment of the old contracts (planning opportunity), and $113 million of long-term capital gain from the constructive sale of the shares due to the establishment of the new contracts (trap).

The taxpayer, however, contended that all he did was modify the existing obligations that he had with the banks. Instead of delivering the shares on the date they were originally due, he extended his obligation to deliver the shares.

McKelvey's attorneys stated that since the parties agreed that each original transaction was not a taxable event, the mere extension of that transaction should not be taxable either and, therefore, that the issue for the court to decide was whether the extension of an obligation was a taxable event under Section 1001. If not, then the discussion under Section 1259 was moot. The judges agreed with taxpayer's counsel as to the economics behind the transactions and the issue to be decided. Once the court agreed to that, the taxpayer had to win.

Making Sense of the Tax Court's Opinion

The court analyzed the taxpayer's economic position at the time the modifications were made. At that time, since the taxpayer already had received the cash, the only thing left for the taxpayer to do was deliver the shares or their cash equivalent. At that point, all the taxpayer had were obligations. Section 1001 states that the gain or loss from the disposition of property shall be the excess of the amount realized therefrom over the adjusted basis of the property. The court had to decide if the taxpayer's obligation under each contract was "property" and, if so, whether it was exchanged for other property differing materially in kind or extent. If not, then Section 1001 did not apply, and the extensions were non-events for federal income tax purposes.

The court first stated that pursuant to Revenue Ruling 2003-7,[4] the PPVFs did not create constructive sales under Section 1259. McKelvey retained enough economic exposure due to the difference between the cap and floor in the PPVFs. The court also cited a few cases that stood for the proposition that amounts received for selling options did not give rise to taxable

[3] Monster's share price was $18.24 at the time of the B of A extension and $17.28 at the time of the MS extension.

[4] 2003-1 CB 363.

income until the options were extinguished.[5] The court, in effect, was stating that the original contracts did not give rise to taxable income, which was not an issue in this case.

Once the court found that the original PPVFs did not give rise to taxable income, it then had to decide whether the extensions did. The court concluded that since the taxpayer was only left with obligations at the time the modifications were made, the taxpayer did not own any property. The court stated that although the amounts of the obligations varied considerably under the PPVFs, they nonetheless were obligations, and obligations alone do not constitute property.

Therefore, the court ruled that Section 1001 did not apply to the extensions. Since Section 1001 did not apply, there were no exchanges of property; thus, there couldn't have been constructive sales when the contracts were extended.

A Better Way to View the Transactions

The court agreed with the taxpayer's explanation of the economics and the issue to be decided, thus deciding in the taxpayer's favor. Not surprising.

However, if the court had looked at the true economics of the transactions in the manner that the investment bankers did, it might have reached a different conclusion. The reason McKelvey had an unrealized gain at the time of the extensions was that Monster had gone down considerably in price. The put portion of the transactions had a very large gain. In determining the amount that McKelvey had to pay for the extensions, the bankers computed the amount that they would receive from the termination of the original contracts and the amount they would pay under the new contracts. The court understood that the amount due under the PPVFs varied, but the court didn't delve into the reason for this. The reason was that the values of the imbedded options in the transactions were fluctuating. Instead of analyzing the extension of one agreement and following the form of the transaction, the court could have found that all three of the underlying components were being extended, following the substance of the transactions.

If the court had followed the economic substance of the transactions, it might have concluded that extending the maturity of the put that was "deep in-the-money" was a taxable event. In the case of *Reily v. Commissioner*,[6] for example, the Tax Court in 1969 found that time is of the essence in dealing with options. This time factor goes to the very nature of an option. An extension of time on an option is a meaningful change. Receiving an option with

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[5] Virginia Iron Coal & Coke Co. v. Comm'r, 37 BTA 195 (1938), aff'd, 99 F2d 919 (4th Cir. 1938), and Fed. Home Loan Mortgage Corp. v. Comm'r, 125 TC 248 (2005).

[6] 53 TC 8 (1969).

more than two years to maturity in exchange for an option with a few months to maturity would be an exchange of property that differs materially.

We are not suggesting that a PPVF should be taxed as three different contracts instead of one. But, in order to decide whether a modification of the contract should be treated as a taxable event, the economic substance of the modification must be determined. The only way to accomplish this is to properly analyze the economics behind the instrument and not necessarily follow the form of the instrument.

Had the court found that the extension was an extinguishment of the first set of PPVFs and the establishment of a second set, then clearly McKelvey would have realized short-term capital gains from the extinguishment of the first contracts.

Next, a second set of PPVFs would have been established, except that the market value of Monster was substantially lower than when the first contracts were entered into. Based on the price of Monster at the time of the second PPVFs, the bands on the B of A PPVF would have created a floor at 167 percent of the current market price and a ceiling at 223 percent; on the MS PPVF the floor would have been at 179 percent and the ceiling at 207 percent. Under Section 1259, these bands almost certainly would have created constructive sales. In such case, McKelvey would have realized long-term capital gains of approximately $113 million upon entering the second set of PPVFs.

A Looming Tax Trap

If one focuses only on the first part of the case—that is, whether the extension creates a gain with respect to each PPVF—then taxpayers in McKelvey's position might decide to extend their contracts, thinking they have nothing to lose. If *McKelvey* is correct, they have deferred the gain, and if *McKelvey* is wrong, then they would recognize the same amount of gain they would otherwise have recognized by closing out the first transaction and entering into a new one.

However, it is the second part of the case that could be a trap. When one is in the position McKelvey was in, entering into a new PPVF with the same bands as the old will in most cases create a constructive sale of the *shares*. This amount of gain would not have been recognized if the taxpayer closed the first PPVF and entered into a new one. And this amount of gain may far exceed the amount of "unrecognized" gain deferred in the PPVF.

The IRS has not announced whether it plans to appeal the decision, but we wouldn't be surprised if it did.

Stay tuned.