Estate of McKelvey v. Commissioner: The Trap Has Been Sprung

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The Second Circuit recently reversed the decision of the Tax Court in the case of Estate of McKelvey v. Commissioner. *The circuit court held that the extension of time in a variable prepaid forward contract was a closing of the first contract and the establishment of a new contract. The closing of the first contract resulted in a taxable gain on the contract and, unhappily for the taxpayer, the establishment of the second contract triggered the unrealized gain of the underlying shares to which the contract related.*

Introduction

We previously wrote an article on the Tax Court's decision in *Estate of McKelvey v. Commissioner*[1] and warned readers that if they relied on the decision they could be falling into a terrible trap. We hope our readers decided to wait to see how the appeal of the case turned out before doing a transaction similar to the one Mr. McKelvey entered into. As we expected, the Second Circuit recently reversed the Tax Court decision.[2] In effect, the Second Circuit has sprung the trap that the Tax Court set up.

The Underlying Transaction

The Original Contracts. McKelvey entered into variable pre-paid forward contracts (VPPFs) with both Bank of America (B of A) and Morgan Stanley (MS) with respect to Monster Worldwide, Inc. (Monster). McKelvey, the founder of Monster, owned a considerable amount of Monster stock with zero basis. The combined VPPFs covered approximately 6.5 million shares. At the

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1 148 TC 312 (2017). See Mark Fichtenbaum & Robert Gordon, "*Estate of McKelvey v. Commissioner*—Tax Planning Opportunity or a Trap for the Unwary?" 34(4) J. Tax'n Invs. 25 (Summer 2017).

2 906 F3d 26 (2d Cir. 2018).

time the contracts were entered into, Monster was trading at approximately $33 per share. The VPPFs were for approximately one year. The amount of shares that were to be delivered under both contracts varied depending on the price of Monster on the delivery dates. The contracts used similar formulas to determine the number of shares to be delivered. The floor and cap on the B of A contract were $30.46 and $40.58, and on the MS contract were $30.89 and $35.77. Based on a price of $33 (which is approximate), the B of A VPPF had a floor at 92 percent of the market price and a ceiling at 123 percent of the market price, while the MS VPPF had a 93.6 percent floor and a 108.4 percent ceiling. At the time the contracts were entered into, McKelvey received approximately $193.5 million from the two investment banks.

McKelvey's reason for entering into the contracts was to protect against a decline in the price of Monster. McKelvey was fully protected against a stock price decline below $30.46 under the B of A contract, and he was protected against a decline below $30.89 on the MS contract. However, the protection only lasted while the contracts were in existence. Once the contracts came due, and were settled, there would be no further protection of the Monster shares if McKelvey continued to hold them.

The Contract Extensions. Prior to the expiration of the original VPPFs, McKelvey asked the banks to extend the contracts for two years, so he could continue to hold the shares and remain protected from further price declines, retaining the original level of protection. If McKelvey had closed the VPPFs when they came due, that would have triggered a short-term capital gain based upon the difference between what he originally received when he entered into the contracts and the amount he later paid to close the contracts. Even more important, if he wanted to continue to hold the shares and be protected against further price declines, he would have had to enter into new VPPFs with percentage bands similar to those of the original contracts, but based on the then-current price. At the time the extensions were requested, Monster had substantially decreased in value.[3] In order to get the extensions McKelvey paid the banks approximately $11.6 million in total.

Arguments and Conclusions of Law: Gain on the Old Contracts

The IRS's Position. The IRS contended that the extensions were in reality extinguishments of the original VPPFs and the entering into new VPPFs. As such, the IRS claimed that McKelvey recognized approximately $88 million

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

of short-term capital gain from the extinguishment of the old contracts and \$113 million of long-term capital gain from the constructive sale of the shares due to the establishment of the new contracts (i.e., the trap).

The Tax Court's Analysis Based on Section 1001. The Tax Court analyzed the case solely on the basis of Internal Revenue Code Section 1001, to determine whether a taxable event had occurred. The Tax Court held that, since McKelvey did not own property but rather only had obligations, the modifications of his obligations did not trigger taxable events under Section 1001. Interestingly, the Second Circuit actually agreed with the Tax Court on this point.

The Second Circuit's Further Holding Based on Section 1234A. However, the Second Circuit decided that Section 1234A did apply to the transactions, and that it created taxable events. Section 1234A states that gain attributable to the cancellation or other termination of a right or obligation with respect to property that is a capital asset in the hands of the taxpayer, shall be treated as gain from the sale of a capital asset. Both parties agreed that a fundamental change in a contract should be treated as an extinguishment of the old contract. The court ruled that the amended contracts replaced the original contracts. The old contracts were about to expire and the extensions of 16–17 months were fundamental changes to the economic positions of the parties under the contracts. The circuit court stated that the new valuation dates in the amended contracts resulted in new contracts, in the same way that new expiration dates for option contracts result in new option contracts. This analogy is perfect because in reality a VPPF has option contracts imbedded in it. The fact that McKelvey had to pay \$11 million to get the extensions showed that the modifications to the contracts were not insignificant. Therefore, the extensions extinguished the old contracts and created new contracts. The extinguishments of the old contracts resulted in short-term gains being recognized.

Effect of New Contracts on the Underlying Shares

When a taxpayer owns an appreciated financial asset and enters into a transaction that eliminates substantially all opportunity for gain and risk of loss from the asset, the taxpayer is deemed to have constructively sold the asset.[4] One such transaction would be entering into a forward contract to sell a substantially fixed amount of property at a substantially fixed price. In this case, under the terms of the original contracts and the price of Monster when the contracts were first entered into, the Commissioner agreed with the taxpayer

[4] IRC § 1259.

that no constructive sale had occurred. But at the time of the establishment of the new contracts, the price of Monster was substantially lower than the floor in the VPPFs: 18.24 and 17.28. The new band percentages were 167 percent and 222 percent for B of A, and 179 percent and 207 percent for MS. The legislative history of Section 1259 implies that the opportunity band must be 15 percent or more *and* include the current market price to avoid constructive sale treatment.[5]

In order for the amount of Monster stock to be delivered under the contracts not to be substantially all of the shares, the price of Monster would have had to increase a meaningful amount above the floors. The court used the Black-Scholes model developed for pricing options to determine this likelihood.[6] Using this model the court concluded that there were 85.1 percent and 87.13 percent probabilities, respectively, that the price of the shares would remain below the floors for the B of A and MS contracts. The court decided that these probabilities were high enough to conclude that a constructive sale of the shares had occurred.

Practical Implications

Going forward, prospective hedgers should heed the legislative history of Section 1259 and not believe that the extension of a contract is not itself a taxable event.

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[5] S. Rep. No. 105-33, at 125–26 (1997).

[6] For a description of this pricing model, see Jean Folger, "Options Pricing: Black-Scholes Model" (Investopedia, n.d.), available at https://www.investopedia.com/university/options-pricing/black-scholes-model.asp.