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IRS Tries New Tactic After Loss in *McKelvey*

by Stephanie Cumings

The IRS is hoping an appeals court will entertain its new argument on whether extensions of variable prepaid forward contracts (VPFC) are taxable.

In an appellate brief to the Second Circuit, the IRS argues that the VPFC extensions should be treated as a taxable termination of the taxpayer's obligations under section 1234A. The appeal in *Estate of McKelvey v. Commissioner*, 148 T.C. No. 13 (2017), which centers on a $200 million gain that went untaxed, could have significant implications for modifications of non-debt instruments. The case has more than $40 million in potential income tax liability at stake.

During arguments before the Tax Court, the IRS contended that VPFC extensions executed by Monster.com founder Andrew McKelvey and two investment banks constituted a constructive sale under section 1259. The Tax Court disagreed and found that the extensions didn't constitute sales or exchanges of property under section 1001. The Tax Court concurred with McKelvey's estate and held that the extensions to the original VPFCs didn't close the original transactions and that open transaction treatment should be applied to the extensions as well. Therefore, the gain was not taxed because the VPFCs would have been stepped up to market value at the time of McKelvey's death.

> ***Leeds is doubtful that the argument under section 1234A will be more successful than the arguments the IRS previously advanced in the Tax Court.***

On appeal, the IRS claims that the Tax Court's approach to what's considered property under section 1001 is unprecedented. "The VPFCs imposed *bilateral* obligations to buy and sell stock at a future date, and our research has revealed no other case in which a court has ever held that a bilateral financial instrument ceased to be property to one party for purposes of [section] 1001 as soon as the other party has performed its obligations," the brief said. "The VPFCs were property to *both* parties at inception and should be treated as such until both parties have satisfied their obligations."

Even if the VPFCs aren't regarded as property by the court, the IRS contends that the extensions should still be taxable under sections 1234A and 61(a)(3) because they terminated the taxpayer's original obligations and replaced them with fundamentally different obligations. The IRS is also still arguing that the extensions were a constructive sale under section 1259.

Mark H. Leeds of Mayer Brown LLP told Tax Analysts he's doubtful that the argument under section 1234A will be more successful than the arguments the IRS previously advanced in the Tax Court. Leeds said the IRS's brief spends a lot of time analogizing the VPFCs to options. "Courts have uniformly held that any extension of an option is a material modification which results in a deemed exchange," he said.

Estate Slams IRS for 'Outlandish Rhetoric'

The taxpayer in *McKelvey* is urging the circuit court "not to be swayed by the Commissioner's outlandish rhetoric."

"The Commissioner's brief sets forth an unprincipled, rhetorical attack on the Tax Court's well-reasoned decision," the taxpayer wrote in its February 27 brief filed with the Second Circuit. In its own brief, the IRS said the Tax Court sanctioned an "abusive scheme" by allowing the taxpayer to sell $194 million in appreciated stock "without paying a dime of federal income tax."

Leeds said that if the Tax Court's decision is upheld, it would give taxpayers ample latitude to make changes to non-debt financial instruments without triggering a sale or exchange. He noted that there's a general dearth of authority on the tax consequences of modifying non-debt instruments.

The IRS said in its brief that if the decision isn't overturned, it would "encourage any taxpayer with unrealized stock gains to monetize those gains by entering into a VPFC, while deferring realization indefinitely by continually rolling over the VPFC and, upon death, avoiding taxation entirely by virtue of the stepped-up basis of the underlying stock." But the estate countered that this was "sky-is-falling rhetoric."

On appeal, the IRS contends that the Tax Court's definition of property under section 1001

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was too narrow, but Leeds said he thinks that's not the key issue. Leeds said that even if the VPFCs are obligations and not property, there still could have been a material modification with tax consequences, something he said the Tax Court seemed to ignore.

As for the IRS's new argument that even if the VPFCs aren't property, the extensions should still be a taxable event under sections 1234A and 61(a)(3), the estate didn't dispute that the circuit court could consider it, but said that it was "just as meritless as [the IRS's] arguments under section 1001 because the extensions did not terminate, or even lessen, Mr. McKelvey's obligations."

> ***Leeds said that if the Tax Court's decision is upheld, it would give taxpayers ample latitude to make changes to non-debt financial instruments without triggering a sale or exchange.***

Leeds said the taxpayer's brief seems to suggest that there's no case law that treats the extension of an option as a taxable event, but he added that that's not his understanding of the legal landscape. He pointed to *Reily v. Commissioner*, 53 T.C. 8 (1969), in which the Tax Court held that the extension of an option should be treated as a taxable exchange of the old option for the new option. The IRS quoted *Reily* in its brief, writing that the "time factor or limitation in an option is of the essence. It goes to the very nature of an option." ■

PTIN Fee Case Victor Decries Justice Department's Appeal

by William Hoffman

The Justice Department has decided to fight a court decision barring the IRS from charging for the issuance of preparer tax identification numbers, prompting the plaintiffs' attorney to accuse the Trump administration of hypocrisy.

The department's 84-page brief to the U.S. Court of Appeals for the District of Columbia Circuit in *Brittany Montrois v. United States*, Dkt. No. 17-5204 (D.C. Cir. 2018), filed February 21, argues — among other things — that the tax agency has the right to charge a fee because a PTIN is legally a "service or thing of value."

Montrois is the latest iteration of *Steele v. United States*, No. 1:14-cv-01523 (D.D.C. 2017), which resulted in the IRS suspending PTIN registration fees in June 2017, although the registration number continues to be required by law of every paid tax return preparer.

Allen Buckley, the plaintiffs' attorney, said he was disappointed with the government's decision to appeal. Buckley said he's written several letters to Treasury Secretary Steven Mnuchin asking the administration to drop the case. "They like to get positive press when it comes to cutting regulations, but it's a different story when it comes to getting money," Buckley said. "I think it's hypocritical."

There's a lot of money at stake. Institute for Justice attorney Dan Alban, who helped overturn the IRS's registered tax return preparer program in *Loving v. IRS*, 742 F.3d 1013 (D.C. Cir. 2014), earlier estimated that refunding fees to more than 1.3 million PTIN holders could cost the government between $275 million and $300 million.

> ***Alban said the Justice Department's appeal relies on circular reasoning.***

Buckley called the Justice Department's appeal a rehash of old arguments that will be answered again by the plaintiffs' attorneys in about a month. "I didn't see much in [the appeal] that we haven't already seen," he said.

Alban said the Justice Department's appeal relies on circular reasoning. "The IRS claims that

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