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780 Third Avenue
New York, NY 10017

TWENTY-FIRST
SECURITIES
CORPORATION

Phone: 212-418-6000
Fax: 212-418-6038
www.twenty-first.com

Tax Court Curiously Rules In Favor of PPVF "Extension"

In a highly unexpected result, in Estate of McKelvey v. Commissioner, the Tax Court 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, hedgers that are rolling-over a profitable PPVF need not realize their gain if they simply extend the maturity of their contract. Commenters have speculated that this decision could also delay the crystallization of profits on an option that one had sold.

In the case, Andrew McKelvey, the founder of Monster Worldwide Inc. entered into PPVFs with both Bank of America and Morgan Stanley with respect to approximately 4,938,000 shares of Monster during September 2007. The original maturity dates of the contracts were September 2008. Prior to their maturity, after Monster's share price had declined, McKelvey "extended" the expiration dates to January and February of 2010. The "floor" of the PPVF was now considerably above the market price.

The IRS contended that the extensions of the contracts created a taxable event under IRC Sec. 1001. The taxpayer contended that Sec. 1001 was inapplicable to the transaction because Sec. 1001 applies to gains realized from the disposition of property and that at the time of the modifications the PPVFs were liabilities, not property, that the taxpayer held.

The Court surprisingly agreed with the taxpayer. The Court reasoned that under a PPVF, the taxpayer only had an obligation under the contract once the taxpayer 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 would appear that the extension of time of any option that was sold would not be treated as giving rise to a taxable event. Once a taxpayer sells an option, the only thing left for them to do is to fulfill either an obligation to sell or 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.

When we first reported on the case in December of last year we thought the taxpayer's arguments were almost frivolous. Our advisors continue to think that the extension of a PPVF is a recognition event.

An even more curious part of the Tax Court's decision was the Court's indifference to the fact that at the time the PPVFs were extended, the option strike prices utilized would have violated the Constructive Sale Rules and triggered gain under Sec. 1259. The Court denied this argument made by the government as well. This could be useful to those rolling over “deep in-the-money” calls as well as those rolling over PPVFs. But should one be wrong on this point, the constructive sale rules would create a sale upon the PPVF extension.

The IRS has not announced whether they plan to appeal the decision but we wouldn’t be surprised if they did.

Stay tuned.