

Tax court rules the extension of variable prepaid forward contracts is not a taxable event

On April 19, 2017, the United States Tax Court, in *Estate of Andrew J. McKelvey v. Commissioner* (“*McKelvey*”),¹ held that the extension of certain variable prepaid forward contracts (“VPFC”) did not result in a sale or exchange of property under IRC section 1001 and that the open transaction treatment provided to VPFCs in Revenue Ruling 2003-7² continues until the transactions are closed through the future delivery of the stock underlying the VPFC, or the cash equivalent. Additionally, the Court held that the extension of the VPFCs did not give rise to a constructive sale under IRC section 1259.

Background

Andrew J. McKelvey (“Taxpayer”) entered into two VPFCs with separate investment banks referencing shares of appreciated stock held by Taxpayer. Under the terms of each contract, Taxpayer received an upfront cash payment in exchange for a legal obligation to deliver a variable number of shares, or cash of equal value, approximately one year later. The number of shares to be delivered under each contract varied depending on the fair market value of the stock on the settlement date. To secure Taxpayer’s obligation, Taxpayer pledged as collateral the maximum number of shares that could be required to be delivered under each contract.

Prior to the scheduled maturity of each VPFC, Taxpayer made a payment to each investment bank to extend the maturity date of each contract by approximately sixteen months. At the time of the extensions, the price of the stock underlying the VPFCs had decreased since the inception of the contracts. Thus, the cash received was greater than the fair market value of Taxpayer’s outstanding obligations. The Tax Court considered the effect of such extensions.

The VPFCs that are the subject of the *McKelvey* case are similar to the VPFC addressed in Rev. Rul. 2003-7³. In Rev. Rul. 2003-7, the IRS concluded that the VPFC in question, (i) was afforded open transaction treatment (i.e. the VPFC did not result in a current sale of the underlying shares), and (ii) did not result in a constructive sale under IRC section 1259.⁴ The Commissioner did not dispute that the conclusion reached in Rev. Rul. 2003-7 applied to the original terms of the VPFCs considered in *McKelvey*.

¹ 148 T.C. No. 13 (2017)

² Rev. Rul. 2003-7, 2003-1 C.B. 363.

³ Unlike the VPFC considered in *Anschutz v. Commissioner* (135 T.C. 78 (2010), *Aff’d* 664 F.3d 313 (10th Cir. 2011)), there was no securities lending arrangement with respect to the underlying stock in *McKelvey*.

⁴ The analysis in Rev. Rul. 2003-7 relies, in part, on the legislative history to IRC section 1259 which states, “A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery, or for cash settlement, of a substantially fixed amount of property and a substantially fixed price. Thus, a forward contract providing for delivery of property, such as shares of stock, the amount of which is subject to significant variation under the contract terms does not result in a constructive sale” (J.C.S.23-97, 105th Cong.).

Tax Court Analysis:

The Tax Court addressed two issues in the *McKelvey* case:

- I. Whether the extension of the VPFCs results in an exchange to which IRC section 1001 applies; and
- II. Whether the extension of the VPFCs results in a constructive sale of the underlying shares pursuant to IRC section 1259

Under IRC section 1001, gain or loss is realized upon a sale or exchange of property differing materially either in kind or in extent. In this regard, the Court focused its discussion on whether, at the time of the contract extensions, the VPFCs were “property” in Taxpayer’s hands. The Court ruled that at the time of the extensions, Taxpayer’s lone right had been satisfied and Taxpayer had outstanding only obligations. The Court thus determined the extensions did not constitute exchanges of property under IRC section 1001 with respect to Taxpayer.

The Court further concluded that the extension of the VPFCs did not result in a constructive sale based on the Court’s conclusion that there was no exchange under IRC section 1001. Therefore, the Court determined there was no need to retest the application of IRC section 1259 to the VPFCs.

Observations:

The Court does not address the materiality of the modifications of the VPFCs, which has long been an area of uncertainty for non-debt financial instruments. In this regard, the IRS included the modification of non-debt financial instruments under IRC section 1001 in its 2016-2017 priority guidance plan.

Further, taxpayers may want to consider what the Tax Court’s conclusion in *McKelvey* means for the modification of other non-debt obligations, such as written options.

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