KPMG

TaxNewsFlash

United States

No. 2018-393
September 26, 2018

Second Circuit: Taxable gain from modified variable prepaid forward contracts

The U.S. Court of Appeals for the Second Circuit today issued a decision that reversed and remanded a case in which the U.S. Tax Court had found for the taxpayer on all issues concerning the treatment of variable prepaid forward contracts (VPFCs) that were modified.

The case is: *Estate of McKelvey v. Commissioner*, No, 17-2554 (2d Cir. September 26, 2018). Read the Second Circuit's **decision** [PDF 302 KB] that includes a concurring opinion.

Background

The taxpayer (now deceased) was the founder and principal shareholder of a publicly traded company.

The taxpayer entered into VPFCs with two investment banks in September 2007. The taxpayer received about $194 million and pledged about 6.5 million shares (having a value of about $218 million). The taxpayer agreed to deliver, one year later, between about 5.4 million and 6.5 million shares (then worth about $181 million and $218 million, respectively). The taxpayer treated the execution of the original VPFCs as open transactions under Rev. Rul. 2003-7.

Ten months later in 2008, the taxpayer paid about $11.7 million to execute amended contracts that extended the settlement dates and the valuation dates that would determine the number of shares to be delivered at settlement.

The taxpayer died in late November 2008. The estate settled the amended contracts by delivering over 6.5 million shares (which the IRS determined had a value of about $88 million) to the investment banks. The taxpayer did not report any gain or loss on the execution of the VPFC extensions, continuing the open transaction treatment, and

neither the taxpayer nor the estate paid any income taxes with respect to the shares subject to the VPFCs.

IRS deficiency determination

The IRS determined that the taxpayer's estate owed $41 million in taxes for 2008.

The IRS found that the taxpayer realized a capital gain of more than $200 million when he executed the VPFC extensions in 2008—based on what the IRS alleged were short-term and long-term capital gains arising from the execution of new contracts extending the valuation dates of two VPFCs.

The IRS asserted that the VPFC extensions were sales or exchanges of the VPFCs under section 1001, and that the taxpayer ought to have reported gain in 2008 from the extensions, and the VPFC extensions resulted in constructive sales of the shares under section 1259.

Tax Court's findings

The Tax Court held that because the taxpayer had only obligations under the VPFCs to deliver shares of stock, the VPFCs were not property under section 1001, making section 1001 inapplicable to the extensions.

Furthermore, the Tax Court concluded that because the extensions did not alter the original reasons for open transaction treatment under Rev. Rul. 2003-7—the tax consequences of settling the VPFCs could not be determined until settlement because the taxpayer's VPFCs obligations could be satisfied by delivering the cash equivalent of the quantity of shares required to be delivered or, if he physically settled, the basis and holding period of the particular shares delivered at settlement would not be fixed until delivered—the open transaction treatment continued until the transactions were closed by the future delivery of stock or cash.

The Tax Court further held that the taxpayer VPFC extensions were not constructive sales of the stock in 2008 under section 1259.

Second Circuit's decision

The Second Circuit today reversed the Tax Court and remanded the case to the Tax Court.

The Second Circuit agreed with the Tax Court that the taxpayer did not incur a short-term capital gain on the basis of the IRS claim that replacement of the VPFCs with the amended contracts was an exchange of property under section 1001(c).

The Second Circuit, however, agreed with the IRS that the extension of the valuation dates resulted in new contracts that replaced the original contracts. Extending the valuation dates was a fundamental change. The appeals court remanded the case to

the Tax Court to determine whether the replacement of the obligations in the original VPFCs with the new contracts satisfied the criteria for a termination of obligations that gives rise to taxable income (presumably capital gains) and the amount of such gain were issues for the Tax Court to determine on remand.

Turning to the constructive sale issue and the issue of the amount of long-term capital gain, the Second Circuit acknowledged that probability analysis may be used to determine whether the number of shares to be delivered under the new contracts were substantially fixed for purposes of section 1259. In general, entering into a contract to deliver a substantially fixed amount of property at a substantially fixed price generally is a constructive sale of an appreciated financial position under section 1259. The appeals court said that the percentages (~85 and ~87) of probability for zero variation in the number of shares to be delivered under the new contracts were sufficiently high (or stated another way the probabilities that the share price would appreciate above the floor prices on the new valuation dates were sufficiently low) to conclude that the number of shares to be delivered under the contracts were substantially fixed. The Second Circuit held that the new VPFCs were constructive sales and remanded to the Tax Court the calculation of the amount of long-term capital gains resulting from the constructive sales.

In a concurring opinion, Judge Cabranes wrote that he agreed with the Second Circuit's conclusion that the taxpayer (as issuer of the "nondebt financial instruments") did not exchange property when he modified his contracts with the banks because he held no property interests under the contracts at the time of modification. Judge Cabranes stressed that this conclusion does not affect the existing application of Reg. section 1.1001-3 to holders and issuers of "debt instruments" and that these principles apply to both the holder-obligee and the issuer-obligor of the instrument. Reference was made to Rev. Rul. 2004-37 (applying the principles of Reg. section 1.1001-3 to require the issuer of a recourse note to recognize gain resulting from the modification of the note).