Second Circuit Backs IRS View on Changes to Forward Contracts

Posted on Sep. 27, 2018

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The estate of Monster.com founder Andrew McKelvey suffered a monster loss after an appeals court held that changes to variable prepaid forward contracts (VPFCs) were taxable events.

“The outcome couldn’t be more grim for the McKelvey family,” Mark H. Leeds of Mayer Brown LLP told *Tax Notes*.

The September 26 opinion by the U.S. Court of Appeals for the Second Circuit reversed a 2017 Tax Court decision that an extension of two variable prepaid forward contracts held by McKelvey didn’t give rise to taxable exchanges under section 1001 or constructive sales under section 1259.

The case has more than $40 million in potential income tax liability at stake.

The three-judge panel agreed with the IRS’s argument that by paying $11 million to extend the valuation dates, McKelvey made material changes to the VPFCs such that his obligations under the original contracts were terminated and new obligations were entered into. The termination of those obligations constituted a taxable event under section 1234A.

The panel also agreed with the IRS that the number of shares to be delivered at settlement was “substantially fixed” within the meaning of section 1259(d)(1) on the date of each new contract, resulting in a long?term capital gain on shares constructively sold. In holding that the extensions constituted a constructive sale, the panel concluded it was appropriate to rely on the probability analysis conducted by the IRS’s expert.

The expert had found there was a probability of 85 percent under the amended Bank of America contract and an 87 percent probability under the amended Morgan Stanley contract that the closing price would be below the floor price on the settlement date.

Those probabilities were sufficiently high to show that the low share price at the execution of each amended contract rendered the amount of shares to be delivered at settlement “substantially fixed,” the panel said.

The matter was remanded to the Tax Court to calculate the short-term taxable gain from the execution of the new contract and the long-term capital gain from the constructive sale of the shares.

Consistent With Existing Authority

While the panel's decision was less taxpayer-favorable than the Tax Court's, it was nevertheless "much more consistent with existing authorities in helping us determine when a modification of a non-debt financial instrument results in a sale or exchange," Leeds said.

The panel's conclusion that VPFCs weren't assets in the hands of McKelvey after they were prepaid was "absolutely the right answer," he added.

"That issue resonates through a lot of different code sections, and derivatives have the capability of flipping between having positive value and negative value," Leeds said. "This decision validates the IRS's position that derivatives with negative values should be treated as obligations and not as assets."

The panel's discussion on the appropriateness of using a probability analysis was also helpful because the question comes up in several areas in the financial products arena, Leeds said.

"I wouldn't be surprised if, over time, people say that if something has an 85 percent probability of happening, then this decision supports the conclusion that it should be treated as sufficiently certain to cause you to worry," Leeds said.

The case is *Estate of Andrew J. McKelvey v. Commissioner*, No. 17-2554 (2nd Cir. 2018). The estate is represented by Mark D. Lanpher, Kristen M. Garry and Robert A. Rudnick of Shearman & Sterling LLP.