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Tax Court: Tax treatment of variable prepaid forward contracts (VPFCs) that were modified

The U.S. Tax Court today released an opinion concerning the tax treatment of variable prepaid forward contracts (VPFCs), and concluded modifications made in 2008 to the VPFCs did not result in taxable exchanges pursuant to section 1001.

The case is: *Estate of McKelvey v. Commissioner,* 148 T.C. No. 13 (April 19, 2017). Read text of the Tax Court's **opinion** [PDF 139 KB]

Summary

The taxpayer (now deceased) entered into VPFCs with two investment banks in 2007. Under the original VPFCs, the investment banks made upfront cash payments to the taxpayer, who was obligated to deliver variable quantities of shares of stock on specified future settlement dates in 2008 (original settlement dates). The taxpayer treated the execution of the original VPFCs as open transactions under Rev. Rul. 2003-7.

In 2008, before the original settlement dates, the taxpayer paid the investment banks to extend the settlement dates until 2010 (VPFC extensions). The taxpayer did not report any gain or loss on the execution of the VPFC extensions, continuing the open transaction treatment. The taxpayer died in 2008 after the execution of the VPFC extensions.

The IRS asserted that the VPFC extensions were sales or exchanges of the VPFCs under section 1001, concluded that the taxpayer should have reported gain in 2008 from the extensions, and determined a deficiency of over $41 million.

The Tax Court today noted that the only issue was whether the modifications made in 2008 to the VPFCs resulted in taxable exchanges under section 1001. The court concluded 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, 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), that open transaction treatment continued until the transactions were closed by the future delivery of stock or cash. The court further held that the taxpayer did not engage in constructive sales of stock in 2008 under section 1259.