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TaxNewsFlash

United States

No. 2023-391
November 2, 2023

U.S. Tax Court: Exchange of variable prepaid forward contracts (VPFCs) taxable under section 1234A as short-term capital gain

The U.S. Tax Court today held that an exchange of one set of variable prepaid forward contracts (VPFCs) for a second set of VPFCs resulted in the termination of the taxpayer's underlying obligations with respect to the first set of VPFCs for purposes of section 1234A, resulting in the recognition of short-term capital gain.

The case is: *Estate of McKelvey v. Commissioner*, 161 T.C. No. 9 (November 2, 2023). Read text of the Tax Court's opinion [PDF 209 KB]

Background

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. 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. 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 in *Estate of McKelvey v. Commissioner*, 148 T.C. 312 (2017), 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, 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.

The Second Circuit reversed the Tax Court's decision in *Estate of McKelvey v. Commissioner* (*Estate of McKelvey II*), 906 F.3d 26 (2d Cir. 2018). Although the Second Circuit agreed with the Tax Court that the replacement of the VPFCs with the amended contracts was not an exchange of property under section 1001(c), it concluded that the extension of the valuation dates resulted in new contracts that replaced the original contracts, and such extension was a fundamental change. The Second Circuit remanded the case 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).

The Second Circuit also found that the replacement of the original VPFCs with the new VPFCs resulted in constructive sales of stock under section 1259 and remanded to the Tax Court the calculation of the amount of long-term capital gains resulting from the constructive sales. The parties subsequently stipulated the amount of such long-term capital gains.

Tax Court decision

The Tax Court today held that the exchange of the original set of VPFCs for the amended set of VPFCs resulted in the termination of the taxpayer's underlying obligations with respect to the first set of VPFCs for purposes of section 1234A, resulting in the recognition of $71,668,034 in short-term capital gain.

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