No. _______

IN THE

Supreme Court of the United States

ESTATE OF ANDREW J. MCKELVEY, DECEASED,
BRADFORD G. PETERS, EXECUTOR,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Over a century ago, this Court held that where Congress conditions a tax result on the promulgation of regulations, but no regulations have been issued, courts are powerless to fill the gap. *See Dunlap v. United States*, 173 U.S. 65 (1899). But for the past 35 years, due to a widespread failure by the Treasury Department ("Treasury") to promulgate needed regulations, lower courts addressing tax cases have been engaging in what they and scholars call "phantom" regulation—making the rules that Congress commanded Treasury to make in order to reach substantive results that courts believe Congress intended. True to both the "phantom" moniker and the belief in tax law exceptionalism underlying the doctrine, neither lower courts nor Treasury have ever squared phantom regulation with this Court's precedent. Here, the Second Circuit expanded the doctrine in new and troubling ways, leaving Petitioner retroactively subject to tens of millions of dollars in taxes as to which no statute or regulation provided fair notice. The question thus presented is:

Whether, or under what circumstances, the Judiciary may enforce an ambiguous provision of the Internal Revenue Code by filling a statutory gap, when Congress delegated gap-filling responsibility to Treasury but Treasury has failed to promulgate required regulations.

PARTIES TO THE PROCEEDING AND RULE 29.6 STATEMENT

Petitioner is the Estate of Andrew J. McKelvey, who is deceased, through Bradford G. Peters, the Estate's executor.

Respondent is the Commissioner of Internal Revenue.

Because the Petitioner is not a corporation, a corporate disclosure statement is not required under Supreme Court Rule 29.6.

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JURISDICTION

The Second Circuit entered its opinion on September 26, 2018. App.1a. On December 10, 2018, it denied a timely rehearing petition. App.71a-72a. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 1259 of the Internal Revenue Code, 26 U.S.C. § 1259, which is reprinted at App.73a-79a.

STATEMENT OF THE CASE

I. The Constructive Sale Statute And Treasury's Failure To Promulgate Necessary Regulations

Congress enacted the "constructive sale" statute in 1997, responding to the growth in novel transactions as to which tax law did not have clearly established rules. App.80a-84a (S. Rep. No. 105-33, 105th Cong. 1st Sess. (1997) (Senate Finance Committee Report discussing the constructive sale statute's genesis)). The constructive sale statute, codified at 26 U.S.C. § 1259, identifies four types of contracts that can trigger "recognition" of gain for income tax purposes even though they do not possess the traditional qualities necessary for "realization" of gain (*e.g.*, selling, exchanging, or otherwise disposing of an asset).

Relevant here are sections 1259(c)(1)(C) and 1259(d)(1), which apply to "forward contracts." Forward contracts typically require the future delivery of a fixed amount of property for a fixed price as set forth in the contract. However, some forward contracts can be variable, as these sections recognize. These sections treat a taxpayer as having constructively sold appreciated stock, requiring a taxpayer to recognize gain, if the taxpayer enters into the following type of forward contract with respect to such stock: "[A] contract to deliver a *substantially fixed* amount of property (including cash) for a substantially fixed price." App.76a (§ 1259(d)(1) (emphasis added)). If a taxpayer enters into such a contract, the taxpayer will be required to *recognize* gain on stock, even before the gain on such stock is *realized* through an actual sale.

Congress did not define what it means for an amount of potentially deliverable property to be "substantially fixed." Congress did not indicate how broad a range in the amount of potentially deliverable property would be enough to remove a given forward contract from section 1259's ambit. Nor did Congress indicate whether, under some circumstances, the variation in potentially deliverable property in a forward contract should be disregarded based on factors impacting the likelihood that any specific amount of property would be delivered.

Instead, Congress directed Treasury to fill in these gaps (and define "substantially" more generally in the constructive sale statute). In section 1259(f), Congress said "[t]he Secretary *shall prescribe* such regulations as may be *necessary or appropriate* to carry out the purposes of this section." App.78a (§ 1259(f) (emphasis added)).[1] In addition, Congress gave Treasury separate discretionary authorization to promulgate regulations to treat taxpayers as having made a constructive sale to the extent that a taxpayer "enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as" one of the listed categories of transactions. App.75a (§ 1259(c)(1)(E)). Given the essential nature of "substantially fixed" to the definition of "forward contracts" under section 1259(c)(1)(C) and 1259(d)(1) (and the critical role "substantially" plays in the statute generally), regulations clarifying the meaning of "substantially" were both "necessary [and] appropriate to carry out the purposes of" section 1259. *See* App.78a (§ 1259(f)); *see, e.g.*, David M. Schizer, *Hedging Under Section 1259*, TAX NOTES, Jul. 20, 1998, p. 352 ("Although central to the statute's meaning, the word 'substantial' is imprecise—a fundamental ambiguity in the regime, at least until clarified in regulations.").

Many who weighed in on the meaning of "substantially fixed," and the need for regulations to implement the constructive sale statute generally, did not envy Treasury's task. Indeed, one commentator—until recently the Acting Chief

[1] This specific delegation is in addition to the general authorization to Treasury to "prescribe all needful rules and regulations for the enforcement" of any Code provision. *See* 26 U.S.C. § 7805(a).

Counsel of the Internal Revenue Service ("IRS")—called it "daunting" given the complex considerations involved. William M. Paul, *Constructive Sales Under New Section 1259*, TAX ANALYSTS (Sept. 15, 1997) at 1472.

Nevertheless, the legislative history expanded on Congress's expectations for forthcoming regulations. The relevant report from the Senate Committee on Finance (the "Senate Report" or the "Report") stated that a contract "providing for delivery of an amount of property, such as shares of stock, that is subject to significant variation under the contract terms does *not* result in a constructive sale," precisely because the amount of property to be delivered would not be "substantially fixed." App.89a (emphasis added). And the Senate Report identified "many of the factors" Treasury could take into account to clarify the sort of transactions that could constitute constructive sales under regulations. *See* App.92a.

The Senate Report gave multiple examples. In one example, the Report described a collar transaction where a taxpayer simultaneously sells a call option at $110 per share and buys a put option at $95 per share, effectively transferring the rights to all gain above $110 and all loss below $95. *See* App.91a. In another example, the Report described a taxpayer that enters into an "in-the-money" option, such as a taxpayer who purchases a put option with a strike price at $120 while the stock is trading at $100. App.92a. In each of these examples, the Senate Report did not take a position on whether that amount of uncertainty rendered the transactions constructive sales—it simply illustrated all of the economic factors Treasury could consider in promulgating regulations, including the duration of the contracts, the volatility of the stock, and the range in potentially deliverable property or price. App.91a-92a. Recognizing the inherent economic complexity in identifying when such transactions constitute constructive sales, the Senate Report suggested that regulations should be "applied prospectively, except in cases to prevent abuse." App.91a.[2]

It has been more than twenty years since the constructive sale statute was enacted. Notwithstanding Congress's statutorily expressed command to regulate, Treasury has never done so.

II. Andrew McKelvey's Contracts

In 2007, taxpayer Andrew McKelvey, the founder of Monster Worldwide, Inc. ("Monster"), entered into two variable prepaid forward contracts ("VPFCs"). Under their terms, McKelvey received approximately $194 million in exchange for his promise to deliver somewhere between approximately 5.4 and 6.5 million Monster stock shares (or cash), on future settlement dates.[3] The precise "amount of property" to be delivered depended on the stock price at those future dates. The stock was trading at approximately $32 per

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[2] Treasury possesses the extraordinary authority to punish tax abuse via retroactive regulation. *See* 26 U.S.C. § 7805(b)(3).

[3] Each contract possessed slightly different terms, and they were entered into on slightly different dates. Petitioner uses approximate and aggregated amounts and dates here for simplicity, as the differences do not impact the question presented.

share when he entered the VPFCs. At settlement, if the stock was trading at approximately $40 or above, he would be required to deliver 5.4 million shares. If the stock was trading at approximately $30 or below, he would be required to deliver 6.5 million shares. If the stock was trading somewhere in between, the amount to be delivered would be calculated based on contractually-specified formulae.

McKelvey entered into his VPFCs to gain immediate access to cash without having to sell stock and while hedging the risk that Monster stock price would decline. In that regard, a VPFC is similar to a combination of the collar transaction and the in-the-money put option described in section 1259's legislative history, and is also similar to other run-of-the-mill contracts that allow taxpayers to borrow money against the value of assets they own without selling them, such as home equity loans and reverse mortgages.

There is no dispute that McKelvey's VPFCs were not constructive sales under section 1259 when he entered them—they were not contracts to deliver a "substantially fixed" amount of property.[4] App.14a

[4] There is also no dispute that, as the Tax Court explained, entering into the VPFCs did not cause McKelvey to realize gain under traditional tax principles. App.60a-61a. When parties enter into a VPFC, the parties know the amount of the prepayment the stockholder receives, but they do not know: (1) how much stock or cash they will be required to deliver at settlement; (2) whether the stockholder will choose to deliver stock or cash; or (3) if stock is in fact delivered, the basis of any shares delivered. App.60a-61a. As all such information is needed to calculate the amount and nature of any gain or loss realized from the transaction, the transaction is considered

("The Commissioner had previously acknowledged that VPFCs did not incur capital gains when executed"). Because McKelvey could ultimately be required to deliver anywhere from 5.4 to 6.5 million shares of stock, which would depend on where the stock was trading a year later, there was "significant variation under the contract terms." App.89a. And although no regulation ever explained the statute's implementation, the IRS had issued a Revenue Ruling recognizing that a VPFC with comparable terms was not a constructive sale under section 1259. *See* Rev. Rul. 2003-7, 2003-1 C.B. 363.

In the 11 months after entering his VPFCs, McKelvey witnessed Monster's stock price drop from approximately $32 per share to approximately $17 per share. While a dramatic drop, this shift was typical of the volatility occurring throughout the stock market in 2008. *See* Kiran Manda, *Stock Market Volatility during the 2008 Financial Crisis*, at 2 (April 1, 2010), http://web-docs.stern.nyu.edu/glucksman/docs/Manda2010.pdf (observing that "the S&P 500 lost about 56% of its value from the October 2007 peak to the March 2009 trough.").

With this volatility and the dip in Monster stock's value, McKelvey faced a choice: *either* deliver in one month's time what would likely be 6.5 million shares, the maximum number of shares he could be required to deliver under his VPFCs, *or*, extend his delivery obligations, giving his Monster shares time to recover the value they lost, in the hope that he

"open," and no gain or loss is realized, until the transaction is settled, or "closed." App.62a-64a.

would be required to deliver only 5.4 million shares. Given the historic volatility Monster had witnessed, such a turnaround was certainly possible.

McKelvey chose to extend his VPFCs' respective delivery dates, each by about 17 months. McKelvey paid approximately $11 million in aggregate to his counterparties in consideration for these extensions.[5] There was no change, however, to the formulae by which he would be required to determine the amount of property to be delivered, or to the potential variation set forth by the terms of the contracts (the range was still between 5.4 and 6.5 million shares).

McKelvey died a few months after his extensions. At his death, McKelvey still had not settled his VPFC obligations. Accordingly, both McKelvey's VPFC obligations and his Monster shares passed on to Petitioner, his Estate. Petitioner settled the VPFC obligations by delivering shares to McKelvey's counterparties.

III. The Tax Court Decision

The IRS issued a deficiency notice against Petitioner claiming that McKelvey had realized short-term capital gain, and was required to recognize long-term capital gain upon extending his VPFCs. Specifically, the IRS claimed that McKelvey realized short-term capital gain because extending his VPFCs constituted an exchange of property (the

[5] Although the Second Circuit suggested this amount was significant, App.19a, it amounted to only approximately 5% of the prepayment amounts he had received as part of the transactions.

"original" VPFCs) for materially different property ("new," extended VPFCs) under 26 U.S.C. § 1001. And the IRS claimed that McKelvey was required to recognize long-term capital gain because his "new" VPFCs were constructive sales (even though his "original" VFPCs were not).

The IRS argued that the "new" VPFCs were constructive sales because, even though the potential variability in the amount of property to be delivered was unchanged from the "original" VPFCs, the drop in stock price had made it more likely that McKelvey would be required to deliver 6.5 million shares. Particularly, the IRS argued that, based on a probability analysis by its expert witness, the likelihood that Monster stock would rise above the VPFC's floor price by the settlement date (the floor price being the threshold necessary to cause McKelvey to owe fewer than the maximum number of shares) was only about 15%. The IRS argued that this probability rendered the amount of property to be delivered under the "new" VPFCs "substantially fixed," even though the range of variation in potentially-deliverable property (i.e., between 5.4 and 6.5 million shares) remained the same as it had been under the "original" VPFCs.

In the Tax Court, Petitioner argued first that the VPFC extensions did not constitute an "exchange of property" given that he had only obligations under the VPFCs (and thus no property rights) at the time of the extensions. Accordingly, there were no "new" VPFCs to analyze under the constructive sale statute. Second, Petitioner argued that even if there were "new" VPFCs, they would not be constructive sales given, among other things, the lack of regulations explaining when, whether, or how one should use shifts in market dynamics to conclude that the amount of property to be delivered under a given contract was "substantially fixed."

Petitioner argued that, absent regulations, the court could only construe section 1259's plain language. This required the court to treat as not "substantially fixed" any amount of property that remained subject to a real possibility of significant variation. Here, given that (1) the amount of property due under the "original" VPFCs had the same contractually stated variability as the amount of property due under the "new" VPFCs, and (2) the IRS conceded that the original amount of property due was not "substantially fixed," Petitioner claimed that the amount of property due under the "new" VPFCs could not be deemed "substantially fixed" either. Indeed, given the very real possibility that, in the next 17 months, Monster stock would recover by the same amount it had just dropped in the preceding 11 months, no one knew whether McKelvey would ultimately need to deliver the minimum number of shares, the maximum number of shares, or some number in between.

The Tax Court rejected the Commissioner's threshold argument—that McKelvey's extensions constituted a property exchange—obviating any need for the Tax Court to decide the constructive sale question. *See* App.67a-68a.

IV. The Second Circuit Decision

The Second Circuit reversed the Tax Court. The Second Circuit held:

1. McKelvey was required to treat his obligations under his "original" VPFCs as replaced with new obligations for tax purposes, because the extended settlement dates rendered the "new" VPFCs fundamentally different from the "original" VPFCs;[6] and

2. The "new" VPFCs were constructive sales of the underlying stock under section 1259, because a "probability analysis" demonstrated that the odds of delivering fewer than the maximum number of potentially deliverable shares was "sufficiently low," and, thus, the amount of property to be delivered should be deemed "substantially fixed."

See App.19a, 28a-29a. Accordingly, McKelvey's Estate, the Petitioner, is now retroactively subject to tens of millions of dollars in taxes. The precise amount will be determined in Tax Court.

The Second Circuit admitted that its holding that the "new" VPFCs were constructive sales relied on a probability analysis that "is neither explicitly authorized nor prohibited by any relevant statute." App.26a. Indeed, it had to do so. Petitioner had explained that the Commissioner's position "asks [the Second Circuit] to apply an unspecified economic test to draw lines that neither Treasury nor the IRS has ever seen fit to draw." Pet'r Br. 49.

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[6] The Second Circuit remanded any tax consequences following from this holding to the Tax Court, so it is not being challenged here. *See* App.19a-20a.

The Second Circuit similarly recognized that its holding was not based on any regulation, while also understating the significance of this admission. The Second Circuit stated that Congress merely "authorized" Treasury to promulgate regulations "to implement the constructive sale statute," App.26a, even though Petitioner had explained that "Congress[] *mandate[d]*" regulations. *See* Pet'r Br. 51-52 (emphasis added); *see also* § 1259(f) ("The Secretary *shall prescribe* such regulations . . . .") (emphasis added). The Second Circuit recognized that "the relevant Senate Report contemplated that the Treasury Department would" promulgate regulations, and that "no such regulations have been issued." App.26a. "Nevertheless," the Second Circuit explained that it was "persuaded to" employ probability analysis in the "context" of VPFCs to determine whether the amount of potentially deliverable property due under the contracts was "substantially fixed." *See* App.26a. It did so because it believed "[t]he Internal Revenue Code should not be readily construed to permit" a contrary result. *See* App.28a.[7]

The Second Circuit implicitly recognized that the drawing of lines based on an extra-statutory

[7] The Second Circuit identified a Sixth Circuit decision where a probability analysis was employed to determine taxation: *Progressive Corp. & Subsidiaries v. United States*, 970 F.2d 188 (6th Cir. 1992). *See* App.24a-25a. But that case provided no support for the Second Circuit's approach. In that case, a regulation had been promulgated. *See* 970 F.2d at 191-192. Here, by contrast, the question is whether the Second Circuit could adopt its own probability analysis to interpret an ambiguous term where Congress had directed Treasury to make such determinations.

probability analysis would encroach on the expertise of other branches of Government, but ultimately concluded that such concerns were tolerable. In the Second Circuit's view, the percentage of likelihood that Monster stock would recover by the settlement of the "new" VPFCs was "sufficiently low" that "the low share price at execution of each amended contract rendered the amount of shares to be delivered at settlement 'substantially fixed.'" App.28a-29a. Put simply, the Second Circuit concluded that the "significant variation under the contract terms," (App.89a), which had been enough to preclude constructive sale treatment at inception, could now be disregarded due to the drop in stock price.

The Second Circuit provided no explanation as to why 15% was a "sufficiently low" likelihood such that a court should disregard the contracts' variability in the amount of deliverable property. Nor is there any explanation as to why the Second Circuit could ignore the possibility that, in the next 17 months, the stock price would recover the amount it had lost in the prior 11 months. Instead, the court simply attached the label "substantially fixed" to its conclusion. This back-of-the-envelope approach is a striking contrast to the view of those who commented on the "daunting" task facing *Treasury* in promulgating regulations. *See supra* p. 4.

More importantly, the Second Circuit evidenced no compunction about enforcing an ambiguous provision of the Internal Revenue Code by filling a gap that Congress reserved for Treasury. Petitioner made this error the thrust of its rehearing or reconsideration petition, but the Second Circuit summarily denied the petition. App.71a-72a. The Second Circuit's decision bespeaks the widespread lower-court phenomenon in tax law of "phantom" regulation.

REASONS FOR GRANTING THE PETITION

This Petition presents an ideal opportunity for this Court to provide much needed guidance to lower courts on what to do when faced with tax provisions that depend on non-existent Treasury regulations. This is a recurring issue of substantial importance, as hundreds of Internal Revenue Code provisions are in need of implementing regulations. Lower courts have applied inconsistent and problematic approaches to address this problem, but have generally concluded that they are free to "phantom" regulate in Treasury's place. As set forth below, that not only creates a substantial fair notice problem—it is fundamentally inconsistent with this Court's precedent.

This case presents the appropriate vehicle for the Court to reaffirm its precedent and to clarify that the rules this Court applies when reviewing inaction of other administrative agencies apply equally when reviewing Treasury inaction. Such a ruling may or may not prompt Treasury to do its job. But, at the very least, it would provide much needed certainty to tax law.

I. The Second Circuit's Decision Evidences A Widespread Need For Guidance In Tax Law: What To Do When Treasury Fails To Regulate?

Eight years ago, this Court explained that it is "not inclined to carve out an approach to administrative review good for tax law only." *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 55 (2011). But this case reveals that lower courts continue to resist a "uniform approach to judicial review" in tax cases. *Id.* Indeed, in an ironic incident of fate, the very same year that this Court issued *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), which informs the judicial review of much agency action, the Tax Court embarked on its own unique approach to judicial review of administrative *inaction* that continues unabated: "phantom" regulation.

"Phantom" regulation is a specific outgrowth of the fact that the Internal Revenue Code currently includes *hundreds* of provisions "requiring regulations to be issued to achieve a particular result." Phillip Gall, *Phantom Tax Regulations: The Curse of Spurned Delegations*, 56 TAX LAW 413, 414 (2003).[8] "In a great many of those cases," not only is

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[8] To list just a few examples aside from section 1259, Congress has explicitly directed Treasury to promulgate regulations in 26 U.S.C. § 1260 (mandating regulations with respect to constructive ownership of derivatives); 26 U.S.C. § 163(i)(5) (mandating regulations with respect to disallowance or deferral of certain interest deductions); 26 U.S.C. § 246A(f) (mandating regulations providing for the treatment of dividends in certain circumstances); 26 U.S.C. § 457A(e) (mandating regulations with respect to the impact on the deferral of income of potential forfeitures); and 26 U.S.C. § 1092(a)(2)(D) (mandating regulations with respect to straddles). Each section involves transactions or situations commonly encountered by sophisticated taxpayers. In each section, it is clear that Congress intended Treasury to make certain policy determinations and promulgate forward-looking regulations that would provide certainty, or at least guidance, to taxpayers.

there no promulgated regulation, "no regulation project has ever been announced." *Id.* Some of those spurned rulemaking commands would, if exercised, benefit taxpayers (such as issuing them a rebate or a credit); others would, if exercised, impose a tax.

The Tax Court began phantom regulating in 1984, when it was confronted with a taxpayer who wanted a statutorily promised benefit that was conditioned on the promulgation of missing regulations. Instead of following this Court's decision in *Dunlap* (discussed *infra*), the Tax Court ruled not only as though the needed regulations had been promulgated, but as though the content of those regulations was known to the court. *See Occidental Petroleum Corp. & Subsidiaries v. Comm'r*, 82 T.C. 819, 829 (1984) (justifying such action because "the failure [of the Treasury Secretary] to promulgate the required regulations can hardly render the new provisions of section 58(h) inoperative. We must therefore do the best we can with these new provisions."). This approach was in direct contradiction to *Dunlap* and other key doctrines discussed *infra*, but neither the Tax Court—nor any Circuit Court—has ever grappled with the disconnect.

Now, as Petitioner's case reveals, phantom regulation is so "well established," *see Int'l Multifoods Corp. v. Commissioner*, 108 T.C. 579, 587

With respect to each section, Treasury has failed to do so. Nevertheless, Treasury continues to enforce such ambiguous provisions—essentially asking courts to employ a "we know it when we see it" approach to tax law.

(1997), that Treasury has turned its nonfeasance into a weapon. Uncertainty in the tax law is strategically preserved so that, even in the absence of any suggestion of taxpayer abuse, Treasury can issue deficiency notices premised on non-existent regulations and ask courts to fill in gaps that Treasury was commanded to fill, with the effect of retroactively imposing taxes.

Instead of squaring with this Court's precedent—that, in the absence of needed regulation, would render certain statutory provisions unenforceable as applied—the Tax Court has contrived its own "imprecise tests" to permit phantom regulation. *15 W. 17th St. LLC v. Comm'r*, 2016 U.S. Tax Ct. LEXIS 37, at *51 (2016) (Holmes J., concurring). They include:

> [T]he legislative-history approach, where we delve[] into extra-statutory sources to determine legislative intent. If we find in the entrails of committee reports, floor statements, and Blue Books what sort of regulations Congress wanted, then we say that the statute is self-executing. We have the equity approach, where we declare that a taxpayer-friendly statute must be self-executing in the name of fairness because the Secretary shouldn't be allowed to subvert the will of Congress by not issuing regulations. And we have the whether-how approach, where we try to figure out if Congress gave the Secretary the power to decide *whether* a result should occur or merely *how* that

> result should occur. Only if the answer is *how* will we deem the Code section at issue to self-execute (or, more precisely, come up with regulation-like rules ourselves).

Id. at *51-52 (internal quotation marks and citations omitted) (alterations in original) (emphasis in original).

In some cases, the Tax Court is explicit about the fact that it is making policy judgments in Treasury's place. *See, e.g.*, *First Chicago Corp. v. Comm'r*, 88 T.C. 663, 677 (1987) ("We do not relish doing the Secretary's work for him, but we have no other course to follow."). And, after making up the needed regulation, the court will explicitly give itself the deference this Court reserves for an agency's reasonable statutory constructions. *See id.* at 676 ("Had [the Secretary] promulgated a regulation providing for the same result that we reach here, that regulation would not be 'unreasonable' or 'plainly inconsistent with the revenue statute.'"). Yet the Tax Court's tests are as internally inconsistent as they are inconsistently applied. For example, despite the "whether-how" test discussed above, the Tax Court made no mention of that test in a case where the plain language of the Internal Revenue Code provision at issue expressly said that regulations would determine "*whether* income is described in [the section]." *Francisco v. Comm'r*, 119 T.C. 317, 322 (2002) (emphasis added) (citation omitted).

Several Circuits have encountered the phantom regulation phenomenon before this case, but only the Ninth Circuit appears to have expressly acknowledged the Tax Court's phantom regulation tests. *See Temsco Helicopters, Inc. v. United States*, 409 F. App'x 64, 67 (9th Cir. 2010). In that case, however, the Ninth Circuit found that "[t]he language of the statute and its legislative history do not establish that regulations are a precondition to applying" the provision at issue, rendering the propriety of phantom regulating a moot question. *See id.* The D.C. Circuit has identified this issue, but—as is often the case when the phantom regulation request works to a taxpayer's benefit—neither party raised it. *See Francisco v. Comm'r*, 370 F.3d 1228, 1230 n.1 (D.C. Cir. 2004). The D.C. Circuit therefore held it had "no occasion to pass upon" whether the court should "have held the statute incapable of application" due to the lack of promulgated regulations. *Id.* The Seventh Circuit has embraced phantom regulation, while simultaneously warning Treasury not to keep outsourcing its regulatory responsibilities to the Judiciary: "In a statute less clear on its face, failure to promulgate regulations as Congress orders could result in a provision not enforceable due to the Secretary's failure." *Pittway Corp. v. United States*, 102 F.3d 932, 936 (7th Cir. 1996). More recently, the Seventh Circuit expanded its warning—holding that "if the IRS's failure to promulgate documents which it was legally obligated to provide prejudices the taxpayer, this failure precludes application of the penalty" at issue. *Jefferson v. United States*, 546 F.3d 477, 484-85 (7th Cir. 2008). By contrast, the Fourth Circuit flatly rejected the application of phantom regulation, even though it arose in a case where the Tax Court applied phantom regulation to benefit taxpayers. *See Hillman v. I.R.S.*, 263 F.3d 338, 343 (4th Cir. 2001) ("this is an inequity in the United States Tax Code that only Congress or the Secretary (as the holder of delegated authority from Congress) has the authority to ameliorate").

Here, the Second Circuit has gone beyond these cases and embraced phantom regulation even where no taxpayer asked for it, where the court recognized regulations were expected to answer the precise question at issue, and where a taxpayer would be retroactively taxed.

The "considerable debate" over phantom regulation has been widely observed. *Principal Life Ins. Co. & Subsidiaries v. United States*, 95 Fed. Cl. 786, 801 n.34 (2010). Courts and scholars have detailed how phantom regulation evidences "yet another instance of tax law's wandering away from general principles of administrative law," one that is particularly hard to square with separation of powers principles. *15 W. 17th St. LLC*, 2016 U.S. Tax Ct. LEXIS at *49 (Holmes J., concurring); *see also* Amandeep S. Grewal, *Substance Over Form? Phantom Regulations and the Internal Revenue Code*, 7 HOUS. BUS. & TAX. L.J. 42, 60 (2006) ("courts and the IRS have likely underestimated the degree to which the use of 'phantom' regulations subverts Congress's desire to implement its policy objectives through the use of regulations developed pursuant to the notice and comment procedures in the Administrative Procedure Act ["APA"]."); Gall, *Phantom Tax Regulations: The Curse of Spurned Delegations*, 56 TAX LAW. at 448 ("Through the Secretary's failure to prescribe regulations, the authority delegated by Congress to the Secretary has essentially been re-delegated to the courts. The courts' willingness to accept that delegation from the Secretary arguably violates the constitutional principle [that delegated authority cannot be re-delegated]."). This brewing debate requires the guidance only this Court can provide.

II. The Varying Phantom Regulation Approaches That Lower Courts Have Developed To Address Treasury Inaction Are Divorced From This Court's Precedent

This Court's guidance is critical not only because lower courts are in need of a clear rule to confront Treasury's widespread nonfeasance—but, equally problematic, lower courts have *never* reconciled phantom regulation with this Court's precedent. Instead, lower courts addressing Treasury inaction act "in apparently blissful disregard for the APA" and the principles that underlie our Constitution's allocation of power. *15 W. 17th St. LLC*, 2016 U.S. Tax Ct. LEXIS at *52 (Holmes J., concurring).

At least three conflicts between phantom regulation and this Court's precedent are in need of redress:

First, phantom regulation is irreconcilable with this Court's holding in *Dunlap*;

Second, phantom regulation is irreconcilable with relevant limitations on Judicial power, including the separation of powers, the structural premises underlying *Chevron*, and the APA; and

Third, at least when applied to impose a tax, rather than a benefit, as was the case here, phantom regulation is irreconcilable with fair notice.

A. Filling In Gaps Delegated To Treasury Is Inconsistent With *Dunlap*

Not a single lower court has ever reconciled phantom regulation with *Dunlap*, the one case in which this Court addressed an analogous situation. Here, after the Second Circuit rejected Petitioner's argument against "this Court . . . apply[ing] an unspecified economic test to draw lines that neither Treasury nor the IRS has ever seen fit to draw," Pet'r Br. 49, Petitioner devoted its rehearing or reconsideration petition to explaining how the Second Circuit's decision raised a conflict with *Dunlap*. But like every other court before it, the Second Circuit blew past the problem.

In *Dunlap*, this Court addressed a Revenue Act provision that conditioned a tax rebate for the "use [of] alcohol in the arts, or in any medicinal or other like compound" on the taxpayer showing that his use complied with "regulations to be prescribed by the secretary of the treasury." 173 U.S. at 70 (internal citation omitted). "There were no regulations in respect to the use of alcohol in the arts at the time this alcohol was used[.]" *Id.* at 71. Nevertheless, the taxpayer argued that his "right to repayment was absolutely vested by the statute, dependent on the mere fact of actual use in the arts, and not on use in compliance with regulations[.]" *Id.* In other words, the taxpayer asked this Court to grant him the benefit prescribed in the statute, as though regulations had been promulgated and as though the Court knew their content.

This Court rejected the taxpayer's request. It held that the Revenue Act provision at issue "was conditioned on the performance of an executive act, and the absence of performance left the condition of the existence of the [rebate] unfulfilled." *Id.* at 71. "[C]ongress required that the thing itself," i.e., determining the conditions for which a taxpayer was eligible for a rebate, "should be done under official regulations," not judicial invention. *Id.* at 73.

Dunlap thus set forth a key principle that should dispel phantom regulation: "courts cannot perform executive duties, nor treat them as performed when they have been neglected." *Id.* at 72 (internal quotation marks and citation omitted). Rather than take on Treasury's role and craft regulations on the uses of alcohol to which the tax rebate should apply, the Court instead acknowledged "the intention of Congress to leave the entire matter to the Treasury Department to ascertain what would be needed[.]" *Id.* at 76; *see also id.* at 74 (observing that Congress left this question to "the exercise of a large discretion based on years of experience in the Treasury Department"). Despite phantom regulation being employed by lower courts for 35 years to address Treasury's nonfeasance, none of those courts have reconciled phantom regulation with *Dunlap.*

The Second Circuit decision here highlights the disconnect. The court was of course free to interpret "substantially fixed" in section 1259 to set forth certain outer bounds to what level of potential variation under the contract terms was sufficient, *e.g.*, whether it was enough that McKelvey could be required to deliver anywhere from 5.4 to 6.5 million shares of stock, or whether a broader range was required. But so long as the range was broad enough, which was undisputed here, and there was genuine uncertainty as to how much property within that range would ultimately delivered, which was also undisputed here, McKelvey's contracts could not possibly fall within the plain language of "substantially fixed." Once the Second Circuit determined that market vagaries should be consulted, contractually specified variation should be disregarded, and a "probability analysis" should be applied, it moved beyond the plain language of "substantially fixed" and into the "executive duties" Congress made subject to Treasury regulation. Indeed, the Second Circuit all but acknowledged this when it said that this case did not involve contracts to deliver "an amount [of property] within a narrow range of limits," but instead, one where "the amount is claimed to be substantially fixed *for a different reason*." App.23a (emphasis added). *Cf. Mayo*, 562 U.S. at 52-53 (regulations required because, even if it is possible to identify some definitions that statutory terms "plainly encompass[]," the "precise question at issue" needed regulations). The Second Circuit did not (and could not) justify how encroaching on the "executive dut[y]" to promulgate regulations is consistent with this Court's precedent.

B. Filling In Gaps Delegated To Treasury Is Inconsistent With Separation Of Powers And Administrative Law

1. Separation Of Powers

For the separation of powers to matter in tax law, Congress's choice of the Treasury Secretary—and not the Judiciary—to carry out a particular function must be respected, even if that means that certain statutory provisions will be rendered unenforceable when Treasury regulation is required but does not exist.

Neither the Judiciary nor the Executive possess an inherent rulemaking power. "[R]ulemaking power originates in the Legislative Branch." *Mistretta v. United States*, 488 U.S. 361, 386 n.14 (1989). It can "become[] an executive function only when delegated by the Legislature to the Executive Branch." *Id.* And it can similarly become a judicial function only when authorized by Congress in an applicable statute. *See id.* at 388.[9] When Congress chooses, therefore, that the Executive—rather than the Judicial—Branch possess rulemaking authority, the Judicial Branch has no basis to usurp that authority. Concluding otherwise would undermine this Court's "expressed vigilance . . . that the Judicial Branch neither be assigned nor allowed tasks that are more properly

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[9] Consistent with this teaching, the power of courts to make federal common law is eclipsed when Congress "establish[es] . . . a comprehensive regulatory program supervised by an expert administrative agency." *City of Milwaukee v. Illinois & Michigan*, 451 U.S. 304, 317 (1981).

accomplished by [other] branches." *Id.* (internal quotation marks and citation omitted).

Phantom regulation allows the Judiciary to acquire rulemaking power not through Congress authorizing it, but through the Executive shirking it. And, it occurs in an *ad hoc*, patchwork manner that gives taxpayers no guidance as to whether, when, or how a court will phantom regulate their tax benefit or liability. Far from vindicating congressional intent, this runs directly contrary to Congress's stated goals crafting a prospective, comprehensive statute like section 1259.

Indeed, the entire premise of phantom regulation is *ipse dixit*: The court *dislikes* the result of not applying a statute's substantive provision to the case, so it simply decides the agent Congress identified in the statute's rulemaking provision should be irrelevant. *See, e.g.*, App.28a (observing that "[i]n this case [McKelvey received a payment of] $194 million, and thus far, no capital gains taxes have been paid. The Internal Revenue Code should not be readily construed to permit that result."); *Occidental Petroleum*, 82 T.C. at 829 ("the failure [of the Treasury Secretary] to promulgate the required regulations can hardly render the new provisions of section 58(h) inoperative. We must therefore do the best we can with these new provisions."). Our system, of course, does not empower one branch to act merely because that branch thinks *somebody* should. *Cf. N.L.R.B. v. Noel Canning*, 573 U.S. 513, 538 (2014) ("It should go without saying . . . that political opposition in the Senate would not qualify as an unusual circumstance" allowing the President to disregard the standard appointment process).

Being blasé about the significance of Congress's choice to delegate a question to a specific agent not only plays fast and loose with a statute's plain meaning—it belies this Court's requirement that, for an authorization of rulemaking power to be "constitutionally sufficient," Congress, among other things, must "clearly delineate[] . . . the public agency which is to apply" the authority. *See Am. Power & Light Co. v. SEC*, 329 U.S. 90, 105 (1946). Phantom regulation also impermissibly permits the Judiciary to speculate as to the "sort of" regulations an agency "*might* . . . impose . . . under the broad authority" Congress provided to Treasury, when the judicial role is typically limited to evaluating "what sort of [regulations] he [i.e., the agency head] did *in fact* impose under that authority." *Cal. Bankers Ass'n v. Schultz*, 416 U.S. 21, 64 (1974) (emphasis in original).

If a court is ever empowered to exercise any "rulemaking" authority from Congress, then Congress must have given the Judiciary that power. Here—and in every other phantom tax regulation case—Congress gave that power to Treasury instead. No court has ever explained why the separation of powers should be modified in the Judiciary's favor simply because Treasury has failed to act on the authority Congress gave it.

2. *Chevron*'s Structural Premises

This Court's administrative law precedent reflects these separation of powers principles. Because "the Executive Branch is not permitted to administer [an] Act in a manner that is inconsistent with the administrative structure that Congress enacted into law," *ETSI Pipeline Project v. Missouri*, 484 U.S. 495, 517 (1988), one Executive agency may not re-delegate a statutorily assigned authority to another Executive agency. *See id.* The same logic should prohibit an agency outsourcing its statutorily-assigned rulemaking responsibility to the Judiciary. And yet that is precisely what happened here and happens across tax law.

Ensuring that "'judges . . . refrain from substituting their own interstitial lawmaking' for that of an agency" "is precisely what *Chevron* prevents." *City of Arlington, Tex. v. F.C.C.*, 569 U.S. 290, 304-305 (2013) (citation omitted). Those dissenting in *City of Arlington* agreed: "We give binding deference to permissible agency interpretations of statutory ambiguities *because* Congress has delegated to the agency the authority to interpret those ambiguities with the force of law." *Id.* at 317 (Roberts, Kennedy, & Alito, JJ., dissenting) (internal quotation marks and citation omitted) (emphasis in original). But phantom regulation cuts against this *Chevron* premise, which itself is "rooted in a legal presumption of congressional intent, important to the divisions of power between the Second and Third Branches. . . . By committing enforcement of the statute to an agency rather than the courts, Congress committed its initial and primary interpretation to that branch as well." *United States v. Mead Corp.*, 533 U.S. 218, 241-243 (2001) (Scalia, J., dissenting) (explaining how this premise is "in accord with the origins of federal-court judicial review" and "[j]udicial control of federal executive officers," even while recognizing *Chevron*'s tension with the APA). Accordingly, once a court concludes, as the Second Circuit did here, that the "precise question at issue" is not covered by the statute's plain meaning, but rather falls within the realm of matters Congress assigned to an administering agent, then that is the agent with principal responsibility to resolve the question. *See Chevron*, 467 U.S. at 842-843.[10]

The fact that Congress's designated agent has yet to resolve the "precise question at issue" does not give the Judiciary the power to step into the agent's shoes. To be sure, courts may end up construing an ambiguous statutory provision to resolve ancillary disputes before an agency promulgates regulations. *See, e.g., Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 979-980, 982-983 (2005) (recounting the Ninth Circuit interpreting the Communications Act before the Federal Communications Commission promulgated regulations). But phantom regulation, as employed below and elsewhere in tax cases, represents something altogether different. With phantom regulation, the Judiciary is not simply beating the agency in a race to interpret ambiguous statutory terms. Rather, the administering agency (Treasury) is outsourcing its interpretive responsibility to the Judiciary and seeking enforcement of substantive provisions that the agency has yet to implement through the sort of rulemaking Congress demanded.

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[10] To be sure, some members of this Court have criticized *Chevron* in particular and congressional delegation in general. An answer to those criticisms consistent with self-government, however, cannot be allowing an agency to outsource the authority Congress gave it to the Judiciary.

Approving phantom regulation's end-run around Congress's assignment of rulemaking authority allows Treasury to "administer [the Internal Revenue Code] in a manner that is inconsistent with the administrative structure that Congress enacted into law." *See ETSI*, 484 U.S. at 517; *cf. also Bowen v. Georgetown Univ. Hosp.*, 488 U.S. 204, 212-214 (1988) (denying deference on similar grounds to an agency interpretation that was never promulgated in rulemaking but crafted by appellate counsel in litigation).[11] At the same time, phantom regulation eliminates the very benefits that are theoretically derived from assigning Treasury rulemaking powers in the first place—agency expertise and public accountability.

"Filling gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes," and the

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[11] It is also entirely unclear how phantom regulation can square with *Brand X*. Take this case as an example. On the one hand, *Brand X* holds that a court can only bind an agency to a particular statutory construction when the statutory provision at issue is *unambiguous*—when the provision is ambiguous, the agency is free to come up with its own reasonable, subsequent construction. *See* 545 U.S. at 982. But on the other hand, the Second Circuit said that "[t]he Internal Revenue Code should not be readily construed to permit" McKelvey to not owe capital gains taxes. App.28a. So, if Treasury decides to regulate on VPFCs in the future, can it come to a different conclusion of "substantially fixed" property amounts in that context, or not? *Brand X* would say yes because "substantially fixed" is ambiguous, but the Second Circuit (like all phantom regulation cases) provides no answer.

"formulation of [tax] policy might require more than ordinary knowledge respecting the matters subjected to agency regulations." *Mayo*, 562 U.S. at 56. (internal quotation marks and citation omitted). And the rulemaking process—unlike judicial decision-making—contains mechanisms for public participation and accountability that would allow taxpayers to weigh in on rules that may impact their tax liability as that expertise is deployed. *See Chevron*, 467 U.S. at 865 ("Judges are not experts in the field, and are not part of either political branch of the Government. . . . While agencies are not directly accountable to the people, the Chief Executive is, and it is entirely appropriate for this political branch of the Government to make such policy choices . . . ."). Allowing a lower court to fill in the gaps on the meaning of "substantially fixed" under section 1259 violates each of these premises. Indeed, that is precisely why Congress said that "[t]he Secretary," not the Judiciary, "*shall* prescribe" any "necessary or appropriate" regulations to implement the statute. App.78a (§ 1259(f) (emphasis added)). Simply put, the fact that Treasury has not done so did not give the Judiciary license to act.

3. The APA

Finally, phantom regulation is in direct tension with the statutory structure Congress created to address judicial review of agency inaction: Section 706(1) of the APA. *See* 5 U.S.C. § 706(1). Under that section, a court "can compel [an] agency to act" when Congress has commanded agency regulation but the agency has failed to act (as in phantom regulation cases). *Norton v. S. Utah Wilderness Alliance*, 542 U.S. 55, 65 (2004). But even with the power to compel needed agency action, the court "has no power to specify what the action must be." *Id.* Were a court to possess such power, it would permit "undue judicial interference" with an agency's "lawful discretion," and a court would be "entangle[d] in abstract policy disagreements which courts lack both expertise and information to resolve." *Id.* at 66. It is hard to fathom how phantom regulation has not produced this exact result in tax law.

Here, not only did the Second Circuit plainly encroach into such "abstract policy disagreements," *id.*—it did so with a stunningly narrow understanding of the complexities involved. The Second Circuit provided no guidance at all as to *when* a taxpayer should disregard contractually-specified variation in property amounts for economic analysis, *how* a taxpayer should interpret the various economic factors that go into a probability analysis, or *what* percentage variation in property amounts is, in fact, "substantially fixed." An estimated 15% likelihood that the stock price would recover has now been held "sufficiently low" in the "context" of McKelvey's VPFCs. *See* App.26a-29a. What about 20%? Or 25%? How does picking 15% square with Treasury's general practice of respecting any contingency greater than 5%? *See* Pet'r Br. 52-53. And how would the Second Circuit's result be impacted if the VPFCs were of longer, or shorter, duration? Or if the range in potential variance in stock to be delivered was broader—say 4 million shares to 6.5 million shares? Establishing rules that would account for the myriad factors would by no means be easy. And it is by no means clear what rules Treasury will promulgate as a matter of tax policy if it ever takes up Congress's command. But that is precisely the problem taxpayers face when attempting to comply with an ambiguity-laden statute like section 1259 that is bereft of the required regulations. APA Section 706(1) ensures courts do not compound the problem by imposing their own policy preferences in the place of agency rules. Rather, the statute gives courts the tools to ensure *agencies* solve the problem by providing the needed rules. Phantom regulation takes the opposite approach.

C. Filling In Gaps Delegated To Treasury, At Least To Impose A Tax, Deprives Taxpayers Of Fair Notice

"Always a taxpayer is entitled to know with fair certainty the basis of the claim against him." *Gen. Utilities & Operating Co. v. Helvering,* 296 U.S. 200, 206 (1935). The reason for this insistence was one recognized by the Framers: "[T]he power to tax involves the power to destroy." *McCulloch v. Maryland*, 17 U.S. 316, 431 (1819) (per Marshall, C.J.). This compelled the Framers to require that all tax statutes originate in the most politically accountable portion of the Federal Government, the House of Representatives. *See* Rebecca M. Kysar, *On the Constitutionality of Tax Treaties*, 38 YALE J. INT'L L. 1, 7-9 (2013); U.S. CONST. ART. I § 7 CL. 1 ("All Bills for raising Revenue shall originate in the House of Representatives . . . .").

Phantom regulation, however, allows Treasury and the Judiciary to take a decidedly unaccountable tact to develop tax regulations. Rather than respect

Congress's decision that Treasury engage in rulemaking—with its attendant opportunity for notice and comment, allowing taxpayers to know whether and how certain tax statutes will apply to their conduct—Treasury has preserved strategic uncertainty in the tax code. Phantom regulation relieves Treasury of rulemaking's burdens while still allowing it, retrospectively, to impose taxes even in cases where there is no suggestion of abuse. Phantom regulation therefore shifts the decision-making authority Congress assigned to Treasury to the *least* politically accountable branch of the Federal Government, the Judiciary. As long as Treasury continues to shirk its responsibilities because it can ask lower courts to fill in statutory gaps, taxpayers confronting the hundreds of spurned delegations throughout the Internal Revenue Code will have no way to predict when they may be subject to a tax or entitled to a benefit.

III. The Second Circuit's Decision Is The Right Vehicle To Address The Significant And Recurring Problem Of Phantom Tax Regulation

There are three principal reasons why this case—which has a stipulated record, no jurisdictional problems, and a Petitioner that has consistently argued against the Judiciary regulating in Treasury's place—is the right case to address the question presented:

First, the Second Circuit's opinion leaves no doubt that it was engaged in phantom regulation. Unlike some phantom regulation cases where there may be ambiguity as to Congress's intent, this case involved a mandatory delegation of regulatory authority to Treasury to issue rules that would address the "precise question" that the Second Circuit addressed. Indeed, the Second Circuit acknowledged the IRS's theory here was based on a "different reason" than the one supported by the plain language of "substantially fixed" in section 1259, *see* App.23, and it further acknowledged that Congress contemplated regulations to "implement" the statute. App.26a. This puts the Second Circuit squarely in *Dunlap's* crosshairs. *See* 173 U.S. at 73 (courts cannot craft the substance of a regulation when "[C]ongress required that the thing itself should be done under official regulations"). To the extent probabilities were to be considered under the constructive sale statute, there is no question that Congress expected *Treasury* to do so when promulgating *prospective* regulations—not through the Judiciary contriving them through retroactive, *ad hoc* decisions.

Second, the Second Circuit's decision goes beyond even the tenuous justifications lower courts have offered for phantom regulation. In prior instances of phantom regulation—cavalier as they are with Congress's assignment of rulemaking authority and *Dunlap*—courts were, at least nominally, seeking to ensure that Treasury's nonfeasance did not deny a taxpayer a benefit promised by Congress, or to fulfill a congressionally mandated choice. *See supra* p. 16. Not so here. Section 1259 subjects taxpayers to taxes, and Congress plainly did not determine when, whether, or how market factors should apply to render a variable amount of property to be delivered under a forward contract "substantially fixed." By retroactively imposing taxes even in the face of a mandatory rulemaking authorization from Congress that covers the question at issue, the Second Circuit's decision epitomizes the extent to which phantom regulation has sprawled beyond even its initial, questionable, confines.

Third, despite the prevalence of phantom regulation in lower courts, this Court will have few opportunities to address the problem—making it all the more important to grant review here. Treasury may occasionally contest the appropriate *content* of a given phantom regulation, but it has no incentive to oppose the propriety of courts engaging in phantom regulation *in general*. Regardless of whether Treasury is faced with a refund suit or is bringing a deficiency notice against a taxpayer, the ability of courts to engage in phantom regulation always benefits Treasury by sparing it the burdens of rulemaking and allowing it to preserve uncertainty in the tax law that it can employ strategically against taxpayers. It will also be rare for taxpayers to question the doctrine. As *Dunlap* shows, a taxpayer seeking a benefit Treasury has yet to effectuate *wants* phantom regulation. Such taxpayers *should* be making use of section 706(1) within the APA to compel the Treasury action they seek. But, so long as phantom regulation is allowed as an alternative, taxpayers will be more likely to seek equitable relief in Tax Court—a time-tested method that delivers faster, more tailored results to individual taxpayers than rulemaking, but which violates this Court's precedent and fails to protect other taxpayers.

Phantom regulation has already caused nearly four decades of legal morass. Now, as the Second Circuit has extended the doctrine to retroactively impose taxes, is the time for this Court to resurrect *Dunlap* and protect taxpayers from Treasury weaponizing its nonfeasance.

CONCLUSION

The Court should grant the Petition.

Respectfully submitted,

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March 8, 2019

APPENDICES

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APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT
August Term 2017
Argued: June 5, 2018 Decided: September 26, 2018
Docket No. 17-2554

ESTATE OF ANDREW J. MCKELVEY, Deceased,

Bradford G. Peters, Executor,

Petitioner – Appellee,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent – Appellant.

Before: NEWMAN, CABRANES, and CARNEY, Circuit Judges.

Appeal from the May 22, 2017, decision of the United States Tax Court rejecting the claim of the Commissioner of Internal Revenue that the Estate of Andrew J. McKelvey owed $41 million in taxes with respect to McKelvey's 2008 income tax return for omitting what the Commissioner alleged were short- and long-term capital gains arising from the execution of new contracts extending the valuation dates of two variable prepaid forward contracts.

Decision reversed, and case remanded for (1) determination, in light of this opinion, of whether the termination of obligations that occurred when the new contracts were executed resulted in taxable short-term capital gains, and (2) calculation of the amount of long-term capital gains that resulted from the constructive sales of the collaterized shares. Judge Cabranes concurs with a separate opinion.

Clint A. Carpenter, (David A. Hubbert, Deputy Asst. Atty. General, Gilbert S. Rothenberg, Joan I. Oppenheimer, on the brief), Tax Division, Appellate Section, U.S. Dep't. of Justice, Washington, D.C., for Respondent-Appellant Commissioner of Internal Revenue.

Mark D. Lanpher, (Robert A. Rudnick, Kristen M. Garry, on the brief), Shearman & Sterling LLP, Washington, D.C., for Petitioner-Appellee Estate of Andrew J. McKelvey.

JON O. NEWMAN, Circuit Judge:

This appeal concerns somewhat unusual financial instruments known as variable prepaid forward contracts ("VPFCs"). A VPFC is an agreement between a short party (typically, the shareholder of a large quantity of low-basis, appreciated stock) and a long party (typically an investment bank). The long party agrees to pay the shareholder a substantial sum of money equal to the value of the stock discounted to present value. In exchange, the shareholder agrees to deliver to the long party on a specified settlement date up to a maximum number of shares of stock (or their cash equivalent), the exact number to be determined by the price of the shares on a specified valuation date. The short party also agrees to secure its delivery obligation with the maximum number of shares to be delivered at settlement. A VPFC usually sets a floor price and a cap price that limit the number of shares to be delivered in the event that the share price on the valuation date is below the floor price, above the cap price, or between them. The issues on this appeal arise because a shareholder, after executing two similar VPFCs with two financial institutions, paid substantial sums of money to each institution to obtain an extension of the settlement date and, more significantly, the valuation date.

There are two precise issues. The first is whether, with respect to each contract, the extensions resulted in a short-term capital gain. The Commissioner of Internal Revenue ("Commissioner") contends that a short-term capital gain occurred because either (1) the extension of the valuation date resulted in an exchange of property with a more valuable new contract replacing the original contract or (2) a termination of the delivery obligation occurred because the obligation in the first contract to deliver shares on the original settlement date was extinguished.

The second issue is whether, with respect to each contract, the extension of the valuation date also resulted in a long-term capital gain. The Commissioner contends that the execution of each new contract resulted in a constructive sale of the shares pledged as collateral to secure the obligation of the new contract. His reason for this claim is that, on the date of the new contract, the share price of the stock pledged as collateral was so far below the floor price that there was no more than a fifteen and thirteen percent probability, respectively, for each contract that the share price would reach that floor price and therefore, under each contract, the shareholder would almost certainly be required to deliver the maximum number of collateralized shares. As a result, the Commissioner contends, the number of shares to be delivered at settlement was "substantially fixed" within the meaning of 26 U.S.C. § 1259(d)(1) on the date of each new contract, resulting in a long-term capital gain on shares constructively sold.

These rather esoteric issues arise on an appeal by the Commissioner from the May 22, 2017, decision of the United States Tax Court (Robert P. Ruwe, Judge) rejecting the Commissioner's claims to collect $41,257,103 from the estate of Andrew J. McKelvey ("Estate") for both short- and long-term capital gain taxes alleged to have been incurred by the decedent in 2008.

Background

McKelvey, who died on November 27, 2008, was the founder and principal shareholder of Monster Worldwide, Inc. ("Monster"), a publicly traded company that maintains a website, monster.com, which helps job-seekers find jobs. In 2007, McKelvey executed two VPFCs, one with Bank of America, N.A. ("BofA") as long party and another with Morgan Stanley & Co. International plc ("MSI") as long party.

The BofA VPFC. Under the BofA contract, which became effective September 11, 2007, BofA agreed to pay McKelvey $50,943,578.31 on September 14, 2007; he agreed to pledge 1,765,188 shares of Monster stock to secure his obligation to BofA; and he agreed to deliver to BofA *up to* 1,765,188 shares of Monster stock (or the cash equivalent) at settlement. Settlement was to be made by delivering to BofA up to ten percent of the 1,765,188 shares on each of ten consecutive weekdays between September 11 and 24, 2008. At the close of trading on the NASDAQ on September 11, 2007, the price of Monster stock was $32.91.

The contract provided that the actual number of shares to be delivered on each of the ten settlement dates would be determined in one of three ways, depending on the closing price of Monster stock on each of the ten dates. If the closing price on a settlement date was *less than* (or equal to) $30.4610 ("BofA floor price"), the number of shares to be delivered on each of the ten dates would be 176,519 (ten percent of 1,765,188).[1] If the closing price on a settlement date was *more than* the BofA floor price but *less than* (or equal to) $40.5809 ("BofA cap price"), the number of shares to be delivered on each of the ten dates would be a fraction of 176,519: the numerator of the fraction would be the BofA floor price and the denominator would be the Monster

[1] The number of shares for the first two dates was 176,518 and for the next eight days was 176,519 so that the total equaled 1,765,188. This slight variation applied to all three methods of determining the number of shares to be delivered at settlement.

stock closing price. If the closing price on a settlement date was *more than* the BofA cap price, the number of shares to be delivered would be a more complicated fraction of 176,519: the numerator of the fraction would be the closing price minus the difference between the BofA cap price and the BofA floor price, and the denominator would be the closing price.

These three methods of determining the number of shares to be delivered at settlement would yield curious results. To illustrate these results, it will be convenient to ignore the fact that ten percent of the total number of the 1,765,188 shares would be delivered on each of ten consecutive weekdays and consider the collateralized shares as a bloc. If the closing price was equal to, or any price below, the floor price, the number of shares to be delivered would always be the total number of shares pledged as collateral, which would be the maximum number of shares required to be delivered at settlement. If the closing price was between the floor price and the cap price, the number of shares to be delivered would *decline* from 1,765,188 the closer the closing price was to the cap price. The decline would end when the closing price equaled the cap price, at which point the number of shares to be delivered would be 1,324,993 (1,765,188 times 30.4610/40.5809).[2] If the closing price was any price above the cap price, the number of shares to be delivered would *increase* from 1,324,993 and continue to increase the more the closing exceeded the cap price. The increase would be continuous as the closing price increased and the

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[2] *See* footnote 9, *infra*.

number of shares to be delivered approached the total number of the collateralized shares, but the number of shares to be delivered would never exceed that maximum total number. These effects are illustrated in the following table, showing an example of how many shares of a 1,000-share bloc would be delivered at various closing prices: some below or equal to the floor price of 30.5 (rounded), some between the floor price and the cap price of 40.6 (rounded), and some above the cap price. The table also shows the fraction used to determine the number of shares to be delivered.

closing price:	20	25	30.5	35	40	40.6	45	50	60
fraction:				30.5/35	30.5/40	30.5/40.6	34.9/45	39.9/50	49.1/60
shares delivered :	1000	1000	1000	850	763	751	776	798	818

Under the BofA contract, McKelvey had the option to settle the contract with the "cash equivalent" no matter which of the three methods for determining the number of shares to be delivered was applicable. The cash equivalent for each share to be delivered was 105 percent of the closing share price three trading days prior to the valuation date for the first portion of the collaterized shares to be delivered, which was September 11, 2008.[3] Of

[3] This simplified explanation is derived from several provisions of the original BofA contract, all of which were carried forward into the amended contract with the valuation dates extended. "If Party B [McKelvey] elects Cash Settlement...Party B shall pay the Preliminary Forward Cash Settlement Amount to Party A [BofA] on the Preliminary Cash Settlement Payment Date." The Preliminary Forward Cash Settlement Amount is defined as "The sum of all the Daily Preliminary Forward Cash Settlement Amounts," and the

course, had McKelvey used the cash equivalent option (for both the BofA and MSI contracts), he would have had to pay a substantial sum of money.

On July 24, 2008, two months before the ten settlement dates, McKelvey paid BofA $3,477,949.92 to amend the BofA contract by extending the original settlement dates, which also served as valuation dates, from ten consecutive weekdays in September 2008 to ten consecutive weekdays in February 2010 ("amended contract"). No other terms of the 2007 BofA contract were changed. On the date of the BofA extension, the closing price of Monster stock was $18.24.

The MSI VPFC. Under the MSI contract, effective September 24, 2007, MSI agreed to pay McKelvey $142,626,185.80 on September 27, 2007; he agreed to pledge 4,762,000 Monster shares to secure his obligation to MSI; and he agreed to deliver to MSI *up to* 4,762,000 Monster shares (or the cash equivalent) on September 24, 2008. At the close of trading on the NASDAQ on September 24, 2007, the price of Monster stock was $33.47.

"Preliminary Cash Settlement Payment Date" is defined as "The Currency Business Day immediately following the Preliminary Cash Settlement Pricing Date." The Daily Preliminary Forward Cash Settlement Amount is defined as "105% of the Forward Cash Settlement Amount that would apply if the Valuation Date were the Preliminary Cash Settlement Pricing Date." The Preliminary Cash Settlement Pricing Date is defined as "The third Scheduled Trading Day immediately prior to the Scheduled Valuation Date for the Component with the earliest scheduled Valuation Date." The earliest scheduled Valuation Date for the first component, *i.e.*, 10 percent of the collateralized shares was September 11, 2008.

The contract provided that the actual number of shares to be delivered on the settlement date would be determined in one of three ways depending on the average of the closing prices of Monster stock on ten valuation dates ("average price"). If the average price was *less than* (or equal to) $30.894 ("MSI floor price"), the number of shares to be delivered would be 4,762,000. If the average price was *more than* the MSI floor price but *less than* (or equal to) $35.772 ("MSI cap price"), the number of shares to be delivered would be a fraction of 4,762,000, the numerator of the fraction to be the MSI floor price and the denominator to be the average price. If the average price was *more than* the MSI cap price, the number of shares to be delivered would be a more complicated fraction of 4,762,000: the numerator of the fraction would be the average price minus the difference between the MSI cap price and the MSI floor price, and the denominator would be the average price. These three methods of calculation yielded precisely the same curious results described above with respect to the BofA contract when the closing price was equal to or below the MSI floor price, above the MSI cap price, or between them.

Under the MSI contract, like the BofA contract, McKelvey had the option to settle the contract with the "cash equivalent" no matter which of the three methods for determining the number of shares to be delivered was applicable, but the calculation of the cash equivalent differed from the BofA contract. Under the MSI contract, the cash equivalent was the number of shares to be delivered multiplied by the closing price of Monster stock on the last of the ten averaging dates.[4] That date was September 24, 2008.

On July 15, 2008, two months before the settlement date, McKelvey paid MSI $8,190,640 to amend the MSI contract by extending the original settlement date from September 24, 2007, to January 15, 2010, and to extend the dates on which the average price would be determined from ten consecutive weekdays in September 2008 to ten consecutive weekdays in January 2010 ("amended contract"). No other terms of the 2007 MSI contract were changed. On the date of the MSI extension, the closing price of Monster stock was $17.28.

On the dates of the extensions of both the BofA and MSI contracts, the value of McKelvey's Monster shares was about $114 million. If McKelvey had delivered his Monster shares on those dates instead of extending the settlement and valuation dates of the VPFCs, he would have realized a substantial capital gain.

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[4] This simplified explanation is derived from two sources. The original MSI contract, with the valuation date extended by the amended contract, provided that "If Cash Settlement applies, then on the Cash Settlement Payment Date, Counterparty [McKelvey] shall pay to MSI plc the Forward Cash Settlement Amount," which "shall be determined in accordance with the Equity Definitions" of the International Swaps and Derivatives Assn., Inc. ("ISDA"). Under the relevant Equity Definitions, Forward Cash Settlement Amount means "an amount equal to the Number of Shares to be Delivered…multiplied by the Settlement Price," § 8.5(f), ISDA, "2002 ISDA Equity Derivatives Definitions" 25 (2002), and Settlement Price means "the price per Share…as of…the Valuation Date, § 7.3(a), *id.* at 22. The MSI contract specified that the Valuation Date was September 24, 2008.

Settlement of amended contracts. After McKelvey's death, the Estate settled the amended BofA contract by delivering 1,757,016 Monster shares to BofA on May 8, 2009,[5] and settled the amended MSI contract by delivering 4,762,000 Monster shares to MSI on August 5, 2009. Both the original VPFCs and the amended contracts provided for expedited settlement in the event of various occurrences including McKelvey's death. The parties make no claim that the expedited settlements have any significance to the issues on appeal. The Estate obtained a stepped-up basis for the Monster shares. *See* 26 U.S.C. § 1014(a)(1).

To recapitulate: by executing both VPFCs in September 2007, McKelvey received about $194 million,[6] pledged about 6.5 million Monster shares,[7] then worth about $218 million,[8] and agreed to deliver one year later between about 5.4 million[9] and

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[5] The parties do not explain why the total number of shares delivered to BofA at settlement, 1,757,016, was slightly less than the anticipated total number of shares, 1,765,188, to be delivered if the closing price was below the floor price in the BofA contract, which it was.

[6] $50,943,578.31 BofA prepayment plus $142,626,185.80 MSI prepayment equals $193,569,564.11.

[7] 1,765,188 shares in the BofA contract plus 4,762,000 shares in the MSI contract equals 6,527,188 shares.

[8] 6.5 million times $33.47, the closing price of Monster stock on Sept. 24, 2007, equals $217,555,000.

[9] Under the BofA and MSI contracts, McKelvey was obligated to deliver the minimum number of shares at settlement if the closing price at that time equaled the cap price. To determine the minimum number of shares in that circumstance, the

6.5 million Monster shares (then worth between about $181 million[10] and $218 million). Ten months later, McKelvey paid $11,668,590 to execute amended contracts, which extended the settlement dates and the valuation dates that would determine the number of shares to be delivered at settlement. The Estate settled the amended contracts by delivering 6,519,016 Monster shares, which the Commissioner states were worth about $88 million, to BofA and MSI. Neither McKelvey nor the Estate paid any income taxes with respect to the Monster shares.

McKelvey's 2008 income tax return. McKelvey's 2008 federal income tax return, filed by the executor of his Estate, reported no income attributable to the execution of the amended contracts. The Estate's reason for not reporting any short-term capital gain was its view that the extensions of the settlement and valuation dates did not result in a taxable exchange of the original VPFCs for the amended contracts. The Estate's reason for not reporting any long-term capital gain

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applicable fraction for the BofA contract is $30.4610 (floor price)/$40.5809 (cap price), which is the smallest applicable fraction under the contract, applied to the number of shares pledged in the BofA contract, 1,765,188, which yields 1,324,993 shares. To determine the minimum number of MSI shares, the applicable fraction is 30.894 (floor price)/$35.77 (cap price) applied to the number of shares pledged in the MSI contract, 4,762,000, which yields 4,112,636 shares. Adding 1,324,993 to 4,112,636 yields 5,437,629 shares. The Commissioner's briefs to the Tax Court reported that the minimum number of shares to be delivered would be about 5.4 million shares.

[10] 5.4 million times $33.47 equals $180,738,000.

was its view that such a gain could not have occurred until the amended contracts were settled by delivery of Monster shares to BofA and MSI, and, by that time, the shares had acquired a stepped-up basis following McKelvey's death, *see* 26 U.S.C. § 1014(a)(1), and the stock price had declined between the date of death and the settlement date.

The Commissioner's deficiency determination. The Commissioner determined a deficiency of more than $41 million in McKelvey's 2008 federal income tax based on his determination that McKelvey realized a capital gain of more than $200 million when he executed the VPFC extensions in 2008. This deficiency was based on two separate determinations. First, McKelvey realized a short-term capital gain because the extensions of the settlement and particularly the valuation dates resulted in taxable exchanges of the original VPFCs for the more valuable amended contracts, which the Commissioner deemed to be "forward contracts" within the meaning of 26 U.S.C. § 1259(d)(1).[11] Second, McKelvey realized a long-term capital gain because the number of shares to be delivered at settlement of these forward contracts was "substantially fixed" within the meaning of subsection 1259(d)(1), resulting in constructive sales of the Monster shares that he had pledged as collateral under what the Commissioner deemed to be forward contracts. We set forth in more detail the

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[11] Subsection 1259(d)(1) provides:

"**Forward contract**.—The term 'forward contract' means a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price."

Commissioner's rationale for these claims of capital gains below when we consider his arguments on this appeal.

The Tax Court decision. McKelvey's estate commenced a Tax Court action to challenge the Commissioner's determinations. On joint motion of the parties, the case was decided without trial based on stipulated facts. *See Estate of McKelvey v. Commissioner*, 148 T.C. No. 13, 2017 WL 1402129, at *1 (2017) ("TC op.").

The Tax Court began its consideration by noting that the execution of the VPFCs in 2007 did not result in recognition of any capital gains and would not result in any capital gains until the VFPCs were settled. The VPFCs were "open" transactions, *i.e.*, the identity of and the number of shares to be delivered at settlement was not substantially fixed because the taxpayer could substitute cash or non-collaterized stock to satisfy his delivery obligations and the amount of cash or stock to be delivered depended on the stock price at settlement. The Commissioner had previously acknowledged that VPFCs did not incur capital gains when executed. That position conformed to Revenue Ruling 2003-7, 2003-1 C.B. 363 (2003).

The Tax Court then noted that the ultimate issue to be decided was "what tax consequences, if any, occurred when [McKelvey] extended the settlement and averaging dates of the original VPFCs." TC op. 14, 2017 WL 1402129, at *4. Judge Ruwe observed that neither party had cited any decisions considering the tax consequences of extending VPFC valuation dates, and the case appeared to be one of first impression in the Tax Court. It is in this Court as well.

The Tax Court ruled in favor of the taxpayer on all issues. With respect to the claimed short-term capital gain, the Court held that the execution of the contracts was not a taxable "disposition of property" under 26 U.S.C. § 1001 because the VPFCs were not "property" to the taxpayer at the time they were exchanged for the amended contracts. *See id.* at 18-23, 2017 WL 1402129, at *6-*8. The Court explained that, at the time the amended contracts were signed, McKelvey had received the cash prepayment due him under each VPFC and "had only obligations under the contracts—and obligations are not property...and therefore section 1001 is inapplicable." *Id.* at 20, 2017 WL 1402129, at *7.

Having concluded that the VPFCs were not property on the date of the amended contracts, the Tax Court did not consider the possibility that the execution of the amended contracts resulted in short-term capital gain on the theory that the obligations of the VPFCs had been terminated by the execution of the amended contracts. *See* 26 U.S.C. § 1234A(1).[12] With respect to the claimed long-term capital gain, the Tax Court ruled that the amended contracts did not result in the constructive sale of the collateralized Monster shares under 26 U.S.C. § 1259. *See* TC op. at 35-36, 2017 WL 1402129, at *11-

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[12] Subsection 1234A(1) provides:

"Gain or loss attributable to the cancellation...or other termination of...a right or obligation...with respect to property which is...a capital asset in the hands of the taxpayer...shall be treated as gain or loss from the sale of a capital asset."

*12. The Court stated that the "open transaction treatment" under the VPFCs "continued" under the amended contracts, s*ee id*. at 36, 2017 WL 1402129, at *12, which the Court did not regard as forward contracts under section 1259(d)(1). The Tax Court also noted that because shares other than the Monster shares pledged as collateral could be used to settle the amended contracts, McKelvey "had the discretion to settle the VPFCs using stock with a higher or lower basis than the stock pledged as collateral." *Id*. at 30, 2017 WL 1402129, at *10.

Discussion

I. Standard of Review

This Court reviews *de novo* Tax Court decisions rendered on a stipulated record. *See General Electric Co. v. Commissioner*, 245 F.3d 149, 154 (2d Cir. 2001). Generally, the Commissioner's determinations in a notice of deficiency are presumed correct, and the taxpayer bears the burden of proving them incorrect by a preponderance of the evidence. *See* Tax Ct. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

II. Short-term Gain

We agree with the Tax Court that McKelvey did not incur a short-term capital gain on the basis of the Commissioner's claim that replacement of the VPFCs with the amended contracts was an "exchange of property." 26 U.S.C. § 1001(c). At the time the VPFCs were extended, McKelvey no longer had any rights in the contracts that could constitute property. He had already received the $194 million prepayments from the banks, and nothing else was owed to him. He had only the obligation to deliver

Monster shares (or their cash equivalent) to the banks in September 2008. As the Tax Court explained, "obligations are not property." TC Op. at 20, 2017 WL 1402129, *7.

Nevertheless, the Commissioner has an alternative claim that McKelvey realized a short-term gain because his obligation under each VPFC was terminated when he executed the amended contracts. "Gain...attributable to the cancellation … or other termination of ... a right or obligation ... with respect to property which is...a capital asset in the hands of the taxpayer ... shall be treated as gain … from the sale of a capital asset." 26 U.S.C. § 1234A(1); *see Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311, 317 (5th Cir. 2015) (interpreting section 1234A(1) to mean that "[c]apital gain or loss results from the termination of contractual or derivative rights with respect to capital assets").

Although the Tax Court did not consider the termination-of-obligation argument, both parties agree that this Court may consider it. The Commissioner asserts that the termination issue "was placed squarely before the Tax Court by the [E]state itself," Brief for Commissioner at 52, and the Estate "does not dispute that this Court may consider the Commissioner's new arguments, given that the Estate explained below why the extensions did not result in a termination of Mr. McKelvey's obligations," Brief for Estate at 27. The parties differ, however, on whether the amended contracts accomplished a termination of McKelvey's obligations under the VPFCs. Normally, we would remand that issue in its entirety to the Tax Court, but because Judge Ruwe's opinion rejected a premise of the Commissioner's termination argument, we will consider the issue in part.

The Commissioner contends, and the Estate disputes that the VPFCs executed in 2007 were replaced by amended contracts executed in July 2008. The Tax Court rejected this premise of the Commission's termination argument by stating, "[T]here is no merit to [the Commissioner's] contention that the extended VPFCs should be viewed as separate and comprehensive financial instruments." T.C. op. at 36, 2017 WL 1402129, at *12. This statement was made in the course of rejecting the Commissioner's claim that the extension of the valuation dates resulted in a constructive sale of the collateralized shares.

We agree with the Commissioner that extension of the valuation dates resulted in amended contracts that replaced the original contracts. The new valuation dates determined the share price upon which the number of shares to be delivered at settlement would be calculated, and these dates were seventeen months later than the dates for the original BofA contract and sixteen months later than the dates of the original MSI contract. As the Commissioner argues, "By extending the valuation dates, the parties fundamentally changed the bets that the VPFCs represented, from bets on the value of Monster stock in September 2008 to bets on the value of Monster stock in January and February 2010." Brief for Commissioner at 36.

As the Estate acknowledged in the Tax Court, "a 'sufficiently fundamental or material change' to an original contract that results in 'a change in the fundamental substance of the original contract' will be considered an exchange of the original contract for the amended contract." Tax Court Brief for Estate at 43 (quoting Rev. Rul. 90-109, 1990-2 C.B. 191 (1990)). Extending the valuation dates was a fundamental change.

The new valuation dates in the amended contracts resulted in new contracts just as new expiration dates for option contracts result in new option contracts. The active trading of option contracts based on significant differences in expiration dates demonstrates that the options market regards different expiration dates as constituting different option contracts. As the report of the Commissioner's expert witness, Dr. Henrick Bessembinder, illustrates, on Sept. 11, 2007, the effective date of the BofA VPFC, call options for Monster stock with a strike price of $35 could be purchased for $0.35 if the expiration date was September 22, 2007, but cost $2.55 if the expiration date was January 19, 2008, and cost $6.10 if the expiration date was January 17, 2009.

In the pending case, McKelvey paid the banks approximately $11 million to obtain the new valuation dates. Obviously, he did not think he was making insignificant changes.

Whether the replacement of the obligations in the original VPFCs with the obligations in what we hold are new contracts satisfies the criteria for a termination of obligations that gives rise to taxable income, presumably capital gain, and the amount of such gain are issues that we leave for determination in the first instance by the Tax Court on remand.[13]

III. Long-term Capital Gain

The Commissioner renews on this appeal the argument he made to the Tax Court: the execution of the 2008 contracts extending the valuation dates resulted in the constructive sale of the shares pledged as collateral.

The Commissioner bases his claim of long-term gains on a statutory ground and a legal contention. The Commissioner's statutory ground is that a constructive sale under 26 U.S.C. § 1259 occurs when a taxpayer holds an "appreciated financial position" in stock and enters into a "forward contract to deliver the same or substantially identical property," 26 U.S.C. § 1259(c)(1)(C), and a "forward contract" is defined as "a contract to deliver *a substantially fixed amount of property* (including cash) at a substantially fixed price," *id.* § 1259(d)(1) (emphasis added).[14] There is no dispute that on the dates of the amended contracts all of McKelvey's

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[13] The parties recognize that this case concerns contracts that are non-debt instruments, and we make no implication as to the tax consequences of fundamental changes in debt instruments.

[14] The relevant Senate report explains the definition of forward contract from the opposite perspective, explaining that "a forward contract providing for delivery of an amount of property, such as shares of stock, *that is subject to significant variation* under the contract terms does not result in a constructive sale." S. Rep. 105-33, at 125-26 (1997) (emphasis added).

Monster shares were an "appreciated financial position."[15]

The Commissioner's legal contention, the disputed issue on the constructive sale portion of this appeal, is that the amount of Monster shares to be delivered at settlement of each amended contract was "substantially fixed" on the date when each amended contract was executed. His rationale is that, because the closing price of Monster stock on that date had fallen so far below the floor price of each contract ("deep in the money" in stock market parlance), there was only a remote chance that the price would recover and exceed the floor price by the valuation date. Based on this circumstance, the Commissioner contends that on the execution date of the amended contracts it was virtually certain that on the settlement date McKelvey would have to deliver all of the collateralized shares pledged under each amended contract, *i.e.*, 1,765,188 shares to BofA and 4,762,000 shares to MSI, which the contracts required if the Monster stock price closed below the floor price. That virtual certainty, the Commissioner concludes, means that, the amount of property to be delivered at settlement was "substantially fixed" within the meaning of subsection 1259(d)(1) and therefore the collateralized shares had been constructively sold.

The key step in the Commissioner's claim of constructive sales is his reliance on the remoteness

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[15] "Appreciated financial position" generally means "any position with respect to any stock...if there would be gain were such position sold...at its fair market value." 26 U.S.C. § 1259(b)(1).

of the possibility that the price of Monster stock would recover and exceed the floor price by the valuation date of each amended contract. He bases his reliance on Dr. Bessembinder's report (the "Report"). The Report used the so-called Black-Scholes formula, a formula widely used for determining the value of option contracts.[16] The Black-Scholes formula uses probability analysis, which, in addition to being used to price options, can also be used to determine the probability that a stock will reach a certain price by a certain date. The formula uses several factors: (1) the market price of the underlying stock on the valuation date, (2) the risk-free interest rate on the valuation date, (3) the period between the purchase of the option and the expiration, (4) the option strike price, (5) the volatility of the rate of change in the spot price of the underlying stock, and (6) the dividend yield.

Using the Black-Scholes formula, the Report stated that for the BofA amended contract "the probability that the settlement price on the

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[16] The Black-Scholes formula, published in 1973 by three economists, Fischer Black, Myron Scholes, and Robert Merton, is "perhaps the world's most well-known options pricing model." Jean Folger, *Options Pricing: Black-Scholes Model*, https://www.investopedia.com /university/options-pricing/Black-Scholes-model.asp (last visited July 8, 2018). For their work, Scholes and Merton were awarded the 1997 Nobel Prize in Economics (Black was ineligible for the award because he had died, but the Nobel committee acknowledged his role). *See id.* The extremely complicated formula is shown in Folger, Figure 4, along with a typical calculator that can be used to apply the formula to the relevant factors, *id.*, Figure 5. *See also Black-Scholes model*, https://en.wikipedia.org /wiki/Black-Scholes_model (last visited July 8, 2018).

expiration date would be greater than the floor price was approximately [*sic*] 14.90% immediately after the extension [of the valuation date], as compared to 52.78% when the contract was originated" and that the comparable figures for the MSI amended contract were 12.87% as compared to 53.62%. Joint App'x at 199.

Whether probability analysis may be used to determine that an amount of property is "substantially fixed" for purposes of subsection 1259(d)(1) is a novel question. Obviously, the modifier "substantially" informs us that the amount need not be exactly fixed and that Congress contemplated some leeway. A clear example of an amount substantially fixed would be an amount within a narrow range of limits. In the pending case, the amount is claimed to be substantially fixed for a different reason: the contract's amount of shares to be delivered is fixed whenever the closing price on the valuation date is below or equal to the floor price, and on the valuation date there was a very low probability that the closing price would reach the floor price before the settlement date. Although the Report presents the probability (for each contract) that the closing price will be equal to or above the floor price on the valuation date, we think the matter should be analyzed by using the reciprocals of the Report's percentages: there was a probability of 85.10% and 87.13% for the BofA and MSI amended contracts, respectively, that the closing price would be below the floor price on the settlement date.[17]

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[17] The Commissioner also uses the reciprocal of Dr. Bessembinder's percentage, stating that "there was a greater than 85% chance that there would be *zero* variation" in the

The arithmetic is the same with either form of expression, but "substantially" in this context is better understood to mean substantially certain that the closing price will be below the floor price, rather than how unlikely it is that the closing price will equal or exceed the floor price.

Neither party cites a decision on the use of probability analysis to determine whether an amount has been "substantially fixed" for purposes of subsection 1259(d)(1). Relevant, however, is *Progressive Corp. v. United States*, 970 F.2d 188 (6th Cir. 1992). That case concerned a corporate taxpayer that bought shares of stock and simultaneously sold call options with respect to the shares.[18] Call options are options enabling the option buyer to buy a stock at a specified price (the strike price) at any time before the option expires. When the taxpayer in *Progressive* sold the call options, they were "in the money," meaning that the strike price was below the market trading price. The spread between the strike and market prices gave the option buyer an opportunity to make an immediate profit by exercising the options at the strike price and selling the stock at the market price (as long as the spread exceeded the purchase price of the options).

In *Progressive* the Commissioner had asked the District Court to decide whether the call options

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number of shares to be delivered at settlement. Reply Brief for Commissioner at 32 (emphasis in original).

[18] As the Sixth Circuit explained, the corporate taxpayer made two sets of complicated arrangements, *Progessive*, 970 F.2d at 190, but only the Court's treatment of the call options in the second set is relevant to the pending appeal.

"were so deep-in-the-money" that, from the option seller's standpoint (the taxpayer), each option "was the equivalent of a contractual obligation to sell" because it was "virtually certain that the purchasers of the call options would exercise them" promptly and take their quick profits. *Id.* at 193. That mattered because an immediate sale would reduce the taxpayer's holding period of the stock to zero, *see* 26 U.S.C. § 246(c)(3), a consequence that would deprive it of a claimed inter-corporate dividend exclusion, *see id.* § 246(c)(1)(A). *See Progressive,* 970 F.2d at 189-90. The District Court had not decided whether the spread was so great that exercise of the options was virtually certain, and the Sixth Circuit remanded that issue to the District Court for its determination. *See id.* at 194.

The Sixth Circuit's analysis and disposition is relevant to our case because the District Court was asked to decide how likely it was that the option buyer would immediately exercise its purchase right. Or, to frame the issue in terms of Dr. Bessembinder's analysis, the issue was whether the spread created so high a probability of the option buyer immediately exercising its rights that the option seller's obligation to sell was "virtually certain." *Progressive* differs from our case in two respects. The probability to be determined needed to meet the high standard of "virtual certainty" rather than "substantially fixed," and the probability concerned action to be taken on the basis of a market price at the time the option was written, rather than at a future evaluation date when the amended contract would be settled. Nevertheless, meeting the Sixth Circuit's standard on the date the options were written would require consideration of a probability, *i.e.*, the likelihood that the option buyer would then exercise its rights.

Using probability analysis to decide in the pending appeal the likelihood that a stock will not reach a floor price, thereby affecting tax consequences, is neither explicitly authorized nor prohibited by any relevant statute. And although Congress authorized the issuance of "necessary or appropriate" regulations to implement the constructive sale statute, *see* 26 U.S.C. § 1259(f), and the relevant Senate report contemplated that the Treasury Department would do so, *see* S. Rep. 105-33 at 126 (1997), no such regulations have been issued. Nevertheless, we are persuaded to accept probability analysis in this context.

Tax laws are to be applied with an eye to economic realities. *See, e.g., Frank Lyon Co. v. United States,* 435 U.S. 561, 573 (1978) (economic realities of transaction to be considered); *Greene v. United States*, 79 F.3d 1348, 1356 (2d Cir. 1996) (26 U.S.C. § 1256 enacted "to harmonize tax treatment of commodity futures contracts with the economic realities of the marketplace"). Virtually all stock transactions rest on the market's (albeit differing) perceptions of the probabilities of share price movement, both the direction and extent of such movement. Probabilities are an economic reality affecting such transactions, and we see no reason why they should not affect the tax consequences of them. Illustrating the point in a context especially relevant to this appeal is the pricing of stock options. Whether or not traders of options know it, a major determinant of option prices that are bid and asked every day in options markets is the Black-Scholes formula, the same formula that Dr. Bessembinder used to determine the probabilities in the pending case. *See* footnote 14*, supra*. So the economic reality pertinent to this case is not only the use of probability analysis in general but the use of the widely accepted Black-Scholes probability formula in particular.

A further consideration guides our resolution of this issue. A taxpayer holding a large bloc of appreciated securities and wishing to diversify his portfolio faces the prospect of a considerable capital gain if he sells his shares. Executing a VPFC provides him with the immediate cash that a sale would produce (but no immediate capital gain in view of Rev. Rul. 2003-7). Because financial institutions are unlikely to set settlement dates much later than execution dates (witness the one- and one-and-a-half-year intervals in the contracts in this case), a taxpayer wishing to obtain his up-front payment without having to settle and incur a large capital gain will want to proceed, as McKelvey did, by executing amended contracts extending his settlement and valuation dates. This device is so alluring that he will be willing to pay substantial sums, in this case $11 million, to obtain the extended dates, and financial institutions, as this case shows, will be willing to extend the dates at an appropriate price.

A taxpayer and his VPFC long party can often be expected to repeat these extensions for the taxpayer's life, knowing that at his death the shares will have a stepped-up basis in the hands of his estate. The up-front payment will have been received without ever incurring the capital gains tax that would have been due had the payment resulted from a sale of the stock. In this case that payment was $194 million, and thus far, no capital gains taxes have been paid. The Internal Revenue Code should not be readily construed to permit that result.

We must acknowledge, however, that using probability analysis to prevent capital gain avoidance in this case does not affect all amended VPFCs but only those amended to become forward contracts where the number of shares to be delivered at settlement is substantially fixed because of a share price significantly below the floor price. Nevertheless, despite the somewhat limited frequency of situations in which amendment of the valuation date of a VPFC will create liability for capital gains taxes, we conclude that probability analysis may be used for such a purpose.

The question remains in this case whether the 85 and 87 percentages of probability are sufficiently high (or the 15 and 13 percentages are sufficiently low) to show that the low share price at execution of each amended contract rendered the amount of shares to be delivered at settlement "substantially fixed." No bright line need be established. The percentages are very high, and the share prices yielding these percentages were so low as to be barely more than half of the floor prices. Dr. Bessembinder's report noted that even in the unlikely event that the share price would slightly exceed the floor price on the amended valuation date of each contract, an increase to $31 a share would decrease the number of shares to be delivered at settlement by less than 50,000 shares, less than 0.8 percent of the approximately 6.5 million total of collateralized shares, hardly a "significant variation." S. Rep. 105-33, at 125-26 (1997). So while the probability that McKelvey would have to deliver the total number of collateralized shares was 85 and 87 percent under the two contracts, the probability that he would have to deliver a number of shares close to the total, which would still be a substantially fixed amount, was even higher.

The taxpayer had the burden to prove the determinations in the Commissioner's notice of deficiency erroneous, *see* T.C. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115 (1933). The Estate presented no evidence to challenge any of Dr. Bessembinder's data or calculations. On this record, we see no basis to conclude that the amount of shares to be delivered at settlement was not "substantially fixed" on the dates each contract was amended. Constructive sales of the collateral shares therefore resulted.

In rejecting the Commissioner's constructive sale contention, the Tax Court did not reach the issue of whether the amount of shares to be delivered at settlement was "substantially fixed." Instead, Judge Ruwe, at least implicitly, rejected the Commissioner's constructive sale claim because the amended contracts did not require McKelvey "to deliver the same or substantially identical property" as the collateralized shares. 26 U.S.C. § 1259(c)(1)(C). We say "implicitly" because Judge Ruwe did not say that subsection 1259(c)(1)(C) was inapplicable. But he did say that (1) "the extensions [of the valuation dates] did not clarify the uncertainty of which property [McKelvey] would ultimately deliver to settle the contracts," and (2)

"[McKelvey] had the discretion to settle the VPFCs using stock with a higher or lower basis than the stock pledged as collateral." T.C. op. at 30, 2017 WL 1402129, at *10. Thus, the Tax Court appears to have rejected the Commissioner's constructive sale claim because the shares to be delivered at settlement did not have to be the same as, or substantially identical to, the shares pledged as collateral.

Somewhat surprisingly, neither party explicitly considers this aspect of the Tax Court's ruling. The Commissioner grounds his constructive sale argument solely on the theory, which we accept, that the *amount* of shares (not the identity of shares) to be delivered at settlement was "substantially fixed" because of the depressed price of Monster stock. The Estate grounds its opposition to a constructive sale on two arguments. First, the Estate contends that "Mr. McKelvey did not enter into new contracts at the time of the extensions," Brief for Estate at 47, leaving the original contracts "open," *id*. We have rejected that argument. Second, the Estate contends that, even if the amended contracts were new contracts, there would not be a constructive sale because the amended contracts "would not constitute forward sales of a substantially fixed *amount* of property under section 1259." Brief for Estate at 48 (emphasis added; capitalization altered). Disputing the Commissioner's probability analysis, the Estate asserts, "[T]he chance that Monster stock would rebound to above the floor price of the VPFCs before the extended expiration was certainly not remote."[19] Brief for Estate at 52. We have rejected that argument. Expanding its second argument, the Estate contends that any fixation of the amount of shares to be delivered was not established by the "terms" of the contracts. Brief for Estate at 48-53. But the contract terms, by focusing on closing prices at settlement and keying the number of deliverable shares to the relation of those prices to the floor and cap prices, necessarily require consideration of what those prices would be.

Perhaps both sides plausibly believe that it is the "substantially fixed price" language of subsection 1259(d)(1) that controls the constructive sale issue. Or they more plausibly believe that the "same or substantially identical property" language of subsection 1259(c)(1)(C) means that the property to be delivered must have the same *value* as the appreciated position. It is clear that McKelvey's option to settle with shares other than the collateralized shares required him to deliver property of equal value. Moreover, the Tax Court's observation that McKelvey could have settled with shares having a different basis than the collateralized Monster stock would affect the amount of capital gain arising from a constructive sale, but not whether a constructive sale occurred. In any event, we decide the constructive sale issue as the parties have presented it and conclude that

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[19] If the price of Monster shares had closed above the floor price and McKelvey had settled the contracts before his death, he would have been entitled to an adjustment in light of the previous taxation of constructive sales. *See* 26 U.S.C. § 1259 (a)(2), (e)(1).

constructive sales of the collateralized shares occurred.

Conclusion

The decision of the Tax Court is reversed, and the case is remanded for (1) determination, in light of this opinion, of whether the termination of obligations that occurred when the amended contracts were executed resulted in taxable short-term capital gains, and (2) calculation of the amount of long-term capital gains that resulted from the constructive sales of the collateralized shares.

APPENDIX B

JOSÉ A. CABRANES, *Circuit Judge*, *concurring*:

I agree with the Court's conclusion that McKelvey, as issuer of the *nondebt* financial instruments in this case, 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. I write separately to stress that this conclusion does not affect, by implication or analogy, the existing application of Treasury Regulations section 1.1001-3 to holders and issuers of *debt* instruments. Section 1.1001-3 sets forth principles for determining when the modification of a debt instrument is sufficiently "significant" to constitute a taxable event. These principles, as I understand them, apply to both the holder-obligee and the issuer- obligor of the instrument. *See, e.g.*, Rev. Rul. 2004-37, 2004-1 C.B. 583 (applying the principles of section 1.1001-3 to require the issuer of a recourse note to recognize gain resulting from the modification of the note).

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals for the Second Circuit, held at the Thurgood Marshall United States Courthouse, 40 Foley Square, in the City of New York, on the 26th day of September, two thousand and eighteen.

Before: Jon O. Newman,
José A. Cabranes,
Susan L. Carney,
Circuit Judges.

JUDGMENT
Docket No. 17-2554

Estate of Andrew J. McKelvey, Deceased, Bradford G. Peters, Executor,

Petitioner - Appellee.

v.

Commissioner of Internal Revenue,

Respondent - Appellant.

The appeal in the above captioned case from a decision and order of the United States Tax Court was argued on the district court's record and the parties' briefs. Upon consideration thereof,

IT IS HEREBY ORDERED, ADJUDGED and DECREED that the decision of the Tax Court is REVERSED and the case is REMANDED for further proceedings consistent with this Court's opinion.

For the Court:
Catherine O'Hagan Wolfe,
Clerk of Court

APPENDIX D

148 T.C. No. 13
UNITED STATES TAX COURT
ESTATE OF ANDREW J. MCKELVEY,
DECEASED, BRADFORD G. PETERS, EXECUTOR,
Petitioner v. COMMISSIONER OF INTERNAL
REVENUE, Respondent

Docket No. 26830-14. Filed April 19, 2017.

Decedent (D) entered into variable prepaid forward contracts (original VPFCs) with two investment banks in 2007. Pursuant to the terms of the original VPFCs, the investment banks made prepaid cash payments to D, and D was obligated to deliver variable quantities of stock to the investment banks on specified future settlement dates in 2008 (original settlement dates). D treated the execution of the original VPFCs as open transactions pursuant to Rev. Rul. 2003-7, 2003-1 C.B. 363, and did not report any gain or loss for 2007.

In 2008, before the original settlement dates, D paid consideration to the investment banks to extend the settlement dates until 2010 (VPFC extensions). D did not report any gain or loss upon the execution of the VPFC extensions and continued the open transaction treatment. D died in 2008 after the execution of the VPFC extensions. R determined that the execution of the VPFC extensions in 2008 constituted sales or exchanges of property under I.R.C. sec. 1001, and thus D should have reported gain from the transactions for 2008.

Held: D's execution of the VPFC extensions did not constitute sales or exchanges of property under I.R.C. sec. 1001, and the open transaction treatment afforded to the original VPFCs under Rev. Rul 2003-7, supra, continues until the transactions are closed by the future delivery of stock.

Held, further, D did not engage in constructive sales of stock in 2008 pursuant to I.R.C. sec. 1259.

Robert A. Rudnick, Kristen M. Garry, and Mark D. Lanpher, for petitioner. Steven N. Balahtsis and Steven A. Sirotic, for respondent.

OPINION

RUWE, Judge: Respondent determined a $41,257,103 deficiency in Andrew J. McKelvey's (decedent) 2008 Federal income tax. The only issue for decision is whether modifications made in 2008 to decedent's variable prepaid forward contracts

(VPFC) resulted in taxable exchanges pursuant to section 1001.[1]

Background

The parties submitted this case fully stipulated pursuant to Rule 122.[2] Some of the facts have been stipulated and are so found. The first amended, second, and third stipulations of fact and the attached exhibits are incorporated herein by this reference.

At the time the petition was filed, Bradford G. Peters had been appointed executor of decedent's estate by the Surrogate's Court of the State of New York, New York County.[3]

Decedent was the founder and chief executive officer of Monster Worldwide, Inc. (Monster), a company known for its website, monster.com. Monster.com helps inform job seekers of job openings that match their skills and desired geographic location. Decedent died on November 27, 2008. Bradford G. Peters is the executor of decedent's estate.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code (Code) in effect for the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] By order dated March 10, 2016, we granted the parties' joint motion to submit case without trial pursuant to Rules 50(a) and 122(a).

[3] The parties stipulate that "[a]t the time the petition was filed, Petitioner's address was 24 Skipper Drive, West Islip, NY 11795-5044."

<u>Bank of America</u>

Effective September 11, 2007, decedent entered into a VPFC with Bank of America, N.A. (BofA), with respect to 1,765,188 shares of Monster class B common stock owned by decedent (BofA VPFC).[4] Pursuant to the terms of the BofA VPFC decedent received from BofA a cash prepayment of $50,943,578.31 on September 14, 2007. In exchange, decedent agreed to deliver to BofA, over the course of 10 separate settlement dates in September 2008, up to 1,765,188 Monster shares or the cash equivalent. The actual number of Monster shares (or the cash equivalent) required for delivery on each settlement date would vary according to the stock market closing price of Monster shares on each specified settlement date. Three different scenarios were contemplated in the BofA VPFC. If the Monster stock closing price on a particular settlement date was less than or equal to $30.4610 per share (BofA floor price), the number of Monster shares (or cash equivalent) deliverable to BofA on the settlement date would be as follows:

Settlement Date	Monster Shares Deliverable to BofA
9/11/08	176,518
9/12/08	176,518
9/15/08	176,519
9/16/08	176,519
9/17/08	176,519
9/18/08	176,519

[4] At the close of trading on the NASDAQ on September 11, 2007, the share price of Monster was $32.91.

9/19/08	176,519
9/22/08	176,519
9/23/08	176,519
9/24/08	176,519

If the Monster stock closing price on a particular settlement date was greater than the BofA floor price but less than or equal to $40.5809 per share (BofA cap price), then the number of Monster shares (or cash equivalent) deliverable to BofA would be the product of:

$$176{,}519 \quad \text{x} \quad \frac{\text{BofA floor price}}{\text{Stock closing price}}$$

The multiplier used for the September 11 and 12, 2008, settlement dates is 176,518 instead of 176,519.

If the Monster stock closing price on a particular settlement date was greater than the BofA cap price, then the number of Monster shares (or cash equivalent) deliverable to BofA would be the product of:

$$176{,}519 \quad \text{x} \quad \frac{\text{BofA floor price + Stock closing price - BofA cap price}}{\text{Stock closing price}}$$

The multiplier used for the September 11 and 12, 2008, settlement dates is 176,518 instead of 176,519.

On each settlement date, decedent could elect to settle the VPFC by delivering the requisite number of Monster shares or the cash equivalent. Decedent pledged 1,765,188 Monster shares to BofA to secure his obligations under the BofA VPFC but could substitute other collateral, subject to BofA's approval, at any time during the term of the VPFC.

On July 24, 2008, decedent paid BofA $3,477,949.92 in additional consideration to extend the BofA VPFC settlement dates (BofA extension), as follows:[5]

Original BofA Settlement Date	Extended BofA Settlement Date
9/11/08	2/1/10
9/12/08	2/2/10
9/15/08	2/3/10
9/16/08	2/4/10
9/17/08	2/5/10
9/18/08	2/8/10
9/19/08	2/9/10
9/22/08	2/10/10
9/23/08	2/11/10
9/24/08	2/12/10

The BofA extension further provides: "Except as amended herein, all other terms and conditions of the * * * [BofA VPFC] shall remain in full force and in effect."

Following decedent's death, petitioner settled the BofA VPFC by delivering to BofA 1,757,016 shares of Monster stock on or about May 8, 2009.[6]

[5] At the close of trading on the NASDAQ on July 24, 2008, the share price of Monster was $18.24.

[6] It appears that the original BofA VPFC provided for expedited settlement upon the occurrence of certain default or termination events, such as decedent's death. Neither party attaches any significance to the fact that there was an event triggering settlement before the contractually specified dates.

Morgan Stanley

Effective September 24, 2007, decedent entered into an agreement with Morgan Stanley & Co. International plc (MSI), with respect to 4,762,000 shares of Monster common stock (MSI VPFC).[7] Pursuant to the terms of the MSI VPFC decedent received from MSI a cash prepayment of $142,626,185.80 on September 27, 2007. In exchange, decedent agreed to deliver to MSI, on or about September 24, 2008, up to 4,762,000 Monster shares or the cash equivalent. The actual number of Monster shares (or cash equivalent) required for delivery would vary according to the average closing price of Monster stock on specified dates (averaging dates). The averaging dates used to calculate the number of deliverable shares under the MSI VPFC were the same 10 settlement dates used in the original BofA VPFC.

Similar to the BofA VPFC, three different scenarios were contemplated in the MSI VPFC. If the average closing price of Monster stock over the 10 averaging dates was less than or equal to $30.894 per share (MSI floor price), then decedent would be required to deliver to MSI 4,762,000 Monster shares or the cash equivalent. If the average closing price of Monster stock over the 10 averaging dates was greater than the MSI floor price but less than or equal to $35.772 per share (MSI cap price), then the number of Monster shares (or cash equivalent)

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[7] At the close of trading on the NASDAQ on September 24, 2007, the share price of Monster was $33.47.

deliverable to MSI would be calculated using the following formula:

$$\frac{4{,}762{,}000 \times \text{MSI floor price}}{\text{Stock average price}}$$

If the average closing price of Monster stock over the 10 averaging dates was greater than the MSI cap price, then the number of Monster shares (or cash equivalent) deliverable to MSI would be calculated using the following formula:

$$4{,}762{,}000 \quad \text{x} \quad \frac{\text{MSI floor price + average price - MSI cap price}}{\text{Stock average price}}$$

The terms of the MSI VPFC, like the terms of the BofA VPFC, provided that decedent could elect to settle the contract either by delivering the requisite number of Monster shares or by paying the cash equivalent. Decedent pledged 4,762,000 Monster shares to secure his obligations under the MSI VPFC but could substitute other collateral, subject to MSI's approval, at any time during the term of the MSI VPFC.

On July 15, 2008, decedent paid MSI $8,190,640 in additional consideration to extend the MSI VPFC averaging and settlement date(s) (MSI extension).[8] Pursuant to the terms of the MSI extension decedent and MSI postponed the settlement date of the MSI contract from September 24, 2008, to January 15, 2010. The MSI extension also postponed the 10 averaging dates to be used for

[8] At the close of trading on the NASDAQ on July 15, 2008, the share price of Monster was $17.28.

the calculation of the average closing price, as follows:

Original MSI Averaging Date	Extended MSI Averaging Date
9/11/08	1/4/10
9/12/08	1/5/10
9/15/08	1/6/10
9/16/08	1/7/10
9/17/08	1/8/10
9/18/08	1/11/10
9/19/08	1/12/10
9/22/08	1/13/10
9/23/08	1/14/10
9/24/08	1/15/10

The MSI extension further provides: "This Confirmation supplements, forms part of, and is subject to, the * * * [MSI VPFC] * * * between you and us. All provisions in the * * * [MSI VPFC] govern this Confirmation except as expressly modified below."

Following decedent's death, petitioner settled the MSI VPFC by delivering to MSI 4,762,000 shares of Monster stock on or about August 5, 2009.[9]

[9] It appears that the original MSI VPFC, like the original BofA VPFC, provided for expedited settlement upon the occurrence of certain default or termination events, such as decedent's death. Neither party attaches any significance to the fact that there was an event triggering settlement before the contractually specified dates. Petitioner received a $95,240 credit from MSI at settlement, and the parties do not explain and it is unclear from the record why MSI credited this amount.

Tax Return

Petitioner timely filed a Form 1040, U.S. Individual Income Tax Return, for decedent's taxable year 2008. On August 14, 2014, respondent issued a notice of deficiency to petitioner for decedent's taxable year 2008. Respondent determined in the notice of deficiency that decedent, upon executing the BofA and MSI extensions in 2008, realized a capital gain of $200,886,619. Respondent's determined gain comprised: (1) decedent's realization of short-term capital gain of $88,096,811.03[10] from his exchange of the VPFC extensions for the original VPFCs and (2) decedent's realization of $112,789,808.03 of long-term capital gain from the constructive sales of Monster shares pledged under the VPFCs.[11] Respondent's determination of long-term capital gain is based on decedent, as the founder of Monster, having zero basis in the Monster shares pledged as collateral to BofA and MSI.[12] Petitioner timely filed a

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[10] Respondent's computation of short-term capital gain is based on (1) decedent's holding period of the original VPFCs before extension and (2) an amount realized for each original VPFC equal to the product of (i) the number of Monster shares pledged as collateral and (ii) the excess of the floor prices under the original VPFCs over the Monster closing price on July 15, 2008, of $17.28 per share.

[11] Respondent's computation of long-term capital gain is based on (1) decedent's long-term holding period of the Monster shares, and (2) an amount realized equal to the product of (i) the number of Monster shares pledged as collateral under the original VPFCs and (ii) the Monster closing price on July 15, 2008, of $17.28 per share.

petition with the Court disputing respondent's determinations in the notice of deficiency.

Discussion

The Commissioner's determinations in the notice of deficiency are generally presumed correct, and the taxpayer bears the burden of proving that the determinations are incorrect. Rule 142(a); Welch v. Helvering, 290 U.S. 111, 115 (1933). Under section 7491(a), if the taxpayer provides credible evidence concerning any factual issue relevant to ascertaining the taxpayer's liability and complies with certain other requirements, the burden of proof shifts from the taxpayer to the Commissioner as to that factual issue. Our conclusions are based on a preponderance of the evidence, and thus the allocation of the burden of proof in this case is immaterial. See Estate of Bongard v. Commissioner, 124 T.C. 95, 111 (2005); McGowen v. Commissioner, T.C. Memo. 2011-186, 2011 Tax Ct. Memo LEXIS 185, at *5 n.3.

We begin our discussion by briefly explaining the financial instrument at the heart of this case, the VPFC. A standard forward contract is an executory

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[12] Pursuant to a 2010 settlement between the Internal Revenue Service (IRS) Office of Appeals and petitioner regarding decedent's taxable year ending December 31, 2002, decedent recognized capital gain of $12,077,427 with respect to 2,500,000 Monster shares. The capital gain of $12,077,427 constitutes his basis in those 2,500,000 shares, which decedent continued to own at his death. Neither decedent nor petitioner has previously claimed as basis in connection with the disposition of Monster shares any part of the $12,077,427 in capital gain, and these shares could have been used to settle part of decedent's obligation under the VPFCs. At the time of his death, decedent owned 9,246,376 shares of Monster stock.

contract in which a forward buyer agrees to purchase from a forward seller a fixed quantity of property at a fixed price, with both payment and delivery occurring on a specified future date. See Anschutz Co. v. Commissioner, 135 T.C. 78, 81 (2010), aff'd, 664 F.3d 313 (10th Cir. 2011). The VPFC is a variation of a standard forward contract, requiring the forward buyer (usually a bank) to pay a forward price (discounted to present value) to the forward seller on the date of contract execution, rather than on the date of contract maturity. A forward seller can use the upfront cash prepayment however he or she deems fit, but the proceeds are often used by the forward seller to diversify a concentrated stock position into other securities or financial instruments. In exchange for the cash prepayment, the forward seller becomes obligated to deliver to the forward buyer: (1) shares of stock that have been pledged as collateral at the inception of the contract; (2) identical shares of the stock which have not been pledged as collateral; or (3) an equivalent cash amount. The actual number of shares (or cash equivalent) to be delivered by the forward seller is determined by a formula which takes into account changes in the market price of the underlying stock over the duration of the contract. Id. at 81-82.

I. Section 1001 Sale or Exchange Treatment

In Rev. Rul. 2003-7, 2003-1 C.B. 363, the IRS recognized that VPFCs are open transactions when executed and do not result in the recognition of gain or loss until future delivery. The rationale of Rev. Rul. 2003-7, supra, is straightforward: A taxpayer entering into a VPFC does not know the identity or amount of property that will be delivered until the future settlement date arrives and delivery is made. In the instant case, the treatment of the original VPFCs is not in dispute. Both parties agree that when decedent entered into the original VPFCs in 2007, the contracts satisfied the requirements of Rev. Rul. 2003-7, supra, and decedent recognized no current gain or loss.

The issue we must decide is what tax consequences, if any, occurred when decedent extended the settlement and averaging dates of the original VPFCs on July 15 and 24, 2008. Respondent argues that the extensions to the original VPFCs resulted in taxable exchanges of the original VPFCs for the MSI and BofA extensions under section 1001. Respondent also argues that the extensions to the original VPFCs resulted in constructive sales of the underlying shares of Monster stock pursuant to section 1259. Petitioner contends that the extensions to the original VPFCs merely postponed the settlement and averaging dates of the contracts, did not trigger any tax consequences to decedent, and that the "open" transaction treatment provided by Rev. Rul. 2003-7, supra, should continue until the contracts are settled by delivery of Monster stock. The parties cite no reported cases addressing the tax consequences resulting from extensions to VPFCs, and this appears to be a case of first impression in this Court.

Section 1001(c) provides that, except as otherwise provided in subtitle A, the entire amount of gain or loss on the sale or exchange of property shall be recognized. Section 1001 provides:

> SEC. 1001(a). Computation of Gain or Loss.--The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

In situations where property is not disposed of for cash but is instead exchanged for other property, section 1.1001-1(a), Income Tax Regs., provides that the exchange is not a taxable event under section 1001 unless the exchanged properties "differ[] materially either in kind or in extent". Accordingly, in order for decedent's VPFC amendments to trigger realization of gain or loss under section 1001(a) and section 1.1001-1, Income Tax Regs., two conditions must be satisfied: (1) the original VPFCs must constitute property to decedent at the time of the extensions and (2) the property must be exchanged for other property differing materially either in kind or in extent.

A. <u>VPFCs as Property</u>

Section 1001 applies to the "sale or other disposition of property". Accordingly, our analysis begins by determining whether, at the time of the extensions, the VPFCs constituted "property" to decedent under section 1001. If the VPFCs were not property to decedent, section 1001 has no application, and respondent's theory fails as a matter of law. The starting point for interpreting a statutory provision is the language of the actual statute. See Watt v. Alaska, 451 U.S. 259, 265 (1981). The plain meaning of the statutory language, as illuminated by the contemporaneous legislative history, often indicates the congressional intent behind enactment of a particular statute. Edwards v. Aguillard, 482 U.S. 578, 594 (1987). In the instant case, neither the statutory language of section 1001 nor the legislative history define the term "property".[13]

Black's Law Dictionary broadly defines property as "[a]ny external thing over which the rights of possession, use, and enjoyment are exercised". Black's Law Dictionary 1335-1336 (9th ed. 2009). In Dickman v. Commissioner, 465 U.S. 330 (1984), the Supreme Court discussed the meaning of the term "property" as used in the Code's gift tax provisions:

> "Property" is more than just the physical thing--the land, the bricks, the mortar--it is also the sum of all the rights and powers incident to ownership of the physical thing. It is the tangible and the intangible. Property is composed of constituent elements and of these elements the right to use the physical thing to the exclusion of others is the most essential and beneficial. * * *

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[13] The determination of something as "property" is significant for tax purposes. Both the definition of a capital asset under sec. 1221(a) and the definition of an installment sale under sec. 453(a) require that the transaction involve "property".

Id. at 336 (emphasis in original) (quoting Passailaigue v. United States, 224 F. Supp. 682, 686 (M.D. Ga. 1963)). The Supreme Court further noted that money is a property interest and the right to use money is a property interest of "the highest order." Id.

In United States v. Craft, 535 U.S. 274, 278-279 (2002), the Supreme Court explained the roles of Federal and State law in determining whether something constitutes property for Federal tax purposes:

> A common idiom describes property as a "bundle of sticks"-- a collection of individual rights which, in certain combinations, constitute property. * * * State law determines only which sticks are in a person's bundle. Whether those sticks qualify as "property" for purposes of the federal tax lien statute is a question of federal law.

Petitioner argues that the VPFCs were not property to decedent when the extensions were executed and therefore decedent had no property that could be disposed of for gain or loss under section 1001. The crux of petitioner's argument is that decedent did not possess property rights in the original VPFCs at the time the settlement and averaging dates were extended but instead had only obligations to deliver the requisite number of shares or the cash equivalent. Petitioner argues that decedent's "only right under each VPFC was to receive the prepayment required by such contract"; however, petitioner contends that following the receipt of the prepayments "each VPFC was solely an obligation of * * * [decedent], not his property."

Respondent argues that the original VPFCs are "comprised of an integrated bundle of valuable investment and other contract rights, as well as obligations, and constituted property within the meaning of I.R.C. § 1001." Respondent argues that the original VPFCs were subject to market forces and appreciation, which are valuable investment rights. Respondent further argues that the original VPFCs also conferred contractual rights, such as the right to use the prepayment cash proceeds, the right to determine how the VPFCs would be settled (i.e., by cash or stock, and if by stock, which particular shares), and the right to substitute collateral acceptable to BofA and/or MSI at any time during the term of the contracts. Respondent contends that, even if decedent possessed primarily obligations, the original VPFCs still constituted property within the meaning of section 1001.

Rights or Obligations

We find that, at the time decedent extended the settlement and averaging dates of the original VPFCs, he had only obligations. When decedent executed the original VPFCs--on September 11 and 24, 2007--he contracted for the right to receive cash prepayments in exchange for his obligation to deliver shares of Monster stock (or cash equivalent) on specified future dates. However, after decedent received his cash prepayments from BofA on September 14, 2007, and MSI on September 27, 2007, his lone right under the VPFCs was satisfied and he had no continuing right to receive anything further. Decedent executed the MSI extension on July 15, 2008, and the BofA extension on July 24, 2008, and these dates are approximately 10 months after his rights to receive cash prepayments were satisfied in full. The MSI and BofA extensions did not provide decedent with the right to receive further payments. The text of the MSI and BofA extensions provide that (1) decedent will pay additional consideration specifically for the extension of the settlement and/or averaging dates and (2) the terms of the original VPFCs remain in full force and effect. The MSI and BofA extensions do not alter any other aspects of the original VPFCs. Thus, when decedent executed the extensions, all that remained under the VPFCs was decedent's obligation to deliver shares of Monster stock or the cash equivalent.

It is true that the amount of decedent's obligation under the VPFCs could vary according to the terms of the VPFCs. That is the nature of a VPFC and a reason the original VPFCs did not result in the immediate recognition of income. Nevertheless, all decedent had (both before and after the execution of the extensions) were obligations to deliver.[14] The expert report of respondent's expert, Hendrik Bessembinder, buttresses this conclusion. Throughout his report, Dr. Bessembinder repeatedly

[14] The extensions of the averaging and settlement dates were undoubtably valuable to decedent, which is evidenced by his payment of valuable consideration in an arm's-length transaction for the extensions. However, decedent's execution of the extensions only postponed the averaging and settlement dates of the original VPFCs and did not change the fact that decedent's interest in the VPFCs were obligations rather than property that could be exchanged under sec. 1001.

refers to decedent having obligations, not rights, under the VPFCs. Dr. Bessembinder's expert report also includes graphs depicting the "Value of Obligation to Deliver Shares" at various settlement prices under both the MSI and BofA VPFCs. Dr. Bessembinder introduces one such graph by stating: "Since the obligation to deliver shares comprises a liability from * * * [decedent]'s viewpoint, I display the dollar amounts as negative quantities." (Emphasis added.) Because decedent had only obligations under the contracts-- and obligations are not property--the VPFCs were not property under section 1001, and therefore section 1001 is inapplicable.

Nevertheless, respondent argues that decedent possessed three valuable rights in the original VPFCs: (1) the right to the cash prepayments; (2) the right to determine how the VPFCs would be settled (i.e., whether with stock or in cash, and if stock, which specific shares); and (3) the right to substitute other collateral.[15] We will address each of respondent's arguments in turn.

Respondent first argues that decedent's right to cash prepayments constituted a valuable property

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[15] Respondent attempts to disaggregate the VPFCs into three components: (1) a discount loan; (2) a long put option; and (3) a short call option. Although the economic value of a VPFC can be calculated by valuing these separate parts, respondent appears to argue that decedent had contract rights in each of these distinct components. We disagree. VPFCs are comprehensive financial products, and decedent did not have the ability to transact separately in discount loans or call and put options. See Chock Full O' Nuts Corp. v. United States, 453 F.2d 300, 305 (2d Cir. 1971).

right. Respondent cites our Opinion in Fed. Home Loan Mortgage Corp. v. Commissioner (FHLMC), 121 T.C. 254, 259 (2003), for the proposition that "[i]t is beyond doubt that the right to use money represents a valuable property interest." Respondent concludes from this statement that decedent's receipt of prepayment cash was a valuable property interest akin to the financing arrangement used by the taxpayer in FHLMC, and therefore the VPFCs are property under section 1001. However, respondent takes our statement in FHLMC out of context. In FHLMC, 121 T.C. at 259, the issue was whether the benefit from a taxpayer's favorable financing arrangement, which provided the taxpayer with the right to use borrowed money over a period at below-market interest rates, could constitute an intangible asset for purposes of section 167(a). Our statement in FHLMC that "the right to use money represents a valuable property interest" was part of a larger discussion concerning "the cost of using borrowed money", and FHLMC involved a unique scenario in which legislation was enacted allowing the taxpayer to go from a tax-exempt entity to a taxable entity and contained special basis provisions permitting amortization deductions. Id. at 257, 259-260. In the instant case, decedent received cash prepayments from BofA or MSI on September 14 and 27, 2007, respectively. Unlike the financing arrangement of the taxpayer in FHLMC, the prepayment cash was not lent to decedent from BofA and MSI and he had no corresponding obligation to repay it to his counterparties. Although the original VPFCs did provide decedent with a right to receive cash prepayments, once these prepayments were received on September 14 and 27, 2007, decedent was left only with obligations to deliver under the terms of the VPFCs and retained no further property rights with respect to the contracts. Thus, when decedent extended the settlement and averaging dates, on July 15 and 24, 2008, respectively, he had no right to receive anything more than what he had previously received on September 14 and 27, 2007. All decedent had under the terms of the VPFCs were obligations that might increase or decrease in amount.

Respondent next argues that decedent had the right to settle the VPFCs with stock or in cash and the right to substitute other collateral for the shares pledged to BofA and MSI. We are not persuaded by respondent's argument. The VPFCs contained contractual provisions that allowed decedent to determine his method of delivery. However, the contractual provisions allowing decedent to choose settlement with stock or in cash and to substitute collateral did not equate to property rights. These provisions had no value that decedent could dispose of in an arm's-length transaction; we cannot foresee a hypothetical buyer willing to pay value for the "right" to deliver stock or cash or the "right" to substitute collateral. Furthermore, decedent's ability to substitute collateral was not absolute; it was subject to the approval of his counterparties. Thus, these contractual provisions are not property rights but rather procedural mechanisms designed to facilitate decedent's delivery obligations. At the time decedent extended the original VPFCs, he had only delivery obligations and not property rights in the contracts. These were purely liabilities as shown in

Dr. Bessembinder's expert report. We hold that the MSI and BofA extensions, executed on July 15 and 24, 2008, did not constitute exchanges of decedent's "property" in the original VPFCs under section 1001.

II. Open Transaction Treatment

Our holding is consistent with the rationale behind the open transaction treatment afforded in Rev. Rul. 2003-7, supra. As a general rule, taxation is imposed only on the realization of gain or loss. See Lucas v. Am. Code Co., 280 U.S. 445, 449 (1930). In order to calculate gain or loss realized from a particular transaction, a taxpayer must ascertain both an amount realized and an adjusted basis. Sec. 1001(a);[16] sec. 1.1001-1(a), Income Tax Regs. Certain transactions, such as VPFCs, are afforded "open" transaction treatment because either the amount realized or the adjusted basis needed for a section 1001 calculation is not known until contract maturity. See Burnet v. Logan, 283 U.S. 404 (1931) (applying open transaction doctrine until a transaction closed). In these instances the component that is known is held in suspense and gain or loss is not realized until the missing component is determined and the transaction is properly closed. The open transaction doctrine is an

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[16] Sec. 1001(a) provides:

SEC. 1001(a). Computation of Gain or Loss.--The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

exception to the usual treatment arising from a sale or exchange of property for cash or other property. See Dennis v. Commissioner, 473 F.2d 274, 285 (5th Cir. 1973), aff'g 57 T.C. 352 (1971). The open transaction doctrine is a "rule of fairness designed to ascertain with reasonable accuracy the amount of gain or loss realized upon an exchange, and, if appropriate, to defer recognition thereof until the correct amounts can be accurately determined." Id. at 285.

In order to determine gain or loss realized from a transaction, a taxpayer needs to readily ascertain both an amount realized and the identity and adjusted basis of property sold, disposed of, or exchanged. See sec. 1.1001-1(a), Income Tax Regs. In a VPFC, the amount realized is known to the forward seller (i.e., the cash prepayment) at the inception of the contract, but the identity, adjusted basis, and value of the property to be delivered (i.e., stock or cash equivalent) is not known until settlement. A forward seller has an obligation of future delivery that is uncertain in amount and maintains the discretion to deliver (1) the collateralized stock; (2) identical shares of stock which were not pledged as collateral; or (3) a cash equivalent. Each of these delivery options will likely result in a different adjusted basis amount. Thus, it is impossible to calculate gain or loss with reasonable accuracy at the outset of a VPFC when the adjusted basis necessary for a section 1001 calculation is uncertain. Of course, a determination of gain or loss under section 1001 becomes certain when a forward seller satisfies his or her delivery obligations under a

VPFC by delivering shares of stock or a cash equivalent thereby closing the transaction.

On February 3, 2003, the IRS published Rev. Rul. 2003-7, supra, which approved "open" transaction treatment for VPFCs that meet certain criteria. Rev. Rul. 2003-7, supra, found that a shareholder who entered into a VPFC secured by a pledge of stock neither caused a sale of stock under section 1001 nor triggered a constructive sale under section 1259. The facts of Rev. Rul. 2003-7, supra, involved a taxpayer that held appreciated shares of a publicly traded corporation. The taxpayer entered into a VPFC with an investment bank, requiring the bank to provide an upfront cash payment in exchange for the taxpayer's agreement to deliver a variable number of shares (determined by a formula in the VPFC) at maturity. As security, the taxpayer in Rev. Rul. 2003-7, supra, pledged as collateral to the investment bank the maximum number of shares that could be required under the contract; however, the taxpayer retained the right to vote the pledged shares and to receive dividends from the stock. The VPFC was for a three-year term.[17]

Pursuant to the terms of the VPFC in Rev. Rul. 2003-7, supra, the taxpayer had the unrestricted legal right to settle the contract at maturity by delivering to the investment bank: (1) the pledged shares; (2) a cash equivalent; or (3) shares other than the pledged shares. The facts of Rev. Rul. 2003-7, supra, also indicate that, at the time the parties

[17] We note that decedent's extended settlement dates were also approximately three years from the dates he entered into the original VPFCs.

entered into the VPFC, the taxpayer intended to settle the contract by delivering the pledged shares to the investment bank on the maturity date. However, the taxpayer was not otherwise economically compelled to deliver the pledged shares and could settle the contract using other shares or cash.

On the basis of the facts set forth in Rev. Rul. 2003-7, supra, the IRS concluded that no sale or exchange treatment under section 1001 is warranted when a taxpayer: (1) receives a fixed amount of cash; (2) simultaneously enters into an agreement to deliver on a future date a number of shares of common stock that vary significantly depending on the value of the shares on the delivery date; (3) pledges the maximum number of shares for which delivery could be required under the agreement; (4) retains the unrestricted legal right to deliver the pledged shares or to substitute cash or other shares for the pledged shares on the delivery date; and (5) is not economically compelled to deliver the pledged shares. The IRS noted in Rev. Rul. 2003-7, supra, that a different outcome might occur if the taxpayer were subject to economic compulsion to deliver the pledged shares rather than cash or other shares. The IRS further concluded that the subject VPFC did not meet the definition of a standard forward contract under section 1259(d)(1) because the stock to be delivered at maturity was subject to "significant variation" and therefore did not cause a constructive sale under section 1259.

In the instant case, decedent did not realize gain or loss when he entered into the original BofA and MSI VPFCs--on September 11 and 24, 2007, respectively--because the contracts satisfied the requirements of Rev. Rul. 2003-7, supra, and the adjusted basis component needed for a section 1001 computation was unknown. Decedent received fixed cash prepayments from BofA and MSI of $50,943,578.31 and $142,626,185.80, respectively. Decedent agreed to deliver on a future date a number of Monster shares based upon the value of those shares on specified future dates. Decedent pledged 1,765,188 shares of Monster stock to BofA and 4,762,000 shares of Monster stock to MSI, the maximum number of shares deliverable under both contracts. Decedent retained the ability to substitute cash or other shares for the pledged shares and the discretion to settle the VPFCs in cash rather than Monster stock. The original VPFCs warranted open transaction treatment because, while the amount realized (i.e., the cash prepayments) was known at the inception of the contracts, it was uncertain how many shares decedent would have to deliver or what stock shares decedent would use to settle the contracts at maturity, or if he would choose to discharge his delivery obligations in cash. Furthermore, if decedent chose to discharge his delivery obligations using Monster stock, it was uncertain which specific shares would be delivered and what adjusted cost basis decedent had in those shares. Accordingly, the adjusted basis component necessary for a section 1001 computation was uncertain at inception and realization of gain or loss could not be accurately determined. Both parties agree that the original VPFCs are entitled to open transaction treatment, and thus decedent realized no gain or loss upon the execution of the original contracts.

The issue is what tax consequences occurred when decedent extended the settlement and averaging dates of the original VPFCs on July 15 and 24, 2008. Respondent argues that the extensions to the original VPFCs closed the original VPFCs and that decedent should have realized gain or loss upon executing the extensions. Petitioner argues that decedent's extensions to the original VPFCs did not close the original transactions and the open transaction treatment afforded to the original VPFCs should continue until the VPFCs were settled by delivery of Monster stock on the extended settlement dates. We agree with petitioner.

The rationale for affording open transaction treatment to VPFCs is the existence of uncertainty regarding the property to be delivered at settlement. As explained above, a section 1001 computation requires both an amount realized and an adjusted basis; however, only an amount realized (i.e., the cash prepayment) was known to decedent when the original VPFCs were executed. The original VPFCs provided decedent with the discretion to settle the contracts by delivering: (1) Monster shares pledged as collateral; (2) other shares that were not pledged as collateral; or (3) a cash equivalent. Decedent had not yet discharged his delivery obligations under the original VPFCs when he executed the extensions, and the original VPFCs were still open transactions. The MSI and BofA extensions made only one change to the original VPFCs: The settlement and averaging dates were postponed. Thus, by only extending the settlement and averaging dates, the extensions did not clarify the uncertainty of which property decedent would ultimately deliver to settle the contracts. Decedent had the discretion to settle the VPFCs using stock with a higher or lower basis than the stock pledged as collateral. Because decedent's obligation to deliver a variable number of shares (or the cash equivalent) was continuing, it remained uncertain whether decedent would realize a gain or loss upon discharge of his obligations, not to mention the characterization of such gain or loss.

Although a VPFC is not an option, an option is a familiar type of open transaction from which we can distill applicable principles. See Rev. Rul. 78-182, 1978-1 C.B. 265; Rev. Rul. 58-234, 1958-1 C.B. 279. Upon executing the original VPFC decedent was similarly situated to the writer of a call option, as he received an upfront payment and maintained an obligation to deliver property at a future date. The writer of a call option (optionor) receives an upfront premium in exchange for the obligation to sell property at a specified strike price if the option is exercised by the option holder (optionee) by a certain date. The premium received by the optionor for writing a call is not included in income at the time of receipt but is carried in a deferred account until either (1) the option expires; (2) the option is exercised; or (3) the optionor engages in a closing transaction. Rev. Rul. 78-182, supra; Rev. Rul. 58-234, supra. If the call option is exercised, the premium received by the optionor is includable in the total amount realized when determining the optionor's total gain or loss, and the gain or loss will be characterized as either short term or long term depending on the holding period of the underlying stock. Rev. Rul. 58-234, supra. If the option expires unexercised, the upfront premium constitutes short-term capital gain to the optionor upon expiration. Sec. 1234(b); Rev. Rul. 78-182, supra. Thus, until exercise, expiration, or termination of the option, uncertainty exists regarding the taxpayer's treatment of the option premium.

Virginia Iron Coal & Coke Co. v. Commissioner (Virginia Coal), 37 B.T.A. 195 (1938), aff'd, 99 F.2d 919 (4th Cir. 1938), and Fed. Home Loan Mortg. Corp. v. Commissioner (Freddie Mac), 125 T.C. 248 (2005), are both instructive regarding options and open transaction treatment. In Virginia Coal, 37 B.T.A. at 196, the taxpayer wrote an option in exchange for an upfront cash premium. The option contract provided the optionee with the right to extend the option from year-to-year by making annual payments to the taxpayer on or before the first day of August. Id. The optionee failed to make a timely extension payment for the third year, which allowed the option to lapse; however, the parties modified the option and agreed to continue it. Id. The Board of Tax Appeals held that the continuation of the option prevented the taxpayer from realizing gain or loss in the year of lapse because the taxpayer maintained a continuing obligation to perform. Id. at 197-198. The Board of Tax Appeals also reasoned that continuing open transaction treatment was appropriate because it was uncertain whether the premium payments would ultimately be included in the computation of gain or loss from the sale of the underlying property or would constitute income to the taxpayer in connection with the expiration of the option. Id.

In Freddie Mac, 125 T.C. at 253, the taxpayer entered into prior approval purchase contracts to purchase mortgages from loan originators in exchange for a nonrefundable commitment fee. The Government argued that the upfront commitment fees did not constitute option premiums because it was a virtual certainty that the transactions would be consummated. Id. at 265. First, we found the prior approval purchase contracts to have the economic substance of options and applied the law and policy rationale governing options. Id. at 264-265. Despite the high level of certainty that a transaction would be consummated, we held that some uncertainty remained whether the loan originator would exercise the right to sell the mortgage to the taxpayer, and whether the option was exercised or allowed to expire affected the tax treatment of the upfront premiums. Id. at 266.

In Virginia Coal and Freddie Mac we approved open transaction treatment because it was uncertain whether the options would be exercised or allowed to expire, and the uncertainty directly affected the taxpayer's treatment of the upfront option premium. In the instant case, ample uncertainty existed regarding the nature and amount of the gain or loss. When decedent entered into the original VPFCs, he had the right to receive a cash prepayment in exchange for his obligation to deliver an undetermined number of Monster shares or cash equivalent. Although the amount of the prepayment was known to the parties at inception, the amount and character of gain or loss could not be determined until decedent determined what property he would deliver at settlement. If decedent delivered Monster shares in settlement of the VPFCs, the gain or loss would be determined by comparing the amount realized (i.e., the prepayment cash) with the basis in the particular shares delivered, and the character of the gain or loss would be determined by the holding period of the shares delivered. If decedent delivered a cash equivalent to settle the VPFCs, the gain or loss would have been determined by comparing the amount realized (i.e., the prepayment cash) to the amount paid to settle the contract. This uncertainty existed with respect to the original VPFCs, and the extensions to the VPFCs did not resolve what property decedent would deliver at settlement.

III. Section 1259 Constructive Sale

Finally, we address respondent's argument that the extensions to the original VPFCs resulted in constructive sales under section 1259 of the Monster shares pledged as collateral to BofA and MSI.

Congress enacted section 1259 because it was concerned that taxpayers holding appreciated equity positions were entering into certain complex financial transactions without paying any tax. Anschutz Co. v. Commissioner, 135 T.C. at 109. In the event there is a constructive sale of an appreciated financial position,[18] the taxpayer shall

[18] The term "appreciated financial position" means any position with respect to stock if there would be a gain if the position were sold at its fair market value. Sec. 1259(b)(1). Petitioner concedes that decedent's Monster stock represents an appreciated financial position at the time the original VPFCs and extensions were executed.

recognize gain as if that position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale. Sec. 1259(a)(1). Section 1259(c)(1)(C) provides that the taxpayer will be treated as having made a constructive sale of an appreciated financial position if the taxpayer "enters into a future or forward contract to deliver the same or substantially identical property." Section 1259(d)(1) defines a forward contract as "a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price." A forward contract that calls for the delivery of "an amount of property, such as shares of stock, that is subject to significant variation under the contract terms" is not a forward contract pursuant to section 1259 and does not result in a constructive sale of stock. S. Rept. No. 105-33, at 125-126 (1997), 1997-4 C.B. (Vol. 2) 1067, 1205-1206.

Decedent's extensions to the original VPFCs do not constitute constructive sales under section 1259, because the original VPFCs are the only contracts subject to evaluation. Respondent acknowledges that decedent's execution of the original VPFCs satisfied Rev. Rul. 2003-7, <u>supra</u>. Implicit in this acknowledgment is that the original VPFCs did not trigger constructive sales of stock under section 1259 because the original VPFCs required the future delivery of Monster stock subject to significant variation. Respondent's argument that the extensions to the original VPFCs triggered constructive sales under section 1259 is predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs under section 1001. As we concluded above, the open transaction treatment afforded to the original VPFCs continued when decedent extended the settlement and averaging dates, and there was no exchange of property under section 1001. Accordingly, because respondent concedes that the original VPFCs were properly afforded open transaction treatment under section 1001--and because the open transaction treatment continued when decedent executed the extensions--there is no merit to respondent's contention that the extended VPFCs should be viewed as separate and comprehensive financial instruments under section 1259.

In reaching our decision, we have considered all arguments made by the parties, and to the extent not mentioned or addressed, they are irrelevant or without merit.

To reflect the foregoing,

Decision will be
entered for petitioner.

APPENDIX E

UNITED STATES TAX COURT
WASHINGTON, DC 20217

ESTATE OF ANDREW J. MCKELVEY, DECEASED, BRADFORD G. PETERS, EXECUTOR,	)	
Petitioner	)	Docket No. 26830 -14.
v.	)	
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent	)	

DECISION

Pursuant to the determination of the Court as set forth in its Opinion (148 T.C. No. 13), filed April 19, 2017, it is

ORDERED and DECIDED: That there is no deficiency in income tax due from, or overpayment due to, petitioner for the taxable year 2008.

(Signed) Robert P. Ruwe
Judge

ENTERED: May 22, 2017

APPENDIX F

UNITED STATES COURT OF APPEALS
FOR THE
SECOND CIRCUIT

At a stated term of the United States Court of Appeals for the Second Circuit, held at the Thurgood Marshall United States Courthouse, 40 Foley Square, in the City of New York, on the 10th day of December, two thousand eighteen.

Estate of Andrew J. McKelvey, Deceased, Bradford G. Peters, Executor,

Petitioner - Appellee.

v.

Commissioner of Internal Revenue,

Respondent - Appellant.

ORDER

Docket No: 17-2554

Appellee Estate of Andrew J. McKelvey, filed a petition for panel rehearing, or, in the alternative, for rehearing *en banc*. The panel that determined the appeal has considered the request for panel rehearing, and the active members of the Court have considered the request for rehearing *en banc*.

IT IS HEREBY ORDERED that the petition is denied.

FOR THE COURT:
Catherine O'Hagan Wolfe,
Clerk

APPENDIX G

§ 1259. Constructive sales treatment for appreciated financial positions

(a) In general

If there is a constructive sale of an appreciated financial position—

(1) the taxpayer shall recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale (and any gain shall be taken into account for the taxable year which includes such date), and

(2) for purposes of applying this title for periods after the constructive sale—

(A) proper adjustment shall be made in the amount of any gain or loss subsequently realized with respect to such position for any gain taken into account by reason of paragraph (1), and

(B) the holding period of such position shall be determined as if such position were originally acquired on the date of such constructive sale.

(b) Appreciated financial position

For purposes of this section—

(1) In general

Except as provided in paragraph (2), the term “appreciated financial position” means any position with respect to any stock, debt instrument, or partnership interest if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value.

(2) Exceptions

The term “appreciated financial position” shall not include—

(A) any position with respect to debt if—

(i) the position unconditionally entitles the holder to receive a specified principal amount,

(ii) the interest payments (or other similar amounts) with respect to such position meet the requirements of clause (i) of section 860G(a)(1)(B), and

(iii) such position is not convertible (directly or indirectly) into stock of the issuer or any related person,

(B) any hedge with respect to a position described in subparagraph (A), and

(C) any position which is marked to market under any provision of this title or the regulations thereunder.

(3) Position

The term "position" means an interest, including a futures or forward contract, short sale, or option.

(c) Constructive sale

For purposes of this section—

(1) In general

A taxpayer shall be treated as having made a constructive sale of an appreciated financial position if the taxpayer (or a related person)—

(A) enters into a short sale of the same or substantially identical property,

(B) enters into an offsetting notional principal contract with respect to the same or substantially identical property,

(C) enters into a futures or forward contract to deliver the same or substantially identical property,

(D) in the case of an appreciated financial position that is a short sale or a contract described in subparagraph (B) or (C) with respect to any property, acquires the same or substantially identical property, or

(E) to the extent prescribed by the Secretary in regulations, enters into 1 or more other transactions (or acquires 1 or more positions) that have substantially the same effect as a transaction described in any of the preceding subparagraphs.

(2) Exception for sales of nonpublicly traded property

The term "constructive sale" shall not include any contract for sale of any stock, debt instrument, or partnership interest which is not a marketable security (as defined in section 453(f)) if the contract settles within 1 year after the date such contract is entered into.

(3) Exception for certain closed transactions

(A) In general

In applying this section, there shall be disregarded any transaction (which would otherwise be treated as a constructive sale) during the taxable year if—

(i) such transaction is closed before the end of the 30th day after the close of such taxable year,

(ii) the taxpayer holds the appreciated financial position throughout the 60-day period beginning on the date such transaction is closed, and

(iii) at no time during such 60-day period is the taxpayer's risk of loss with respect to such position reduced by reason of a circumstance which would be described in section 246(c)(4) if references to stock included references to such position.

(B) Treatment of positions which are reestablished

If—

(i) a transaction, which would otherwise be treated as a constructive sale of an appreciated financial position, is closed during the taxable year or during the 30 days thereafter, and

(ii) another substantially similar transaction is entered into during the 60-day period beginning on the date the transaction referred to in clause (i) is closed—

(I) which also would otherwise be treated as a constructive sale of such position,

(II) which is closed before the 30th day after the close of the taxable year in which the transaction referred to in clause (i) occurs, and

(III) which meets the requirements of clauses (ii) and (iii) of subparagraph (A),

the transaction referred to in clause (ii) shall be disregarded for purposes of determining whether the requirements of subparagraph (A)(iii) are met with respect to the transaction described in clause (i).

(4) Related person

A person is related to another person with respect to a transaction if—

(A) the relationship is described in section 267(b) or 707(b), and

(B) such transaction is entered into with a view toward avoiding the purposes of this section.

(d) Other definitions

For purposes of this section—

(1) Forward contract

The term "forward contract" means a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.

(2) Offsetting notional principal contract

The term "offsetting notional principal contract" means, with respect to any property, an agreement which includes—

(A) a requirement to pay (or provide credit for) all or substantially all of the investment yield (including appreciation) on such property for a specified period, and

(B) a right to be reimbursed for (or receive credit for) all or substantially all of any decline in the value of such property.

(e) Special rules

(1) Treatment of subsequent sale of position which was deemed sold

If—

(A) there is a constructive sale of any appreciated financial position,

(B) such position is subsequently disposed of, and

(C) at the time of such disposition, the transaction resulting in the constructive sale of such position is open with respect to the taxpayer or any related person,

solely for purposes of determining whether the taxpayer has entered into a constructive sale of any other appreciated financial position held by the taxpayer, the taxpayer shall be treated as entering into such transaction immediately after such disposition. For purposes of the preceding sentence, an assignment or other termination shall be treated as a disposition.

(2) Certain trust instruments treated as stock

For purposes of this section, an interest in a trust which is actively traded (within the meaning of section 1092(d)(1)) shall be treated as stock unless substantially all (by value) of the property held by the trust is debt described in subsection (b)(2)(A).

(3) Multiple positions in property

If a taxpayer holds multiple positions in property, the determination of whether a specific transaction is a constructive sale and, if so, which appreciated financial position is deemed sold shall be made in the same manner as actual sales.

(f) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

(Added Pub. L. 105–34, title X, § 1001(a), Aug. 5, 1997, 111 Stat. 903; amended Pub. L. 105–206, title VI, § 6010(a)(1), (2), July 22, 1998, 112 Stat. 812, 813.)

AMENDMENTS

1998—Subsec. (b)(2)(A)(i) to (iii). Pub. L. 105–206, § 6010(a)(1)(A), substituted "position" for "debt".

Subsec. (b)(2)(B), (C). Pub. L. 105–206, § 6010(a)(1)(B),

(C), added subpar. (B) and redesignated former subpar. (B) as (C).

Subsec. (d)(1). Pub. L. 105–206, § 6010(a)(2), inserted "(including cash)" after "property".

EFFECTIVE DATE OF 1998 AMENDMENT

Amendment by Pub. L. 105–206 effective, except as otherwise provided, as if included in the provisions of the Taxpayer Relief Act of 1997, Pub. L. 105–34, to which such amendment relates, see section 6024 of Pub. L. 105–206, set out as a note under section 1 of this title.

EFFECTIVE DATE

Section applicable to any constructive sale after June 8, 1997, with certain exceptions, see section 1001(d) of Pub. L. 105–34, set out as an Effective Date of 1997 Amendment note under section 475 of this title.

APPENDIX H

105TH CONGRESS 1ST SESSION } SENATE { REPORT 105–33

REVENUE RECONCILIATION ACT OF 1997

AS REPORTED BY THE COMMITTEE ON FINANCE)

S. 949

COMMITTEE ON FINANCE
UNITED STATES SENATE

[Including cost estimate of the Congressional Budget Office]

JUNE 20, 1997.—Ordered to be printed

TITLE VIII. REVENUE-INCREASE PROVISIONS

A. Financial Products

1. Require recognition of gain on certain appreciated positions in personal property (sec. 801(a) of the bill and new sec. 1259 of the Code)

Present Law

In general, gain or loss is taken into account for tax purposes when realized. Gain or loss generally is realized with respect to a capital asset at the time the asset is sold, exchanged, or otherwise disposed of. Gain or loss is determined by comparing the amount realized with the adjusted basis of the particular property sold. In the case of corporate stock, the basis of shares purchased at different dates or different prices generally is determined by reference to the actual lot sold if it can be identified. Special rules under the Code can defer or accelerate recognition in certain situations.

The recognition of gain or loss is postponed for open transactions. For example, in the case of a "short sale" (i.e., when a taxpayer sells borrowed property such as stock and closes the sale by returning identical property to the lender), no gain or loss on the transaction is recognized until the closing of the borrowing.

Transactions designed to reduce or eliminate risk of loss on financial assets generally do not cause realization. For example, a taxpayer may lock in gain on securities by entering into a "short sale against the box," i.e., when the taxpayer owns securities that are the same as, or substantially identical to, the securities borrowed and sold short. The form of the transaction is respected for income tax purposes and gain on the substantially identical property is not recognized at the time of the short sale. Pursuant to rules that allow specific identification of securities delivered on a sale, the taxpayer can obtain open transaction treatment by identifying the borrowed securities as the securities delivered. When it is time to close out the borrowing, the taxpayer can choose to deliver either the securities held or newly-purchased securities. The Code provides rules only to prevent taxpayers from using short sales against the box to accelerate loss or to convert short-term capital gain into long-term capital gain or long-term capital loss into short-term capital loss (sec. 1233(b)).

Taxpayers also can lock in gain on certain property by entering into offsetting positions in the same or similar property. Under the straddle rules, when a taxpayer realizes a loss on one offsetting position in actively-traded personal property, the taxpayer generally can deduct this loss only to the extent the loss exceeds the unrecognized gain in the other positions in the straddle. In addition, rules similar to the short sale rules prevent taxpayers from changing the tax character of gains and losses recognized on the offsetting positions in a straddle (sec. 1092).

Taxpayers may engage in other arrangements, such as "futures contracts," "forward contracts," "equity swaps" and other "notional principal contracts" where the risk of loss and opportunity for gain with respect to property are shifted to another party (the "counterparty"). These arrangements do not result in the recognition of gain by the taxpayer.

The Code accelerates the recognition of gains and losses in certain cases. For example, taxpayers are required each year to mark to market certain regulated futures contracts, foreign currency contracts, non-equity options, and dealer equity options, and to take any capital gain or loss thereon into account as 40 percent short-term gain and 60 percent long-term gain (sec. 1256).

Reasons for Change

In general, a taxpayer cannot completely eliminate risk of loss (and opportunity for gain) with respect to property without disposing of the property in a taxable transaction. In recent years, however, several financial transactions have been developed or popularized which allow taxpayers to substantially reduce or eliminate their risk of loss (and opportunity for gain) without a taxable disposition. Like most taxable dispositions, many of these transactions also provide the taxpayer with cash or other property in return for the interest that the taxpayer has given up.

One of these transactions is the "short sale against the box." In such a transaction, a taxpayer borrows and sells shares identical to the shares the taxpayer holds. By holding two precisely offsetting positions, the taxpayer is insulated from economic fluctuations in the value of the stock. While the short against the box is in place, the taxpayer generally can borrow a substantial portion of the value of the appreciated long stock so that, economically, the transaction strongly resembles a sale of the long stock.

Other transactions that have been used by taxpayers to transfer risk of loss (and opportunity for gain) involve entering into notional principal contracts or futures or forward contracts to deliver the same stock. For example, a taxpayer holding appreciated stock may enter into an "equity swap" which requires the taxpayer to make payments equal to the dividends and any increase in the stock's value for a specified period, and entitles the taxpayer to receive payments equal to any depreciation in value. The terms of such swaps also frequently entitle the shareholder to receive payments during the swap period of a market rate of return (e.g., the Treasury-bill rate) on a notional principal amount equal to the value of the shareholder's appreciated stock, making the transaction strongly resemble a taxable exchange of the appreciated stock for an interest-bearing asset.

Explanation of Provision

General rule

The bill requires a taxpayer to recognize gain (but not loss) upon entering into a constructive sale of any appreciated position in stock, a partnership interest or certain debt instruments as if such position were sold, assigned or otherwise terminated at its fair market value on the date of the constructive sale.

If the requirements for a constructive sale are met, the taxpayer would recognize gain in a constructive sale as if the position were sold at its fair market value on the date of the sale and immediately repurchased. Except as provided in Treasury regulations, a constructive sale would generally not be treated as a sale for other Code purposes. An appropriate adjustment in the basis of the appreciated financial position would be made in the amount of any gain realized on a constructive sale, and a new holding period of such position would begin as if the taxpayer had acquired the position on the date of the constructive sale.

A taxpayer is treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain circumstances, a person related to the taxpayer) does one of the following: (1) enters into a short sale of the same property, (2) enters into an offsetting notional principal contract with respect to the same property, or (3) enters into a futures or forward contract to deliver the same property. A constructive sale under any part of the definition occurs if the two positions are in property that, although not the same, is substantially identical. In addition, in the case of an appreciated financial position that is a short sale, a notional principal contract or a futures or forward contract, the holder is treated as making a constructive sale when it acquires the same property as the underlying property for the position. Finally, to the extent provided in Treasury regulations, a taxpayer is treated as making a constructive sale when it enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described.

The positions of two related persons are treated as together resulting in a constructive sale if the relationship is one described in section 267 or section

707(b) and the transaction is entered into with a view toward avoiding the purposes of the provision.

Whether any part of the constructive sale definition is met by one or more appreciated financial positions and offsetting transactions generally will be determined as of the date the last of such positions or transactions is entered into. More than one appreciated financial position or more than one offsetting transaction can be aggregated to determine whether a constructive sale has occurred. For example, it is possible that no constructive sale would result if one appreciated financial position and one offsetting transaction were considered in isolation, but that a constructive sale would result if the appreciated financial position were considered in combination with two transactions. Where the standard for a constructive sale is met with respect to only a *pro rata* portion of a taxpayer's appreciated financial position (e.g., some, but not all, shares of stock), that portion would be treated as constructively sold under the provision. If there is a constructive sale of less than all of any type of property held by the taxpayer, the specific property deemed sold would be determined under the rules governing actual sales, after adjusting for previous constructive sales under the bill. Under the regulations to be issued by the Treasury, either a taxpayer's appreciated financial position or its offsetting transaction might in some circumstances be disaggregated on a non-*pro rata* basis for purposes of the constructive sale determination.

The bill provides an exception from constructive sale treatment for any transaction that is closed before the end of the 30th day after the close of the taxable year in which it was entered into. This exception does not apply, however, where a transaction is closed during the last 60 days of the taxable year or within 30 days thereafter (the "90-day period") unless (1) the taxpayer holds the appreciated financial position to which the transaction relates (e.g., the stock where the offsetting transaction is a short sale) throughout the 60-day period beginning on the date the transaction is closed and (2) at no time during such 60-day period is the tax-payer's risk of loss reduced (under the principles of section 246(c)(4)) by holding positions with respect to substantially similar or related property. These requirements do not apply to a transaction that is closed during the 90-day period where a similar transaction is reopened during such period, so long as the reopened transaction is closed during the 90-day period and the requirements of the previous sentence are met after such closing.

A transaction that has resulted in a constructive sale of an appreciated financial position (e.g., a short sale) is not treated as resulting in a constructive sale of another appreciated financial position so long as the taxpayer holds the position which was treated as constructively sold. However, when that position is assigned, terminated or disposed of by the taxpayer, the taxpayer immediately thereafter is treated as entering into the transaction that resulted in the constructive sale (e.g., the short sale) if it remains open at that time. Thus, the transaction can cause a constructive sale of another appreciated financial position at any time thereafter. For example, assume a taxpayer holds two appreciated stock positions and one offsetting short sale, and the taxpayer identifies the short sale as offsetting one of the stock positions. If the taxpayer then sells the stock position that was identified, the identified short position would cause a constructive sale of the taxpayer's other stock position at that time.

Definitions

An appreciated financial position is defined as any position with respect to any stock, debt instrument, or partnership interest, if there would be gain upon a taxable disposition of the position for its fair market value. A "position" is defined as an interest, including a futures or forward contract, short sale, or option. An exception is provided for debt instruments that are not convertible and the interest on which is either fixed, payable at certain variable rates (Treas. reg. sec. 1.860G–1(a)(3)) or is based on certain interest payments on a pool of mortgages. Other debt instruments, including those identified as part of a hedging or straddle transaction, are appreciated financial positions.

A notional principal contract is treated as an offsetting notional principal contract, and thus, results in a constructive sale of an appreciated financial position, if it requires the holder of the appreciated financial position to pay (or provide a contractual credit for) all or substantially all of the investment yield and appreciation on the position for a specified period and also gives the holder a right to be reimbursed for (or receive credit for) all or substantially all of any decline in value of the position.

A forward contract results in a constructive sale of an appreciated financial position only if the forward contract provides for delivery of a substantially fixed amount of property and a substantially fixed price. Thus, a forward contract providing for delivery of an amount of property, such as shares of stock, that is subject to significant variation under the contract terms does not result in a constructive sale.

A constructive sale does not include a transaction involving an appreciated financial position that is marked to market, including positions governed by section 475 (mark to market for securities dealers) or section 1256 (mark to market for futures contracts, options and currency contracts). Nor does a constructive sale include any contract for sale of an appreciated financial position which is not a "marketable security" (as defined in section 453(f)) if the contract settles within one year after the date it is entered into.

Treasury guidance

The bill provides regulatory authority to the Treasury to treat as constructive sales certain transactions that have substantially the same effect as those specified (i.e., short sales, offsetting notional principal contracts and futures or forward contracts to deliver the same or substantially similar property).

It is anticipated that the Treasury will use the provision's authority to treat as constructive sales other financial transactions that, like those specified in the provision, have the effect of eliminating substantially all of the taxpayer's risk of loss and opportunity for income or gain with respect to the appreciated financial position. Because this standard requires reduction of both risk of loss and opportunity for gain, it is intended that transactions that reduce only risk of loss or only opportunity for gain will not be covered. Thus, for example, it is not intended that a taxpayer who holds an appreciated financial position in stock will be treated as having made a constructive sale when the taxpayer enters into a put option with an exercise price equal to the current market price (an "at the money" option). Because such an option reduces only the taxpayer's risk of loss, and not its opportunity for gain, the above standard would not be met.

For purposes of the provision, it is not intended that risk of loss and opportunity for gain be considered separately. Thus, if a transaction has the effect of eliminating a *portion* of the taxpayer's risk of loss and a *portion* of the taxpayer's opportunity for gain with respect to an appreciated financial position which, taken together, are substantially all of the taxpayer's risk of loss and opportunity for gain, it is intended that Treasury regulations will treat this transaction as a constructive sale of the position.

It is anticipated that the Treasury regulations, when issued, will provide specific standards for determining whether several common transactions will be treated as constructive sales. One such transaction is a "collar." In a collar, a taxpayer commits to an option requiring him to sell a financial position at a fixed price (the "call strike price") and has the right to have his position purchased at a lower fixed price (the "put strike price"). For example, a shareholder may enter into a collar for a stock currently trading at $100 with a put strike price of $95 and a call strike price of $110. The effect of the transaction is that the seller has transferred the rights to all gain above the $110 call strike price and all loss below the $95 put strike price; the seller has retained all risk of loss and opportunity for gain in the range price between $95 and $110. A collar can be a single contract or can be effected by using a combination of put and call options.

In order to determine whether collars have substantially the same effect as the transactions specified in the provision, it is anticipated that Treasury regulations will provide specific standards that take into account various factors with respect to the appreciated financial position, including its volatility. Similarly, it is expected that several aspects of the collar transaction will be relevant, including the spread between the put and call prices, the period of the transaction, and the extent to which the taxpayer retains the right to periodic payments on the appreciated financial position (e.g., the dividends on collared stock). The Committee expects that the Treasury regulations with respect to collars will be applied prospectively, except in cases to prevent abuse.

Another common transaction for which a specific regulatory standard may be appropriate is a so-called “in-the-money” option, i.e., a put option where the strike price is significantly above the current market price or a call option where the strike price is significantly below the current market price. For example, if a shareholder purchases a put option exercisable at a future date (a so-called “European” option) with a strike price of $120 with respect to stock currently trading at $100, the shareholder has eliminated all risk of loss on the position for the option period and assured himself of all gain on the stock for any appreciation up to $120. In determining whether such a transaction will be treated as a constructive sale, it is anticipated that Treasury regulations will provide a specific standard that takes into account many of the factors described above with respect to collars, including the yield and volatility of the stock and the period and other terms of the option.

For collars, options and some other transactions, one approach that Treasury might take in issuing regulations is to rely on option prices and option pricing models. The price of an option represents the payment the market requires to eliminate risk of loss (for a put option) and to purchase the right to receive yield and gain (for a call option). Thus, option pricing offers one model for quantifying both the total risk of loss and opportunity for gain with respect to an appreciated financial position, as well as the proportions of these total amounts that the taxpayer has retained.

In addition to setting specific standards for treatment of these and other transactions, it may be appropriate for Treasury regulations to establish "safe harbor" rules for common financial transactions that do not result in constructive sale treatment. An example might be a collar with a sufficient spread between the put and call prices, a sufficiently limited period and other relevant terms such that, regardless of the particular characteristics of the stock, the collar probably would not transfer substantially all risk of loss and opportunity for gain.

Effective Date

The provision is effective for constructive sales entered into after June 8, 1997. A special rule is provided for transactions before this date which would have been constructive sales under the provision. The positions in such a transaction will not be taken into account in determining whether a constructive sale after June 8, 1997, has occurred, provided that the taxpayer identifies the offsetting positions of the earlier transaction within 30 days after the date of enactment. The special rule will cease to apply on the date the taxpayer ceases to hold any of the offsetting positions so identified.

In the case of a decedent dying after June 8, 1997, if (1) a constructive sale of an appreciated financial position (as defined in the provision) occurred before such date, (2) the transaction remains open for not less than two years, and (3) the transaction is not closed in a taxable transaction within 30 days after the date of enactment, such position (and any property related to it, under the principles of the provision) will be treated as property constituting rights to receive income in respect of a decedent under section 691.