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Rethinking Property, Terminations, and Gain After *McKelvey*

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In this first installment of a two-part article, Wood and Board examine the three decisions in the *McKelvey* litigation and the difficulties created by the widespread assumption that section 1234A applies only to gains and losses realized from a sale or other disposition of property described in section 1001.

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The *McKelvey* case[1] started when Andrew McKelvey, the founder of Monster.com, extended the settlement dates of a pair of gargantuan variable prepaid forward contracts (VPFCs) shortly before his death in 2008. The contracts, which dated back only to 2007, were extended to save on tax. But after an IRS audit, the seemingly innocuous extensions ended up leaving McKelvey's estate on the hook for $174 million of capital gain, $72 million of which was taxable at short-term rates. Fifteen years' worth of interest running from 2008 to 2023 is no small matter either.

Fiscal consequences aside, *McKelvey* is notable for the basic questions that it raised — but missed the opportunity to resolve — regarding the structure of the code and the meaning of gain. The structural question is the relationship between section 1001, which deals with gain or loss from a "sale or other disposition of property," and section 1234A. The latter is a once-esoteric provision that addresses the character of gain or loss attributable to the cancellation, lapse, expiration, or other termination of derivative rights and obligations "with respect to property."[2]

Who's on First?

The code famously omits any single, overarching definition of income.[3] What about gain, a fundamental term that appears in many of the code's most technical provisions? Does the code provide a definition of gain — or, for that matter, loss — that applies across the board or at least to a large swath of it? Or is gain, like income, a concept that the code expects us to understand

[1] The *McKelvey* litigation comprises three judicial decisions: (1) the Tax Court's original decision in *Estate of McKelvey v. Commissioner*, 148 T.C. 312 (2017) (*McKelvey I*); (2) the Second Circuit's decision on appeal reversing *McKelvey I* and remanding the case to the Tax Court, 906 F.3d 26 (2d Cir. 2018) (*McKelvey II*); and (3) the Tax Court's decision on remand, 161 T.C. No. 9 (2023) (*McKelvey III*).

[2] *See Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311, 315 (5th Cir. 2015) ("By its plain terms, section 1234A(1) applies to the termination of rights or obligations with respect to capital assets (e.g. derivative or contractual rights to buy or sell capital assets).").

[3] Section 61(a) purports to define gross income. However, it does so by referring to "all income from whatever source derived," so the statutory definition is really just a list of examples of income.

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and apply in a variety of contexts even without a statutory definition?

Viewed from this perspective, *McKelvey* is the latest installment in a long simmering but largely unacknowledged dispute about what gain and loss mean for purposes of section 1234A ("Gains or Losses From Certain Terminations"). Section 1234A provides that:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of . . . a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset.

The issue in the interpretive dispute has not been clearly formulated, but perhaps it goes something like this: Does section 1001 implicitly define gain and loss for general code purposes or at least for purposes of subchapter O ("Gain or Loss on Disposition of Property"), which includes section 1234A? We will refer to the view that section 1001 plays this critical role in the application of section 1234A as the "expansive" interpretation of section 1001.

Section 1001 is the first provision in subchapter O, which seems like a natural place to look for definitions of key terms. Section 1001 defines amount realized,[4] although this is not surprising in a provision captioned "Determination of Amount of and Recognition of Gain or Loss." But section 1001 never purports to define gain and loss themselves. It simply provides uniform rules for calculating the amount of gain or loss realized from a sale or other disposition of property, which is all that Congress expected it to do.[5]

We might well just leave it at that — the "narrow" interpretation of section 1001. The expansive interpretation, on the other hand, does not limit itself to the text of section 1001. It treats section 1001 as implicitly defining (or at least limiting) what counts as gain or loss more generally. In particular, it holds that there can be no gain or loss to which section 1234A can apply unless: (1) there is a "sale" or "disposition" of something; and (2) that something is "property."

In the first part of this article, we examine the influence of the expansive view of section 1001 on the *McKelvey* litigation. The expansive view is what drove the Tax Court's dubious decision in *McKelvey I*. Although the Second Circuit reversed the result reached by the Tax Court, *McKelvey II* did not address the expansive view itself, which reemerged, alive and seemingly well, on remand in *McKelvey III*. If the Tax Court had not (to its credit) rejected the implications of its own reasoning in *McKelvey III*, it would have held, based on the expansive interpretation of section 1001, that the amount of McKelvey's gain could not be calculated under the code.

In the second part of the article, we will discuss the effect of the expansive interpretation on the IRS's thinking outside of *McKelvey*. We will begin with FAA 20154701F, in which the IRS rejected a litigation funder's reliance on section 1234A to report capital gain from the termination of a successful investment. Like the Tax Court in *McKelvey I*, the IRS concluded that section 1234A did not apply because the funder did not realize a gain from a "sale or other disposition of property" as supposedly required by the statute.

As we will see, however, the IRS backed away from the expansive view of section 1001 in several rulings involving corporations claiming ordinary deductions for breakup fees paid in abandoned merger and acquisition transactions. With the shoe on the other foot, the IRS concluded that section 1234A applied after all, so the corporations were required to report capital losses.

In a 2022 legal memorandum (CCA 202224010), the IRS made a notable effort to reconcile capital loss treatment under section 1234A with the expansive interpretation of section 1001. We conclude, however, that the IRS and the courts will be able to simplify their analyses and reach more reliable results if they simply abandon the assumption that section 1234A applies only

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[4] *See* section 1001(b).

[5] Section 1001(a) can be traced back, substantially unchanged, to section 202(a) of the Revenue Act of 1924. When Congress enacted section 202(a), it did not imagine that it was providing a statutory definition of the terms "gain" and "loss." Rather, it adopted section 202(a) "to show clearly the *method of determining the amount of gain or loss* from the sale or other disposition of property [and it] merely embodies in the law the present construction by the Department and the courts of the existing law." S. Rep. No. 398 (1924), *reprinted in* 1939-1 C.B. (Part 2) 266, 275 (emphasis added).

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when there is a sale or other disposition of property. We should recognize that the function of section 1001 is to tell us how to calculate certain types of gain or loss, but it does not define what the terms "gain" or "loss" mean in section 1234A or anywhere else.

Stock Monetization and Deferrals

The *McKelvey* saga began in September 2007, when McKelvey entered into VPFCs with two banks to monetize his highly appreciated shares of Monster Worldwide Inc. The contracts provided that McKelvey would sell the banks up to 6.5 million Monster shares in September 2008. The exact number of shares would depend on a formula keyed to the future value of Monster stock. The banks, in turn, paid McKelvey $194 million as the upfront purchase price of whatever number of shares they would receive when the sale closed.

McKelvey did not report any of the $194 million he received on his 2007 federal return. He took the position that the transaction, which included his pledge of 6.5 million Monster shares to an independent trustee, was not a realization event because the VPFCs were structured to meet the requirements of Rev. Rul. 2003-7, 2003-1 C.B. 363.[6] The IRS did not object to this treatment, which should hearten taxpayers who use VPFCs to obtain cash while deferring taxable income from a planned sale.

McKelvey, however, did not leave well enough alone. Under the original terms of the contracts, he was required to deliver Monster shares (or their value in cash) to the banks in September 2008. But in July 2008 he paid the banks $12 million to amend the VPFCs to extend their settlement dates to 2010. McKelvey, who was in failing health, evidently extended the contracts in the expectation that (1) he would die before the Monster shares were sold, and (2) his estate would be entitled to use a stepped-up, date of death basis to calculate the gain realized when the shares were delivered to the banks.

McKelvey died in November 2008, and his estate closed out the VPFCs by delivering shares to the banks the following year. McKelvey's final income tax return did not report any income in connection with his extension of the VPFCs in July 2008. As far as the estate was concerned, the extension of the VPFCs was a contract modification that did not involve a taxable event.

The IRS disagreed, asserting that McKelvey should have treated the extension as a deemed exchange of the original VPFCs for two new VPFCs. Under the IRS's theory, McKelvey's 2008 return should have reported (1) $72 million[7] of short-term capital gain from the sale or exchange of the original VPFCs,[8] and (2) $102 million of long-term capital gain because his deemed entry into the new VPFCs triggered a constructive sale of his pledged shares under section 1259.

'Property' and Section 1001

In *McKelvey I*, the Tax Court rejected both of the IRS's contentions. The government argued that the deemed exchange of the VPFCs caused McKelvey to realize a gain described in section 1001. By its terms, however, section 1001 applies only to gain from a sale or other disposition "of property." This convinced the Tax Court that the whole case could be decided based on the threshold question of whether the original VPFCs were property for purposes of section 1001.

The Tax Court concluded that the contracts were not property in McKelvey's hands when he extended them in July 2008. The court reasoned that McKelvey had received everything he was entitled to under the original VPFCs the moment the banks wired him the $194 million purchase

[6] Rev. Rul. 2003-7 held that entry into a VPFC, even when combined with a stock pledge, did not trigger gain or loss from an actual or constructive sale of stock when (1) the number of shares that the taxpayer was required to deliver to the buyer varied "significantly" depending on the value of the shares on the delivery date, (2) the contract gave the taxpayer the right to substitute cash or other identical shares for the pledged shares, and (3) the taxpayer was not economically compelled to deliver the pledged shares.

[7] We are using the figures for McKelvey's gains as later determined by the Tax Court or stipulation of the parties in *McKelvey III* to simplify the exposition. This is not intended as an endorsement of the Tax Court's calculation of McKelvey's short-term capital gain.

[8] Since McKelvey entered into the VPFCs in September 2007, he had not held the contracts for more than one year when they were extended.

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price. From that point on, all he had was a bundle of duties owed to the banks,[9] which the Tax Court refused to treat as property within the meaning of section 1001.

This set up a tidy conceptual argument. If the VPFCs were no longer property in McKelvey's hands, extending them could not have been a sale or other disposition "of property" as required by section 1001. With no sale or other disposition of property, McKelvey could not have realized gain in July 2008 — assuming, of course, that section 1001 is the only way for a taxpayer to realize gain absent a code section to the contrary.

The Tax Court also relied on the absence of "property" to reject the IRS's argument that the extension triggered a constructive sale of McKelvey's shares under section 1259. According to the court, the claim that McKelvey entered into a new pair of VPFCs in July 2008 was "predicated upon a finding that there was an exchange of the extended VPFCs for the original VPFCs under section 1001." However, since the VPFCs were not property, there was no exchange described in section 1001. Without an exchange, there could be no new contracts to trigger a constructive sale of the underlying shares under section 1259.[10]

Logical but Implausible?

For the Tax Court, McKelvey's resounding victory was a matter of logic. The IRS had claimed that the extension of the VPFCs triggered gain under sections 1001 and 1259. But the VPFCs were not property, so neither provision applies. Ergo, no tax was due on the $174 million profit that the IRS had mistaken for taxable gain.

This sounds logical, at least in form. But was the Tax Court's conclusion even remotely plausible in the context of our tax system? Imagine a parallel case in which McLovin, the founder of Leviathan.com, enters into a pair of VPFCs identical to McKelvey's in every respect but one: For regulatory or other reasons having nothing to do with tax, the banks pay McLovin only 99 percent of the purchase price on signing, with 1 percent[11] held back for payment when the contracts are settled.[12]

Now *McKelvey I* is turned on its head. As long as McLovin's VPFCs are not 100 percent prepaid, he will have not only duties but also the right to be paid something on settlement. Hence, his contracts will still be property when he extends them before his death. Under the Tax Court's rationale, McLovin's estate will have to pay tax on $174 million of capital gain.

Here is where plausibility comes in. If we consider the range of possible payment terms, we find that McLovin's estate always gets taxed on $174 million — except if he is paid the full purchase price before the contracts are extended. Then, like one of those drawings in which a rabbit's head suddenly turns into a duck's, McLovin's estate goes from having a gigantic tax liability to having no liability at all.

This discontinuity should have been at least a flashing yellow light. *McKelvey I* was a case of first impression, so the Tax Court had to improvise. Given the amount of tax at stake, the court should have asked itself whether an analysis that gives one result when the taxpayer receives 100 percent of the purchase price upfront and the opposite result in every other case advances any substantive tax policy.

If no such policy was identified, the Tax Court might have recognized that its proposed $174 million ruling in favor of McKelvey's estate was

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[9] The IRS unsuccessfully argued that McKelvey continued to have rights against the bank since the VPFC left him free to choose whether he would meet his obligations by delivering shares or cash. The Tax Court dismissed this argument because it could not foresee anyone actually giving value to acquire McKelvey's supposed entitlement.

[10] The Tax Court did not explain why there must be an exchange under section 1001 to a treat a fundamental modification of a contract as resulting in the issuance of a "new" contract solely for the purpose of evaluating the effect of the modification under section 1259. Presumably the court reasoned backward from the fact that fundamental modifications are often described — and taxed — as if there had been an exchange of property described in section 1001. Because the court had held that there was no exchange of property, that (supposedly) would have implied that there could not have been an exchange for purposes of testing the contract under section 1259.

[11] If 1 percent seems potentially de minimis, reduce the banks' initial payment so that McLovin is entitled to receive 5 percent (or 10 percent or 50 percent or 90 percent) of the purchase price on the settlement date.

[12] For examples of a partially prepaid forward contract, see *U.S. Freight Co. v. United States*, 422 F.2d 887 (Ct. Cl. 1970), and *Modesto Dry Yard v. Commissioner*, 14 T.C. 374 (1950). As originally proposed, section 1259(d)(1) would have defined "forward contract" as including "a fully or partially prepaid forward contract." *See* H.R. 846 (1997).

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essentially random.[13] That would presumably have motivated the court to reexamine the premises from which it had logically deduced an anomalous result. Number one would have been the assumption that taxpayers cannot realize gain without engaging in a sale or other disposition of property as described in section 1001.

Terminations and Section 1234A

In *McKelvey II*, the Second Circuit agreed with the Tax Court that (1) the VPFCs were not property when they were extended in July 2008, and hence (2) the deemed exchange of the original contracts for their extended replacements did not trigger gain from a sale or other disposition of property described in section 1001. Unlike the Tax Court, however, the Second Circuit did not assume that a sale or other disposition of property was the only way for McKelvey to realize gain when he extended the VPFCs.

In *McKelvey I*, the IRS focused exclusively on section 1001. On appeal to the Second Circuit, however, the IRS wisely brought section 1234A into the mix.[14] Section 1234A provides that gain or loss attributable to the termination of a right or obligation "with respect to property" will be treated as gain or loss from the sale of a capital asset if the property is, or on acquisition would be, a capital asset in the hands of the taxpayer.

Section 1234A by its terms presupposes that taxpayers can realize gain or loss in connection with the termination of a right or obligation concerning property. Its function is to prescribe the character of that gain or loss, which it does based on the character of the property to which the right or obligation relates. But nothing in section 1234A indicates that the gain or loss from the termination of a right or obligation must derive from a "sale or other disposition of property" described in section 1001.

The Second Circuit appears not to have recognized that the Tax Court had concluded, based on its expansive interpretation of section 1001, that McKelvey simply could not have realized gain when he terminated his initial contracts with the banks. Instead, the court of appeals seems to have taken for granted that, if a taxpayer concludes his involvement in an economic transaction, we can and should calculate the taxpayer's resulting gain or loss. From this transactional perspective, the sales or other dispositions of property to which section 1001 applies are an extremely important type of transaction in which a taxpayer can realize gain or loss, but they are not the only one.

This would account for what is perhaps the most notable feature of the Second Circuit's opinion — namely, the fact it made no effort to justify its conclusion under section 1001. In particular, it did not claim that (1) the termination of McKelvey's obligations somehow qualified as a "sale or other disposition" of the obligations, or (2) the obligations should be regarded as "property."[15] The court of appeals did not even refer to section 1001 in connection with section 1234A, indicating that it regarded section 1001 as irrelevant to the termination analysis.

However, the Second Circuit did not spell this out. Instead of closing the theoretical loop on how section 1001 relates to section 1234A, it simply set out its bottom line: McKelvey had realized capital gain when he extended the original VPFCs, assuming that the substitution of the amended contracts terminated his original obligations within the meaning of section 1234A. The court of appeals then remanded the case to the Tax Court to resolve the termination issue and (if warranted) to calculate McKelvey's gain.

Second Detour Into Section 1001

On remand, the Tax Court was instructed to determine whether the extension of the VPFCs had in fact terminated McKelvey's contractual obligations. This appears to have been a mere courtesy since the Second Circuit had already stated that the extension of the contracts was a

[13] The IRC, of course, is full of quantitative rules that yield opposite results depending on which side of a statutory line the taxpayer happens to be standing. If "substantially all" is defined to mean 80 percent, 77.9 percent does not suffice, even though there is no substantive tax policy that would actually warrant treating the two cases differently. But if Congress (or even a court) wants to implement a policy using a bright-line rule, it has to draw (and enforce) the line somewhere. However, that was not what the Tax Court was doing in *McKelvey I*.

[14] Because McKelvey's estate had itself argued in the Tax Court that section 1234A did not apply, it could not claim that the IRS was introducing a new issue on appeal.

[15] Because the Second Circuit agreed with the Tax Court that the VPFCs were not property for purposes of section 1001, it would have reached the same conclusion regarding the obligations themselves.

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"fundamental change." The court said that this had triggered a deemed exchange of the VPFCs for the same reason that the extension of an option triggers a deemed exchange of the original option for a new option with modified terms.[16]

The Tax Court took the hint and duly concluded that the extension of McKelvey's original obligations had resulted in their termination for purposes of section 1234A. That was enough to establish that McKelvey had indeed realized a short-term capital gain. The real question for the Tax Court was the amount of that gain.

The Second Circuit had treated McKelvey as realizing gain from the termination of an obligation. So it would logically have expected the Tax Court to determine the amount of the gain by analyzing McKelvey's transaction in those terms. There would have been no reason to expect the Tax Court to try to calculate McKelvey's gain using the rules that section 1001 provides for calculating gain from a sale or other disposition of property.

Unfortunately, the Second Circuit's failure to address the underlying structural issue left the Tax Court adrift. The Tax Court understood that its assignment was to calculate McKelvey's gain in a transaction that did not involve a sale or other disposition of property described in section 1001. Yet, it declared without hesitation that "section 1001 dictates the method of calculating such gain."

The result was a paradox. As the Tax Court observed, section 1001 provides rules for calculating gain from a sale or other disposition of property. However, the VPFCs were not property in McKelvey's hands, as even the Second Circuit had acknowledged. So how could McKelvey's gain be calculated under section 1001? And if McKelvey's gain was incalculable, how could he be taxed?

Multiple Choice

The Tax Court attempted to summarize the dilemma: "The capital gain calculation as codified under section 1001 requires the sale or exchange of property, and decedent's gain from the VPFCs, while derived from a sale or exchange [in accordance with section 1234A], would seem to be omitted as non-property." At this point, the Tax Court might have reconsidered its assumption that section 1001 "dictates the method" of calculating the gain and loss realized from the termination of an obligation as described in section 1234A.

The Tax Court, however, remained loyal to the expansive view of section 1001 as the code's go-to provision for both the definition and calculation of gain and loss. But now it acknowledged that this leads to a serious complication. Requiring a sale or other disposition of property as a condition to the realization of gain "leaves a gap in the Code's application of capital gain tax treatment when it comes to VPFCs and other non-property derivatives."[17]

To its credit, the Tax Court did not simply let McKelvey's estate walk away scot-free through this alleged "gap in the Code." After briefly reviewing the IRC's general approach to derivatives, the court concluded that Congress clearly would have wanted McKelvey's gain to be calculated, so he could pay tax on the gain realized when he terminated his original VPFCs. Taking the bull by the horns, the Tax Court announced that, even though the contracts themselves were not property, it would still use section 1001 to calculate McKelvey's gain on the basis that the contracts related to corporate shares, which were property.

The Tax Court then calculated McKelvey's gain using familiar sale terminology taken from section 1001. It treated the banks' $194 million upfront payment as McKelvey's "amount realized." Then it subtracted what it describes as McKelvey's "adjusted basis provided in section 1011 for determining gain."

Here the Tax Court made a telling conceptual adjustment. It said it was calculating McKelvey's gain by subtracting his "basis in the *transactions*" (emphasis added). The court also quoted the Supreme Court's statement in *Bruun* that "gain may occur as a result of exchange of property, payment of a taxpayer's indebtedness, relief from

[16] Rev. Rul. 90-109, 1990-2 C.B. 191.

[17] *McKelvey III*, 161 T.C. No. 9, at 20.

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liability, or other *profit realized from the completion of a transaction*" (emphasis added).[18]

If a transaction does not involve a sale or disposition of property, it is awkward to describe the taxpayer as having a basis in property as section 1001 requires. However, if a non-property transaction has been concluded and it is now time to reckon the taxpayer's overall profit or loss, something has to be done. *McKelvey III* tried to facilitate the calculation under section 1001 by quietly ascribing basis to the transaction.

A more direct solution would have been to drop the assumption that section 1001 dictates the method for calculating gain or loss realized from transactions in general. Instead, we could view the code as assuming that we will be able to identify and calculate a taxpayer's gain or loss even when it does not derive from a "sale or other disposition of property." If the Tax Court had taken this approach in *McKelvey I*, it would not have been led astray by the conceptually alluring but substantively hollow argument that McKelvey could not be taxed because his VPFCs were no longer property for purposes of section 1001.

A narrower view of the role of section 1001 does not mean that we should expect bottom-line results that depart fundamentally from those that we expect in analogous situations that do involve a sale or other disposition of property. After all, section 1001's rules for calculating gain or loss from property-based transactions are derived from the same general concepts of gain and loss that apply in other contexts. We should expect the same conceptual logic to apply and to produce essentially the same results when we calculate gain or loss in non-property transactions.

In that case, the Tax Court's reference to McKelvey's basis "in the transactions" is right on the money, even if that notion is not present in section 1001. However, "basis" is simply shorthand for "basis for determining gain or loss." So a taxpayer's "basis in a transaction" could sensibly include some or even all the amounts that we believe — based on our general concepts of gain and loss — should be subtracted when calculating the gain or loss realized when the transaction is closed. ■

[18] *Helvering v. Bruun*, 309 U.S. 461 (1940).

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