Monster *McKelvey* Estate Tax Case and Litigation Finance

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In this article, Wood and Board examine a recent Tax Court case that could affect litigation finance and encourage prepaid forward contracts that delay taxes.

This discussion is not legal advice.

Prepaid forward contracts are unusual but becoming less so. One reason for a new uptick in interest is a tax case that seems almost too good to be true. In *McKelvey*,[1] the Tax Court allowed a man to "sell" stock for an upfront payment of $194 million in 2007 without incurring current tax.

In 2008 he extended the deal by two more years, and that too wasn't taxed. And since Andrew McKelvey died, the lifetime appreciation of his shares was never taxed. Instead, his estate received a stepped-up basis for income tax purposes. More than a few tax planners are trying to work this new arrow into their quiver.

One use of prepaid forward contracts is with stock positions such as McKelvey's. You enter into a contract to sell a specific value of a stock (in McKelvey's case, setting a floor and a cap) in the future. When the contract matures, you deliver your shares (or their cash equivalent), which triggers capital gains tax *then*.

Yet the cash you received upfront was not taxed until the end of the deal, years later. *McKelvey* has made that even better by upholding an extension of the deal to stretch the tax savings even further. Another common context for prepaid forward contracts is litigation funding, and the benefits can be big.

Litigation Funding

If a litigant sells a piece of the case, that is income, right? It is basically a sale, and normally the recipient of the sale proceeds pays tax on the ordinary income or capital gain, depending on the circumstances. Yet a prepaid forward sale seems to be taxed at first more like a loan.[2]

The prepaid forward contract may involve the plaintiff selling a piece of his claim. Alternatively, it may involve the plaintiff's lawyer selling a piece of the contingent fee he hopes to earn.[3] The lawyer (or law firm) is clearly a service provider, so one

[1] *Estate of Andrew McKelvey v. Commissioner*, 148 T.C. No. 13 (2017).

[2] *See generally* Robert W. Wood, "The *Long* and Winding Road of Litigation Finance," *Tax Notes*, Mar. 16, 2015, p. 1419.

[3] *See* Wood and Jonathan Van Loo, "Litigation Funding: The Attorney's Perspective," *Tax Notes*, Jan. 27, 2014, p. 435.

might assume that the proceeds are in each case ordinary income for services.

Even then, however, the lawyer may receive a material benefit in the form of tax-free cash to help finance the litigation, or to maintain an appropriate lifestyle. Cash first, tax later isn't a bad deal. From every angle, the prepaid forward arguably offers the best tax result for the plaintiff and the plaintiff's lawyer if they want to convert a portion of their contingent rights to dollars in hand.

Because the transaction involves a sale, one might assume that the recipient would have to report the sale proceeds as income. However, this is a sale contract with an unclear final return. When the seller signs the documents and receives the money, he has entered a contract to sell a portion of the case (the client) or a portion of the contingent fee (the lawyer), but only when the lawsuit is resolved.

That is why it is a *forward* contract. You are contracting to sell now, but the sale does not close until the case is resolved. You generally should not have to report income until the conclusion of the case. That sounds similar to a loan, but it is actually better in many cases.

A loan is easier to document, and some lawyers and clients prefer it. But most litigation funders do not like loans because of usury concerns or regulatory rules. The risk premium the litigation funder charges might equate to a very high interest rate. Further, these loans are generally nonrecourse, secured only by the proceeds (if any) realized from the claim. That can make the loan look more like equity. For those reasons, loans seem to be increasingly rare. Prepaid forward contracts have the advantage of no immediate tax on the upfront payments, like loans, but have better treatment overall.

McKelvey

In *McKelvey*, the Tax Court held that the extension of variable prepaid forward contracts between the founder of Monster.com and two investment banks did not constitute sales or dispositions of property for purposes of section 1001. The Tax Court held that the open transaction treatment of the original forward contracts continued until the transactions were closed by the future delivery of stock.

Andrew McKelvey was the founder and chief executive of Monster Worldwide Inc. He entered into deals with Bank of America and Morgan Stanley in 2007. The investment banks made huge upfront cash payments to McKelvey, who was obligated to deliver variable quantities of stock to the banks on specified dates in 2008.

McKelvey treated the deals as open under Rev. Rul. 2003-7,[4] so he did not report any gain or loss for 2007. In 2008, before the original settlement dates, McKelvey paid millions of dollars in fees to the banks to extend the settlement dates for two years. Notably, he entered into the extensions when he was fighting pancreatic cancer. He died in November of 2008.

On his 2008 tax return, he did not report any gain or loss on the execution of the extensions, and he continued the open transaction treatment. The IRS determined that the execution of the extensions in 2008 constituted sales of property and that McKelvey should have reported gain from the transactions in that year. The IRS issued a $41 million deficiency notice.

The IRS nixed the extension argument, saying that in each instance, it was an old contract being closed and a new one being opened. The IRS determined that McKelvey recognized $88 million of short-term capital gain when he closed the old contracts and $113 million of long-term capital gain from the constructive sale of the shares when he entered into new ones.

But the Tax Court said the IRS was wrong, stating that extending the deals did not close the original open transactions. The open tax treatment simply continued. The Tax Court relied on the IRS's conclusions in Rev. Rul. 2003-7, so the IRS was hoisted on its own petard.

Reviewing the original transaction, the Tax Court found ample uncertainty regarding the nature and amount of the gain or loss from any sale. The parties knew the amount of the prepayment at inception. However, the amount and character of gain or loss could not be determined until McKelvey decided what property he would deliver at settlement.

That uncertainty existed from the beginning, and it remained after the extensions were

[4]Rev. Rul. 2003-7, 2003-1 C.B. 363.

executed, the court wrote. There was no constructive sale either, said the court, even though the banks received Monster shares as collateral. That security feature of the deals did not amount to a sale.

Fun With Forward Contracts

In a traditional forward contract, a forward buyer agrees to purchase a fixed quantity of property from a forward seller at a fixed price, with payment and delivery on a specified future date.[5] In a *prepaid* forward contract, the forward buyer agrees 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. The forward seller can use the upfront cash without restriction.

A forward buyer is unlikely to consent to such an arrangement without collateral to secure the forward seller's obligation to deliver the agreed-upon property. If the forward seller pledges the property to the forward buyer, the transaction begins to look like a sale. If the property is stock, an additional concern is that the forward contract might be a constructive sale of the shares under section 1259.

Planners have responded by developing variable prepaid forward contracts (VPFCs). These are designed to avoid a sale of a fixed number of shares for a fixed price. Section 1259 applies only to contracts in which both the price and the amount of property are fixed.

Under a typical VPFC, the number of shares (or the amount of the cash equivalent) the forward seller must deliver to the forward buyer is determined by a formula that takes into account changes in the market price of the underlying stock over the duration of the contract. The specific *identity* of the shares is not fixed, either. The forward seller can settle the VPFC by delivering: (1) shares of stock that have been pledged as collateral at the inception of the contract; (2) identical shares of the stock that have not been pledged as collateral; or (3) an equivalent cash amount.

Rev. Rul. 2003-7

In Rev. Rul. 2003-7, the IRS applied open transaction treatment to a prepaid variable forward contract structured as described above.[6] The forward seller of shares therefore did not recognize gain or loss until future delivery. After all, the seller did not know the identity or amount of property that it would deliver until the future settlement date arrived and delivery was made. Even the IRS in *McKelvey* agreed that the *initial* tax treatment was correct.

But what about the extension? The IRS said this was a sale, regular or constructive. The estate said if it was nontaxable at the start, it still was. The extensions kept it open, pure and simple. In fact, the Tax Court said that the tax regulations under section 1001 (on sales and other dispositions of property) supported the estate.[7]

For the extensions to trigger gain or loss, two conditions would have to be satisfied: (1) the original forward contracts would have to constitute property to the decedent at the time of the extensions; and (2) the property would have to be exchanged for other property differing materially either in kind or in extent. Were these contracts property?

What is property? The Tax Court admitted even that is not clear. *Black's Law Dictionary* says that property is "any external thing over which the rights of possession, use, and enjoyment are exercised."[8] In *Dickman*,[9] 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

[5] *See Anschutz Co. v. Commissioner*, 135 T.C. 78, 81 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011).

[6] For a general discussion, see Wood, "Prepaid Forward Contracts Aren't All Bad," *Tax Notes*, Apr. 16, 2012, p. 365.

[7] *See* reg. section 1.1001-1(a) (exchange of property is not a taxable event unless the exchanged properties differ "materially either in kind or in extent").

[8] *Black's Law Dictionary*, at 1335-1336 (2009).

[9] *Dickman v. Commissioner*, 465 U.S. 330 (1984).

to the exclusion of others is the most essential and beneficial.[10]

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."[11]

In *Craft*,[12] the Supreme Court explained the roles of federal and state law in determining whether something constitutes property for federal tax purposes. Property is a bundle of sticks, a collection of individual rights, which in some combinations constitute property. State law determines only which sticks are in a person's bundle. Whether those sticks qualify as property for federal tax purposes is a question of federal law.

McKelvey's estate argued that the decedent did not possess property rights in the original forward contracts at the time of the settlement or when the dates were extended. The contracts were just contracts, not property. But the IRS saw it differently, arguing that these complex contracts included an integrated bundle of valuable investment and other contract rights, as well as obligations, and constituted property for tax purposes.

The Tax Court sided with the estate. Once McKelvey received the upfront cash, he had no further rights against the investment banks. All he — and later, his estate — had were *obligations* to deliver shares or a cash equivalent. The Tax Court acknowledged that McKelvey had the "right" to select *how* he would satisfy his obligations. But this was a "procedural mechanism," not property. There was no way McKelvey could have disposed of such a "right" for value in an arm's-length transaction.

Open Transactions

The IRS is generally no fan of open transaction treatment. Yet sometimes it makes sense, as it does when you simply have to keep the deal open to calculate gain or loss. As Rev. Rul. 2003-7 suggests, some transactions are afforded open transaction treatment because the amount realized or the adjusted basis needed for a section 1001 calculation is unknown until contract maturity.[13]

In those 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 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."[14]

To determine gain or loss, a taxpayer must ascertain both an amount realized and the identity and adjusted basis of property sold, disposed of, or exchanged.[15] Under a VPFC, the forward seller has an obligation of future delivery that is uncertain in *amount*. Plus, the seller maintains the discretion to deliver: (1) the shares of stock pledged as collateral; (2) identical shares that were not pledged; or (3) a cash equivalent.

Each delivery option might result in a different adjusted basis. Thus, it is impossible to calculate gain or loss with reasonable accuracy at the outset of the forward contract. At that point, both the number of shares and the adjusted basis necessary for a section 1001 calculation are uncertain.

Of course, a determination of gain or loss under section 1001 becomes certain when a forward seller satisfies his or her delivery obligations by delivering shares of stock or a cash equivalent. This is what finally closes the transaction.

Seminal Ruling

Rev. Rul. 2003-7 approved open transaction treatment for prepaid forward contracts that meet specific criteria. That the VPFC was secured by a pledge of stock did not cause a sale of stock under section 1001, and did not trigger a constructive sale under section 1259.

[10] *Id.* at 336 (emphasis in original) (quoting *Passailaigue v. United States*, 224 F. Supp. 682, 686 (M.D. Ga. 1963)).

[11] *Id.*

[12] *United States v. Craft*, 535 U.S. 274, 278-279 (2002).

[13] *See Burnet v. Logan*, 283 U.S. 404 (1931) (applying open transaction doctrine until a transaction closed).

[14] *Id.* at 285.

[15] *See* reg. section 1.1001-1(a).

The taxpayer in Rev. Rul. 2003-7 owned appreciated shares of a publicly traded corporation. The taxpayer entered into a contract 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) at maturity. As security for its obligations to the investment bank, the taxpayer pledged 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. 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. Rev. Rul. 2003-7 also indicates that at the time the parties entered into their contract, the taxpayer *intended* to settle the contract by delivering the pledged shares to the investment bank on the maturity date.

Notably, though, the taxpayer was not legally or economically compelled to deliver the pledged shares. He could settle the contract using other shares or cash. 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.

Economic compulsion to deliver the pledged shares (rather than cash or other shares) might change the result.

Constructive Sale?

The IRS had another argument in *McKelvey*. In Rev. Rul. 2003-7, the IRS said the contract was not a standard forward contract as defined in section 1259(d)(1). After all, the stock to be delivered at maturity was subject to "significant variation." Hence, the taxpayer's entry into the VPFC did not cause a constructive sale under section 1259.

In *McKelvey*, though, the IRS claimed that the extensions resulted in constructive sales under section 1259 of the Monster shares pledged as collateral. Congress enacted section 1259 because it was concerned that taxpayers holding appreciated equity positions were entering into complex financial transactions without paying any tax.

Section 1259 says that if there is a constructive sale of an appreciated financial position, the taxpayer recognizes gain as if that position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale.[16] 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."

Much to the IRS's chagrin, the Tax Court said that McKelvey's contracts were covered by Rev. Rul. 2003-7. And the extensions did not change that. The IRS had already conceded that these contracts were protected by Rev. Rul. 2003-7 when they were entered into. The Tax Court held that they were still protected when they were extended.

In fact, the Tax Court called the IRS argument that the extended contracts should be viewed as separate and comprehensive financial instruments under section 1259 "without merit." It is unclear whether the IRS will appeal *McKelvey*. But assuming that the Tax Court case stands, it seems reasonable to believe that prepaid forward contracts may be emboldened. At a minimum, they are even more flexible if one can extend them.

Litigation Finance?

Prepaid forward contracts have become common in the growing field of litigation finance.

[16] Section 1259(a)(1).

Thus, it is worth asking whether *McKelvey* will have an effect there too. The most direct effect, approving extensions of contract terms, seems unlikely to have direct application.

After all, in litigation finance, the event that triggers the closing of the sale is invariably the conclusion of the case, usually by settlement. So there is presumably never a need for the contract to be extended, which was the direct subject of *McKelvey*. Whether there will be a more general effect is hard to say.

McKelvey gives a major boost to prepaid forward contracts. The IRS conceded in the case that Rev. Rul. 2003-7 applied. If the IRS thought it could argue about that, it surely would have. In that sense, this was a big concession.

That in itself could boost the application of prepaid forward contracts to litigation finance. Much of the recent discussion in the litigation finance industry has been on tax treatment to investors, who often hope for capital gain. The IRS took at least a limited swipe at that in FAA 20154701F, stating that gain realized by an investor was ordinary income because there was no sale or exchange of a capital asset.

FAA 20154701F is heavily redacted, so it is hard to tell exactly what is going on. The field attorney advice assumed that the contract was a capital asset, but it is too early to say whether that reflects the IRS's considered opinion. The IRS concluded that section 1234A did not apply, suggesting a narrow reading of its scope.

Notably, it is curious that FAA 20154701F did not mention *Pilgrim's Pride*.[17] Moreover, the analysis in the advice relied heavily on the language in the litigation finance contract under consideration. FAA 20154701F notes that the terms of the agreement strongly suggest that the parties did not view the payments received by the investor as a disposition of property.

The importance of specific contract language seems notable. In fact, it seems to invite all of us to focus on saying what we want to achieve in our contracts. Perhaps self-serving language can be criticized as such. Still, it is hard to see how using the language of sales and exchanges would hurt.

Indeed, the intent of the parties is often key to determining the tax consequences of a transaction. A typical litigation finance contract involves the purchase and sale of an asset, and there will be numerous rights and obligations. The contract can highlight that these rights and obligations terminate upon settlement of the litigation and payment to the investor.

Conclusion

If its holding endures, *McKelvey* makes a nice capstone to a nice deal. In a good prepaid forward contract, the taxes come later. And *McKelvey* says that if you play your cards right, you can extend the deal even longer, and the taxes will come later still.

Most of the direct benefits of this Monster "taxes later" case will presumably occur outside the litigation finance industry. On the other hand, the increased acceptance and familiarity with prepaid forward contracts could have some spillover effect on litigation finance and beyond. ■

[17] *Pilgrim's Pride Corp. v. Commissioner*, 141 T.C. 533 (2013), *rev'd*, 779 F.3d 311 (5th Cir. 2015). For a discussion of the competing interpretations of section 1234A by the Tax Court and the Fifth Circuit, see Wood, "Take Pride in Ordinary Losses After *Pilgrim's Pride*," *Tax Notes*, May 18, 2015, p. 823.