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Pinch-Hitting for the IRS: Second Circuit Adopts Phantom Regulations to Curb a Monster Abuse of Financial Derivatives

*Frank G. Colella, Esq.**

ABSTRACT

In *Estate of McKelvey v. Commissioner*, the Second Circuit Court of Appeals adopted the IRS's position that probability analysis should be employed to determine that the taxpayer's particular performance under the terms of a financial instrument was "virtually certain." However, the IRS had steadfastly refused to promulgate regulations that, under a statutory delegation of authority to issue regulations to interpret and enforce the statute, could have administratively imposed that outcome.

Instead, by employing what are commonly referred to as "phantom regulations," the Second Circuit judicially mandated that result. The Panel's decision effectively bypassed application of the Administrative Procedure Act's notice and comment requirements. More significantly, it permitted the IRS to avoid its responsibility to issue regulations and, thereby, deprived the public, and the taxpayer, of the expertise and professionalism of the IRS rulemaking process.

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Congress:

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

Commissioner:

“I would prefer not to.”***

I. INTRODUCTION

In 1997, Congress enacted Internal Revenue Code (“IRC”) § 1259 as part of the Taxpayer Relief Act.¹ It was intended to curb a particularly abusive form of “short selling”² – a technique grounded in efforts to defer income taxation.³ Section 1259 treats certain financial transactions in appreciated securities as “constructive sales” of those securities,⁴ which, in turn, triggers taxation of the proceeds received from the deemed “sale.” A constructive sale under § 1259 treats “as sold” the securities that are still “owned” by the taxpayer. Congress specifically directed the Internal Revenue Service (“IRS”) to “prescribe regulations ... to carry out the purposes of this section.”⁵ Unfortunately, more than 22 years since the statute was enacted, the IRS has steadfastly refused to promulgate *any* regulations pursuant to that

** I.R.C. § 1259(f) (2004).

*** Herman Melville, *Bartleby, the Scrivener: A Story of Wall Street* 7 (1853), in *PIAZZA TALES* (1856). “You may be surprised to learn that courts and the Service have generally been willing to wink at the delegatory language in the Code and conjure ‘phantom’ regulations to achieve the result that was meant to be achieved in actual regulation.” Phillip Gall, *Phantom Tax Regulations: The Curse of the Spurned Delegations*, 56 *TAX LAW*. 413 (2003).

1. “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)[.]” I.R.C. § 1259(a) (2004). Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788.

2. “The core transaction at which the legislation is aimed is the short-against-the-box transaction, and the most celebrated use of that transaction was by members of the Estee Lauder family, *who reportedly avoided over \$100 million in taxes by using the transaction.*” William M. Paul, *Constructive Sales Under the New Section 1259*, Tax Notes 1467 (Sept. 15, 1997) (emphasis added) (footnote omitted).

3. When an asset, such as stock, is sold, the taxpayer reduces the proceeds garnered from the sale by the cost basis of the asset. The gain, when proceeds exceed the cost basis, is taxed as a capital gain. *Can You Tell Me How to Calculate Capital Gains Tax?*, H&R BLOCK (2019), <https://www.hrblock.com/tax-center/income/investments/how-to-figure-capital-gains-tax/>.

4. “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, ... if there would be gain were such position sold, assigned, or otherwise terminated at its fair market value.” 2 I.R.C. § 1259(b); 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)—(C) enters into a futures or forward contract to deliver the same or substantially identical property[.] I.R.C. § 1259(c) (emphasis added). Subpart (d)(1) defines a forward contract: “Forward contract The term ‘forward contract’ means a contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.” I.R.C. § 1259(d)(1) (emphasis added).

5. In addition to the specific grant of rulemaking authority in subpart (f), Congress textually committed a *second, separate*, grant of authority to promulgate regulations in section 1259(c)(1)(E): “to the extent prescribed by the Secretary in regulations, [if a taxpayer] 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

grant of rulemaking authority. It has, however, issued “sub-regulatory” guidance under § 1259, which has taken the form of Revenue Ruling 2003-7 and Chief Counsel Advice 201104031.⁶

In the absence of promulgated regulations and in view of the limited sub-regulatory guidance actually issued, the IRS has preferred to rely on informal interpretation and enforcement of § 1259. Interestingly, the lack of formal regulatory guidance may, in fact, be intentional as part of what some commentators have referred to as “strategic tax law uncertainty.”⁷ By 2010, only one court had considered § 1259 in connection with a potential constructive sale. The Court observed that

[s]ection 1259 gives the Secretary two sources of authority for issuing regulations to carry out Congress’ intent – section 1259(c)(1)(E) and (f) – *but no regulations have been issued defining either phrase.*⁸

In 2010, the Tax Court in *Anschutz* lacked IRS regulations but, instead, relied on the legislative history and sole revenue ruling to consider the applicability of § 1259.⁹ Notably, via traditional statutory analysis, the Tax Court held that the taxpayer’s transaction had resulted in an “actual” sale of the securities that collateralized the financial instruments under review and, therefore, did not resolve the §

of the preceding subparagraphs.” Subpart (c)(1)(E) is a discretionary grant of authority, as contrasted with the subpart (f) delegation, which is more forceful. *See* I.R.C. § 1259 (emphasis added).

6. Rev. Rul. 2003-7, 2003-1 C.B. 363, 2003 WL 124818; *See* James H. Combs, *Will a Variation Lead to Consistency? Implications of Forward Contract Ruling for Hedging Appreciated Stock*, Tax Notes 1245 (March 8, 2004) (“Rev. Rul. 2003-7 concludes, based on the stated facts, that execution of a forward contract does not result in either a common law sale or a constructive sale.”). To date, Rev. Rul. 2003-7 is the only significant authority issued by the IRS on section 1259. “*The Revenue Ruling provides a road map for VPFCs that the IRS will not challenge*, but also raises other questions under the common law and section 1259.” *Id.* at 1254 (emphasis added). For example, “the IRS’s discussion of section 1259 is brief and the ruling that the VPFC is not a ‘forward contract’ is reached with little discussion and no useful analysis.” *Id.* (emphasis added); IRS Chief Counsel Advice 201104031 (Jan. 28, 2011). IRS concluded that a VPFC settled with borrowed stock is a taxable event. *Id.*

7. *See, i.e.,* Leigh Osofsky, *The Case Against Strategic Tax Law Uncertainty*, 64 TAX L. REV. 489, 489–90 (2011). “Prominent tax compliance scholars have argued that strategic use of tax law uncertainty may cause taxpayers to report higher tax liabilities. Strategic tax law uncertainty, in this context, means strategically withholding tax law guidance, so that taxpayers have less certainty regarding their tax liability.” *Id.* at 489–90 (emphasis added) (footnotes omitted). “However, there are also disadvantages to regulating. The promulgation of regulations by the IRS is often met with aggressive tax planners’ attempts to get around the new regulation.” Leon Dalezman & Philip Lenertz, *When the IRS Prefers Not To: Why Disparate Regulatory Approaches to Similar Derivative Transactions Hurts Tax Law*, 7 HARV. BUS. L. REV. 81, 82 (2017). “Any time a bright-line rule is advanced, it increases the ability of planners to create transactions that fall just barely on the right side of the line while getting their desired tax advantage.” *Id.* at 87.

8. *Anschutz v. Commissioner*, 135 T.C. 78, 112 (2010), *aff’d*, 664 F.3d 313 (10th Cir. 2011) (emphasis added).

9. “The legislative history provides some guidance as to determining whether a transaction is treated as a constructive sale under section 1259.” *Id.* at 112. “The Senate Finance Committee Report ... in stating that a forward contract results in a constructive sale only if it provides for delivery of a substantially fixed amount of property at a substantially fixed price, goes on to say 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.’ *The report does not define or provide any guidance relative to the term ‘significant variation’ and the Secretary has not issued any regulations interpreting the term.*” *Id.* (emphasis added). “Rev. Rul. 2003-7 ... provides some limited guidance in evaluating whether ... VPFCs trigger constructive sale treatment.” *Id.* at 113.

1259 question.¹⁰ Eight years after *Anschutz*, the Tax Court revisited this issue, and the Second Circuit considered the application of § 1259, again *sans* any formal regulatory guidance from the IRS.

In *Estate of McKelvey v. Commissioner*,¹¹ while scrutinizing a pair of variable prepaid forward contracts (“VFPCs”),¹² the Second Circuit Court of Appeals reversed an earlier holding by the Tax Court and upheld the IRS’s position that a constructive sale of securities, pursuant to § 1259, had occurred;¹³ this appeared to be a determined effort to prevent the taxpayer from reaping a sizable tax windfall from complex financial transactions. Lacking any formal regulations, the Second Circuit instead relied on the novel use of a valuation model that employed probability analysis, which determined that the constructive sale of the taxpayer’s securities had occurred.¹⁴ The court’s adoption of the Black-Scholes valuation model to test compliance with § 1259, as argued for by the IRS, can be viewed as form of judicial rulemaking.¹⁵

Had the IRS formally issued regulations that adopted the Black-Scholes model (or really any option-pricing methodology), and had those regulations been subjected to a statutory notice and comment period, the taxpayer’s procedural due process rights would have been protected. The Administrative Procedure Act (“APA”)¹⁶ ensures that the public has an opportunity to participate in the rulemak-

10. While *Anschutz* involved financial instruments similar to those in *McKelvey*, they were subject to the terms and conditions of both a Master Stock Purchase Agreement (MSPA) and separate share-lending agreements, *McKelvey*’s were subject to neither of those additional agreements. *Anschutz* held the MSPA, share-lending agreements and the underlying securities were inextricably interrelated. It concluded that, as a result of the transaction’s structure, the taxpayer had sold the underlying securities pursuant to section 1001. *Anschutz* did not, accordingly, reach the application of section 1259. “Considering all of these factors together, we agree with the Tax Court that the transactions should be treated under the IRS as current sales of [the] shares[.]” *Anschutz*, 664 F.3d at 329 (emphasis added). *Anschutz* did not, accordingly, reach the application of section 1259.

11. *Estate of McKelvey v. Comm’r*, 906 F.3d 26 (2nd Cir. 2018) [hereinafter *McKelvey II*], *reh’g en banc denied* (Dec. 10, 2018), *cert. denied sub nom*, *Peters v. Comm’r*, 139 S. Ct. 2715 (2019). The panel consisted of Judges Jon O. Newman, Susan L. Carney, and Jose A. Cabranes. The Second Circuit’s opinion was written by Judge Jon O. Newman. A short concurrence was written by Judge Jose A. Cabranes.

12. *Id.*; “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.*” *Id.* at 39 (emphasis added). *But see*, *Petition for Writ of Certiorari* at 32, *Peters v. Comm’r*, 139 S. Ct. 2715 (2019) (No. 18–1177).

13. *Estate of McKelvey v. Comm’r*, 148 T.C. 312 (2017) [hereinafter *McKelvey I*], *rev’d*, 906 F.3d 26 (2d Cir. 2018). The Tax Court opinion was written by Judge Robert P. Ruwe.

14. “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.” *McKelvey II*, 906 F.3d at 37 (emphasis added).

15. The IRS, and subsequently the Second Circuit, relied on the stock price calculated with the Black-Scholes formula to conclude that the number of shares to be delivered under the contracts were “substantially fixed” and, accordingly, a constructive sale had taken place. “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.” *Id.* at 36–37 (emphasis added).

16. 5 U.S.C. § 551 (2011); *See generally* MICHAEL I. SALTZMAN & LESLIE BOOK, *IRS PRACTICE AND PROCEDURE* 1151 (2019) [hereinafter *SALTZMAN & BOOK*]. The administrative law principles of the APA apply with equal force to the IRS and its rulemaking. *See Mayo Found. for Med. & Educ. Research v. United States*, 131 S. Ct. 704, 713 (2011). “In the absence of such justification, we are not inclined to carve out an approach to administrative review good for tax law only. *To the contrary, we have expressly [r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action.*” *Id.* (emphasis added) (citations omitted).

ing process. Strict adherence to the notice and comment provisions ensures constitutionally sound rulemaking. Moreover, an administrative agency's failure to comply with APA requirements would, in and of itself, afford taxpayers a judicial remedy.¹⁷ Even the absence of any required rulemaking is subject to judicial review.¹⁸ Unfortunately, when the courts effectively adopt "regulations" that should have been formally issued by the IRS, taxpayers are denied the rulemaking protections afforded by the APA—which, at a minimum, seek to ensure their participation in the process. More significantly, fundamental procedural due process is ignored when the APA is circumvented.¹⁹

With "phantom regulations,"²⁰ courts adopt rules that they believe the IRS would have issued as regulations, *but did not in fact promulgate*, to enforce the statutory provisions at issue.²¹ The Second Circuit, in its analysis of whether the complex financial transactions under review had resulted in a constructive sale of the underlying securities, specifically adopted the probability analysis methodology argued for by the IRS.²² As a result, the Second Circuit permitted the IRS to accomplish, *de facto*, what it had refused to do for 22 years – the issuance of Congressionally mandated regulations.²³ That procedural shortcut, whether justified or not by the fact pattern of a given case, significantly undermines taxpayer confidence in the operation of our federal tax system.

Not only does the IRS avoid the direct responsibility for promulgating the specific regulatory guidance called for by Congress, but the court becomes a willing partner in abetting the circumvention of the APA's statutory notice and comment requirements. Whether the disregard of the APA's statutory rulemaking provisions rise to the level of a constitutional procedural due process violation is a reasonable concern. However well-intentioned or seemingly necessary, the procedural shortcut of phantom regulations eliminates any public participation in the rulemaking process and fuels the notion of strategic tax law uncertainty.²⁴

17. JARED P. COLE, CONGRESSIONAL RESEARCH SERVICE, AN INTRODUCTION TO JUDICIAL REVIEW OF FEDERAL AGENCY ACTION (2016).

18. *Id.*

19. "The purpose of these [notice and comment] procedures is to encourage public participation in the rulemaking process. 'In enacting the APA, Congress made a judgment that notions of fairness and informed administrative decision making require that agency decisions be made only after affording interested persons notice and an opportunity to comment.'" Kristin E. Hickman, *Coloring Outside the Lines: Examining Treasury's (Lack Of) Compliance with Administrative Procedure Act Rulemaking Requirements*, 82 NOTRE DAME L. REV. 1727, 1728 (2007) (emphasis added) (footnote omitted).

20. "To give the statute effect, the reviewing court invokes 'phantom regulations,' *deciding the case in accordance with the interpretation it believes the Secretary might offer were he to issue regulations.*" Amandeep S. Grewal, *Substance over Form? Phantom Regulations and the Internal Revenue Code*, 7 HOUS. BUS. & TAX L.J. 42, 45 (2006) [hereinafter *Substance over Form?*] (emphasis added) (footnote omitted). "Though the practice [of adopting phantom regulations] began in situations where taxpayers would have otherwise been deprived of an intended tax benefit, it has expanded beyond that." Gall, *supra* note ***, at 414 (emphasis added).

21. Phantom regulations are by no means a universally accepted means of adjudication. "Although some courts have adopted this approach, *other courts apply the plain meaning of statutes and do not apply phantom regulations*. Additionally, most circuits have not definitely addressed phantom regulations one way or another[.]" Amandeep S. Grewal, *Mixing Management Fees with Mayo*, 16 FLORIDA T. REV. 1, 3 (2014) [hereinafter *Mixing Management Fees*] (emphasis added).

22. *Estate of McKelvey v. Comm'r*, 906 F.3d 26, 38 (2nd Cir. 2018), *reh'g en banc denied* (Dec. 10, 2018), *cert. denied sub nom. Peters v. Comm'r*, 139 S. Ct. 2715 (2019).

23. *Estate of McKelvey v. Comm'r*, 148 T.C. 312, 332 (2017), *rev'd*, 906 F.3d 26 (2d Cir. 2018).

24. See Paul, *supra* text accompanying note 2, at 1468.

While not as readily apparent as the procedural due process shortcomings, another constitutional infirmity may be the separation of powers issue that arises when a court occupies the regulatory vacuum created by the IRS's refusal to promulgate mandated regulations to implement § 1259.²⁵ Having the judiciary step into the breach may be viewed as laudatory by some; others can equally view that behavior as an encroachment—not just upon the executive branch prerogative to engage in rulemaking, but also upon the legislative prerogative to require the IRS to undertake the rulemaking process. This would be true even if the executive and legislative branches ultimately endorsed the particular outcome.

Part II of this article examines the factual background of *McKelvey* and the nature of the financial instruments the taxpayer employed to monetize his position in the Monster securities, together with a review of the provisions of § 1259 that could apply to the transaction.²⁶ It then reviews the Tax Court and Second Circuit decisions,²⁷ together with a brief discussion of the APA, IRS rulemaking, and phantom regulations.²⁸ Part III of this article analyzes the Second Circuit's decision to incorporate probability analysis to reach its decision in light of both the APA notice and comment requirements and the IRS's regulatory rulemaking process.²⁹ It also briefly examines the separation of powers concerns raised by the use of phantom regulations.³⁰

Part IV of this article concludes that the Second Circuit's overarching policy concern that the taxpayer would otherwise reap too great a tax benefit from the complex, financially-engineered securities, caused it to overstep its judicial mandate.³¹ The court adopted *de facto* regulations that should have, instead, been promulgated by the IRS pursuant to the unambiguous Congressional directive.³² The Panel's decision to step in and adopt the regulatory guidance denied the taxpayer any opportunity to participate in the rulemaking process via the APA's statutory notice and comment requirements. More significantly, had the Second Circuit not endorsed the Black-Scholes model (or the use of probability analysis in general), and instead affirmed the Tax Court, the IRS might have been spurred to finally enact the very regulations that it has so far spurned.

25. The taxpayer raised separation of powers concerns over the appropriateness of the Second Circuit's "phantom regulations" in both of its petitions, for a *rehearing en banc* and for *certiorari*. Since the courts denied both petitions, neither the full Second Circuit nor the Supreme Court took the opportunity to address the separation of powers issue. *See infra* text accompanying notes 205–19; *See also*, Kristen A. Parillo, *Supreme Court Urged to Address 'Phantom' Reg Problem*, Tax Notes, 462 (April 15, 2019). "The McKelvey petition says that courts' decisions to fill in regulatory gaps in tax law are inconsistent with Congress's express intent that Treasury exercise rulemaking authority. '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,' it says." *Id.* at 463–464 (referencing Petition for Certiorari).

26. *See infra* Parts IIA, IIB.

27. *See infra* Parts IIC, IID.

28. *See infra* Parts IIE, IIF, IIG.

29. *See infra* Parts IIIA, IIIB.

30. *See infra* Part IIIC.

31. *See Mixing Management Fees*, *supra* text accompanying note 21, at 6.

32. *See Estate of McKelvey v. Comm'r*, 148 T.C. 312 (2017), *rev'd*, 906 F.3d 26 (2d Cir. 2018).

II. STATUTORY, FACTUAL, & JUDICIAL BACKGROUND

A. IRC Section 1259 and Constructive Sales

In the wake of numerous reports of abusive tax-driven financial transactions, which culminated in the news that the Estee Lauder family had avoided significant tax liability from short sales of their company's securities,³³ President Bill Clinton proposed to amend the IRC to prohibit these particularly abusive transactions. What was ultimately enacted, § 1259, while somewhat different from the President's initial broad-range proposals,³⁴ was a major step forward in combating the abuses of short sales against the box.³⁵ The remedy was essentially to treat these devices—regardless of their complexity—as constructive sales instead of open transactions.³⁶

Section 1259 applies to “appreciated financial positions” and can result in the “deemed sale” of the applicable securities, regardless of how the taxpayer structures the actual transaction.³⁷ It is, as an anti-abuse tool, a classic example of the substance over form doctrine. In addition to the deemed “sale” of the underlying securities, § 1259 adjusts the amount of gain or loss realized upon that subsequent actual sale of the securities.³⁸ In addition, it triggers the commencement of a new holding period for the post-constructive securities.³⁹ Section 1259 essentially bifurcates the taxpayer's securities position into a pre- and post- constructive sale position, with a separate taxable component attributed to each holding.

In addition to statutory definitions of various terms, the drafters specifically envisioned that further clarification of the statute's application and operation would be provided by Treasury Regulations.⁴⁰ Not only does the statute include two separate, textually committed directives that authorize the promulgation of regulations

33. See Paul, *supra* text accompanying note 2, at 1467. For a fuller discussion of the Lauder family's financial transactions, see generally Simon D. Ulcickas, *Internal Revenue Code Section 1259: A Legitimate Foundation for Taxing Short Sales Against the Box or a Mere Makeover?*, 39 WM. & MARY L. REV. 1355, 1365 (1998) (“Estée Lauder Companies' November 15, 1995 IPO served as the driving force behind enactment of section 1259” (footnotes omitted)).

34. “The administration's attack on this ‘abuse’ was broad-gauge. Rather than targeting multiyear deferral transactions – or even the traditional year-end deferral transaction – the administration's proposal reflected what might be called a pure tax policy approach (as opposed to an ‘anti-abuse’ approach).” See Paul, *supra* note 2, at 1467–68.

35. “When Congress took up the issue, the focus turned more toward preventing abusive transactions, particularly the types of transactions attracting press reports. . . . Congress thus sought a pragmatic approach that would prevent tax-motivated deferral transactions without adversely affecting legitimate short-term hedges.” *Id.* at 1468.

36. *Id.* at 1469.

37. “The basic rule in new section 1259 is deceptively simple: If taxpayer makes a ‘constructive sale’ of an ‘appreciated financial position,’ the taxpayer will recognize gain as if the position were sold at fair market value on the date of such constructive sale.” *Id.* at 1468 (footnotes omitted).

38. “[A] proper adjustment is to be made to the amount of any gain or loss subsequently taken into account with respect to the position” *Id.*

39. “[T]he taxpayer's holding period in the position begins anew at the time of the constructive sale transaction is entered into.” *Id.* (footnote omitted).

40. “As is often the case, Congress has left the really hard work [of writing regulations] to Treasury.” *Id.* at 1470 (emphasis added).

(exclusive of the Treasury’s general delegation of authority to promulgate regulations),⁴¹ but the legislative history also contains numerous references to the expected guidance.⁴² More significantly, the legislative history includes specific examples of what the regulations should cover, and what issues the IRS should endeavor to resolve.⁴³ In his discussion of the various issues that needed to be addressed as part of the § 1259 rulemaking, one commentator observed that “Treasury faces a daunting task in carrying out its regulatory authority.”⁴⁴

The legislative history of § 1259, for example, discussed the role of probability analysis: “[O]ne approach that Treasury might take in issuing regulations is to rely on option prices and option pricing models.”⁴⁵ It is instructive to note that the very position taken by the IRS in *McKelvey* was suggested by Congress when it enacted the statute, yet it was never formalized in regulations, or sub-regulatory guidance, by the IRS.⁴⁶ The fact that such guidance would be difficult to draft or that taxpayers may, undoubtedly, seek ways to circumvent an unfavorable rule, should not excuse the refusal to promulgate the necessary regulations.

B. *The McKelvey Financial Transactions*

In September 2007, Andrew J. McKelvey⁴⁷ entered into two separate VPFCs, which were defined as

agreement[s] 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

41. I.R.C. § 7805. “[T]he Secretary shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue.” *Id.* § 7805(a).

42. “The legislative history makes clear that Congress expects Treasury to provide ‘specific standards’ for determining whether several common transactions will be treated as constructive sales.” Paul, *supra* note 2, at 1471 (footnote omitted).

43. “In addition, the Conference Report urges Treasury to issue ‘prompt guidance, including safe harbors, with respect to common transactions entered into by taxpayers.’” *Id.* (footnote omitted).

44. *Id.* at 1472 (emphasis added).

45. S. REP. NO. 105-33, at 127 (1997) (emphasis added). However, “the notion that a taxpayer should have to apply an option pricing model to determine whether a hedge constitutes a constructive sale may itself be fundamentally impracticable.” However, “[T]he notion that a taxpayer should have to apply an option pricing model to determine whether a hedge constitutes a constructive sale may itself be fundamentally impractical.” Paul, *supra* note 2, at 1473.

46. Paul, *supra* note 2, at 1472. “The legislative history suggests that Treasury may want to refer to option prices and option pricing models to determine the amount of risk/reward the taxpayer has eliminated.” *Id.* (emphasis added).

47. The taxpayer entered into the financial transactions in September, 2007. The contracts at issue were subsequently “extended” in July, 2008. Mr. McKelvey died thereafter and it was his Estate that settled the contracts in August, 2009. In August, 2014, the IRS issued a notice of deficiency that challenged the taxpayer’s treatment of the transactions. The taxpayer has, since, variously been referred to as taxpayer, petitioner, decedent, and Estate. More recently, in its petition for *certiorari*, the Estate’s Executor, Bradford Peters, was substituted as the named plaintiff. For convenience, throughout this Article the plaintiff will be referred to as either the taxpayer or the decedent. *Estate of McKelvey v. Comm’r*, 148 T.C. 312, 313–18 (2017), *rev’d*, 906 F.3d 26 (2d Cir. 2018).

cash equivalent), the exact number to be determined by the price of the shares on a specified valuation date.⁴⁸

A successfully structured VPFC will, *by its design*, avoid classification as a constructive sale under the provisions of § 1259.⁴⁹ As the name suggests, this is accomplished by the “variability” in the number of shares that must ultimately be delivered when the contract is closed. A successful VPFC defers the recognition of the income until the closing date of the transaction because the numbers of shares required for delivery under the contract terms will not be known until the specified measurement date.⁵⁰

In 2007, the decedent entered into the first of two contracts:⁵¹ one with Bank of America (“BA-VPFC”) which covered 1.765 million shares of Monster class B common stock. The second contract was entered into with Morgan Stanley (“MSI-VPFC”) and covered 4.762 million shares of Monster common stock.⁵² The decedent received the sums of \$50.9 million and \$142.6 million, respectively, as cash pre-payments on the VPFCs from Bank of America and Morgan Stanley.⁵³

Both VPFCs were secured by the maximum number of the underlying securities described in the particular instrument.⁵⁴ Accordingly, in exchange for the cash pre-payments, the decedent agreed to secure the VPFCs with 1.765 million shares of Monster class B common stock and 4.762 million shares of Monster common stock.⁵⁵ The maximum number of shares required to be delivered at the closing date would not exceed those maximum caps.⁵⁶ However, by design, the number of shares to be delivered could also be significantly fewer than the maximum number allowed.⁵⁷ Hence, the spread between the minimum and maximum number of shares required to be delivered at settlement would, presumably, keep the financial instruments from being treated as constructive sales.⁵⁸

48. *Estate of McKelvey v. Comm’r*, 906 F.3d 26, 27–28 (2nd Cir. 2018), *reh’g en banc denied* (Dec. 10, 2018), *cert. denied sub nom, Peters v. Comm’r*, 139 S. Ct. 2715 (2019).

49. “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.” *McKelvey I*, 148 T.C. at 326. *See also infra* text accompanying note 72.

50. *See also infra* text accompanying note 81.

51. For a fuller discussion of the precise details of the contractual obligations required under the terms each of the two VPFCs, *see McKelvey II*, 906 F.3d at 28–33; *see also McKelvey I*, 148 T.C. at 313–318.

52. *See McKelvey II*, 906 F.3d at 30–31 n.3 & 4 (detailing contractual provisions for BA-VPFC and MS-VPFC).

53. *Id.* at 32 n.6.

54. *Id.* at 28.

55. *Id.* at 32 n.7.

56. *Id.* at 29.

57. *See* Brief for Petitioner-Appellee at 13, *McKelvey I*, 148 T.C. 312 (2017) (No. 17-2554). The actual number of shares due at settlement varied under the terms of each VPFC. The number of shares covered by the BA-VPFC ranged from a minimum of 1,324,993 shares to a maximum of 1,765,188 shares. The MSI-VPFC ranged from a minimum 4,112,636 shares up to a maximum of 4,762,000 shares. In lieu of the actual delivery of shares, both of VPFCs provided for payment of the cash equivalent. *Id.* at 3–4.

58. “[A]t the outset of a VPFC, the parties know the amount of the prepayment but do not know: (1) whether the stockholder will deliver stock or cash; (2) *how much stock or cash will be delivered*; or (3) the basis of any shares that will be delivered, in the event the stockholder chooses to settle in stock. Because knowledge of each of these components is needed to determine the amount and character of any gain or loss resulting from the VPFC, *it is undisputed that no gain or loss is realized upon entry into a VPFC.*” *Id.* at 3. (emphasis added) (citation omitted).

The VPFC transactions were, as initially structured, not designed to be treated as constructive sales under § 1259.⁵⁹ However, the decedent would thereafter enter into “extensions” of the two contracts in 2008 that would alter how the modified contracts would be viewed by the IRS.⁶⁰ In 2008, the decedent paid Bank of America \$3.5 million to amend its BA-VPFC contract to extend its closing date until 2010.⁶¹ He then paid Morgan Stanley \$8.2 million to amend the MSI-VPFC contract and also extend the closing date until 2010.⁶² The tax consequences that resulted from the decedent’s contract amendments and extensions were challenged by the IRS.⁶³

Following the decedent’s death in November 2008, his shares in Monster common and Monster class B common stock received a step-up in basis to their fair market values at the date-of-death.⁶⁴ The estate settled the BA-VPFC in May 2009, with delivery of 1.8 million shares to Bank of America.⁶⁵ The estate settled the MSI-VPFC in August 2009, by delivery of 4.8 million shares to Morgan Stanley.⁶⁶ Because of the stepped-up basis in the shares, the estate reported no capital gains upon the closing of the VPFCs and delivery of the shares to the respective financial institutions.⁶⁷

While there was no dispute that neither of the two VPFCs was a constructive sale at the time they were entered into,⁶⁸ the IRS contended that upon the subsequent amendments, both VPFCs resulted in constructive sales.⁶⁹ The IRS took that view because, had the decedent closed the original contracts, he would have incurred a substantial tax liability: “[i]f McKelvey had delivered his Monster shares on those dates of the VPFCs, he would have realized a substantial capital gain.”⁷⁰ Subsequently, the Tax Court would agree, in total, with the taxpayer—and conclude the

59. “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 VPFCs were settled. . . . 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)*.” *McKelvey II*, 906 F.3d at 33; *see also, infra* Part II(C).

60. “[T]he ultimate issue to be decided was ‘what tax consequences, if any, occurred when [McKelvey] extended the settlement and averaging dates of the original VPFCs.’” *McKelvey II*, 906 F.3d at 33 (citing the Tax Court’s decision).

61. *Id.* at 30.

62. *Id.* at 31.

63. *Id.* at 32.

64. “The Estate obtained a stepped-up basis for the Monster shares. *See* 26 U.S.C. section 1041(a)(1).” *Id.* at 31.

65. *Id.*

66. *Id.*

67. “The Estate’s reason for not reporting any long-term capital gain 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*, . . . and the stock price had declined between the date of death and the settlement date.” *Id.* at 32. (emphasis added).

68. “The Commissioner had previously acknowledged that VPFCs did not incur capital gains when executed.” *Id.* at 33; *See also, Estate of McKelvey v. Comm’r*, 148 T.C. 312, 329 (2017), *rev’d*, 906 F.3d 26 (2d Cir. 2018) (“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.” (emphasis added)).

69. *McKelvey II*, 906 F.3d at 33; *See also*, Robert W. Wood & Donald P. Board, *Monster McKelvey Estate Tax Case and Litigation Finance*, Tax Notes 1299, 1302 (Sept. 4, 1997).

70. *McKelvey II*, 906 F.3d at 31. “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

contract amendments were not taxable events. The Second Circuit, conversely, viewed the extended VPFCs differently and reversed the Tax Court, holding that the IRS's position was correct.

C. *The Tax Court Decision*

The Tax Court, in its review of the transactions, determined that the subsequent amendments to the VPFCs did not result in taxable events.⁷¹ Key to the decision was the notion that the VPFCs were not property and the extensions, therefore, merely postponed the settlement date under the open transaction doctrine.⁷² The Tax Court noted that the significance of the contract extensions had not been considered in previous cases.⁷³

Under the property theory, there could be no sale or exchange when the contracts were extended to generate a gain or loss unless the underlying VPFC was a property right.⁷⁴ The taxpayer's argument was that since the pre-payment had already been received, all that remained under the VPFC was *the obligation to deliver the specified shares*.⁷⁵ The IRS contended that, "even if the decedent possessed primarily obligations, the original VPFCs still constituted property[.]"⁷⁶ The Tax Court held that at the time of the of the contract extensions, the decedent "*had only obligations*."⁷⁷

Continuing with that line of analysis, the Tax Court found that both before and after the extensions, the decedent only had obligations to deliver.⁷⁸ Despite this, the IRS contended that the decedent possessed valuable rights in the original VPFCs, beyond the obligations to deliver the securities.⁷⁹ The court rejected each contention, in turn, and concluded that "the extensions did not constitute exchanges of the decedent's property[.]"⁸⁰

It followed from that conclusion that if no sale or exchange had occurred under § 1001 at the time the extensions were entered into, then the "open transaction"

gain of more than \$200 million when he executed the VPFC extensions in 2008." *Id.* at 32 (emphasis added).

71. See Wood, *supra* text accompanying note 69.

72. "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.'" Wood, *supra* note 69, at 1302 (footnote omitted).

73. "The parties cite no reported cases addressing the tax consequences resulting from extensions to the VPFCs, and this appears to be a case of first impression in this Court." *Estate of McKelvey v. Comm'r*, 148 T.C. 312, 320 (2017), *rev'd*, 906 F.3d 26 (2d Cir. 2018).

74. "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.'" *Id.*

75. *Id.* at 322. The Tax Court agreed with the taxpayer's position. "We find that, at the time decedent extended the settlement and averaging dates of the original VPFCs, *he had only obligations*." *Id.* (emphasis added).

76. *Id.*

77. *Id.* (emphasis added).

78. Generally, under I.R.C. § 1001, a taxpayer is required to recognize a gain or loss on the sale or exchange of property. If the transaction does not involve "property," as that term is defined for tax purposes, then the section 1001 recognition provisions would be inapplicable "[b]ecause the decedent only had obligations ... and obligations are not property – the VPFCs were not property under section 1001, and therefore section 1001 is inapplicable." *Id.* at 323–24.

79. *Id.* at 324.

80. *Id.* at 325.

doctrine prevented realization of a taxable event from those same facts. The Court's view was consistent with the rationale articulated in Revenue Ruling 2003-7, the only formal guidance issued by IRS on the taxation of VPFCs and § 1259.⁸¹ The Ruling "approved 'open' transaction treatment for VPFCs that meet certain criteria."⁸² Applied to the contract extensions: "[t]hus, by only extending the settlement... dates, the extensions did not clarify the uncertainty of which property decedent would ultimately deliver to settle the contract positions."⁸³

In addition to ruling against the IRS on the sale or exchange position, the Tax Court also held that the constructive sale provisions of § 1259 did not apply to the extensions. The court concluded that for purposes of § 1259, the only contracts subject to evaluation were the original VPFCs.⁸⁴ While the IRS argued that the extensions themselves triggered the reevaluation and, thus, constructive sales, the Tax Court disagreed. It held that the "constructive sales" outcome could only be reached if the extensions constituted sales or exchanges under § 1001.⁸⁵ Since the court concluded they did not and, moreover, that the open transaction doctrine applied, the contract extensions did not result in constructive sales.⁸⁶ Therefore, the Tax Court did not reach the issue of whether the modified VPFCs constituted "constructive sales" pursuant to § 1259.

81. "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." *Id.* at 329 (emphasis added).

82. *Id.* at 327; *See also*, Combs, supra text accompanying note 6, at 1253. ("In *Rev. Rul. 2003-7*, the IRS formally addressed the question of whether an actual or constructive sale occurred on the execution of a VPFC. The IRS concluded, based on the terms of the contract...that a sale did not occur... under section 1259."). It should be emphasized that *Rev. Rul. 2003-7* considered an initial VPFC – not the contractual extension of an existing VPFC, such as those before the Tax Court in *McKelvey*. Moreover, in *Anschutz*, the court considered VPFCs that were subject to the provisions of a Master Stock Purchase Agreement (MSPA) and separate share-lending agreements – again, a significant difference from the given facts of *Rev. Rul. 2003-7*. *Anschutz v. Commissioner*, 135 T.C. 78, 112 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011) (emphasis added).

83. *Estate of McKelvey v. Comm'r*, 148 T.C. 312, 329–30 (2017), *rev'd*, 906 F.3d 26 (2d Cir. 2018). "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." *Id.* at 332 (emphasis added).

84. "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." *Id.* at 333.

85. "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." *Id.*

86. The reasoning of the Tax Court's opinion was met with some skepticism. *See, e.g.*, Mark Fichtenbaum & Robert Gordon, *Estate of McKelvey v. Commissioner – Tax Planning Opportunity or a Trap for the Unwary?*, 34 J. TAX'N INV. 25, 30 (2017) [hereinafter *Tax Planning Opportunity*]; *see* Mark Fichtenbaum & Robert Gordon, "Estate of McKelvey v. Commissioner: The Trap has been Sprung," 36 J. TAX'N INV. 41, 43-44 (2019) [hereinafter *The Trap has been Sprung*]. The authors contended that if the Tax Court reasoning was incorrect and the extensions were, in fact, taxable events – and, thus, constructive sales under section 1259 – then taxpayers such as *McKelvey* would owe more in taxes than if they had simply closed out the original VPFCs instead of extending their closing dates. Their skepticism of the Tax Court's decision was, indeed, proven prescient. *Id.* at 44; *see also* Wood & Board, supra note 72 ("Prepaid forward contracts are unusual but becoming less so. One reason for a new uptick in interest is a tax case [*McKelvey*] that seems almost too good to be true.").

D. *The Second Circuit Decision*

In reviewing the VPFC transactions, the Second Circuit agreed with the Tax Court that the extensions to the VPFCs were not property and, thus, could not trigger sale or exchange treatment.⁸⁷ However, the Second Circuit disagreed that § 1001 sale or exchange treatment was the sole method to analyze the financial instruments.⁸⁸ Instead, the panel considered an alternative theory to analyze the VPFC extensions. The Second Circuit examined whether “cancellation” of the original VPFC contract obligations via the extensions and their replacement with new obligations resulted in a taxable event.⁸⁹ It concluded that the 2008 extensions to the original VPFCs were in the nature of cancellation of indebtedness income and, accordingly, taxable events—which generated short-term capital gains.⁹⁰

In reaching that conclusion, the Second Circuit opted not to remand the case back to the Tax Court for resolution of the capital gains question. The parties differed on whether the amended contracts “accomplished a termination” which would, thus, trigger application of the cancellation of indebtedness provisions.⁹¹ The Second Circuit agreed with the IRS’s position that the extension of the valuation dates of the VPFCs resulted in “amended contracts that replaced the original contracts.”⁹² Once it held the extensions were taxable events, the panel remanded the calculation of the amount and the character of the gains so recognized to the Tax Court.⁹³

Having concluded the original VPFCs had therefore been replaced by amended contracts as a result of the extensions, the Second Circuit proceeded to examine whether the newly amended VPFCs constituted § 1259 constructive sales.⁹⁴ The Tax Court had not reached this question because it viewed the VPFCs, despite the contract modifications, as one continuous open transaction that did not require reevaluation simply because the contract closing dates had been extended.⁹⁵ But the new closing date, in the panel’s view, marked a significant change in the dynamics of the underlying economics of the VPFCs and, therefore, required a retesting under the § 1259 rules.⁹⁶

87. “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 a replacement of the VPFCs with the amended contracts was an ‘exchange of property.’” *Estate of McKelvey v. Comm’r*, 906 F.3d 26, 34 (2nd Cir. 2018), *reh’g en banc denied* (Dec. 10, 2018), *cert. denied sub nom*, *Peters v. Comm’r*, 139 S. Ct. 2715 (2019).

88. *See The Trap has been Sprung*, *supra* note 86, at 44.

89. *Id.* at 43; *see McKelvey II*, 906 F.3d at 34 (“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.”) (emphasis added).

90. I.R.C. §1234A(1) (“Gain or loss attributable to the cancellation . . . or other termination of . . . a right or obligation . . . shall be treated as a gain or loss from the sale of a capital asset.”). *See The Trap has been Sprung*, *supra* note 86, at 42.

91. *McKelvey II*, 906 F.3d at 34. (“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.”).

92. *Id.* at 35.

93. *Id.* at 41. (“[T]he 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.”).

94. *Id.* at 35–39.

95. *Id.*

96. *Id.*

The IRS argued that as a result of the extensions, “the amount of Monster shares to be delivered at settlement of each amended contract [VPFC] was ‘substantially fixed’ on the date when each amended contract was executed.”⁹⁷ The IRS reasoned that since the current price of Monster stock had fallen so significantly below the “floor price” that was established at the time the VPFCs were established, there was only a remote likelihood that the share price would recover and eventually exceed the “floor price” by the settlement dates.⁹⁸ If so, then “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[.]*”⁹⁹

However, to arrive at the position that delivery upon settlement of the maximum number of shares was a virtual certainty, the IRS had to employ the Black-Scholes probability analysis formula. Despite the statutory call for regulations to effectuate Congressional intent to curb abusive constructive sale transactions,¹⁰⁰ the IRS had refused to promulgate regulations.¹⁰¹ Had the IRS issued those regulations, or even sub-regulatory guidance, and informed taxpayers who engage in forward contract transactions that those instruments would be subject to testing under probability analysis, they could hardly decry the altered outcome that resulted from the extensions.

In any event, the Second Circuit agreed with the IRS’s conclusion, premised as it was on the use of the Black-Scholes formula, and held that the amended VPFCs were constructive sales under § 1259.¹⁰² As a consequence, instead of a taxable gain computed as of the original date of the VPFCs (2007), the taxpayer calculated the capital gain as if the shares had been sold when the contracts were *amended* (2008).¹⁰³ The capital gain in 2008, given the dramatic drop in stock price, was significantly greater than if the taxpayer had merely closed out the original VPFCs.¹⁰⁴

Despite its decision to adopt the probability analysis methodology and conclude that the number of shares was “substantially fixed” for purposes of § 1259,¹⁰⁵ the panel (surprisingly) suggested that it could have reached a different outcome on

97. *Id.* at 36.

98. *Id.*

99. *Id.* (emphasis added). The court further held “[t]hat virtual certainty, the Commissioner concludes, means that the amount of property to be delivered at settlement was ‘substantially fixed’ within the meaning of section 1259(d)(1) and therefore the collateralized shares had been constructively sold.” *Id.*; See also, *Anschutz v. Commissioner*, 135 T.C. 78, 112 (2010), *aff’d*, 664 F.3d 313 (10th Cir. 2011).

100. See Paul, *supra* note 2, at 1470.

101. *McKelvey II*, 906 F.3d at 37–38 (“And although Congress authorized the issuance of ‘necessary or appropriate’ regulations to implement the constructive sale statute, see I.R.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.”).

102. *The Trap Has Been Sprung*, *supra* note 86, at 44. (“The Court used the Black-Scholes model developed for pricing options to determine this likelihood. Using this model, the court concluded that there were 85.1 percent and 87.3 percent probabilities, respectively, that the price of the shares would remain below the floors for [the VPFCs]. *The court decided that these probabilities were high enough to conclude a constructive sale of the shares had occurred.*”) (emphasis added).

103. See *McKelvey II*, 906 F.3d at 35.

104. *Trap for the Unwary*, *supra* note 86, at 30 (“When one is in the position McKelvey was in, entering into a new [VPFC] with the same bands [floors and ceilings] as the old will in most cases create a constructive sale of the *shares* (emphasis in original). This amount of gain would not have been recognized if the taxpayer had closed out the first [VPFC] and entered into a new one. *And this amount of gain may far exceed the amount of ‘unrecognized’ gain deferred in the [VPFC].*”) (emphasis added).

105. *McKelvey II*, 906 F.3d at 38. (“Nevertheless, we are persuaded to accept probability analysis in this context.”).

the second element of the constructive sale.¹⁰⁶ The panel considered in *dicta* the possible impact that the “same or substantially identical property” language of § 1259(c)(1)(C) had on the VPFC transactions.¹⁰⁷

The panel observed that even though the Tax Court did not reach the constructive sale question because it viewed the original and amended VPFCs as one continuous open transaction, Judge Ruwe commented that what was to be delivered was not, in and of itself, a fixed thing. “[H]e did say that (1) the ‘extensions ... *did not clarify the uncertainty of which property ... would ultimately [be] delivered 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.*’”¹⁰⁸ From that passage, the panel believed that the Tax Court implicitly ruled against the IRS’s constructive sale position “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.”¹⁰⁹

The panel observed that neither party raised this issue on appeal.¹¹⁰ The IRS based its constructive sale argument “solely on the theory, which we accept, that the *amount* of shares (not the identity of shares) was ‘substantially fixed’ because of the depressed price of Monster stock.”¹¹¹ Likewise, the panel continued, “[t]he Estate grounds its opposition to a constructive sale on two arguments.”¹¹² Neither of the estate’s arguments raised the question of substantially identical property.¹¹³ The panel speculated that, “[p]erhaps both sides plausibly believe that it is the ‘substantially fixed price’ language that controls[.] Or they more plausibly believe that the ‘same or substantially identical property’ language ... means that the property to be delivered has the same *value* as the appreciated position.”¹¹⁴

The Second Circuit passed up the opportunity to resolve that issue, saying that: “[i]n any event, *we decide the ... issue as the parties have presented it and conclude that constructive sales of the collateralized shares occurred.*”¹¹⁵ While the Second Circuit’s discussion of the “substantially identical” issue does not bear on this article’s consideration of the phantom regulation aspect of the “substantially fixed” analysis, it does, however, merit considering whether it was even necessary for the panel to reach the “substantially fixed” question—via probability analysis or otherwise—if the case could have been resolved by conventional methods of statutory

106. *Id.* at 39.

107. *Id.* at 40 (“Justice 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.”) (emphasis added).

108. *Id.* (citation omitted) (emphasis added).

109. *Id.*

110. *Id.*

111. *Id.* (emphasis in original).

112. *Id.*

113. *Id.* (stating that the first was the contract extensions did not result in “new” contracts. The second was that even if the amended contracts were “new” contracts, the number of shares to be delivered was not substantially fixed. The Court, as it observed, had rejected both arguments.)

114. *Id.* at 40–41 (emphasis in original). An alternative and perhaps more realistic explanation this issue wasn’t argued may simply be that McKelvey did not have any other shares that he could deliver to satisfy the contract terms. While it was theoretically possible different shares could be delivered at closing, *it was unlikely he could avoid delivery of the actual shares he owned.*

115. *Id.* at 41 (emphasis added).

interpretation. The panel was under no duty, *sua sponte*, to address, much less resolve, a matter that was not briefed by the parties. But for the panel to discuss the issue at length, only to then largely avoid a resolution, seems disingenuous.

E. *The Administrative Procedure Act*

The Administrative Procedure Act expressly provides for the judicial review of an administrative agency's rulemaking activities.¹¹⁶ That review extends to "a claim that an agency or an officer or employee thereof acted *or failed to act* in an official capacity or under color of legal authority."¹¹⁷ In other words, the APA's reach also extends to the administrative agency's "inaction"¹¹⁸ which would include, for example, its failure to promulgate regulations. The APA does not, however, create any new substantive rights beyond those that have already been statutorily committed to the agency. Likewise, the APA does not permit the award of monetary damages.

In brief, whenever an administrative agency engages in "rulemaking," it is required to notify the public of the proposed rule and provide any and all interested persons the opportunity to comment on the proposed rule.¹¹⁹ While the agency is under no obligation to adopt any of the proposed changes or modifications that are proffered by any interested parties,¹²⁰ such statutory notice and comment is required, unless an exception to the general rule applies.¹²¹ Significantly, however, the APA provides that notice and comment is not required for "*interpretative rules, general statements of policy, or rules of agency organization, procedure, or practice[.]*"¹²²

116. 5 U.S.C. § 702 (1976) ("A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof."). However, the APA does not create any additional judicial remedies if Congress has already provided adequate remedies for review of the action in question.

117. *Id.* (emphasis added).

118. 5 U.S.C. § 706 (1966) ("Scope of Review: To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall - (1) *compel agency action unlawfully withheld or unreasonably delayed[.]*") (emphasis added).

119. 5 U.S.C. § 553(b) (1966) ("General notice of proposed rulemaking shall be published in the Federal Register.... The notice shall include— (3) a statement of the time, place, and nature of public rule making proceedings; (4) reference to the legal authority under which the rule is proposed; and (5) either the terms or substance of the proposed rule or a description of the subjects and issues involved"); 5 U.S.C. § 553(c) ("After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation.").

120. 5 U.S.C. § 553(c) (1966) ("After consideration of the relevant matter presented [the comments], the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose.").

121. 5 U.S.C. § 553. "If the action of an agency, such as the Service, is quasi-legislative, the APA's rulemaking requirements of pre-adoption notice and public comment must be followed before the agency finalizes its rule." SALTZMAN & BOOK, *supra* note 16, at § 3.02[1] (footnote omitted).

122. 5 U.S.C. § 553(b)(1)(3)(A) (1966) (emphasis added); *see also* SALTZMAN & BOOK, *supra* note 16, at § 3.02[2][c]. ("Interpretative, or more accurately, 'non-legislative' rules include interpretative rules, policy statements, and procedurally defective legislative rules. An interpretative rule clarifies or defines statutory language, a previous administrative rule, or a judicial or agency adjudicative decision.") (footnote omitted). "[A]n agency may publish regulations without following notice-and-comment procedures if the preamble to the regulations states that the agency has determined 'for good cause' that notice-and-comment' procedures are 'impracticable, unnecessary, or contrary to the public interest.' Such temporary regulations would then be in effect until superseded by permanent regulations." *Id.* at §3.02[3][c].

For purposes of the APA, the IRS is treated like any other administrative agency.¹²³ Thus, judicial review of IRS regulatory rulemaking (or the lack thereof) is clearly within the scope of APA jurisprudence.¹²⁴ Accordingly, taxpayers can employ the provisions of the APA as one more resource to test the appropriateness of IRS rules and regulations. In the absence of congressionally mandated regulations, taxpayers can, in some circumstances, seek judicial intervention under § 706(1) to compel the promulgation of guidance.¹²⁵

F. The IRS Rulemaking Process

The process of regulatory rulemaking rightfully includes numerous steps before public adoption of the final regulation.¹²⁶ From initiation of a rulemaking project to the formal promulgation, the process must generally include the APA's mandated notice and comment period in which any interested parties can participate (which may include, *inter alia*, voicing opposition to the proposal, offering modifications or alternatives, or expressing support for the measure). The IRS need not adopt the comments suggested, but it must consider them; in some cases, it must also include a response to those comments when the final version is adopted.¹²⁷

A Regulation Project is typically the opening step in the promulgation of any regulatory guidance.¹²⁸ This is the start of what is often a long process: “[m]ost

123. Compare *Mayo Foundation*, *supra* note 16, at 20 (holding that the IRS is to be treated like any other agency), and Stephanie Hoffer & Christopher J. Walker, *The Death of Tax Court Exceptionalism*, 99 MINN. L. REV. 221, 223 (2014) [hereinafter Hoffer & Walker] (finding that there is a misconception that tax law is so different from the rest of the regulatory state that general administrative law doctrines and principles do not apply) with Michael D. Kummer & James G. Steele III, “What Other Courts Can Learn from Tax Court Exceptionalism,” 157 Tax Notes 1225 (Nov. 27, 2017) (proposing that in some contexts there are reasons to embrace that there is a sort of “Tax Court exceptionalism”).

124. In reaching this conclusion, the court [in *Mayo Foundation*] remarked that “the IRS is not special in this regard; no exception exists shielding it – unlike the rest of the Federal Government -- from suit under the APA.” Hoffer & Walker, *supra* note 123, at 223 (footnote omitted); see also SALTZMAN & BOOK, *supra* note 16, at §1.07[1] (“Since the Service is an authority of the U.S. Government ... it is considered an agency for purposes of the [APA]. Accordingly, the statutory provisions of the APA applicable to other ‘agencies,’ apply with equal force to the Service.”).

125. Compare *Telecommunications Research & Action Center v. FCC*, 750 F.2d 70, 76-77 (D.C. Cir. 1984) (indicating that “section 706(1) coupled with section 555(b) does indicate a congressional view that agencies should act within reasonable time frames and that courts designated by statute to review agency actions may play an important role in compelling agency action that has been improperly withheld or unreasonably delayed.”) (emphasis added) with *Norton v. South Utah Wilderness Alliance*, 542 U.S. 55, 64 (2004) (holding that a claim under §706(1) can only proceed when the plaintiff asserts the agency failed to take an action it is required to take) and *15 W. 17th St. LLC v. Commissioner*, 147 T.C. 557, 590 (2016) [hereinafter *15 W. 17th St. LLC*] (Holmes, J., concurring) (indicating a reluctance for a taxpayer to proceed under the APA, unless administrative remedies had first been exhausted.).

126. For a thoughtful overview of the IRS rulemaking process, see Sheryl Stratton, *How Regulations are Made: A look at the Reg Writing Process*, 13 TAX PRAC. 165 (Feb. 10, 1997) [hereinafter *How Regulations are Made*] (“The regulatory process: Teeth gnashing, hair pulling and endless bickering. And that’s just what some practitioners say they go through waiting for the government to issue guidance.”) (emphasis added) (footnote omitted).

127. SALTZMAN & BOOK, *supra* note 16, at § 3.02[3][b][i] (“When publishing a final regulation, the Service will include a preamble that summarizes the regulation, discusses differences between rules contained in the NPRM and the rules finally adopted, and explain the reason for the changes. Also, the preamble explains why the agency adopted some public comments but not others.”) (emphasis added).

128. Gall, *supra* note ***, at 416 (“How (and why) a particular regulation project is initiated is somewhat mysterious. Many mandatory delegations seem to lack the cachet necessary to instigate a regulation project.”).

projects, however, take months and sometimes years to turn into full-fledged regulations.”¹²⁹ Each Project is assigned a drafting team whose size varies based upon the complexity of the project and how many subject areas are covered within its scope. An initial draft of the regulation is prepared and reviewed by personnel from the IRS and the Treasury Department, as well as attorneys from the Office of Chief Counsel.¹³⁰ Once the draft is approved by the IRS Commissioner and the Secretary of the Treasury (or his delegate, such as the Assistant Secretary for Tax Policy),¹³¹ the regulation is published in the Federal Register as a Notice of Proposed Rulemaking.¹³²

The statutory Notice must include three components: (1) a statement of the time, place and public rulemaking proceedings that are to take place, (2) a reference to the authority under which the regulations are proposed, and (3) the text of the proposed regulations.¹³³ In the event of a public hearing, any comments submitted or testimony given must be “considered in the process of finalizing the regulations, and any responses to the comments are required to be discussed in the preamble to the final regulations.”¹³⁴ Following the notice and comment period, the regulations are published as “final” regulations in the Federal Register.

As one commentator has keenly observed, *the entire process*—from the initiation of the regulation project through publication of the final regulation—is valuable, in and of itself:

The gestation process for regulations is a valuable process, clearly designed to produce better regulations than would otherwise be produced. Moreover, the regulations are more likely to be accepted by the public because the public is provided with an opportunity to participate in the process. Consequently, any practice that has the effect of bypassing that process, whether it be the application of phantom regulations or the issuance of temporary regulations or a Notice, must be closely scrutinized.¹³⁵

The judicial adoption of phantom regulations should be put to an exacting level of scrutiny. Not only does a phantom regulation deny the public the opportunity to participate in the process; it likewise denies the taxpayer before the court any of the

129. Stratton, *supra* Note 126, at 166.

130. *See generally*, SALTZMAN & BOOK, *supra* note 16, at § 3.02[2] (giving a brief overview of the process).

131. 26 C.F.R. §601.601(a)(1) (1987) (“After approval by the Commissioner, regulations and Treasury decisions are forwarded to the Secretary or his delegate for further consideration and final approval.”).

132. “Where required by 5 U.S.C. 553 [the APA] and in such other instances as may be desirable, the Commissioner publishes in the Federal Register general notice of proposed rules[.]” *Id.* at §601.601(a)(2).

133. *Id.* at §601.601(a)(2)(i-iii). These requirements essentially mirror the language contained in the APA’s notice and comment provisions. 5 U.S.C. § 553(b)(1-3) (1966); Gall, *supra* note ***, at 417 (“After the notice is given, interested persons have the opportunity to participate in the submission of written data, views, or arguments, with or without opportunity for oral presentation.”). In addition, the IRS is required to make all submissions available to the public for review and inspection. “It will be presumed by the Internal Revenue Service that every written comment submitted to it in response to a notice of proposed rulemaking is intended by the person submitting it to be subject in its entirety to public inspection and copying[.]” 26 C.F.R. § 606.601(b)(1).

134. Gall, *supra* note ***, at 417 (“The Secretary is required to consider and respond to any objections and suggestions.”) (footnote omitted).

135. *Id.* at 418 (emphasis added).

due process protections of the APA. Given the significant drawbacks, phantom regulations are rarely advisable.

G. Phantom Regulations

Phantom regulations represent judicial positions that are intended to operate in place of the actual regulations that could, or should, have been promulgated by the IRS but have not been issued.¹³⁶ Courts have presented various rationales to step in and provide the “missing” regulatory guidance.¹³⁷ Typically, courts examine whether the delegation was “mandatory” or “discretionary,” with a view toward determining if the missing regulation is necessary for implementation of the statutory scheme:

Common to all these delegations is a difficult issue – absent any action by the Secretary, does the delegating statute have any operative effect? Or, in the language commonly used by courts in the administrative procedure setting, is the statute ‘self-executing’ in the absence of regulations?¹³⁸

If a statute is determined to be self-executing, a judicial assist with phantom regulations is much more likely.¹³⁹ Additionally, the majority of phantom regulation cases focus, in particular, on statutes that include “mandatory” delegations of authority to promulgate the necessary regulations.¹⁴⁰

Initially, it was thought appropriate to “fill in the gap,” so to speak, when the judicially-adopted phantom regulation inured to the taxpayer’s benefit.¹⁴¹ The court would provide for a statutorily authorized benefit when IRS inaction would prevent the taxpayer from receiving it.¹⁴² Courts were reluctant to employ phantom regulations in situations that operated to the taxpayer’s detriment,¹⁴³ or when the statutory

136. See generally *Substance Over Form?*, *supra* note 20, at 61–62 (indicating that these judicial positions do not undergo the same scrutiny of regulation under §553) (footnote omitted).

137. “Though the courts sometimes express discomfort with doing the Secretary’s job for him, they believe that doing so is consistent with Congress’s intent.” *Id.* at 45 (footnote omitted).

138. *Id.* 44.

139. *Id.*

140. “The major cases deal largely with mandatory delegations, which the courts usually deem self-executing.” *Id.* at 47. (emphasis in original) (footnote omitted).

141. See generally *id.* at 44–45 (“As one might expect, where the delegating statute offers a benefit, the taxpayer frequently argues that the Secretary should not be able to withhold the enjoyment of that benefit by delaying the issuance of regulations.”) (emphasis added); see also Gall, *supra* note ***, at 444 (“The early cases appeared to stand for nothing more than the courts’ refusals to allow the Secretary, through inaction, to deprive taxpayers of congressionally mandated benefits.”) (emphasis added).

142. Compare *Hillman v. Commissioner*, 114 T.C. 103 (2000) (where the Tax Court had specifically adopted the taxpayer-benefit view and applied phantom regulations to achieve that result, in the absence of regulations) with *Hillman v. Commissioner*, 263 F.3d 338 (4th Cir. 2001), *rev’g*, 114 T.C. 103 (2000) (where the court, on appeal, reversed, refusing to adopt such a position, instead finding that the legislative history did not support the taxpayer’s position.).

143. *Substance Over Form?*, *supra* note 20, at 45 (“Similarly, where the delegation is taxpayer-unfriendly, the IRS often argues that the statute is self-executing, notwithstanding the lack of implementing regulations.”). Hesitation aside, courts have applied phantom regulations to a taxpayer’s detriment. For example, in *Pittway v. United States*, 102 F.3d 932 (7th Cir. 1997), the court held, in the absence of regulations, that the taxpayer was nevertheless subject to the excise taxes at issue.

intent was silent or ambiguous.¹⁴⁴ In those instances it was generally viewed as inappropriate to “reward” IRS regulatory inaction.¹⁴⁵ However, by whatever framework the judiciary determines whether it should endorse phantom regulations in light of IRS inaction, the overriding consideration should be whether it underscores public faith in not just the IRS, but the courts as well.

For example, in *McKelvey*, the panel accepted probability analysis and that decision was clearly detrimental to the taxpayer’s interest.¹⁴⁶ One reason it did so was based on simple policy considerations, *e.g.*, it sought to enforce the anti-abuse objectives of § 1259.¹⁴⁷ Alternatively, it may have viewed the choice to rely on the Black-Scholes model as straightforward statutory interpretation, relying on the statute’s plain meaning and legislative history. While the latter is acceptable, the former should be left to the other branches, not the judiciary.

III. ANALYSIS

The analysis section of this article examines a trio of significant drawbacks to judicially imposed phantom regulations. The first two parts, ignoring the notice and comment rules of the APA and bypassing the formal role of the Treasury and IRS, focus on the damage to the credibility and legitimacy of the “regulation” that results when judicial rulemaking circumvents the traditional process. The third part discusses how phantom regulations encroach on the prerogative of both the executive and legislative branch to promulgate rules. There the analysis is primarily concerned with how phantom regulations impact the constitutional distribution of authority over the administration of our federal tax system. Less of an issue are the specifics of how, why, and when courts choose to employ phantom regulations to resolve a particular tax matter.

144. One commentator has suggested that in the wake of *Mayo Foundation*, phantom regulations of any kind would be inappropriate. “*Mayo thus suggests that phantom tax regulations have evaporated.* That is, in line with general administrative law authorities, tax statutes that call for regulations necessarily lack effect until the regulations have been issued.” *Mixing Management Fees*, *supra* note 21, at 3 (emphasis added). That view may have been too expansive; *McKelvey* was decided seven years after the Supreme Court handed down *Mayo Foundation* in 2011. Phantom regulations, at least in the Second Circuit, have not yet evaporated.

145. See note 182 *infra*, at 598.

146. Gall, *supra* note ***, at 442 (“Although the law of spurned delegations supports applying phantom regulations in virtually all situations, there does appear a reluctance to penalize taxpayers *who do not anticipate and comply with phantom regulations.*” Gall, “) (emphasis added). This is the essence of procedural due process.

147. See Gall, *supra* note ***, at 414. It should be noted, the taxpayer repeatedly and vigorously challenged the IRS’s assertion that the VPFCs were abusive transactions.

Affirming the Tax Court’s well-reasoned decision will not result in some parade of tax avoidance; the only reason Mr. McKelvey was never required to pay income taxes on the \$194 million he received in connection with the VPFCs is because he died. Death is not an ‘abusive scheme.’ And Mr. McKelvey did not avoid taxes in death. The value of Mr. McKelvey’s estate, including any remaining cash from the prepayment (or assets he had acquired using that cash), was subject to estate tax. This is precisely the regime Congress chose for the taxation of individuals and their estates at death, and is certainly consistent with how the IRS treats open short sales when a taxpayer dies.

Brief for Petitioner-Appellee at 43, *McKelvey I*, 148 T.C. 312 (2017) (No. 17-2554). (emphasis in original).

With respect to the APA discussion, it is considered how phantom regulations eliminate any public participation from the rulemaking process. While public participation has a statutory role in IRS rulemaking,¹⁴⁸ the subsection examines instead how the Treasury and the IRS bring a particularized level of tax expertise to the process that is simply unavailable to the judiciary. Moreover, a series of checks and balances is built in via the multiple internal reviews that the proposed regulations undergo before finalization, that is, again, unavailable to the courts.

A. Second Circuit Ignored Applicability of APA

If, *arguendo*, the outcome of the Second Circuit's analysis was correct and probability analysis was an appropriate tool to determine the "substantially fixed/likelihood" question, the panel's decision nevertheless eliminated any public participation in announcing the rule. Stated bluntly, the APA was simply ignored. Additionally, to seemingly underscore that disregard, the Second Circuit not only omitted any specific reference to the APA, but also made no mention of the rulemaking process in general. If public participation in the administrative rulemaking process is the *sine qua non* of the policy considerations that animate the APA rulemaking requirements,¹⁴⁹ then abandoning the opportunity for notice and comment in and of itself should be enough to question the legitimacy of phantom regulations.

As an initial observation, the notice and comment provisions are the default standard for statutory compliance with the APA. But for an applicable exception, statutorily sound rulemaking must include the required notice and comment opportunity.¹⁵⁰ However, when the IRS promulgates "interpretive" regulations, those regulations are exempt from the notice and comment requirements.¹⁵¹ Regulations promulgated under the authority delegated by § 1259 would instead be classified as "legislative" regulations.¹⁵² Those regulations, accordingly, would not be exempt from notice and comment. Phantom regulations that addressed § 1259 would therefore bypass that statutory component of rulemaking.¹⁵³ That failure would in turn produce fatally-defective regulations. Ironically, a court confronted by such conduct

148. I.R.S., Part 32: Published Guidance and Other Guidance to Taxpayers § 32.1.1.2.6 (Nov. 13, 2019), https://www.irs.gov/irm/part32/irm_32-001-001. Significantly, while proposed guidance still undergoes the traditional rulemaking gestation period, the APA does not require "notice and comment" for "interpretive" rules. In addition, not only can the IRS avoid public participation in promulgating those "interpretive" rules, it can also avoid notice and comment by issuing "Temporary Regulations" instead of the traditional proposed regulations.

149. *Bullock v. IRS*, 401 F. Supp. 3d 1144, 1156 (D. Mont. 2019) ("The APA's notice-and-comment requirement grants interested persons, organizations, and entities 'an opportunity to participate in the rulemaking process' by submitting written data, opposing views, or arguments. *This procedural gate [notice and comment] holds government agencies accountable and ensures that these agencies issue reasoned decisions.*") (emphasis added). *Bullock* involved a case in which the IRS issued regulations without notice and comment. The IRS argued they were interpretive regulations, thus exempt from statutory notice and comment. The court agreed with plaintiff that the new regulations were legislative, and thus required compliance with the APA's notice and comment provisions.

150. See 26 U.S.C § 601.601(a)(2)-(3).

151. *Bullock*, *supra* note 149, at 1156.

152. *Id.* at 1157 ("Legislative rules ... create rights, impose obligations, or effect change in existing law pursuant to authority delegated by Congress.")

153. *Id.* at 1159 ("A proper notice-and-comment procedure will provide the IRS with the opportunity to review and consider information submitted by the public and interested parties. Then, and only then, may the IRS act on a fully-informed basis when making potentially significant changes to federal tax law.")

on the part of the IRS could vacate those very defectively-promulgated regulations and remand the rulemaking process back to the IRS with instructions to provide the statutory notice and public comment period.¹⁵⁴

More importantly, putting aside the due process concerns raised by the panel's bypass of the APA in *McKelvey*, whether it reached the correct result is legitimately open to question because of its *ad hoc* consideration of the issues associated with § 1259. In addition to the actual decision, the panel went on to observe, in dicta, that there were other factors that bore on the "constructive sale" question.¹⁵⁵ But those factors were not argued by the parties on appeal, and the court did not formally address them.¹⁵⁶ But that alternative analysis, and its suggestion of a possible different outcome, highlights the complexity associated with the consideration of § 1259. It is great disservice to conduct piecemeal interpretations of a complex statute and, likewise, bypass any input from taxpayers in the process.

Nevertheless, even the straightforward probability analysis determination it relied upon to reach its decision was not based on any textually committed provision in the statute. One could readily expect that interested parties, if given the opportunity, would seek to provide their input during a "noticed" rulemaking process that sought to bring probability analysis within the ambit of § 1259. The court itself readily acknowledged that it was confronted with a novel question over the use of probability analysis;¹⁵⁷ nevertheless, the panel decided that it was appropriate to apply it to the financial transactions under review: "[u]sing 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. ... Nevertheless, we are persuaded to accept probability analysis in this context."¹⁵⁸

In reaching that decision and, just as importantly, its subsequent impact on the tax liability of the taxpayer, the panel did not demonstrate any concern for the due process implications associated with its ruling.¹⁵⁹ As it pointed out, perhaps this was due to the perceived minimal impact the decision would have on other possible VPFC transactions, given the relative infrequent use of these complex financial devices. Assuming, *arguendo*, that limited impact is a valid counterweight to bypassing the APA requirements, the same cannot be said for imposing the "new" guidance retroactively. Equitable considerations alone should have required the court to impose the new rule prospectively to future transactions so structured. This is how

154. *Id.* ("This Court holds unlawful and will set aside [the rule] as adopted by the IRS. *The IRS must follow the proper notice-and-comment procedures pursuant to the APA if it seeks to adopt a similar rule.*") (emphasis added).

155. *Estate of McKelvey v. Comm'r*, 906 F.3d 26, 36 (2nd Cir. 2018), *reh'g en banc denied* (Dec. 10, 2018), *cert. denied sub nom*, *Peters v. Comm'r*, 139 S. Ct. 2715 (2019).

156. *Id.*

157. *Id.* at 37.

158. *Id.* at 38 (emphasis added).

159. *Id.* Perhaps the Panel perceived its decision would have little impact beyond the instant case. "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." (emphasis added). *Id.* at 39.

formal administrative guidance is typically applied, prospectively.¹⁶⁰ The court did not address the retroactive application of its phantom regulation.

Instead, the Second Circuit began its consideration of probability analysis by its citation of the Sixth Circuit's 1992 decision in *Progressive Corp. v. United States*.¹⁶¹ The panel cited *Progressive Corp.* as an example in which a court, seemingly, made use of that probability analysis to resolve a tax controversy that concerned financial instruments, in that case the treatment of certain option contracts.¹⁶² While the Sixth Circuit *did not specifically discuss probability analysis*, the Second Circuit instead inferred its use from the court's decision: "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."¹⁶³ The panel observed that *Progressive Corp.* was relevant to the instant case because the court "was asked to decide how likely it was that the option buyer would immediately exercise its purchase right" to the underlying securities.¹⁶⁴

In actuality, *Progressive Corp.* had relatively marginal relevance to the probability question that confronted the Second Circuit. While the Sixth Circuit held that it was virtually certain that an "in-the-money" option would be exercised, the "analysis" was essentially one-dimensional.¹⁶⁵ The "probability" that the option would be exercised was predetermined. In other words, the probability of non-exercise was non-existent, or zero, because there was no possibility the option would lapse unexercised.¹⁶⁶ Failure to exercise an "in-the-money" option would simply forgo realization of the value in excess of the option's strike price. The lesson, if any, of *Progressive Corp.* was simply inapposite of the issue confronting the Second Circuit.¹⁶⁷

To highlight the irony of citing *Progressive Corp.* to bolster the Second Circuit's decision to adopt a phantom regulation, it would be instructive to note that the merits of *Progressive Corp.* involved the application of an actually promulgated

160. Notices of Proposed Rulemaking often contain language that indicate the final rule will be given "retroactive effect" to the date the NPRM was issued. IRC section 7805(b) authorizes this particular form of "retroactivity" in regulations, but the "notice" that informs the retroactive application in that instance is glaringly absent in the case of a judicially created phantom regulation. *See generally*, James M. Puckett, *Embracing the Queen of Hearts: Deference to Retroactive Tax Rule*, 40 FLA. ST. U. L. REV. 349, 357 (2013) ("[T]he agency's formulation of a new rule simultaneously applied to a party that has already undertaken conduct burdened by the new rule – is an old theme in administrative law. In theory, agencies could be required to announce new policies only prospectively, but the Supreme Court has never suggested such a requirement exists.").

161. *Progressive Corp. & Subsidiaries v. United States*, 970 F.2d 188 (6th Cir. 1992), *reh'g en banc denied* (Aug. 25, 1992).

162. *See McKelvey II*, 906 F.3d at 38.

163. *Id.*

164. *Id.* ("[T]o frame the issue in terms of Dr. Bessembinder analysis [using the Black-Scholes model], the issue was whether the spread created so high a probability of an option buyer immediately exercising its rights that the option seller's obligation to sell was 'virtual certain.'").

165. *Id.*

166. As stated by Petitioner: "[Progressive's] holding is premised on there being *no* probability that an 'in-the-money' option would be unexercised (calling its exercise a virtual certainty), and finding that the probability of variation is 'sufficiently low[.]' The former scenario does not require a 'probability analysis'; the latter turns on one." Petitioner's Brief for Rehearing and Rehearing at 11, n. 1, *McKelvey II*, 906 F.3d 26 (2d Cir. 2018) (No. 17-2554).

167. To put that question simply: What was the likelihood that the price of Monster stock would recover sufficiently, in the 17 months until the exercise date, that it would exceed the floor price of the VPFC? A cursory glance reveals that the answer requires speculation about what will come to pass – not what has already occurred.

IRS regulation. This regulation seemingly conflicted with the text of the statute it was meant to interpret. The District Court *upheld application of the existing regulation* and ruled for the taxpayer;¹⁶⁸ the Court of Appeals *reversed and held the IRS regulation had misapplied the statute's text* and, accordingly, ruled for the IRS.¹⁶⁹ It is no small irony that the IRS had argued that the court misapplied its own regulation and, instead, should simply apply the statute as written.¹⁷⁰

Progressive did not involve a phantom regulation. It was a decision that required the court to conduct a relatively straightforward, albeit complex, statutory analysis. Statutory interpretation is precisely the role of a judiciary when confronted with the application of a statute to decide a case. In sharp contrast, in *McKelvey*, the IRS refused to promulgate its own regulation and, yet, argued that the court should rule as if one had been issued.¹⁷¹ The court was not asked to *interpret* an existing and enforceable regulation but, rather, to *provide* one. Significantly, the panel agreed to do so, and it ignored the statutory rulemaking required by the APA in the process.¹⁷²

A more relevant and instructive case, *15 West 17th Street, LLC v. Commissioner*,¹⁷³ asked the precise question that confronted the Second Circuit: “[h]ow should a court respond when a taxpayer or the IRS desires to have a particular tax treatment apply in the absence of the regulations to which the statute refers?”¹⁷⁴ The panel, glaringly, did not discuss the Tax Court’s decision in *15 West 17th Street LLC*. There, the Tax Court had to decide whether the taxpayer could claim a charitable deduction when he had failed to substantiate, via a contemporaneous written acknowledgment from the donee, the specific details of the contribution.¹⁷⁵ The IRS had not issued guidance to answer that specific question. To resolve it, the Tax Court produced four separate decisions; the majority opinion which denied the taxpayer’s deduction, a concurrence, and two separate dissents.¹⁷⁶

The *15 West 17th Street LLC* majority, with respect to the APA’s applicability, observed that

168. *Progressive Corp. & Subsidiaries v. United States*, No. 1:88CV4598, at 1 (N.D. Ohio Dec. 19, 1990), *rev’d*, 970 F.2d 188 (6th Cir. 1992). “Progressive was justified in relying on the regulation when it adopted the forward conversion investment strategy.” *Id.* at 8.

169. *Progressive*, 970 F.2d at 193 (“The district court’s *erroneous reliance on a Treasury regulation it has misinterpreted* results in the nullification of the applicable statutory mandate in this case[.]”) (emphasis added).

170. *Id.* at 194. It should be noted Progressive concerned application of an existing regulation and not the adoption of a phantom regulation. Moreover, the Sixth Circuit observed that the statutory language itself was so straightforward that the decision did not rise to the level of statutory interpretation. “The answers in this case are clear enough from the statute, however, and ‘where the language is plain and admits of no more than one meaning, the duty of interpretation does not arise, and the rules which are to aid doubtful meanings need no discussion.’” *Id.* (emphasis added).

171. *Estate of McKelvey v. Comm’r*, 906 F.3d 26, 38 (2nd Cir. 2018), *reh’g en banc denied* (Dec. 10, 2018), *cert. denied sub nom*, *Peters v. Comm’r*, 139 S. Ct. 2715 (2019).

172. *Id.*

173. *15 West 17th Street LLC v. Commissioner*, 147 T.C. 557 (2016). Surprisingly, this case was cited by neither the Second Circuit nor the Tax Court, in their respective decisions.

174. *Id.* at 572 (“In some cases the Secretary may have affirmatively declined to issue regulations, having concluded that they are unnecessary or inappropriate. In other cases, the Secretary may intend to issue regulations but they have encountered delays because of subject matter complexity or the press of other business.”).

175. *Id.*

176. *Id.* Judge Lauber wrote the majority opinion for the Tax Court. Judge Holmes wrote a concurrence. Judges Foley and Gustafson each wrote in dissent.

courts have struggled to define the proper judicial response in these scenarios. In each case, Congress has delegated to an executive branch agency the task of using its expertise to craft appropriate regulations. Under the Administrative Procedures Act and familiar separation-of-powers principles, a court's usual role is to review the regulations had issued, not conjure what regulations might look like had they been promulgated.¹⁷⁷

After an exhaustive review of the various judicial doctrines courts have employed to justify the use of phantom regulations, the majority concluded it could not accept the taxpayer's invitation to fill in the regulatory gaps and permit the charitable deduction.¹⁷⁸ The majority concluded that the statute provided for a discretionary (non-mandatory) delegation; therefore it would not provide a phantom regulation.¹⁷⁹

The outcome was somewhat surprising because the statute provided for the taxpayer benefit and the equities would have militated in favor of the deduction, if only to prevent IRS inaction from frustrating Congressional intent.¹⁸⁰ Conversely, Judge Foley dissented, indicating he would have allowed the charitable deduction: "[t]he Secretary's failure to create such rules ... however, does not render [it] inoperative. Indeed, '[w]e have frequently held that the Secretary may not prevent implementation of a tax benefit provision simply by failing to issue regulations.'"¹⁸¹ Judge Gustafson's dissent made a similar point: "[t]he Tax Court should not give to Treasury the power to veto ... by regulatory inaction – a power that Congress did not grant – and thereby deprive taxpayers of a means that Congress did grant."¹⁸²

Judge Holmes, in his concurrence, took an indirect approach to the APA's applicability: "[w]e've built up this body of tax law *in apparently blissful disregard for the APA*, which provides a generally applicable procedure to 'compel agency action unlawfully withheld or unreasonably delayed.'"¹⁸³ His suggestion was that an aggrieved taxpayer, unsatisfied by IRS inaction and who wanted the Service to undertake the mandated rulemaking, could petition the IRS directly via the APA.¹⁸⁴ Then, if the IRS still refused to promulgate rules, that very denial would be reviewable by the courts, again via the APA.¹⁸⁵ Judge Holmes' approach would practically eliminate courts from the business of promulgating "phantom regulations," to a certain extent.

177. *Id.* at 573.

178. *Id.* at 573-80. The Tax Court majority opinion examined two lines of cases that considered phantom regulations: (a) Delegations for Mandatory Rulemaking and (B) Delegations for Permissive Rulemaking. *Id.*

179. *Id.* at 587 ("In sum, we conclude that section 170(f)(8)(D) sets forth a delegation of discretionary rule making authority.")

180. *Id.* ("The statute thus commits to the Secretary's discretion whether a regime for donee reporting should be implemented and (if so) how.")

181. *Id.* at 592 (Foley, dissenting).

182. *Id.* at 598 (Gustafson, dissenting).

183. *Id.* at 590 (Holmes, concurring) (emphasis added).

184. *Id.* at 589, n. 2 ("[I] would note that a taxpayer who disagrees with Treasury's inaction could try to seek relief under the APA, which requires agencies to 'give an interested person the right to petition for the issuance, amendment, or repeal of a rule.' Denial of a taxpayer's petition is appealable to the Courts."); See *Estate of McKelvey v. Comm'r*, 906 F.3d 26 (2nd Cir. 2018), *reh'g en banc denied* (Dec. 10, 2018), *cert. denied sub nom*, *Peters v. Comm'r*, 139 S. Ct. 2715 (2019).

185. *15 West 17th Street LLC*, 147 T.C. at 589, n. 2.

Unfortunately, despite the brief references to the APA, none of the four *15 West 17th Street LLC* opinions discussed the public's statutory role in the rulemaking process. As one commentator observed, "[i]f the IRS and Treasury must follow notice and comment procedures to establish binding regulations, logically they cannot shirk these obligations by asking courts to apply 'phantom regulations' instead."¹⁸⁶ While the various opinions from *15 West 17th Street LLC* discussed the "when" and "how" of phantom regulations, none discussed how the reliance on them can directly undermine the policy objectives of the APA. Granted, in limited instances they may be appropriate. But even in those circumstances, any short-term reward garnered from judicial intervention in the rulemaking process must be weighed against the long-term damage to the public's right to participate in the process and, significantly, the transparency of the process.

The case for limiting phantom regulations to narrowly circumscribed situations is even greater when weighed against the increased "legitimacy" of rules subject to public participation:

The public benefits of pre-adoption public participation are well-recognized. Public input provides valuable information to rulemaking agencies at low cost to the agencies. Rules adopted with public participation are more likely to be more effective and less costly to administer than rules written without such participation. They contain fewer mistakes. They are more likely to deal with unexpected and unique applications or exceptional situations, and are more politically acceptable to the persons who must live with them.¹⁸⁷

Moreover, when crafted by IRS employees who have subject-matter expertise, a rule promulgated with public participation is immeasurably more polished and professional than any phantom regulation could possibly be, given the comparatively constrained judicial process that produced it.¹⁸⁸

B. The Second Circuit Bypassed IRS Rulemaking

In certain circumstances Congress may specifically intend for the Treasury Department and the IRS to undertake the rulemaking process to produce the expected guidance. It is that very deliberative rulemaking process that is sought by Congress when it delegates the authority to the IRS:

A non-policy mandatory delegation requires the Secretary to prescribe regulations to accomplish a particular result. Presumably, the reason for enacting the delegation is that Congress wanted the Secretary, through the

186. Tom Greenaway, *The IRS and the APA: Denial is Not a Strategy*, Tax Notes, 247, 254 (Jan. 8, 2018).

187. Michael Asimow, "Interim-Final Rules: Make Haste Slowly," 51 ADMIN. L. REV., 703, 707-08 (1999).

188. *Substance over Form?*, *supra* note 20, at 61 ("Judicially decreed phantom regulations, of course, do not comply with any of the requirements of [the APA], and they consequently offer none of the benefits typically associated with notice-and-comment rulemaking.").

regulatory process ... to develop workable rules to achieve the intended result.¹⁸⁹

When courts, instead, adopt phantom regulations, or otherwise substitute the judiciary's rulemaking processes, Congressional intent has been disregarded. More significantly, any of the benefits that inure to guidance produced as a consequence of the administrative rulemaking process and the public's input may forever be lost.

In those cases, the very intention of the Congressional delegation of authority is to engage the Treasury and IRS, together with their combined resources and expertise, in the rulemaking process: "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 notice and comment procedures in the [APA].*"¹⁹⁰ Given the ample legislative history that accompanied the enactment of § 1259, for example, it would seem Congress had specifically desired that the administrative rulemaking process be undertaken by the Treasury Department and IRS, and not bypassed via a convenient judicial shortcut.

Section 1259, while otherwise comprehensive in scope, left the meaning of "substantially all" undefined. But the legislative history, and statute itself, made clear that Congress had instructed the IRS and Treasury Department with the duty to provide that definition.¹⁹¹ Despite the plain directive from Congress, and the significant passage of time, no administrative pronouncement was issued that defined the meaning of "substantially all," as it is intended to be construed when determining whether a constructive sale under § 1259 has occurred.¹⁹² Given the importance of this term in the overall statutory scheme, one would have imagined that the rulemaking would have been undertaken, and completed, expeditiously.

Instead of actually promulgated regulations, the IRS sought the judicial approval of its "*administrative interpretation of that provision [§ 1259] reflected in the Commissioner's deficiency determination.*"¹⁹³ In providing approval of that "administrative interpretation," the Second Circuit also effectively rubber-stamped its approval of the IRS's *self-imposed refusal* to engage in the statutorily mandated rulemaking via the APA's notice and comment process. That judicial decision ef-

189. Gall, *supra* note ***, at 447 (emphasis added); *See also Substance Over Form?*, *supra* note 20, at 60.

190. *Substance Over Form?*, *supra* note 20, at 60 (emphasis added); *see also* Gall, *supra* note ***, at 447 ("Consequently, the application of phantom regulations may be thwarting, not furthering, congressional intent.") (emphasis added).

191. *See supra* note 40 and accompanying text.

192. *Anschutz v. Commissioner*, 135 T.C. 78, 112 (2010), *aff'd*, 664 F.3d 313 (10th Cir. 2011) ("If a transaction has the effect of eliminating *substantially all* of the taxpayer's risk of loss and *substantially all* of the taxpayers opportunity for gain with respect to an appreciated financial position, *it is intended that the Secretary's regulations* would treat the transaction as a constructive sale. Again, however, section 1259 and the legislative history do not define 'substantially all.'") (emphasis added).

193. Brief for the Respondent in Opposition at 18, *Peters v. Commissioner of Internal Revenue*, 2019 U.S. S. Ct. Briefs LEXIS 1703 (2019) (No. 18-1177); *see* *Estate of McKelvey v. Comm'r*, 906 F.3d 26, 33 (2nd Cir. 2018), *reh'g en banc denied* (Dec. 10, 2018), *cert. denied sub nom*, *Peters v. Comm'r*, 139 S. Ct. 2715 (2019) ("This deficiency was based on two separate determinations. First, McKelvey realized a short-term gain because the extensions... resulted in taxable exchanges of the original VPPCs for the more valuable amended contracts[...] . . . Second, McKelvey realized a long-term capital gain because the number of shares to be delivered ... was 'substantially fixed' within the meaning of section 1259(d)(1), resulting in constructive sales of the Monster shares he had pledged as collateral[.]").

fectively frustrated the Congressional intent to make use of that very formal rule-making process.¹⁹⁴ Instead, IRS guidance by “notice of deficiency” can be viewed, in its most charitable light, as a variant of “informal” sub-regulatory rulemaking. That is hardly what Congress intended when it enacted § 1259.¹⁹⁵

While probability analysis provides one factor and methodology to analyze the substantially fixed portion of the constructive sale, it is clearly insufficient to address the myriad of issues mentioned in the legislative history of the provision. For example, there is no discussion of which, *if any*, of the additional factors discussed in the legislative history to § 1259 went into that “administrative interpretation” relied upon by the IRS and, subsequently, adopted by the Second Circuit. It seems to follow that the IRS considered only that one factor, to the exclusion of all others.

Focusing on just one factor is at odds with the various enumerated factors that Congress listed in the legislative history. The notice of deficiency apparently considered no additional factors in conjunction with the probability analysis. One example from the legislative history is instructive in demonstrating how complex the analysis might be, and why it is critically important not to rely on any one factor in reaching a conclusion:

Congress anticipated that the Secretary would use his authority to issue regulations which, like those listed in section 1289(c)(1), have the effect of eliminating “substantially all of a taxpayer’s risk of loss and opportunity for income or gain” with respect to the appreciated financial position. However, transactions in which the taxpayer eliminated his risk of loss, or opportunity for income or gain, *but not both*, were not to be treated as constructive sales under section 1259.¹⁹⁶

That language indicates that Congress expected that the taxpayer, in a constructive sale, would hedge both sides of a given transaction; that is, limit both the opportunity for loss *and* the opportunity for gain.¹⁹⁷

Locking in only one variable—such as by limiting the potential loss—while permitting variance in the other variable—by permitting additional gain realization, for example—will not, without more, result in a constructive sale. In *McKelvey*, the panel specifically noted that there are additional factors that can be considered, beyond “substantially fixed” for example, when it highlighted the alternative prong of the constructive sale analysis.¹⁹⁸ Had formal rulemaking be undertaken, the process would inevitably have considered these issues and, equally as important, the IRS would have benefitted from any public comments on it proposed rulemaking.

194. 15 West 17th Street LLC v. Commissioner, 147 T.C. 557, 590 (2016). (“When Congress tells an agency that it shall issue regulations, it is a command to the *agency* [emphasis in original] and not a court, to issue regulations. *It is also a command to the agency to act by ‘regulation’ – a term with a fixed meaning in administrative law and one that usually means that a regulation has to run through the normal APA rulemaking gauntlet.*”) (Holmes, concurring) (emphasis added).

195. See *supra* notes 40 and accompanying text.

196. *Anschutz*, 135 T.C. at 112 (emphasis added).

197. *Id.* (“The report goes on to state that *it is not intended that the risk of loss and opportunity for gain be considered separately*. If a transaction has the effect of eliminating substantially all of the taxpayer’s risk of loss *and* substantially all of the taxpayer’s opportunity for gain with respect to the appreciated financial position, *it is intended that the Secretary’s regulations would treat the transaction as a constructive sale.*”) (emphasis added).

198. *Estate of McKelvey v. Comm’r*, 148 T.C. 312, 332–33 (2017), *rev’d*, 906 F.3d 26 (2d Cir. 2018).

Moreover, even if, *arguendo*, the IRS provided the correct interpretation of § 1259 in the notice of deficiency, one would expect it to have been applied prospectively, only after the affected taxpayers had been given notice of the IRS's new position. As mentioned, basic notions of due process would demand no less, and perhaps a great deal more,¹⁹⁹ before a taxpayer is summarily assessed a tax liability based on a "novel" statutory interpretation.²⁰⁰ A governmental agency cannot simply pronounce a new rule in any guise, without prior notice, and then demand that it be applied to any and all pre-existing transactions. While regulations are routinely given retroactive application, that retroactivity is fundamentally premised *on the notice provided during the rulemaking process*.²⁰¹

The idea that promulgated regulations can be applied retroactively is only permissible when and if the IRS has provided taxpayers with the proper statutory notice.²⁰² One example would involve the IRS promulgation of proposed regulations that are coupled with a notice of proposed rulemaking and request for public comments. The proposed regulations would routinely state that, if and when finalized, the rule would be applied retroactively to the date the proposed regulations were formally issued. In these circumstances, providing retroactive effective is appropriate because the taxpayer was put on notice that such effect would be given. Phantom regulations do not, and cannot possibly, comply with that rulemaking paradigm.

The Second Circuit's adoption of the IRS's administrative interpretation of § 1259, announced as it was via the statutory notice of deficiency, underscores the inherent flaw in phantom regulations. Judicially adopted regulations are, essentially, creatures of an *ad hoc* confluence of facts, circumstances, and events; they are by no means the result of any meaningful deliberative process.²⁰³ Instead, phantom regulations are basically a procedural shortcut designed to reach a speedier resolution.²⁰⁴ Despite the availability of ample legislative guidelines to inform the traditional rulemaking process, the Second Circuit and the IRS thwarted Congress's desire to employ that very deliberative process. Moreover, phantom regulations dispense with the need to convince stakeholders of the correctness of the newly adopted rule. In sum, the proposition that any minimal level of procedural due process is manifest in the process of judicial rulemaking is simply disingenuous.

199. Hickman, *supra* note 19, at 1728.

200. This argument was directly raised in the taxpayer's petition for *certiorari*: "Here the Second Circuit expanded the doctrine [phantom regulations] 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*." Petition for Writ of Certiorari at 18, *Peters v. Commissioner of Internal Revenue*, 2019 U.S. S. Ct. Briefs LEXIS 1703 (No. 18-1177).

201. I.R.C. § 7805(b) (2019).

202. *15 West 17th Street LLC v. Commissioner*, 147 T.C. 557, 587 (2016).

203. Petition for Writ of Certiorari at 39-41, *Peters v. Commissioner of Internal Revenue*, 2019 U.S. S. Ct. Briefs LEXIS 1703 (2019) (No. 18-1177) ("[I]t [phantom rulemaking] 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 state goals of crafting a prospective, comprehensive statute like section 1259.")

204. *Substance Over Form?*, *supra* note 20, at 65 ("Though the use of phantom regulations produces rules quickly, that does not justify judicial usurpation of the agency's role. Congress obviously understands that notice-and-comment rulemaking will take time, and in such circumstances it cannot possibly intend that a statute with an express delegation of rulemaking authority will have immediate effect.") (emphasis added).

C. *The Second Circuit Encroached on Inter-Branch Prerogatives*

Perhaps it is the notion that a court acting in place of the IRS that raises concerns that the court, however well-intentioned its motives are, has overstepped its role in the tax regulation tableaux.²⁰⁵ It is one thing to interpret an existing statute, regulation, or rule; that is, unquestionably, the court's constitutionally mandated duty. It is another matter, however, for a court—even at the express invitation of the IRS—to engage in judicial rulemaking to fill the void left by the missing rule or regulation.²⁰⁶ Constitutionally, that concern is often expressed as the non-delegation doctrine or some variation thereof.²⁰⁷

The non-delegation doctrine prohibits the re-delegation of Congressional authority from one institution to another, such as the executive branch to the judiciary.²⁰⁸ In the oft-cited case for this doctrine, *Dunlap v. United States*,²⁰⁹ the Supreme Court held that “Congress granted the Secretary [of Treasury], not the judiciary, the discretion to [promulgate regulations], and the Court had no authority to ‘perform executive duties.’”²¹⁰ This is especially true when the statute is not self-executing. In those cases, the statute, *sans* the necessary implementing regulations, simply cannot be enforced if the court must supply the necessary “regulations” to do so: “[i]ndeed, when interpreting statutory delegations in non-tax contexts, *most circuits readily conclude that such statutes lack force in the absence of regulations.*”²¹¹

Moreover, in the post-*Mayo Foundation* era, with the notion that tax-exceptionalism is no longer an operative presumption, the opportunities to adopt phantom regulations should have significantly diminished. In non-tax situations, “numerous courts, including the Supreme Court, apply the plain meaning approach and flatly

205. In the popular vernacular, it is often said that courts interpret laws, they don't make laws. While that is a gross oversimplification of the role of the judiciary, it does reflect the notion that courts are charged with interpretation and decision-making.

206. This was the taxpayer's question presented in the petition for *certiorari*: “Whether, or under what circumstances, the Judiciary may enforce an ambiguous provision of the Internal Revenue Code by filling in a statutory gap, when Congress delegated gap-filling responsibility to the Treasury but Treasury has failed to promulgate required regulations.” Petition for Writ of *Certiorari* at 6, *Peters v. Commissioner of Internal Revenue*, 2019 U.S. S. Ct. Briefs LEXIS 1703 (No. 18-1177).

207. *J.W. Hampton, Jr. & Co. v. United States*, 276 U.S. 394, 405–06 (1928) (“The well-known maxim ‘*Delegata potestas non potest delegari* [delegated authority cannot be redelegated],’ applicable to the law of agency in the general and common law, is well understood and has had wider application in the construction of our Federal and State Constitutions than it has in private law.”).

208. Indeed, this was one of the taxpayer's principle arguments in seeking a rehearing of the panel's decision (and, subsequently, when a hearing was denied, in their petition for *certiorari*). “The panel created and applied a ‘probability analysis’ that Treasury has never endorsed. *Exercising authority delegated to Treasury in this manner violates the prohibition on judicial re-delegation*[.]” Petition for Rehearing and Rehearing en banc, *supra* note 124, at 2 (emphasis added); see also, Petitioner for Writ of *Certiorari*, *supra* note 147, at Part II A (“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.”).

209. *Dunlap v. United States*, 173 U.S. 65, 72 (1899). The first sentence of Petitioner's Brief for *Certiorari* cited *Dunlap*: “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.*” Brief for Petitioner at i, *Estate of McKelvey v. Comm'r*, 906 F.3d 26 (2d Cir. 2018) (No. 18-1177), 2019 WL 1170260, at *1 (emphasis added).

210. *Mixing Management Fees*, *supra* note 21, at 28 (citing *Dunlap v. United States*, 173 U.S. 65, 76 (1899)).

211. *Substance Over Form?*, *supra* note 20, at 78 (emphasis added) (footnote omitted).

hold that courts cannot implement statutes that call for regulations.”²¹² No longer would it be necessary to determine whether the statute is self-executing or not; in either case judicial phantom regulations would be inappropriate.²¹³ Without mandated regulations in place, the statute is simply inoperative.

But this is not the case, because courts (like the one that handed down the *McKelvey* decision) have continued to employ phantom regulations without regard to the potential damage they inflict on institutional comity.²¹⁴ Despite the Supreme Court’s holding in *Dunlap* that “courts cannot perform executive duties, nor treat them as performed when they have been neglected,”²¹⁵ courts have continued to do so.²¹⁶ It is worth noting that in *Mistretta v. United States*,²¹⁷ the Supreme Court specifically considered the role, and scope, of permissible judicial rulemaking.²¹⁸

In *Mistretta*, the Supreme Court opinion cautioned, however, that a specific Congressional delegation of authority was required for courts to undertake judicial rulemaking: “Congress may delegate to the Judicial Branch *non-adjudicatory functions that do not trench upon the prerogatives of another Branch and that are appropriate to the central mission of the Judiciary*.”²¹⁹ The Court clearly highlighted what it believed was the limited nature of any permissible judicial rulemaking. That limited scope encompassed rulemaking that involved (a) non-adjudicatory functions that did not trench upon the prerogative of the other branches, and is (b) appropriate to the judiciary’s central mission. Assuming those two tests could be met, the judicial rulemaking would be appropriate.

However, if phantom regulations are tested against that straightforward binary formulation in *Mistretta*, they would still be held as inappropriate exercises of judicial authority. In other words, even if Congress provided for a specific delegation of authority to the judiciary that bypassed the executive branch, that delegation would most likely fail to meet *Mistretta*’s two-part approach. First, the “non-adjudicatory function” of crafting phantom regulations would not be within the central mission of the judiciary. Second, and more importantly, that delegation would encroach upon the prerogatives of another branch (the executive). Interestingly, even

212. *Mixing Management Fees*, *supra* note 21, at 32.

213. *Id.* at 53.

214. Given the Second Circuit’s denial of *en banc* review to *McKelvey* (together with the Supreme Court’s denial of *certiorari*), it seems likely the Second Circuit is open to continued use of phantom regulations should the need for them arise in future cases. See *15 West 17th Street LLC v. Commissioner*, 147 T.C. 557 (2016), where the majority of the Tax Court declined an opportunity to provide a phantom regulation, the Court nevertheless remained open to the possibility it would do so in a future case – should the appropriate facts present themselves.

215. *Dunlap v. United States*, 173 U.S. 65, 72 (1988) (emphasis added) (citations omitted).

216. As evidenced by the Second Circuit in *McKelvey*. See *Estate of McKelvey v. Comm’r*, 906 F.3d 26 (2d Cir. 2018), *reh’g en banc denied* (Dec. 10, 2018), *cert. denied sub nom. Peters v. Comm’r*, 139 S. Ct. 2715 (2019).

217. In *Mistretta*, the Supreme Court held that judicial participation in a Congressionally established Federal Sentencing Commission was not a violation of the separation of powers doctrine. *Mistretta v. United States*, 488 U.S. 361 (1989).

218. *Id.* at 383. “In cases specifically involving the Judicial Branch, we have expressed our vigilance against two dangers: first, that the Judicial Branch neither be assigned nor allowed ‘tasks that are more properly accomplished by [other] branches,’ and, second, that no provision of law ‘impermissibly threatens the institutional integrity of the Judicial Branch.’” *Id.* (citations omitted) (quotations and insertions as in original).

219. *Id.* at 388 (emphasis added).

if the executive branch were to acquiesce to the judiciary's assumption of rulemaking authority under limited circumstances, the erstwhile phantom regulations would still not fall within the central mission of the judiciary.

If judicially crafted phantom regulations could not meet *Mistretta*'s two-part test pursuant to a putative grant of authority, how could such judicial rulemaking be justified in the absence of any delegation of authority whatsoever? Even if the judicial rulemaking resulted in the correct outcome, it cannot cure the IRS's failure to act in accordance with its own mandate. The proper solution is for the IRS to act, to promulgate the mandated guidance. In the absence of that guidance, the statute would—as is the case with any other administrative agency—be unenforceable. Again, the alternative in the face of a recalcitrant IRS, unwilling to promulgate guidance, would be to simply have Congress enact statutes that do not require implementing regulations to become operative.

Finally, if *arguendo*, the APA and IRS rulemaking process concerns are adequately addressed, phantom regulations still seek to accomplish what has not been undertaken (or if started, remains incomplete) by the co-committed branch of government. The executive's failure to fulfill its Congressional mandate cannot be cured by an act of the judiciary, however well-intentioned, without in turn rewriting the historical genesis of our tripartite system of government and the separation of powers among those three co-equal branches. To do otherwise would be to deny the duties and obligations, the constitutionally committed functions, of the individual branches of government.

IV. CONCLUSION

If only to underscore the commitment to public policy considerations that underlie the APA, in which the notice and comment requirements for administrative rulemaking are the statutory default, phantom regulations should be eschewed at all costs. That one straightforward objection—the elimination of public participation from the process—should be enough to end judicially adopted phantom regulations. Any process that effectively eliminates public comment will, subsequently, undermine the very public confidence in the rulemaking from which they were excluded.

Even in situations where public participation is not critical to the particular rule under consideration, bypassing the Treasury Department and the IRS is, again, unfortunate. To sidestep administrative participation in the drafting process ignores the wealth of tax specific expertise that would be otherwise available and, instead, opts for an *ad hoc* approach. That approach, while faster and capable of producing a speedier resolution, is inherently fact-sensitive and results in rules created to address the particular facts and circumstances of the case before the court.

Either of those two objections, on the merits, should prevent courts from employing phantom regulations. But the third, institutional comity, is as equally compelling as the first two because it not only highlights that courts are ill-suited to engage in rulemaking but, more importantly, it also demonstrates that the rulemaking role has already been committed to the other branches. There is no justification for a court, regardless of the end, to usurp another branch's duties and obligations.

Nonetheless, it is logical to ask whether there are any appropriate times for a court to engage in phantom regulations. Commentators have ventured a hesitant “yes,” with the proviso that the supposed gap to be filled by the judiciary has some

clearly defined solution. *McKelvey*, with its detailed legislative history to the contrary, would not be one of those instances. One commentator has suggested that “[i]f the delegation orders the Secretary to prescribe regulations that are intended to provide a benefit to taxpayers, *for equitable reasons*, phantom regulations must be applied to prevent the Service from depriving taxpayers of that benefit through inaction.”²²⁰

However, even in those limited circumstances, due process concerns present themselves. Given the host of issues that can bedevil even well-meaning courts that attempt to divine congressional intent, one commentator has argued, “phantom regulations are *never* an appropriate response to agency delay.”²²¹ Although, he did offer several alternative avenues for aggrieved taxpayers to consider.²²²

One could argue that with the petition provisions of the APA, no court should seriously undertake the job of crafting a phantom regulation—regardless of the equities or urgency—unless the taxpayer had first sought to compel the IRS to undertake the rulemaking. Similarly, no court should entertain the IRS’s request to provide a phantom regulation when the IRS itself has refused to promulgate the regulation (or any relevant guidance). This more stringent approach to the question, which would compel an administrative agency (here the IRS) to undertake some minimal level of rulemaking, would certainly lessen the incidents of judicially created phantom regulations, and all the interested parties would benefit from that outcome.

220. Gall, *supra* note ***, at 449 (emphasis added). The author further contended: “Phantom Regulations should be applied to effect a mandatory delegation in two situations: (1) where the delegation is intended to provide a taxpayer benefit and (2) where it is reasonably clear how to accomplish the desired result of the delegation. *In all other situations, courts should not get involved.*” *Id.* at 450 (emphasis added).

221. *Substance Over Form?*, *supra* note 20, at 46 (emphasis added).

222. *Id.* at 79–91.