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TAX NEWS

Tax Planning with Options to Purchase July 1992 15 CEB Real Property Law Reporter

Stephen L. Feldman / Paula C. Leibovitz / Belan Kirk Wagner

STEPHEN L. FELDMAN received his B.A. from Claremont Men's College, his J.D. from the University of California (Berkeley), and his LL.M. from New York University. He is a partner with Morrison & Foerster, Irvine, where his practice emphasizes corporate, partnership, and real estate transactions.

PAULA C. LEIBOVITZ received her B.A. from the University of Colorado, her J.D. from Hastings College of the Law, and her LL.M. from Golden Gate University. She is a partner in the firm of Dooley & Leibovitz, Berkeley, where she specializes in real estate taxation matters.

BELAN KIRK WAGNER received his B.A. from the University of California (Santa Barbara), his J.D. from McGeorge University, and his LL.M. from the University of Miami. He is a partner with Wagner, Kirkman & Blaine, Sacramento, where he specializes in real estate and taxation matters.

This column examines tax planning issues that arise in connection with real estate purchase options.

Income Tax Considerations

The income tax benefits of an option are unique in that the optionor can receive money tax free and use it in an unrestricted manner without imputed interest. Payments received by an optionor for the grant of an option are simply not taxable to the optionor until the option is exercised, or lapses, without regard to whether the payments are credited against the purchase price. *Carl E. Koch* (1976) 71 TC 67, 85, acq 1980-1 Cum Bull 1 (payments not credited); IRS Letter Ruling 9129002 (payments credited in full); *Virginia Iron, Coal & Coke Co. v Commissioner* (4th Cir 1938) 99 F2d 919 (payments credited in part); Rev Rul 78-182, 1978 Cum Bull 265. The reason for keeping the transaction open for tax purposes is that the character of income received by the optionor cannot be identified until either the option is exercised, which would result in gain derived from a sale or exchange, or the option lapses, which would result in ordinary income. *Commissioner v Dill Co.* (3d Cir 1961) 294 F2d 291 (and cases cited therein); Reg §1.1234-1(b). Also, the amount of any gain would not be known.

For the optionee, the acquisition price of property under an option includes any amount paid for the option. Rev Rul 58-234, 1958-1 Cum Bull 279, 286. The period during which the optionee held the option is not tacked on to the holding period of the property, and therefore, the holding period of the property begins upon exercise of the option. *Helvering v San Joaquin Fruit & Investment Co.* (1936) 297 US 496. If an optionee sustains a loss by allowing the option to lapse, the character of the loss is determined by referring to the character of the underlying property. Reg §1.1234-1(b). If the underlying property is inventory or IRC §1231 property, the loss will be ordinary; if the underlying property is a capital asset, the loss will be capital.

An interesting planning opportunity to consider is structuring a long-term option as a series of short-term options, thereby *originally* giving the optionor the opportunity to write off

the option payments. The tax court approved this structure in *Paul D. Dunlap* (1980) 74 TC 1377, 1429. However, the Eighth Circuit Court of Appeals reversed in a two-to-one decision, holding that the series was really a single, ten-year option. *Dunlap v Commissioner* (8th Cir 1982) 670 F2d 785. The court of appeals may have concluded that if an optionee has a fixed right to elect to extend an option by merely paying an additional fee, the inability of the optionor to refuse the extension effectuates a single long-term option. If so, the planning success of such an option may be limited.

Estate Tax Consideration

Options can also offer substantial estate planning opportunities. An appropriately structured option can be advantageous as a substitute for an installment sale of property because it avoids the double imposition of income tax and estate tax that affects installment sales. For example, assume that an elderly client wants to sell property for 20-percent down and carry back a 10-year balloon note to provide income for retirement. If the transaction is structured as an installment sale, the client or the client's heirs would be subject to income tax on the gain from the sale and the note would also be included in the client's estate. See IRC §691(a)(4), 2033. If, on the other hand, the transaction is structured as an option, then the gain on the sale would be deferred until the option is exercised; if the optionor dies before the option is exercised, then the basis of the property is stepped up under IRC §1014 to its fair market value, thereby minimizing or eliminating the gain for income tax purposes. IRC §1014(b); Rev Rul 71-265, 1971-1 Cum Bull 223.

The deferral of income tax on the option payments, combined with the possible elimination of gain on sale under IRC §1014 in the event of death, may result in substantial monetary savings. For example, assume that a client owns property with a value of \$4,000,000 and a basis of \$800,000, that will be sold for 20 percent down and the balance of \$3,200,000 payable interest only 10 percent for eight years with the balance then due. Provided, of course, that the transaction is not recast as a sale, it can be structured either as an installment sale or as an option on substantially the same economic terms. See, e.g., *C.V.L. Corp.* (1951) 17 TC 812; *Estate of Mary G. Gordon* (1951) 17 TC 427. Assuming all payments are invested in 6 percent tax-free bonds, the use of an option rather than an installment sale will result in monetary savings of approximately \$273,504 over an eight-year period if the optionor survives until the closing date.

INTEREST INCOME INSTALLMENT SALE

Year	Cumulative Payments	Cumulative (Taxes)	Cumulative Investment	Cumulative Interest Income
1	\$1,800,000	(\$1,296,000)	\$1,504,000	\$130,240
2	\$1,120,000	(\$1,414,400)	\$1,705,600	\$142,336
3	\$1,440,000	(\$1,532,800)	\$1,907,200	\$154,432
4	\$1,760,000	(\$1,651,200)	\$1,108,800	\$166,528
5	\$2,080,000	(\$1,769,600)	\$1,310,400	\$178,624
6	\$2,400,000	(\$1,888,000)	\$1,512,000	\$190,720
7	\$2,720,000	(\$1,006,400)	\$1,713,600	\$102,816
8	\$5,920,000	(\$2,190,400)	\$3,729,600	\$223,776

TOTAL INTEREST INCOME \$689,472

INTEREST INCOME OPTION PAYMENT

Year	Cumulative Payments	Cumulative (Taxes)	Cumulative Investment	Cumulative Interest Income
1	\$1,800,000	\$???-0-	\$1,800,000	\$148,000
2	\$1,120,000	\$???-0-	\$1,120,000	\$167,200
3	\$1,440,000	\$???-0-	\$1,440,000	\$186,400
4	\$1,760,000	\$???-0-	\$1,760,000	\$105,600
5	\$2,080,000	\$???-0-	\$2,080,000	\$124,800
6	\$2,400,000	\$???-0-	\$2,400,000	\$144,000
7	\$2,720,000	\$???-0-	\$2,720,000	\$163,200
8	\$5,920,000	(\$2,190,400)	\$3,729,600	\$223,776
TOTAL INTEREST INCOME				\$962,976
OPTION SAVINGS				\$273,504

Tests to Determine Whether a Transaction is an Option or a Sale

The determination of when an agreement is an option rather than a contract of sale is not an easy one, as indicated by the Tax Court in *Estate of Charles T. Franklin* (1975) 64 TC 752:

Whether the several agreements in the instant case are to be construed as constituting an option or a contract of sale depends not upon any particular phraseology used in the documents but rather upon what the parties actually did, gleaned from a consideration of the written instruments (both the sale agreement and the lease) in their entirety and the surround circumstances.

See also *Smith v. Morton* (1973) 29 CA3d 616, 106 CR 52; *Commissioner v. Stuart* (3d Cir 1962) 300 F2d 872.

Although *Franklin* unquestionably enunciates a “facts and circumstances” test, the body of case law has basically distilled two different rules for testing whether agreements are options or sales contracts for tax purposes: the “definitional test” and the “comparative test.” The definitional test analyzes legal rights and obligations under state law and then applies a federal standard to determine whether the agreement creates an option or a sale. See *Major Realty Corp.*, TC Memo 1981-361, n16. The federal standard is whether the buyer and seller have entered into a binding agreement that *obligates* the buyer to purchase and the seller to sell. *W.A. Drake, Inc. v. Commissioner* (10th Cir 1944) 145 F2d 365; *Commissione v. Stuart, supra*.

If the agreement passes muster under the definitional test, it is tested under the comparative test, which examines the economic relationship between the potential seller and the buyer, under the agreement, to determine whether the economic relationship more closely resembles an option or a sale. *Karl R. Martin* (1965) 44 TC 731, 740.

Straight and Possession Options

The definitional and comparative