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Primer #2: Options

Real estate transactions often begin with an option contract, which provides the potential buyer an exclusive opportunity to acquire the target property at a set price, provided that it enters into a binding contract to do so, or closes the deal, within the prescribed “option period.” In the charitable context, where the potential buyer is an organization described in Internal Revenue Code (IRC) § 501(c)(3) or a governmental entity, the option may also involve an express or implied commitment to make a charitable gift, by providing the buyer the chance to make the acquisition at a price demonstrably below its fair market value.

The tax considerations arising out of option contracts are the subject of this primer:

(1) What is the effect of the land trust’s payment of consideration for the option (the “option premium”)?
(2) If a charitable contribution is intended to be made, when does it occur, and how is it measured?
(3) How does the seller report the gain or loss on the overall transaction?
(4) If the option is not exercised, what will be the effect upon the optionor?
(5) May the option itself be transferred by the land trust; for example, to the intended ultimate owner, a government agency?

The option premium

In order to make the option contract binding, the land trust typically pays modest consideration in the form of an option premium. To illustrate, suppose that Thalweg O’Rourke, owner of a 300-acre island in northern Lake Huron, appraised at $600,000, agrees to offer the Ipperwash Conservancy the opportunity to purchase the island for $449,000, and to that end, enters into an option contract for which the Conservancy pays $1,000. Under the option, the Conservancy may commit to purchase, at any time within 18 months from the date of the option contract, by providing written notice to Thalweg. The effect of that notice, should it be given, is to turn a unilateral obligation (i.e., a contract under which Thalweg is obligated to sell, but the Conservancy is not obligated to buy) into a binding bilateral contract.

Thalweg’s receipt of the $1,000 option premium does not produce current gross income. In effect, that amount is held “in suspense,” pending the event (exercise or non-exercise of the option) that will enable us properly to characterize the payment.*

Charitable contribution

Pursuing our example, it is clear that such charitable intentions as Thalweg may have harbored were expressed in terms of the option contract. After entering into that agreement, the bargain price is effectively locked in, and any subsequent hardening of Thalweg’s heart will not affect the Conservancy’s opportunity to acquire the island at a bargain price. One might think, then, that the charitable contribution has occurred at the time the option contract was executed. Indeed, in a family gift situation—if the optionee were Thalweg’s granddaughter, for example—that is precisely the result, and a potentially taxable gift would have been made at that time.

But the Internal Revenue Service (IRS), for sound practical reasons, has ruled that the charitable contribution represented by the bargain element occurs, if at all, only at the time of exercise. Revenue Ruling 82-197, 1982-2 C.B. 72. Although the rationale for that ruling—the lack of “payment” at the time the option is created—is hardly beyond theoretical challenge, the Service posi-
tion provides clear guidance and averts serious potential abuses. (Consider, for example, the grant of an option to a tiny and underfunded rural land trust, representing the opportunity to acquire a $1 million property at a price of $900,000.)

Measuring gain or loss
If the option is exercised, the seller's gain or loss is measured by aggregating the option premium and the price paid upon exercise. In our example, the $1,000 premium and the $449,000 "strike price" would produce an amount realized of $450,000. If Thalweg's basis in the property were $100,000, it would be allocated between the "sale" and "gift" elements of the transaction according to their relative amounts (see The Back Forty Primer #1: Bargain Sales, February 1991) producing a gain of $375,000 ($450,000 minus $75,000 allocated basis) and a charitable contribution of $150,000, consisting, presumably, of appreciated long-term capital gain property. The contribution would, of course, be subject to the usual 30%-of-adjusted-gross income limitation applicable to all such contributions.

There is nothing to prevent the "sale" portion of the transaction described here from being constructed on the installment method; i.e., the Conservancy's total payments made in respect of the acquisition could be spread out over two or more years, and the tax liabilities attributable to the total gain of $375,000 would be deferred under the installment method described in IRC § 453. In such a case, the tax consequences attributable to the $1,000 option premium would occur on the closing of the sale, as would the deemed payment of the $150,000 charitable contribution under Revenue Ruling 82-197.

Non-exercise
If the option expires unrequited, Thalweg will simply have $1,000 of ordinary gross income as of that time. The income is ordinary because it is not realized on account of the transfer of a capital asset, but is simply received in respect of the creation of the option contract, which, by its terms, has been extinguished by the running of the option period.

Transfer of option
Despite the sensible rule as to the timing of the charitable contribution, the optionee may own, as of the creation of the option, a valuable intangible property. Depending upon the option provisions as to transferability, the contract itself may be a marketable asset, and, ignoring public relations considerations, the option may be sold to produce operating revenues. Or, if the ultimate management of the target property is to be assumed by a government agency, the option might be transferred to that agency prior to exercise (an increasingly attractive scenario in this era of toxic wastes).

Correspondingly, the private owner of an option held for more than one year is possessed of an appreciated, intangible capital asset, which is an entirely fit subject for a bargain sale or an outright donation to a land trust.—William T. Hutton

*If Thalweg's tax advisor is more than normally aggressive, it may occur to him or her that the tax treatment of option premiums offers a unique opportunity to defer income. For example, it might be suggested, where it is reasonably clear that the Conservancy will have the resources ultimately to make the purchase, that the premium be increased to, say, $150,000. Such a taxpayer thrust is apt to be met with an IRS parry, based on recharacterization of the overall transaction as an installment sale from its inception. If the chance of non-exercise, as measured by the relativity of the option premium to the ultimate sale price, is quite remote, the IRS is apt to prevail. This area is another graphic illustration of the "pig theory"—you can make money being a bull, and you can make money being a bear, but you can't save tax dollars being a pig.

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