OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR
ASSOCIATE DISTRICT COUNSEL

ATTN:

FROM: DEBORAH A. BUTLER
ASSISTANT CHIEF COUNSEL CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated July 16, 1998. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

A =
B=

C =
D =
Taxpayer =
The Property=
Date 1 =
Date 2 =
Date 3 =
$x =
$y =
$z =
$a =

$b	=
$c	=
$d	=
$e	=
$f	=
$g	=
h%	=
j%	=
Tax Year 1	=
Tax Year 2	=
Tax Year 3	=
Tax Year 4	=
The County	=

ISSUE:

Whether the Taxpayer incurred a deductible loss on the lapse or abandonment of an option.

CONCLUSION:

Subject to further factual development, the Taxpayer did not incur a deductible loss on the lapse or abandonment of the option.

FACTS:

A, a corporation, exempt from taxation under § 501(c)(3), issued an option to purchase The Property to Taxpayer on Date 1. Taxpayer is a wholly-owned subsidiary of B. B, in turn is a wholly-owned subsidiary of A. B and Taxpayer file a consolidated federal income tax return.

Taxpayer paid $x as the premium for the option. The option premium was to apply toward payment of the purchase price of the property. When option was issued, the fair market value of the property was approximately $y.

The Option Agreement provided that the "option shall terminate 15 years from the date of the *first exercise* of this Option," (emphasis added) if it has not already been terminated. If, within 5 years from the effective date of the Option Agreement (Date 1), Taxpayer had been unable to obtain a development order through the review process of a certain government agency, then either A or Taxpayer had the right to terminate the option as to the remainder of the property. Thus, Taxpayer had until Date 2 to terminate the option contract because of failure to obtain the development order. If, within 5 years, Taxpayer obtained a development order that was unacceptable to Taxpayer, then Taxpayer had the right to terminate the option.

Taxpayer had the right under the contract to select any parcel of property, provided that it furnish a survey stating the area and legal description of the property upon which it intended to exercise its option. The survey was to be at Taxpayer's expense. The Option Agreement also stated:

> For any given year, if Buyer [Taxpayer] exercises its option on an amount of acreage that is less than the minimum amount shown in the above chart (Column II), Owner [A] shall be entitled to reduce the amount of acreage subject to this portion on an annual basis in such amounts as determined by Owner up to the annual maximum number shown in the chart above (Column III). If, after the tenth (10th) year, Buyer fails to exercise this option for a minimum of five hundred (500) acres in any year, owner may, in its sole discretion, terminate this option as to all remaining acreage to which Owner holds title.

Column II gives the minimum number of acres upon which the option must be exercised by Taxpayer on an annual basis to avoid reductions in property available by A. The chart lists separate amounts for years 0-5, 6-10, and after year 10, from the effective date of the option.

The purchase price of the property, as established in the Option Agreement "shall be [h] percent ([h]%) of the fair market value as hereinafter defined, subject to credits and adjustments." Taxpayer was permitted to take credits for "soft costs" paid in connection with the development and securing regulatory approval for development. The soft costs included costs for planning, developing, application fees, feasibility and environmental studies, engineers, attorneys, and other necessary consultants. Taxpayer would receive a credit for costs against the purchase price only if the option was exercised, and would not receive a credit if the option was not exercised or if the option was terminated before the expiration date.

Prior to closing on any parcel of property, A was to bear the risk of loss to the property. If damage to the property occurred prior to closing, and A declined to repair the property, Taxpayer had the right to terminate the option with respect to that parcel.

Taxpayer did not exercise this option, due in part to environmental concerns. According to the incoming request for assistance and information gathered from the minutes of the Board of Directors' Meetings, Taxpayer and A withdrew development plans in Date 3 that they had submitted to state and county officials. According to representations made in connection with this request for assistance, the Option Agreement was terminated under subparagraph 5(is) of the Agreement due to Taxpayer inability to obtain a development order through the review process as contemplated by the parties under the agreement.

The Tax Year 1 Amended U.S. Corporation Tax Return, form 1120, filed for C on Schedule M-1, line 8 (Deductions on this return not charged against book income this year (itemize) - D), lists a loss amount of -$z. This same amount is also listed on an attached schedule with the description of “Abandonment loss” and with the words “option loss included” handwritten next to it. This loss figure also appears on Form 4797, Part 1, under (f) Cost or other basis, plus improvements and expense of sale, and under (g) Loss.

The tax years in issue are Tax Year 3 and Tax Year 4.

LAW AND ANALYSIS

Section 1234 reads, in relevant part, as follows:

> (a) TREATMENT OF GAIN OR LOSS IN THE CASE OF THE PURCHASER.-
>
> (1) GENERAL RULE.- Gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him).
>
> (2) SPECIAL RULE FOR LOSS ATTRIBUTABLE TO FAILURE TO EXERCISE OPTION.- For purposes of paragraph (1), if loss is attributable to failure to exercise an option, the option shall be deemed to have been sold or exchanged on the day it expired.

Treas. Reg. § 1.1234-1(a) reads, in relevant part, as follows:

> (a) Sale or exchange - (1) Capital assets. Gain or loss from the sale or exchange of an option (or privilege) to buy or sell property which is (or if acquired would be) a capital asset in the hands of the taxpayer holding the option is considered as gain or loss from the sale or exchange of a capital asset (unless, under the provisions of subparagraph (2) of this paragraph,

> the gain or loss is subject to the provisions of section 1231). The period for which the taxpayer has held the option determines whether the capital gain or loss is short-term or long-term.

Treas. Reg. § 1.1234-1(b) reads, in relevant part, as follows:

> (b) Failure to exercise option. If the holder of an option to buy or sell property incurs a loss on failure to exercise the option, the option is deemed to have been sold or exchanged on the date that it expired. Any such loss to the holder of an option is treated under the general rule provided in paragraph (a) of this section.

A preliminary issue is whether the agreement at issue was actually an option. Whether the agreement is actually an option to purchase land, known as a "call option," depends upon the facts of the agreement.

An option contract has two elements: "(1) a continuing offer to do an act, or to forebear from doing an act, which does not ripen into a contract until accepted; and (2) an agreement to leave the offer open for a specified or reasonable period of time." Old Harbor Native Corp. v. Commissioner, 104 T.C. 191, 201 (1995).

An option from the perspective of the holder has been defined by one commentator as a "contract in accordance with which the holder has the right, but not the obligation, for a specified period of time, to buy or sell a specified amount of the underlying interest at a fixed or determinable price." 1 Andrea Kramer, Financial Products: Taxation, Regulation and Design, § 5.1, at 100 (1991). The writer is obligated to perform if and when the holder exercises his option. Id. "A call option conveys to the holder the right to buy (and obligates the writer to sell) the underlying interest." Id.

The Tax Court in Estate of Franklin v. Commissioner, 64 T.C. 752 (1975), aff'd, 544 F.2d 1045 (9th Cir. 1976), decided that certain obligations entered into by a partnership (of which decedent taxpayer was a limited partner) were not legally enforceable or were too indefinite and tentative to create indebtedness under section 163(a). Rather, the obligations gave the partnership an option to purchase certain property. The court said, "An option to purchase property does not create an enforceable obligation to pay the purchase price or give the taxpayer a cost basis for the property. 'It is simply a contract by which the owner of property agrees with another person that the latter shall have the right to purchase the property at a fixed price within a certain time,'. . . It gives the optionee no present estate . . . and imposes on him no obligation to consummate the transaction." Franklin, 64 T.C. at 762 (citations omitted).

The Fourth Circuit in Halle v. Commissioner, 83 F.3d 649 (4th Cir. 1996), relied on four factors in examining the economic realities of a transaction when determining whether an agreement was a stock purchase agreement (indebtedness) or an option. These four factors are: "(1) the amount of the contractually specified liquidated damages, (2) the extent to which [the purchaser] assumed real economic burdens of ownership before settlement, (3) [the buyer's] peripheral activities before settlement, and (4) the absence of apparent motives for creating an option contract." Halle, 83 F.3d at 655.

The court examined the first factor, the amount of specified liquidated damages, because "the greater the sanction for failing to discharge a contractual obligation, the less free the obligor is to walk away from the deal." Id. at 655. If the amount of liquidated damages payable approximate or exceed the seller's actual damages in the event of default, this is evidence of indebtedness.

The court in Halle found that the contract provided for sufficient liquidated damages that would have covered the seller's actual damages had the buyers not purchased the stock. The buyers would have forfeited the down payment and any settlement deferment payments that it had made.

Under the second factor, the extent to which economic burdens are assumed prior to ownership, the court said, "Because the holder of an option retains the right not to purchase the subject property, he is unlikely to undertake significant obligations associated with ownership of that property." Id. at 657. The buyer had incurred $500,000 in expenses, and the court determined that this fact supported the conclusion that the buyer did not have an option giving it free choice to proceed or not with the purchase.

Under the third factor, peripheral activities, the court in Halle looked to the fact that the buyer was not considering other, similar purchases, and it spent time and money securing financing for the one project.

The fourth factor the court examined was the absence of a motive to purchase an option. Option contracts permit parties to shift risks of contingencies. "Where there are no significant risks to apportion, therefore, there is little reason for the parties to contract for an option." Halle, 83 F.3d at 657. The risk in Halle was obtaining the needed rezoning of the property, which the court determined was a foregone conclusion. Based on all four factors, the court allowed the interest deductions and concluded that the transaction created genuine indebtedness.

The option at issue would not be an option if the benefits and burdens of ownership passed from A to Taxpayer because of the $x payment; rather, the transaction could be viewed as a sale of the property.

The benefits and burdens of ownership include: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether the purported purchaser acquired an equity interest in the property; (4) whether there was an obligation on the purported seller to deliver a deed and an obligation on the purported purchaser to make payments; (5) whether the purported purchaser was vested with the right of possession; (6) which party paid the property taxes; (7) which party bore the risk of loss or damage; and (8) which party received profits. Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981); Highland Farms, Inc. v. Commissioner, 106 T.C. 237 (1996).

An option contract must create an unconditional power of acceptance in the offeree. Saviano v. Commissioner, 765 F.2d 643, 651 (7th Cir. 1985). In Saviano, the taxpayer had sold a third party merely the right to first refusal to purchase gold. The taxpayer was under no obligation to actually sell any gold to the third party.

An application of the facts indicative of an option reveals that this agreement is an option. Taxpayer did not have an obligation to pay the purchase price of the property.

In this case, there is a question as to whether the Option Agreement created an unconditional power of acceptance in Taxpayer in light of A's right to terminate under subparagraph 5(is) of the agreement in the event Taxpayer was unable to obtain a development order. Based upon the available facts, it appears that Taxpayer held sufficient control over the process for the procurement of a development order to satisfy the requirement that the option create an unconditional power of acceptance. The Option Agreement granted Taxpayer all rights and powers necessary to apply for and obtain necessary governmental approvals (e.g. to inspect and survey the property, conduct drilling and testing, take samples) and required that A cooperate in Taxpayer's efforts to obtain approval. Even though it appears that procurement of government approval was not contingent upon the acts of A, there is still a question as to whether its procurement was otherwise outside Taxpayer's control. In light of the type of approval being sought from government officials, it is likely that Taxpayer held the degree of control needed to distinguish it from a right of first refusal.

It also appears that the Option Agreement will satisfy the second element requiring that an option be left open for a specified or reasonable period of time even though the agreement did not set out a definite date. In subparagraph 5(is) of the Option

Agreement, the parties agreed that, in the event the option was not otherwise terminated under paragraph 5, it would expire 15 years from the date that the option was first exercised. Under this provision, there is no specific date of expiration because the date the option is first exercised depends upon a future event or occurrence. Nonetheless, reading the agreement as a whole, the term is not indefinite because the agreement calls for mandatory exercise of the option for a minimum number of acreage each year, beginning in the 6th year from the effective date of the agreement, Date 1. Thus, it is unlikely that the option will be treated as having an unlimited or unspecified term.

The first factor under Halle is the amount of contractually specified damages. The contract provides for no liquidated damages. The only loss to Taxpayer, the buyer, was its payment for the option and the other costs that Taxpayer incurred, which Taxpayer apparently incurred in its attempt to obtain the development order. On the Tax year 1 consolidated return, on an attached statement, Taxpayer listed $z in abandonment loss, which includes the option loss of $x, for a difference of $a. The specific costs are not detailed, however. Under the option contract, Taxpayer had the right to incur "soft costs" which were to be credited against the purchase price but which were incurred at its own risk in the event that Taxpayer did not purchase the property. These costs included feasibility and environmental studies, planners, engineers, surveyors and attorneys.

When looking at the absolute and relative costs, these expenses paid by Taxpayer are not insignificant. The cost of the option plus expenses represents j% of the approximate $y fair market value of the entire property. Since no exercise price is indicated in the contract, but rather the price of the property is indicated as a percentage of its fair market value, the costs paid up front as a percentage of the exercise price of the option cannot be determined. Additionally, Taxpayer had the choice to purchase only a portion of the property. Thus, if Taxpayer had elected to purchase a small amount of the property, the costs of the up-front expenses would have been significantly higher relative to the property than they would have been if Taxpayer purchased more of the property.

The seller, A, reserved the right to harvest its crops growing on the property even after the closing, and thus was to benefit economically from the crop whether the transaction was completed or not.

While payment of $x for an option and $a for accompanying expenses is not negligible, it is, nevertheless, less than the cost of purchasing property which is not zoned according to Taxpayer's needs. From the facts available, it is not possible to say that Taxpayer could not reasonably walk away from the transaction. Also, risk to the seller was minimized because the seller reserved the right to benefit from the crop harvest. These facts are more indicative of an option.

The second factor under Halle is whether, under the contract, Taxpayer assumed few real economic burdens of ownership. A agreed to bear the risk of all loss to the property. If condemnation or eminent domain proceedings were commenced, then Taxpayer would have had the choice to proceed with the transaction (with the property under condemnation or eminent domain proceedings) or terminate the option. Finally, the parties agreed, in the Option Agreement, that the option would not be recorded among the public records of The County or anywhere else, and that neither party would record the option unless Taxpayer reasonably deemed that recording would be necessary or desirable to preserve its rights under the option agreement. If the option is recorded, upon the early termination or expiration of the option, Taxpayer agreed that it would record a notice evidencing the option's expiration or termination. These facts are more indicative of an option.

The third factor in Halle is the buyer's peripheral activities before settlement, specifically whether the buyer was looking to purchase solely the property in the option, or whether the holder was considering other properties. There is no evidence that Taxpayer was or was not considering purchasing other properties. This fact is neutral.

The absence of a motive for an option, or the lack or presence of risks to apportion, is the fourth factor under Halle. In this case, unlike in Halle, procurement of the development order from the state was not a forgone conclusion. In fact, the order was never obtained. Obtaining the development order presented significant risk to Taxpayer; therefore, Taxpayer had reason to obtain the option. This fact is more indicative of an option.

In this case, the parties ostensibly treated the contract as an option contract. The facts do not indicate that Taxpayer acquired an equity interest in the property. The contract did not obligate A to deliver a deed, nor did it obligate Taxpayer to make payments in addition to the cost of the option. Taxpayer was not vested with the right of possession; A reserved the right to harvest the crop should the property be transferred. Taxpayer did have the right under the contract to make certain improvements upon the land and to pay for certain services to facilitate procurement of the development order. Taxpayer did not appear to obtain any economic benefits or burdens of ownership, and Taxpayer did appear free to walk away from the deal. Taxpayer faced real risk in obtaining its desired development order. Although Taxpayer suffered not insignificant financial harm from walking away from the option, financial damage appears to have been minimal. Additionally, it appears that Taxpayer was vested with the right, but not the obligation, to purchase the property at issue, and did not receive merely a right of first refusal.

Therefore, we conclude for purposes of this memorandum that the agreement at issue is an option contract. Thus, the next issue is whether under section 1234, Taxpayer could deduct the $x loss due to its failure to exercise an option to purchase property, and if so, when Taxpayer could deduct the loss.

Section 1234, which concerns options to buy and sell, is applicable to this transaction. Under section 1234, the general rule is that "[g]ain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him). Under the special rule for a loss attributable to a failure to exercise and option, if the loss is "attributable to failure to exercise an option, the option shall be deemed to have been sold or exchanged on the day it expired."

It appears that none of the exceptions listed in section 1234(a)(3) apply to this option (the option is likely not section 1221(1) inventory; it is likely that the option is a capital asset; and it is not an option to sell property as described by section 1233(c)).

The termination of the Option Agreement due to Taxpayer's inability to obtain a development order may constitute an expiration of the option, thereby causing the recognition of gain or loss under section 1234. For purposes of determining whether the termination will be treated as a sale or exchange under section 1234, the termination must leave no possibility for subsequent exercise of the option, in whole or in part. See <u>Rosenberg v. Commissioner</u>, T.C. Memo. 1978-303; Rev. Run. 58-234, 58-1 C. B. 279, <u>clarified by</u> Rev. Run. 68-151, 1968-1 C.B. 363. This is a factual issue to be determined based upon the circumstances surrounding the termination. Based upon the representations made in connection with the request for assistance, it is likely that the termination left no possibility that the option could be exercised, and therefore qualifies for sale treatment under section 1234. The loss is recognized on the date of such termination.

From the facts available to us, it appears that this option to buy property is a capital asset in Taxpayer's hands. Under Treas. Reg. § 1.1234-1(a), character of the loss from the sale or exchange of this option would be according to the period for which Taxpayer held the option.

Taxpayer purchased this option on Date 1. It was to expire either 15 years from the date of the first exercise of the option; alternatively, the option could have been terminated by either party within 5 years of the effective date of the option contract if the required development order was not obtained. There is evidence that this development order was not obtained and that the option was terminated early. Taxpayer is deemed to have “sold” the option on the date that the option was terminated or expired, which may have been Date 2.

Taxpayer realized $0 in the sale of the option. Ordinarily, Taxpayer would have had a loss equal to its adjusted basis of $x under section 1001. Taxpayer realized and recognized a long-term capital loss under section 1222(4) because Taxpayer held the option for what appears to have been five years. This loss would have been deductible in the year in which the option expired or was terminated, which may have been Tax Year 2.

Nevertheless, we do not think Taxpayer suffered a loss in this situation because the option probably was not worthless. At the time Taxpayer purchased the option, the fair market value of the underlying property was approximately $y. The Option Agreement did not state an exercise price, but it did provide that the purchase price “shall be [h] percent ([h]%) of the fair market value” of the underlying property at the time the option is exercised. It also stated that, if the option is exercised, Taxpayer would be permitted offsetting credits for both the option price and the “soft costs” (a total of apparently about $b).[1]

H percent of $y is $c. Assuming that Taxpayer immediately exercised the option and did not incur any expenses other than the $x option purchase expense, the exercise price (minus the option price) would have been approximately $d ($c-x). Expenses over and above the option price (here, the "soft costs") incurred by Taxpayer only strengthens the argument that Taxpayer had nothing to lose and much to gain in exercising the option. If $e, the soft costs reported on the Tax Year 1 consolidated return, are subtracted from $d, the exercise price is reduced to about $f. Taxpayer would thereby have recognized a gain of $g if it had exercised the option and then immediately sold the property at fair market value.[2] Hence, only if the property’s value dropped below $f (at the time the option was canceled), would the taxpayer have any argument that the option was worthless when canceled.

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[1] The Tax Year 1 consolidated return shows that Taxpayer listed abandonment costs of $b.

[2] $y (fair market value of the property) minus Taxpayer’s basis of $c ($f exercise price plus $b expenses, including option price) = $g.

Taxpayer chose to abandon rather than exercise the option. In doing so, it purportedly incurred a $b loss, which included the purchase price of the option. Based on the above analysis, the option was not worthless and Taxpayer's abandonment of the option appears to be unreasonable. Here the parties to the transaction are closely related and the property remained within the controlled group. The abandonment of the option in this case is akin to the cancellation of a debt owed by the parent corporation to its wholly-owned subsidiary, resulting in a constructive distribution by the wholly-owned subsidiary to its parent corporation. Section 61(a)(7); Treas. Reg. § 1.61-12(a); Shepard v. Commissioner, 340 F.2d 27 (6th Cir. 1965) (a corporation's cancellation of a shareholder's fully collectible indebtedness may be a constructive dividend to the shareholder).

Thus, we conclude that Taxpayer may not claim a loss on the abandonment of the option.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted] If you have any further questions, please call (202) 622-7900.

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