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Case Law and RRs: Sales v. Options

Halle v. Commissioner, 83 F.3d 649 (4th Cir. 1996). In this case, taxpayer agreed to buy stock for $29 million; the target company held real estate that taxpayer sought to develop. The purchase agreement required a forfeitable $3 million down payment and a $225,000 monthly fee to defer the sale. Taxpayer was only liable to the extent of the $3 million payment and any monthly payments, i.e., the seller could not sue taxpayer for additional damages in the event of taxpayer's breach of the sales contract. The taxpayer eventually purchased the stock after incurring $900,000 in fees to defer the sale for four months. The taxpayer claimed an interest deduction for the $900,000; the Service argued that the "sales contract" was actually an option, and that the $900,000 that taxpayer paid prior to the completed stock purchase constituted nondeductible option premiums.

The court concluded that the contract was a sale, rather than an option. In so doing, the court relied upon the following four factors to distinguish an option from a sale: (1) the amount of contractually specified liquidated damages (the higher the amount, the more it resembles a sale); (2) the extent to which the taxpayer assumed real economic burdens of ownership before settlement (the holder of an option is unlikely to undertake obligations associated with ownership); (3) the taxpayer's peripheral activities before settlement; and (4) the absence of apparent motives for creating an option contract (were there downside risks inherent in owning the property such that an option was meaningfully different than a sales contract?). Id. at 655-57. With regard to factor (1), the court concluded that the liquidated damages were not akin to an option premium because the damages "amply covered" the seller's losses if taxpayer failed to complete the stock purchase. With regard to factor (2), the court concluded that taxpayer's payment of $500,000 in engineering and planning costs prior to settlement was inconsistent with the activities of a mere option holder. With regard to factor (3), the court concluded that taxpayer, between the contract date and settlement, looked at no other properties, entered into joint development ventures with respect to a portion of the property while negotiating to sell other portions, and secured an additional $53 million in financing to actually develop the tract upon settlement. With regard to factor (4) the court concluded that there were no meaningful contingencies affecting the property's value that would justify an option in lieu of a sales contract.

Commissioner v. Baertschi, 412 F.2d 494 (6th Cir. 1969). Taxpayers in this case agreed to sell their residence, conditioned upon receiving the full purchase price in three installments. The taxpayers were entitled to recover their property without recourse to the buyer if buyer defaulted on one of the installments. Taxpayers received two of the three scheduled installments, constituting 29% of the purchase price, but had to wait unexpectedly for the final installment. After paying the second installment, the buyers possessed the property and paid real estate taxes and insurance. In order to be eligible for the tax-deferred rollover for real estate gains set forth in now-repealed § 1034, taxpayers had to convince the court that the sale occurred at the time of the final installment, rather than when they received the second installment. The court concluded that the sale occurred after the second installment, although there was limited recourse against the buyer for failure to complete the transaction. The court reasoned that the buyer had already paid 29% of the purchase price, possessed the property, and paid taxes and insurance.

Lowe v. Commissioner, 44 T.C. 363 (1965). Taxpayer in this case sold all of the stock of a corporation that held a long term lease on a hotel. The buyer made a down payment and was obligated to make additional payments of interest and principal for eight years. The agreement provided that, upon buyer's default, taxpayer could assume operation of the hotel and keep all payments received from buyer as liquidated damages. The buyer operated the hotel for three years, then defaulted on its obligation to taxpayer, who assumed control over the hotel and kept $22,500 in payments received from buyer. The taxpayer argued that the $22,500 received pertained to its prior sale of the stock, and should either reduce its basis or be treated as capital gain, while the Service argued that the $22,500 should be treated as ordinary income that the taxpayer received upon expiration of an option. The court concluded that the agreement between taxpayer and buyer was a sale, with taxpayer retaining a security interest. The court reasoned that the buyer assumed all responsibility for operating the hotel, having possession and dominion over the property, and could enjoy resulting profits or suffer resulting losses.

Rev. Rul. 82-150, 1982-2 C.B. 110. In this ruling, the Service held that a "deep-in-the-money" call option was actually a completed sale of the underlying assets to the holder of the option. The ruling reasoned that, where the strike price for the underlying asset ($30X) is significantly lower than the fair market value of the assets ($100X), the holder of the option was economically compelled to prevent the option from lapsing without exercise or a demanding a settlement payment in lieu thereof. Whereas the court in Baertschi deemed a sale where buyer payments equaled 29% of the purchase price, the revenue ruling deems a sale where the "option" premium equals 70% of the purchase price.

Rev. Rul. 80-238, 1980-2 C.B. 96. In this ruling, the Service held that a taxpayer is deemed to own stock for the purpose of sec. 246(c)(1)(A) even if the taxpayer writes a call option that entitles a third-party option holder to purchase the stock; however, the ruling further holds that a taxpayer is deemed to no longer own the stock if the call option is "in-the-money" at the time that the taxpayer sells the option, i.e., the strike price is below market price. The Court of Appeals for the Sixth Circuit has acknowledged the validity of the notion, set forth in the ruling, that deep-in-the-money call options may be disguised sales "since in such a situation the exercise of such options may be virtually guaranteed and the element of risk is either greatly reduced or eliminated." See Progressive Corp. v. United States, 970 F.2d 188, 193 (6th Cir. 1992) (adopting language from Rev. Rul. 80-238).

Rev. Rul. 75-563, 1975-2 C.B. 199. In this ruling, the Service held that a putative option held by the taxpayer was actually a sale. The "option" contract entitled the taxpayer to immediate possession and unrestricted use of all the land covered by the contract, and required the taxpayer to pay all real estate taxes. Taxpayer received title to a portion of the property equal in value to the amount of each payment taxpayer made to seller; if taxpayer defaulted, seller could keep the payments it had received and force taxpayer to surrender any portion of the property to which the taxpayer had not acquired legal title. The Service reasoned that the option was really a sales contract because the taxpayer had all benefits and most of the burdens of ownership pursuant to the "option" contract.

[redacted] TP actually owns the underlying securities, and is not merely the holder of an option to buy the securities. Below are some authorities that address whether a transaction is a sale, rather than an option. Halle is particularly helpful to our case because it looks to the taxpayer's motives to enter into an option rather than a sale.

In this regard, the "knock out" provision is illustrative of the parties' motives to enter into a sale. Option purchasers use knock out provisions to reduce the premium that they would pay under a standard option. The knock out provision lowers the premium because the holder agrees that the option will terminate worthless if the underlying asset hits a certain price point. In our case, however, the taxpayer gets no economic benefit from the knock out provision vis-à-vis an outright sale because when the knock out price is reached, the taxpayer forfeits an amount equal to the difference between the strike price and the knock out price. That is, the taxpayer forfeits/loses the same exact amount that it would lose if it bought the securities and sold them at the knock out price.

For example, assume I buy a six month call option with an at-the-money strike of $10/share, but also with a knock out provision that terminates the option if the stock hits $8. Economically, it only makes sense to buy the option rather the underlying stock if I'm pay less than $2. Otherwise, I assume the same downside liability as an owner of the underlying asset -- which is what call options are fashioned to avoid. This is exactly what our taxpayer did here, i.e., strike price was $, premium was $, knock out was $. This, combined with the fact that taxpayer controlled trading within the account, is strong indication of ownership.