Tax Tip

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Options to Acquire Real Estate: When Will They Not Be Respected as "Options" for Tax Purposes?

Tax-savvy real estate investors have long been familiar with the benefits of structuring deferred payment or multi-phase dispositions of real estate as options rather than as installment sales. For example, assume that taxpayer X owns a large tract of undeveloped land that has been held by X's family for two generations and has been used by X and his family for farming. The land is now ripe for development and X has received a number of inquiries from developers who propose to acquire X's property for as much as $20 million. However, all offers received by X thus far would have required X to hold a substantial purchase money mortgage and to subordinate to the developer's/purchaser's development loans.

Recently, X received an alternative proposal from a well-known developer with a substantial net worth and a proven track record. The developer has proposed to acquire X's property in a series of four "rolling options." Under this approach, X's property would be divided into four separate parcels. The developer would pay $500,000 as consideration for an option to purchase the first option parcel for a total purchase price of $5 million, which option would remain open for a period of 18 months. The 18-month period is designed to enable the developer to pursue and obtain the necessary permits and approvals to develop the property. If the option is exercised, the $500,000 option payment will be applied against the purchase price for the first option parcel. If the option lapses, however, the option payment will be forfeited.

The purchase price for the second through the fourth option parcels will also be negotiated, as well as the timing and sequence that such options would be exercisable. The prices for each of these option

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parcels will take into account the time value of money and the risk that the developer, even if it purchases the first option parcel, may not exercise its options to acquire any or all of the remaining option parcels. At the time of exercise of the options with respect to the first through the third option parcels, developer would be required to pay an additional $500,000 to X as consideration for holding the remaining options open, which option payments would also apply against the purchase prices for such parcels if exercised or would be forfeited if the options were allowed to lapse. The purchase price for each option parcel would be payable in cash at closing.

There are some significant tax advantages to X in this proposal. First, despite the fact that X will have unrestricted use of the $500,000 option monies from the point in time that he receives them, he will not be taxed on these monies until the options to which they relate are either exercised or lapse.[1] If an option is exercised and the option monies are applied against the purchase price, the monies will be treated as having been received in a sale or exchange of the underlying option properties.[2] If the option lapses, the option monies must be reported by X in his tax year in which the lapse occurred and will be taxed either as ordinary income or, if the property subject to the option was a capital asset in the hands of the optionor, as capital gain.[3]

Contrast the tax consequences associated with the rolling option above with those that would be imposed upon X if he had sold the property for a small down payment and received a purchase money note and mortgage for the balance of the purchase price. Although X would be entitled to defer the reporting of a portion of his gains under the installment sale provisions of Code Sec. 453, all interest payable under the purchase money note would be taxed as ordinary income, and the original issue discount rules of Code Secs. 1272 through 1275 would apply if the interest rate is less than the applicable federal rate. By contrast, although the option pricing procedures will unquestionably have a "time value of money" component built into them, no portion of the option consideration or the exercise price will be treated as interest if the option is respected for tax purposes.[4] Moreover, the original issue discount rules of Code Secs. 1272 through 1275 will not apply since a true option contract will not constitute a "debt instrument," as defined in Code Sec. 1275(a)(1).[5] In addition, since the installment note received by X will have a face amount in excess of $5 million, a significant "toll tax" will be imposed under Code Sec. 453A for the privilege of deferring gain, and any pledge of the installment obligation by X can accelerate income under Code Sec. 453B. Neither of these provisions will apply to a rolling option. Finally, if any portion of X's gain from the disposition of the property will result in depreciation recapture under Code Secs. 1245 or 1250, all of the depreciation recapture income is accelerated into the year of closing under Code Sec. 453(i). In the case of a rolling option, however, depreciation recapture attributable to any option parcel that is closed upon must be reported in the year of closing, but the depreciation recapture inherent in other option parcels which have not been closed upon will not be accelerated.

Risks that the Options Will Not Be Respected for Tax Purposes

Despite all the above-described benefits to the use of options in structuring the sales of real property, there is a risk that an option will not be respected as such and that the IRS will attempt to recast the transaction as a deferred payment sale of the subject property. An analysis of case law sets forth a number of factors to be considered in crafting an option in order to avoid such recharacterization.

First, the option agreement should ensure that the benefits and burdens of ownership do not pass from the optionor to the optionee. In *Frank Lyon Co.*,[6] the taxpayer entered into a sale-leaseback transaction with an option to repurchase the leased building at various times at prices equal to the sum of the unpaid balance of the taxpayer's mortgage and the taxpayer's initial investment plus interest. In determining whether the purported sale of the building should be respected for federal income tax purposes, the Court held that the structure was not a sham, finding that where "there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."[7]

Some of the factors to be considered in ensuring that the benefits and burdens of ownership of the property remain with the optionor include whether the optionor (1) retains the right to possess the property and to enjoy the use, rents or profits

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thereof; (2) has a duty to maintain the property; (3) is responsible for insuring the property; (4) bears the property's risk of loss; (5) is obligated to pay the property's taxes, assessments or charges; and whether the optionee (6) has the right to improve the property without the owner's consent.[8] To avoid recharacterization as a completed sale, therefore, it is important that the option agreement not transfer any of the aforementioned benefits or burdens from the optionor to the optionee.

As a corollary to the benefits and burdens analysis described above, the IRS might also argue in certain circumstances that the exercise of the option by the optionee is highly likely and that the option should, therefore, be recast as a completed deferred-payment sale.[9] For example, if the option to acquire the first option parcel described at the outset of this article required the optionee to make an option payment in the amount of $2 million (rather than $500,000), and if the optionee were permitted under the option agreement to commence construction of improvements on the first option parcel prior to closing and the optionee actually made an additional $1 million of improvements prior to closing, and, further, if the improvements would be forfeited if the optionee did not exercise its option, the IRS might justifiably argue that it was a virtual certainty that the optionee would exercise its option.

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The IRS has generally addressed this issue in the context of leases which contain purchase options. In Rev. Rul. 55-540, the IRS provided that, in the absence of compelling factors to the contrary, a transaction will be treated as a purchase and sale rather than as a lease coupled with an option if one or more factors or conditions is present, including "a purchase option at a price which is nominal in relation to the value of the property at the time when the option may be exercised, as determined at the time of entering into the original agreement, or which is a relatively small amount when compared with the total payments which are required to be made."[10] Based upon this ruling, a taxpayer entering into a lease-option agreement would have to ensure that the lease payments did not apply against the purchase price if the option is exercised and the exercise price of the option reflected the anticipated fair market value of the underlying property at the time in which the option may be exercised.[11] This ruling, and the authorities following it, analyzed the likelihood of whether an option would be exercised using a "virtual" or "absolute certainty" standard.[12] However, recent case law has established a lower standard.

There has been a series of recent cases in the context of sale-in/lease-out ("SILO") and lease-in/lease-out ("LILO") transactions, in which a taxpayer leases assets to or from an entity (generally a tax-exempt or tax-indifferent entity) and the tax-indifferent entity has an option to acquire the taxpayer's/lessee's interest in the property.[13] In each of these cases, the courts denied the taxpayer its claimed tax benefits under the substance vs. form doctrine, finding that the circularity of the transactions eliminated the economic risks for the taxpayer and further finding that the option to acquire the property held by the tax-indifferent party was virtually certain to be exercised.

In the most recent case involving a LILO transaction, *Consolidated Edison Co.*,[14] the Federal Circuit also applied the substance over form doctrine to conclude that there was no economic substance to the transaction. The opinion includes overly broad language in its analysis that, if applied literally to conventional real estate options, would call into question whether any of such options should be respected for tax purposes. With respect to the option contained in the LILO transaction, the court found that there was a "reasonable likelihood that the tax-indifferent entity in the LILO transaction would exercise its purchase option at the conclusion of [the sublease]," which thus rendered the master lease "illusory." The court quoted from its earlier opinion in *Wells Fargo & Co.*,[15] in which the court stated that the "appropriate inquiry is whether a prudent investor in the taxpayer's position would have reasonably expected" that the options would be exercised.[16] Nevertheless, it appears that the court may have taken its prior statement out of context. The portion of its *Wells Fargo& Co.* opinion quoted in its *Consolidated Edison Co.* analysis was followed by a statement that the "characterization of a tax transaction based on a highly probable outcome may be appropriate, particularly where the structure of the transaction is designed to strongly discourage alternative outcomes." Thus, the Federal Circuit in

its *Wells Fargo* decision tempered its "reasonable expectation" standard with an explanation that this is to be applied only in a pre-wired transaction with a highly probable outcome and coupled with a structure that is designed to "strongly discourage alternative outcomes." The very broad "reasonable likelihood" standard articulated by the same court in its *Consolidated Edison Co.* opinion goes far beyond the application of the substance-over-form analysis employed by other courts as well as by the Federal Circuit itself in its *Wells Fargo & Co.* opinion. While this broad language appears unnecessarily broad and is not in keeping with the application of this standard to similar transactions by other courts, it nevertheless raises a new level of uncertainty in analyzing whether options to acquire real estate will be respected for tax purposes.

Based upon the foregoing, taxpayers and their advisors should, wherever possible, structure option agreements in as conservative a fashion as reasonably possible to ensure that the benefits and burdens of ownership have not shifted to the optionee and that the exercise of the option is by no means assured. For example, it would be advisable to limit option payments to a commercially reasonable level. Thus, option payments which do not exceed 10 percent of the option price would appear to be safe, but option payments in excess of perhaps 20 percent of the option price would certainly be more vulnerable and might suggest that the optionee was more likely to exercise its option. Although this will always be a facts-and-circumstances analysis, a factual pattern such as the one set forth at the outset of this article is advisable: an option payment that is not so large as to economically compel the optionee to exercise the option, coupled with an exercise price reflecting the fair market value of the property at the time of exercise and the retention by the optionor of the benefits and burdens of ownership while the option remains outstanding.

Endnotes

1 *See Virginia Iron, Coal & Coke Co.*, 37 BTA 195, Dec. 9930, *aff'd*, CA-4, 38-2 USTC ¶9572, 99 F2d 919, *cert. denied*, 307 US 630; *The Dill Company*, 33 TC 196, Dec. 23,825, *aff'd* CA-3, 61-2 USTC ¶9611, 294 F2d 291; *J.F. Kitchin*, 22 TCM 1738, Dec. 26,439(M), TC Memo. 1963-332, *rev'd and rem'd*, CA-4, 65-1 USTC ¶9213, 340 F2d 895; *C.E. Koch*, 67 TC 71, Dec. 34,062 (1976); and *G.T. Hicks*, 37 TCM 1540, Dec. 35,418(M), TC Memo. 1978-373. The reasoning behind these rulings is that the taxability of payments cannot be determined until the options either lapse or are exercised.

2 Code Sec. 1234(a)(1); Reg. §1.1234-1(a). Even if the option monies are not applied against the purchase price, the Tax Court in *C.E. Koch*, 67 TC 71, Dec. 34,062 (1976), held that the same rule applies.

3 Reg. §1.1234-1(b); Rev. Rul. 57-40, 1957-1 CB 266 provide for ordinary income treatment upon lapse, but Code Sec. 1234A(1) treats such income as capital gain if the property subject to the option was a capital asset in the hands of the optionor. In the example set forth in the article, the property was used in the trade or business of farming and was, thus, Code Sec. 1231 property rather than a capital asset.

4 Supra note 2.

5 *See* Code Sec. 1274(a).

6 *Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561.

7 *Id.* at 577.

8 *A.E. Blanche, Jr.*, 81 TCM 1301, Dec. 54,277(M), TC Memo. 2001-63, *aff'd*, CA-5 (unpublished opinion), 33 Fed. Appx. 704, *citing W.O. Derr*, 77 TC 708, Dec. 38,299 (1981); and *Grodt & McKay Realty, Inc.*, 77 TC 1221, Dec. 38,472 (1981).

9 *See, e.g., Wells Fargo & Co.*, FedCl, 2010-1 USTC ¶50,127, 91 FedCl 35, *aff'd*, CA-FC, 2011-1 USTC 50,327, 641 F3d 1319, at 1325–1326, involving a LILO transaction.

10 1955-2 CB 39, *citing Burroughs Adding Machine Co. v. Bogton*, 9 F2d 54; *Holeproof Hosiery Co.*, 11 BTA 547, Dec. 3825; *H.T. Benton*, 9 TCM 811, Dec. 17,873(M), *rev'd*, CA-5, 52-1 USTC ¶9367, 197 F2d 745.

11 *See also*, *W. Oesterreich*, 55-2 ustc 9733, 226 F2d 798 (finding that there was "virtually no question" that the option would be exercised because the option price was "token consideration"); *LTV Corp.*, 63 TC 39, Dec. 32,814 (1974); *but cf. Northwest Acceptance Corp.*, 58 TC 839, Dec. 31,496 (1972) (where the option prices range from 10 percent to over 50 percent of the original cost of depreciating equipment, there is "more than a mere nominal option price" and the purpose of the options was not to give the lessee an equity in the equipment or to make the exercise of the option "an absolute certainty").

12 *Supra* note 9.

13 *See Wells Fargo & Co., supra* note 9; *BB&T Corporation*, DC-NC, 2007-1 USTC ¶50,130, 523 F3d, 461, *aff'd*, CA-4, 2008-1 USTC ¶50,306, 523 F3d 461; *AWG Leasing Trust*, DC-ND, 2008-1 USTC ¶50,730 592 F2d 953.

14 *Consolidated Edison Co.*, FedCl, 2009-2 USTC ¶50,696, 90 FedCl 228, *rev'd and rem'd*, CA-FC, 2013-1 USTC ¶50,136, 703 F3d 1367.

15 *Id.*

16 *Id.* at 1326.

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