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THE OPTION CONUNDRUM IN TAX LAW: AFTER ALL THESE YEARS, WHAT EXACTLY IS AN OPTION?

Kevin Liss

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Some of the latest financial products that have become prevalent on Wall Street defy easy categorization for tax purposes. Certain products, such as economic derivatives or weather derivatives, bear the trappings of options, but lack an underlying property component. Other products, such as credit default swaps, have option-type payouts, but are cast in the form of financial swaps. Which of these products are truly options and why? When and how to tax these instruments depends on proper resolution of this fundamental classification issue. Unfortunately, however, the essential nature of what truly constitutes an option is found nowhere in the tax law and has eluded generations of tax commentators. With respect to credit default swaps, arguably the single most important product innovation on Wall Street in the last 20 years, hundreds of millions of dollars in potential withholding tax liability (on cross-border swap payments) are riding on a resolution of this issue.

This pathbreaking article, focusing on what exactly makes an option an option, is both timely and exceedingly relevant. It tackles a longstanding philosophical question which has modern-day resonance in the ongoing debate over the appropriate taxation of the latest generation of financial products. Relying on contract-law principles and economic risk analysis, the article revisits longstanding case law to fashion a modern-day definition for what constitutes an option. In the process, it reassesses some of the leading cases on options based on this new understanding. Ultimately, it resolves the question of whether the concept of an option properly encompasses non-property-based options, such as economic or weather derivatives, as well as contingent options, such as credit default swaps.

As a coda to the pursuit of a new framework for defining options, the article concludes by proposing a basis for differentiating between options, properly understood, and financial swaps, two product categories which up to now have had overlapping reach, allowing taxpayers to avoid undesired tax results by the simple expedient of selecting the desired form of transaction. While the article's suggested approach would deprive taxpayers of the flexibility inherent in current law's ambiguity, this flexibility conflicts with the government's asserted interest in promoting neutrality in the taxation of financial products. Equally important, the financial products sector is more likely to thrive when uncertainties in the taxation of economically useful transaction are satisfactorily resolved.

INTRODUCTION

An option is typically described as a contract between two parties that provides one party the right, but not the obligation, to buy or sell an underlying stock or other asset at a set price and date. In fact, most option contracts are explicitly labeled as such, with the contract by its terms providing one party the choice of whether or not to perform its side of the contract in exchange for an option premium. Sometimes, however, contracts not labeled as options may bear some economic resemblance to

options, making it difficult to ascertain whether the parties have entered into some kind of financial swap, a conventional purchase and sale agreement, or whether the contract is more in the nature of an option. Alternatively, a contract may be styled as an option, and bear the option label and terminology, even though it does not by its literal terms provide a right to buy or sell an underlying asset at a set price and date. In these situations, proper characterization of the contract depends upon being able to precisely identify the essential elements of an option.

Both of these challenges have arisen in the financial product sector in recent years, as Wall Street has churned out a whole host of new option-like financial products that defy easy categorization for federal income tax purposes. The likes of these products is so exotically different from traditional option products that tax professionals have seemingly tied themselves into Gordian knots trying to classify them. As it happens, two of the earliest such products, namely catastrophe options and weather derivatives, have either fizzled out (catastrophe options) or have enjoyed relatively modest growth (weather derivatives).[1] While the income taxation of these products has yet to be fully resolved, the financial world has not exactly been standing still waiting for closure from the tax realm. Most recently, investment banking firms have been unveiling a wide array of so-called economic derivatives, which offer cash-settled options on various categories of published economic data, such as fluctuations in gas storage inventories or unemployment figures, and accordingly give rise to similar concerns.

All of the aforementioned products are cast in the form of options, but because there is no underlying property interest, commentators have questioned whether they should truly be respected as options for tax purposes.[2] Another modern-day option-type product, known as a credit default swap, suffers from the opposite problem. Although it is not styled as an option, a credit default swap has option-like features. However, because this product requires resolution of a contingency prior to paying off, some commentators have raised questions as to whether such a contingent product can truly qualify as an option.[3]

In terms of its importance to the financial world, the credit default swap looms much larger than all the preceding product categories combined. According to the latest data, the volume of outstanding credit

[1] The total volume of weather derivatives transactions in 2004 was $8.4 billion, according to the Weather Risk Management Association. www.wmra.org.
[2] See, e.g., Thomas Humphreys, Gambling on Uncertainty – The Federal Income Tax Treatment of Weather Swaps, CAT Options, and Some Other New Derivatives (Nov. 2, 1998) (Tax Forum No. 528).
[3] See, e.g., Matthew Stevens, The Tax Treatment of Contingent Options, Tax Notes 525 (Jan. 26, 2004)(Example 4)
.

derivatives in the first half of 2005 exceeded $12.4 *trillion*. This represents a year-on-year growth rate of 128% from $5.44 trillion at mid-year 2004.[4] While the market for the other new products is still relatively young, credit derivatives have clearly become an integral part of the financial market. Obviously, we have reached a point at which attention must be paid.

The international or cross-border arena stands at the epicenter of the tax world's concern, since knowing whether or not a credit derivatives product is truly an option or not has important withholding tax consequences. Simply put, it is imperative that contracting parties know whether the product is a bona fide option, in which case cross-border payments may be made on a tax-free basis,[5] or whether the product might be better characterized as some other category of financial product, such as a guarantee or insurance, that might be fully subject to dreaded withholding or insurance excise taxes.[6] In the ever burgeoning credit derivatives market, hundreds of millions of dollars are riding on a favorable resolution of this question. For this reason, knowing how credit default swaps should be classified may be the single most important topic confronting the tax world today.[7]

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[4] ISDA's 2005 Mid-Year Market Survey, available at http://www.isda.org.

[5] Credit derivatives would also avoid withholding tax if they could be classified as "notional principal contracts." Withholding tax under that classification would be avoided because the regulations source such payments at the residence of the recipient. Treasury Regulation § 1.863-7(b). See also Treasury Regulation § 1.1441-4(a)(3) (generally no withholding on notional principal contracts). Leading commentators have urged this approach. *See, e.g.,* Gregory May and Robert Scarborough, Attorneys Advise Against Issuing Further Guidance on Credit Default Swaps (Oct. 1, 2002), 2002 TNT 226-21 (hereinafter "May and Scarborough"); David Nirenberg and Stephen. Kopp, Tax Treatment of Total Return Swaps, Default Swaps and Credit Linked Notes, 87 J. Tax'n 82 (August 1997). In truth, however, neither one of these product categorizations unambiguously fit these new financial products. With respect to the option analysis, substantial doubts have been expressed as to whether a contingent option can truly be regarded as an option for tax purposes. Doubts have also been expressed as to whether these products truly satisfy the definition of notional principal contracts or whether they sufficiently resemble them economically. These issues are discussed more fully in Part V below.

[6] Bruce Kayle, Will the Real Lender Please Stand Up? The Federal Income Tax Treatment of Credit Derivative Transactions, 50 Tax Lawyer 561 (1997), (suggesting that a CDS may be more analogous to a guarantee or letter of credit).

[7] In Notice 2004- 52, 2004-32 IRB 168, the IRS launched a project to characterize and determine the tax treatment of credit derivatives. A number of practitioners have weighed in with commentaries on the proper treatment of these products. *See, e.g.,* ISDA Comments, 2003 TNT 232-17; Jonathan Talisman and Joseph Mikrut, Writers Make Second Request for Guidance on Credit Default Swaps (July 02, 2002), 2002 TNT 148-34; May and Scarborough, note 5; David Garlock, Harold Leventhal and Alan Munro, E&Y Comments on Tax Treatment of Credit Default Swaps 2005 TNT 16-21; New York CPA Group Comments On Credit Default Swap Rules. 2005 TNT 215-12, November 7, 2005); New York State Bar Association, Report on Credit Default Swaps (September 9, 2005) (NYSBA 2005 CDS Report) available on NYSBA's website at http://www.nysba.org/taxreports/ .

Unfortunately, there is precious little guidance on just what makes an option an option for tax purposes.[8] Usually, an option is defined as an agreement whereby one party pays the other a premium in exchange for the right, but not the obligation, to buy or sell property. This deceptively simple and straightforward definition masks a whole host of important questions. What elements are really necessary to cause an economic arrangement to be treated as an option for federal income tax purposes? Is it really essential for a premium to be paid in exchange for an option, and to the extent that it is, must it necessarily be paid upfront? Is an option still an option if the premium is payable on the exercise date, rather than when the contract is executed? Is an underlying property really a necessary element for the existence of an option? Does a non-property based option still qualify as an option? If so, how does a non-property-based option differ from a wager? What if an option contract is subject to a contingency? Does the contingency obviate the essential nature of an option contract as an option? How is it possible to differentiate between an option and a financial swap? For all the apparent clarity subsumed in the traditional definition of an option, there is little authority on these underlying questions, and yet the question of what constitutes an option is of vital importance to the financial product sector. The purpose of this paper is to develop an appropriate standard for ascertaining whether a product should be treated as an option for tax purposes, and, ultimately, to apply that standard to the latest generation of financial products.[9]

I. OVERVIEW OF NEW FINANCIAL PRODUCTS

[8] The absence is not for want of trying. There have in fact been several good articles on the nature of options. See, e.g., Bruce Kayle, Realization Without Taxation? The Not-So-Clear Reflection of Income from an Option to Acquire Property, 48 Tax Law Rev. 233 (Winter 1993); Humphreys, note.2; Stevens, note 3.

[9] This article addresses only standalone options, in which the option element is transaction-determinative, in contrast with secondary or embedded options that are an incidental part of a larger bilateral executory contract. Bilateral contracts typically entail a bundle of rights and obligations, and as such they commonly address contingencies that may provide for alternative paths through embedded options. For instance, the pre-payment option in a home mortgage is designed to deal with an unanticipated home sale. An auto lease might allow customers to terminate the lease early and return their car in the first 12,000 miles for any reason, without incurring any penalty. Loan agreements typically contain covenants that allow the bank to take action when a borrower's default risk increases. Each of these provisions constitutes a mechanism for dealing with unspecified contingencies, and as such are analogous to options. Generally, these options are incidental to a larger transaction (i.e., a mortgage, a lease, or a loan), they are not easily severed, and may be difficult to separately value. Accordingly, they are outside the scope of this article.

A. *Credit Default Swaps*

Before delving into the relevant authorities on options, it is worthwhile to reflect more fully on the latest generation of financial products whose classification for tax purposes has been subject to continuing doubts.

The most important category, credit default swaps ("CDSs"), are option-type derivative products that allow market participants to put a price on, and thereby transfer to a counterparty, third-party credit risk. Although these products have payout terms reminiscent of options, they generally are not cast as options in form. In the simplest form of CDS, one party (often referred to as the credit protection buyer) makes either a single lump sum payment or a series of periodic payments that are based on a notional principal amount, in exchange for a contingent payment from the other party (the credit protection seller) that is triggered solely upon the happening of a "credit event" regarding a reference obligor, i.e., a specified company that has outstanding indebtedness.[10] The happening of a defined credit event and the calculation of the settlement amount due from the seller are determined by reference to objective financial information. A credit event can be a default on any obligation of the third party obligor (a reference obligation) or some other specified event that indicates a decline in the creditworthiness of the third party.

If there is no credit event, the product simply expires worthless. If there is a credit event, the credit protection buyer must pay the credit protection seller for the decline in value of the reference obligation. The terms of payout very from product to product, but in general, a CDS may be either cash-settled or physically settled. If settled in cash, the protection seller generally will pay the buyer an amount equal to the excess of the notional principal amount of the CDS over the reference obligation's post-credit event fair market value or, in some cases, a predetermined fixed amount. If settled physically, the protection buyer delivers to the protection seller a "deliverable obligation"[11] and receives the par amount of that deliverable obligation. It is not necessary for the credit protection buyer to actually own a deliverable obligation of the third party obligor; if physical settlement is provided for, the protection buyer should be able to purchase one in the marketplace if need be.

B. *Non-Property Based Options*

[10] In more complex forms, referred to as basket products, the product may reference multiple obligors.

[11] "Deliverable obligations" are specified types of obligations of the reference entity that may be tendered, and which are generally expected to approximate the post-credit event value of the reference obligations.

Unlike the credit default swap, all of the other product categories described in the Introduction are actually styled as options, but they differ from conventional options insofar as they lack an underlying property. Product categories fitting this description include catastrophe options, weather derivatives, prepayment derivatives, storage derivatives, and economic derivatives.

Catastrophe Options. One of the oldest and perhaps best-known products of this genre, catastrophe options, or CAT options,[12] gave the holder, in exchange for an upfront option premium, a specified cash payment if and when an index thatm easured insurance industry catastrophe losses exceeded a certain level. If the index failed to reach that threshold, the option expired worthless, and the seller kept the premium. Payout might be tied to an earthquake reaching 7.0 or higher in moment magnitude, a measure of earthquake intensity similar to the more commonly known Richter scale. These options were used mainly by insurance companies to hedge catastrophe risk.

Weather Derivatives. Weather derivatives, which have enjoyed steady growth since their introduction in the late 1990's, employ a weather-related construct as the basis for determining payouts under financial contracts that are styled as either cash-settled options contracts or swaps. These products are generally tied to an index measuring some aspect of the climate, such as temperature, precipitation, or wind speed. To date, most contracts have been temperature-related, so called "degree-day options" which have payouts that are linked to the extent to which daily average temperatures rises or falls below a benchmark temperature of 65° Fahrenheit. These instruments require days of the month to be classified as either cooling degree days ("CDD's) or heating degree days ("HDD's), depending on whether the average of the highest and lowest temperature during a particular day at a specified weather station exceeds, or falls short of, 65 degrees Fahrenheit.[13] A particular contract specifies a fixed number of such cooling degree days (or heating degree days) as the strike price, and if during the relevant period the number of such days exceeds the number fixed in the contract, the option pays out.[14]

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[12] CAT options were ultimately delisted by the Chicago Board of Trade (CBOT) in the year 2000 due to lack of trading volumes.

[13] More precisely, cooling and heating degree-days are defined as follows :

Daily CDD = max (daily average temperature – 65° Fahrenheit, 0)

Daily HDD = max (65° Fahrenheit – daily average temperature, 0)

[14] A CDD season generally runs from May to September, and HDD season runs from November to March. The final settlement price is defined by the HDD or CDD (cumulative) index of the contract month for a specified city as calculated by Earth Satellite Corporation (Earth Sat), an international service firm. The products are available on the Chicago Mercantile Exchange or as privately negotiated weather derivatives, which are typically documented under a master agreement such as the ISDA Weather Swap Confirmation.

Otherwise, the options expire worthless. Since HDD's and CDD's are not currency units, they must be translated into dollars under the terms of each contract. Thus, payoff should equal the number of such excess days multiplied by a specified notional amount.

Economic Derivatives. Options on economic statistics constitute a whole new class of options that reference various real economic data releases. The derivatives are bought and sold in Dutch auctions[15] prior to the public release of the relevant economic data, with the options settling according to the release. The options pay the difference between the selected strike price and the actual outcome.

Mortgage Prepayment Derivatives. Similarly, mortgage prepayment derivatives, another new type of option that is traded through monthly auctions, have payoffs dependent upon the prepayment speeds of mortgage backed securities. In particular, payout is determined by reference to the realized monthly conditional prepayment rate ("CPR") of the benchmark FNMA 30-year mortgagee-backed securities ("MBS") issued in a specific year.

Storage Options. Options on gas storage contracts, known as inventory options, are cash-settled options on the weekly natural gas storage number released by the Energy Information Administration (EIA) of the U.S. Department of Energy. The auction, which takes place a day ahead of the weekly release of the gas storage number, gives traders an opportunity to buy and sell options that pay off, or not, depending on where the storage number comes out. The weekly change in the inventories determines which options are in-the-money and which are out-of-the-money. The strike units of the options is the number of billions of cubic feet of natural gas or millions of barrels of oil that could potentially be the difference in inventory from the previous week's report.

All of the aforementioned options resemble ordinary options in virtually all respects, save for the presence of an underlying property. As in the case of conventional options, participants are able to go long or short the statistic using call and put options. Investors can choose from a range of strike prices, and payout profiles conform to standard option conventions. In the case of so-called vanilla options, payoff is determined based on the difference between the relevant strike price and the actual data release. Call (put) options expire worthless if settlement is below (above) the option strike. Digital options are binary options which either expire worthless, or pay a specified dollar amount regardless of how much

[15] Dutch auctions enable liquid markets to develop in the absence of an underlying instrument. In a Dutch auction, option prices are determined by the market, based on the relative demand for outcomes among all market participants.

in-the-money the option settles. Options are generally booked and settled as standard over-the-counter derivatives documented through ISDA agreements.

Whether or not any of the aforementioned products truly constitutes an option depends on one's ability to identify the essential elements of an option, which as noted is famously lacking under current law. In the case of non-property options, does any product that is cast in the form of an option automatically qualify for the benefits of options taxation? With respect to credit default swaps, the operative question is whether contingent options truly qualify as options for tax purposes. These questions will be taken up in Parts III and IV below.

C. *Option Ambivalence*

Before proceeding down these respective paths of inquiry, it bears some acknowledgement that tax professionals have long been ambivalent about the tax regime governing options, with many leading practitioners openly questioning whether the historical regime really gets it right.[16] Options are subject to a unique set of tax rules, making them somewhat of an anomaly in the tax realm. For example, upfront payments for options are not subject to immediate taxation, nor, for that matter, are they required to be taken into income until the time of exercise. The option holder, for its part, is not allowed to deduct or amortize option premiums. In the case of credit default swaps, leading practitioners are ambivalent about option characterization; it would result in satisfactory results for withholding tax purposes, but less than optimal results on issues of timing and character.

Whether or not the longstanding rules for taxation of options are correct, it is important to ascertain in the first instance the true nature of these latest financial instruments. If it turns out, after careful reflection, that these products are not options, contrary to what is argued here, it may well be that they merit their own *sui generis* method of taxation after all. However, before undertaking that approach, it behooves us to first see if it is possible to rule out any of the existing financial categories. In order to

[16] See, e.g., New York State Bar Association, Report on Timing and Character Rules for Prepaid Forwards and Options (2001); David Weisbach, Colloquium on Financial Instruments: Tax Responses to Financial Contract Innovation, 50 Tax L. Rev. 491 (1995); Kayle, note 8. Noel Cunningham & Deborah Schenk, Taxation with Realization,: A Revolutionary Approach to Ownership, 47 Tax L.Rev. 725 (1992); Reed Shuldiner, General Approach to the Taxation of Financial Instruments, 71 Tex. L. Rev. 24, (December, 1992).

undertake that task, it is important to properly identify what qualities truly make a product an option. The premise of this article is that once we have properly identified an option's crucial characteristics, we should be able to conclude that these products are in fact options properly speaking, obviating the need for a separate new financial product category.

Having introduced some of the new financial products, the next order of business, then, is to thoroughly vet the relevant case law for guidance as to what elements are essential to the existence of an option, which is the topic of the immediately following section. In reviewing the relevant case law, the objective is to derive and substantiate as a matter of law a sufficiently workable definition for what constitutes an option against which the various new kinds of financial products may be analyzed. The operating premise of this paper is that unless we can first identify what an option truly is for tax purposes, there seems little basis upon which to conclude whether or not any of these specific financial products should properly be treated as options for tax purposes.

II. IN SEARCH OF A COMMON LAW DEFINITION OF AN OPTION

A. Economic Rationale For Option Premiums

Although the term option is used in various Internal Revenue Code ("Code") sections[17] and is prominently featured in various sets of attribution rules,[18] neither the Code nor the regulations define the term "option." Cases involving a determination of whether or not a contract is an option usually cast the definition in terms of contract law notions of offer and acceptance. The primary legal effect of an option, according to these cases, is that it limits the promisor's ability to revoke his or her offer, creating, in effect, an unconditional power of acceptance in the offeree.[19] . This definition appears to closely track the definition of options found in contract law treatises and Restatements of Law.[20]

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[17] See, e.g.., Secs. 318(a)(4); 1032, 1233, 1234, 1236.

[18] See, e.g. Sec.318(a)(4), Sec. 958, regarding the definition of controlled foreign corporation; Sec. 1297(a)(4), regarding the attribution of stock in a PFIC; Sec. 1563(e)(1), regarding the definition of controlled group of corporations; and Sec. 382, regarding a change in ownership.

[19] See, e.g. Saviano v. Comm'r, 80 T.C. 955 (1983) (An option contract has two elements: (1) a continuing offer to do an act, or to forbear from doing an act, which does not ripen into a contract until it is accepted; and (2) an agreement to leave the offer open for a specified period of time.) See also, Old Harbor Native Corp. v. Comm'r, 104 T.C. 191, 201 (1995); Koch v. Comm'r, 67 T.C. 71, 82 (1976); Carter v. Comm'r 36 T.C. 128, 130 (1961); Drake v. Comm'r, 3 T.C 33, 37 (1944).

[20] 1 Williston on Contracts §§ 5:15 and 5:16 (4th ed. 2004) describes an option as a unilateral contract which binds the optionee to do nothing but grants him the right to accept or reject the offer in accordance with its terms. The Restatement, Contracts 2d,

This formulation of the option definition recognizes that an option is fundamentally a contract that is antecedent to some other, more fundamental transaction. Buyers in effect pay a non-refundable amount in return for time to decide whether or not to conclude an underlying transaction. This oft-cited definition at least has the virtue of suggesting why parties enter into options in the first place and the reason why options call for the payment of a premium by the option holder. After all, parties in the midst of negotiations normally have the right to withdraw an offer prior to its acceptance, and an offer that is irrevocably left open for a period of time has real value to the other party. As such, it is something that must be paid for in order for the "free option" to be legally binding. In short, some consideration is required to be paid in order to induce the other side to relinquish a valuable legal right – the discretionary right to take back an ill-considered offer.[21]

The case law emphasizes the significance of free choice on the part of the option holder to proceed with the underlying transaction, especially in juxtaposition to the corresponding absence of free choice on the part of the option writer. According to the Claims Court in *United States Freight Co. v. United States,* an option gives rise to an irrevocable offer on the part of the owner of the underlying property, obliging it to comply, come what may, while at the same time granting the purchaser a *choice* of whether or not to buy the property at the specified price within the time specified in the contract. In short, it imposes on the option holder no obligation to consummate the transaction, allowing it the choice of exercising the option and performing or allowing the option to lapse.[22] In that respect, an option is a contract in which obligations of the parties to perform their respective sides are not symmetrical.[23]

In order for the option holder's choice of performance to be meaningful, the contract by its terms must limit its liability for damages for failing or refusing to perform, in contrast to the option writer whose liability is not so limited. As a practical matter, free choice is typically

Sec. 25(d) defines an option contract as a promise which meets the requirements for the formation of a contract and limits the promisor's power to revoke an offer.

[21] Assuming that it encompasses the basic requirements of a valid contract, including mutual assent, consideration, legality of subject matter, and compliance with the statue of frauds, an option contract is an enforceable contract under applicable state law.

[22] 422 F.2d 887, 894-895 (1970).

[23] See, e.g., Saunders v. United States, 450 F.2d 1047 (9th Cir. 1971) (An option is limited to unilateral agreements which inflexibly bind the owner of property, but not the counterparty.); See also, Koch v. Commissioner, 67 T.C. 71, 82 (1976)(the clear distinction between an option and a contract of sale is that an option gives a person a right to purchase at a fixed price within a limited period of time but imposes no obligation on the person to do so, whereas a contract of sale contains mutual and reciprocal obligations, the seller being obligated to sell and the purchaser being obligated to buy).

achieved through the mechanism of requiring the holder to pay an acceptably low upfront option premium at the inception of the contract, while absolving the option holder from any further liability if he is subsequently unable or unwilling to pay the full purchase price.

B. *Capped Liability and Free Choice*

Normally, option premiums are separately stated in the option agreement, and the contract relieves the option holder from any obligation to pay liquidated or any other damages to the writer for failing or refusing to perform. If the option is not exercised, the writer becomes entitled to keep only the amount paid as consideration for granting the option and has no enforceable right of action against the option holder for damages.[24] In that respect, an option premium bears some economic resemblance to a liquidated damages clause in a regular bilateral contract, because it sets the maximum liability exposure of the option holder to the option writer for non-performance. In fact, an option premium may be viewed as a special category of liquidated damages provision, albeit one that typically calls for payment in advance. Holders who choose not to consummate a transaction by declining exercise of the option bear only the cost of a pre-determined (and generally, previously paid) amount which may bear no relation to the damages that might otherwise arise if they were calculated as of the exercise (or closing) date. As the Tax Court explained in *Estate of Franklin v. Commissioner*,[25] an agreement not styled as an option may constitute an option if its provisions enable the "purchaser" to withdraw from the agreement without incurring any additional liability"

In contrast, the option writer's potential damages for non-performance would not ordinarily be so limited. The writer is generally held fully liable for any damages for its non-performance, measured on or after the time of exercise.[26] One of the trademark features of an option, therefore, is an executory contract which has, implicitly or explicitly, unbalanced or uneven liquidated damages provisions as between the two contracting parties. In other words, options are contracts which tend to provide for sharply circumscribed damages for one party, but not the other.[27]

[24] United States Freight Co. v. United States, 422 F.2d at 895. (Ct. Cl. 1970).

[25] 64 T.C. 752, 767 (1975), aff'd, 544 F.2d 1045 (9th Cir. 1976),

[26] A contract of sale imposes an enforceable obligation to pay the purchase price. Accordingly, the purchaser in a bilateral contract is liable for full contract damages if she fails to perform. United States Freight Co. v. United States, 422 F.2d at 895. (Ct. Cl. 1970).

[27] If an option is not exercised, the option holder becomes entitled to keep only the amount paid as consideration for granting the option and has no enforceable right of action against the optionee for damages. Id. at 895. A contract of sale, in contrast, carries mutual obligations on the part of the seller to sell and the buyer to buy. See W. A. Drake, Inc. v. Commissioner, 145 F.2d 365, 367 (10th Cir. 1944), affg. 3 T.C. 33 (1944); Lawler

In order to have a bona fide option, the amount of the option premium should generally be much less than the holder's potential liability for non-performance in a conventional bilateral contract. In a normal bilateral contract, damages are determinable after the fact, based on the value of a party's position measured as of the closing date. By contrast, the amount of an option premium is determined at the inception of the contract, not on the exercise date, before any underlying contingencies have been resolved. In fact, this distinction goes to the heart of the bargain that is negotiated for in an option contract. Because the amount payable is determined at inception, the prospective amount of damages embodied by the option premium reflects only the *potential* value of the holder's position, meaning that it is discounted by the contingency underlying the option.

Suppose, for purposes of illustration, that a property owner owns property worth $100 that has a 50% chance of appreciating in value to $120 and a 50% chance of declining in value to $80.[28] Assume further that the owner writes an option to buy the property for $100, effectively providing for a $20 payout if the property appreciates in value, in exchange for a $10 upfront premium. The option writer may be willing to relinquish the upside potential on the property for only $10 at the contract's inception, because of the substantial doubt as to payoff, even though the position might be worth $20 once the contingency has been resolved. By contrast, if she entered into a conventional forward sales contract for $100 and the property declined in value instead of appreciating, a putative buyer would be fully liable for $20 in damages for failing to perform. The "bargain" to the option holder is attributable to the fact that the "damages" are fixed in advance of the resolution of the contingency that is the basis for the option.

There is clear recognition in the case law for the notion that a liquidated damages provision in a bilateral contract can operate to convert what is formally a bilateral purchase and sale contract into an option, at least as long as the amount of stipulated damages is sufficiently low. A common fact pattern in some of the earliest cases involves a taxpayer entering into a purchase and sale agreement which requires the property buyer to make a down payment at the time of signing, and provides for forfeiture of the down payment as liquidated damages in the event that the

v. Commissioner, 78 F.2d 567, 568 (9th Cir. 1935). The purchaser in such a bilateral contract is liable for full contract damages if he fails to perform. United States Freight Co. v. United States, 422 F.2d at 895.

[28] Of course, in the real world, property values are not literally binary, but for any equilibrium price, a given property should have an equal probability of alternately increasing or declining in value by a given amount. Although the potential variations in value are seemingly limitless, the point is that for any particular variation, the probability of an increase or a decrease in value by that amount should be the same.

buyer fails to close on the sale. The down payment in these cases clearly corresponds to the premium typically paid upfront on an option contract.

In *Lawler v. Commissioner,*[29] the issue was whether a sales contract which had a liquidated damages provision should really be treated as an option contract for tax purposes. *Lawler* involved a contract for the subdivision and sale of a 703-acre tract of land which provided for a down payment to be made at the inception of the contract, and for the land to be deeded in trust pending a closing of the sale in a later year. The classification issue was relevant to the problem of identifying the taxable year in which the sale should be deemed to take place for tax purposes, either the year of inception, or if the contract were truly an option, in a later year. Although the contract was not labeled an option contract, the court construed its provisions as amounting to an option which was exercised by the buyer's act of subdividing and platting a parcel of land within the larger area. In reaching that conclusion, the court honed in on the implications of the relevant liquidated damages provision, stating that

> The agreement also fixes the rights of the parties in a case of failure of the buyer to perform his obligations with diligence. . . . [It] is sufficient to say there is no provision for the payment by the buyer of any portion of the purchase price after the seller has exercised his option to terminate the contract. It is provided that all sums theretofore paid shall be retained by the seller as "liquidated damages."

Accordingly, the court held that no sale could have taken place at the inception of the contract, insofar asthe contract was in the nature of an option.

Another landmark option case, *Estate of Franklinv. Commissioner*,[30] involved whether a purported sale and leaseback of a motel was in substance an option. In finding that the contracts granted only an option to purchase the property, the court noted that a distinguishing characteristic of an option is that it imposes no obligation on the option holder to complete the transaction. Applying this rule to the facts presented, the court found that neither the sales agreement nor the lease obligated the putative purchaser to buy the motel or pay anything in the way of damages if it failed to do so. In reaching this conclusion, the court noted that the purchaser's liability was limited to a forfeiture of its rights under the sales agreement and thatit was released from any further liability. As the court pointed out,

[29] 78 F.2d 567 (9th Cir. 1935).
[30] 64 TC 752 (1975). affd., 544 F.2d 1045 (9th Cir. 1976).

> if the partnership fails to consummate the sale, it will lose only its rights under the contract to buy the motel property on January 15, 1979, at the computable price. It cannot be compelled to assume the mortgages or pay any other portion of the option price.

On that basis, the court concluded that the contracts essentially gave rise to an option, notwithstanding that the parties never literally documented their relationship in that fashion.

The absence of any guidance as to the true essence of what constitutes an option has occasionally caused courts to incorrectly treat certain bona fide option contracts as ordinary bilateral contracts.[31] Conversely, the lack of guidance has at other times prevented courts from recognizing that a purportedly bilateral executory contract is in reality an option. For instance, when the putative buyer in a purchase and sale contract fails to close on an underlying transaction, resulting in forfeiture of his down payment, his situation is comparable to an option holder whose option has lapsed, resulting in a loss of the option premium. If the putative sales contract had been drawn up as an option contract, with the would-be buyer failing to exercise the option, the resulting loss on the lapse of the option premium would get capital loss treatment by virtue of Section 1234, which treats the lapse of an option as a sale of exchange of property. The issue in the cases where there are analogous down payments is whether the buyer's failure to exercise its right to purchase, and the concomitant forfeiture of the down payment as liquidated damages, similarly constitutes the sale or exchange of a capital asset.[32]

Harold S. Smith v. Commissioner,[33] for example, involved a forfeited down payment in the context of a contract of sale. The Tax Court in that case found the loss to be an ordinary loss, and the court of appeals agreed, but both courts did so without even addressing the potential relevance of Section 1234, the statutory option rule (or its predecessor, former Sec. 117(g)(2)) to the character of income (capital vs. ordinary) issue. In fact, the issue of option equivalence is not mentioned in either one of the reported decisions. The resemblance of the contract to an option contract apparently escaped the notice of each of the parties as well as the judges of the two tribunals. Relieved of the need to differentiate a sales contract from an option contract, the Tax Court relied on a line of older decisions holding that liquidated damages received by a seller upon the buyer's breach of a contract to purchase must be reported as ordinary income. In none of the cited cases, however, did the relevant

[31] See *Old Colony*, discussed at length in Part IV(E)(2) below.

[32] Under the common law applicable at the time, payments in settlement of a contract generally gave rise to ordinary income. The case would not arise under current law, since sale or exchange treatment would in any event be warranted under section 1234A.

[33] 50 T.C. 273 (1968), aff'd, 418 F2d 573 (9th Cir. 1969).

contracts economically resemble options, because in each of those cases the liquidated damages provision did not serve as the seller's exclusive remedy. In short, the contracts in question in the cited authorities did not in fact cap the buyer's liability for non-performance, as would be necessary in order for the contract to constitute a true option.[34]

The option-resemblance issue was squarely addressed in *U.S. Freight Co. v. United States*,[35] a case in which the IRS sought capital loss treatment by attempting to apply section 1234 to an option-like contract. The court in that case sided with the taxpayer, arguing that insofar as the contract in question was not by its terms an option contract, the statutory option rule was not literally applicable. As the court explained,

> And in the quite different situation where an option to purchase property expires without having been exercised, a specific statutory provision, section 1234(a), supplies the necessary sale or exchange upon which capital loss treatment depends. But in the case now before us, where a contract to purchase property is unilaterally breached by the buyer, the right to purchase being thereby relinquished, and the down payment is forfeited as liquidated damages, we perceive no sale or exchange in the traditional sense, nor do we understand there to be a statutory provision to satisfy the requirement.

The court in *Freight* recognized that option contracts have fundamentally different economic consequences compared to bilateral executory contracts, due to "the dissimilar rights and liabilities incident to each." As the court explained,

> The holder of an option to buy has the truly alternative choice of exercising the option, or allowing it to lapse. … If the option is not exercised, the amount paid for the option is forfeited and the optionor is entitled to that amount only, as the optionee was not obligated to perform. The purchaser in a bilateral contract with a liquidated damages provision, if he fails to perform, however, is liable for full contract damages, the liquidated contract amount being a measure thereof only to the extent that it is reasonably so related. … The compared interests do not have, as defendant suggests, the same economic effect. (citations omitted)

Ironically, although the court's explanation of the difference between options and ordinary bilateral contracts was well-founded, the

[34] See W. A. Drake, Inc. v. Commr, 145 F.2d 365, 367 (10th Cir. 1944), affg. 3 T.C. 33 (1944); A. M. Johnson v. Comm'r, 32 B.T.A. 156 (1935).
[35] 422 F2d 887 (Ct. Cl. 1970).

court's application of the law to the facts of that case seems wrong. In particular, the court rejected the argument that the liquidated damages provision in the contract under review operated to convert what was formally a bilateral purchase and sale contract into an option because it apparently believed that the liquidated damages remedy was not the seller's exclusive remedy. The court also appears to assume that the seller in fact reserved the right to enforce his full rights against the purchaser in lieu of claiming the amount stipulated as liquidated damages. However, the facts as stated in the court's own opinion do not bear out that conclusion. The sellers in *Freight* had in fact agreed to relinquish their claims for any other damages, which would make the contract more like an option, based on the court's own definition of what constitutes an option. The court appears to have been influenced by the fact that the sellers had explicitly declined to enter into an option contract before entering into the sales contract. Be that as it may, the fact that the resulting contract had similar economic effect to an option contract should have led the court to a different conclusion.

Despite reaching the wrong result on the facts, the explanation of the distinction between an option contract and a bilateral sales contract in the Claims Court's opinion in *Freight* is well-founded, and is on a par with the Tax Court's expressed understanding of an option in *Estate of Franklin*. According to the Tax Court in *Franklin*, a contract is an option if the provisions of the agreement permit the buyer to withdraw and incur no liability other than his initial payment.[36] Putting these two cases together, it is possible to derive an appropriate common law litmus test for ascertaining whether a contract should be regarded as an option for tax purposes.

In general, an option arises whenever an executory contract releases one party, but not the other, from liability for full contract damages, if that party should be unable or unwilling to perform his side of the contract, in consideration for that party's covenant to pay, usually upfront, a prescribed amount that is a fraction of the contract amount. In other words, a contract is economically equivalent to an option if the contract, by its terms, caps one party's liability for non-performance at an amount that is significantly less than the full contract amount. In analyzing a particular contract, therefore, the relevant question is whether the contract enables the "purchaser" to withdraw from the agreement without incurring any additional liability at a fraction of the total contract price.

[36] Estate of Franklin v. Commissioner, 64 TC 752 (1975) (Although terms such as "seller" and "purchaser" ordinarily are used only in bilateral sales instruments, an agreement nonetheless may constitute an option if its provisions enable the "purchaser" to withdraw from the agreement without incurring any additional liability.)

It follows, then, that the presence of a liquidated damages provision in a bilateral contract can in some cases operate to convert what is formally a bilateral purchase and sale contract into an option. However, in order to do so, and to vindicate the notion of free choice inherent in the notion of an option, it is essential that the non-refundable amount payable be only a small fraction of the total contract price. Otherwise, the option holder will have too much "skin in the game" as to make exercise a foregone conclusion.[37] In fact, one of the factors that courts have considered in assessing whether or not a contract is an option is the size of the non-refundable payment relative to the total contract price.

In *Lloyd Williams, Jr. v. Commissioner*,[38] for example, the taxpayers signed agreements for the purchase of (to-be-constructed) condominiums in a transaction valued at $500,000, of which $60,000 was due on or shortly after the contract was signed. In the event of default by the buyers, the sellers' exclusive remedy was to retain, as liquidated damages, the $60,000 down payment. According to the court, the transaction was essentially equivalent to the sale of a call option on the property for $60,000, with the call exercisable in the following year. The cost of the purchase option amounted to 12% of the purchase price, which in the court's view was not sufficient to convert the option into a sale at the time that the contract was signed. The court noted, however, that as the amount to be forfeited increases, a point is reached at which there will be a deemed sale. By analogy, in the case of *Baertschi v. Commissioner,*[39] the court found that the transaction resulted in a sale, rather than the grant of an option, when the buyer was required to make a 29% down payment that the seller could retain as its sole remedy. Together, these cases show that when the down payment is substantial in size relative to the balance of the contract, a putative sales contract may be respected as one of purchase and sale, rather than as a true option contract.

The same issue (excessively large down payment) arises in reverse when a contract that is styled as an option calls for an unusually large premium, and a correspondingly small amount payable on exercise. The economic arrangement gives rise to the question of whether or not the putative option holder truly has free choice in whether or not to proceed with the underlying transaction. The issue, in other words, is whether or not there is an economic compulsion on the part of the option holder to exercise his purchase rights.[40] For example, in Revenue Ruling 82-150,[41]

[37] Courts have held that the holder of an option must have a "truly alternative choice" to exercise the option or to allow it to lapse. Freight, 422 F2d at 895; Koch v. Comm'r, 67 T.C. at 82.

[38] 1 F.3d 502 (7th Cir. 1993), affg TC Memo 1992-269 (1992),

[39] Baertschi v. Comm'r, CITE

[40] See Rev. Rul. 2003-7, 2003-5 I.R.B. 363 (holding that a collateralized forward contract to sell stock is not a current sale if the shareholder is not economically

the Service treated the holder of an option to purchase stock as the current owner of the shares when the holder paid 70 percent of the stock's value for the option and the strike price of the option was 30 percent of the stock's value. Similarly, in Revenue Ruling 85-87,[42] a put option sold by the taxpayer was treated as a contract to acquire stock for purposes of the wash sale rules where there was “no substantial likelihood” that the holder would not exercise the option given the spread between the stock’s value and the option exercise price, the premium paid, the historic volatility of the stock, and other objective factors. The term of art for options of this nature is “deep-in-the-money,” referring to options which have a nominal exercise price or that are otherwise substantially certain to be exercised. The holder of a deep-in-the-money option may be treated for tax purposes as directly owning the underlying property, and accordingly be taxed as if he were the direct owner of the property, rather than as the holder of an option.[43]

The Fourth Circuit in *Halle v. Commissioner*,[44] applied the proper analysis for distinguishing between a stock purchase agreement (indebtedness) and an option, describing the following four factors as relevant to its analysis:

> (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.

The court viewed the amount of specified liquidated damages (the first listed factor) as critical to its treatment of the contract as one of sale and not an option contract because "the greater the sanction for failing to

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compelled to deliver the pledged shares); See also American Realty Trust v. United States, 498 F.2d 1194, 1199 (4th Cir. 1974) (upholding a verdict that a transaction was a good-faith sale and lease-back with a repurchase option, in part because the seller was not under “economic compulsion” to exercise the option); see also Comtel Corp. v. Comm’r, 45 T.C. 294, 307 (1965) (arrangement for stock purchase and subsequent sale of stock pursuant to an “option” was characterized as in substance a financing arrangement, in part because the Court concluded, after evaluation of the economic terms of the transaction, that taxpayer was “practically compelled” to exercise the option), aff'd, 376 F.2d 791, 796 (2d Cir.) cert. denied, 389 U.S. 929 (1967).

[41] 1982-2 C.B. 110.

[42] 1985-1 C.B. 268

[43] When both sides are economically compelled to follow through on the underlying transaction, in the sense that non-performance subjects the party to damages that are more than nominal, the contract is more properly regarded as a current sale, at least in situations where the option is exercisable at any time, or at least a conventional forward contract, in situations where the option has a fixed exercise date. In either event, the contract does not get option treatment for tax purposes.

[44] 83 F.3d 649 (4th Cir. 1996).

discharge a contractual obligation, the less free the obligor is to walk away from the deal." Under the second factor cited by the court, 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."[45] Since the buyer in *Halle* had already incurred almost $4 million in costs, which were non-recoverable, the court concluded that the buyer was too vested in the property not to proceed with the purchase.

C. Contemporaneous Conveyance of Underlying Property

Implicit in the *Halle* court's analysis is the notion that a bona fide option is predicated on a delayed transfer of either possession or the benefits and burdens of ownership of the underlying property from the inception of the relevant contract. If there should be a current transfer of possession in conjunction with the granting of an option, the transaction is more properly viewed as a current disposition of the underlying property made on an installment sale basis

In *Commissioner v. Paulson*,[46] the taxpayer contracted in 1923 to purchase a building for $78,000, with the contract calling for an $8,000 down payment, another $20,000 payable later in 1923, and $50,000 payable in March 1934. Upon execution of the contract, the taxpayer took possession, while undertaking obligations to keep the building in repair, keep it insured, and pay taxes. While in possession of the building the taxpayer rented it for profit and made valuable improvements. Pursuant to the terms of the contract, upon the taxpayer's failure to make the final payment in 1934, the property reverted back to the seller, who was also entitled to retain prior payments, and that is what in fact happened. The court concluded that the reacquisition of the building by the seller in satisfaction of the purchase-money indebtedness constituted a sale or exchange and, therefore, the taxpayer was not entitled to deduct the prior payments as an ordinary loss. Similarly, in *Alvin B. Lowe v. Commissioner,*[47] when the buyer made a down payment, gave a note for the balance of the price, took possession and began operation of a hotel in 1955, the court held that there was a completed sale in that year, notwithstanding the later default by the buyer that resulted in a reconveyance of the property back to the original owner.

Finally, the contract at issue in Revenue Ruling 75-563[48] was described as an irrevocable written option for the purchase of land under

[45] Id. at 657.
[46] 123 F.2d 255 (8th Cir. 1941).
[47] 44 T.C. 363 (1965).
[48] 1975-2 CB 199.

which payments were to be made in ten equal annual installments, title to a portion of the tracts to pass with each installment paid. In some respects, the contract resembled a bona fide option. For example, the purchaser could terminate the contract by not tendering an installment when due, in which case he would only be required to surrender possession of the portion of the tract to which title had not passed. However, the purchaser had the right to immediate possession of the entire tract of land, had unrestricted use of the property, and was obligated to pay all real estate taxes and special amounts levied against the entire tract. Under the circumstances, the transaction was treated as a sale from the outset.

D. Options in Disguise: Earnest Money Deposits, Loan Commitments, and Wal-Mart's Layaway Plan

Based on the foregoing analysis, the defining characteristic of an option is the undertaking by one party at the inception of the contract to make a guaranteed non-refundable payment to the other --ordinarily paid upfront -- that is a fraction of the contract price, and whose payment relieves the payor of any further liability if it should be unable or unwilling to perform its end of the contract on or before the proscribed closing or exercise date. This definition is well-grounded in such case law precedents as *Lawler, Estate of Franklin, U.S. Freight Co.,* and *Halle*. However, many recent cases concerning options have overlooked these authorities and focused more on language from recent cases such as *Old Colony* which are not really very illuminating in differentiating between options and other ordinary bilateral contracts.

In reviewing some of the earliest cases, it is apparent that taxpayers have at times entered into options without quite realizing it, since the contracts call for non-refundable upfront payments but are not labeled as options. The question that inevitably arose in these cases was how to account for the upfront payments that the property sellers received at the inception of their respective contracts.[49] Given the dearth of any real

[49] For example, in Bourne v. Commissioner, 62 F.2d 648, 649 (4th Cir. 1933), affg. 23 B.T.A. 1287 (1931), the taxpayer entered into a contract to sell property the following year, with payment of $5,000 due on signing, and the remaining $20,000 due at closing. The court held that the $5000 deposit was not income until the property sale closed or failed to close, which is consistent with the rule for options.

Similarly, in Baird v. United States, 65 F.2d 911, 912 (5th Cir. 1933), a partnership entered into a contract to sell an oil and gas lease for $2,500,000, with $500,000 payable upon signing, and another $300,000 due at closing along with a promissory note for the balance. The agreement further provided that upon the failure of the buyer to make the payment of $300,000 on or before February 8, 1920, the seller would have the right and option to declare the contract forfeited and to retain the sums already paid in full liquidation and settlement for damages, in lieu of any other or further damages whatever, and to discharge the buyer from any and all liability incurred by virtue of the agreement. The buyer defaulted on the payment of the $300,000. Cast in the terminology of modern

analysis of the defining features of an option, along with the apparent unawareness on the part of the various parties that the contract may constitute an option contract, it is hardly surprising that the courts and the IRS have struggled to reach consistent results in all of the cases that have come their way.

The best evidence of this confusion can be found in the fact that certain common transaction patterns featuring options have given rise to their own proprietary lexicons to describe the premium payments. For example, the real estate sector uses the term “earnest money deposit” to refer to forfeitable down payments, while the term of art in the banking sector is “commitment fee.” Even retail consumers who are not quite sure that they really need that new camera have for many years had the opportunity to enter into options to purchase the merchandise, at least when shopping at such discount retailers as Wal-Mart and Target. In the retail sector, the preferred terminology is “layaway.”

Earnest Money Deposits. It is common in real estate transactions for prospective buyers to make an earnest money deposit at the inception of the contract. If the buyer changes his mind and decides not to buy the property that is the subject of the agreement, the seller typically is allowed to retain the deposit, and the buyer is relieved of any further liability to the seller. Interestingly, the cases which have addressed the tax treatment of earnest money deposits have essentially given them option treatment. That is, the recipient was not required to include the deposit in income until the buyer defaulted.[50] However, the courts in these cases generally reached this result without ever appearing to recognize that the underlying contract was essentially an option contract. [51]

Loan Commitments. When lenders issue a loan commitment to a potential borrower, they typically charge a commitment or loan origination fee, usually a percentage of the proposed loan, in return for the lender's agreement to make a future loan at a specified rate of interest. In essence, they are fees for having money made available on a when-needed basis. Likewise, much bank lending is in the form of lines of credit which give the borrower the right to borrow money as the need arises, even if their creditworthiness declines. This right clearly has value, because in practice, borrowers tend to draw down unutilized credit lines as they deteriorate

day options, the buyer simply failed to exercise. The court ruled that the premium was not income in the year of receipt, in reliance on North American Oil Consol. v. Burnet and an open transaction analysis.

[50] Bourne v. Commissioner, 62 F.2d 648, 649 (4th Cir. 1933), affg. 23 B.T.A. 1287 (1931). Kang v. Commissioner, T.C. Memo. 1993-601; Kellstedt v. Commissioner, T.C. Memo. 1986-435. Baird v. United States, 65 F.2d 911, 912 (5th Cir. 1933).
[51] Cf. Elrod v. Commissioner, 87 T.C. 1046, 1068-1069 (1986) (Because earnest money is in the nature of a payment for an option, it is included in the seller's ordinary income when forfeited to him.).

towards default. The credit agreement specifies the terms of the proposed loan and generally requires the borrower to pay a nonrefundable commitment fee. The right to increase their borrowing is analogous to the kind of protection sought by holders of options on property against adverse price fluctuations.[52]

Substantively and economically, loan commitments are clearly options to borrow money. However, the IRS has ruled that commitment fees are includible in the income of lending institutions in the taxable year in which it is due or actually received, if earlier.[53] This ruling is directly contrary to the tax treatment of option premiums, which are held in a suspense account until the expiration date. Interestingly, the revenue ruling did not explicitly reject option treatment for commitment fees; it simply never addressed it.[54] The oversight presumably has its roots in the dearth of clear guidelines as to the true essence of an option.

Another possible source of confusion is that the term "commitment fee" is often used in different settings with different meanings, so it is important to give proper consideration to the factual setting in order to avoid confusion. For example, when the Tax Court in *Chesapeake Fin. Corp.*,[55] held that commitment fees which compensate a lender for the performance of services are includible in income upon receipt, it was not necessarily affirming the revenue ruling. The fees in that case were received as a payment for specific services rendered to the borrower in arranging for a favorable loan package for the borrower with an

[52] When real estate investors need to lock in financing for projects under construction or undergoing rehabilitation, they sometimes take advantage of rate-locked forward commitment programs. The lender agrees to grant a borrower a loan that takes effect at some future date, possibly one to two years. The loan is signed at the current interest rate and that rate is held or locked in until the loan begins. Thus, if the current rate is 4% and interest rates rise to 7% in two years, an investor who gets a two-year forward commitment would pay the 4% rate plus a slight premium, rather than 7% when the loan begins in two years. The fee is typically 2 or 3% and is non-refundable.

[53] Rev. Rul. 70-540, 1970-2 C.B. 101 (concerning the treatment of points, commitment fees, and service fees by the lender) The ruling was rendered obsolete in part by Rev. Proc. 94-29, 1994-1 CB 616 – but only with respect to the treatment of points by the lender—the portion of the ruling pertaining to commitment fees is still valid.

[54] By comparison, the Tax Court held that nonrefundable "commitment fees" that loan originators paid to the Federal Home Loan Mortgage Corp. (Freddie Mac) should be recognized as premiums for put options, and therefore were not taxable income to Freddie Mac vs. Comm'r, 125 T.C. No. 12 (2005). Despite the favorable holding, the court took pains to note, in dicta, that the commitment fees in that case were distinguishable from the commitment fees received by lenders for an option to borrow money, which is the situation that was addressed by the revenue ruling. The court noted that Freddie Mac did not make loans to originators; instead, Freddie Mac agreed to purchase mortgages from them. On that basis, the court reasoned, the commitment fees in *Freddie Mac* did not pertain to an option to enter into a lending transaction, but rather an option to purchase mortgages from mortgage originators. As argued in the text above, the distinction is ill-founded.

[55] Chesapeake Fin. Corp. v. Comm'r 78 T.C. 869 (1982).

institutional investor.[56] The Court explained that the commitment fees compensated the taxpayer for "evaluating the economic potential of the proposed project, finding a willing investor to provide financing and then negotiating two separate commitments, one from the institutional investor and one that it issues to the borrower."[57] On that basis, the Court held that the commitment fees were taxable in the year of receipt. However, *Chesapeake Fin. Corp*. does not address fees of the kind discussed above, namely those that compensate the lender for undertaking a commitment to fund a loan at specified terms if and when the borrower should request the funds.[58]

There is in fact no principled distinction between loan commitment options and other types of options. The lender is paid a non-refundable fee upfront in exchange for obligating itself to lend money on pre-arranged terms, even if circumstances should change. The borrower, for its part, has the right to borrow the money, or not to borrow, as it sees fit. If the borrower decides not to borrow, the lender keeps the upfront fee, but the borrower otherwise has no further obligation to the lender.

On the borrower's side, borrowers have attempted to deduct these commitment fees as interest, but the IRS and the courts have rejected that characterization.[59] Instead, the IRS has held that a commitment fee must be capitalized and amortized over the term of the loan.[60] This happens to

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[56] Id. at 878.
[57] Id.
[58] In fact, in *Chesapeake Fin. Corp*., the Court did not even address whether or not the fees might constitute option premiums. Instead, the taxpayer in Chesapeake Fin. Corp. argued that the "all events" test was satisfied when the loans were actually funded, not when it received the fees.

[59] According to the IRS, commitment fees, i.e., fees charged by a lender to make funds available to a potential borrower on a standby basis are not interest because they are not payments for the *use* of funds. Rev Rul 81-160 , 1981-1 CB 312 revoking Rev Rul 56-136 , 1956-1 CB 92. See also, Metropolitan Mortgage Fund Inc, v. Comm'r, 62 TC 110 (1974) (If the fee is paid out of the potential borrower's separate funds, is not refundable in any event and will not be applied in reduction of any other charge (e.g., points, stated interest, or other fees), the fee is not interest.); Rev. Rul. 70-540, 1970-2 C.B. 101 (Under the above circumstances, the commitment fee is a charge for agreeing to make funds available to *B* rather than for the use or forbearance of money and, therefore, is not interest.).

[60] Rev. Rul. 81-161, 1981-1 CB 313; Rev. Rul. 81-160, 1981-1 C.B. 312. Current law requires that such fees must be deducted ratably over the term of the loan to which they relate, and should not be added directly to the basis of the property that is acquired with the loan proceeds. Loan fees are viewed as part of the cost of acquiring a loan as an asset (see Rev. Ruls. 86-67; 81-161). Generally, the Service does not "look through" the loan to consider the ultimate purpose for which it was secured. Rev. Rul. 81-160, 1981-1 CB 312. Herbert Enoch, v. Comm'r, 57 T.C. 781, 795 (1972) (loan and escrow fees are amortizable over the life of the loan. Square D v. Comm'r.,. 121 T.C. 168 (2003)(amortization allowed for a nonrefundable loan commitment fee equal to 0.3 percent per annum on $1 billion, payable monthly in advance until the bridge loan was disbursed) See also Anover Realty Corp. v. Commissioner, 33 T.C. 671 (1960) (loan

be consistent with characterization of the arrangement as an option. Ironically, the IRS itself has drawn an analogy to options in justifying the need for the borrower to capitalize these fees.

> A loan commitment fee in the nature of a standby charge is an expenditure that results in the acquisition of a property right, that is, the right to the use of money. Such a loan commitment fee is similar to the cost of an option, which becomes part of the cost of the property acquired upon exercise of the option. Therefore, if the right is exercised, the commitment fee becomes a cost of acquiring the loan and is to be deducted ratably over the term of the loan. If the right is not exercised, the taxpayer may be entitled to a loss deduction under section 165 of the Code when the right expires. (citations omitted).

Layaway. Options at the retail level, known more formally as layaway programs, are available at popular discount retailers such as Wal-Mart Stores, K-Mart, Burlington Coat Factory, Marshalls, and TJ Maxx. Instead of buying an item on credit and taking it home, the customer pays a minimum deposit (10% at Wal-Mart) towards a fixed price, and the retailer physically sets the item aside. The customer, who has 60 days to pay the rest before the purchases can be taken home, makes regular payments until the items are paid in full, and then retrieves it from the retailer. There are no interest charges.

If the customer fails to make his payments, then after 60 days, the down payment is forfeited. In some cases, if the customer changes his mind and cancels a layaway purchase, many stores will simply subtract a service fee, typically a $5 restocking fee, while refunding the balance of the layaway deposit. Although there is no published guidance on how retailers should account for the layaway premiums, the arrangement is essentially an option contract, because there is no current transfer of possession of the merchandise, and the customer potentially forfeits a portion of the purchase price of the item and is released from any further obligation to the retailer.

III. NON-PROPERTY-BASED OPTIONS

A. Cash-Settled Options

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acquisition costs amortized over the life of a loan, regardless of the loan's purpose or use of funds); In *Anover*, the Tax Court held that loan -related expenses had to be amortized over the life of the underlying loan on the theory that such expenses are incurred in order to secure the use of money, throughout the loan period, as a basis for deriving income.

Historically, the term “option” has been largely synonymous with property-based options. In fact, the usual and customary textbook definition of an option generally envisions a contract that ultimately culminates in the purchase and sale of property. In exchange for a non-refundable sum of money (the option premium), generally payable at the inception of the contract, the writer (seller) of the option contract grants its counterparty (the option holder) the right, without any obligation on the holder’s part, to buy or sell an underlying property interest at a specified price (the exercise price) on some future date (the exercise date).

Notwithstanding this traditional definition, options to purchase property frequently do not necessarily result in an actual conveyance of property, as many property-based options tend to be cash-settled. A cash settlement option is an option which, on exercise, settles in cash or property other than the property that underlies the option. For example, if an option holder has the right to call a share of Google stock for $ 100, the option would settle for an amount of cash equal to the excess, if any, of the trading price of a share of Google stock on the settlement date over $ 100. Cash settlement options are clearly recognized as bona fide options for tax purposes. The Tax Code specifically provides that a cash settlement option shall be treated as an option to buy or sell property for purposes of the statutory option character rules.[61] According to a published revenue ruling, such options are considered options for purpose of other Code provisions as well.[62]

It is not difficult to see why cash-settled options are recognized as bona fide options for tax purposes. Even if an option contract literally contemplates only the actual conveyance of the property, in practice, these instruments are frequently cash-settled by the mutual consent of the parties. Accordingly, if the parties to an option contract include a provision expressly allowing cash settlement in lieu of conveyance of the property, the option should not be regarded as any less of an option. Cash-settled options function in much the same way as any other options. Like any other option, they will either expire worthless, or else finish in-the-money, resulting in either a physical conveyance or cash payout.

[61] Section 1234(c)(2)(A).

[62] In Rev. Rul. 88-31, 1988-1 C.B. 302, analyzes, in a variety of different factual circumstances, the tax consequences of payments to a holder of a cash-settlement put option on publicly traded stock of a corporate issuer. The corporation had issued investment units, consisting of one publicly traded common share and a separately tradeable contingent payment right, the value of which varied inversely with the market value of the underlying common stock. The contingent payment was scheduled to be made to the holder two years after the date of issue of the right. In concluding that the separate interests were subject to the straddle rules of section 1092, the Service characterized that right as a cash settlement put option under section 1234(c)(2) as well as an option for purposes of the stock straddle exception of section 1092(d)(3)(B)(1).

It must be acknowledged, however, that once an option has been untethered from the need to convey physical property, it has been effectively transformed into a bet or wager on the underlying price index. Referring back to the example of a cash-settled option on Google stock, if the parties do not contemplate an actual conveyance of shares when they enter into the option, they are simply making opposite bets on the direction of the stock price of Google shares. If option traders can make bets on a price index, it is not too difficult to construct option-type bets on other types of indicies as well.

As noted earlier, there is in fact a whole new generation of option products, including weather derivatives, catastrophe options, and economic derivatives, in which the contingency is determined with reference to objective financial or meterological information, rather than with respect to an underlying property. In the case of economic derivatives, for example, which allow investors to buy and sell options on a wide variety of economic data releases, there is seemingly no limit to the type of data index that can be used as the predicate for an option, including inflation statistics, initial jobless claims, auctions on nonfarm payrolls, U.S. GDP, international trade balances, U.S. initial jobless claims, and retail sales less autos.

These cash-settled, non-property based products collectively raise the question as to whether or not they truly constitute options for tax purposes, notwithstanding that they are cast in the form of options. Given their similarity in all other respects to conventional options, except for the absence of an underlying property, the operative question is whether the existence of some underlying property is a *sine qua non* for the existence of an option.

B. Lease Options, Service Options, and Swaptions

In truth, although commentators commonly refer to options as if they invariably relate to the purchase and sale of property, options are regularly, although less commonly, granted in other settings. Options to lease property, for example, are common in the marketplace. Clearly, these do not implicate the purchase or sale of property. Suppose for example, that a law firm with a growing practice and currently leasing 5 floors of an office building enters into an option to lease another 3 floors in order to accommodate future growth and pays a non-refundable premium in exchange for the privilege. Should that contract not qualify as an option? Presumably it should, and the lessor should not be required to take the option premium into income in the year in which it enters into the lease option.

An option can just as easily relate to future services as it can to an underlying property. Contractors and employees often enter into option contracts with respect to the future performance of services. Options contracts are prevalent in the professional sports sector, as teams that enter into multi-year employment contracts with their players are often granted a team option to secure a player's services for an additional year at a specified level of compensation. To cite just one example, when the New York Yankees signed pitcher Mike Mussina to a 6-year $88.5 million contract in 2001, the player granted the Yankees an option, in exchange for a $1.5 million premium, for a 7th year at his 2006 salary of $17 million, which is exercisable in the 6th year of his employment.[63] What part of that contract fails to qualify as an option?

Alternatively, sometimes an option can pertain to the right to enter into another contract, such as a financial contract, rather than the right to purchase property or services. *Black Hills Corp. v. Commissioner*[64] involved an insurance policy that had a one-year term, but which permitted the taxpayer to renew the policy indefinitely at the same premium. According to the court, the premiums paid in early years effectively created a reserve, and a large portion of that amount represented the option to renew indefinitely. The court was clearly willing to recognize that an option to renew an insurance policy could qualify as a bona fide option for tax purposes.[65]

In the financial products area, swaptions, which are option contracts granting the holder the option, but not the obligation, to enter into a financial swap contract with the writer at prescribed terms at some future designated date, have no underlying property as such. The delivery obligations of the swaption writer upon exercise of the swaption consist of an undertaking to enter into a new bilateral contract for a period of years. Nonetheless, since the primary features of an option on a swap remain economically similar to those of any other option, the notional principal contract regulations provide that swaptions should be taxed as options.[66]

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[63] See http://www.mlb4u.com/nyy.html, the unofficial Yankees website. The option premiums on player contracts are often paid on the exercise date, rather than at the time of grant, and are often labeled a buyout fee. The website includes descriptions of similar contracts for other players, including Tino Martinez and Bernie Williams, both of whose options were declined by the team.

[64] 73 F.3d 799 (8th Cir. 1996)

[65] The taxpayer in *Black Hills* was not allowed to take a deduction for the option premium because he could not demonstrate the portion of each annual premium payment that was attributable to the option to renew. However, there is no reason why future taxpayers could not learn from this case and arrange for a separately negotiated option agreement with separately stated option premiums.

[66] Reg. Sec. 1.446-3(g)(3). Upon exercise of a swaption, the amount of the option premium would be taken into account like any other upfront premium paid on a notional principal contract. If the swaption instead lapses unexercised, the writer would treat the

Swaptions in fact resemble options in every material respect. In a swaption, one party (the "purchaser") pays an initial "premium" payment in exchange for the right, without any corresponding obligation, to cause the other party (the "writer") to enter into a specified swap position, either on a particular "exercise" date, or like an "American Style" option, at any time during a particular period. If the purchaser exercises its option, the parties will enter into a swap on the terms specified in the option contract. If the purchaser fails to exercise its option prior to the stated expiration date, the parties will have no further contractual obligations.

Swaptions also provide the kind of downside price protection common to other types of option products. An interest rate swaption, for example, could provide protection to a prospective issuer of fixed-rate debt (or floating rate debt coupled with a swap into a fixed rate) concerned that prevailing interest rates may rise before the issue date. The swaption would presumably be exercisable on the anticipated issue date for the taxpayer's debt, and permit the purchaser to swap a fixed rate that is determined by reference to rates prevailing at the time that the swaption is purchased, rather than the time when the underlying swap is entered into, and receive a floating rate that effectively decreases the interest payments on its debt obligations.

C. New Products: The Wagering Conundrum

Since there are many examples of non-property-based options, what is the apparent basis for the assumed requirement of an underlying property for purposes of option classification? In all probability, the standard definition may simply reflect the commercial norm that options have traditionally arisen most frequently in the context of conveyances of property. Most of the case law on options involves options on real property, where physical settlement has long been the norm. Another explanation may have its roots in the unspoken fear that, in the absence of an underlying property requirement, it may not be possible to differentiate between an option and a wager. As one leading practitioner put it:

> [C]an we comfortably say that any contract right involving a “premium” and a “strike price” and a payoff that depends on whether any objective information is above or below that strike price is an option? That would, of course, lead racetracks to sell

premium amount as income, and the purchaser would treat such amount as a loss, for the period that includes the option's expiration date.

race options based on whether Nicki's Song wins the fifth race at Aqueduct. [67]

The concern raised by this writer, if true, would be rather ominous, since wagering transactions are subject to highly punitive tax rules, including rules preventing gambling losses from offsetting other non-gambling sources of income,[68] as well as a restriction against carrying losses either forward or backwards.[69]

To be sure, options do bear an uncomfortably close resemblance to wagers.[70] How is a cash-settled option different from a sports wager, economically speaking? Both entail risking money on the happening or not, of a contingent event. To the extent that cash-settled options are virtually the same as wagers, how do we differentiate between options and wagering or gambling transactions? The stakes are immeasurable, as noted, in light of the significant tax penalties associated with transactions that bear the wagering label.

Fortunately, the term wagering as used in the Tax Code has not been broadly applied to all manner of bets; rather, it traditionally applies only to bets that are properly characterized as gambling.[71] The common law definition of gambling for tax purposes is the same as the definition of gambling for state law purposes, which essentially entails a product that has the elements of prize, chance and consideration.[72] While this definition could be interpreted broadly to cover a wide array of financial products, as a practical matter, true gambling has generally been limited to the world of sports, contests and other activities that may properly be described as consisting of fun and games, including card games like

[67] Humphreys, note 2, at 19. Without engaging in any further analysis other than highlighting the apparent absurdity of the example, the author goes on to assert "Thus, we can safely conclude that the tax law does not extend option treatment to all contracts based on a contingency that can by styled an option."

[68] Sec. 165(d) provides that "losses from wagering transactions shall be allowed only to the extent of the gains from such transactions." The term "wagering" is undefined for this purpose.

[69] Section 172(c) defines a net operating loss as the excess of deductions allowed over gross income. Under Section 165(d), gambling losses in excess of gross income are non-deductible.

[70] On the surface, options may seem distinguishable from gambling-style wagers because most wagers have fixed odds and therefore have binary payouts. However, binary options exist as well in the financial sector including cash-or-nothing calls, which pay off nothing if the asset price ends up below the strike price at time T and pays a fixed amount if it ends up above the strike price, or an asset-or-nothing call, which pays off nothing if the underlying asset price ends up below the strike price and pays an amount equal to the asset price if it ends up above the strike price.

[71] See, e.g., PLR 200532025 (a wagering pool is an arrangement to pool bets into a common fund, which are wagered on a sports event or contest, with the successful bettor (or bettors) receiving the pool proceeds...")

[72] *See, e.g.*, Rev. Rul. 70-556, 1970-2 CB 326.

blackjack and baccarat or table games such as craps and roulette.[73] The distinction, in other words, between cash-settled options and conventional wagers depends not on whether payoffs are triggered by the happening or not of contingent events, since that is true of all kinds of bets, but rather, on whether a particular bet in question arises in the context of sports, contests and activities that may properly be described as consisting of fun and games. Only those types of bets are properly regarded as gambling both for state law and federal tax purposes. In short, financial bets may be (and in fact, almost surely are) wagers, but they are not gambling-type wagers of the type subject to sanctions under the tax law.[74]

For that reason, speculation about, or incidental to, market- based risks is not gambling. The underlying risks in this settingpertain to real business risks rather than contests, sporting events or other activities centered around leisure activities. Weather derivative products, for example, may be used to hedge a business's exposure to weather-related risks, allowing companies like power producers and insurance companies to hedge weather uncertainties just as they do commodity prices, currencies and interest rates. Wind options, which are designed to pay out when the wind drops below a preset level, may seem frivolous in the abstract, but for wind farms, whose key risk is calm days, with too little wind to drive the turbines and generate electricity, they serve an important business need.

Economic derivatives are used by hedge funds and large banks as a means of hedging portfolio risk on macro-economic statistics, since the investments they hold can quickly gain or lose value based on the latest releases. The index to which the gas storage options relate is one of the leading indicators for gas prices. Investors in this market include natural gas and oil companies and other companies seeking to manage their energy market risks as well as institutional investors and other risk intermediaries. The market for mortgage prepayment derivatives draws heavily on investors in mortgage-backed securities, who face prepayment risk when mortgage prepayments are made faster than expected.

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[73] In fact, section 4421 defines "wager" for excise tax purposes as "(A) any wager with respect to a sports event or a context placed with a person engaged in the business of accepting such wagers, (B) any wager placed in a wagering pool with respect to a sports event or a contest, if such pool is conducted for profit, and any (C) wager placed in a lottery for profit." A contest includes any type of contest involving speed, skill, endurance, popularity, politics, strength, appearances, etc., such as a general or primary election, the outcome of a nominating convention, a dance marathon, a log-rolling, wood-chopping, weight-lifting, corn-husking, beauty contest, etc. Sec. 44.4421-1(c)(3),

[74] See Kevin Liss, Economic Derivatives and Other Speculative Bets: Reconsidering Traditional Notions of Gambling for the 21st Century (forthcoming article, a draft of which is on file with the author)

What these disparate products share in common is the potential to allow traders to better manage specific categories of risks, while minimizing the basis risk associated with hedging using other types of financial instruments. Under the circumstances, concerns about such business-related products crossing over into gambling terrain turn out to be misplaced, given the business justification for trading in these products. Accordingly, whatever passing resemblance these products may bear to gambling activity should not detract from their status as true options for tax purposes.

III. CONTINGENT OPTIONS

A. Dubious Case Law Precedents

Does the fact that an option holder's right of exercise is dependent upon the resolution of one or more contingencies prevent the instrument from qualifying as an option for tax purposes? The question is highly relevant to credit default swaps, described earlier, which do not pay out unless there has been a credit event. Some of the cases on options have suggested just that, thereby casting doubt, in the view of some commentators, as to whether contingent options such as credit default swaps should be respected as options for tax purposes.[75]

The Tax Court in *Saviano v. Commissioner*,[76] for example, stated that an option whose exercise is subject to a contingency may fail to qualify as an option for federal income tax purposes. In *Old Colony v. Commissioner*,[77] the Tax Court was unwilling to ascribe option treatment to a contract in which the seller's rights to the underlying property had not yet been perfected, leading the court to describe the option as merely conditional. Further support for this view can be found in Revenue Ruling 68-601,[78] which addresses whether warrants and convertible debentures should be viewed as options for purposes of applying certain option attribution rules.

However, careful examination of each of the relevant authorities shows that any implication in the reported decisions that the existence of contingencies is fatal to option classification is simply unwarranted, especially when the referenced opinion language is viewed within the proper context. Taking the last of these authorities first, Revenue Ruling 68-601 implies that in order for a right to be considered an option, there must be no conditions or contingencies attached to its election. According to the ruling,

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[75] See, e.g., Kayle, note 6.
[76] 80 T.C. 955, 971 (1983), affd. 765 F.2d 643 (7th Cir. 1985)
[77] Old Harbor Native Corp. v. Comm'r, 104 T.C. 191, 201 (1995)
[78] 1968-2 C.B. 124

> In order for a warrant to acquire stock to qualify as an option, the holder must have the right to obtain the stock at his election. When this right to acquire stock exists, warrants or convertible debentures are not realistically different from options as referred to in section 318(a)(4) of the Code. In each instance, stock may be acquired at the election of the shareholder *and there exist no contingencies with respect to such election.* (emphasis added)

However, in a subsequent ruling, Rev. Rul. 89-64, the IRS noted that the phrase "at the election of the shareholder" was really just intended to distinguish options in which the right to exercise is subject to the control of the other party. Obviously, if the right of exercise was contingent upon some element within the *issuer's* control, that would undermine the option-like character of the instrument.

The Tax Court decision in *Old Colony* (discussed at length later on in Part IV(E)(2)) rests on the proposition that an option contract must create an unconditional power of acceptance in the holder, if the holder chooses to exercise. If the writer does not yet have ownership rights to the subject property, the existence of that contingency potentially undermines his fixed obligation to close at the election of the holder. However, there is a difference between extraneous contingencies and conditions that are within the control of the option writer, a distinction that is glided over in these opinions. For example, in the course of the Tax Court's opinion in *Saviano*, the court rejected the taxpayer's argument that his conditional option could be viewed as a bona fide option. As the court explained,

> Petitioner describes his financing vehicle as a "conditional option" and refers to the "conditional nature of the option." We have found no case law, nor has he cited us to any, in support of his hypothesis that such an option qualifies for tax deferral. To the contrary, the courts have treated such an "option" as vague and unenforceable. See *Saunders v. United States, supra; Booker v. Commissioner, supra.* We conclude that the right to purchase extracted gold was not a binding, legal option.

The court in *Saviano* was clearly right to reject the taxpayer's request for option treatment, but upon closer examination, the problem presented for option classification purposes was not the existence of a condition as such, as the court unfortunately implied in the preceding statement, but the fact that the condition was wholly within the control of the putative option writer. The contract in issue, a purported option to buy all of the gold produced from a mine at a fixed price, by its terms did not require the option writer to mine any gold. In concluding that the option to purchase the extracted gold was not a true option, the Tax Court noted that "If the optionee's power to accept is dependent upon some

further act of the offeror, then there is no unconditional option contract."[79] The court characterized the option as a preferential right of first refusal, noting that the "offeree's power of acceptance is severely limited by the condition that it is subject to the petitioner's decision to mine gold."

Clearly, some contingencies are inconsistent with an option's status as such. If the option writer has control over whether or not the contingent event happens, he may be tempted to exercise it, because the option writer in that event can retain the premium free and clear of any obligation to perform his side of the contract. An option, after all, is supposed to be an asymmetrical contract. The option holder has the clear right not to perform his leg of the contract, but the option writer has no such freedom. Otherwise, the option is elective for both sides.

For that reason, the case law holds that if the holder's power to accept is dependent upon some further act of the offeror, then the holder has no true option. For example, in private letter ruling 8936016, the IRS ruled that holders of stock warrants are not deemed to own the underlying stock when the warrants may only be exercised if the corporation issues additional shares. Clearly, the contingency was within the writer's control. Likewise, if a taxpayer has a right to buy all of the interests in a partnership within a fixed period of time following the partnership's receiving and accepting an offer from a third party to buy the partnership, it has a mere right of first refusal.[80] Rights of refusal have traditionally not been viewed as option contracts. Rather, rights of refusal have generally been viewed as preemptive rights which are transformed into options to purchase only upon the holder's receiving notice from the grantor that the time period in which to refuse or accept should commence.[81]

In ruling that a right of first refusal is not a bona fide option, *Saviano* is therefore consistent with a long line of authorities that have reached a similar conclusion. Since the Tax Court in *Saviano* itself regarded the contract as one that implicated a mere right of first refusal, it would be a mistake to read the case more broadly as a rejection of contingent options generally, especially in situations where the underlying contingency is outside of the control of the option grantor.

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[79] Id, at 970.

[80] Montelepre Systemed Inc, 61 TCM 1782 (1991), affd. 956 F2d 496 (5th Cir. 1992).

[81] See, e.g., Anderson v. United States, 468 F Supp 1085 (D.C. MN 1979) (taxpayer's right to purchase an additional Holiday Inn franchise in Rochester, Minnesota was contingent upon Holiday Inn initiated action with respect to additional franchises. As such it was a right of first refusal that never progressed to a point where it could be properly termed an option); City of Kenai v. Burnett, 860 P.2d 1233, 1240 (Alaska 1993) (agreement between two shareholders providing that if one party decides to sell or dispose of his stock in a bona fide transaction, the other may purchase the stock at the same price at which the proposed sale or disposition was to be made, isn't an option.

B. *Risk-Neutral Closing Conditions in Bilateral Executory Contracts*

Should a contract that is subject to contingencies, even very substantial contingencies, be disqualified from option classification by virtue of those contingencies? In order to properly address this question, it pays to first explore how an option that is subject to contingencies differs from an ordinary bilateral executory contract that is subject, as such contracts commonly are, to routine (or, in some cases, not so routine) closing conditions. Does the presence of contingencies in that context detract in any way from the status of such contracts as legally binding bilateral contracts?

Many ordinary bilateral contracts, in fact, contain a set of usual and customary closing conditions, such as the receipt of permits, regulatory approval, satisfactory construction or performance, or the availability of acceptable financing, which must be favorably resolved before the underlying transaction can proceed to closing. These kinds of closing conditions are essentially exceptions to the obligation of the parties to perform their respective sides of the contract when they are unable or unwilling to close. Ordinarily, the failure of a party to perform his side of a bilateral contract could expose that party to significant damages. By contrast, if one or more closing conditions are not satisfied, then each party can walk away without being held in breach or required to pay damages to its counterpart.

Closing conditions, by their very nature, represent contingencies that must be favorably resolved in order for the underlying transaction to proceed to closing. In practice, closing conditions often concern contingencies that the parties fully expect to be favorably resolved, but which are sufficiently important that at least one side or the other desires certainty before proceeding with the transaction. However, closing conditions can also address contingencies that are far from certain to be favorably resolved. Regardless of how uncertain the underlying contingency may be, the common denominator is that the non-fulfillment of the condition allows the two sides to part ways without either one incurring any liability to the other for failure to perform.

Regardless of whether the obligations of the respective parties to complete a transaction may be subject to reasonable closing conditions, such contracts are commonly regarded in the market place as enforceable binding executory contracts. The presence of contingencies does not

detract from the binding nature of these contracts as a matter of state law, at least as long as the condition is outside of the control of the two sides.[82]

Suppose, for example, that B agrees to buy S's house on the condition that an expected job offer will come through for B. If the condition is expressed as a closing condition, so that the sales contract is simply voided if the offer falls through, then B and S have a binding sales contract that is subject to a closing condition. If the job offer does happen to fall through, B can decline to purchase the property without incurring any further liability. The ability to walk away from the contract scot-free is what renders the contract an ordinary bilateral sales contract that is subject to closing conditions. The result is the same if B is required to make a down payment which is fully refundable upon failure to close. The contract remains a bilateral sales contract that is subject to closing conditions.

Alternatively, suppose, as in the prior example, that B intends to purchase the house as long as an expected job offer comes through, but instead of entering into a contract with closing conditions, B is required to make a modest deposit that is non-refundable if B is unable or unwilling to close on the purchase by a certain date, and that B is otherwise released from any further liability to S for failing to close. Alternatively, suppose that B is required to pay the same amount as liquidated damages if it fails to close.

As long as the amount payable is only a fraction of the contract price, such a contract would essentially be in the nature of an option. Comparing this example to the example in the preceding paragraph, it is evidently not the contingency alone that transforms a bilateral contract into an option, since most bilateral executory contracts have closing conditions that amount to contingencies. Rather, it is only when the contingency is coupled with a forfeitable deposit that serves as liquidated damages in the event that the contingency is not favorably resolved, that the contract becomes economically equivalent to an option.[83]

The foregoing distinction between an option and an ordinary bilateral contract with closing conditions, which focuses on whether one party is relieved from liability in exchange for an upfront payment, is consistent with the definition of an option which was developed earlier in Part I. This benchmark furnishes an appropriate standard for assessing

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[82] On the other hand, if the stated condition happens to be within the control of the seller, the contract is more properly viewed as a conditional sales contract.

[83] In Insilco vs. United States, 53 F.3d 95 (5th Cir. 1995), the Fifth Circuit declined to treat a bilateral contract subject to closing conditions as an option on the apparent premise that a bona fide option must be unconditional. The case did not in fact involve contingent options; it involved a bilateral contract subject to closing conditions, which is in fact distinguishable from an option contract because of the ability of the parties to walk away from one another without penalty if the conditions go unfulfilled.

whether an arrangement truly constitutes an option for tax purposes. Suppose, for example, that a putative buyer makes a deposit on a contract to purchase property that is subject to a structural inspection satisfactory to the purchaser or subject to regulatory approval. Would such a contract be regarded as an option? The real question is whether the contract enables the "purchaser" to withdraw from the agreement, for a modest fee, without incurring any additional liability. If so, the contract is an option. If there is no such fee or any other liability, the condition is a condition to closing, and the contract is an ordinary bilateral contract.

Based on the foregoing analysis, determining whether or not a contract should be treated as an option contract depends upon whether and under what circumstances any required deposit is refundable, and insofar as the deposit is non-refundable, proper classification depends on the size of the deposit relative to the contract price. If the deposit is refundable, the contingency is merely a closing condition.[84] If, however, the contract

[84] This rule does not necessarily apply with respect to put options. A put option premium that is refundable upon purchase of the underlying property may be equivalent to a non-refundable premium and a reduced purchase price. For example, in *Freddie Mac,* a case involving putative put options permitting mortgage originators to sell mortgages to Freddie Mac, the upfront fees payable by originators consisted of a 0.5-percent nonrefundable portion and a 1.5-percent refundable portion. If a mortgage was in fact sold, the refundable portion of the commitment fee was refunded to the seller, but the remaining 0.5% balance of the fee was not. If the originator failed to deliver a loan, Freddie Mac was allowed to retain the entire 2-percent commitment fee, which was deemed forfeited. The IRS objected to Freddie Mac's failure to take into income the 0.5% portion of the fee that was non-refundable in all circumstances. The Tax Court held that this portion of the fee should be treated as premium for put options, resulting in deferred income recognition.

Interestingly, the opinion addressed only whether the nonrefundable portion of the commitment fees was deferrable as an option premium, the IRS conceding that the refundable portion of the upfront premium was properly excludable from income. In a footnote, the court noted that the IRS was not challenging the taxpayer's exclusion of the 1.5-percent refundable portion of the commitment fee from income at the time of receipt. As the court explained, the taxpayer had set up a payable upon its receipt of refundable fees, and these amounts were only taken into income if the underlying mortgages were not delivered to petitioner. While the treatment of these fees seems appropriate for book purposes, the tax law does not allow taxable income to be excluded by the mechanism of setting up an offsetting payable. If the refundable fee was properly excludable for tax purposes, there must be some other rationale justifying its exclusion. What was the basis for excluding this portion of the fee? The answer, oddly enough, is that this fee, too, constituted an option premium, even though it was nominally refundable.

The critical fact is that even the nominally refundable 1.5% upfront payment was rendered non-refundable should the option holder decline to exercise the option. In that respect, the payment perfectly resembled the economics of a typical option premium. The payment was "refundable" to the put option holder if the holder exercised the option, but since the option was a put option, the option writer was required in any event to make a payment to the purchaser at the time of exercise. If the contract by its terms had simply provided for a reduced purchase price corresponding to the amount of the upfront fee, while providing no refund of the upfront payment, the transaction economics would have

calls for forfeiture of the deposit should the condition remain unfulfilled as of closing, the contract should be viewed as an option contract, at least as long as the deposit is only a small fraction of the contract price. If the deposit is more than a modest amount, the putative option may be a deep-in-the-money option, which would not be regarded as a bona fide option for tax purposes. Regardless of the facts, the option definition developed thus far furnishes asuitable basis for ascertaining whether or not the arrangement truly amounts to an option for tax purposes.

C. (Buyer) Risk-Shifting in Option Contracts

In *Halle*, one of the options cases discussed earlier, the court took into account, in assessing whether the contract at issue was either a sales contract or an option, the absence of any motive to purchase an option. The court pointed out that option contracts by their very nature permit parties to shift the risks of contingencies. According to the court, "Where there are no significant risks to apportion, therefore, there is little reason for the parties to contract for an option."[85]

The court's observation about risk-shifting reflects a critical insight into one of the fundamental purposes of an option. An option premium in respect of a call option economically represents a payment for a shift in the risk of buyer-specific contingencies from the buyer to the seller compared to the risks normally undertaken in a bilateral executory contract. The assumed risk entails buyer protection from a decline in the value of the property pending the closing or exercise date, which would

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been exactly the same. The analogous situation in the case of a call option would be a contract that by turns provides for an upfront premium to be credited against the exercise price, or alternatively provides no such credit, but contains an exercise price that is reduced by a like amount. The IRS has acknowledged the equivalence of these two cases in the call option context. Rev. Rul. 58-234, 1958-1 C.B. 279
Since the IRS in the Freddie Mac case was troubled by the taxpayer's exclusion from income of only the 0.5% non-refundable portion of the upfront premium, the taxpayer could presumably have avoided the litigation by modifying its contracts so that the purchase price formula was automatically grossed up by the amount of the 0.5% fee, and then providing for a refund of the 0.5% fee upon closing a purchase of the mortgage. If no mortgage was ultimately tendered, the refundable 0.5% fee would be still be forfeitable, just as the remaining 1.5% was. But insofar as the fee was nominally refundable, the IRS apparently would not have objected if the taxpayer failed to include it in income.

[85] Halle v. Comm'r, 83 F.3d at 657; Similarly, the Tax Court in Federal Home Loan Mortgage Corporation (Freddie Mac) vs. Comm'r, examined why an originator would be willing to pay a nonrefundable commitment fee in return for retaining an option to deliver the mortgage. The court found that originators chose to pay the commitment fee to protect themselves from fluctuations in interest rates during the period when the option was open and the uncertainty associated with the possibility that the mortgages might not close within the delivery period. 125 T.C. No. 12 at .

normally be for the buyer's account if the buyer had entered into a bilateral contract.[86]

A comparison between options and bilateral executory contracts which contains conditions to closing is instructive to illustrate the risk shifting that is normally undertaken when parties enter into option contracts. Bilateral contracts containing closing conditions generally do not shift the risk of a contingent event from the party that structurally bears it to a counterparty that is willing to assume it. For that reason, money generally does not change hands when closing conditions go unfulfilled in a bilateral contract. Closing conditions carry no financial penalty because they tend to be inherent seller risks that that no buyer would be expected to assume, at least not as long as the buyer is contracting to pay the full, undiscounted value for the underlying item. Options, on the other hand, tend to allocate buyer-specific risks to the seller in exchange for a non-refundable premium. For this reason, ordinary bilateral contracts subject to closing conditions tend generally to implicate seller-specific risks, such as title defects or problems relating to the condition of the specific property, whereas option contracts tend to implicate buyer-specific risks, including risks peculiar to the particular buyer or market-based risks.

Options contracts provide prospective buyers a means of compensating property owners for laying off buyer-specific risks, and in return, the seller agrees to release the prospective buyer from his purchase obligations if the event happens or fails to happen, as the case may be, without any further obligation.[87] For example, a property may be worth $155 to the prospective buyer if a job offer comes though, but not if it does not. If the prospective buyer were to enter into a bilateral sales contract, and the job offer failed to materialize, he would be left holding a property that he no longer wants. He would be assuming liquidity risk, carrying costs for the unwanted property, the time and the expense of having to sell the property, and the prospect of a loss on the resale since the previous highest bidder – himself– is no longer in the pool of potential buyers. By entering into an option, the option holder, in exchange for a fixed fee, is shifting the burden of that particular contingency to the seller. Sometimes there may even be more than one contingency.

In principle, it is possible, although less common, for buyer-specific risks to be included as closing conditions. The problem is that sellers are generally unwilling to take on these risks as mere closing

[86] Put option premiums, by contrast, entail risk-shifting in the opposite direction, from the seller of the underlying property to the buyer. A put option preserves for the seller the benefit from any upside movements in the value of the property pending the closing or exercise date.

[87] The roles of the parties is reversed in the case of a put option.

conditions if they can sell the property to another buyer for the same price. If the sale falls through, the seller must bear the carrying costs of the property pending a resale to some other buyer. A seller is liable to ask why he should bear the risk of the buyer's uncertainty, unless he is being compensated to do so. As long as the risks are peculiar to the particular buyer, the buyer will usually have to pay the seller an inducement fee in order to induce the seller to bear this buyer-specific risk, which could take the form of an option premium, or by charging an above-market price.

D. Closing Conditions in Option Contracts

The preceding section distinguishes option contracts from bilateral contracts which have closing conditions. It is certainly possible, however, to have an option contract which also contains closing conditions. In fact, there is no reason why the parties should not be able to agree that certain stated closing conditions must be fulfilled, or else the option holder will be refunded his premium. Routine closing conditions amount to exceptions to the rule that an option premium is not refundable. Accordingly, an option contract that has closing conditions would presumably require the option premium to be refunded upon the non-fulfillment of that condition. As long as there remain other circumstances beyond the control of either party under which the buyer's deposit is non-refundable, the option should still be viewed as a bona fide option contract notwithstanding the presence of closing conditions.

Closing conditions, as previously noted, tend to pertain to seller-specific contingencies that would affect any buyer with whom the seller chooses to engage. For example, the buyer may be relying on seller representations as to the condition of the subject property, which are assumed by the buyer to be true as he decides whether or not to exercise the option. If the representations prove false, the buyer should be entitled to a refund of his premium, because his decision not to exercise was not based on an unfulfilled buyer-related contingency, but rather, due to the fault of the seller.

Suppose for example that a seller who does not have clear title to the property writes an option to sell the property to a prospective purchaser who is awaiting a job offer, and receives in exchange an upfront premium. In this situation, there are both buyer-specific risks and seller-specific risks. How might we reasonably expect the parties to allocate these risks?

Since no buyer would be expected to pay full value for the property unless he can acquire clear title, the contract may require the seller to clear up title as a condition to closing, failing which the buyer should be refunded its option premium. On the other hand, as long as the

seller is able to convey clear title, meaning that the closing condition is fulfilled, the seller should ordinarily not be expected to bear the burden of the buyer's job offer falling through unless the buyer compensates the seller to bear that risk. Accordingly, one might reasonably expect that the contract would provide for the buyer to forfeit his premium if his job offer falls through, as is standard practice with respect to options. In short, there is no fundamental problem with having an option contract that is also subject to specific closing conditions whose non-fulfillment would cause the option premium to be refunded, without detracting in any way from the status of the contract as an option contract.

The case of *Ferydoun Ahadpour v. Commissioner*,[88] addressed a contract that was essentially an option, but one which also had significant closing conditions attached. The taxpayers in *Ahadpour* were paid an option premium, which was described as a non-refundable escrow payment, in connection with a contract to sell property. However, the contract also provided that if the transaction failed to close for any reason other than a buyer default, the deposit would be refunded to the buyer.

The prospective sale was in fact called off after the State of California claimed a public trust easement on the property, making it impossible for the sellers to deliver clear title. As a result, the sellers returned most of the escrow money under a release agreement. This is exactly what we would expect to happen when closing conditions go unfulfilled. The fact that the upfront payment was refundable under these circumstances does not mean that the contract was not an option. What it means is that the conditions to closing went unfulfilled. As with any option, had the sale failed to close because the buyer was unable or unwilling to do so, the buyer would have been required to forfeit his upfront payment.

The court in *Ahadpour* managed to reach the right result, holding that the sellers did not have to include the deposit in income in the year of receipt, but managed to do so not by characterizing the contract as an option, which is what it truly was, but because it claimed that the sellers had only a conditional right to retain the deposits. There was, after all, an existing and fixed obligation for petitioners to repay the deposits in the event that the sale did not close "for any other reason other than a default by Buyer." The court's "obligation to repay" analysis operated to remove the transaction from the scope of the "claim of right" doctrine, a common law tax rule which normally requires cash proceeds to be taken into income upon receipt. In truth, there was no such fixed obligation to repay the deposit, as such, since the deposit was still forfeitable as long as the seller could cure his title problem. The court was apparently confused by the interaction between the option element and the contract's conditions to

[88] T.C. Memo 1999-9

closing. The better explanation for not applying the claim of right doctrine is that the contract was essentially an option contract. Even non-refundable premiums are in fact refundable if the seller is unable or unwilling to convey the underlying property at the time of exercise.

E. Seller-Based Risk-Shifting

1. Clouded Title and Next Wave Scenarios

As a further demonstration of how seller-based contingencies can coexist with a bona fide option, consider the situation that arose in connection with the disputed ownership rights in certain airwave licenses that the federal government attempted to sell at auction during the mid-1990's. A company called Next Wave Telecom Inc. ("Next Wave") won an auction for airwave licenses in 1996 and made a down payment of $500,000 as the first installment on its obligation to pay approximately $5 billion over 10 years. However, the company was unable to make its remaining payments, and wound up filing for bankruptcy protection. The government responded by confiscating the licenses and reselling them in an auction for an even greater amount. Next Wave litigated, on the grounds that federal bankruptcy law prohibited the Federal Communications Commission (FCC) from taking back the licenses notwithstanding Next Wave's default on its obligation to pay for them.

Whether or not Next Wave's claim was meritorious, its property rights in the licenses were in doubt at that point, as the matter was before the courts. Assume for purposes of this analysis, that the license had a value (after subtracting the balance due on the acquisition indebtedness) of $10 billion in the absence of any controversy over its ownership rights, and that Next Wave had a 50:50 chance of prevailing in the litigation. In that event, Next Wave would have been in possession of contingent property rights worth $5 billion, an amount which is derived by calculating the expected value of a binary option that has even odds of either paying off $10 billion or expiring worthless. If Next Wave had wanted to sell down its interest in these contingent property rights pending resolution of the litigation, it had several contractual alternatives, including a contract for sale at full value, subject to closing conditions concerning successful pursuit of its claim; an outright sale of its contingent ownership rights, properly discounted for the uncertainty of the litigation; or the writing of an option.

In the first instance, Next Wave could conceivably have agreed to sell its interest for $10 million, its full value, subject to a closing condition that Next Wave must prevail in vindicating its rights to the license against the federal government. Failing that condition, the sale would be off, with neither party owing the other any damages. This scenario would appear to

be commercially reasonable, since the underlying risk was a seller-based risk, and these kinds of risks are commonly covered by closing conditions.

In the alternative, since waiting for the litigation to be resolved could take many years, Next Wave might see fit to monetize its investment sooner rather than later. If Next Wave chose to bail out of its investment without waiting for a resolution of the federal litigation, it could do so by selling its interest outright under the terms of a contract containing no closing conditions related to theoutcome of the litigation. In these circumstances, however, the rights should sell for only $5 billion, which would be the value of the rights while under a cloud of litigation.

Finally, suppose instead that Next Wave wanted to maintain an interest in the litigation, but preferred to scale down its exposure from the all-or-nothing situation in which it found itself. Instead of an outright sale of its rights for discounted value, or a sale for full value subject to closing conditions, as in the prior scenarios, it might choose to sell an option to buy the disputed license in exchange for a smaller, non-refundable option premium. Under this scenario, it would be commercially reasonable for Next Wave to sell a $1 billion option to buy the license for $7 billion, exercisable at any time within a fixed period of time, which should be greater than the anticipated amount of time needed for the litigation to be resolved. Realizing $1 billion in this fashion might very well be a more attractive proposition to Next Wave than taking a chance on receiving nothing should it lose the litigation, and it also provides a mechanism for monetizing a portion of its investment.

If an option having these terms should pay off, the option holder would be able to resell the license for $10 million, yielding a $2 million gain. If the option expired worthless, it would have a loss on the $1 million premium payment. Next Wave, for its part, would reduce its downside exposure and upside exposures overall from a possible loss of $500,000 and a gain of $10 million to a guaranteed net profit ranging in size from $500,000 to $7.5 million depending on the outcome of the litigation.

Does the fact that Next Wave's property rights in the licenses under this scenario are wholly contingent defeat the existence of an option? After all, Next Wave has no clear property rights to convey until the contingency is resolved, which means that the option holder does not have the right to acquire the property at any time by paying the exercise price. On the other hand, the option holder would be risking $1 billion in the hopes of realizing a $2 billion profit, because if Next Wave lost the litigation, the holder would be out $1 billion, and if Next Wave prevailed, the option would pay out. By comparison, if the option holder had

purchased the contingent rights outright, it would have been risking $5 million, a much greater amount.

It is not readily apparent how these economics are any different from those inherent in any other garden-variety option. Consistent with the definition of an option developed earlier, the contract enables the "purchaser" to withdraw from the agreement, for a modest fee, without incurring any additional liability. Under the circumstances, writing an option on contingent property rights appears to be no less tenable than writing an option on any other property rights.

2. **OLD COLONY** ***CASE***

The lessons derived from the Next Wave scenarios are useful for dissecting *Old Harbor Native Corp. v. Commissioner*,[89] a rare case which implicates a seller-based contingency. The taxpayer in *Old Harbor* granted an oil producer an option to lease subsurface rights to property that it did not currently own, in exchange for non-refundable upfront payments. The taxpayer was in the process of acquiring the subject property from the federal government, and the acquisition was undertaken pending resolution of several contingencies that were outside the control of the parties, including, *inter alia*, Congressional approval. Ultimately, the contingencies were never resolved, the taxpayer never acquired ownership of the subject property, and the lease rights were terminated.

At issue was whether the taxpayer should have reported the upfront payments as income in the years of receipt as advance contractual payments, or whether the premiums should get the benefit of deferral treatment, under the rules applicable to option premiums. As with the Next Wave situation described in the preceding section, the underlying property rights that were the subject of the putative option were contingent property rights, rather than property that the option grantor owned outright.

The Tax Court in *Old Harbor*rejected the taxpayer’s characterization of the contract as an option, concluding that an option holder's right to lease subsurface rights that it did not currently own was “too vague and uncertain” to constitute an unconditional option to lease those rights. The court was particularly troubled by the fact that the contract to acquire the property rights from the federal government was subject to various contingencies outside of the taxpayer’s control, and that two of those contingencies were never met. Under the circumstances, the putative lessee “possessed nothing more than a *mere expectancy* of receiving those rights.”

[89] 104 T.C. 191 (1995).

As the court correctly observed, the taxpayer's right to the mineral lease (and therefore its ability to deliver the mineral lease to the counterparty) was clearly subject to material contingencies not within its control (a change of law to allow drilling in the Alaskan wilderness and the execution of an agreement with the Department of Interior). In that respect, however, the contract to acquire those rights was simply an ordinary bilateral contract subject to various closing conditions, no different from many other common commercial bilateral contracts.[90]

The lease option agreements, for their part, were asymmetrical in nature, like most garden-variety options. The agreements called for the lessee to pay the taxpayer $5.3 million in premiums for an option on property that had a fair market value of $45 million. The contracts provided that the lease would expire if the taxpayer was unable to close on its acquisition of the underlying property by certain prescribed dates, or earlier if it became known that the anticipated closing would not occur, with no apparent obligation on the part of the grantor to refund the option premium – again another sign of a bona fide option The taxpayer grantor, for its part, could not unilaterally terminate the lease agreements, and thus could not have prevented the lessee from unilaterally accepting the taxpayer's offer to lease that property. In other words, one party had free choice as to whether to proceed to closing; the other did not, consistent with option treatment. The amount of the option premium was a relatively small fraction of the total contract price. All in all, there is nothing here that is fundamentally inconsistent with option treatment.

That said, the case does present an odd set of facts because options do not commonly arise in connection with seller-based contingencies, risks that, one would assume, should properly be for the seller's account, rather than something that the *buyer* would willingly pay to undertake. Normally, a prospective purchaser in those circumstances might reasonably be expected to enter into a conventional bilateral contract for the full fair market value of the property, but subject to closing conditions related to the seller's ability to acquire the relevant rights. If the conditions were to remain unfulfilled, both parties would have a free "out." Under this scenario, there would be no need for either side to make an upfront premium payment to the other. Alternatively, insofar as the

[90] In particular, the contract consisted of an agreement with the DOI to exchange surface rights to certain Alaskan lands for Government-owned subsurface rights in oil and gas located in the Arctic National Wildlife Refuge on the North Slope of Alaska (ANWR). The Proposed DOI Agreement was contingent upon the occurrence of the following three events: (1) Ratification of the Proposed DOI Agreement by petitioner's shareholders; (2) enactment by the Congress of legislation opening the ANWR to oil and gas development (Opening Legislation); and (3) enactment by the Congress of legislation approving the Proposed DOI Agreement (Exchange Legislation). Two of these contingencies were never met.

contract did require the lessee to make an upfront down payment, the contract would reasonably be expected to provide for that payment to be fully refundable should the option writer fail to acquire rights to the underlying property. In *Old Colony*, however, the lease agreement purported to be for the full fair market value of the property rights, and provided for several conditions to closing, and yet, contrary to the usual failure of closing conditions, the lessee's upfront payments were apparently non-refundable. In short, the arrangement does not seem commercially reasonable, if the facts are what the taxpayer claimed them to be.

Since the taxpayer's rights to the property were under a legal cloud, it might have been commercially reasonable for the lessee to contract to acquire the contingent property rights outright, unconditionally, i.e., without any closing conditions, as long as the unconditional contract bore a discounted price, reflecting the value of the property properly discounted for the cloud on the taxpayer's legal rights to that property.[91] However, the contract in *Old Colony* did not meet this description of an outright purchase, because it was in fact conditional, and, if the transaction were to be consummated, the lessee was required to pay the full undiscounted value for its rights. In short, the lease agreement did not implicate an outright unconditional acquisition of the lease rights.

It is also conceivable under these circumstances that a buyer would be willing to enter into a conventional option contract, paying an upfront premium in exchange for the chance to make a bargain purchase of the property, similar to the last Next Wave scenario described in the previous section. In *Old Colony*, however, although the lease agreement required the lessee to make two non-refundable upfront payments, the contract would have required the lessee, upon exercise, to pay full value for the lease rights, assuming that the taxpayer was able to acquire them from the government. It does not make sense economically for the lessee to risk a non-refundable payment on an acquisition of potentially worthless property unless there is some upside potential should the seller's legal rights to the property be perfected. In other words, a prospective buyer should not have to pay the seller money for the assumption of what are peculiarly seller-based risks, namely its ability to perfect its own legal title to the property underlying the option. Under the circumstances, it is not

[91] Interestingly, an outright purchase of all of the seller's interest in contingent property rights would under the circumstances give the purchaser all of the economics of an option – the prospect of making alternately either a worthless purchase, or a bargain purchase of valuable property. However, a contract giving rise to these option-like economics could not properly be considered an option contract, since there is no mechanism for releasing the purchaser's contractual obligations for a fraction of the contract price. In short, the entire contract price would be due and payable unconditionally, contrary to the mechanics of an conventional option.

easy to reconcile the required payment of a non-refundable option premium in *Old Colony* with reasonably expected commercial norms.

If it was not commercially reasonable for the lessee to make an upfront payment on the lease agreement, it seems most likely that the counterparty was paying for something other than an option on the lease rights, as the Tax Court itself ultimately appears to have recognized. As the court explained,

> We also believe that the payments that Texaco made to petitioner for the Lease Agreements were not made in their entirety for the privilege of electing to lease the subsurface rights that petitioner might have received from the Government. Among other things, we find that petitioner received part of those payments in consideration of its agreeing to promote the Opening and Exchange Legislation. In addition, we find that Texaco executed the Lease Agreements, in part, to persuade petitioner to consummate the Proposed DOI Agreement.

In other words, it appears that *Old Colony* may have been correctly decided, after all, based on the facts presented, on the grounds that the upfront payments were not really intended as option premiums. Under the circumstances, the court's assertion that contingent options can not qualify as bona fide options was not only ill-considered, in light of the foregoing analysis, but really unnecessary to resolve the case before it. In any event, *Old Colony* hardly furnishes a robust foundation upon which to hitch the notion that a contingent option is necessarily a defective option, as insinuated by some of the authorities that have followed that decision. The option at issue in *Old Colony* plainly satisfies the common law standard for an option, and since the court had separate grounds for requiring inclusion of the deposits in income in the year of receipt, the court's comments about the fundamental nature of an option should not guide an analysis of other option-related cases.[92]

[92] On the surface, *Freddie Mac* appears to be another contingent option case like*Old Colony*, because the mortgages underlying the options in that case were all yet-to-be-issued mortgages. Unlike *Old Colony*, the court did not address whether the contracts might have failed to constitute options on the grounds that they were merely contingent or conditional options, insofar as the underlying property was not yet owned by either party. However, the factual context differed from that in *Old Colony*. The option at issue in *Freddie Mac* was a put option, which is fundamentally different from a call option because the roles of the parties are reversed. With respect to a put option, the option writer is the putative purchaser of the property, and the option holder is the seller. Since the option holder has the inherent right to choose not to proceed with the underlying transaction in any event, the fact that he does not yet have ownership of the property poses no issues for option classification. In fact, it is common for investors to buy put options without holding the underlying property. The options in *Freddie Mac* were treated as bona fide options.

F. Formulary Nature of Options

The question presented at the outset of this Part IV was whether an option can still qualify as an option if the ability to exercise the option is subject to one or more contingencies. Stated differently, if there are restrictions on the right of a holder to exercise the option, or if the right of exercise is subject to contingencies which may never occur, can the instrument still qualify as an option? The preceding analysis not only answers this question affirmatively, it also demonstrates that even ordinary bilateral contracts tend to be imbued with underlying contingencies.

The conventional portrayal of an option implies that the decision to exercise or not is a matter for the unfettered discretion of the option holder. In short, the decision to exercise or not is entirely subjective. While true in a literal sense, since the holder clearly has the ultimate power to decide, the question of whether or not the holder will in fact exercise the option is more often than not highly determinable and thus does not depend upon the mood or whim of the holder. Rather, it generally depends upon the resolution of one, or possibly even more than one, contingency.

A large category of options, for example, pertains to publicly traded property. Suppose for example that an investor purchases an option on Google stock for $300 a share at a time when it is trading at $295. Obviously, if the market price exceeds the exercise price as of the exercise date, the option will be exercised. If the price does not cross that threshold, it will not be exercised. In fact, whenever an option is based on a market price or an index, exercise is wholly determinable by reference to objective criteria. In that respect, it is probably more accurate to describe such options as formulary rather than discretionary. All cash-settled options by their very nature are formulary.[93] Only rarely does option exercise in the real world depend upon the subjective motivations of the option holder.[94]

It is ironic in the extreme that a contract's qualification as a bona fide option could be questioned on account of some underlying

[93] For that very same reason, any cash-settled option is essentially a bet on an index, as previously noted. In the case of any index-based options, including options based on a price index, the non-discretionary element makes it more like a bet.

[94] In fact it is hard to conjure up examples of options that are truly subjectively driven. One candidate is a popular mortgage product, option adjustable-rate mortgages ("option ARMs"), are specifically structured to provide payment flexibility for people with varying incomes. In particular, the option ARM gives borrowers as many as four payment options each month, which typically include a minimum payment, an interest-only payment, a traditional payment based on a 30-year term or an accelerated payment on a 15-year term. Since the choice of payment is within the discretion of the mortgagor, there is no way for the mortgagee to determine which payment option will be chosen.

contingency. An option by its very nature is a contract that is subject to a contingency whose resolution will determine whether or not the contract will be performed, *i.e.,* whether an underlying property is transferred or whether there will be a required payout.[95] If the existence of preconditions or contingencies circumscribing the exercise of an option really operated to prevent the instrument from qualifying as an option, any option that is granted out-of-the-money would have a hard time qualifying. Suppose, for example, that someone buys a 3-month call option on Intel stock for $51 a share at a time when shares of Intel are trading at $47 a share. While the holder has the right to exercise the option and gain control of the shares even when the option is out-of-the-money, as a practical matter, such an option would never be exercised unless and until the stock price rises to the level of the strike price. For all intents and purposes, the option is an instrument whose exercise is subject to a contingency.

G. Trigger Options

1. In General

Even when options are not tied to an index, an option holder usually enters into the option precisely because of some specific contingency (or contingencies) whose resolution will determine whether or not it is in his interest to perform his side of the contract. The property may have a specific ascertainable value to the buyer under certain circumstances, for example, upon the happening of an event, or the non-happening of an event, but would have little or no value to him otherwise. After all, why does an option holder enter into an option in the first place? In general, were it not for the uncertainty arising out of some particular contingency, the option holder would presumably have entered into a bilateral contract committing himself to the outright purchase or sale of the underlying property. The fact that the option holder chose not to do so implies the presence of some underlying contingency the risk of which he is willing to pay someone else to bear.

Options are especially useful when the value of an underlying property to a prospective buyer depends on the resolution of some contingency or contingencies specific to that particular buyer. The particular contingency -- an ability to get a property rezoned, for example, will often be mutually known between the two parties transacting, but it will not necessarily be stated explicitly in the option contract. As a rule, options tend not to be expressly based on the resolution of one or more

[95]Federal Home Loan Mortgage Corporation (Freddie Mac) vs. Comm'r, 125 T.C. No. 12 (2005)(("An essential part of any option is that its potential value to the optionee and its potential future detriment to the optionor depends on the uncertainty of future events.)

contingencies, even when the condition is known to both sides. An option contract usually just gives the buyer the choice of whether or not to proceed, in exchange for an upfront payment, referred to as a premium, within a specified time frame, but without explicitly mentioning or describing the underlying contingency that was the basis for the option contract. If the hoped-for event fails to happen, such as, for example, a job opportunity, or the rezoning of property, the prospective buyer forfeits its premium, and is allowed to walk away without incurring any further damages. From the terms of the contract, one might never know what contingency or contingencies were inhibiting the prospective buyer from committing himself to purchasing the property.

For example, in *Southern Coast Corporation v. Commissioner*,[96] the taxpayer entered into an option to secure a supply of gas in anticipation of entering into a contract to sell the gas on to another company. The taxpayer intended to exercise the option only if it managed to close the back-end gas sales contract. The option contract by its terms had a fixed expiration date, and made no mention of the underlying contingency. The parties in *Southern Coast* could just as easily have written the relevant condition, the need to secure a customer for the gas, right into the contract by tying the right of exercise to the fulfillment of the condition. In that case, the option would have been a trigger option, exercisable only upon the happening of the specified event. Trigger options are a form of contingent option whose exercise is triggered by some specified contingent event.

Option exercise can be contingent upon virtually anything, including whether a price changes by a certain magnitude, or whether a hoped-for event has transpired, such as the rezoning of land. It is a relatively easy matter for any conventional option with a fixed exercise date to be transformed into a trigger-based option, if there is some underlying contingency that is objectively determinable. As long as there is some contingency outside the control of the parties that will determine whether or not the contract is exercised, the buyer's dilemma can be usually be expressed in objective terms, which can be written right into the contract.

That the parties did not do so in *Southern Coast* seems besides the point. Ultimately, the anticipated back-end gas sales contract fell through, and the taxpayer allowed the option to lapse. Ironically, the taxpayer claimed an ordinary, rather than a capital, loss, on the forfeiture of its premium, on the grounds that the loss was attributable to the failed contingency, rather than the lapse of the option – as if there were any substantive difference between these two propositions. In effect, the taxpayer was arguing that the contingent nature of the contract obviated its

[96] 17 T.C. 824 (1951).

status as an option contract, causing it to fall outside the scope of the statutory predecessor to section 1234, the statutory rule mandating capital loss treatment on the lapse of an option. As the court explained,

> What petitioner would have us do is determine not so much the cause of the loss as the anterior reason leading to its decision to allow the option to lapse; and in this case to attribute the loss not to petitioner's failure to take up its option but to its lack of success in obtaining the customer who would make the option profitable. Such philosophic speculation would go far to make the section impossible of practical administration.

Would the result have been any different had the contract by its terms been exercisable only upon the completion of the back-end sales contract – in other words, if the contract had explicitly been cast as a trigger option contract? Although one can never be sure, there hardly seems to be any real difference between the two types of contracts. To hold otherwise would be to exalt form over substance, for no apparent reason.

Another example, grounded in real events, may be instructive. In the aftermath of the hurricane that devastated the City of New Orleans in 2005, there was heavy trading in options on the stock of a New Orleans based banking company that was scheduled to be acquired by another bank. According to published reports, the heavy trading was driven by speculation thatthe acquiring bank might try to lower its price or possibly seek to back out of the deal altogether in light of the storm.[97] Suppose that instead of purchasing a traded option, with a traditional fixed exercise date, an investor had acquired an option on the company's stock that was exercisable only if the proposed acquisition went through. How would such an option be any different from the conventional options that were being traded in the market place, whose terms presumably made no mention of the proposed acquisition that was driving most of the trading? The trigger feature does not seem to detract in any way from the fundamental nature of the instrument as an option, compared to one that has a fixed expiration date.

2. Time-Based Triggers

Sometimes an option cannot be exercised until a specified period of time has elapsed. A contingent event that is certain to occur can hardly be labeled a contingency. Nevertheless, until the prescribed amount of time has elapsed, the holder does not have the unlimited power to exercise the option at his election.

[97] Cynthia Schreiber, Options Trading in Hibernia Surges On Uncertainty in Capital One Deal, WSJ, September 2, 2005

A European-style option by definition is one that is exercisable only on a specific date (as opposed to an American-style option that is exercisable over a period of time). By implication, a European option is one which is exercisable only after the lapse of a period of time. Nonetheless, the passage of time, which is objectively determinable and beyond the option writer's control, does not detract from what is otherwise clearly an option.

In Revenue Ruling 89-64,[98] the IRS considered whether an option that can only be exercised after the lapse of a fixed period of time qualifies as an option within the meaning of section 318(a)(4), in which case it would be taken into consideration in determining whether a redemption qualifies as substantially disproportionate within the meaning of section 302(b)(2). In essence, the ruling inquires whether a European option is properly viewed as an option. The answer, it seems, is self-evident, and fortunately the IRS agreed.

Sometimes, a trigger event that is specified in an option is destined to occur eventually, but at some unknown time. A good example is an option to purchase property that is exercisable only after the death of the grantor. Death implicates a mere timing contingency, rather than an event contingency, insofar as death, although uncertain as to timing, is certain to occur. In other words, although the threshold date for exercising the option is indeterminate, the option will clearly be exercisable at some point in time. In Revenue Ruling 71-265,[99] the IRS sensibly concluded that an option contract with this kind of contingency does not give rise to a current sale or exchange of the underlying real estate, which remains the property of the grantor and becomes part of his estate. The ruling does not suggest that the option is anything other than a bona fide option.

3. Early-Exercise Triggers

It is possible for a European style option (i.e., an option which has a fixed exercise date) to have an early trigger provision, allowing for premature exercise upon the happening of certain prescribed events. An option of this variety was the subject of a revenue ruling which examined whether the occurrence of an early trigger event should be viewed as a "modification" for purpose of section 421.[100] The restricted stock option in issue was exercisable after a fixed date, like most conventional options, but the option could be exercised earlier upon the occurrence of any one of several specified events, including the employee's retirement, total and

[98] 1989-1 CB 91
[99] 1971-1 CB 223.
[100] Rev. Rul. 64-230, 1964-2 CB 118.

permanent disability, or the company's liquidation, dissolution, or participation in a merger. Despite the presence of a trigger feature, the classification of the option as an option was never raised as an issue, as the Service clearly assumed eligibility for option treatment under section 421. As the ruling explained,

> while it may be that an additional benefit will accrue to the employee at the time of the occurrence of any of the events specified, it accrues under the existing terms of the option rather than from a subsequent revision of the option. Accordingly, it is held that the occurrence of any of the specified events which make the option exercisable in accordance with its original terms, prior to the time when it would otherwise become exercisable, will not be considered a modification of the option for purposes of [section 421 of the Code].

4. Pure Trigger Options

The option at issue in Revenue Ruling 64-230 was bound to become exercisable no later than the specified exercise date, assuming that none of the early trigger provisions had previously been activated. What happens if a trigger option has a lapse date rather than an exercise date, meaning that if the event has not happened by that date, then the option expires worthless? Such options may be referred to as pure trigger options, because the option has a trigger event that may never happen. The option will simply lapse, expiring worthless, if not triggered bythe date specified.

The credit default swap is by far the most conspicuous form of pure trigger option. A credit default swap allows a party to transfer, in exchange for a fee or series of fees, the risk of a decline in credit risk associated with a specific reference entity (i.e., Microsoft, Amazon, etc) over a fixed term, calculated by reference to the decline in value of the reference entity's debt instruments. For example, an investor might enter into a 5-year CDS with a notional principal amount of $1000 on General Motors ("GM") with a counterparty under which periodically, the counterparty pays 100 basis points per annum to the investor on a notional amount of $1000. The contract pays off if, but only if, GM becomes insolvent or defaults on any of its material debt obligations. In that event, the Investor either pays the Counterparty the decline in value of a reference GM bond or takes delivery of $1000 par amount of a GM bond of the counterparty's choice) in return for $1000. Otherwise, if the trigger is unfulfilled, the contract expires worthless.

These contracts are essentially trigger-type options because they only pay off if there is a credit event with respect to the reference obligor

(GM) or a debt instrument of the obligor. In other words, it does not suffice for the contract to merely be in-the-money; in order to pay off, one of the designated credit events must be triggered as well.

Trigger options of this nature are in fact more common than is generally appreciated. Stock options granted to employees, for example, are often subject to a substantial risk of forfeiture. Exercise of the option may be contingent upon the employee's continuing employment over a specified number of years. Despite the contingency, there seems to be little doubt that such options are bona fide options for tax purposes.[101]

Other examples of trigger options would include clean-up call options (if not embedded in some larger agreement). Clean up calls are commonly used in securitizations to allow the servicer to purchase the underlying assets in a pool of financial assets and close out the outstanding securities when their aggregate principal balance drops below a specified percentage, 5 or 10 percent, of their initial aggregate principal balances. The calls may only be exercised for administrative reasons, namely, when the administrative cost of servicing the interests outweighs the benefits of keeping them outstanding.[102] In effect, these are event-based options which can only be exercised based upon the happening of an event.[103]

Many corporations have golden parachute arrangements, under which certain senior executives are entitled to certain lump-sum payments upon both a change in ownership or control and if their employment is involuntarily terminated within a specified period of time. Although they are not usually described as options, these contingent-on-control-change employment related payments are essentially compensatory cash-settled binary options which are also pure trigger options.

Turning to the world of sports, when the Boston Red Sox baseball team signed All-Star pitcher Curt Schilling in 2003 to a 2-year contract, the pitcher reportedly granted the team an option for a 3rd year that would automatically be triggered if the Red Sox were to win the Major League World Series during the duration of his employment. When the Red Sox swept the St. Louis Cardinals in the 2004 World Series, the option for an additional year was triggered and automatically deemed exercised. Assuming that the Red Sox made a non-refundable option premium to the pitcher for the rights to a third year of his services at a specified rate of compensation, the contract appears to be a bona fide trigger option.

[101] Cramer v. Comm'r., 64 F.3d 1406,(9th Cir. 1995), aff'g 101 T.C. 225 (1993) (Taxpayer could only exercise the option in 20% increments in each of the following five years, and only so long as he remained employed by IMED).

[102] See Reg. Sec. 1.860G-2(j).

[103] Admittedly, the relevant trigger resembles a time-based trigger, since the principal should decline over time. However, it is always possible that the issuer will default before that time, so it would probably be a reach to call it an inevitability.

The tax consequences arising in connection with an ill-fated trigger option was the subject of an opinion of the Tax Court in *Harry L. Booker v. Commissioner*.[104] *Booker* involved the tax treatment of an amount that was received in settlement of a threatened lawsuit to recover certain expenses that arose out of a breached trigger option agreement. The relevant option provided a retailer with the right to lease the premises adjacent to his store. At the time that the option was granted, the relevant property was occupied by another commercial tenant, and the option did not set a fixed exercise date. Instead, the right of exercise would be triggered if and when the neighboring tenant chose to vacate his space. As it happened, the grantor subsequently sold the building before the neighbor's departure, and when the option holder subsequently sought to enforce his option, the new owner declined.

Ultimately, the court concluded that the settlement proceeds constituted ordinary income. However, in the course of its analysis, the court clearly assumed that the relevant contract was an option contract:

> Here, the basis of the out-of-court recovery was an asserted breach of an option contract. The damages represented profits which would have been earned in the event the option had been exercised and reimbursement for additional rental expense anticipated because of the acquisition of new quarters.

The prospect that the underlying contract might not be a bona fide option does not appear to have been considered by the court or either of the two parties, nor does there appear to be any good reason for them to have done so.

5. Correlation Effects and Multiple Contingencies

In some situations, the trigger event causing the option to become exercisable may be correlated with the option's having intrinsic value. In other words, the option may be out-of-the-money during the non-trigger period, and at the very moment in which the right of exercise is triggered, the option ripens into an in-the-money option. For example, consider the hypothetical option scenario discussed earlier with respect to Next Wave's disputed licensing rights, involving an American-style option with a fixed expiration date. Although no contingency was explicitly stated in the terms of the option, the option would not have been exercised unless Next Wave were to prevail in its litigation. Suppose, however, that the option by its terms could only be exercised after a final determination of a court of law vindicating Next Wave's rights to the disputed license, and would otherwise lapse by a fixed date. Since it was possible that no such

[104] 27 T.C. 932 (1957).

favorable determination would ever be made, an option which contained these terms would be a pure trigger option.

Assuming that Next Wave prevailed in the litigation, the property rights would presumably increase in value from $5 million to $10 million because the rights would at that point no longer be under any legal cloud. However, the same event that caused the property to increase in value also happens to be the option trigger, so at that very same moment, the option would for the first time become fully exercisable. On the one hand, the option is not exercisable until the stated contingency is triggered, but at the very instance in which that happens, the option will be in-the-money and the holder will be economically bound to exercise the option. Since the contingency cannot be favorably resolved without also causing the option to be in-the-money, there is no risk that the option will be unexercisable at any time when it happens to be in-the-money. In short, there seems to be little reason economically to distinguish this kind of pure trigger option from an option that has a clearly defined expiration date.

It is also possible, however, that the prescribed trigger event may be wholly uncorrelated with whether and the extent to which an option is in-the-money. A credit default swap, for example, will often be in-the-money as soon as the creditworthiness of the obligor begins to deteriorate, as the value of the underlying debt instrument should at that point begin to decline below the par value of the instrument. Nevertheless, the holder's right of exercise is circumscribed by the requirement that there must be some credit event in order to trigger exercise. In this situation, the option holder's right of exercise is clearly constrained by the happening, or non-happening, of an extraneous contingency. Is this type of contingent option still properly viewed as an option? The question implicated here is whether it is permissible for an option to be subject to a *dual* contingency, namely that an option must not only move into-the-money, but, in addition, some other condition, uncorrelated with the in-the-money status, is fulfilled as well.

By analogy, options on publicly-traded property appear to implicate only a single contingency, namely the price of the underlying commodity on the delivery date. Suppose, for example, that an investor buys an option on natural gas at $10 per mmbtu at a time when gas is trading at $9.30. On the surface, it appears that the option is subject to a single contingency, namely whether or not within the designated time frame the price of natural gas appreciates sufficiently to warrant exercise at the $10 exercise price.

The appearance of a single contingency in this setting is highly misleading. Market pricing by its nature generally masks a myriad

number of contingencies. In a liquid market with public trading, prices posted for the underlying property provide a mechanism for assimilating a wide range of information in the world-at-large that implicates one or more contingencies or variables that will impact whether or not the option is worth exercising. The price level is simply a proxy for the happening, or not, of any number of fortuitous events. One of the so called marvels of the price system is how it is able to accommodate a virtually limitless number of contingencies, which is what makes the price mechanism so economically efficient.[105]

What, after all, determines prices in the natural gas market? In general, gas prices may be impacted by a confluence of events, including, but not necessarily limited to, pipeline receipts, weather statistics, rig counts, power plant outages, nuclear capacity utilization, and hydroelectric dam water levels, among other factors. Prices in the crude oil market, for their part, may be affected by emerging demand from China and Third World countries, worldwide economic growth, the level of OPEC production, the amount of spare capacity, crude oil inventories, refining capacity, not to mention political events. Sometimes cataclysmic political or meteorological events can cause a sudden and sharp increase in prices, such as, the Iranian revolution in 1979 or more recently, damage sustained to oil rigs from Hurricane Katrina. Bond prices, for their part, are impacted by supply and demand, fluctuations in interest rates, foreign exchange rates, prepayment rates and rating-agency analysis, among other factors. The point is that for virtually any commodity, one can recite a similar litany of forces potentially impacting prices and consequently, whether an option on the commodity will be exercised or not.

In the case of non-traded options which are motivated by a single contingency not expressly written into the contract, the option holder possesses the right not to exercise the option for any other reason, including reasons that he may not have been contemplating when he originally entered into the contract. In other words, although the parties may have originally had in mind a single contingency, contractually there are no such limitations on the number of reasons for which an option

[105] The notion that a whole host of contingencies are implicit or embedded in any price or index was the predicate for Friedrich Hayek's model of how the economic market pools information so efficiently despite its decentralized character, its lack of a master coordinator. Hayek's big claim about the price system, one of the greatest insights of the Twentieth Century, was that it aggregates widely dispersed information and tastes. In particular, Hayek claimed that any "price" is a signaling system that captures the information and tastes of many people, in a way that will outperform the judgments of even the best experts. No matter how many variables are in play, a social or economic system can be rational and efficient, even without planning. The price mechanism coordinates the economic activity of millions of individuals, urging them to divert resources to where rising prices indicate an excess of demand over supply, or to remove resources from unproductive uses. For this reason, he described it as a "marvel." Friedrich Von Hayek, "The Use of Knowledge in Society,"American Economic Review 35 (September 1945): 519-30.

holder might ultimately choose not to proceed with the underlying transaction. Suppose, for example, that a buyer takes an option on real property located in another part of the country in the hope of getting a job offer. Suppose further that he gets the offer, but in the interim, he decides not to take it because his elderly parents have taken ill. He still has the right to decline the option, and can do so without having to provide any explanation or incur any liability.

This example shows why there is no principled basis for distinguishing between options burdened by a single contingency and those that are burdened by multiple contingencies. In fact, our analysis to this point has demonstrated how the presence of an underlying contingency goes to the very essence of what makes an option an option. Under the circumstances, on what basis should we deny option status to a contract whose performance is dependent on multiple contingencies? What difference does it make whether performance by an option holder with respect to its side of the contract is dependent upon one factor, two factors, seven factors, or a hundred factors?

In fact, there are abundant examples of options in the financial marketplace that implicate multiple contingencies. Compound contingencies arise whenever a payment reflects the difference between two contingent amounts. An option may provide for payments based on the difference between two floating-rate indices as applied to the same dollar amount. For example, an option that pays amounts determined by the excess, if any, of 3-month LIBOR over 3-month U.S. Commercial Paper rates on each payment date implicates dual contingencies.

Cross-rate foreign currency options, which are options to purchase or sell foreign currency at an exercise price that is denominated in another foreign currency, implicate dual contingencies as well. For example, if a United States investor acquires an option to purchase Japanese yen at an exercise price denominated in Euros, the investor will be exposed to fluctuations in the price of both Euros and yen. In other words, exercise of the option is contingent upon two variables. A LIBOR-contingent foreign currency option is a foreign currency option whose payoff only occurs if a pre-specified interest rate falls within a certain range at maturity.

The New York Mercantile Exchange ("NYMEX") makes available "crack spread" options contracts, including one for the spread between the price of heating oil futures and light, sweet crude oil futures, and another that is based on the spread between the New York Harbor unleaded gasoline and light, sweet crude. Such products are sought after by petroleum refiners, for example, which must navigate between two separate markets: the raw materials they have to purchase and the finished products they offer for sale. Refiners find themselves at enormous risk

when crude oil prices rise more than refined product prices, thus narrowing the so-called crack spread, which measures the spread in the prices of these two products.

A whole class of options referred to as knock-out options or knock-in options (or barrier options) are path-dependent options whose payoff depends on whether an underlying asset's price reaches a certain level during a certain period of time. An option is knocked-out or knocked-in if the underlying interest reaches or crosses a specified barrier at any time during the life of the option. Options of this variety regularly trade in the over-the-counter market and because they feature compound contingencies, they tend to be less expensive then the corresponding regular options.

An out barrier or knock-out option pays off only if two conditions are simultaneously met; the underlying interest finishes in the money and the specified barrier is never crossed before expiration. As long as the barrier of a knock-out option is not crossed, it functions just like a standard option of the same type with the same strike and expiration. However, if the underlying interest crosses the barrier, the option expires worthless, even if it would otherwise finish in-the-money. For example, it is possible to buy options on credit default swaps, which are European style knock-out options. The holder has an option to enter into a credit default swap, meaning it has the right to buy or sell protection on a specified reference entity for a predetermined period, typically five years. However, the option will generally knock out if the reference entity defaults during the life of the option (i.e. before the underlying credit default swap takes effect).[106]

An in barrier or knock-in option pays off if both (i) the underlying interest finishes in-the-money and (ii) if the specified barrier is crossed sometime before expiration. If the underlying interest never crosses the barrier, the option expires worthless, even if it would otherwise finish in-the-money. One such product that has been used in the electric power sector, a so-called nuclear outage contingent call option, entails such dual contingencies. The knock-in event for these options is a covered outage of a specified nuclear unit. If knocked-in, these options pay an amount for each peak hour during a knock-in event equal to the product of the notional quantity and the excess of the floating price over the strike price (e.g. $100 per MWh.) A covered outage would typically occur with respect to a particular unit if the percentage of power reported in the plant status report of the U.S. Nuclear Regulatory Commission for that unit for a particular day is off by 25% or more.

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[106] This product is essentially an option on an option, the strangeness of which poses no pedagogical issues.

Basket options, which are options whose payoff is dependent upon the value of a portfolio (basket) of assets, accommodate as many contingencies as there are assets in the basket. The underlying assets may be individual stocks or stock indices or currencies. Citibank's Private Bank, for example, links a call option to a basket of Asian currencies, the Korean won, the Thailand Baht, the Indian rupee, the Taiwan dollar and the Singapore dollar. In return for a premium of 5 to 10% of the face value of the option, usually about $1 million, investors participate in the upside if the value of the currencies increases, but risk losing their premium if the value is lower at the end of the contract.

Standard & Poor's 500 index options, whose pay off is contingent upon the stock performance of 500 separate companies, resemble options in every respect. Structured as either "call" options or "put" options and having terms ranging from three weeks to five years, they can be exercised only on expiration (that is, they are European-style options), and they can be settled only in cash. The holder of a call option has a right to receive cash based on the extent to which the index on the exercise date is above a pre-stated value. The writer of a call option has an obligation to pay cash determined in the same way. A put option resembles a call option except that a holder's right to receive cash and a writer's obligation to pay cash are based on the extent to which the index on the exercise date is below a pre-stated value. The IRS has ruled favorably that options based on a stock index are treated as options subject to section 1256.[107]

V. OVERLAP BETWEEN OPTIONS AND FINANCIAL SWAPS

A. The Controversy Over Characterization of Credit Default Swaps

The preceding section explains why credit default swaps are pure trigger options which should be respected as bona fide options for tax purposes. The trigger event for exercise of these options is the occurrence of a credit event, which generally includes a reference debtor's failure to make payments on an obligation when due, or the reference entity's insolvency, or bankruptcy. The specified issuer is typically not a party to the credit derivatives contract. If the contract pays off, the writer pays the decline in value below par of a reference obligation of the same notional amount.

As previously described, a credit default swap typically requires the buyer to make periodic payments for a period of time, which are based on a fixed number of basis points (typically, the spread over Treasuries of a reference credit's actual debt obligations) applied to a notional principal amount. Because of the provision for periodic premiums, many

[107] See Rev. Rul. 94-63, 1994-2 CB 188.

commentators believe that, whether or not these products satisfy the criteria for an option, credit default swaps appear to fall within the scope of the definition of a notional principal contract.[108] Since some of the tax rules governing notional principal contracts are different from those applicable to options, particularly with respect to timing and character of income and expense, the question arises as to whether credit default swaps are properly regarded as options or whether they are more properly regarded as notional principal contracts for tax purposes.

A notional principal contract is tax jargon for what the rest of the world calls a financial swap. The tax law definition of a notional principal contract includes any financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a "specified index" applied to a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.[109] The reference to the payment of "amounts" at "specified intervals" appears to distinguish such swaps from options, since options generally do not require either party to make multiple payments at specified intervals. Moreover, regulations specifically provide that options, other than swaptions (options to enter into notional principal contracts) and caps and floors, are excluded from the definition of notional principal contracts.

Nevertheless, it is certainly possible for options to provide for periodic premiums payable over time, rather than a single upfront premium, and in those circumstances, there is some potential for overlap between these two product categories. For example, a multi-period cash-settled option that is issued for premiums payable in installments at a rate equal to LIBOR times a notional amount would appear to qualify as an option for federal tax purposes as well as a notional principal contract. So too would a credit default swap.

Tax professionals have never quitebeen able get their arms around the exact nature of credit default swaps, alternately describing these products as arguably options or notional principal contracts, despite doubts about each label. The tax definition of a notional principal contract results in what is at best an awkward fit for these products insofar a protection seller may never, and in fact, usually does not, make a payment in the other direction, and if it does do so, settlement is on an actual rather than a notional basis. At the same time, tax professionals have been united in arguing strongly against characterization as either guarantees or insurance, since the latter two categories could result in significant withholding or excise taxes on cross-border payments, while the former two would not.[110]

[108] See note 5.
[109] Reg. Sec. 1.446-3(c).
[110] See note 5.

The IRS has received several commentaries from leading commentators urging the Service to adopt the position that no withholding or excise taxes apply with respect to credit default swaps if payments are made to foreign counterparties, on the grounds that these products are properly classified as either options or notional principal contracts.

Since neither one of these product categories would result in any withholding or excise taxes due in respect of cross-border payments on these products, resolution of solely the withholding tax issue would not seem to require the IRS to choose between these two product categories in classifying credit default swaps. It would appear, then, that by arguing in the alternative that credit default swaps can wear either one of these two labels, the case against assessing withholding taxes on cross-border CDS is mutually reinforcing.

The problem with this approach, however, is that it tends to cast doubt on whether these products deserve to be classified under *either* one of these categories, thereby undermining the ultimate conclusion that is being sought, namely that these instruments should unequivocally be exempt from withholding or excise tax.[111] In other words, the ambiguous classification of these instruments, far from mitigating any cross-border tax issues, may in fact be exacerbating them. Under the circumstances, it makes greater sense to try to fundamentally resolve the option/ notional principal contract overlap both generally, and with respect to credit default swaps in particular, by focusing on the inherent economic differences between these two product categories. Insofar as it can be proven that these products plainly qualify as options, as this paper has amply demonstrated to this point, and that, further, the notional principal contract label is in fact an improper fit economically, then the withholding tax issue may be safely put to rest without any reservations.

B. Options and Bullet Swaps

As a prelude to delving further into the fundamental economics of notional principal contracts, some general background on financial swaps is in order. A financial swap generally refers to a contract between two parties providing for the contemporaneous exchange of cash flows based on changes in the value or level of one or more interest rates, currencies, commodities, securities, or other asset categories applied to a specified notional quantity or amount of the underlying asset category. In a typical interest rate swap, for example, one party makes periodic payments to the

[111] In fact, IRS officials have reportedly told practitioners informally that no future guidance would be forthcoming any time soon pending resolution of the classification issue. See Tax Officials Discuss Financial Products At NYSBA Annual Meeting, 2006 TNT 18-6 (January 26, 2006)

other party equal to an interest rate index (such as LIBOR) times a notional principal amount in exchange for periodic payments equal to a fixed rate times the same notional principal amount. In a typical commodities swapone party makes periodic payments to the other party equal to the monthly average of settlement prices for a specified commodity, such as a natural gas futures contracts on the NYMEX, times a specified quantity (i.e., mm btus of natural gas) in exchange for a fixed rate of payments times the same quantity of the commodity.

In practice, as long as the parties' payment obligations to one another arise on the same day, as is typically the case, the counter parties "net" their obligations against one another so that only the net amount due from one party to the other actually changes hands.[112] Whenever there are a series of such exchanges at specified intervals, as is commonly the case, the contract will be referred to here as a serial swap,[113] but when the contract contemplates only a single such exchange, the product is often referred to as a bullet swap. The tax definition of a notional principal contract expressly contemplates only serial swaps. The term does not literally cover bullet swaps, since bullet swaps refer to a one-off exchange.[114]

In order to properly address the potential overlap between an option and a notional principal contract, it is important to begin with more of an apples-to-apples comparison, by addressing how a simple cash-settled option differs from a simple bullet swap. As noted above, a bullet swap is a contract that provides for a single exchange of payments at maturity based on some notional amount and a specified index. We will begin by discussing how a simple bullet swap differs from a cash-settled option, and then proceed to a comparison between an option and a series of such swaps, which encompasses what the tax world calls a notional principal contract.

[112] See generally John C. Dugan, Derivatives: Netting, Insolvency, and End Users, 112 Banking L.J. 638 (1995).

[113] The market convention is to refer to serial swaps as simply swaps. This paper uses the term serial swaps to avoid confusion with bullet swaps.

[114] Despite the similar economics between a notional principal contract as defined in section 1.446-3 and a series of bullet swaps, the payments made under the former are covered by the regulation, whereas the payments under the other are not. The regulations define a notional principal contract as a "financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount, in exchange for specified consideration or a promise to pay similar amounts." Section 1.446-3(c)(1)(i). Bullet swaps are not literally covered by the definition of NPC's because there are no "payments" made at "specified intervals." See also, Prop. Reg. section 1.1234A-1(c)(2) (providing for distinct character rules on settlement).

As it happens, cash-settled options differ from bullet swaps in a fundamental way. Swaps result in payments reflecting changes in *either direction* in the valuation of a specified asset or index. An option results in a payment being made only if prices or an index moves in a *single direction*. In particular, in the case of an option, one party grants the other party (in consideration of a premium payment) the right to receive a payment equal to the amount by which an index either exceeds (in the case of a call) or is less than (in the case of a put) a specified strike price. Otherwise, no payment is made and the option expires worthless.

The contrasting economics can be illustrated if the range of possible outcomes for each of these two products is plotted along a graph. Options have a non-linear payout profile, reflecting the fact that there is a wide range of possible outcomes in which the value of the instrument is zero. In contrast, swaps are instruments which have a linear payout profile, since the product pays out regardless of the direction in which the underlying price or index moves.[115]

These contrasting economics help bring to the fore another related difference between an option and a bullet swap. An option, unlike a swap, is a limited risk instrument. As such, iteconomically requires the payment of a premium. Options require the payment of premiums because options by their nature are asymmetrical, or one-sided bets. One side fixes its exposure to either the upside or downside price movements in exchange for the amount paid (the premium), and assumes unlimited exposure to price movements in the opposite direction. An option, in short, is fundamentally an imbalanced contract because one side obtains potential benefits not available to the other.

Bullet swaps, by contrast, and other financial contracts involve symmetrical or dual wagers. A swap by its nature will always pay out on one side or the other by reference to the excess or shortfall of the variable leg to the other (except for the rare instances when the two legs happen to exactly equal one another on the settlement date). In that respect, swaps by their nature tend to have mutual contemporaneous payment obligations. A contracting party will enter into a financial swap with an unrelated party only if the present value of the financial asset it thereby acquires is at least equal to the present value of its matching liability. Since there are mutual contingent payment obligations on a swap, the contract is inherently balanced and no upfront payments are required upon entry into an on-market contract.

This distinction between options and bullet swaps parallels the traditional difference between options and bilateral executory contracts generally. Options are one-sided contracts which require an upfront

[115] In other words, the contrast is between a bent line and a straight line.

payment at the inception to balance the two positions. Swaps have bilateral payment responsibilities, and do not require any upfront payments unless the contract is an off-market contract.[116]

A swap requiring an initial premium payment is an off-market swap, which arises only under certain limited circumstances.[117] If the payments to be exchanged on the settlement date are not equivalent at the outset, then the party whose payment obligation is lesser will have to make a compensating payment, often at the inception of the contract. Since that payment, economically, is essentially a balancing payment to offset the mismatch between payment obligations on the settlement date, the regulations attempt to relate any such upfront payment back to the time period in which it properly belongs, by precluding the upfront payment from being taken into income or deducted at the time of payment.[118]

Unlike a swap, the single cash premium payment made by the option holder does not merely represent the present value of a schedule of fixed-rate amounts. Rather, the premium necessarily takes into account the fact that, in contrast to a swap, the option holder will receive no offsetting payments from the other party (the "writer") if the level of the specified floating rate on the measurement date is less (more, in the case of a put option) than the scheduled fixed rate. As previously noted, one type of option, a call option, pays out only if the variable leg proves to be greater than the fixed leg, -- but not otherwise. A put option pays out only if the fixed leg proves to greater than the variable -- but not otherwise. In either case, if the underlying contingency fails, no payment is made by either side and the option expires worthless.

A corollary to the principle that options economically require premiums, whereas a swap does not, is that a swap, like most bilateral executory contracts, should have zero value at the time of its signing. An option, by contrast, always has positive value to the holder once he has paid a premium for the contract.

The precise nature of the relationship between options and swaps can be explained by showing how the option exercise price in a cash-settled option corresponds to the fixed leg of a swap. When an option is

[116] See, e.g.,W. A. Drake, Inc., 3 T.C. 33, 37 (1944), affd. 145 F.2d 365 (10th Cir. 1944); Geo. S. Carter, 36 T.C. 128, 130 (1961).

[117] In particular, parties may enter into off-market swaps where (i) a party desires to match an existing asset or liability, and therefore wishes to pay (or receive) fixed-rate amounts that do not correspond to current market rates, or (ii) a party wishes to assume (or induce another party to assume) an existing swap position that no longer reflects market rates.

[118] The analysis uses reasoning by analogy, since technically, the notional principal contract regulations do not cover a bullet swap.

cash-settled, the option writer simply pays the option holder the excess, if any, of the value of the underlying property over the exercise price, so the exercise price need not literally be paid. If the exercise price exceeds the value of the underlying property on the settlement date, no payment is required in the case of an option.

No payment is required because the option holder has previously fixed his downside risk exposure by paying an upfront premium. By contrast, payment of that differential would be required if the product were a swap, because a swap consists of reciprocal options. If, in lieu of entering into a swap, the parties were to literally enter into equal and identical offsetting cash-settled options, no premium payment would be required, because the two premiums would offset one another. This observation is consistent with the fact that parties to a swap generally do not pay one another a premium.

Based on the foregoing analysis, there is a simple and straightforward relationship between a bullet swap and an option that helps illuminate the difference between the two products. A bullet swap may be viewed as a single instrument that consists of a pair of equal and offsetting cash-settled options, one a put and the other a call option, having the exact same strike price. This analogy is consistent with put-call theory in finance which holds that a forward contract consists of the combination of a put and a call option having identical terms. Since a swap is itself a forward contract, albeit one that is financially settled, with no actual exchange of the notional, applying the put-call theory to a swap yields the equivalency between a swap with a pair of identical options.

The aforementioned relationship between an option and a bullet swap can be illustrated by a series of related examples.

Classic Option. In a classic option transaction, assume that on January 1, 2000, H pays W a $30 premium for the right to purchase 10 widgets for $100 apiece, for a total of $1000, exercisable on December 31 of the same year. Assuming that the option calls for cash settlement in lieu of physical settlement, W must pay H on December 31 the increase, if any in the value of 10 widgets over the $1000 contract price. This contract, as noted, is a classic option. (Example 1)

Mirror Image of Classic Option. Suppose, alternatively, that W pays H a $30 premium for the right to *sell* H 10 widgets for $100 apiece, exercisable on December 31 of the same year. Assuming that the option calls for cash settlement in lieu of physical settlement, H must pay W on December 31 the decrease, if any in the value of 10 widgets below the $1000 contract price. This contract, too, is a classic option, and what's more, it is a mirror image of the option in Example 1. If the parties were

to enter into a single contract or arrangement that includes both of the foregoing options, the premiums would net to zero and the parties would have essentially created the economic equivalent of a bullet swap. (Example 2)

Classic Bullet Swap. By merging the parallel options in examples 1 and 2 above into a single contract, the overall transaction can be reformulated using traditional swap *parlance* as a fixed-for-floating swap. H would be required to pay W the value of 10 widgets in one year based on their $100 forward price at the time that the option is entered into, and in return, W would be required to pay H the spot market value of the widgets as of that date. Since the two legs of the contract have equal value, no premium payment would be required. The resulting contract, corresponding to a combination of the contracts in the first two examples, is a classic bullet swap, providing as it does for mutual wagers. (Example 3)

Off-Market Bullet Swap. A conventional bullet swap can itself be reconstructed so as to require an upfront payment, but doing so does not change its fundamental economics, and thus should not affect its classification. Going back to the preceding examples, suppose that H's financial obligation under the terms of the bullet swap is altered so that H is required to pay $90 as an upfront premium and another $900 on the settlement date, which is equivalent to having to pay $1000 in one year based on 10% compounding. (Example 4.)

Notwithstanding the presence of an upfront payment, the product is still a bullet swap, not an option. True options are asymmetrical contracts, with one side having limited risk exposure in exchange for the premium. Accordingly, in analyzing a particular financial contract for product classification purposes, the relevant question should be whether the two sides have equal and offsetting risk exposures, so that the contract contains mutual wagers, as in a swap, or whether the implicit bet is entirely one-sided, in the sense that one side's downside exposure is limited in a meaningful way to a fraction of the potential downside exposure. In the current example, while H is required to pay $90 upfront, its downside risk exposure is not limited to the amount of the upfront premium. In fact, if the value of widgets declines by more than $100, H will be required to make a net payment to W. If the contract were truly an option, H would have no additional downside exposure beyond the initial $90 payment. Accordingly, a bullet swap cannot be transformed into an option by the simple expedient of requiring a portion of H's future payment obligation to be made at the inception of the contract.

C. Options and Serial Swaps

Having addressed the fundamental differences economically between an option and a bullet swap, it should be possible to demonstrate the fundamental differences between an option and a series of swaps, *i.e.,* what is referred to as a notional principal contract. Consider the following examples.

Option with Periodic Premiums, but Single Settlement. Assume the same set of facts as the classic option described in Example 1 above except that (i) the option to purchase 10 widgets is exercisable over a period of 5 years, rather than a single year, and that (ii) the option calls for H to make annual $3 premium payments every January 1 for as long as the option remains outstanding. (Example 5)

Option Series (Periodic Premiums and Periodic Settlements). Assume, as in Example 5, that the contract calls for annual $3 premiums over a 5-year period, but that every December 31 is a separate net cash settlement date, so that W pays H the excess of the value of 10 widgets over the $1000 contract price at each year-end over the course of 5 years. (Example 6)

Serial Swaps. Finally, assume that the fixed-for-floating exchange of payments described in the Example 3 bullet swap is made not just once on December 31, but is undertaken every year for 5 years. (Example 7)

When option premiums are payable periodically, but there is still only one right of exercise, or one single settlement, as in Example 5, the case law is clear that the contract should still be regarded as an option.[119] An option is an asymmetrical contract in which one party has fixed its downside liability. The fact that the premiums are payable periodically rather than as a single upfront payment does not detract from the asymmetrical nature of the contract. (Of course, if the option premiums collectively are sufficiently large so as to give rise to a deep-in-the-money option, the contract may be reclassified as a sales contract.)

In *Koch v. Commissioner*,[120] a case which involved periodic option premiums, the question for the court was whether the contract under review should be viewed as consisting of a series of options, each with reference to one of the periodic premiums (analogous to Example 6), or whether the entire contract constituted only a single option that provided for periodic premiums (analogous to Example 5). The court concluded that the payments in the case before it were made to keep a five-year

[119] Virginia Iron Coal & Coke Co. v. Comm'r, 37 B.T.A. 195, aff'd, 99 F.2d 919 (4th Cir. 1938), cert. denied 307 U.S. 630 (1939).
[120] 67 TC 71 (1976), acq

option in effect, meaning that, as in Example 5, there was a single option and not a series of three-month options. In short, the payments received under the agreements were in return for the continuing right of the option holder to purchase the property

When an option provides for physical settlement by conveyance of an underlying property, the option would normally lapse as soon as there has been a single physical settlement, since once the property has been conveyed, no further settlements are possible. In that event, the contract clearly consists of a single option. In the case of a cash-settled option, however, it is possible to have multiple settlements. The distinction between the options in Examples 5 and 6 ultimately depends on whether the contract contemplates a single settlement or multiple settlements.

An option begins to more closely resemble a series of swaps when there are not merely multiple premium payments, but also a series of exchanges or settlements, as in Example 6. However, a series of cash-settled options bears no closer resemblance to a serial swap (i.e., consisting of periodic exchanges) than a classic option (single premium) bears to a bullet swap. The option described in Example 6 provides for a series of one-way payments, or for no payment at all if the index moves in the opposite direction. In short, the contract is a classic asymmetrical contract in the nature of an option. Example 7 by contrast, provides for payments from one party to the other no matter which direction prices move in, which renders that contract a true swap contract. A swap contract, by its nature, is a symmetrical contract.

With respect to options that provide for periodic premiums, on what basis can we distinguish between a notional principal contract and an option? Based on the foregoing analysis, the relevant standard is the same as the benchmark used for differentiating between a bullet swap and an option. In sum, while swaps have as a primary characteristic the bilateral exchange of rights and obligations, options have economic features that clearly distinguish between the roles assigned to each of the contracting parties. One product is a limited risk, symmetrical, contract and the other is not. The former is properly viewed as an option, while the latter generally falls within the rubric of notional principal contracts.

D. Options, Caps and Floors

These contrasting features furnish an appropriate means for relieving the existing tension between notional principal contracts and options in a way that is both simple to understand and easy to apply. There is an important exception, however, to the proposition that notional principal contracts are symmetrical contracts. Caps and floors (described more fully below) are governed by the notional principal contract rules

and not by the rules governing options for no apparent reason other than that the regulations expressly provide for such treatment. The result is surprising because caps and floors bear a much strong economic resemblance to options than to conventional notional principal contracts.

Under a typical interest rate cap, one party (the "purchaser") pays an initial "premium" amount in exchange for an agreement by the other party (the "writer") to make a series of payments equal to the excess on each payment date of a floating-rate index over a specified fixed rate, each as applied to a notional principal amount. If, on a scheduled payment date, the relevant floating rate is less than the specified fixed rate, no payment is made. An interest rate floor, conversely, requires the writer to make payments based on the amount by which a floating rate is less than the specified fixed rate. If, on a scheduled payment date, the relevant floating rate is less, in the case of a cap, or more, in the case of a floor, than the specified fixed rate, no payment is made.

The economics of caps and floors are identical to option economics. Caps and floors, unlike swaps, typically are structured to provide for an initial premium payment. As a result, the purchaser of a cap or floor normally is viewed as having a tax basis in the contract.

Moreover, as interest rates rise, the value of a cap contract increases in value, just as would the value of a put option on a fixed-rate debt instrument. If interest rates decline, the loss to the cap holder is limited to its initial premium payment. Like the holder of an option, the purchaser of a cap therefore has an unlimited potential for gain, and a risk of loss limited to its initial premium payment. Likewise, the writer of a cap has the unlimited loss and limited gain potential characteristics of an option writer.

These products are economically analogous to the option described in Example 6 above, except that the unlike a series of separately stated options, the initial premium paid for a cap or floor contract is often stated as a single lump sum. The timing of income from caps and floors under the Regulations differs from the taxation of options. Since regulations require amortization of upfront payments received in respect of notional principal contracts,[121] these upfront premiums must be amortized over the term of the contract.[122] In particular, the premium allocable to each period on a cap or floor is required to be recognized on a ratable daily basis over

[121] Reg. Sec. 1.446-3(f).

[122] Reg. Sec. 1.446-3(f)(2)(iv) requires that non-periodic payments under a cap or floor contract be allocated over the contract's term "in accordance with the price of a series of cash-settled option contracts." The amount of a non-periodic payment allocated to each deemed option under the cap or floor then is taken into account (as income or deduction) only in the period during which that deemed option is scheduled to expire. Straight-line and "accelerated" amortization methods are specifically disallowed.

that period. Under the tax rules applicable to options, option premium is generally recognized upon the lapse, exercise, or other termination of the option (except in the case of a party who takes delivery of the optioned property, who generally realizes income or loss attributable to the option as income or loss from such property).

The character of income or loss from a cap or floor also differs from the treatment of options, with payments under caps and floors generally qualifying for ordinary treatment. Accordingly, taxpayers otherwise indifferent to entering into, for example, a three-year cap or a set of three options effectively may elect the tax treatment preferred. Insofar as the tax implications of these products depends upon the taxpayer's choice of terminology, thereby giving taxpayers the right to choose their desired tax treatment, current law violates the IRS's asserted neutrality principle. Under the circumstances, it would makes sense for the IRS to conform the tax treatment of caps and floors to the tax treatment of options, in recognition of the economic resemblance of a cap or floor contract to a series of option contracts

E. Assessing Credit Default Swaps

Like other trigger options, credit default swaps are simply options that are subject to an explicitly-stated contingency. Aside from the trigger feature, they economically resemble conventional options in every respect. Like a conventional option, the buyer of protection pays to the seller a regular premium, or series of premiums, which are specified at the beginning of the transaction. If no Credit Event, such as default, occurs during the life of the contract, these premium payments are the only cash flows, and the contract expires worthless. Should there be a credit event, the protection seller makes a payment to the protection buyer based on the decline in value of the underlying property. If the contract pays off, the protection buyer stops paying the periodic premiums.

Like conventional options, the contract may be physically settled or cash settled. A CDS may be cash-settled, with a payment based on the difference between the principal amount of the reference obligation and its post-credit event fair market value. Alternatively, in some cases, the buyer may be permitted to deliver the reference security to the seller in exchange for the full par value amount. Either way, the protection buyer is not required to own the reference obligation. The protection buyer is able to deliver any qualifying loan or bond issued by the reference entity, typically one ranked *pari passu*, in return for a full par payment.

Swaps by their nature contemplate a series of mutual exchanges of cash flows between two contracting parties. In fact, one of the underlying themes of the notional principal contract regulations is to ensure that the

corresponding cash flows are appropriately matched to one another. Unlike traditional swaps, credit default swaps have no reciprocal cash flows. One side makes regular periodic payments, generally fixed payments, and the other side either pays nothing over the life of the contract, or else it makes a single payment at termination that is liable to substantially exceed the amounts cumulatively paid by the other side. If the contract does pay off, which tends to happen only rarely, it automatically terminates, and no further payments are due from either side. In sum, the contract either pays off, or else it expires worthless, which is the classic economic profile of an option. A manifestly asymmetrical contract, credit default swaps bears no substantive resemblance to a financial swap and accordingly, they should be treated exclusively as options for tax purposes.

CONCLUSION

The purpose of this paper was to identify what elements are really necessary to cause an economic arrangement to be treated as an option for federal income tax purposes. Based on a review of the case law, a contract qualifies as an option if it includes an undertaking by one party at the inception of the contract to make a guaranteed non-refundable payment to the other --ordinarily paid upfront -- that is a fraction of the contract price, and whose payment relieves the payor of any further liability if it should be unable or unwilling to perform its end of the contract.

Applying this definition of what constitutes an option, it is possible to address all of the ancillary questions set forth in the Introduction to this paper. While it is economically essential for a premium to be paid in exchange for an option, it is not necessary for the premium to be paid upfront. That means that an option is still an option if the premium is payable on the exercise date, rather than when the contract is executed. The payment need not be described as a premium, but it must be non-refundable and constitute only a fraction of the total potential contract liability.

There is no underlying property requirement for a product to meet the definition of an option, so a non-property based option may still qualify as a bona fide option for tax purposes. For that reason, catastrophe options, weather derivatives, economic derivatives, mortgage pre-payment derivatives and economic derivatives are all properly described as options for tax purposes. Non-property-based options can be distinguished from wagers insofar as the term wager is generally used to describe bets made in the context of games, sports events and contests, rather than business settings. All of the aforementioned derivatives are furnished in a typical business setting.

If an option contract is subject to a contingency, it should still be classified as an option. The existence of a contingency does not obviate the essential nature of an option contract as an option; in fact, it is an essential characteristic of an option for it to be premised on either an explicit or implicit contingency. Options that have explicitly-stated contingencies are described herein as trigger options, because exercise is triggered by the happening of the specified contingency. The most prevalent example of a pure trigger option is a credit default swap.

The option definition developed in the first part of this paper presupposes, as is normally true for physically settled options, that the option holder would be required to make an additional payment to the option seller on the exercise date if she wishes to proceed with the underlying transaction. Cash-settled options, however, typically dispense with the need for the option holder to pay any further amounts on the exercise date. If and when a cash-settled option pays off, the parties' respective payment obligations are netted, and the seller simply pays the difference between the market price and the strike price. Nevertheless, this paper has also fashioned a clear definition for options that recognizes the distinctive economic nature of these instruments. In particular, a cash-settled option is an asymmetrical contract that is a limited risk one-way bet which will either pay out from one side to the other, or else expire worthless. By this definition, caps and floors are incorrectly treated as notional principal contracts for tax purposes. For the sake of consistency, these products should be recognized for their closer similarity to cash-settled options and thereby taxed accordingly.

Issues of financial product classification may sometimes be the unavoidable result of the existence of two types of financial instruments which have similar economic effect but different legal forms. However, as this paper has demonstrated, it is possible to differentiate between an option and a financial swap based on their differing economics. In particular, an option is a limited risk, one-sided bet, whereas a swap entails a wholly symmetrical two-sided bet. The tension inherent in classifying instruments as either options or notional principal contracts is strictly a matter of having inadequately drawn, overlapping regulatory definitions. To resolve this potential conflict, the definition of an option can be clarified so as to make explicit the substantive differences between such contracts and notional principal contracts.[123]

[123] Although the regulations give the IRS the right under Reg. Sec. 1.446-3(g)(1) to recharacterize all or part of a transaction or series of transactions if the effect is to avoid application of the notional principal contract rules, in the absence of a clear way to differentiate between options and notional principal contracts, it is not clear to what effect the IRS could apply this tool, which seems to presuppose the existence of standards for analysis.

If the IRS were to adopt a universal definition for an option along the lines just described, it would be in position to conclude thatcredit default swaps are properly classified as options for tax purposes. In so doing, it would put to rest an important source of concern about the potential exposure of payments on these products to withholding taxes, which is currently a multi-million dollar concern to the financial products sector. Having a clearly defined definition of what constitutes the essential nature of an option would also permit better differentiation between options and notional principal contracts, insofar as there are very real differences in the tax treatment between these two product classifications for timing and character purposes.

In recent years, the IRS has emphasized the importance of the neutrality principle in the financial products area, *i.e.,* requiring consistent treatment of different instruments with similar economic characteristics. The goal of neutrality rests on the notion that tax rules providing for differences in tax treatment which do not reflect real economic differences invariably lead to inappropriate tax consequences. If taxpayers have the ability to enter into notional principal contracts with the same economic characteristics as options, and the two types of instruments do not receive the same tax treatment, tax-advantaged products can be developed to arbitrage the tax differences between the two instruments, which can lead to a whipsaw of the government. By the same token, not all taxpayers welcome the ability to pick and choose the proper classification of instruments. A lack of guidance in the financial products sector tends to give rise to uncertainties that may discourage economically useful transactions.

The overlapping definitions of options and notional principal contracts create problems for the neutrality principle precisely because existing rules governing options and notional principal contracts are so inconsistent with one another. Accordingly, it is important to decide, when developing rules for new financial products, which set of existing rules should be followed. In determining whether instruments should most appropriately be characterized as options or notional principal contracts, the IRS needs to provide clear guidelines that reflect the fundamental economic differences between these two products.

There is nothing wrong with having significantly different tax results obtain for economically dissimilar financial instruments. A clear definition of what constitutes an option would serve the IRS's goal of minimizing cherry picking of character and timing results while ensuring a consistent application of the policy rationale for the different tax regimes. In this context, the neutrality principle can best be given consistent effect by properly differentiating between options and notional principal contracts based on their differing economic characteristics.