15 T.C. 220 (1950)

Gains or losses attributable to the failure to exercise an option to buy property are considered short-term capital gains or losses, subject to the limitations on deducting capital losses.

Summary

Nordblom Associates paid $25,000 for an option to purchase stock, anticipating that Western Fuel & Oil Co. would exercise the option and compensate Nordblom. When Western withdrew, the option lapsed, and Nordblom forfeited the $25,000. Nordblom claimed an ordinary business expense deduction, but the Commissioner argued it was a short-term capital loss. The Tax Court held that the loss was indeed a short-term capital loss, and since Nordblom had no capital gains that year, no deduction was allowed. This case clarifies the tax treatment of option forfeitures under Section 117(g)(2) of the Internal Revenue Code.

Facts

Nordblom, a brokerage firm, sought a purchaser for Chalmette Petroleum Corporation stock. An attorney representing Chalmette shareholders required a $25,000 deposit for an option to purchase the stock and to receive detailed company information. Baskerville, president of Western Fuel & Oil Co., expressed interest but lacked immediate authority to deposit funds. Baskerville assured Nordblom that Western would acquire the stock, so Nordblom paid for the option. Western later deposited funds for the purchase but ultimately withdrew from the deal, causing the option to lapse and Nordblom to forfeit the $25,000.

Procedural History

Nordblom claimed the $25,000 as an ordinary business expense deduction on its tax return. The Commissioner of Internal Revenue disallowed the deduction, treating it as a short-term capital loss. Nordblom appealed to the Tax Court, contesting the Commissioner’s determination.

Issue(s)

Whether the $25,000 loss incurred by Nordblom due to the forfeited option is deductible as an ordinary and necessary business expense under Section 23(a)(1)(A) of the Internal Revenue Code, or whether it must be treated as a short-term capital loss under Section 117(g)(2) of the Code.

Holding

No, because Section 117(g)(2) of the Internal Revenue Code specifically states that losses attributable to the failure to exercise an option to buy property are considered short-term capital losses, and Section 117(d)(1) limits deductions for

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corporate capital losses to the extent of capital gains, of which Nordblom had none.

Court's Reasoning

The court relied on the plain language of Section 117(g)(2) of the Internal Revenue Code, which explicitly addresses the tax treatment of gains and losses from the failure to exercise options. The court emphasized that the statute is clear: a loss from failure to exercise an option is a short-term capital loss. Nordblom, as the purchaser of the option, directly incurred the loss when the option expired unexercised. The court rejected Nordblom's argument that the loss should be treated as an ordinary business expense, stating that such a holding would require the court to overstep its judicial function. The court noted that it could find no indication in the legislative history of Section 117(g)(2) that Congress intended to exempt brokerage corporations from its provisions. The court stated, "If we held in accordance with petitioner's theory, under the circumstances of this case, this Court would be stepping beyond its judicial function into the field of legislation."

Practical Implications

This case provides a clear rule for the tax treatment of forfeited option payments: they are generally treated as short-term capital losses. This has significant implications for businesses and investors using options. It emphasizes the importance of understanding the capital gains and losses rules when dealing with options. Legal practitioners should advise clients that losses from unexercised options are subject to the limitations on deducting capital losses. Later cases would cite Nordblom to reinforce the principle that the express language of the tax code governs the characterization of gains and losses from options, even if the taxpayer's intent was business-related.

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