***Pittston Co. v. Commissioner, 26 T.C. 967 (1956)***

Payments received for the failure to exercise an option are treated as short-term capital gains, regardless of whether the option itself would have qualified for long-term capital gain treatment if sold or exchanged.

**Summary**

The Pittston Co. case addresses the tax implications of receiving payment for failing to exercise an option. The Tax Court held that the payment constituted a short-term capital gain under Section 117(g)(2) of the Internal Revenue Code, irrespective of the holding period of the underlying asset or the option itself. The court emphasized that the specific statutory provision governing the failure to exercise an option overrides general capital gains principles. This case clarifies that such payments are not treated as proceeds from a “sale or exchange” but are specifically categorized by statute.

**Facts**

The petitioner, Pittston Co., received $27,848.24 in 1942 from Cotwool Manufacturing Corporation. Pittston had previously acquired an option to purchase assets from Cotwool. Instead of exercising the option, Pittston received a payment in exchange for allowing the option to lapse or surrendering it. Pittston argued that this payment should be taxed as a long-term capital gain, either as an additional amount realized from a prior stock sale or as proceeds from the sale of a capital asset (the option) held for more than six months. The Commissioner argued it was ordinary income or a short-term capital gain.

**Procedural History**

The Commissioner determined a deficiency in Pittston’s income tax for 1942. Pittston challenged this determination in the Tax Court. The Tax Court reviewed the facts and relevant provisions of the Internal Revenue Code to determine the proper tax treatment of the payment received for not exercising the option.

**Issue(s)**

1. Whether the payment received by Pittston for failing to exercise the option should be treated as a long-term capital gain, either as an additional amount realized on a prior sale or as gain from the sale of a capital asset held for more than six months.
2. Whether the payment is instead taxable as ordinary income or a short-term capital gain.

**Holding**

1. No, because the transaction falls under the specific provision of Section 117(g)(2) of the Internal Revenue Code, which treats gains from the failure to exercise an

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option as short-term capital gains.
2. The payment is taxable as a short-term capital gain.

**Court’s Reasoning**

The court reasoned that while options can be sold or exchanged, triggering general capital gains rules, the specific scenario of a *failure* to exercise an option is governed by Section 117(g)(2). This section explicitly states that gains or losses attributable to the failure to exercise options are considered short-term capital gains or losses. The court emphasized that the option was property in the petitioner’s hands, but it ceased to exist upon surrender or expiration, akin to the satisfaction of a debt. The court distinguished this situation from a sale or exchange, where property passes from one person to another. The court cited legislative history indicating that this provision was intentionally designed to treat such gains as short-term, regardless of other circumstances. As the court stated, “Here the petitioner was paid for failing to exercise his option. A gain resulted. The transaction is thus literally within the words of section 117 (g) (2) and the gain must be treated as a short term capital gain.”

**Practical Implications**

The Pittston Co. case provides clear guidance on the tax treatment of payments received for not exercising options. It establishes that Section 117(g)(2) (or its successor provision in the current Internal Revenue Code) takes precedence over general capital gains principles in such situations. Attorneys advising clients on option agreements must consider this rule when structuring transactions and advising on the tax consequences of allowing options to lapse or surrendering them for payment. This ruling prevents taxpayers from strategically claiming long-term capital gain treatment on such payments by arguing that the option itself would have qualified for long-term treatment if sold. Later cases cite Pittston Co. for the proposition that specific statutory provisions override general principles of tax law.

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