***Cadby v. Commissioner*, 12 T.C. 999 (1949)**

An inherited option has a tax basis equal to its fair market value at the date of inheritance, and this basis is used to determine the gain or loss from the subsequent sale of the option.

Summary

The case concerns the determination of the tax basis for an option inherited by the taxpayer. The taxpayer's father's will granted an option to purchase stock, which the taxpayer later sold. The Commissioner argued the option had a zero basis, resulting in the entire sale proceeds being taxable income. The Tax Court disagreed, holding that the option acquired a basis upon inheritance, calculated as the difference between the stock's fair market value and the option's exercise price. The court considered the option as property, separate from the stock itself, and subject to valuation at the time of inheritance, thereby determining a tax basis for the option, and ultimately finding no taxable gain from the sale of the option.

Facts

The taxpayer, Cadby, inherited an option to purchase stock from his father's estate. The will granted W. Winne Cadby and Charles D. DeFreest the option to purchase shares of preferred and common stock of Cadby & Son, Inc., provided they purchased his wife's preferred shares and made the purchases within two years. The taxpayer sold his rights under this option to DeFreest for $13,000. The Commissioner asserted a tax deficiency, arguing the option had a zero basis, and the entire $13,000 was taxable as gain.

Procedural History

The case originated in the United States Tax Court. The Commissioner determined a tax deficiency for Cadby, which Cadby contested. The Tax Court reviewed the facts and legal arguments and ruled in favor of the taxpayer, determining the correct basis for the inherited option.

Issue(s)

1. Whether an inherited option has a tax basis.

2. If so, how is the tax basis of the inherited option determined?

3. Whether the sale of the inherited option resulted in taxable gain.

Holding

1. Yes, an inherited option has a tax basis.

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2. The tax basis is determined by its fair market value at the date of inheritance.

3. No, because the option was sold for less than its basis, there was no taxable gain.

Court's Reasoning

The court focused on whether the option itself constituted property with a basis that could be determined at the time of inheritance. The court distinguished the case from *J. Gordon Mack, 3 T.C. 390*, which involved the exercise of an option and sale of the underlying property, and *Helvering v. San Joaquin Fruit & Investment Co., 297 U.S. 496*, which concerned the basis of property acquired after exercising an option. The court emphasized that in this case, Cadby sold the option itself, not the underlying stock. The court cited prior cases, *Bell's Estate v. Commissioner, (C. A. 8) 137 F. 2d 454; McAllister v. Commissioner, (C. A. 2) 157 F. 2d 235*, to support the idea that an option, like other property, could acquire a basis through inheritance.

The court stated: "The option was property. It had value…It acquired a basis by virtue of its transmission by inheritance."

The court calculated the option's value (and thus its basis) by subtracting the exercise price from the fair market value of the stock as determined in the estate tax return. The court found the conditions attached to the option—the requirement that the optionee purchase the widow's preferred stock—did not render the option valueless.

Practical Implications

This case provides a clear precedent for the tax treatment of inherited options. It establishes that such options have a basis equal to their fair market value at the time of inheritance. This has significant implications for estate planning, as it impacts the tax consequences of selling or exercising inherited options. Attorneys should advise clients to obtain proper valuations for options at the time of inheritance and to document the calculation of gain or loss upon any subsequent sale. When advising clients about inherited property, it is critical to determine what the property is and how the basis is determined. This ruling clarified that an option itself is property separate from the underlying asset. Also, the specific facts, such as the option to purchase stock, are key factors in determining the correct tax treatment, and it helps guide the determination of the tax basis.

The principles established in *Cadby* are important when analyzing similar tax situations involving the transfer of options through inheritance or other means.

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