Molbreak v. Commissioner, 61 T. C. 382 (1973)

Exercising an option to purchase property does not constitute an exchange under section 1031, resulting in short-term capital gain if the property is sold within six months.

Summary

Vernon Molbreak and others formed Westshore, Inc. , which leased land with an option to purchase. After failing to obtain court approval to buy part of the land, the company liquidated under section 333, distributing the leasehold to shareholders who then exercised the option. The shareholders sold a portion of the land shortly thereafter, claiming long-term capital gain. The Tax Court held that exercising the option was a purchase, not an exchange under section 1031, resulting in short-term capital gain due to the short holding period after the option was exercised.

Facts

In 1960, Westshore, Inc. , leased 6 acres of land with a 99-year lease including an option to purchase for $200,000. In 1967, after failing to get court approval to buy 1. 3 acres, Westshore liquidated under section 333, distributing the leasehold to shareholders Molbreak, Schmidt, and Schmock. On May 15, 1967, the shareholders exercised the option, purchasing the entire property. Four days later, they sold 1. 3 acres, reporting the gain as long-term capital gain.

Procedural History

The Commissioner determined deficiencies in the shareholders' income taxes, asserting the gain was short-term. The Tax Court consolidated the cases of Molbreak and Schmidt, while Schmock's case was continued for settlement. The court held a trial and issued its opinion.

Issue(s)

1. Whether the profit realized by the petitioners from the sale of 1. 3 acres on May 19, 1967, should be taxed as short-term or long-term capital gain.

Holding

1. No, because the exercise of the option on May 15, 1967, constituted a purchase of legal title to the fee and did not result in a qualifying section 1031 exchange of a leasehold for the fee, leading to a short-term capital gain on the sale of the property on May 19, 1967.

Court's Reasoning

The court distinguished between an option and ownership of property, stating that

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an option does not ripen into ownership until exercised. When the shareholders exercised the option, the leasehold merged with the fee, and they acquired full legal title. The court rejected the argument that this was an exchange under section 1031, as the shareholders did not exchange the leasehold for the fee; rather, they purchased the fee with cash. The court cited Helvering v. San Joaquin Co. , where the Supreme Court similarly held that exercising an option was a purchase, not an exchange. The court also noted that no provision in the tax code allows tacking the holding period of property subject to an extinguished option to the new property interest.

Practical Implications

This decision clarifies that exercising an option to purchase does not constitute an exchange under section 1031, impacting how similar transactions are treated for tax purposes. Taxpayers must be aware that the holding period for tax purposes begins when the option is exercised, not when the option is obtained. This ruling may affect real estate transactions where options are used, as it limits the ability to claim long-term capital gains treatment on property sold shortly after exercising an option. Subsequent cases have followed this reasoning, reinforcing the principle that exercising an option is a purchase, not an exchange.

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