**8554. When is the gain or loss from sale or exchange of an option to purchase property treated as a capital gain or capital loss?**

The sale or exchange of an option to purchase property may result in capital gain if the underlying property subject to the option is a capital asset. Similarly, losses arising from the taxpayer’s failure to exercise the option may be treated as capital losses if the underlying property is a capital asset.[[1]](#footnote-1)

*Example:* Brenda is considering an investment in real property, but, because the purchase price is high, she purchases an option to buy the property for $5,000 within the next two years. The option is a capital asset because if Brenda had purchased the property outright it would have been a capital asset. Eleven months later, Brenda sells the option for $6,000. The $1,000 gain ($6,000 selling price minus $5,000 basis) is a short-term capital gain because Brenda held the option for less than one year.

Similarly, if the taxpayer fails to exercise the option, the option is treated as though it was sold or exchanged on the day the option expired for no consideration. Based on the taxpayer’s holding period, the loss will be either long-term or short-term capital loss.[[2]](#footnote-2)

In a recent Tax Court decision, the Tax Court held that a taxpayer was entitled to an ordinary loss deduction, rather than recognition of a capital loss, when the taxpayer abandoned an option to purchase certain real property. Because the taxpayer was in the business of purchasing and developing real property, the underlying real property was not a “capital asset.” For that reason, the loss realized by the taxpayer when he abandoned his option was as an ordinary loss rather than a capital loss.[[3]](#footnote-3)

IRC Section 1234 provides special rules with regard to options to buy or sell stock, securities or commodities. Specifically, IRC Section 1234(b) provides short-term capital gain or loss treatment for the grantor of an option as follows:

* The option lapses or is terminated in a closing transaction.
* The underlying property is stock, securities, commodities or commodities futures.
* The option is not issued in the ordinary course of the grantors trade or business

A “closing transaction” is defined as any transaction that terminates the taxpayer’s obligations under the option other than an exercise or lapse of the option.[[4]](#footnote-4)

See Q 8543 for a discussion of what constitutes a capital asset for purposes of capital gains treatment.

1. . IRC Sec. 1234(a)(1). [↑](#footnote-ref-1)
2. . IRC Sec. 1234(a)(2). [↑](#footnote-ref-2)
3. . *Sutton v. Commissioner*, TC Summ. Op. 2013-6, IRC Sec. 1221(a). [↑](#footnote-ref-3)
4. . IRC Sec. 1234(b)(2). [↑](#footnote-ref-4)