December 15, 2005

When Is A Contract An Option?

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It is sometimes unclear whether a contract that appears to be a mutually binding agreement on its face should be classified for tax purposes as an option or, conversely, whether an agreement that purports to be an option should be classified as something else.

One such situation was addressed recently by the Tax Court in *Federal Home Loan Mortgage Corporation ("FHLMC") v. Commissioner* (125 T.C. No. 12, Nov. 21, 2005). The principal issue in the case was whether "prior approval purchase contracts" executed by Freddie Mac (the name by which the petitioner is commonly known) were, in substance, options to purchase loans. The Tax Court concluded, in a close case that could easily have been decided in the government's favor, that Freddie Mac had properly treated the contracts as options. Accordingly, Freddie Mac was not required to take payments received in connection with entering into the contracts into income at the time of receipt.

Facts in FHLMC v. Commissioner

In the course of its business, Freddie Mac acquires residential mortgage loans from loan originators. Mortgages on multifamily housing were acquired by Freddie Mac during the years at issue pursuant to two programs, the "immediate delivery purchase program" and the "prior approval program."

The immediate delivery purchase program was designed to accommodate the purchase of loans that had already closed at the time the originator contacted Freddie Mac. Under this program, an originator would contact Freddie Mac to request that Freddie Mac purchase a loan on specified terms. If the offer was accepted, a contract would be executed for the sale of the mortgage. The originator would be required to pay an application/review fee equal to the greater of $1,500 or 0.1% of the purchase contract amount, and to deliver the loans within 30 days after the contract was accepted.

If an originator failed to deliver loans pursuant to immediate delivery contracts, Freddie Mac reserved the right to disqualify or suspend the eligibility of the originator to sell additional loans to Freddie Mac.

The prior approval program was designed to accommodate loan originators who wanted to have a commitment from Freddie Mac to purchase a loan before it was made. To obtain such a contract, an originator would submit a request for approval of a specific project and pay a loan application fee similar to that described above. If the mortgage were found to be acceptable, Freddie Mac would offer to enter into a prior approval purchase contract with the originator that would commit Freddie Mac to purchase the loan for a formula price, designed to provide Freddie Mac with a minimum yield (as computed at the time of closing of the purchase) that could vary --subject to a cap -- during the term of the commitment.

To accept this offer, the originator would have to enter into a delivery contract within 10 days after the offer by Freddie Mac, and pay a commitment fee of 2% of the principal amount of the mortgage. One-fourth of that fee was not refundable. The balance of the commitment fee (1.5% of principal) would be refunded when the mortgage was delivered pursuant to the contract.

The delivery of a mortgage loan pursuant to a contract under the prior approval program was at the originator's option. If the loan originator did not deliver the mortgage, however, the entire 2% fee (including the 1.5% "refundable" portion) was forfeited. Failure to deliver a loan pursuant to a contract under the prior purchase program would not cause the originator to be disqualified or suspended as a seller of mortgages to Freddie Mac.

Freddie Mac treated the nonrefundable portion of the commitment fees received under the prior approval program during its taxable years 1985 through 1991 as option premiums, received for the grant of options to loan originators that provided them with the right, but not the obligation, to sell property to Freddie Mac (that is, a "put").

Consistent with the general tax treatment of put options (discussed below), Freddie Mac did not include the 0.5% nonrefundable portion of the commitment fees in its income in the year of receipt. If the option was exercised and the loan was acquired, the initial cost basis of the loan would be reduced by the amount of the fee and that discount would be amortized over the estimated remaining life of the mortgage in Freddie Mac's hands. If the originator did not deliver the loan, the nonrefundable commitment fee would be included in the income of Freddie Mac at the time of lapse of the loan originator's rights under the prior approval purchase contract.

Approximately 99% (by value) of the loans for which prior approval purchase

contracts were executed were, in fact, delivered to Freddie Mac by the loan originators. Freddie Mac believed that the typical reason for a failure to deliver under this program was a failure to consummate the underlying mortgage loan (as opposed to a decision by the loan originator to sell its loan to a different buyer).

A tax deficiency was asserted by the IRS for the years at issue, apparently premised on the argument that the prior approval purchase contracts were not options and that the nonrefundable fees should therefore have been included in Freddie Mac's income when received. Before the Tax Court, Freddie Mac contended that its reporting of the nonrefundable fees as option premiums was correct.

Discussion

The court reviewed the essential components of an option under prior case law, namely, the provision, for consideration, of (i) an offer to buy or sell property for a specified price, which offer would not become a binding contract until accepted; and (2) an agreement to keep the offer open for some period of time. By contrast, a contract of sale generally contains mutual obligations on the part of the seller and the buyer, with the seller being obligated to sell and the buyer being obligated to buy on the terms set forth in the contract.

The tax treatment of payments for options reflects the uncertainty, at the time the option is granted, as to whether or not the option will be exercised. As the appropriate treatment of the premium paid for the option will differ depending on whether or not the option was exercised, the option premium is not included in income before the year in which any failure to exercise the option becomes final. If a put option is exercised, the option premium reduces the optionor's basis in the property purchased, but, if the option lapses, the optionor may have income in the year of lapse (*see* Rev. Rul. 58-234, 1958-1 C.B. 279).

The Commissioner argued that the contracts were not options because the purchase price for each loan could fluctuate over the term of the contract. Because the contracts included a yield-based formula that would determine the price for which a loan would be purchased on any particular day, the court found that those contracts met the requirement that an option include an agreement between the parties as to the exercise price.

The Commissioner also asserted that an essential part of the rationale for the "open transaction" tax treatment of an option is the existence of uncertainty, at the time the option is granted, as to whether or not it will be exercised. The Commissioner argued that this element of uncertainty was lacking in this case because the potential forfeiture of the 1.5% refundable portion of the fee under a prior approval purchase contract, if the loan was not delivered to Freddie Mac within the period specified in the prior approval purchase contract, made it a virtual certainty that the sale of the mortgage loan would be consummated. The fact that approximately 99% of the loans for which such contracts were entered into were in fact sold pursuant to those contracts appeared to lend support to the Commissioner's argument.

The court noted, however, that the circumstance that many loan originators used the prior purchase program, rather than the immediate delivery purchase program (with respect to which the 0.5% nonrefundable fee was not imposed), to sell loans to Freddie Mac, indicated that originators were concerned that there was significant risk that a loan could not be delivered within the required period, in which case the option would not be exercised.

The court also rejected the Commissioner's argument that the treatment of the nonrefundable fee as income upon receipt was supported by *Chesapeake Financial Corp. v. Commissioner* (78 T.C. 869 (1982)). That case dealt with the tax treatment of certain fees received by a mortgage banker in return for issuing loan commitments. The fees had been reported by the recipient as income in the year the loans were funded, rather than when the fees were received, but the Tax Court concluded that the fees were received in consideration of the underwriting services rendered in connection with making the loan commitment and were therefore taxable in the year of receipt. In the *FHLMC* case, the Tax Court distinguished the earlier case as dealing with a taxpayer that was originating loans, rather than agreeing to purchase loans; no argument had been made to the Tax Court in *Chesapeake* that the loan commitment fees might constitute option premiums.

The Tax Court concluded that the prior approval purchase contracts had all the key components of an option because, under those contracts, the loan originators had the right, but not the obligation, to cause Freddie Mac to purchase the loans.

OBSERVATIONS

The Tax Court in *FHLMC* does not seem to have focused on the economic equivalence between (i) an "option" under which 1.5% of the principal amount of the underlying loan (over and above the basic nonrefundable cost of obtaining the option) would be forfeited if the holder failed to exercise the option, and (ii) a bilateral contract where the remedy of the buyer, in the event of the seller's default, is limited to receipt of the same 1.5% amount. In both cases, if the seller does not sell the specified property, the seller suffers a loss (above and beyond the value inherent in the option or contract), that is limited to a pre-determined amount. This economic equivalence may place in question the concept of identifying a fundamental distinction between a bilateral contract and an option of this nature.

From a planning perspective, however, the case is clearly worthy of review as a reminder of the significant tax stakes that may be at issue in determining whether a contract is a bilateral agreement in substance or a "mere" option, and as to the factors that a court may consider in making this determination.

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