



**PIASCİK & ASSOCIATES**  
CERTIFIED PUBLIC ACCOUNTANTS

Main / 804-527-1815

Toll Free / 866-527-1815

Fax / 804-527-1816

Innsbrook Corporate Center

4470 Cox Road, Suite 250

Glen Allen, Virginia 23060

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Mr. A. Smith  
ABC Smith Company

Dear Mr. Smith:

### **Options: A Useful Tool in Real Estate Not Just the Stock Market**

Although options are usually thought of as stock market or commodities tools, they can also be useful tools in other types of property, such as real estate (“real property”). Below are a few of the tax attributes of an option to buy real property, from the point of view of the prospective seller (the option “grantor” discussed below) and the prospective buyer (the option “holder” discussed below).

In a simple option to buy real property, one person (the “grantor”) grants to another person (the “holder”) the right, for a fixed period of time, to buy the real property under stipulated terms. In exchange, the holder pays the grantor an agreed-upon sum. The main tax benefit for the grantor is that the amount paid for the option is not subject to income tax until the option lapses or is exercised.

If the option lapses (that is, the holder chooses not to buy the real estate), the grantor recognizes income equal to the amount paid to him for the option.

If the option is exercised (that is, the holder buys the real estate), the grantor recognizes gain (or loss) on the sale of the real property, which includes the amount received for the option.

The grantor's tax deferral can only be achieved if the agreement is a true option. This option is one that unconditionally binds the grantor to sell the real estate at the option's terms, while giving the holder the right to accept or reject the terms. One of the many tax traps to avoid in this complex area is including terms that resemble a lease or a sales agreement rather than an option. If the economic reality indicates that a sale has taken place and the benefits and burdens of ownership of the real estate have been transferred, the transaction will be treated as a sale, resulting in immediate tax consequences (i.e. gain or loss on the transaction will have to be reported).

From the holder's point of view, the option technique can yield significant economic benefits (for example, the holder ties down property without being committed to its purchase); however the cash paid by the holder for the option will not yield an immediate tax benefit. If the holder ultimately exercises the option and buys the real property, the option price is added to the real property's “basis” (cost for tax purposes). If the holder does not buy the real property, the holder will have either an ordinary or capital loss for the option price, depending on the ordinary or capital character of the real property that is the subject of the option (and, where the holder is engaged in business, depending on the holder's business-property transactions).



Options can be powerful tools for buyers and sellers of real property, but understanding the risks and rewards, and structuring the transactions carefully is important. Please feel free to contact us for more details about this or other selling or buying techniques.

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Very truly yours,  
PIASCIK & ASSOCIATES, P.C.

Ryan L. Losi, CPA  
*Director of Business Development*