New York State Bar Association

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Ladies and Gentlemen:

I am pleased to enclose the New York State Bar Association Tax Section Report No. 1005 on the taxation of partnership options and convertible securities. Our report responds to a request for comments set forth in Notice 2000-29, 2000-23 I.R.B. 1241. We commend Treasury on undertaking this important project to provide guidance on taxation of partnership options, which we expect will bring much-needed clarity to an area of increasing commercial significance.

Part I of the report sets forth our principle conclusions and recommendations. Part II examines issues related to noncompensatory options generally. In addition to discussing the tax consequences upon option issuance, exercise, lapse or repurchase, Part II addresses other Subchapter K issues, such as accounting for option premium and Section 704(b) and Section 704(c)-type issues related to the exercise of noncompensatory options. Part III discusses noncompensatory debt-linked or preferred-linked options, including the tax treatment of convertible debt, convertible preferred equity and warrants issued with partnership debt or preferred equity. Part IV discusses compensatory options, including the tax consequences of issuance, exercise, lapse or repurchase, Section 704(c) and reverse 704(c) allocation issues, and vesting arrangements. Part V of the report discusses the characterization of partnership options as options or equity for tax purposes and considers substance-over-form and anti-abuse issues.

A unifying theme informing our analysis of these complex issues is our view that existing principles of taxation applicable to options, including in the corporate context, should apply to partnership options in most cases. Consistent with this view, we believe that in the case of noncompensatory options neither the partnership nor the option holders should recognize gain upon the exercise of an option. As a corollary to this conclusion we address issues relating to the maintenance of capital accounts and recommend that any "capital shifts" that occur merely as a result of implementing the economics of a noncompensatory option not give rise to income.

In the case of compensatory options, different considerations apply. We address certain issues relating to the interplay of subchapter K with section 83. We also address the two most prominent views on the consequence of exercise of a compensatory option – the "constructive sale of assets theory" and the "circular flow of cash" theory. While we do not take a strong position on this matter, we tend to favor the circular flow of cash theory. What is most important, however, is that guidance be issued on the subject.

Respectfully submitted,

Samuel J. Dimon

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cc: Deborah Harrington