Report #1005

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE TAXATION OF PARTNERSHIP OPTIONS AND CONVERTIBLE SECURITIES

January 29, 2002

TABLE OF CONTENTS

Page

Report #1005

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE TAXATION OF PARTNERSHIP OPTIONS AND CONVERTIBLE SECURITIES

January 29, 2002

This report[1] has been prepared in response to IRS Notice 2000-29,[2] requesting public comment on the federal income tax treatment of (1) the exercise of an option to acquire a partnership interest, (2) the exchange of convertible debt for a partnership interest, and (3) the exchange of a convertible preferred partnership interest for a common partnership interest.

In contrast to the substantial body of law concerning the tax treatment of corporate stock options and convertible securities, currently there is very little legal authority (and accordingly much speculation and uncertainty) regarding the federal income tax treatment of options to acquire equity interests in partnerships, limited liability companies and other entities treated as partnerships for federal income tax purposes (collectively, "partnerships") and of partnership debt and preferred equity instruments convertible into common partnership equity (collectively, "partnership options").[3]

---

[1] This report was prepared by members of the Committee on Partnerships of the New York State Bar Association. The principal drafter was Patrick C. Gallagher, with substantial contributions from William B. Brannan, Joel Scharfstein, and David H. Schnabel. Helpful comments were received from Andrew N. Berg, Kimberly S. Blanchard, Pamela Boorman, Richard Castanon, Samuel J. Dimon, Adam M. Grenker, Robert A. Jacobs, Sherwin Kamin, Audra K. Lazarus, Deborah L. Paul, Greer L. Phillips, Yaron Z. Reich, Michael L. Schler and Alan J. Tarr.

[2] 2000-23 I.R.B. 1241.

[3] This report addresses only options granted by the partnership issuer of the underlying equity. It
(continued...)

The treatment of corporate stock options and convertible corporate securities provides guidance by analogy, but the corporate analogy may be of limited use, given the treatment of a partnership for some purposes as an aggregate of individual persons owning undivided interests in the partnership's assets.

Accordingly, basic legal guidance is needed concerning the taxation of partnership options, which is a matter of significant and (particularly given the growing use of limited liability companies) increasing commercial interest. We commend the Internal Revenue Service (the "Service") for recognizing this need and initiating a project to develop guidance.

This report is divided into five parts:

- Part I summarizes our principal conclusions and recommendations.
- Parts II and III discuss partnership options issued in a noncompensatory context ("noncompensatory options"), with Part II addressing noncompensatory options other than convertible securities and Part III addressing convertible securities and special issues concerning other debt-linked and preferred-equity-linked options.
- Part IV discusses partnership options issued in connection with the performance of services ("compensatory options").
- Part V compares the tax treatment of partnership options and partnership equity and discusses substance-over-form and anti-abuse considerations.

---

[3] (...continued)
does not discuss options granted by a partner to another person with respect to an outstanding partnership interest, the tax consequences of which are reasonably well understood.

Appendices I and II provide several simplified examples illustrating some of the report's conclusions and recommendations concerning noncompensatory options (Appendix I) and compensatory options (Appendix II).

I. PRINCIPAL CONCLUSIONS AND RECOMMENDATIONS

A. In General. As an overarching principle, we recommend that partnership options (both noncompensatory and compensatory) be characterized for tax purposes in accordance with general option principles (subject to the substance-over-form and anti-abuse considerations noted in I.E and V below). Accordingly, for tax purposes, partnership options generally would be respected as such (and not treated as partnership equity interests), so that the holder would not be treated as a partner for tax purposes prior to exercise. In addition, we recommend that the issuance, exercise, and lapse or repurchase of a partnership option be governed by the general principles applicable to other options except to the extent the partnership taxation principles of Subchapter K dictate a different result.

B. Noncompensatory Options Generally

1. Issuance (see II.A). Consistent with general option principles (including in the corporate context), the issuance of a noncompensatory partnership option should be treated (i) from the purchaser's perspective as a nondeductible capital expenditure and (ii) as an open transaction that is not taxable to the partnership or the historic partners before lapse, repurchase or exercise of the option.

2. Exercise (see II.B). We recommend adopting a general rule that the exercise of a noncompensatory partnership option (whether in the form of a separate option or a conversion feature) is tax-free to the holder, the partnership and the historic partners under Section 721.[4] We believe this result is appropriate as a policy matter and well-supported by the statute. This rule would apply whether the exercise price is in the form of cash or property, and also whether or not there is a so-called "capital shift" (based on the principles of Treas. Reg. §1.721-1(b)(1)) by the historic partners in favor of the optionee. The general rule would be subject to the normal statutory exceptions potentially applicable in connection with the ordinary issuance of a partnership interest, including (i) the Section 707 disguised sale rules, (ii) actual distributions in excess of basis taxable to a partner under Section 731, (iii) constructive Section 731 distributions taxable to the historic partners as a result of Section 752 liability shifts, and (iv) Section 751 income in connection with such actual or constructive distributions. Consistent with general principles, (i) the holder's tax basis in the partnership interest acquired upon exercise should be equal to the sum of the holder's basis in the option, the exercise price, and the holder's Section 752 share of any partnership liabilities, and (ii) the holder's holding period in the partnership interest should begin on the day after the date of exercise.

Though the exercise price and the option premium are "property" for Section 721 purposes, it is less clear whether the option itself is "property," because the option is extinguished upon exercise. It would seem appropriate to treat the option as "property" for Section 721 purposes, though we do not believe such treatment is necessary to conclude that Section 721 nonrecognition treatment applies to the exercise of a partnership option.

3. **<u>Lapse or Repurchase</u> (see II.C).** Section 1234(a) by its terms should govern how the holder is taxed on the lapse or repurchase of a noncompensatory partnership option. Under

---

4 Unless otherwise indicated, all "Section" references herein are to the Internal Revenue Code of 1986, as amended to date.

Section 1234(a), the holder generally recognizes on the lapse or repurchase date (i) if the option lapses, loss in the amount of any forfeited option premium, or (ii) if the option is repurchased, gain or loss equal to the difference between the repurchase price and the option premium. For determining whether the gain or loss is capital or ordinary, we recommend a rule treating the partnership interest subject to the option (rather than the optionee's share of the underlying partnership assets) as "the property to which the option relates" for purposes of Section 1234(a). By reason of Section 741, this would result in capital gain or loss except as otherwise provided in Section 751.

Section 1234(b) by its terms appears to provide for gain or loss recognition to the issuing partnership upon lapse or repurchase of a noncompensatory partnership option. On the other hand, repurchase of a partnership option is economically similar to exercise of the option followed by a redemption of the resulting equity, both of which (based on Section 731(b) and our recommendation in B.2 above) would be tax free to the partnership, and the resulting disparity may raise tax avoidance concerns. To address these issues, consideration might be given to either (1) adopting, instead of the Section 1234(b) approach, a Section 1032-type rule for noncompensatory partnership options, providing that the partnership issuer recognizes no gain or loss on the repurchase or lapse of such an option, or (2) retaining Section 1234(b) as generally applicable but including a targeted anti-abuse rule. Implementing either approach would seem to require a legislative change.

4. Option Premium (see II.D.1). We recommend that, prior to exercise or lapse, any option premium be recorded in some type of equity account (presumably either a general equity account or a suspense account in the optionee's name), rather than be treated as a contingent liability or as tax-exempt income. We suggest that such an equity account reflect only the option premium amount and not be adjusted from time to time as the value of the option fluctuates, except possibly upon certain extraordinary events such as a book-up of the capital accounts. See Examples 3 and 4 in Appendix I.

5. Capital Accounts and Book-Tax Differences (see II.D.2-3). Partnership options raise difficult issues with respect to maintaining capital accounts (Section 704(b)) and eliminating book-tax differences (Section 704(c)) which the relevant Treasury Regulations in their current form may not adequately address. While this report does not purport to solve all these issues, it makes several suggestions. In the capital account area, these include (i) modifying (or clarifying) Treas. Reg. §1.704-1(b)(2)(iv)(f) to permit partner capital accounts to be booked up immediately after (rather than before) an optionee becomes a partner, and (ii) permitting or requiring nontaxable reallocations of book capital among the partners, where appropriate, upon exercise of a partnership option to the extent necessary to reflect the economic arrangement of the parties. Regardless of their treatment for Section 721 purposes, we recommend that partnership options not be treated as "property" for Section 704(c) purposes, because disappearance of the option on exercise means there is no mechanism under Section 704(c) itself to eliminate the resulting book-tax differences. Instead, such book-tax differences should be eliminated through "reverse" Section 704(c) allocations under Treas. Reg. §1.704-1(b)(4)(i) with respect to the partnership's historic assets. We suggest modifying this regulation to require, in appropriate cases, the allocation of notional tax items based on Section 704(c) remedial allocation method principles. Some of the foregoing principles are illustrated in the examples in Appendices I and II.

C. Noncompensatory Debt-Linked or Preferred-Linked Options. Part III of the report recommends that the taxation of noncompensatory debt-linked or preferred-linked options (i.e., convertible debt, convertible preferred equity, and warrants that are issued as an investment unit with partnership debt or preferred) be conformed with the recommended treatment of other noncompensatory partnership options (as described above and in II below) with appropriate modifications, including to reflect (i) the treatment of a conversion feature embedded in the debt or preferred security as part of that security and not as separate property, (ii) the application of the original issue discount and bond premium amortization rules, and (iii) in the case of convertible securities, tacking of the holder's holding period upon conversion under Section 1223(1).

We recommend that, consistent with the treatment of corporate debt instruments convertible into issuer stock under Treas. Reg. §1.1275-4(a)(4), it be clarified that the contingent payment debt rules do not apply to a debt instrument issued by a partnership merely because it is convertible into equity of the issuer, possibly subject to an anti-abuse provision (see III.A.1).

We also recommend, in connection with the repurchase of partnership convertible debt at a premium, adopting a rule similar to Section 249 (which by its terms applies only to corporate convertible debt) limiting the amount of the partnership's deduction to a "normal call premium" on nonconvertible debt (see III.A.3).

D. Compensatory Options

1. Section 83 (see IV.A). We believe that Section 83 provides the proper legal framework to resolve many of the issues presented by compensatory partnership options, and we recommend that guidance clarify that Section 83 applies to compensatory partnership options, except as noted in D.3 below.

2. **<u>Issuance</u> (see IV.B).** Assuming Section 83 applies and that the option does not have a "readily ascertainable fair market value" under Treas. Reg. §1.83-7, the grant of a compensatory partnership option to a service provider is not a taxable transfer for the service provider or the partnership because it is not a transfer of "property" for Section 83 purposes. We believe this is the appropriate result.

3. **<u>Exercise</u> (see IV.C).** Assuming that Section 83 applies, that the option did not have a readily ascertainable fair market value on the grant date, and that the partnership interest issued upon exercise of the option is fully vested: (i) Section 83(a) requires the holder to include in income (as ordinary compensation income) at exercise the excess of the value of the partnership interest on the exercise date (discussed below) over the sum of the option exercise price plus (if applicable) any premium paid; (ii) the holder's basis in such interest is its value on the exercise date (as determined for purposes of clause (i)) plus the holder's Section 752 share of any partnership liabilities; and (iii) the partnership (as service recipient) is entitled to a deduction (subject to capitalization rules and other limitations) in the amount of the optionee's compensation income under Treas. Reg. §1.83-6(a). Again, we believe these results are appropriate.

We believe that Section 704(b) will normally dictate that the partnership's Section 83 compensation deduction arising upon exercise is allocated to the historic partners (rather than to the incoming partner) and request guidance on this point.

In determining the amount of the holder's compensation income and the partnership's deduction at exercise, it is unclear whether the partnership interest should be valued (i) under Section 83 principles at its true fair market value, taking into account all relevant facts and circumstances, or (ii) under Subchapter K principles based on a liquidation analysis consistent with

Rev. Proc. 93-27 and related authorities. We believe the Subchapter K approach is more appropriate (for both profits interests and capital interests), because it would harmonize with the taxation of direct issuances of compensatory partnership interests and would be easier to apply.

Perhaps the most uncertain, and contentious, legal issue regarding compensatory partnership options is whether their exercise is a taxable event to the historic partners. Two basic analytical approaches seem plausible. Under a "circular flow of cash theory," the partnership is deemed to pay cash compensation to the optionee, which the optionee is deemed to contribute (together with the exercise price) to the partnership in a Section 721 transaction. There is no taxable income to the partnership or the historic partners (subject to potential Section 752 and 751 issues), and there is no adjustment to partnership asset basis. Alternatively, under a "constructive sale of assets theory," exercise is treated as resulting in the same cash compensation payment to the optionee, followed by a cash sale of a portion (the amount of which is subject to debate) of the partnership's historic assets to the optionee for fair market value, which assets (plus any remaining cash) are recontributed by the exercising holder in exchange for an interest in the partnership. The historic partners would recognize gain or loss based on the difference between the value of the assets deemed sold and the partnership's tax basis therein, and there would be a corresponding step-up in partnership asset basis. Because this is a difficult policy issue, we do not have a strong position on which of these two theories should govern, though we tend to favor the circular flow of cash theory. Whichever approach is considered appropriate, we do strongly recommend that the law be clarified to eliminate the significant uncertainty that now exists. These alternative approaches are illustrated in the example in Appendix II.

We also recommend that future guidance clarify the application of Rev. Proc. 2001-43 to partnership interests received upon exercise of compensatory partnership options (see IV.E.3).

4. **Lapse or Repurchase.** If a compensatory partnership option is repurchased for an amount exceeding any option premium paid by the holder, then assuming Treas. Reg. §1.83-7 (concerning stock options) applies and that the option did not have a readily ascertainable fair market value on the grant date, (i) the optionee should have compensation income in the amount of such excess, and (ii) the partnership should have a corresponding deduction (subject to applicable limitations). If a premium is paid for the option and the option lapses or is repurchased for less than the premium amount, then under Section 1001 and general tax principles the partnership should have taxable gain and the optionee a taxable loss (though Section 1234 would not apply). As for future guidance, either the current law result of taxable gain to the partnership could be preserved, or a Section 1032-type nonrecognition rule (along the lines described in I.B.3 above) might be implemented.

5. **Capital Accounts and Book-Tax Differences (see IV.E)**. As discussed in the report and illustrated in the example in Appendix II, compensatory partnership options raise many of the same Section 704(b) and 704(c) issues that arise in the noncompensatory context, with some differences.

E. **Tax Characterization of Partnership Options (see V).** As noted above, we recommend that partnership options generally be respected as such and not be treated as partnership equity. As a limitation on this rule, we recommend that substance-over-form principles generally applicable to options and similar securities (such as Rev. Rul. 82-150 concerning deep-in-the-money options) apply in the partnership context in appropriate cases. However, we recommend that any guidance concerning partnership options not alter the equity status of a partnership profits interest of the type contemplated by Rev. Proc. 93-27, despite its possible economic resemblance to a partnership option.

It may be possible to structure potentially abusive transactions involving the use of partnership options that would not necessarily be adequately addressed by existing substance-over-form principles. Accordingly, consideration might be given to a targeted anti-abuse provision. At the same time, we believe it would not be appropriate to fashion a broad anti-abuse rule which would recharacterize any partnership option arrangement that had the effect of reducing or deferring the taxation of overall partnership income.

II. NONCOMPENSATORY OPTIONS GENERALLY

This part of the report addresses ordinary noncompensatory partnership options, i.e., options issued other than in connection with the performance of services and not part of a convertible security or investment unit. Noncompensatory options typically are issued in exchange for payment of an arm's length premium.

Although there is little direct authority prescribing the treatment of noncompensatory or compensatory partnership options, as an overarching principle we recommend that partnership options be characterized for tax purposes in accordance with general option principles (see Part V below for further discussion of this point and of substance-over-form and anti-abuse considerations). Theoretically, it would be possible to treat a partnership option as actual partnership equity for tax purposes (and hence to tax the option holder as a partner) in all cases. For the reasons discussed in Part V, however, we believe this would be inappropriate and recommend that the holder not be treated as a partner for tax purposes prior to option exercise (except in limited cases described in V below). In addition, we recommend that the issuance, exercise, and lapse or repurchase of a partnership option be governed by the general principles applicable to other options except to the extent the partnership taxation principles of Subchapter K dictate a different result.

The discussion below and in Parts III and IV assumes the partnership options under consideration are respected as options (and not treated as partnership interests) for tax purposes and otherwise proceeds from the above principles.

A. Option Issuance

1. Consequences to Option Holder. Consistent with general option principles, the purchase of a partnership option for cash is merely an investment in the option -- a capital expenditure neither taxable to nor deductible by the optionee.[5]

In the non-partnership context, if the optionee acquires the option by transferring appreciated (or depreciated) property (rather than cash) to the issuer, then in contrast to the cash purchase case the transfer generally is treated as a taxable disposition of the property by the optionee under Section 1001.[6] In the partnership context, however, the tax treatment of such a property transfer is less clear. As further discussed in A.2 below, Section 721, which provides nonrecognition

---

[5] See, e.g., Rev. Rul. 57-40, 1957-1 C.B. 266 (option to acquire patent license); Rev. Rul. 58-234, 1958-1 C.B. 279 (put and call options on securities); Rev. Rul. 78-182, 1978-1 C.B. 265 (Chicago Board Options Exchange puts and calls). Rev. Rul. 58-234 and Rev. Rul. 78-182 are hereinafter referred to as the "Option Rulings."

[6] See, e.g., Rev. Rul. 72-198, 1972-1 C.B. 223 (transfer of appreciated property to a corporation in exchange for a warrant to acquire stock of the issuer in a transaction outside the scope of Sections 368 and 351 is a taxable exchange to the transferor under Section 1001). See also Davis v. U.S., 370 U.S. 65 (1962); Treas. Reg. §1.1001-2(c) (Example 7); and other authorities on the use of appreciated property to satisfy obligations.

treatment for a partnership and its partners with respect to contributions of property to the partnership "in exchange for an interest in the partnership," appears not to apply to the issuance of a partnership option, because (consistent with respecting the option's form) a partnership option is not a present "interest" in the partnership. Nevertheless, arguably the purchase of an option using appreciated property should not be subject to current taxation under an open transaction theory (i.e., viewing the purchase and any later exercise of the option as parts of an integrated transaction), assuming Section 721 would protect the holder and the historic partners from taxation upon any subsequent exercise of the option (see II.B below). However, this position may not be easy to reconcile with the treatment of corporate options.[7]

2. **Consequences to Partnership and Historic Partners.** Under established open transaction doctrine principles applicable to options generally, issuing an option is not taxable to the issuer until exercise, lapse or repurchase of the option.[8] This broad principle encompasses partnership options, so that neither the partnership nor the historic partners should be taxed prior to the exercise, lapse or repurchase of the option.

This result conforms to the treatment of corporate stock options. In the case of corporate options, however, in addition to applicability of the open transaction doctrine, Section 1032(a) expressly provides that no gain or loss is recognized by the corporation upon issuing an

---

[7] See, e.g., Rev. Rul. 72-198 (summarized in previous note). One possible basis for distinction is that, even applying open transaction principles, normally neither Section 368 nor Section 351 (which are much more restrictive than Section 721) will apply upon exercise of a corporate option.

[8] See, e.g., Rev. Rul. 57-40, 1957-1 C.B. 266 (premium received by taxpayer for granting an option is taxable only in the year of exercise); and the Option Rulings (there is neither a closed transaction nor income realized upon receipt of a premium for granting an option).

option to acquire its stock or upon receipt of a premium with respect thereto.[9] Moreover, Section 118(a) protects the issuing corporation from including the amount of any option premium in its gross income. By contrast, Section 721, the Section 1032 analog for partnerships, appears not to govern a partnership option issuance. Section 721 provides nonrecognition treatment for a partnership and its partners only for property contributions to the partnership "in exchange for an interest in the partnership." Assuming (as discussed in V below) that a partnership option is respected as such and not treated as an immediate partnership interest, the optionee's payment of the option premium is not in exchange for a current partnership interest and thus, viewed in isolation, is outside the ambit of Section 721. Moreover, the optionee's payment does not invariably represent the first installment of a deferred payment obligation for a partnership interest, because option exercise is purely voluntary to the optionee and may not occur. On the other hand, to the extent the option is exercised, Section 721 might furnish a rationale for not taxing the historic partners upon the partnership's issuance of the option, under the open transaction approach described in II.A.1 above.

B. Option Exercise

The central unresolved issue raised by noncompensatory partnership options is the extent, if any, to which the historic partners and/or the optionee should be taxed on exercise. The tension between the aggregate and entity views of partnerships has led to competing theories of taxation.

---

[9] Section 1032(a) states: "No gain or loss shall be recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock (including treasury stock)." The legislative history to Section 1032 clarifies that the reference in the statute to "acquisition of an option" includes the corporation's issuance of an option. See H.R. Rep. No. 98-861, at 827 (1984).

1. Consequences to Option Holder. General option principles uniformly provide (including in the case of corporate stock options) that the exercise of a noncompensatory option and the receipt of the optioned property in connection therewith is a non-taxable bargain purchase for the option holder.[10] The optionee's basis in the acquired property is equal to the optionee's basis in the option plus the exercise price.[11] The holding period for the acquired property begins on the day after the date of exercise and does not include the option holding period.[12]

Though there appears to be no direct authority, the exercise of a noncompensatory partnership option should be treated under these established principles as a bargain purchase not taxable to the holder, with correlative basis and holding period consequences. Moreover, Section 721 itself (discussed in greater detail below) provides nonrecognition treatment for the partnership and "any of its partners" upon a contribution of property in exchange for a partnership interest.

[10] See, e.g., the Option Rulings; Rev. Rul. 84-121, 1984-2 C.B. 168 (option to purchase real estate); Palmer v. Commissioner, 302 U.S. 63, 69 (1937) (stating, in connection with the exercise by a corporation's shareholders of previously issued rights to purchase property from the corporation, that "one does not subject himself to income tax by the mere purchase of property, even if at less than its true value, and ... taxable gain does not accrue to him before he sells or otherwise disposes of it").

[11] See Rev. Rul. 84-121, 1984-2 C.B. 168, and the Option Rulings.

[12] See, e.g., Helvering v. San Joaquin Fruit and Investment Co., 297 U.S. 496 (1936) (exercise of option to purchase real property is treated as a purchase of the property on the exercise date); Rev. Rul. 70-598, 1970-2 C.B. 168 (holding period of stock for Section 1223 purposes excludes the day the stock is purchased and includes the day the stock is sold). See also Weir v. Commissioner, 10 T.C. 996 (holding period of stock acquired by exercise of an employee stock option begins on the day following the exercise date); PLR 8921027 (May 26, 1989) (same, citing Weir favorably). Weir concluded that the predecessor of Section 1223(6) (providing that the holding period of stock or securities acquired by the exercise of "rights to acquire such stock or securities" begins on and includes the exercise date) applies only to rights to acquire stock that are granted in respect of existing share ownership, and not to stock options of other types.

Accordingly, the exercising option holder should not recognize gain or loss until the partnership interest is sold or otherwise disposed of.

As discussed below, one might argue that any "capital shift" by the historic partners in favor of the optionee is taxable to the optionee. We believe this result would be inappropriate upon the exercise of a noncompensatory option, however, because it would depart from the well-established general option principles noted above without any sound rationale. In addition, there are strong arguments why the capital shift concept should not apply in this context, as further discussed in II.B.2.b.ii below.

If the partnership option requires the holder to contribute property as the exercise price, the property contribution should be tax-free to the holder under Section 721, because, unlike the somewhat harder case of using property to pay a premium, the property is contributed in exchange for the partnership interest.[13]

2. Consequences to Partnership and Historic Partners. Under general option principles, an option's exercise is treated as a sale of the optioned property by the grantor of the option for an amount equal to the sum of the option exercise price plus any option premium

---

[13] Cf. Rev. Rul. 84-121, 1984-2 C.B. 168 (where an option to purchase real estate permitted exercise by delivery of either cash or other real estate (property X) with a value equal to the cash exercise price, deliver of property X by the optionee upon exercise was treated as a taxable disposition of property X by the optionee after an analysis concluding that the optionee failed the requirements for Section 1031 nonrecognition treatment). If the option calls for a cash exercise price and the partnership later agrees to accept a property contribution instead, Section 721 nonrecognition treatment would still appear to apply, though there is some question whether delivery of the property might be taxed to the holder as a deemed sale of the property for its fair market value, on the theory that the property is being used to satisfy a pre-existing obligation to deliver cash. See, e.g., U.S. v. Davis, 370 U.S. 65 (1962).

previously paid.[14] Such a sale is taxable unless a nonrecognition provision applies. In the corporate option context, there is a nonrecognition provision in Section 1032(a), which provides that "[n]o gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock ... of such corporation."

How a partnership and its historic partners should be taxed upon exercise of a noncompensatory option to acquire a partnership interest depends primarily on one's view of the scope of Section 721. As discussed below, we believe nonrecognition treatment for the partnership and the historic partners is appropriate and easily supported by Section 721.

a. Theory for nonrecognition treatment: Section 721 applies. The exercise of a noncompensatory partnership option seems to qualify for nonrecognition treatment for the partnership and its historic partners under a literal reading of Section 721(a), which provides that "no gain or loss shall be recognized either to the partnership or to any of its partners upon a contribution of property to the partnership in exchange for an interest in the partnership." In this context, the option premium and the exercise price qualify as "property."[15] Less clear is whether the option itself is contributed "property" for this purpose, because the option is extinguished upon its exercise and therefore never becomes property in the hands of the partnership.[16] On the other hand, there appears to be no theoretical obstacle to treating a partnership option as property for Section 721 purposes, and we suggest this approach. This treatment would be consistent with (i) published

---

[14] See, e.g., the Option Rulings.

[15] Though the premium was previously paid in a non-partner capacity, under the Option Rulings and other open transaction principles, the premium would relate to the later exercise.

[16] As a result, the option presumably cannot be viewed as "property" for Section 704(c) purposes, as discussed in II.D.3 below.

rulings that analyze the conversions of a general partnership into a limited partnership, and of a partnership into a limited liability company as tax-free, constructive Section 721 exchanges,[17] and (ii) a 1977 general counsel memorandum in which the Service concluded that Section 721 applied to the conversion of partnership debt into partnership equity pursuant to the terms of the debt.[18] Treating the option as Section 721 property also would bring the option's exercise squarely within Section 721. Even if the option is not "property," however, Section 721 can be read to provide for nonrecognition treatment, notwithstanding any difference between the value of the partnership interest acquired and either the exercise price or the value of the "property" contributed.[19] For a narrower readings of Section 721, see 2.b. below.

---

[17] See Rev. Rul. 84-52, 1984-1 C.B. 157, and Rev. Rul. 95-37, 1995-1 C.B. 130. There are also numerous private letter rulings to this effect in various contexts. See, e.g., PLR 200022016 (Feb. 29, 2000) (conversion of general partnership to LLC).

[18] See GCM 37053 (Mar. 22, 1977).

[19] If the option itself were not regarded as property for Section 721 purposes, consideration would need to be given to the treatment of an option permitting cashless exercise (where, upon exercise, the option holder pays no exercise price, but rather receives a partnership interest with a fair market value equal to the value of the interest subject to the option reduced by the exercise price). Rev. Rul. 88-31, 1988-1 C.B. 302, suggests that the net settlement of an option for property (here, the partnership interest received by the holder) where no exercise price is paid may be taxable to the option holder. We believe a cashless exercise feature should not alter the nonrecognition treatment to the parties in the partnership option context, on the theory that either (i) the option itself is property for Section 721 purposes, or (ii) to the extent Section 721 would protect the parties upon the exercise of an option for what may be a small amount of property in relation to the partnership interest's value, a net settlement of the option should not change the result. A similar issue would be presented if the exercise of a partnership option (including a convertible security) were bifurcated into (i) an exchange of the exercise price (plus any premium paid) for a portion of the partnership interest having equivalent value (which would qualify under Section 721) and (ii) an exercise of the option itself for the remainder of the partnership interest. Cf. Rev. Rul. 80-244, 1980-2 C.B. 234 (applying such a bifurcated approach to conclude that an employee using appreciated stock to satisfy the exercise price of an employee stock option to acquire additional shares from the same issuer did not recognize gain in respect of the appreciation under Section 1036).

Tax-free exercise of noncompensatory partnership options would be consistent with the treatment of corporate options. Under Section 1032, the exercise of an option to acquire stock of a corporate issuer is tax-free to the issuer, even if the value of the stock exceeds the sum of the exercise price and any option premium paid.

b. Possible theories for income recognition.

i. Aggregate theory. If the partnership is viewed as an aggregate of its partners in testing the taxability of option exercise, the partners could be treated as individually having issued options on a portion of their respective shares of partnership property. In that event, option exercise would represent a simple sale of property by each historic partner to the exercising optionee.

Even under that construct, however, we believe Section 721 still should be read to provide nonrecognition treatment, based on the view that the aggregate theory should not apply to tax a partnership transaction if taxation would contradict an express statutory provision to the contrary. Under a more aggressive (and, we believe, incorrect) application of the aggregate theory that disregards Section 721, the historic partners would recognize gain or loss equal to the difference between (1) the purchase price paid by the optionee (exercise price plus option premium) and (2) the partnership's historic basis in the assets deemed sold (i.e., the optionee's share of the partnership's assets immediately after exercise), based on the general option principles described above.[20]

[20] To the extent the basis of the partnership's assets with respect to any partner was previously adjusted pursuant to a Section 754 election, that partner's share of gain or loss from the deemed sale would be calculated taking this basis adjustment into account.

ii. Capital shift theory. Under Treas. Reg. §1.721-1(b)(1), "to the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share of partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation) section 721 does not apply." This language has given rise to a "capital shift" theory under which, upon exercise of a noncompensatory option, (1) the optionee recognizes gain to the extent the "capital" value of the interest received by the optionee exceeds the exercise price, and (2) the historic partners recognize gain because they are viewed as selling part of their partnership capital. Even if the partnership does not maintain capital accounts or expressly shift capital to the optionee, this theory may apply if the economic effect of the partnership agreement is similar.[21] Moreover, it could be argued that any pre-exercise appreciation should be regarded as historic partner "contributions" for this purpose, though this result is not compelled by the regulation.

There are several responses to the capital shift theory. First, under the regulation, a taxable capital shift occurs only if capital is transferred as compensation for services or "in satisfaction of an obligation." A noncompensatory option does not represent compensation for services, and arguably it also is not an "obligation" of the partnership or its historic partners.[22] Second, applying the taxable capital shift theory to the exercise of a partnership option is not supported by any specific authority. Third, if, as suggested earlier, the option itself is viewed as "property" for Section 721

---

[21] For further discussion of capital shifts, see II.D.2 below and Appendix I, Example 3.

[22] Cf. Helmer v. Commissioner, 34 TCM (CCH) 727 (1975) (an option to acquire a partnership interest did not result in a liability for Section 752 purposes), and PLR 7704269550A (Apr. 26, 1977) (contingent liability is not a liability for Section 752 purposes). But see Rev. Rul. 95-26, 1995-1 C.B. 131, and Salina Partnership v. Commissioner, T.C. Memo 2000-352 (contingent short sale liability is taken into account for Section 752 purposes).

purposes, then upon exercise the holder contributes value equivalent to the partnership interest received and there is no capital shift. Fourth, the capital shift theory, if it did apply, would produce results inconsistent with general tax principles governing noncompensatory option exercise. Those principles would preclude (i) taxing the optionee on any amount and (ii) taxing the historic partners based on an amount realized that may exceed the sum of the exercise price plus the option premium, either of which could result under the capital shift theory.[23] It would be inappropriate to interpret this ambiguous, 50-year-old regulation in a manner that overrides a fundamental legal doctrine for no compelling policy reason.

c. Exceptions to nonrecognition treatment. Even if Section 721 were interpreted generally to extend nonrecognition treatment to the exercise of noncompensatory partnership options, the normal statutory exceptions to nonrecognition treatment would (and we believe should) apply. Such exceptions include the following:

i. Disguised sale rules. Payment of the option premium followed by payment of the exercise price might be treated as a disguised sale under Section 707 where there is (1) a related distribution to a partner, (2) the payment of a liability assumed or taken subject to by the partnership, or (3) a reduction of a partner's share of such a liability under Section 752 as discussed below. To the extent Section 707 applied, the transaction would be treated as a taxable sale by one or more historic partners of a portion of the assets contributed by them to the partnership, or possibly as a sale by those partners of such assets (or a portion of their partnership interests)

[23] For example, the capital shift theory could tax the historic partners, upon exercise, based on the excess of the full fair market value of the interest issued to the exercising holder (rather than merely the sum of any option premium paid by the holder plus the exercise price) over the partnership's asset basis.

directly to the optionee. On the other hand, to the extent cash and other property furnished by the optionee remain partnership assets and are not distributed or deemed distributed to the historic partners, the disguised sale rules generally should not apply (subject to (3) above).[24]

ii. Distributions in excess of basis under Section 731. If a partner receives a cash distribution in connection with the exercise of a partnership option and the disguised sale rules do not apply, the partner nevertheless will be taxed under Section 731 to the extent the cash exceeds the partner's basis in its interest.

iii. Liability shifts under Section 752. The allocation of any partnership debt to the option holder upon the holder's admission to the partnership in accordance with Section 752 will reduce the amount of partnership debt allocable to the historic partners. Those liability share reductions will be treated as constructive distributions of cash to the historic partners and taxed to them under (1) Section 731 to the extent, if any, that the distributions exceed the historic partners' respective bases in their partnership interests or (2) possibly in some cases under the Section 707 disguised sale rules.[25]

iv. Section 751. The historic partners could recognize income under Section 751 if they receive (or are deemed to receive as a result of a change in partnership liability shares under Section 752) distributions of cash in exchange for relinquishing an ownership interest in the partnership's Section 751 assets to the exercising option holder.

---

[24] See Section 707(a)(2).

[25] See e.g., Treas. Reg. §1.707-5(a)(3).

d. Recommendation. We recommend adopting a general rule that the exercise of a noncompensatory partnership option (whether in the form of a separate option or a conversion feature) is tax-free under Section 721 to (i) the holder, (ii) the partnership and (iii) the historic partners. The general rule would be subject to the normal statutory exceptions described immediately above (Sections 707, 731, 751, 752, etc.).

We recommend a general nonrecognition rule for the following reasons:

- Statutory and other authority. As discussed above, Section 721 provides ample authority for this position (protecting both the historic partners and the optionee), and general option principles, properly applied, protect the optionee. Moreover, as noted earlier, there are compelling arguments against applying the statement in Treas. Reg. §1.721-1(b)(1) concerning capital shifts to the exercise of noncompensatory partnership options.
- Tax policy considerations. We believe taxing the optionee under a capital shift or other theory would be misguided, given the uniform nonrecognition treatment afforded optionees in the corporate and other contexts under the Option Rulings and similar authorities. Taxing the historic partners on some basis could be reconciled with general option principles. As noted earlier, however, nonrecognition treatment for the historic partners is both supported by Section 721 and consistent with the treatment of similar corporate options under Section 1032. In any event, taxing the historic partners based on an amount realized that exceeds the sum of the exercise

price plus the option premium (as the capital shift theory in some cases would appear to do) would be inconsistent even with general option principles.[26]

Finally, in the absence of abusive circumstances or statutory obstacles, there is no compelling policy reason to tax the exercise of a noncompensatory partnership option, because (1) all taxable income earned by the partnership prior to exercise has been allocated to the historic partners,[27] and (2) exercise simply puts the parties in a pre-tax position similar to what they would have had if the optionee had originally purchased partnership equity.[28] We see no rationale for increasing the overall tax burden of the parties merely because they choose to structure their arrangement using an option rather than economically similar equity.

- Commercial considerations. Taxing the exercise of noncompensatory partnership options, depending on the details of the rule and the facts, could be quite onerous for the parties, particularly if the exercise does not coincide with some liquidity event for

[26] In particular, it would be inconsistent with the general principle that an optionee's tax basis in property acquired upon exercise equals the option premium plus the option exercise price. See, e.g., the Option Rulings.

[27] However, the income has been allocated among the parties differently than if a partnership interest had been issued to the optionee at the outset or the option had been exercised in a prior tax year. As a result, upon exercise of the option, among other things the partner capital accounts must be adjusted to properly reflect the parties' economic arrangement, as discussed in II.D.2 below.

[28] There would be a difference in pre-tax positions under the two approaches if the partnership had made distributions to the historic partners prior to exercise of the option. The option holder's economics might be protected by either prohibiting distributions before exercise of the option or structuring the option with an anti-dilution feature that adjusts the option terms in favor of the holder in the event of certain distributions. See II.D.5 below for further discussion of anti-dilution provisions.

the partners.[29] This would make partnership options much less attractive commercially than corporate options and could make them essentially unusable. Partnerships would become less flexible vehicles for accommodating reasonable business objectives. While these commercial concerns may not be determinative, they are significant, particularly in the absence of compelling technical, fiscal or other policy reasons to adopt a commercially adverse rule.[30]

Because of the support furnished by Section 721 itself, we believe a nonrecognition rule of the above type requires no statutory change, but rather could be implemented by regulations or even through the issuance of one or more revenue rulings.

C. Option Lapse or Repurchase

1. Consequences to Option Holder. Section 1234(a) provides that, upon the lapse or repurchase of an unexercised option to acquire "property," the holder recognizes gain or loss on the lapse or repurchase date.[31] Thus the holder generally recognizes (i) if the option lapses, loss in the amount of any forfeited option premium, or (ii) if the option is repurchased, gain or loss equal

[29] The partnership in all events would have the exercise price, but that would not help unless it were in the form of cash and the cash were distributed to the partners liable for the resulting tax. Moreover, if the tax were calculated by reference to the full fair market value of the partnership interest issued upon exercise (e.g., under a capital shift theory), the tax could exceed the exercise price.

[30] If the optionee were taxed upon exercise under a capital shift theory, it might be argued that the historic partners should receive an offsetting tax deduction. Even if such a deduction were permitted, however, it would not reduce the optionee's phantom income, so that the tax result would remain unattractive for the optionee unless the parties implemented a (likely cumbersome) mechanism for transferring to the optionee the tax savings (if any) that the deduction actually generated for the historic partners. Moreover, the phantom income issue would be aggravated if the partnership's deduction were less than the optionee's income.

[31] See also the Option Rulings.

to the difference between the repurchase price and the option premium. Whether a partnership option is considered an option to acquire a partnership interest (under an entity view of partnerships) or an option to acquire an undivided interest in partnership assets (viewing the partnership as an aggregate of its partners), the optioned property would seem to be "property" for Section 1234(a) purposes. Therefore Section 1234(a), by its terms, apparently applies to noncompensatory partnership options as well as corporate options.

Under Section 1234(a), whether the holder's gain or loss is capital or ordinary depends upon the character of "the property to which the option relates." While this rule normally is easy to apply upon lapse or repurchase of an option on corporate stock or other property, under current law it is unclear whether the partnership should be viewed as an entity or an aggregate of its partners for this purpose. Under the entity view, the relevant property is the partnership interest, and Section 741 treats gain or loss from the sale of a partnership interest as capital (except as otherwise provided in Section 751). Thus, under this view, the optionee's gain or loss on expiration or repurchase of the option generally would be capital gain or loss. Under the aggregate view, the relevant property would be the optionee's share of the underlying partnership assets, which would necessitate examining the character of all partnership assets. Because a partnership option by its terms provides for the purchase of a partnership interest (not partnership assets) upon exercise, the entity view seems more appropriate from a policy perspective and is consistent with the usual treatment of transfers of partnership interests for other Subchapter K purposes.[32] The entity view also

---

[32] See, e.g., Sections 741 (gain or loss from sale of partnership interest is capital except to the extent Section 751 otherwise provides) and 743 (no adjustment to basis of partnership property upon transfer of partnership interest unless a Section 754 election is in effect). But cf. Rev. Rul. 91-32, (continued...)

poses a lesser administrative burden for both taxpayers and the government. Consideration might also be given to simplifying the rule further to provide that, at least in de minimis cases, the optionee's gain or loss on lapse or repurchase of the option will always be capital in nature, without regard to the Section 751 exception contained in Section 741, though this would seem to require a statutory amendment.[33]

2. Consequences to Partnership and Historic Partners. Under Section 1234(b), the issuer normally recognizes (i) upon lapse of an option to acquire "property," short-term capital gain equal to the forfeited premium amount, and (ii) upon repurchase of the option, short-term capital gain or loss equal to the difference between the option premium amount and the repurchase price.[34] Section 1032(a) modifies this general rule with respect to corporate options, providing that "[n]o gain or loss is recognized by a corporation with respect to any lapse or acquisition of an option to buy or sell its stock." Similarly, Section 118 excludes from gross income

[32] (...continued)
1991-1 C.B. 107 (determining source and character of foreign partner's gain or loss from selling a partnership interest based on consequences of a deemed sale of the partnership's assets) and TAM 9651001 (Dec. 20, 1996) (determining tax-exempt organization's debt-financed UBTI from selling a partnership interest based on similar look-through approach), both discussed in note 38 below.

[33] In addition to the application of Section 1234, Section 1234A might be read broadly enough to cover taxation of the optionee upon lapse or termination of a partnership option. Section 1234A treats as capital gain or loss any "[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination of ... a right or obligation with respect to property which is (or upon acquisition would be) a capital asset in the hands of the taxpayer." Even if Section 1234A applied, however, it should not affect the above conclusions. Consistent with the analysis under Section 1234(a), under Section 1234A the optionee would have capital gain or loss on the lapse or repurchase of a partnership option except to the extent the optioned "property" (i.e., the partnership interest or the underlying partnership assets), by reason of Section 751 or otherwise, is not treated as a capital asset.

[34] See also the Option Rulings.

any contribution to capital "in the case of a corporation." These two exceptions expressly apply only to corporate issuers, and there is no counterpart in the partnership context.[35]

Therefore, under current law, the general rule of Section 1234(b), by its terms, would apply to a noncompensatory partnership option if the property subject to the option is "property" for this purpose. "Property" is defined for Section 1234(b) purposes as "stocks and securities . . . , commodities, and commodity futures."[36] Though the result is not clear under current law, for the reasons discussed above in connection with taxation of the holder, we believe it is appropriate to view the partnership interest (rather than the underlying partnership assets) as the "property" subject to the option for Section 1234 purposes. Under this view, while there is again little guidance on the point, the term "security" as used in Section 1234(b) would seem broad enough to include a partnership interest, in which case Section 1234(b) would apply.[37]

[35] See also GCM 38944 (Dec. 27, 1982) (Section 118 principles do not apply to partnerships). The Section 1032 option exception originated from a corporate tax whipsaw plaguing the government under prior law. Under pre-1984 law, certain corporate issuers of warrants were arguing, in connection with the repurchase or lapse of a warrant, that (1) if the warrant was repurchased by the issuer at a discount or lapsed, the profit to the corporation was a capital contribution by the warrant holder that was not taxable to the corporation, citing Appeal of Illinois Rural Credit Ass'n, 3 B.T.A. 1178 (1926), but (2) if the warrant was repurchased by the issuer at a premium, the corporation's loss was deductible, citing Rev. Rul. 72-198, 1972-1 C.B. 223 (discussed in II.A.1 above). In 1984, Congress enacted the Section 1032(a) option rule to disallow any loss to the corporation from these transactions.

[36] Section 1234(b)(2)(B); Treas. Reg. §1.1234-3(b)(2).

[37] But see PLR 8104164 (October 31, 1980). There the taxpayer granted to a third party an option to purchase an outstanding partnership interest owned by the taxpayer. The option was later canceled in exchange for a payment by the third party. The ruling concludes, without explanation, that Section 1234(b) did not apply, because "the option to buy the partnership interest is not property" under Section 1234(b)(2). The quoted statement is of course flawed, because the critical issue under Section 1234 is whether the partnership interest, not the option thereon, is property.

(continued...)

On the other hand, repurchase of a partnership option is economically similar to exercise of the option followed by a redemption of the newly issued partnership interest, both of which normally would be tax free to the partnership -- the exercise under Section 721 (based on the approach recommended in II.B above), and the redemption under Section 731(b). To treat a one-step repurchase of the option differently could lead to abuse or other inappropriate results. For example, suppose a foreign person or tax-exempt entity purchases a partnership option. Under the above approach, if the underlying partnership interest appreciates in value, the partnership could repurchase the option at a premium, recognizing a loss under Section 1234(b) with no corresponding taxable income to the holder. (If instead the option were exercised and the equity were immediately repurchased, the result (assuming the transaction's form were respected) could be adverse for both parties: the foreign or tax-exempt partner could be taxed on effectively connected income ("ECI") or unrelated business taxable income ("UBTI"), respectively,[38] and the partnership would not be

[37] (...continued)
As in the case of taxation of the option holder (see footnote 33 above), Section 1234A might be read broadly enough to cover taxation of the partnership issuer upon lapse or repurchase of a partnership option. If so, it would result in capital gain or loss to the issuer on lapse or repurchase of the option to the extent the optioned "property" (within the meaning of Section 1234A) is a capital asset. This is not inconsistent with Section 1234(b), which similarly provides for capital gain or loss to the issuer but also deems the holding period to be short-term.

[38] See, e.g., Rev. Rul. 91-32, 1991-1 C.B. 107 (treating a foreign partner's gain or loss from disposing of its interest in a partnership engaged in a U.S. trade or business as U.S.-source ECI to the extent that the partner's distributive share of the partnership's gain or loss from a deemed sale of the partnership's assets for fair market value would be U.S-source ECI to the partner under Section 875(1)). It is less clear whether a similar "look-through" rule applies to determine if a tax-exempt organization has UBTI on its disposition of a partnership interest. TAM 9651001 (Dec. 20, 1996) concluded that a tax-exempt organization's gain from selling a partnership interest was debt-financed UBTI under Section 514 to the extent of debt-financing within the partnership, suggesting a look-through rule at least to that extent, though this result does not appear to be compelled by the Code
(continued...)

entitled to a deduction.) In contrast, if the partnership equity declines in value, either the holder could exercise the option and the partnership could then repurchase the newly issued equity at a discount without recognizing gain, or the option could be extended indefinitely to avoid Section 1234(b) income to the partnership on expiration of the option.[39]

To the extent this discontinuity between apparent Section 1234(b) gain or loss recognition on the repurchase or lapse of a partnership option, on one hand, and the Section 731(b) non-recognition treatment afforded a repurchase of the underlying equity, on the other, is viewed as undesirable, consideration might be given to alleviating it in one of two ways. Under one approach, in lieu of Section 1234(b), a Section 1032-type rule could be adopted for noncompensatory partnership options, providing that the partnership issuer recognizes no gain or loss on the repurchase or lapse of such an option. This would mesh with the taxation of the economically equivalent tax-free exercise of the option followed by repurchase of the resulting equity interest. Given the application of Section 721 only to partnership "interests," and the general application of Section 1234(b) to all options on "securities," such a rule would seem to require a statutory change. An alternative approach would be to retain Section 1234(b) as generally applicable but include a targeted anti-abuse rule (e.g., disallowing loss to the partnership upon repurchase of an option at a premium in certain circumstances), though it is unclear what reasonable parameters such an anti-abuse rule might have.

---

[38] (...continued)
or the Treasury regulations. See, e.g., Section 512(c); Treas. Reg. §1.514(c)-1(a)(2), Example (4).

[39] The first approach (exercise followed by repurchase of equity) assumes the two steps are not integrated under a step transaction analysis, which could well be an issue. The second approach (extending the option) assumes the extension itself would not be deemed a taxable exchange under Section 1001, which it well might if the extension materially modified the option. See Treas. Reg. §1.1001-1(a).

To the extent a nonrecognition rule were to apply to the partnership upon an option's lapse or repurchase, it would be inappropriate to treat the partnership as having earned tax-exempt income (if the option lapses or is repurchased at a discount) or incurred a nondeductible, noncapitalizable expenditure (if the option is repurchased at a premium) for Section 705 purposes, because such treatment would increase or reduce the partners' bases in their interests in the absence of any recognition event. Therefore, a nonrecognition rule generally would create a disparity between inside and outside basis upon the lapse or repurchase of an option. As a possible correlative measure to address this disparity, consideration might be given to permitting a Section 754 election to apply in this context. This would allow a Section 734 adjustment to be made which would conform the partnership's asset basis to the continuing partners' bases in their partnership interests.[40] Finally, under such a nonrecognition approach, a mechanism would be needed to properly adjust the capital accounts of the continuing partners (whether or not a Section 734 adjustment is made). This might be achieved in some circumstances through an asset revaluation under Treas. Reg. §1.704-1(b)(2)(iv)(f), assuming that regulation were altered to permit a revaluation upon lapse or repurchase of an option. However, revaluation may be burdensome and will not always achieve the desired capital account result in this context, (e.g., because the partnership's assets have a value equal to

---

[40] A Section 734 adjustment would be permitted in the equivalent two-step transaction where the option is exercised and the resulting equity is repurchased for a premium or discount (assuming the form of that transaction is respected). However, as currently written, Sections 754 and 734 apply only in connection with "a distribution of property to a partner" and not a repurchase of an option from a non-partner. As a technical matter, the repurchase of a partnership option might be brought within the scope of Sections 754 and 734, if desired, by constructing the non-recognition rule (at least from the standpoint of the partnership, if not the holder) as a deemed exercise of the option followed by a deemed repurchase of the equity, which repurchase is subject to Section 731(b). This construct would also make it clear that the option's lapse or repurchase does not cause a Section 705 basis adjustment to the continuing partners' interests, as recommended above.

basis), and it is unclear whether the current regulations (e.g., Treas. Reg. §1.704-1(b)(2)(iv)(m)) are otherwise adequate for this purpose. Accordingly, a special rule may be needed providing that any difference between the amount paid by the partnership in connection with the lapse or repurchase of an option and the option premium originally received by the partnership constitutes partnership income or loss that is allocated to the historic partners for book purposes, but not for tax or Section 705 purposes.[41]

D. Other Subchapter K Issues

In addition to the basic taxation issues discussed above, partnership options raise novel questions concerning capital account maintenance, Section 704(b) and 704(c) allocations, and other matters.

1. Accounting for Option Premium. One vexing issue on which guidance should be issued is how to account for the option premium under the Section 704(b) capital account rules during the period between the option's issuance date and the option's exercise, lapse or repurchase. While the premium itself is an asset (normally cash) that will be reflected on the left side of the balance sheet, what is the nature of the offsetting entry needed for the partnership's Section 704(b) balance sheet to balance? The possible approaches include the following:

a. Equity account. Under this approach (which is illustrated in the examples in Appendix I), the partnership would record the option premium in an equity account (presumably either a general equity account or a suspense account in the optionee's name) until

---

[41] Cf. Treas. Reg. §1.704-1(b)(2)(iv)(i)(2), concerning partnership organizational costs that are neither deductible nor amortizable under Section 709. This is similar to the issue that arises in connection with the repurchase of an outstanding partnership interest in the absence of a Section 754 election or an asset revaluation.

exercise, lapse or repurchase. The rationale is that (i) the option holder is not a partner and therefore has no capital account in the ordinary sense, and (ii) the ultimate tax treatment of the premium is uncertain until exercise, lapse or repurchase (i.e., upon exercise of the option, the premium is treated as a nontaxable capital contribution to the partnership, but upon lapse or repurchase, the partnership's tax treatment of the premium will depend on which of the approaches described in II.C.2 above is adopted).[42] We consider this method of accounting for the option premium superior to the alternatives described below. It is also similar to the treatment of option premiums under generally accepted accounting principles.[43]

If this approach were adopted, there would be a further question as to whether the equity account should reflect only the option premium amount or be adjusted from time to time as the value of the option fluctuates. For administrative simplicity, because of difficult Section 704(c) issues, and in keeping with the principle that an option holder is not a partner for tax purposes, we suggest that under this approach the option equity account not be adjusted, except possibly upon certain extraordinary events such as a book-up of the capital accounts under Treas. Reg. §1.704-1(b)(2)(iv)(f). This issue is illustrated in Appendix I, Examples 3 and 4.[44]

---

[42] See the Option Rulings and the discussion in II.B and II.C above.

[43] Proceeds allocated to a noncompensatory option to purchase stock of the issuer are generally accounted for as paid-in capital. See, e.g., APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants, ¶14.15 (March 1969) (proceeds received for debt issued with stock purchase warrants); EITF Issue No. 86-35, Accounting for Debentures with Detachable Stock Purchase Warrants, ¶16 (Sept. 24, 1986). See also EITF Issue No. 96-13, Accounting for Sales of Options or Warrants on Issuer's Stock with Various Forms of Settlement, ¶6 (Sept. 1996) (the consensuses in EITF Issue No. 86-35 should continue to apply to companies whose stock is not publicly traded).

[44] The question of accounting for option premium and some other issues raised by noncompensatory

(continued...)

b. Contingent liability. Another approach would be to record the option premium as a contingent liability. Like the equity account approach, this approach requires determining whether the amount of the liability recorded should increase or decrease with the spread between the exercise price of the option and the value of partnership interest subject to the option. While not entirely clear, under current law it appears that a partnership option should not be treated as a liability for Section 752 or other Subchapter K purposes.[45] We believe treating the option premium as a contingent liability could, in some circumstances, lead to abuse to the extent the liability was reflected in the historic partners' tax bases in their partnership interests under Section 752, particularly if the amount of the liability increased with the option spread. Moreover, this contingent liability approach does not seem to offer any practical or conceptual advantage over the equity account approach described above. For these reasons, we discourage treating outstanding options as contingent liabilities.

---

[44] (...continued)
partnership options bear an analogy to another thorny situation – the contribution to a partnership of assets with respect to which the contributing partner has previously received cash, yet, under established principles, has not at the time of contribution recognized income in respect of that cash. Examples include long term contracts accounted for under the percentage of completion method of accounting (see Preamble to Proposed Regulations under Section 460, REG-105946-00, released February 16, 2001, requesting comments on the treatment of contributions of long term contracts to partnerships) and businesses that earn prepaid subscription income (see James M. Pierce Corp. v. Comm'r, 326 F.2d 67 (8th Cir. 1964), analyzing the disposition of such a business). An option premium, like advance payments under a long term contract and prepaid subscriptions premiums, may be received without current tax. The tax event occurs after receipt of the cash. The treatment of partnership transactions involving long term contracts and prepaid subscription income is well beyond the scope of this report. However, the "step into the shoes" theory that the Service has proposed under Section 460 for certain types of nonrecognition transactions may be consistent with the open transaction treatment we recommend for partnership options.

[45] See footnote 22 above.

c. Tax exempt income. A third approach would treat the option premium as tax-exempt income earned by the partnership and immediately credit it to the capital accounts of the historic partners in their income sharing percentages.[46] We consider this tax exempt income approach inappropriate, in part because it is inconsistent with the ultimate tax treatment of the premium upon exercise (i.e., as a nontaxable contribution) or upon lapse or repurchase (see the alternatives discussed in II.C.2 above). In addition, the treatment of an option premium as tax-exempt income would appear to increase the bases of the historic partners in their partnership interests by the amount of the exempt income under Section 705(a)(1)(B), and further adjustments may be required to reflect the option's exercise, lapse or repurchase.[47] This approach also would increase the likelihood and/or magnitude of a capital shift from the historic partners to the option holder upon option exercise.

2. Option Exercise: Section 704(b) Capital Account Adjustments. The exercise of a partnership option introduces difficult Section 704(b) capital accounting issues. These issues are particularly significant where the partnership agreement follows the Section 704(b) "substantial economic effect" rules and requires liquidating distributions to be made in accordance with the capital account balances of the partners, because then it is critical that capital account balances be properly adjusted to reflect the economic arrangement of the parties after option exercise. As demonstrated by Examples 1-4 in Appendix 1, in such cases economic distortions can easily result

---

46 Cf. Helmer v. Commissioner, 34 TCM (CCH) 727, 731 n.4 (1975) (alluding to but not endorsing this approach).

47 In contrast, as discussed in II.C.2 above, one possible approach on repurchase or lapse would be to treat the partnership as having income or loss for book purposes but not for tax or Section 705 purposes.

unless some adjustment is made, since the capital accounts of the historic partners may be too high and the capital account of the option holder may be too low.

Described below are several possible alternatives to address these capital account concerns, some of which are illustrated in the examples in Appendix 1. These alternatives concern only the mechanics of achieving capital account balances that reflect that parties' economic deal. As discussed in II.B above, we believe that the exercise of a noncompensatory partnership option should be tax-free to the option holder, the partnership and the historic partners. Any steps that merely adjust capital accounts to implement the business deal should not change that result.

a. Conventional pre-exercise "book-up". Treas. Reg. §1.704-1(b)(2)(iv)(f) and (g) permit a partnership to revalue its assets and make corresponding adjustments to the partners' capital accounts in connection with the admission of a new partner, including where such admission results from the exercise of an option. As applied to partnership options, however, this conventional approach seems flawed, because the regulation appears to require the built-in gain or loss inherent in the partnership assets upon exercise (including gain or loss that accrued during the pendency of the option) to be allocated only to the historic partners immediately before admission of the option holder.[48] This, in turn, does not allow the option holder's capital account to be credited with any unrealized appreciation that economically "belongs" to the option

[48] Treas. Reg. §1.704-1(b)(2)(iv)(f) states that the capital account adjustments resulting from revaluing the partnership's property must "reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property ... would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date." Though this rule does not specify the timing of the adjustments, regulatory examples require adjustments resulting from the admission of a new partner to be made only with respect to the historic partners immediately before admission of the new partner. See Treas. Reg. §1.704-1(b)(5), Examples (14) and (18). These examples, however, do not involve the exercise of partnership options.

holder.[49] In addition, other capital account adjustments that occur before exercise of the option (including as a result of a prior book-up) may exacerbate this problem (see Examples 3 and 4 in Appendix I). Thus, special allocations of post-exercise income or loss under Section 704(b) or other adjustments generally would be required to properly implement the economic arrangement of the parties. As a result, this approach may accelerate income to some partners compared to the approaches described in b. and c. below. In addition, in a partnership that liquidates based on capital account balances, one or more of the parties would be taking the economic risk that such adjustments would not occur. Therefore, the conventional pre-exercise book-up approach is inadequate to properly adjust capital accounts upon option exercise.

b. Modified post-exercise "book-up". We believe a better approach is to revalue the partnership's assets under Treas. Reg. §1.704-1(b)(2)(iv)(f), but then perform the corresponding book-up of the partner capital accounts immediately after the option holder exercises and becomes a partner. The book-up would occur in two phases. First, the partnership would

[49] Unless the option itself is treated as contributed "property" for Section 704(b) purposes, the optionee's opening capital account will reflect only the exercise price and option premium, which normally will be less (frequently, significantly less) than the fair market value of the optionee's partnership interest after exercise. See Treas. Reg. §1.704-1(b)(2)(iv)(b)(2). See the discussion below concerning obstacles to treating the option as "property" for Section 704(c) purposes. Assuming the option is not property for Section 704(c) purposes, it would seem appropriate to not treat it as property for Section 704(b) purposes as well. (Though we do not believe this precludes treating the option as property for Section 721 purposes, as suggested in II.B.2 above.) Even if a partnership option were treated as property for Section 704(b) purposes, the post-exercise capital accounts of the partners would not necessarily reflect their economic deal (e.g., due to pre-exercise capital account book-ups or other pre-exercise income or loss allocations to the historic partner capital accounts that ultimately must be shifted in part to the option holder in connection with exercise, as further discussed below and in the examples in Appendices I and II). The balance of this report assumes that partnership options are not treated as property for Section 704(b) purposes.

allocate unrealized gain to the historic partners until their capital accounts reflect the partnership value at which the option holder economically becomes entitled to participate in further gain (i.e., the point at which it becomes economic for the option to be exercised). The amount of gain allocated in this step would generally be the amount necessary to adjust the historic partner capital accounts to the partnership's enterprise value implied by the option exercise price. Second, any remaining gain would be allocated among all partners as necessary to properly reflect their economic arrangement.

This approach is superior to the conventional pre-exercise book-up, because it permits the option holder to share in the book-up of unrealized appreciation that exists at the time of exercise. However, in some cases even this modified approach may not work completely (or at all), including where, by reason of prior allocations (including allocations of unrealized gain attributable to a prior book-up by the partnership), the capital account of one or more historic partners immediately before exercise of the option exceeds the post-exercise value of the historic partner's interest. In that event (as with a pre-exercise book-up), special allocations of future income or loss, or other adjustments, may be required to conform the capital accounts to the economic deal struck by the partners (see Examples 3 and 4 in Appendix I).

Requiring capital account adjustments to be made under this approach whenever an option is exercised could be cumbersome, particularly if the partnership had multiple options outstanding and such options could be exercised on irregular dates. To alleviate this difficulty, this approach (as well as the approaches described in a. above and c. below, which raise the same issue) might permit capital account adjustments to be made on a periodic basis (e.g., quarterly or annually) rather than whenever an option is exercised.

This post-exercise book-up approach would seem to require a regulatory amendment or clarification. For examples of this approach, see Appendix I, Examples 1 and 2.

c. Capital reallocation. Under this approach, upon exercise partnership capital would be reallocated among the partners' capital accounts as required to implement the intended economic arrangement among the parties.[50] We recommend that such a capital reallocation be preceded by a post-exercise book-up of the capital accounts as described in b. above, so that the capital accounts reflect current fair market value (which also would help address Section 704(c)-type issues as discussed in II.D.3 below). Such a capital reallocation would ensure that the post-exercise capital accounts of the parties reflect their relative economic rights. It would also eliminate any risk of economic distortion in partnerships where distributions are driven by capital accounts. For these reasons, we support this approach.

However, reallocating partnership capital could result in a capital shift in favor of the option holder (e.g., where the pre-exercise capital account balance of a historic partner exceeds the fair market value of the partner's interest immediately after exercise). As discussed in II.B.2.b above, it is unclear under current law whether such a capital shift would be taxable to the option holder or the historic partners. Accordingly, consistent with our basic proposal for the tax-free exercise of noncompensatory partnership options, and because any such capital reallocation would merely adjust the capital accounts to reflect the economic arrangement among the parties, we recommend that this

---

[50] This approach presumably would require amending the Section 704(b) regulations, though it may fall within the ambit of Treas. Reg. §1.704-1(b)(2)(iv)(q). That regulation generally requires, where guidance is lacking under the Section 704 capital account regulations, that the capital accounts be adjusted in a manner that (1) maintains equality between aggregate capital accounts and partnership book capital, (2) is consistent with "the underlying economic arrangement of the partners," and (3) is based, where practicable, on federal tax accounting principles.

approach, if adopted, be linked to guidance clarifying that these capital shifts are not taxable. For an illustration of this approach, see Appendix I, Example 3.

d. No immediate adjustments/future special allocations. Under this approach, the partnership would not adjust partner capital accounts upon the option's exercise, but instead would specially allocate future income and loss among the partners as necessary to align the capital accounts with the post-exercise economic arrangement over time.

However, this approach would tend to accelerate taxable income to some partners, and it presents a significant risk (generally much greater than in approach a. or b. above) that there will be insufficient income and loss to properly adjust the capital accounts prior to partnership liquidation. As a result, under this approach either the relative economic risks borne by the partners would be inconsistent with their business deal (in a partnership where liquidating distributions are based on capital account balances), or the capital accounts would be subject to challenge for not properly reflecting the partners' relative economic interests (in a partnership where liquidating distributions are based on the business deal and not on capital accounts). For this reason, we discourage this approach.

3. Option Exercise: Section 704(c)-Type Issues. The exercise of a partnership option usually will result in disparities between the tax and book capital accounts of the historic partners and/or the option holder that raise Section 704(c)-type issues. A mechanism to eliminate these disparities over time should be included in any future guidance regarding partnership options.

a. Inapplicability of Section 704(c). We recommend that a partnership option not be treated as "property" for Section 704(c) purposes, because the option is eliminated upon its exercise. Even if the option were regarded as property, there are no ongoing tax and book items attributable to the option itself, and thus there is no mechanism under Section 704(c) for eliminating any book-tax difference to the optionee arising from exercise. This observation applies not only to ordinary noncompensatory options, but also to convertible partnership securities, discussed in III below.

b. Asset revaluation with reverse Section 704(c) allocations. We believe a better approach would be to revalue the partnership's assets pursuant to Treas. Reg. §1.704-1(b)(2)(iv)(f) and to book up the capital accounts under the modified post-exercise approach described in D.2.b above. To the extent of any book-tax difference in the partnership's assets after revaluation, partner book-tax disparities can be addressed through "reverse" Section 704(c) allocations under Treas. Reg. §1.704-1(b)(4)(i), which applies Section 704(c) principles by reference to the continuing revalued partnership assets, rather than by reference to the extinguished option. Where there is such a post-exercise book-up in connection with exercise of an option, the option holder usually will be subject to reverse Section 704(c) allocations, because typically the option holder's book capital account will exceed the holder's tax basis. Such reverse Section 704(c) allocations are illustrated in Appendix I, Examples 1, 2 and 4.

One drawback of the current regulations regarding reverse Section 704(c) allocations, however, is that they eliminate partner book-tax differences only to the extent a book-tax difference exists with respect to the partnership's assets. Therefore, if either (i) partner book-tax differences for one or more partners exceed the book-tax difference in the partnership's assets,[51] or (ii)

---

[51] In general, the net partner book-tax differences for all partners will equal the net book-tax differences in the partnership's assets. However, partner book-tax differences for some partners may exceed book-tax differences in the partnership's assets. For an illustration, see Appendix I, (continued...)

partnership tax items available to be allocated under the regulations are otherwise less than partner book-tax differences, the reverse Section 704(c) allocation mechanism in its current regulatory form may not fully eliminate the partner book-tax differences. To address this problem, we recommend including a rule requiring, in appropriate cases, that the partners be allocated notional tax items based on Section 704(c) remedial allocation method principles (see Treas. Reg. §1.704-3(d)), as illustrated in Appendix I, Example 3.

4. Secondary Transfers of Options. When the holder of an outstanding partnership interest sells the interest to a third party and the partnership has made a Section 754 election, the basis of the partnership's assets is adjusted with respect to the transferee partner under Section 743 to reflect the transferee's cost basis in the acquired partnership interest. If the partnership's assets are appreciated at the time of the transfer, this adjustment avoids taxing the appreciation twice (once on sale of the interest and again when the partnership sells its assets).

Consistent with the position that an option is not a partnership interest, no Section 743 adjustment to partnership asset basis would be made in connection with the transfer of a noncompensatory partnership option (even if a Section 754 election were in effect). Moreover, when the option transferee exercises the option, apparently no portion of the basis in the transferee's partnership interest arising from the transferee's purchase of the option is reflected in the basis of the partnership's assets, because (i) Sections 754 and 743 do not apply to the acquisition of a partnership interest directly from the partnership, and (ii) notwithstanding the possible treatment of the option as "property" for Section 721 purposes (see II.B.2 above), the extinguishment of the option upon

[51] (...continued)
Example 3.

exercise seems to preclude any Section 723 step-up in the basis of partnership property beyond the option's exercise price.[52] As a result, no mechanism seems to be available to achieve the equivalent of a Section 743 adjustment in connection with the secondary transfer of a noncompensatory partnership option, so that a significant inside-outside basis disparity may result upon exercise.[53] In this respect, the transfer and exercise of a noncompensatory partnership option resembles a secondary transfer of an outstanding partnership interest without a Section 754 election.

5. **<u>Anti-Dilution Adjustments</u>.** Like a corporate option, a partnership option may be structured with anti-dilution protection to preserve the option holder's economic rights in connection with certain pre-exercise distributions to the historic partners (which might include distributions to cover partner tax liabilities) and other dilutive events. While anti-dilution protection will tend to magnify any shift in economics (including historic partner capital) away from the historic partners in favor of the optionee upon exercise of the option, it does not appear to raise any fundamental issues that are not adequately addressed by the overall approach to non-compensatory options recommended in this Part II.

---

[52] The second point follows from the more general observation that, in the case of a non-compensatory partnership option (including a convertible security), any excess (at the time of exercise) of the fair market value of the partnership interest received by the optionee over the sum of the option premium originally paid by the optionee plus the exercise price (or, the case of a convertible security, the original cost of the security) is not reflected in the basis of the partnership's assets under Section 723.

[53] Assuming a secondary transfer at a premium, the resulting inside-outside basis disparity with respect to the underlying partnership interest after exercise normally would be reconciled upon a liquidation or sale of the interest through either (i) a capital loss (or reduced gain) to the holder under Section 731(a) or 741, or (ii) a step-up in the basis of property distributed to the holder under Section 732(b).

Accordingly, we recommend that (i) consistent with the treatment of corporate stock options and convertible securities,[54] adjustments to the optionee's rights pursuant to customary anti-dilution features of a partnership option not be taken into account by the optionee, the partnership or the historic partners for tax or capital account purposes prior to exercise, (ii) upon exercise, such adjustments not give rise to tax, and (iii) upon exercise, the Section 704(b) and 704(c) consequences of such adjustments be addressed consistent with the recommendations in II.D.2 and 3 above.

E. Examples

Appendix I contains several examples illustrating some of the foregoing conclusions and recommendations concerning noncompensatory partnership options.

III. NONCOMPENSATORY DEBT-LINKED OR PREFERRED-LINKED OPTIONS

This section considers special issues raised by (1) partnership debt that is convertible into "common" (i.e., participating) equity of the issuer, (2) preferred partnership equity that is convertible into common equity of the issuer, and (3) warrants to purchase common partnership equity that are issued in connection with an investment by the holder in the issuer's debt or preferred equity.[55] This discussion assumes, as typically would be the case, that the relevant securities are not

---

[54] See, e.g., Treas. Reg. §1.305-7(b) (no deemed distribution occurs under Section 305(c) as a result of a change in conversion ratio or conversion price of a convertible security, or in the exercise price of a warrant, "pursuant to a bona fide, reasonable, adjustment formula ... which has the effect of preventing dilution of the interest of the holders of such ... securities"); and Treas. Reg. §1.1504-4(c)(4)(ii)(D) (similar safe harbor for purposes of Section 1504 corporate affiliation test).

[55] This discussion does not consider the taxation of exchangeable securities where an option or convertible security issued by one entity is exercisable for or exchangeable into equity of another entity.

issued in connection with the performance of services (though sometimes they might be, in which case Section 83 and other compensation-related issues would be presented -- see generally IV below).

A. Convertible Debt

The following discussion assumes a partnership issues a debt instrument that is convertible into common equity of the issuer and that is respected as debt for tax purposes. Just as a deep-in-the-money partnership option might be treated from the outset as partnership equity (see I.E above and V below), if the convertible debt instrument has significant equity features or is certain to be exercised, the debt might be recharacterized as an equity interest in the partnership under general debt/equity classification principles.[56]

1. Debt Issuance.

a. Treatment of conversion right. The right to convert a debt instrument issued by a corporation into equity of the issuer generally is not treated as separate property for federal income tax purposes. This is clear from the regulations governing "original issue discount" ("OID"), which provide that (i) for purposes of determining Section 1272 OID inclusions, one ignores "an option to convert a debt instrument into the stock of the issuer, into the stock or debt of a related party . . . , or into cash or other property in an amount equal to the approximate value of

[56] See, e.g., Rev. Rul. 72-350, 1972-2 C.B. 394 (a nonrecourse loan to a partnership that was secured by "unproven leases and ... virtually unsalvageable oil and gas well installations" and that was convertible into a 25 percent partnership interest was "in reality, capital placed at the risk of the venture"); IRS Notice 94-47, 1994-1 C.B. 357 (identifying certain types of purported debt instruments that the Service may recharacterize as equity because significant equity features are present).

such stock or debt,"[57] (ii) any amount paid for such an option is included in determining the issue price of the debt instrument,[58] and (iii) a debt instrument is not treated as providing for contingent payments merely because it contains such an option.[59] Although these regulations do not specifically refer to convertible debt issued by a corporation, they were almost certainly drafted with corporate convertible debt in mind, and their repeated reference to the "stock" of the issuer casts doubt on their literal application to convertible debt issued by non-corporate debtors.[60] The conclusion that the conversion feature included in corporate convertible debt is not treated as separate property was also clear under prior law.[61]

We recommend modifying the OID regulations to clarify that the rules relating to conversion rights extend to partnership convertible debt. We are aware of no policy reason for distinguishing between corporate and partnership convertible debt in this respect and believe

---

[57] Treas. Reg. §1.1272-1(e).

[58] Treas. Reg. §1.1273-2(j).

[59] Treas. Reg. §1.1275-4(a)(4).

[60] The OID regulations do not define the term "stock," although Section 7701(a)(7) makes the nonexclusive statement that "'stock' includes shares in an association, joint stock company or insurance company." In other contexts, Treasury has avoided the word "stock" when it clearly intended a broader concept. See Treas. Reg. §1.1001-3(c)(2)(ii) (referring to rights to "convert the instrument into equity of the issuer").

[61] See, e.g., Treas. Reg. §1.1232-3(b)(2)(i); Chock Full O'Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971); Hunt Foods and Industries, Inc. v. Comm'r, 57 T.C. 633 (1972), aff'd per curiam, 496 F.2d 532 (9th Cir. 1974); AMF, Inc. v. United States, 476 F.2d 1351 (Ct. Cl. 1973), cert. denied, 417 U.S. 930 (1974). See also Rev. Rul. 72-265, 1972-1 C.B. 222 (conversion of debt into stock of the corporate issuer pursuant to the terms of the debt is not a realization event).

There are some limited exceptions to this rule. See, e.g., Section 171(b)(1) and Treas. Reg. §1.171-1(e)(1)(iii) (for determining whether a purchaser of convertible debt has amortizable bond premium, purchaser's basis in the debt is reduced by value of conversion feature).

taxpayers would be surprised if a different rule applied to partnership debt.[62] Moreover, as in the case of corporate convertible debt, there are administrative benefits to avoiding the valuation issues and other difficulties that would arise if conversion rights embedded in partnership convertible debt were treated as separate property.[63]

The remainder of this Part III.A assumes that the conversion feature included in a partnership convertible debt instrument is not treated as separate property for tax purposes.

b. Consequences to debt holder. Like a purchase of corporate debt, the purchase of partnership debt (whether or not convertible) from the issuer for cash is a loan by the holder that is tax-free to the holder under general tax principles.

Prior to conversion, a holder of partnership convertible debt would be subject to the normal interest inclusion rules, including the Section 1272-1275 OID rules which (in contrast to the

[62] The flexibility of partnership arrangements under Subchapter K might lead to abuse of the contingent debt rules if the conversion feature exclusion contained in Treas. Reg. §1.1275-4(a)(4) were extended to partnership convertible debt. For example, a debt instrument providing for payments based on the value of specified property presumably is subject to the contingent payment debt rules. If the borrower instead contributes the property to a partnership, a debt instrument convertible into partnership equity might be structured to provide comparable economics to the lender, while avoiding the contingent payment debt rules. If such a transaction achieved an "unreasonable result" in light of the purposes of the OID rules (or other provisions of the Code), the anti-abuse rules of Treas. Reg. §1.1275-2(g) would permit the Service to apply or depart from the regulations as appropriate to achieve a reasonable result.

[63] Treating the conversion right as part of the underlying debt instrument also would alleviate, if not eliminate, the capital accounting difficulties that arise from option premiums. See II.D.1 above. For example, the entire amount paid for the debt instrument (including any amount paid for the conversion right) would be included as part of the liability for the debt instrument reflected on the partnership's books.

regulations thereunder concerning the treatment of conversion features) on the whole are drafted broadly to apply to debt issued by noncorporate as well as corporate issuers.[64]

A holder that purchases partnership convertible debt from the issuer at a premium generally would be subject to the Section 171 bond premium amortization rules, which also broadly apply to noncorporate as well as corporate debt.[65] It seems clear from the statute that, in calculating bond premium on a convertible debt instrument, including partnership convertible debt, the value of the conversion feature is excluded.[66] However, there is a question whether the regulations elaborating on this rule apply to partnership convertible debt, because like the OID regulations they define "convertible bond" narrowly as a bond convertible into "stock" of the issuer or "stock or debt" of a related party.[67] We suggest these regulations be amended to confirm that they apply to partnership convertible debt, consistent with the statute.

If the holder uses appreciated (or depreciated) property to purchase partnership debt, the exchange is taxable to the holder under Section 1001 and the other authorities noted in II.A.1

---

[64] See, e.g., Section 1275(a)(1) and Treas. Reg. §1.1275-1(d) (broadly defining "debt instrument" for purposes of OID rules).

[65] See Section 171(d) and Treas. Reg. §1.171-1(b)(1) (broadly defining "bond" for Section 171 purposes).

[66] See Section 171(b)(1), last sentence.

[67] See Treas. Reg. §1.171-1(e)(1)(iii). As noted earlier, these rules reduce the holder's basis in the bond by the value of the conversion feature for purposes of determining whether there is amortizable bond premium.

above. Section 721 does not apply because the debt (including the imbedded conversion feature) is not a partnership "interest."[68]

c. Consequences to partnership and historic partners. As in the case of corporate debt, under general tax principles a partnership's receipt of proceeds from issuing debt (whether or not convertible) is not a taxable event to the partnership or the historic partners. Prior to conversion of the debt, like a corporate issuer of convertible debt, the partnership issuer generally would, subject to certain limitations, report (i) interest deductions corresponding to the holder's interest income (including OID)[69] and (ii) interest income corresponding to the holder's deductions for bond issuance premium.[70]

2. Conversion.

a. Consequences to debt holder. The conversion of partnership debt into a partnership interest pursuant to the terms of the debt generally should not be taxable to the holder.[71] Three alternative theories support this result. First, published rulings have long concluded that the

---

[68] The open transaction theory described in II.A.1 above which may apply in connection with issuing an ordinary partnership option also does not apply here, because the purchase of the debt is a closed transaction, and the conversion feature is not a separate asset for tax purposes. However, the holder might be eligible to defer some or all of any gain recognized in the transaction under the installment method. See Section 453.

[69] See Sections 163(a), 163(e).

[70] See Treas. Reg. §1.163-13.

[71] We believe the holder would appropriately be taxed on any accrued and unpaid interest on the convertible debt at the time of conversion. This result is supported by Treas. Reg. §1.721-1(b)(1), because the existing partners have given up their right to capital in satisfaction of the partnership's obligation to pay interest, as further discussed in b. below. The corporate analog to this rule is Section 351(d)(3), which provides that interest on debt of the transferee corporation that accrued during the transferor's holding period is not "property" for Section 351 purposes.

conversion of corporate debt into stock of the issuer pursuant to the terms of the debt is generally not a realization event to the holder.[72] Accordingly, the holder is not taxed on conversion and takes a carryover basis and a tacked holding period in the stock.[73] Under this view, the exchange of the convertible debt for stock is "regarded as a transformation of a security rather than a disposition of it."[74] Converting partnership convertible debt into a partnership interest similarly could be viewed as a transformation of the debt instrument under the non-realization theory.[75] Second, the conversion of partnership debt into partnership equity could be viewed as tax-free to the holder under the general open transaction and bargain purchase principles discussed earlier in connection with the exercise of ordinary partnership options (see II.B.1). Third, the conversion of partnership debt into a partnership equity interest would seem to qualify for nonrecognition treatment under Section 721, viewing the debt as contributed "property" for this purpose. This conclusion is supported by the analogous Subchapter C rule that certain debt of the transferee corporation constitutes property for Section 351

[72] See, e.g., Rev. Rul. 72-265, 1972-1 C.B. 222.

[73] Id.

[74] See Fleischer & Cary, "The Taxation of Convertible Bonds and Stock," 74 Harv. L. Rev. 473, 478 (1961).

[75] Certain conversions of corporate convertible debt into stock might also be viewed, depending on the circumstances, as either a tax-free recapitalization under Section 368(a)(1)(E) or a tax-free Section 351 exchange. Of course neither of these Subchapter C-based theories is available in the partnership context. Moreover, even in the corporate context both theories apply only to an exchange of a "security" for stock of the issuer. See Sections 354 and 351(d)(2). In contrast, the nonrealization theory described above applies even to short-term convertible debt that might not be considered a "security" for Subchapter C purposes. Regarding the treatment of corporate convertible debt as a "security," in Federal Income Taxation of Corporations and Shareholders, ¶ 12.41[4] (7th ed. 2000), Bittker & Eustice note that the "[c]onvertibility into stock of the issuing corporation would seem to make classification of the debt obligation as a security more likely because of the potential equity participation feature."

purposes.[76] In addition, the Service concluded in a 1977 general counsel memorandum that Section 721 applied to the conversion of partnership debt into partnership equity pursuant to the terms of the debt.[77] As in the case of ordinary partnership options, this Section 721 view would need to be reconciled with the disappearance of the "property" upon conversion, which, for example, would preclude viewing the debt as property for Section 704(c) purposes (see II.B.2.a and II.D.3 above).

Not taxing the holder upon conversion of partnership convertible debt is consistent with our recommended treatment of the exercise of an ordinary partnership option (see II.B.1 above). The choice among the above alternative theories for tax-free conversion may have ancillary consequences. For example, as noted above, treating partnership options (including convertible securities) as "property" for Subchapter K purposes presents potential difficulties under Section 704(c). In addition, different theories may lead to differences in the application of the market discount rules.[78]

---

[76] Section 351(d)(2) provides that issuer debt not evidenced by a "security" is not treated as property under Section 351. However, Section 721 contains no similar limitation.

[77] See GCM 37053 (Mar. 22, 1977).

[78] Generally a holder's gain on any "disposition" of a debt instrument is ordinary income to the extent of accrued market discount on the debt. Section 1276(a). This gain recognition rule generally trumps any non-recognition rule that is not specifically referenced in Section 1276(d)(1). Under the non-realization theory, presumably the conversion of corporate convertible debt into stock is not a "disposition" and therefore no market discount is recognized. See Garlock, Federal Income Taxation of Debt Instruments ¶11.04, n. 66 (4th ed. 2000). If the non-realization theory also applied to the conversion of partnership convertible debt into partnership equity, the no-disposition result should be the same. In contrast, if Section 721 (but not the non-realization theory) applied, under current law the application of the market discount rules is unclear. The ambiguity arises from the fact that (i) Section 1245(b)(3) (which is cross-referenced in Section 1276(d)(1) and specifically refers to transactions in which "the basis of property in the hands of a transferee is determined by reference

(continued...)

The holder's holding period in the partnership interest received upon conversion of the debt should include the holder's holding period in the debt.[79]

b. Consequences to partnership and historic partners. The conversion of a corporate convertible debt into stock of the issuer is tax free to the corporation under Section 1032. Consistent with the analysis of ordinary partnership options in II.B.2 above, we believe that under Section 721 the conversion of partnership convertible debt should be tax free to the partnership and the historic partners, subject to the normal statutory exceptions under Sections 707, 731, 751 and 752.

As with ordinary partnership options, it could be argued that converting partnership debt into partnership equity runs afoul of the Section 721 regulatory exclusion providing: "To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share of partnership profits) in favor of another partner ... in satisfaction of an obligation ... section 721 does not apply."[80] In the case of partnership convertible debt, there are three facets to this issue. First, although converting partnership debt into partnership equity does satisfy a partnership obligation with partnership capital, to the extent of the issue price of the debt that

---

[78] (...continued)
to its basis in the hands of the transferor by reason of the application of section . . .721") arguably does not apply to a conversion of partnership debt since the debt disappears in the conversion and therefore is never held by the transferee partnership, and (ii) Section 721 is not listed in Section 1276(d)(1)(B). If Section 721 is determined to be the applicable theory, we suggest adding Section 721 to the non-recognition exceptions contained in Section 1276(d)(1)(B), so that corporate convertible debt and partnership convertible debt are treated consistently under the market discount rules.

[79] Section 1223(1).

[80] Treas. Reg. § 1.721-1(b)(1).

capital was provided by the lender and not by the historic partners. Accordingly, to this extent we believe Treas. Reg. §1.721-1(b)(1) by its terms does not (and should not) apply. Second, to the extent the holder receives partnership equity that includes capital attributable to unpaid interest on the debt, we believe Treas. Reg. §1.721-1(b)(1) appropriately does apply, because that partnership capital (i) is issued in exchange for the partnership's obligation to pay the interest and (ii) is provided by the historic partners. Accordingly, the holder and partnership will recognize any interest income and expense, respectively, not previously taken into account. A more difficult issue here is whether the partnership and the historic partners should also recognize gain or loss as though the partnership had sold some of its assets to satisfy the interest obligation. This is similar to the question of whether the partnership and historic partners should recognize gain or loss under a deemed asset sale theory when a compensatory partnership option is exercised (discussed in IV.C.2.b below). The same analytical approach adopted to resolve the compensatory option question probably should be applied here as well, unless for administrative reasons a different result is desirable. If the approach we tend to favor for compensatory partnership options is adopted, the conversion would be viewed for book and tax purposes – to the extent there is any unpaid interest – as a payment of the interest for cash followed by a recontribution of the cash by the debt holder in exchange for the partnership interest, with no deemed asset sale gain or loss to the partnership and historic partners (see IV.C.2.b below). Third, if, upon conversion, the holder receives partnership equity that includes a capital interest exceeding the adjusted issue price of the debt (including any unpaid interest) -- which will typically be the case -- that excess capital will be attributable to the conversion feature. For all the reasons discussed in connection with the exercise of ordinary partnership options (see II.B.2 above), we believe the issuance of a partnership interest in consideration for the conversion feature inherent in partnership convertible debt should not be a taxable transaction to the partnership or the historic partners. This was also the Service's position in GCM 37053,[81] which concluded that the conversion of partnership convertible debt into a limited partnership interest was tax-free to the historic partners under Section 721 and not covered by Treas. Reg. §1.721-1(b)(1), because "[t]he only partner who could benefit from such a conversion is the noteholder and there is no reason to assume that the noteholder is in any way being compensated for services or receiving satisfaction for an obligation."

As in the case of ordinary partnership options, the conversion may result in actual or deemed distributions taxable to the historic partners under the normal statutory exceptions of Sections 707, 731, 751 and/or 752, including due to reductions in their partnership liability shares. In the case of convertible debt, some liability share reductions will always occur upon conversion due to the reduction in the overall amount of partnership liabilities.

The conversion of partnership convertible debt raises Section 704(b) and 704(c) issues of the type discussed in II.D above, which we recommend be addressed in a manner consistent with the exercise of ordinary partnership options.

3. Lapse of Conversion Right or Repurchase of Convertible Debt.

a. Lapse. As in the case of corporate convertible debt (but in contrast to the lapse of an ordinary partnership option), the expiration of the conversion feature of a partnership convertible debt instrument should not have any tax consequences to the holder or the partnership, because the conversion feature is not treated as a separate asset for tax purposes.

---

[81] Mar. 22, 1977.

b. Repurchase. Section 1271(a) generally provides that amounts received by the holder on "retirement" of a debt instrument are considered amounts received "in exchange" for the debt. Accordingly, upon a repurchase by the issuer, the holder generally recognizes gain or loss equal to the difference between the repurchase price and the holder's basis in the debt, as adjusted to reflect any accrued but unpaid interest.[82] Subject to several statutory exceptions, this broad rule by its terms applies to debt of any type, and hence it should apply to partnership debt. Because the conversion feature is not treated as an asset separate from the debt for tax purposes, and assuming the debt is held as a capital asset, a holder of partnership convertible debt therefore normally should recognize capital gain or loss when the partnership issuer repurchases the debt.

If a corporate issuer repurchases convertible debt for less than the debt's adjusted issue price, the issuer recognizes cancellation of debt income under Treas. Reg. §1.61-12(c)(ii), unless one of the exceptions under Section 108 (bankruptcy, insolvency, etc.) applies. These provisions again are broadly drafted and by their terms extend to partnership debt, though the Section 108 exceptions generally apply at the partner, not the partnership, level.[83]

If a corporate issuer repurchases a debt instrument for more than the debt's adjusted issue price, the issuer normally may deduct the repurchase premium as interest expense in the year of repurchase.[84] However, if the debt is convertible into "stock of the issuing corporation" (or of a corporation controlling or controlled by the issuer), Section 249 limits the issuer's deduction to "a

---

[82] See, e.g., Sections 1271(d) and 1272.

[83] Section 108(d)(6). The mechanics of applying Section 108 to the repurchase of partnership debt at a discount are complex and beyond the scope of this report.

[84] Treas. Reg. §1.163-7(c), §1.61-12(c).

normal call premium" on nonconvertible debt. Section 249 is designed to prevent a corporate issuer from claiming an interest deduction for amounts attributable to repurchasing the conversion right, because it is capital in nature.[85] This is consistent with the nonrecognition treatment afforded the issuer in the economically equivalent two-step transaction in which the debt is converted into appreciated stock and the issuer then redeems the stock.[86] It is also consistent with the Section 1032 disallowance of a deduction to a corporate issuer upon repurchase of an ordinary noncompensatory corporate option (see II.C.2 above).

If a partnership issuer repurchases debt for more than its adjusted issue price, the broadly drafted general rule permitting a deduction for the repurchase premium by its terms applies.[87] In contrast, if the debt is convertible into partnership equity, the Section 249 deduction disallowance rule applicable to corporate convertible debt by its terms does not apply, because that rule is expressly limited to convertible debt issued by a corporation. Moreover, under current law there is no partnership analog to Section 249. Therefore, under current law a partnership issuer that repurchases convertible debt for a premium would appear to have deductible interest expense equal to the full excess of the repurchase price over the adjusted issue price of the debt. As in the case of an ordinary partnership option, the repurchase of partnership convertible debt is economically similar to exercise of the conversion right followed by a redemption of the newly issued partnership interest, both of which would be tax free to the partnership under the approach described in III.B.2.b above and

---

[85] See H.R. Rept. No. 413 (Part I), 91st Cong., 1st Sess. 110-11 (1969).

[86] See III.A.2 above (no gain or loss on conversion of corporate convertible debt into issuer stock) and Section 311(a) (no gain or loss to corporate issuer on nonliquidating distribution with respect to its stock).

[87] See Treas. Reg. §1.163-7(c), §1.61-12(c).

Section 731(b), respectively. Therefore, in light of the consistency considerations noted in connection with the repurchase of ordinary partnership options in II.C.2 above, and for the sound policy reasons underlying Section 249, we recommend that a Section 249-type rule be adopted with respect to the repurchase of partnership convertible debt at a premium. Presumably this would require a statutory amendment.

If such a rule is adopted, the ancillary issues discussed in II.C.2 above in connection with a possible Section 1032-type rule for the lapse or repurchase of an ordinary partnership option should be considered (i.e., the consequences to outside partner basis under Section 705, the possibility of a Section 734 adjustment to inside basis, and appropriate modifications to the capital accounts).

B. Convertible Preferred Equity

The following discussion assumes a partnership issues a preferred equity interest that is convertible into common equity of the issuer.

1. Issuance of Preferred Equity.

a. Treatment of conversion right. Consistent with the treatment of corporate convertible debt (see III.A.1.a), the conversion feature in convertible preferred stock generally is not treated as separate property for tax purposes.[88] Based on these corporate debt and

[88] See, e.g., Rev. Rul. 75-33, 1975-1 C.B. 33 (right to convert preferred stock into common stock of issuer is not separate property for "B" reorganization purposes); Rev. Rul. 78-142, 1978-1 C.B. 112 (right to convert preferred stock into common stock of issuer is not "other property" for Section 356 purposes); Rev. Rul. 69-265, 1969-1 C.B. 109 (right to convert stock of subsidiary into stock of parent is not treated as separate property for reorganization purposes if right is exercisable against the subsidiary but not against the parent); Section 305(c) and Treas. Reg. §1.305-5(b) and -5(d) Example 2 (ignoring conversion feature in determining preferred issue price for purposes of (continued...)

preferred stock analogies, presumably the conversion feature embedded in a partnership convertible preferred interest should not be treated as property separate from the partnership interest. The remainder of this Part III.B assumes this is the case.

b. Consequences to holder. The issuance of a convertible preferred partnership interest is tax-free to the purchaser. Even if the holder acquires the interest using appreciated property, the holder normally would be protected by Section 721, because, in contrast to an ordinary partnership option (see II.A above), convertible preferred (including the embedded conversion feature) is an "interest" in the partnership in its entirety.[89] This result assumes the holder is treated as a partner from the outset, which should be the case if the holder intends to share in partnership profits as a co-proprietor and if the traditional indicia of a debtor/creditor relationship do not exist.[90] Special concerns regarding partner status, which are beyond the scope of this report, may arise if, as is frequently the case, the preferred interest holder is not entitled to share in partnership profits beyond a predetermined annual amount prior to exercise (though these concerns might be mitigated by the presence of the conversion feature).

c. Consequences to partnership and historic partners. Under Section 721, no gain or loss should be recognized by the partnership or its historic partners upon issuance of the

---

88 (...continued)
calculating "preferred OID"). But see Rev. Rul. 70-108, 1970-1 C.B. 78 (where a holder of voting preferred stock, convertible into one share of common, has the option upon conversion to pay cash for another share of common, the cash option is a separate property right, so the preferred stock is not "solely" voting stock for "B" reorganization purposes).

89 See Treas. Reg. § 1.704-1(b)(2)(ii)(h) (which defines "partnership agreement" to include "all arrangements" among the parties, including "puts, options," etc.).

90 See, e.g., Commissioner v. Culbertson, 337 U.S. 733 (1949) (considering all facts the parties intended to join together in the present conduct of a business enterprise).

convertible preferred interest, assuming the holder is treated as a partner for tax purposes from the outset.

In some instances, however, the issuance of a convertible preferred interest may result in actual or deemed distributions taxable to the historic partners under the normal statutory exceptions of Sections 707, 731, 751 and/or 752, including due to reductions in their partnership liability shares arising from admission of the preferred holder (see II.B.2.c. above).

2. Conversion.

a. Consequences to preferred interest holder. The conversion of convertible preferred stock into common stock is generally considered a tax-free recapitalization under Section 368(a)(1)(E).[91] Tax-free treatment of the holder can also be supported, however, by the non-realization and/or bargain purchase theories applicable to corporate convertible debt (see III.A.2.a above). Therefore, as in the case of partnership convertible debt, tax-free treatment of the holder upon conversion of partnership convertible preferred into a common partnership interest can (and we recommend it should) be supported by one or more of (i) the non-realization theory, (ii) the bargain purchase theory, or (iii) Section 721.[92]

---

[91] See Rev. Rul. 56-179, 1956-1 C.B. 187 and Rev. Rul. 77-238, 1977-2 C.B. 115 (conversion of preferred stock into common stock, and conversion of common stock into preferred stock, pursuant to terms of incorporation permitting, or requiring, the conversions and in furtherance of a corporate business purpose, are "E" reorganizations).

[92] As additional authority for the application of Section 721 in this context, see the published rulings discussed in footnote 94.

The holder's holding period in the partnership interest received upon conversion of the preferred should include the holder's holding period in the preferred.[93]

b. Consequences to partnership and historic partners. The conversion of convertible preferred stock into common stock of the issuer is tax free to the corporation under Section 1032. Consistent with the analysis of ordinary partnership options (in II.B.2 above) and partnership convertible debt (in III.A.2 above), we believe that under Section 721 the conversion of partnership convertible preferred should be tax free to the partnership and the historic partners, subject to the normal statutory exceptions under Sections 707, 731, 751 and 752.[94]

Neither the issuance of the convertible preferred interest nor its conversion should be treated as a "sale or exchange" for purposes of the Section 708 partnership termination rules.[95]

3. Lapse of Conversion Right or Repurchase of Convertible Preferred. As in the case of partnership convertible debt (but unlike the lapse of an ordinary partnership option), the expiration of the conversion feature of a convertible preferred partnership interest should not have any tax consequences to the holder or the partnership, because the conversion feature is not separate property for tax purposes.

---

[93] Section 1223(1).

[94] Published rulings have concluded that, under Section 721, no gain or loss is recognized on (i) the conversion of a general partnership interest to a limited partnership interest in the same partnership or (ii) the conversion of a state law partnership into a limited liability company classified as a partnership for tax purposes. See Rev. Rul. 84-52, 1984-1 C.B. 157, and Rev. Rul. 95-37, 1995-1 C.B. 130, respectively. In contrast to the conversion of a preferred interest into a common interest, the partners' economic interests in the partnerships at issue in the rulings were not altered as a result of the conversions, though these authorities nevertheless lend support to the application of Section 721 to the conversion of partnership convertible preferred.

[95] See Treas. Reg. §1.708-1(b)(2); Rev. Rul. 75-423, 1975-2 C.B. 260; and PLR 8015088 (Jan. 17, 1980).

Upon the repurchase of a partnership convertible preferred interest, the holder recognizes (i) gain or loss, if the repurchase terminates the partner's entire interest in the partnership (Sections 731(a) and 736) or (ii) gain but not loss if the partner retains some other partnership interest (Section 731(a)).[96] Under Section 731(b), the partnership recognizes no gain or loss upon the repurchase of a partnership interest, which would include a partnership convertible preferred interest. However, the repurchase appropriately would give rise to a Section 734 adjustment to the basis of the partnership's assets if a Section 754 election were in effect. Repurchase of a convertible preferred partnership interest should not be treated as a sale or exchange for Section 708 purposes.[97]

C. <u>Warrants Issued with Partnership Debt or Preferred Equity</u>

Suppose that, in connection with making a loan to, or purchasing preferred equity in, a partnership, the investor receives an option to purchase partnership common equity.

1. <u>Issuance</u>. If an option is issued in connection with a loan, the lender would be treated as having purchased two separate securities (the debt and the option) for tax purposes. Under the "investment unit" rules of Section 1273(c)(2) and the regulations thereunder, the total purchase price would be allocated between the debt and the option based on their respective fair market values. The amount allocated to the warrant (i) presumably would be accorded the tax-free open transaction treatment associated with pure options (see II.A above), but (ii) may create or

---

[96] In the latter case, the partner's taxable gain is limited to the excess of the cash repurchase price received by the partner over the partner's basis in its entire partnership interest (including the retained interest) immediately before the preferred is repurchased.

[97] <u>See</u> Treas. Reg. §1.708-1(b)(2).

increase OID on the debt, which would be reportable by the partnership and lender over the life of the loan under the OID rules.

Similarly, if the option is issued in connection with preferred equity, the partnership and the holder would be required to allocate the combined purchase price between the option and the preferred equity based on their respective values.[98] The resulting discount on the preferred equity may result in income to the holder.[99]

2. Exercise. If the option is exercised for cash, the general rules applicable to pure investment options described in II.B above should apply. If, pursuant to the terms of the option, the holder uses the related partnership debt or preferred equity as consideration to pay the option exercise price,[100] we believe the exchange should be tax-free to the holder, the partnership and the historic partners under the Section 721 theory (and/or possibly other theories) that apply to ordinary partnership options generally and to partnership convertible debt and preferred, subject to the normal statutory exceptions under Sections 707, 731, 751 and 752 (see II.B., III.A.2 and III.B.2 above).[101]

---

[98] Cf. Section 1273(c)(2) (requiring such valuations in the case of debt and property issued as an investment unit).

[99] If the face amount of the preferred equity (i.e., the liquidation value) exceeds the amount paid for the equity, the difference could be income to the holder, either immediately under a capital shift theory or over time by reason of income allocations or guaranteed payments. Cf. Section 305(c) and the regulations thereunder, which apply OID-type principles in the analogous corporate context.

[100] If the option does not by its terms permit the use of partnership debt or preferred equity to fund the exercise price, it would appear to raise issues similar to those discussed in footnote 13.

[101] However, such an exchange may raise issues that do not apply where the exchange is pursuant to a conversion right embedded in the debt or preferred equity. For example, suppose that a partnership issues for $100 a debt instrument with a $100 face amount payable in 10 years and a 10% current pay interest rate. Assume that later, due to changes in the debt markets, the prevailing interest rate is 5%, the debt instrument is worth $110, and the holder then exercises the related

(continued...)

3. **Lapse or Repurchase.** The lapse or repurchase of a debt-linked or preferred-linked partnership warrant should be treated as described in II.C above concerning stand-alone partnership options.

IV. COMPENSATORY OPTIONS

In this part of the report, we examine the law governing compensatory partnership options, meaning options to acquire partnership interests issued to persons (typically individuals) who have provided or who will provide services to the issuing partnership. Typically, the service provider pays no premium for a compensatory option. Compensatory partnership options present many of the same issues introduced by pure investment options, as well as other issues unique to the compensatory context.

Consistent with the general comments concerning partnership option treatment at the beginning of Part II above, the discussion and recommendations below follow from our view that compensatory partnership options generally should be taxed in a manner consistent with the taxation of nonqualified corporate stock options, which is governed by well-developed rules.[102]

---

[101] (...continued)
warrant by exchanging the debt for a common partnership interest worth $110. It is not entirely clear how or whether Section 721 would apply to the $10 excess of the debt's fair market value over its face amount and basis.

[102] Section 422, which contains special rules concerning the taxation of incentive stock options, by its terms applies solely to a narrow category of options on corporate stock and has no bearing on the taxation of compensatory partnership options.

A. Introductory Comments Regarding Section 83

Section 83 and the regulations thereunder provide well-established legal principles for the treatment of options and other property transferred by a corporation to its employees and independent contractors as compensation. By its terms, Section 83 applies to any transfer of "property" by one person to another in connection with the performance of services, which literally includes the issuance of a partnership interest to a person who performs services for the partnership.[103] At least one court actually has applied Section 83 principles to a compensatory partnership option.[104] Most of those involved in preparing this report believe that Section 83 does provide the proper legal framework to address many of the issues presented by compensatory partnership options. As discussed below, however, there is some tension between Section 83 and Subchapter K principles which must be resolved to determine, for example, the proper amount of income realized by the holder of a compensatory partnership option upon its exercise and the effect of vesting and forfeiture arrangements.

B. Option Issuance

1. Consequences to Option Holder. Although there does not appear to be any authority specific to the partnership context, Section 83 provides appropriate results on this issue. The grant of an option to a service provider generally is not treated as a taxable property transfer

---

[103] Strictly speaking, the regulations under Section 83 (but not Section 83 itself) refer only to services provided in an employee or independent contractor capacity, but not services provided in a partner capacity. See Treas. Reg. §1.83-1(a)(1). Thus, there may be a question whether Section 83 principles apply to the grant of a compensatory partnership option to a person in consideration for services rendered by the person in a partner capacity. See also note 117 below concerning Rev. Proc. 93-27.

[104] See Schulman v. Commissioner, 93 T.C. 623 (1989).

under Section 83.[105] There is an exception for cases where the option has "a readily ascertainable fair market value" on the date the option is granted, but that exception would not apply to the typical compensatory partnership option.[106]

2. Consequences to Partnership and Historic Partners. Assuming Section 83 principles govern compensatory partnership options, issuing a compensatory partnership option normally would not be a taxable event for the partnership or the historic partners.[107] Even if Section 83 principles do not apply in this context, existing authorities regarding the issuance of ordinary options would tend to support the same conclusion. As noted in II.A.2 above, under open transaction doctrine principles issuance of a noncompensatory option is not a taxable event. Those same principles should apply in a compensatory setting.

C. Option Exercise

The following discussion assumes the partnership interest received by the holder upon exercise of the compensatory option is fully vested (see IV.E.3 below for comments on vesting arrangements).

1. Consequences to Option Holder. Assuming Section 83 principles apply and that the option did not have a readily ascertainable fair market value on the grant date, Section 83(a) requires the holder to include in income (as ordinary income), at exercise, the excess of (i) the value

---

105 Section 83(e)(3); Treas. Reg. §1.83-3(a)(2).

106 Treas. Reg. §1.83-7 provides that an option has a readily ascertainable fair market value if either (i) the option itself is actively traded on an established market (which would be extremely unusual for a partnership option) or (ii) the value of the option is readily determinable under standards that would not be satisfied by a typical partnership option.

107 See Section 83(e)(3); Treas. Reg. §1.83-3(a)(2).

of the partnership interest on the exercise date (discussed further below) over (ii) the sum of the option exercise price plus any option premium paid.[108] The holder's basis in the partnership interest would be its value on the exercise date plus the holder's share of partnership liabilities as determined under Section 752.

It is not clear how the value of the partnership interest should be determined for this purpose. Under Section 83 principles, the partnership interest generally should be valued at its true fair market value, taking into account all the relevant facts and circumstances.[109] This process requires taking into account not only the economic attributes of the interest (e.g., the value of the partnership's assets and the holder's entitlement to distributions), but also the noneconomic attributes of the interest (e.g., the holder's rights, if any, to participate in management, and any transfer limitations).[110]

Although Section 83 principles literally would seem to apply to compensatory partnership options under current law, those principles may conflict with Subchapter K principles regarding the direct issuance of compensatory partnership interests.[111] Under such Subchapter K

---

[108] Though we have suggested treating a partnership option as property for Section 721 purposes (see II.B.2 above), we do not believe that is inconsistent with taxing the holder under Section 83 upon exercise of a compensatory partnership option, because Section 83(e)(3) expressly provides that an option with no readily ascertainable fair market value is not property for Section 83 purposes.

[109] See Section 83(a) and Treas. Reg. §1.83-1(a)(1). The effect of any restriction that will lapse over time would be disregarded in determining the value of the partnership interest.

[110] See, e.g., Schulman v. Commissioner, 93 T.C. 623 (1989) (applying Section 83 principles in valuing a compensatory partnership interest).

[111] We will not attempt to recount the significant body of law and commentary in this area. The most notable recent authorities are Rev. Proc. 93-27, 1993-2 C.B. 343 (as amplified by Rev. Proc. 2001-43, 2001-34 I.R.B. 191), and Campbell v. Commissioner, 943 F. 2d 815 (8th Cir. 1991).

principles, as embodied particularly in Rev. Proc. 93-27[112] and Rev. Proc. 2001-43,[113] a service provider to a partnership normally may receive a "profits interest" in the partnership without current taxation, even if (as would usually be the case) the interest has positive fair market value. By contrast, the grant of a partnership capital interest is taxable to the service provider. The distinction between a capital interest and a profits interest is based upon a liquidation analysis, with a capital interest representing any amount that the holder would receive upon an immediate liquidation of the partnership and a profits interest representing any entitlement to future distributions in excess of the liquidation value of the interest.[114] The foregoing principles, taken together, stand for the proposition that the taxable value of a compensatory partnership interest should be determined based upon the liquidation value of the interest.[115] That valuation approach makes irrelevant any noneconomic factors (such as management rights and partnership interest transfer restrictions) that, in theory, should be taken into account in determining true fair market value. It also makes irrelevant any "carried interest" feature associated with the interest (i.e., a proportionate share of partnership profits

---

112 1993-2 C.B. 343. While Rev. Proc. 93-27, by its terms, is only a statement of the Service's audit position rather than a statement of substantive law, it is a reasonably fair interpretation of the prior case law and is so heavily relied upon in practice that it has become tantamount to law.

113 2001-34 I.R.B. 191.

114 See Rev. Proc. 93-27, 1993-2 C.B. 343; Rev. Proc. 2001-43, 2001-34 I.R.B. 191. See also Treas. Reg. §1.704-1(e)(1)(v) (a partner's capital interest is the amount distributable to the partner upon the partner's withdrawal or the partnership's liquidation).

115 In most circumstances where the partnership interest received by the option holder represents a simple pro rata interest in the partnership, the liquidation value of the interest would tend to approximate the true fair market value of the interest, except to the extent that fair market value is affected by noneconomic terms such as transfer restrictions.

in excess of the interest's proportionate share of partnership capital), unless the carried interest is "in the money" and thereby creates liquidation value for the interest on the issue date.[116]

These Subchapter K principles could be applied to compensatory partnership options, with the result that the tax consequences from the exercise of the option would be determined as if

[116] For a compensatory partnership interest that is not a pure profits interest but rather includes an interest in partnership capital (whether acquired directly or, as discussed below, by exercise of an option), the Section 83 approach, because it takes into account noneconomic factors (such as transfer restrictions, limitations on governance rights, and minority discount) may in some cases result in a lower valuation than the Subchapter K approach. Examples of such interests include a simple pro rata interest in the partnership (see the previous footnote), or a capital interest that is burdened by a carried interest held by another partner. As indicated, we believe valuing both compensatory capital interests and profits interests under the Subchapter K liquidation approach is appropriate as a policy matter and may reasonably be inferred from existing authorities. However, to the extent the Section 83 approach results in a lower value, a taxpayer might take a contrary position with respect to a compensatory capital interest, on the grounds that (i) Rev. Procs. 93-27 and 2001-43 (which apply the Subchapter K liquidation approach to, and imply that Section 83 does not govern, the receipt of a compensatory profits interest under certain conditions) do not apply to a partnership capital interest, and (ii) regardless of the Service's administrative position as reflected in these Revenue Procedures or otherwise, the statutory valuation principles of Section 83 may be relied upon. Accordingly, to the extent the government concludes that the Subchapter K liquidation approach should control the valuation of compensatory partnership capital interests as well as profits interests, consideration should be given to amending Section 83 to clarify that result.

the underlying partnership interest had been transferred in exchange for services.[117] There would need to be an appropriate adjustment to reflect any option premium payment.

While either the Section 83 approach or the Subchapter K approach might reasonably be applied in this context, we believe the Subchapter K approach is more appropriate. First, that approach would harmonize the tax treatment of the exercise of compensatory partnership options with the tax treatment of direct issuances of compensatory partnership profits interests. We see no compelling rationale for differentiating between the valuation methodologies used in those two situations, and harmonizing the two sets of rules would eliminate the incentive to restructure compensatory options as partnership profits interests in order to achieve a more favorable tax result. Second, the Subchapter K approach generally would be easier to apply, because it requires valuing only the partnership's assets and does not require analyzing myriad other factors (many of which are quite subjective) relevant to determining the true fair market value of a partnership interest. The Subchapter K approach would create a difference between the law regarding compensatory partnership options and the law regarding compensatory corporate stock options, but that difference would simply mirror the existing tension, implicit in Rev. Proc. 93-27, between the treatments of

---

[117] Rev. Proc. 93-27, by its terms, applies only if the recipient of the partnership interest renders the services "in a partner capacity or in anticipation of being a partner." Because the holder of a compensatory partnership option would not be treated as a partner solely by reason of holding the option, prior to exercise of the option the services could be performed only in an employee or independent contractor capacity, unless the holder already had a partnership interest (in which case the services could be performed in a partner capacity) or the holder is viewed as performing the services in anticipation of becoming a partner. It is unclear what the legal basis is for this fine distinction based upon the capacity in which the services are rendered, but in any event it would seem that the option holder should be regarded as rendering the services in anticipation of becoming a partner, particularly because the holder normally would expect to exercise the option, and the holder's ultimate decision whether to exercise will depend on how the partnership's business has fared.

partnership equity and corporate stock. On balance, we believe it more important to have internal consistency within Subchapter K.

If the holder of a compensatory option is an employee of the partnership, a further issue that arises upon exercise is whether the holder, upon becoming a partner, should continue to be regarded as an employee for tax purposes. This issue arises because the Service takes the position that a partner of a partnership may not also act in an employee capacity.[118] Accordingly, unless that position (which is somewhat questionable) is changed, an employee holder of a compensatory partnership option presumably should be treated for tax purposes as losing employee status upon exercise. Any ordinary compensation that is payable to the "employee" thereafter presumably would be treated as a guaranteed payment and as self-employment income.

2. Consequences to Partnership and Historic Partners.

a. Deduction. In the corporate context, the service recipient is normally granted a deduction under Section 162 or Section 212 for compensation expense at the time a nonqualified stock option is exercised by an employee or other service provider.[119] The deduction is equal to the compensation income recognized by the option holder, and the deduction is subject to the capitalization rules and other limitations. Assuming Section 83 principles apply in the partnership context, the same result would occur when a compensatory partnership option is exercised.

---

[118] See, e.g., Rev. Rul. 71-502, 1971-2 C.B. 199; Rev. Rul. 70-411, 1970-1 C.B. 91; and Rev. Rul. 69-184, 1969-1 C.B. 256.

[119] Section 83(h); Treas. Reg. §1.83-6(a), -7(a).

The tax and book deductions generated by the option exercise presumably should be allocated among the historic partners (and not to the incoming partner), because the compensation liability arose prior to option exercise. These deductions would be allocated in the manner specified in the applicable partnership agreement, provided the allocation has "substantial economic effect" as required by Section 704(b) and the regulations thereunder. Some partnerships purport to specially allocate the compensation deduction to the incoming partner in an attempt to reduce or eliminate the partner's Section 83 income arising from the option's exercise, but often there is a serious question whether the attempted allocation complies with Section 704(b). Accordingly, we recommend guidance requiring the compensation deduction to be allocated exclusively to the historic partners (as illustrated by the example in Appendix II), or otherwise clarifying what the appropriate treatment should be.

b. Gain or loss recognition. Perhaps the most uncertain, and contentious, legal issue regarding compensatory partnership options is whether their exercise is a taxable event to the historic partners as a result of a deemed sale of a portion of the partnership's assets. If the interest received by the holder represents only a profits interest, and is not taxable to the exercising holder based upon the Subchapter K theory recommended in IV.C.1 above, then the answer is easy: exercise is not taxable to the partnership or the historic partners. However, if the interest received by the exercising holder includes a capital interest and therefore is taxable to the holder, then the answer is unclear (as it also is in the case of a simple direct grant of a compensatory capital interest). There appears to be virtually no legal authority on this issue. Moreover, there is not even an obvious analytical framework to be applied to determine the tax consequences. Two basic analytical approaches seem plausible.

The first approach we call the "circular flow of cash theory."[120] Under this construct, the partnership is deemed to have paid cash compensation to the option holder in an amount equal to the option spread at the time of exercise. The optionee is deemed to then contribute that cash (together with the exercise price) to the partnership in exchange for the partnership interest in a nonrecognition transaction under Section 721. Under this analysis, there is no taxable income or loss to the partnership or the historic partners (subject to potential Section 707, 731, 751 and 752 issues). Because no gain or loss is recognized by the partnership or its historic partners from the exercise of the option, there is no adjustment to partnership asset basis.

The second approach we call the "constructive sale of assets theory." Under this approach, the exercise of a compensatory option to acquire a partnership interest is treated as resulting in the same cash compensation payment to the optionee, followed by a cash sale of a portion of the partnership's historic assets to the optionee for fair market value, which assets (plus any remaining cash) are recontributed by the exercising holder in exchange for the partnership interest. The amount of historic assets the partnership is deemed to have sold under this theory is not at all clear and has been the subject of speculation. At a minimum, assuming Section 721 nonrecognition treatment for the partnership to the extent the option is exercised for actual cash, the value of the partnership assets deemed sold and then contributed should equal the amount of compensation

---

[120] Curiously, this theory is not even mentioned in the two leading partnership tax treatises. See McKee, Nelson and Whitmire, Federal Income Taxation of Partnerships and Partners (1997) ("McKee") ¶5.08; and Willis, Pennell and Postlewaite, Partnership Taxation (1999) ("Willis") ¶4.05[5]. However, it has been advocated by other commentators. See, e.g., Cowan, "Substantial Economic Effect--The Outer Limits for Partnership Allocations", 39 N.Y.U. Tax Institute ¶23.08 (1981), and Gunn, "Partnership Interests for Services: Partnership Gain and Loss?", 47 Tax Notes 699 (May 7, 1990).

income recognized by the holder upon exercise. At a maximum, under the most far-reaching application of the aggregate view of partnership taxation (with no Section 721 protection at all for the partnership), the value of the assets deemed sold should equal the total value (immediately after exercise) of the partnership interest received by the exercising holder less the portion of such value representing the holder's share of the exercise price itself.[121] In either case, the historic partners recognize gain or loss on the deemed asset sale in an amount equal to the difference between the fair market of the assets deemed sold and the partnership's tax basis in those assets. There would be a corresponding step-up (or step-down) in the basis of the partnership's assets.[122]

Both the circular flow of cash and the constructive sale of assets theories are hampered because they require imputing events that actually did not happen.

The principal arguments favoring the circular flow of cash theory are the following. First, the deemed flow of cash is consistent with deemed flows of cash associated with the use of appreciated property to satisfy obligations in certain other contexts (notably under Section 1032, the corporate analog of Section 721)[123] and is otherwise consistent with the economics of the transaction.

---

[121] The amount of gain calculated under this expansive interpretation generally corresponds to the amount of gain the partnership would recognize under Treas. Reg. §1.83-6(b) in a fully taxable transaction without the application of Section 721. Treating the partnership as having sold to the optionee historic partnership assets having a value equal to the full option exercise price would be inappropriate, because it overlooks the fact that some of the exercise price is in consideration for the holder's acquisition of an undivided interest in the exercise price itself, which becomes a partnership asset by reason of the exercise.

[122] For an illustration of both methods of gain calculation under the constructive sale of assets theory, as well as the circular flow of cash theory, see the compensatory option example in Appendix II.

[123] Under general tax principles, a taxpayer's use of appreciated property to pay an obligation normally results in a deemed sale of the property for the amount of the obligation. See, e.g., U.S. v.
(continued...)

Second, this theory is consistent with the suggested treatment of a partnership option as "property" for Section 721 purposes. This treatment would preclude gain or loss recognition by the partnership or the historic partners, because the issuance of the partnership interest would be entirely in exchange for property (see II.B.2.a above). Third, even if the capital shift rule of Treas. Reg. §1.721-1(b)(1) causes Section 721 not to apply to the service provider (on the ground that partnership "capital" is being transferred "as compensation for services"), this regulation might be read narrowly to apply only to the service provider and not to the partnership or the historic partners.[124] Fourth, this theory

---

[123] (...continued)
Davis, 370 U.S. 65 (1962), and Treas. Reg. §§1.83-6(b) and 1.1032-1(a). While applicable legal authorities do not always expressly use this analysis, they usually cite as a rationale the fact that it would have been economically equivalent if the taxpayer had paid cash to the transferee in satisfaction of the obligation and then the transferee had used the cash to purchase the property in question. This analysis is expressly contemplated by Treas. Reg. §1.1032-1(a) (last sentence) in the case of corporate stock transferred as compensation for services.

[124] Section 721, by governing the taxation of both the contributing partner and the transferee partnership, serves the dual functions of Sections 351 and 1032 in the corporate context. The regulatory capital shift rule might be read narrowly as an intended analog to Section 351(d), which taxes a contributing shareholder (but not the issuing corporation, which continues to be protected under Section 1032) if stock is issued for services or in satisfaction of certain liabilities of the corporation. Under this view, any capital shift resulting from the exercise of a compensatory partnership option would be taxable to the recipient partner, but not to the partnership or the historic partners, who would continue to be protected by Section 721. Though the regulation literally removes Section 721 protection altogether in connection with a capital shift, this narrower reading is not inconsistent with the regulatory illustrations of the capital shift rule, which solely address taxation of the contributing partner. See Treas. Reg. §1.721-1(b)(1). The preambles to the proposed (1955) and final (1956) versions of Treas. Reg. §1.721-1(b)(1) contain no substantive discussion and therefore shed no light on the intent of the regulation. See 55 Fed. Reg. 6574 (1955) (proposed regulations); T.D. 6175, 1956-1 C.B. 211 (final regulations). However, the regulation was promulgated shortly after the predecessor version of Section 351(d) (originally part of Section 351(a)) was enacted in 1954.

To the extent a narrower reading of this type is regarded as appropriate, consideration should be given to clarifying the regulation accordingly. For further discussion of the capital shift rule, see
(continued...)

does not deter the use of partnership options by creating potentially onerous tax consequences to the historic partners (and it does not force partnerships to try to restructure options into economically similar profits interests).[125] Fifth, this theory avoids creating a trap for the unwary, in that the historic partners may escape taxation under the constructive sale of assets theory by creating an actual circle of cash (using cash on hand or borrowed funds) upon exercise of the option. Sixth, this theory equates the treatment of compensatory partnership options with the treatment of compensatory corporate stock options, which is the paradigm many business people have in mind when they consider compensation arrangements in partnership transactions, especially for limited liability companies that a few years ago would have been organized as corporations. Seventh, this theory is much simpler to administer.

The principal arguments favoring of the constructive sale of assets theory are the following. First, the theory logically follows from viewing a partnership for this purpose as an aggregate of its partners, rather than as an entity protected from gain recognition by Section 721. Second, it is supported by a broad reading of the capital shift rule of Treas. Reg. §1.721-1(b)(1), which applies in this context to the partnership and historic partners (rather than merely to the service

---

[124] (...continued)
II.B.2.b.ii above.

[125] The potentially onerous consequences associated with the constructive sale of assets theory would not apply to a compensatory profits interest, even one that is economically comparable to a compensatory partnership option. Such an economically comparable profits interest could be structured by providing the service provider with (i) an initial capital account balance equal to any amount paid for the interest, (ii) the right to share in future profits on a priority basis until the service provider achieves a capital account balance equivalent to what the service provider would have received in connection with exercising the option, and (iii) an appropriate share of future profits beyond those described in (ii). See V below for further discussion of partnership options and profits interests.

provider under the narrow reading suggested above). Third, it arguably is supported by a 1974 Tax Court case.[126] Fourth, it is supported by Treas. Reg. §1.83-6(b), which provides that an employer's transfer of "property" to a service provider is taxable to the transferor, except to the extent provided in Section 1032 in connection with the exercise of compensatory corporate stock options.

One additional argument that some have advanced to support the constructive sale of assets approach is that taxing the partnership and historic partners when a partnership interest is transferred for services produces inside basis adjustments to the partnership's assets that are needed to avoid double taxation to the service provider (i.e., once under Section 83 when the interest is issued and again later when the partnership sells its assets).[127] We do not agree with this. In support of the constructive sale of assets approach, McKee notes that "[i]f the partnership does not recognize gain with respect to the transfer, there is no way to characterize the transaction that will cause the basis of its assets to be increased" to reflect that the service provider (who is taxed under Section 83) is deemed to have "paid" fair market value for his or her partnership interest.[128] While this statement is correct, it does not follow that gain recognition to the partnership is necessary to avoid double

---

[126] McDougal v. Commissioner, 62 T.C. 720 (1974), acq. 1975-1 C.B. 2. Although the opinion in McDougal seems to adopt the constructive sale of assets theory, it seems more appropriate to view the facts of the case as involving the transfer of a partial interest in appreciated property to the person who provided the services, followed by the formation of a new partnership by the service provider and the service recipients. There appears to be no other case that deals with the issue of gain recognition by the partnership or the historic partners.

[127] The argument seems to derive primarily from McKee at ¶5.08[2][b], which may not explicitly state this rationale, though many have read it into that section. See also Willis at ¶4.05[5], which also favors the constructive sale of assets theory but does not say why. Any such double taxation should not be permanent, because the service provider would normally realize a capital loss (or reduced gain) on an ultimate liquidation of the partnership or sale of the partnership interest.

[128] McKee at ¶5.08[2][b], n. 165.

taxation to the service provider (or for any other compelling reason). As McKee notes, under the constructive sale of assets approach, the benefit of any basis increase in the partnership's assets is allocated to the service provider under Section 723 and Treas. Reg. §1.704-1(b)(2)(iv)(f), thus protecting the service provider from recognizing gain again when the assets are later sold. However, an asset basis increase is not required to avoid double taxation, since the service provider is equally protected under the circular flow of cash theory by the same regulation.[129] Under the circular flow of cash theory, as with the constructive sale of assets theory, the partnership's assets should be revalued when a partnership interest is transferred for services (including upon exercise of a compensatory option) pursuant to Treas. Reg. 1.704-1(b)(2)(iv)(f), resulting in a capital account book-up (see IV.E.1below and, in the noncompensatory context, II.D.2 above). Under reverse Section 704(c) principles, any taxable gain inherent in the partnership's assets at the time of revaluation generally should be allocated solely to the historic partners as the assets are sold, with no double taxation to the service provider (see IV.E.2 below, the example in Appendix II, and, in the noncompensatory context, II.D.3 above). The only difference between the constructive sale of assets

[129] Under the circular flow of cash theory, the partnership's basis in its assets does not change. (Technically, asset basis is first reduced by the partnership's compensation deduction and then restored by the service provider's corresponding deemed cash contribution.) Nor should the aggregate outside basis of all the partners in their partnership interests change. The service partner, having been fully taxed on the receipt of his or her interest, will have a fair market value basis in that interest. The partnership's compensation deduction, assuming it is allocated to the historic partners, reduces their outside basis in their interests. As a result, under the circular flow of cash theory, outside basis simply shifts from the old partners to the incoming partner. Double tax is avoided through reverse Section 704(c) allocations as discussed in the text below.

theory and the circular flow of cash theory in this regard is the amount of gain subject to the reverse Section 704(c) allocation.[130]

Because the choice between the circular flow of cash approach and the constructive sale of assets approach is ultimately a difficult policy issue, we do not have a strong position as to which approach should govern, though we tend to favor the circular flow of cash theory for the reasons described above. Whichever approach is considered appropriate, we do strongly recommend the law be clarified to eliminate the significant uncertainty that now exists, which is a serious impediment to the use of compensatory partnership options.

D. **Option Lapse or Repurchase**

Suppose a compensatory partnership option is repurchased for an amount exceeding any option premium paid by the holder. Assuming Treas. Reg. §1.83-7 (concerning stock options) applies and that the option did not have a readily ascertainable fair market value on the grant date, (i) the optionee should have compensation income in the amount of such excess, and (ii) the partnership should have a corresponding deduction (subject to applicable limitations). Because no premium typically is paid in connection with the grant of a compensatory partnership option, the

[130] This difference is illustrated in the compensatory option example in Appendix II. In Example 5-7 appearing in McKee at ¶5.08[2][b], under the circular flow of cash approach, after C's admission as a partner, the tax basis of A, B and C in their partnership interests is $10, $10 and $40 respectively (rather than $20, $20 and $40 under McKee's application of the constructive sale of assets approach). Upon C's admission, the partnership assets would be booked-up to their $120 value, and each partner's capital account would be increased to $40. This results in a $60 book-tax difference ($120 value less $60 basis) both in the partnership's assets and in the partner capital accounts. Under reverse Section 704(c) principles, A and B (not C) each would be allocated $30 of this built-in gain if the assets were sold. In contrast, under the constructive sale of assets approach applied in the actual example (where the partnership recognizes $20 of gain on C's admission), there is only $40 of built-in gain, of which A and B each would be allocated $20 if the assets were sold.

option's lapse generally should have no tax consequences to the holder, the partnership or the historic partners.

If an option premium was paid, however, and the option lapses or is repurchased for less than the premium amount, under current law the partnership should have taxable gain and the optionee a taxable loss, based on Section 1001 and general tax principles.[131] Taxing the partnership's gain differs from the corporate option case, where the corporation recognizes no income under Section 1032. However, taxable gain to the partnership is symmetrical with the partnership's compensation deduction under Section 83 when a compensatory option is repurchased at a premium. As for future guidance, either the current law result of taxable gain to the partnership could be preserved, or a Section 1032-type nonrecognition rule (along the lines described in II.C.2 above) might be implemented, though this presumably would require a legislative change.

E. Other Issues

1. Capital Accounts. Compensatory options involve many of the same issues regarding the proper maintenance of capital accounts discussed in II.D.2 above in the context of noncompensatory options.

One important distinction is that upon exercise of a compensatory option the holder, who is fully taxed under Section 83, clearly should be treated as having made a capital contribution in an amount equal to the full value of her partnership interest, whether the circular flow of cash theory or the constructive sale of assets theory applies. Specifically, if the circular flow of cash theory is followed, the holder is treated as paying all cash for the interest. If the constructive sale of assets

---

[131] Section 1234, however, which applies to the lapse or repurchase of a noncompensatory option (see II.C above), does not apply to compensatory options. See Treas. Reg. §1.1234-3(d).

theory is followed, the holder is treated as paying a combination of cash (up to the sum of the option exercise price plus any premium paid for the option) and property with a fair market value basis (to the extent the value of the interest received exceeds the cash payment). However, difficult Section 704(c) issues might arise if the latter theory is adopted and Section 83 principles apply to determine the value of the interest received, because Section 83 principles may result in values being assigned to the interest (and, in turn, the underlying assets) that do not accurately reflect the true fair market values of the underlying assets.

For an illustration, see the example in Appendix II.

2. <u>Section 704(c) and Reverse 704(c) Allocation Issues</u>. As with noncompensatory options (see II.D.3 above), the exercise of a compensatory option may give rise to Section 704(c) and reverse Section 704(c) allocation issues. The key difference in this context is that only the historic partners, not the option holder, potentially will be subject to Section 704(c) or reverse Section 704(c) allocations. Although the nature of the property deemed contributed by the option holder will vary depending upon whether the circular flow of cash or the constructive sale of assets theory governs the analysis, in either case the option holder is viewed as contributing property with a value equal to its tax basis. However, as the discussion in the previous section suggests, even the holder may be subject to Section 704(c) if the constructive sale of assets theory is adopted and Section 83 valuation principles apply to value the interest received.

For an illustration, see the example in Appendix II.

3. <u>Vesting Arrangements</u>. While a compensatory option often is subject to vesting or forfeiture restrictions, normally the equity interest received upon exercise is fully vested, in which case the tax consequences described in Section IV.C above apply to the parties at the time of exercise.

In certain cases, however, the partnership interest received upon the exercise of a compensatory option will be subject to vesting or forfeiture restrictions. Assuming that Section 83 principles relating to such restrictions apply to compensatory partnership options, to the extent of any so-called "lapse restriction" the holder would not be viewed as receiving an immediate transfer of property and therefore would not be treated as a partner unless a Section 83(b) election were made (subject to the administrative relief furnished by Rev. Proc. 2001-43 in the case of certain "profits interests," as described below).[132] Instead, the holder would be viewed as receiving the applicable portion of the interest as the restrictions lapse and as that portion of the interest either becomes transferable or ceases to be subject to a substantial risk of forfeiture. Consequently, application of the principles regarding the exercise of compensatory partnership options discussed in IV.C above would need to be modified in these cases to reflect the delayed transfer of the property for tax purposes, including the potential change of the nature of the interest as a capital or profits interest by reason of changes in the value of the partnership's assets between the exercise date and the later, Section 83 transfer date.

---

[132] See generally Section 83 and Treas. Reg. §§1.83-1 through 1.83-8. While most of those involved in preparing this report believe that, at least in the absence of Rev. Proc. 2001-43, Section 83 does provide the proper legal framework for resolving many issues raised by compensatory partnership interests, including those subject to vesting or forfeiture arrangements, a minority believes that, even before the issuance of Rev. Proc. 2001-43, Rev. Proc. 93-27 (discussed in IV.C above) removed partnership profits interests (both vested and unvested) entirely from the scope of Section 83, and that Section 83 principles therefore do not apply to such interests.

Notwithstanding the foregoing, Rev. Proc. 2001-43[133] indicates that the Service will treat the recipient of a compensatory partnership profits interest that is subject to vesting or forfeiture restrictions as the tax owner of the interest from the date of receipt, without the need for a Section 83(b) election, in the situations described in the Revenue Procedure. Questions exist about the actual and intended scope of Rev. Proc. 2001-43 and its tension with substantive law (i.e., Section 83), which questions are beyond the scope of this report. Presumably, however, the Service's new position also applies to a partnership interest received upon the exercise of a compensatory option, taking into account the characteristics of the partnership interest on the exercise date. For example, Rev. Proc. 2001-43 presumably would apply to such an interest if (i) on the exercise date the interest represents merely an interest in future profits and not an interest in partnership capital, (ii) the partnership claims no compensation deduction (under Treas. Reg. §1.83-6) based on the value of the interest on the issue date or any subsequent vesting date, and (iii) the other conditions of Rev. Proc. 2001-43 are satisfied. In contrast, Rev. Proc. 2001-43 by its terms would not apply if on the exercise date the interest received includes an interest in historic partner capital or in prior appreciation (which would not be unusual given the normal passage of time between the grant of an option and its exercise) and the partnership claims a compensation deduction for the excess of the value of the interest on the exercise date (or on a subsequent vesting date) over the exercise price (plus any option premium) paid by the holder for the interest. In any event, any future guidance on compensatory partnership options should clarify the application of Rev. Proc. 2001-43 to partnership interests received upon their exercise.

[133] 2001-34 I.R.B. 191.

V. TAX CHARACTERIZATION OF PARTNERSHIP OPTIONS

As discussed below, and as the foregoing discussion has assumed, we recommend that, like the treatment of options of other types, partnership options generally be respected as options for tax purposes, subject to certain substance-over-form principles (see V.B below) and, to the extent these are considered to be inadequate, targeted anti-abuse rules (see V.C below).

A. Tax Differences Between Partnership Options and Partnership Equity

Like options on other types of property, an option to acquire a partnership interest may bear a close economic resemblance to an actual partnership interest, though if respected as an option and not as a current partnership interest it may have substantially different tax results. Compare two examples involving compensatory arrangements:

> Example 1: A and B each contribute $100 to a partnership ("PS") and receive equal interests. In exchange for services to PS, C receives a fully vested profits interest in PS entitling C to one-third of PS's net profits. If C's employment terminates (other than for cause), PS will repurchase her profits interest for its fair market value at the time of termination.
>
> Example 2: Same as Example 1, except that C receives, instead of a profits interest, a fully vested option entitling C to purchase a one-third interest in PS's profits and capital for a $100 exercise price. If, before exercising her option, C's employment terminates (other than for cause), C will receive a cash payment equal to the spread between (i) the value of the one-third partnership interest that C would receive upon exercising the option and (ii) the $100 option exercise price.

Assume that in each case (and, in Example 2, before C exercises the option): (i) PS earns $300 of net ordinary income (which PS retains); (ii) the fair market value of PS's assets (including the $300 of accumulated earnings) appreciates to $1,700; and (iii) C's employment then terminates, resulting in a termination payment to C of $500.[134]

The above two examples, though they achieve similar pre-tax economics for the parties, are taxed very differently if their forms are respected. C should not be taxed upon issuance of the partnership interest (in Example 1) or the option (in Example 2) under Rev. Proc. 93-27[135] and Section 83, respectively (see IV.B.1 above). In Example 1, however, C is taxed currently on one-third of PS's $300 net operating income prior to her employment termination (which increases the tax basis of C's partnership interest to $100), and upon termination C recognizes $400 of capital gain income under Section 741 (i.e., the $500 termination payment less C's $100 basis in her partnership interest), subject to ordinary income characterization to the extent Section 751(b) applies. In Example 2, C recognizes no income before termination, but $500 of ordinary compensation income upon termination under Section 83.[136] Thus, there are significant timing and character differences between these two examples.

---

[134] C's termination payment is calculated as follows. In Example 1: 1/3 x [$1,700 fair market value of PS assets less $200 initial capital of A and B] = $500. In Example 2: [1/3 x $1,800 fair market value of PS assets after deemed exercise by C (as increased to reflect the exercise price)] less $100 option exercise price = $500.

[135] 1993-2 C.B. 343.

[136] The tax difference is less striking in the noncompensatory setting. In the preceding examples, if the partnership interest and the option were noncompensatory, the results to C would be the same in Example 1 ($100 of current operating income, and $400 of capital gain on repurchase of the partnership interest), but in Example 2 C's $500 gain should be capital (rather than ordinary) under Section 1234 (see II.C.1 above). Therefore the main difference is the current inclusion of the operating income, and not the character distinction that arises in the compensatory case.

B. Substance-Over-Form Considerations

These examples illustrate the disparate taxation of two economically equivalent arrangements, raising the question to what extent economic substance, rather than form, should control the tax characterization of partnership options (and, for that matter, partnership equity).

Generally, an option holder is not treated for tax purposes as directly owning the underlying property, and accordingly is taxed differently from a direct owner of the property. For example, options to acquire corporate stock generally are not treated as stock.[137] However, "deep-in-the-money" options, i.e., options with a nominal exercise price or that are otherwise substantially certain to be exercised, may be treated as stock.[138] Conversely, a transaction characterized as a

---

[137] See, e.g., Rev. Rul. 67-269, 1967-2 C.B. 298 (options and warrants that "have none of the attributes of immediate stock ownership, such as the right to vote ... or ... receive dividends," are not treated as stock); PLR 8811061 (Dec. 23, 1987) (an option holder is not a shareholder until the option is exercised); Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942) (corporate warrants do not qualify as voting stock for purposes of reorganization provisions under Revenue Act or 1934). One narrow statutory exception is Section 305(d) which, for purposes of the Section 305 rules governing stock dividends, treats a "right to buy stock" as "stock" and treats the owner of such a right as a "shareholder."

[138] See, e.g., Rev. Rul. 82-150, 1982-2 C.B. 110 (where taxpayer purchased for $70x an option to acquire for $30x stock of a foreign corporation worth $100x, the option was treated as equity under substance-over-form principles, because the taxpayer "assumed the risks of an investor in equity" and "assumed the benefits and burdens of ownership" of the underlying stock); Rev. Rul. 85-87, 1985-1 C.B. 268 (put option sold by taxpayer is treated as a contract to acquire stock for purposes of wash sale rules where there was "no substantial likelihood" that the holder would not exercise the option given the spread between the stock's value and the option exercise price, the premium paid, the historic volatility of the stock, and other objective factors); Morrison v. Commissioner, 59 T.C. 248 (1972) (in a pre-Section 83 case, compensatory option to purchase for $1 a share stock worth $300 on the date of grant was the "substantial equivalent of the stock itself," resulting in immediate taxation of the holder on the grant date under Section 61). But see Victorson v. Commissioner, 326 F.2d 264 (2d Cir. 1964) (an option to purchase shares of stock at an exercise price equal to 0.2% of the stock's fair market value at the option grant date was respected as an option); Simmons v. Commissioner, 23 T.C.M. 1423 (1964) (same when exercise price was 0.1% of the underlying stock's
(continued...)

purchase of stock (or of other property) may be characterized as a mere option to acquire the property if the holder does not possess sufficient incidents of ownership.[139]

We believe a similar regime should govern both compensatory and noncompensatory partnership options. Specifically, we recommend that, in general, partnership options be respected as such and not treated as partnership equity, for the following reasons:

- Consistency with taxation of other options. The treatment of options as distinct from the underlying property is uniform throughout the tax law, and the special issues raised in the partnership context do not merit a different general rule for partnership options. An option to acquire an interest in other types of pass-through entities generally is not treated as an equity interest even when the option holder also owns outstanding shares.[140]
- No compelling policy reason to depart from form. We are aware of no compelling policy reason to tax customary, non-abusive, partnership options other than according

---

138 (...continued)
value at the grant date). Cf. Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942) (holders of unsecured corporate notes were treated as stockholders for purposes of the reorganization provisions of the Revenue Act of 1928 on the date the holders instituted bankruptcy proceedings against the issuer and thereby acquired "effective command over the disposition of the [issuer's] property" which extinguished any proprietary interest of the former shareholders; the actual issuance of new stock to the noteholders in the bankruptcy was merely a formality).

139 See, e.g., Treas. Reg. §1.83-3(a)(2) (a transaction in which property is purchased with a nonrecourse note secured only by the purchased property, so that the holder bears no risk of loss, "may in substance be the same as the grant of an option"). For critical commentary on this provision, see Report on Possible Modifications to Section 83 and the Regulations Thereunder (NYSBA Tax Section), Dec. 7, 2000.

140 See Sections 852 (regulated investment companies), 857 (real estate investment trusts), 951 (controlled foreign corporations), and 1293 (passive foreign investment companies with respect to which a qualified electing fund election is in effect), and Treas. Reg. §1.1361-1(l) (S corporations).

to their form, in part because all taxable income earned by the partnership prior to exercise (including any taxable income that would have been allocated to the optionee had the optionee held the underlying partnership interest from the outset) is allocated to the historic partners.[141]

- Administrative considerations. A lay person who acquires a partnership "option" generally would expect to be taxed as an option holder and not a current partner. An important purpose of partnership options, particularly in the compensatory context, is often to spare the holders of these instruments the tax reporting complexities associated with being a partner who receives a Schedule K-1 each year and may be required to file tax returns in multiple state (and possibly national) jurisdictions. Partnership option tax consequences should be, as much as possible, straightforward and predictable and not create unnecessary complexity or traps for the unwary or the unadvised.
- Option exercise not certain. Exercise of an option is voluntary for the holder and therefore generally not certain, which fundamentally distinguishes a partnership option from the underlying partnership interest. Allocating partnership income and loss items to an option holder who never exercises her option strikes us as singularly inappropriate.[142]

---

[141] See, however, footnote 27.

[142] Where the option holder also owns a true partnership interest, there may be a somewhat stronger argument that the holder should be allocated income attributable to the optioned interest. See Treas. Reg. §1.704-1(b)(2)(ii)(h) (broadly defining "partnership agreement" to include "all arrangements" (continued...)

As a limitation on this general rule, however, we recommend that substance-over-form principles comparable to those applicable to corporate and other securities described above also apply in the partnership context in appropriate cases. For example, substance-over-form principles may require the optionee to be treated as a partner for tax purposes when the option has a nominal exercise price or is otherwise substantially certain to be exercised.[143] Any optionee that is so treated as a constructive partner would be allocated partnership income and loss under Section 704. Conversely, there may be circumstances where the nominal holder of a partnership interest should be treated as owning an option based, for example, on the principles of Treas. Reg. §1.83-3(a)(2).

However, the ability, under Rev. Procs. 93-27 and 2001-43, to issue tax-free to a service provider a profits interest that lacks any capital element and hence mimics the economics of an option (as illustrated in Examples 1 and 2 above) suggests that, at least in the absence of abusive circumstances, some degree of formalism should be respected in distinguishing between partnership options and partnership equity, as it is in characterizing options on other types of property.[144] This principle does not seem to raise any fundamental policy concerns, though it may mean that substance-

---

[142] (...continued)
among the parties, including "puts, options," etc.). But given the holder's ability to decline to exercise the option, unless exercise is substantially certain the foregoing regulation should not result in allocations being made to the option holder.

[143] See, e.g., Rev. Rul. 72-350, supra note 56; and IRS Field Service Advice 1999-1095 (Nov. 12, 1993) (concluding, subject to further development of the facts, that a partnership loan and option arrangement was in substance a sale of a partnership interest, because the lender "obtained many of the significant benefits and burdens of ownership that constitute the normal indicia of a partnership interest").

[144] For example, while less common in practice, common stock could be structured similarly as a corporate profits interest with no capital element (though the service partner would be taxed on the initial value of the interest under Section 83). Despite its economic resemblance to a stock option, such a security would normally be respected as stock for tax purposes in accordance with its form.

over-form principles in some cases should be applied in the partnership context more by reference to non-economic factors (e.g., presence of state law partner rights, "voting" rights, etc.). Whatever substance-over-form approach may be adopted, we believe the forms in which Examples 1 and 2 above are cast generally should be respected in the absence of abuse. In particular, we recommend that any guidance concerning partnership options not alter the equity status of a profits interest of the type described in Example 1 and contemplated by Rev. Procs. 93-27 and 2001-43, despite its resemblance to a partnership option.

C. Abuse Considerations

We recognize it may be possible to structure potentially abusive transactions involving partnership options that would not necessarily be thwarted by existing substance-over-form precedent governing options and similar securities. Consider the following example:

> Example: A and B form a partnership ("PS") to invest in U.S. stocks for capital appreciation. A and B, each a foreign corporation (or a U.S. tax exempt entity, or a corporation with significant net operating losses), each contribute $100 for a 50% interest in PS. C, a taxable U.S. corporation or individual, pays $10 (or $30 or $50) to PS for a noncompensatory option to purchase a one-third interest in P for an exercise price of $100 (or $80 or $60). C also may make a $90 (or $70 or $50) nonrecourse loan to PS, secured by some or all of PS's investment assets (thus furnishing PS with the cash PS would have received had C purchased an actual one-third partnership interest). PS invests and reinvests the cash, earning significant investment income over the life of the fund, on which little or no current U.S. tax is paid because all income and gains are allocated to A and B. When C ultimately exits the partnership (either by selling the option at a gain or by exercising the option and then selling

the underlying partnership interest), C will recognize gain on C's share of the accumulated earnings and appreciation in PS. But, in comparison to an arrangement in which C is a 1/3 partner from the outset (where C would have been taxed currently on C's share of PS's earnings), C's tax has been deferred,[145] and if C is an individual, perhaps significantly reduced to the extent gain attributable to accumulated interest and dividends is taxed upon the sale as long-term capital gain.

We draw no conclusion as to whether the above example is abusive, but simply observe that some configuration or variant of the example might fairly be viewed as leading to inappropriate results that would not necessarily be addressed by general substance-over-form principles.

Transactions of the above type of course are not limited to partnership options, but rather can also be structured using regular options outside the partnership context, and general substance-over-form principles for the most part have seemed adequate to address those arrangements. In addition, we believe it would be inappropriate to fashion a broad anti-abuse rule recharacterizing any partnership option arrangement that has the effect of reducing the overall tax burden of the parties, because partnership option arrangements in general (like bona fide option arrangements of other types) are likely to have some impact on the amount or timing of overall income and loss inclusions by the parties.

Nevertheless, if general substance-over-form principles and other anti-abuse protection currently available to the government were regarded as inadequate, consideration might be given to fashioning a targeted anti-abuse provision that will not disrupt normal commercial arrangements.

---

[145] Moreover, C's deferral might be extended if C's interest is liquidated in kind.

Such protection might be implemented either by a stand-alone rule applicable to partnership options, or by adding one or more examples to the general anti-abuse rule of Treas. Reg. §1.701-2. The substantiality rules under Treas. Reg. §1.704-1(b)(2)(iii) concerning shifting and transitory allocations might also be reviewed and possibly refined in connection with implementing guidance on partnership options. If an anti-abuse rule is promulgated, we recommend that it (1) be appropriately tailored to reflect the particular concern at issue, and (2) include safe harbors for specified customary, non-abusive transactions (such as options issued in customary lending transactions, and compensatory options with customary terms and conditions), which could be modeled after some of the safe harbors contained in the option regulations applicable to Section 382 ownership changes, S corporations and affiliated group determinations.[146]

---

[146] See Treas. Reg. §1.382-4(d)(7), §1.1361-1(l), §1.1504-4.

APPENDIX I -- NONCOMPENSATORY OPTION EXAMPLES

The following examples illustrate some of the conclusions and recommendations described in Part II concerning the tax treatment of noncompensatory partnership options.

Example 1-- Nondepreciable Property

Facts: A and B each contribute $100 cash to form partnership PS. A and B each receive 10 equity units of PS, becoming equal 50% partners. PS purchases land for $200. C pays $30 to PS for an option to acquire 10 PS units (a one-third partnership interest) for $200. PS deposits C's cash in a non-interest-bearing account. C exercises the option when the land is worth $700. Assume no other PS activity.

Consequences of option grant: The option grant is not taxable (see II.A above). The PS initial tax and book balance sheets are as follows. The option premium is recorded in a special equity account in the optionee's name (see II.D.1 above).

Tax Balance Sheet			Book Balance Sheet	
$ 30 Cash	$100 A Capital		$ 30 Cash	$100 A Capital
200 Land	100 B Capital		200 Land	100 B Capital
	30 Option account			30 Option account
$230	$230		$230	$230

Consequences of option exercise: Exercise of the option is not taxable to A, B or C (see II.B above). Immediately after exercise, the PS tax and book balance sheets are as follows:

Tax Balance Sheet			Book Balance Sheet	
$230 Cash	$100 A Capital		$230 Cash	$310 A Capital
200 Land	100 B Capital		700 Land	310 B Capital
	230 C Capital			310 C Capital
$430	$430		$930	$930

As shown, the $30 option premium is added to the tax basis of C's partnership interest and is reflected in the partners' capital accounts upon exercise.

Eliminating book-tax disparity. The above book balance sheet assumes that (i) the land is "booked up" to its $700 fair market value pursuant to Treas. Reg. §1.704-1(b)(2)(iv)(f), and (ii) there is a corresponding $500 book-up of the partner capital accounts under the modified post-exercise book-up approach described in II.D.2.b, which here is effective to conform the capital accounts to the economic deal. The book-up is allocated among the capital accounts in two steps: (i) the first $260 is allocated equally to A and B to conform their capital accounts to C's $230 investment (above which C is entitled to share in appreciation), and (ii) the remaining $240 is allocated equally to A, B and C consistent with their one-third sharing ratios. Because the land has been revalued, if it were sold for $700, the $500 tax gain would be allocated $210 to each of A and B and $80 to C as reverse Section 704(c) allocations under Treas. Reg. §1.704-1(b)(4)(i).

Example 2 -- Depreciable Property

Facts: Same as Example 1, except that PS uses the $200 contributed by A and B to construct an asset that is depreciable on a straight-line basis over 10 years (the "Property"). The asset appreciates to $700 and is placed in service when C exercises her option.

Consequences of option grant: Same as Example 1.

Consequences of option exercise: As in Example 1, exercise of the option is not taxable to A, B or C, and the PS post-exercise tax and book balance sheets are as follows:

Tax Balance Sheet			Book Balance Sheet	
$230 Cash	$100 A Capital		$230 Cash	$310 A Capital
200 Property	100 B Capital		700 Property	310 B Capital
	230 C Capital			310 C Capital
$430	$430		$930	$930

Eliminating book-tax disparity. (a) Depreciation. The Property has been revalued and the partner capital accounts have been booked up as in Example 1. After the revaluation, the $70 of annual book depreciation on the Property is allocated one-third each to A, B and C under Section 704(b). To determine how to allocate the $20 of annual tax depreciation among A, B and C, first determine the book value the Property would need to have for C's book capital account to equal C's $230 tax capital account:

Tax Balance Sheet			Book Balance Sheet	
$230 Cash	$100 A Capital		$230 Cash	$230 A Capital
200 Property	100 B Capital		460 Property	230 B Capital
	230 C Capital			230 C Capital
$430	$430		$690	$690

Using the resulting $460 book value for the Property, the $20 annual tax depreciation should be allocated under Treas. Reg. §1.704-1(b)(4)(i): $15.33 to C (i.e., 1/3 of $46 annual book depreciation) and the remainder ($2.34 each) to A and B. (Thus, as the Property depreciates, the book-tax difference for each of A, B and C converges to zero, with the book and tax capital accounts for each converging to $76.67 (i.e., one third of the $230 cash remaining in PS).

(b) Sale. If the Property were sold immediately after exercise for its $700 fair market value, the tax gain would be allocated in the same manner as in Example 1.

Example 3 – Pre-Exercise Asset Sale

Facts: Same as Example 1 except that, immediately before C exercises her option, PS sells the land for $700 cash and purchases new land for $700.

Consequences of option grant: Same as Example 1.

Consequences of pre-exercise land sale: Upon the sale of the original land, PS incurs $500 of book and tax gain, allocating both equally between A and B. Immediately after the sale and purchase transactions, but before C exercises the option, the tax and book balance sheets of PS are as follows:

Tax Balance Sheet			Book Balance Sheet	
$ 30 Cash	$350 A Capital		$ 30 Cash	$350 A Capital
700 Land	350 B Capital		700 Land	350 B Capital
	30 Option account			30 Option account
$730	$730		$730	$730

The book option account continues to reflect only the $30 option premium, although the implied value of the option is now substantially higher (because C has a right to purchase for $200 a partnership interest which, after exercise, would now be worth $310). As an alternative, the book option account might be revalued (e.g., to $110) at the time of the sale, with a corresponding reduction (to $310 each) of the book capital accounts of A and B, though that approach would be at odds with the allocation of taxable income from the sale and thus create a book/tax disparity for A and B. See II.D.1 above concerning accounting for option premiums.

Consequences of option exercise: As in Example 1, exercise of the option is not taxable to A, B or C. Immediately after exercise, the PS tax and book balance sheets (subject to the discussion below on book capital accounts) are as follows:

Tax Balance Sheet			Book Balance Sheet	
$230 Cash	$350 A Capital		$230 Cash	$310 (?) A Capital
700 Land	350 B Capital		700 Land	310 (?) B Capital
	230 C Capital			310 (?) C Capital
$930	$930		$930	$930

In contrast to Example 1, A's and B's pre-exercise book and tax capital accounts ($350 each), as well as their shares of PS's asset tax basis (also $350 each) exceed the post-exercise fair market value of their interests ($310 each). Also in contrast to Example 1, here the PS assets prior to exercise already are booked at their fair market value. Therefore, the asset and capital account revaluation provisions of Reg. §1.704-1(b)(2)(iv)(f)-(g) by their terms do not apply, nor does the modified post-exercise book-up approach used in Examples 1 and 2. In the absence of other available adjustment mechanisms, the capital reallocation approach described in II.D.2.c could be used to reduce A's and B's book capital accounts from $350 to $310 each, and to increase C's capital account to $310, in order to reflect the post-exercise fair market value of their relative interests. If, in connection with the sale of the original land, the option account had been "booked up" to reflect the larger ($110) claim represented by the option at that time, A's and B's book capital accounts would match the post-exercise value of their interests without the need for this capital reallocation.

Eliminating book-tax difference: (a) Depreciation. If the new land purchased by PS for $700 instead were a depreciable asset, the tax depreciation deductions could be specially allocated among the partners in a manner that reduced their book-tax differences by using the approach described in Example 2, notwithstanding that there is no book-tax difference inherent in the land itself.

(b) Sale. Suppose the new land is sold for its $700 value immediately after exercise of the option. In contrast to Example 1, PS would incur no taxable gain or loss to allocate to its partners. Nevertheless, a taxable sale of the land would seem an appropriate event for eliminating the partner book-tax differences. To the extent actual PS tax items are insufficient to eliminate these differences, reverse Section 704(c) allocation rules based on the Section 704(c) remedial allocation method (Treas. Reg. §1.704-3(d)) could be implemented (see II.D.3.b above). Here, for example, where C's interest has a built-in tax gain of $80, mirrored by a built-in tax loss of $40 each for A and B, upon sale of the land C could be permitted or required to include in income notional tax gain of $80, and A and B each a notional tax loss of $40. (Similarly, if the property were depreciable, notional items could be allocated based on remedial method principles if actual tax depreciation deductions allocated by PS were insufficient to eliminate the partner book-tax differences.) If the partnership owned multiple properties, the notional items would need to be allocated among the assets on some basis (e.g., in proportion to their relative fair market values at the time of option exercise).

Example 4 – Pre-Exercise Admission of New Partner

Facts: Same as Example 1 except that, shortly before C exercises the option (and when the land is worth $700), D is admitted to PS paying $310 for 10 PS units (a one-third interest). D's $310 purchase price is the fair market value of a one-third interest if C's option is viewed as an economic claim against PS equal to the $110 option spread at that time (i.e., the $310 value of the interest C would receive upon exercise of the option, less the $200 option exercise price).

Consequences of option grant: Same as Example 1.

Consequences of pre-exercise admission of D: To equalize the capital accounts of A, B and D in connection with D's purchase, normally PS would revalue the land on its books and allocate the book-up to the capital accounts of A and B under Treas. Reg. §1.704-1(b)(2)(iv)(f)-(g). However, since D's $310 purchase price was determined on a fully diluted basis (valuing the option at $110), this approach seems to work only if part of the book-up is allocated to C's option account (other otherwise reflected as a claim against PS), resulting in the following tax and book balance sheets for PS immediately after D's purchase:

Tax Balance Sheet			Book Balance Sheet	
$340 Cash	$100 A Capital		$340 Cash	$310 A Capital
200 Land	100 B Capital		700 Land	310 B Capital
	310 D Capital			310 D Capital

	30 Option account			110 Option account
$540	$540		$1040	$1040

If the book option account were not revalued as indicated but instead left at $30, the capital accounts of A, B and D would not reconcile unless the $80 appreciation in C's option were allocated equally among A, B and D's capital accounts, giving them capital accounts of $336.67 each. However, giving D an opening capital account in excess of D's contribution would be inconsistent with the basic rules of Treas. Reg. §1.704-1(b)(2)(iv)(*b*).

Consequences of pre-exercise land sale: Assume PS sells the land for $700 after D's investment but before C exercises the option. PS will recognize $500 of tax gain, of which presumably (i) $210 will be allocated to each of A and B as reverse Section 704(c) allocations (Treas. Reg. §1.704-1(b)(4)(i)), and (ii) the remaining $80 will be allocated equally to A, B and D, resulting in tax capital accounts of $336.67 each. There is no book gain on the sale, and therefore the book capital accounts are not affected.

Consequences of pre-sale option exercise: In contrast to the preceding paragraph, assume C exercises the option for $200 (receiving 10 PS units representing a 25% partnership interest) before the land is sold but when it is worth $700. The following tax and book balance sheets would then result:

Tax Balance Sheet			Book Balance Sheet	
$540 Cash	$100 A Capital		$540 Cash	$310 A Capital
200 Land	100 B Capital		700 Land	310 B Capital
	230 C Capital			310 C Capital
	310 D Capital			310 D Capital
$740	$740		$1240	$1240

Consistent with Example 1, upon C's option exercise, the $30 cash option premium is added to the tax basis of C's partnership interest, and the book option account (here $110, based on the revaluation approach described above in connection with D's admission) is added to partner book capital.

If, after C's exercise, the land were sold for $700, the $500 tax gain would be allocated $210 to A, $210 to B, and $80 to C under reverse Section 704(c) principles. There would be no book gain.

APPENDIX II -- COMPENSATORY OPTION EXAMPLE

The following example illustrates the application of some of the principles described in Part IV concerning the tax treatment of compensatory partnership options.

Facts (same as Example 1 of Appendix I except that C is granted the option in connection with services he renders to PS, rather than for cash): A and B form partnership PS, with each contributing $100 for a 50% partnership interest. PS uses the $200 contributed by A and B to purchase land. Solely in consideration for services, PS grants C an option to acquire a one-third partnership profits and capital interest for $200. The option does not have readily ascertainable fair market value (for purposes of Treas. Reg. §1.83-7) on the grant date. C exercises the option when the land has appreciated to $700 and receives a fully vested partnership interest. Assume no other PS activity.

Consequences of option grant: Because the option does not have a readily ascertainable fair market value, the option grant is not taxable (see IV.B above). The initial tax and book capital balance sheets of PS are determined consistent with Example 1 in Appendix I except that there is no option premium:

Tax Balance Sheet			Book Balance Sheet	
$ 0 Cash	$100 A Capital		$ 0 Cash	$100 A Capital
200 Land	100 B Capital		200 Land	100 B Capital
$200	$200		$200	$200

Consequences of exercise: Under Section 83, upon exercise of the option, C realizes compensation income of $100, equal to the excess of (i) the $300 value of C's partnership interest on the exercise date over (ii) the $200 option exercise price. Similarly, unless capitalization is required, PS recognizes compensation expense of $100 under Treas. Reg. §1.83-6, which is allocated equally between A and B as the historic 50% partners (see IV.C.2.a).[147] The further tax consequences of exercise to PS and the historic partners will depend on whether exercise is considered to result in taxable gain to PS. The alternative theories described in IV.C.2.b are applied below.

[147] As discussed in IV.C.2.a. above, some partnership agreements may purport to specially allocate the deduction to C to offset C's Section 83 income, though such an allocation may not comply with Section 704(b).

Circular flow of cash theory: Under the circular flow of cash theory, upon exercise (i) PS is deemed to have paid C $100 cash as compensation, and (ii) C is then deemed to have contributed that $100 to PS as a capital contribution, together with the $200 option exercise price, resulting in a total deemed cash contribution of $300. As a result of this construction, PS recognizes no taxable income on exercise. Assuming, consistent with Example 1 of Appendix I, a book-up of A's and B's book capital accounts to fair market value, the tax and book balance sheets immediately after exercise are as follows:

Tax Balance Sheet			Book Balance Sheet	
$200 Cash	$ 50 A Capital		$200 Cash	$300 A Capital
200 Land	50 B Capital		700 Land	300 B Capital
	300 C Capital			300 C Capital
$400	$400		$900	$900

Unlike the noncompensatory option examples in Appendix I, there is no book-up of C's capital account upon exercise, because C is fully taxed under Section 83 and is treated as contributing full value for his interest. In addition, the allocation of the $100 compensation expense to A and B has reduced their tax capital accounts from $100 to $50 each.

If PS subsequently sells the land for $700, PS will recognize $500 of tax gain, which will be allocated $250 each to A and B under reverse Section 704(c) principles, thus conforming their tax and book capital accounts. No book gain arises from the sale.

Constructive sale of assets theory: Under the constructive sale of assets theory, PS is deemed to have sold some of its historic assets (i.e., the land) to C upon exercise. PS recognizes taxable gain or loss equal to the difference between the fair market value of the assets deemed sold and their tax basis, and there is a corresponding tax basis step up to PS. There are at least two means of calculating the amount of assets deemed sold by PS:

(a) Under one approach, PS is deemed to sell to C an undivided interest in the land with a value equal to the $100 of compensation income recognized by C upon exercise. The tax and book balance sheets of PS immediately after exercise would then be as follows:

Tax Balance Sheet			Book Balance Sheet	
$200.00 Cash	$ 85.71 A Capital		$200 Cash	$300 A Capital
271.43 Land	85.71 B Capital		700 Land	300 B Capital
	300 .00 C Capital			300 C Capital
$471.43	$471.43		$900	$900

Under this approach, C is deemed to have received an undivided interest in the land worth $100 as compensation income. This represents one-seventh of the $700 value of the land, and accordingly PS recognizes one-seventh of the $500 built-in gain in the land ($71.43). C is then deemed to contribute to PS his undivided interest with a basis equal to its $100 value which, together with C's $200 cash contribution, gives C $300 of tax and book capital. PS's tax basis in the land increases to $271.43 by reason of the recognized gain. A and B are each allocated 50% of PS's $71.43 tax gain ($35.71) and 50% of the $100 compensation deduction ($50), resulting in a net reduction of their capital accounts to $85.71 each.

If PS subsequently sells the land for $700, PS will recognize $428.57 of tax gain, of which 50% ($214.29) will be allocated to each of A and B under reverse Section 704(c) principles.

(b) Alternatively, under the most aggressive aggregate view of partnership taxation, A and B would be taxed as though PS had sold to C for fair market value a one-third undivided interest in the land (worth $233.33). The tax and book balance sheets of PS immediately after exercise would then be as follows:

Tax Balance Sheet			Book Balance Sheet	
$200.00 Cash	$133.33 A Capital		$200 Cash	$300 A Capital
366.67 Land	133.33 B Capital		700 Land	300 B Capital
	300.00 C Capital			300 C Capital
$566.67	$566.67		$900	$900

Under this approach, C is deemed to have received a one-third undivided interest in the land worth $233.33 in exchange for a cash payment of $133.33 (i.e., the portion of the option exercise price not representing C's one-third post-exercise interest in the $200 cash exercise price itself). The $100 difference results in C's $100 of compensation income and PS's $100 of compensation expense. In addition, upon PS's deemed sale of the one-third interest in the land to C, PS recognizes one-third of the $500 built-in gain in the land ($166.67). C is then deemed to contribute to PS (i) the undivided interest in the land with a basis equal to its $233.33 value and (ii) the remaining $66.67 of cash, again giving C $300 of tax and book capital. PS's tax basis in the land increases to $366.67 by reason of the $166.67 tax gain recognized by PS. A and B are each allocated 50% of that gain ($83.33) and 50% of the $100 compensation deduction ($50), resulting in a net increase in their capital accounts to $133.33 each.[148]

If PS subsequently sells the land for $700, PS will recognize $333.33 of tax gain, of which 50% ($166.67) will be allocated to each of A and B under reverse Section 704(c) principles.

As illustrated, the circle of cash theory and the two approaches under the constructive sale of assets theory all result in identical tax and book treatment of the option holder and identical book treatment of the historic partners. They differ solely in the timing of recognition by the historic partners of the built-in gain inherent in the PS assets when the option is exercised. To the extent PS recognizes gain upon option exercise, the post-exercise built-in gain in the land is reduced. Regardless of when it is recognized, the gain is allocated pro rata to A and B (under reverse Section 704(c) principles to the extent the gain is recognized after C becomes a partner).

[148] In the foregoing calculation under alternative (b), the tax consequences to A, B and C are the same as the tax consequences would be to them in a non-partnership context if (1) A and B directly owned the land, directly employed C, and directly issued to C an option to buy a one-third interest in the land for $133, and (2) C exercised the option (keeping the $67 cash difference between the $200 exercise price in the partnership example and the $133 exercise price in this modified example) when the land was worth $700. See Section 83 and the Treasury Regulations thereunder, including Treas. Reg. §1.83-6(b) for the calculation of gain recognized by A and B.