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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

PROPOSED REGULATIONS REGARDING THE TAX TREATMENT OF NONCOMPENSATORY PARTNERSHIP OPTIONS

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Introduction

This report[1] ("**Report**") provides comments on proposed regulations issued on February 5, 2013 (the "**Proposed Regulations**") regarding the tax treatment of noncompensatory options issued by partnerships ("**NCOs**").[2] The Proposed Regulations were issued concurrently with final regulations (the "**Final Regulations**") also addressing the tax treatment of NCOs.[3] The Final Regulations finalize proposed regulations issued in 2003, and provide rules addressing, among other things, when the holder of an NCO will be treated as a partner in the issuing partnership rather than as an NCO holder and the U.S.

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[1] The principal author of this report is Marcy Geller, with substantial assistance from Adam Wells and Jessica Garcia. Significant contributions were made by Janet Andolina, Stephen Foley, Matthew Lay, Eric Sloan and Diana Wollman. Helpful comments were given by Stephen Land, Amanda Nussbaum, and Michael Schler. This letter reflects solely the views of the Tax Section of the New York State Bar Association and not those of the New York State Bar Association Executive Committee or the House of Delegates.

[2] Notice of Proposed Rulemaking, Treatment of Grantor of an Option on a Partnership Interest, 78 Fed. Reg. 8060 (Feb. 5, 2013) ("**Notice of Proposed Rulemaking**"). Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and the regulations promulgated thereunder.

[3] For this purpose, the Final Regulations define a noncompensatory option as "an option issued by a partnership, other than an option issued in connection with the performance of services" (Treas. Reg. § 1.761-3(b)(2)), and define an option as "a contractual right to acquire an interest in the issuing partnership, including a call option, warrant or other similar arrangement…[including] convertible debt and convertible equity." Treas. Reg. § 1.761-3(b)(3).

Federal income tax consequences of the exercise of an NCO (to the holder and the issuing partnership).[4] The Proposed Regulations would add:

(i) three additional "measurement events" when an NCO would be tested (under the rules in the Final Regulations) to determine if the NCO should be treated as a partnership interest, and

(ii) rules addressing the tax treatment of the issuing partnership when an NCO lapses or is repurchased by the issuing partnership.

In the preamble to the Proposed Regulations (the "**Preamble**"), the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**") also stated that they are continuing to study whether Section 751(a) should apply to the lapse, repurchase, sale, or exchange of an NCO, including (i) if Section 751 applies, how the NCO holder's share of income or loss from Section 751 property would be determined under Treas. Reg. § 1.751-1(a)(2) and how a partner in the issuing partnership that transfers its interest while the NCO is outstanding would determine its share of income or loss from Section 751 property under Treas. Reg. § 1.751-1(a)(2), and (ii) if Section 751 does not apply, what measures, if any, should be taken to ensure that ordinary income is not permanently eliminated. The Preamble also requests comments on the appropriate procedures for notifying the partners and the partnership upon the occurrence of a measurement event.

This Report comments on the Proposed Regulations and responds to the request for comments on the application of Section 751 and the notification procedures. This Report is divided into three parts. Part I summarizes our recommendations. Part II provides background and discusses our recommendations relating to the Proposed Regulations. Part

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[4] We previously submitted two reports addressing the tax treatment of NCOs: *New York State Bar Association Tax Section Report on the Proposed Regulations Relating to Partnership Options and Convertible Securities* (January 23, 2004) (responding to the 2003 proposed regulations) (the "**2004 Report**"), and *New York State Bar Association Tax Section Report on the Taxation of Partnership Options and Convertible Securities* (January 29, 2002) (responding to Notice 2000-29's request for comments) (the "**2002 Report**").

III explores the Section 751(a) issues raised in the Preamble and includes our recommendations regarding those issues.

I. Summary of Recommendations

Our principal recommendations are summarized as follows:

1. With respect to the new measurement events, because the Principal Purpose of Reduction Test (defined below) is a component in each of the new measurement events, we generally support the new measurement events, subject to two recommendations:

    a. We recommend that the Service and Treasury clarify that (i) the deemed events that occur pursuant to a technical termination of a partnership under Section 708(b)(1)(B) do not themselves give rise to a measurement event, and (ii) those events do not include a deemed issuance or transfer of any NCO issued by the terminated partnership or any lower-tier partnership; and

    b. We recommend that the Service and Treasury provide a list of relevant factors that should be considered in determining if the Principal Purpose of Reduction Test is met in the case of events involving transfers, issuances or modifications of partnership interests in upper-tier entities; we also suggest some factors that might be appropriate;

2. In response to a request for comments in the Preamble, we recommend the Service and Treasury not provide rules regarding notification of partners or partnerships upon the occurrence of a measurement event, but rather that such notification procedures be left to the partners to determine;

3. We support the proposal that the Proposed Regulations have the same effective date as the Final Regulations; and

4. In response to the Preamble's request for comments, we discuss in detail whether Section 751(a) should apply to the lapse, repurchase, sale, or exchange of an NCO, and conclude that it should not. We recommend that the Service rely on its carefully drafted Characterization Rule to ensure that NCO holders are treated as partners (subject to Section 751) when appropriate. In the event that our recommendation is not taken, we suggest how regulations could apply Section 751(a) to transfers of NCOs.

II. **Discussion**

A. The Proposed Addition of Three New Measurement Events

The Characterization Rule Under the Final Regulations. Under the Final Regulations, a holder of an NCO is treated as holding an option (and not a partnership interest) unless certain conditions are met, in which case the holder of the NCO is treated, for U.S. Federal income tax purposes, as holding an interest in the issuing partnership (this is referred to as the "**Characterization Rule**").[5] Once a specific NCO has been treated as a partnership interest pursuant to the Characterization Rule, each holder of that NCO from that point forward is treated as a partner and, as such, is allocated a distributive share of the partnership's income, gain, loss, deduction, and credit.

An NCO is treated as a partnership interest under the Characterization Rule only if, on the date of a "measurement event" (described below) with respect to that NCO,[6] two conditions are met:

(i) the NCO provides the holder with rights that are substantially similar to the rights of a partner (the "**Partner Attributes Test**"), which is considered to be the case if either

(A) the NCO is reasonably certain to be exercised, or

(B) the NCO holder possesses partner attributes;[7]

and

(ii) there is a strong likelihood that failure to treat the holder of the NCO as a partner would result in a substantial reduction in the present value of the

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[5] The Final Regulations also provide that even if an NCO holder is not treated as holding a partnership interest pursuant to the Characterization Rule, general principles of U.S. Federal tax law may cause the NCO holder to be treated as holding a partnership interest. Treas. Reg. § 1.761-3(a)(2).

[6] The measurement events are specific to an NCO, so only that NCO is tested on its measurement dates; other outstanding NCOs are not tested.

[7] Treas. Reg. § 1.761-3(d).

partners' and the NCO holder's aggregate U.S. Federal tax liabilities (the "**Substantial Reduction Test**").[8]

The Measurement Events Under the Final Regulations. The Final Regulations provide for the following "measurement events":[9]

(i) the issuance of the NCO;

(ii) a modification of the NCO or the underlying partnership interest (including an adjustments contemplated by the terms of the NCO or the underlying partnership interest); and

(iii) the transfer of the NCO if

(A) the NCO may be exercised or settled more than 12 months after its issuance (the "**12 Months Test**"), or

(B) the transfer is pursuant to a plan in existence at the time of the issuance or modification of the NCO that has as a principal purpose the substantial reduction of the present value of the aggregate U.S. Federal tax liabilities of the partners and the NCO holder (the "**Principal Purpose of Reduction Test**").

The Three Proposed Additional Measurement Events Under the Proposed Regulations. The Proposed Regulations would add three additional measurement events,[10] each of which (similar to measurement event (iii) above) has two components:

The first component is one of the following events:

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8 Treas. Reg. § 1.761-3(a) .

9 Treas. Reg. § 1.761-3(c). The following events are excluded from the definition of measurement event: (i) a transfer of the option that would otherwise be a measurement event if the transfer is at death or between spouses or former spouses under Section 1041, or in a transaction that is disregarded for federal tax purposes; (ii) a modification that neither materially increases the likelihood that the option will be exercised nor provides the option holder with partner attributes; (iii) a change in the strike price of an option, or in the interests in the issuing partnership that may be issued or transferred pursuant to the option, made pursuant to a bona fide, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the option holder; and (iv) any other event as provided in guidance published in the Internal Revenue Bulletin. Treas. Reg. § 1.761-3(c)(2). In the preamble to the Final Regulations, the Treasury and Service explained that these events were excluded because they provide little potential for abuse. T.D. 9612, 78 Fed. Reg. 7997 (Feb 5, 2013).

10 These three measurement events in the Proposed Regulations are subject to the exceptions in Treas. Reg. § 1.761-3(c)(2).

1. the issuance, transfer, or modification of an interest in, or the liquidation of, the issuing partnership;

2. the issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities,[11] owns the NCO; and

3. the issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership.[12]

The second component, which would be needed in each case, is meeting the Principal Purpose of Reduction Test. That test, as applied to the three events above, is as follows:

> the issuance, transfer or modification event is "pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory option that has as a principal purpose the substantial reduction of the present value of the aggregate Federal tax liabilities of the partners and the noncompensatory option holder."[13]

In the case of measurement event (iii) in the Final Regulations (*i.e.*, the transfer of the NCO itself), the second component of that measurement event could be *either* the Principal Purpose of Reduction Test or the 12 Months Test. By contrast, in the Proposed Regulation's proposed additional measurement events, the Principal Purpose of Reduction Test must always be met for the event to be a measurement event (and the 12 Month Test is not relevant).

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[11] For this purpose, a look-through entity is (i) a partnership; (ii) a subchapter S corporation; (ii) a trust or an estate; (iv) an entity that is disregarded for U.S. Federal tax purposes, such as a qualified subchapter S subsidiary under Section 1361(b)(3), an entity that is disregarded as an entity separate from its owner under Treas. Reg. §§ 301.7701-1 through 301.7701-3, or a qualified REIT subsidiary within the meaning of Section 856(i)(2); or (v) a controlled foreign corporation (but only with respect to its subpart F income) if United States shareholders of the controlled foreign corporation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership's taxable year. Treas. Reg. § 1.761-3(b)(1).

[12] Prop. Treas. Reg. § 1.761-3(c)(1)(iv).

[13] Prop. Treas. Reg. § 1.761-3(c)(1)(iv). We note that the phrase "the issuance or modification of the noncompensatory option" is presumably referring to the initial issuance, or any subsequent modification of the terms, of the NCO.

The Preamble explains the reasons for these additional measurement events as follows:

> The [Treasury] and the [Service] believe that the first of these measurement events is necessary because it is inconsistent to test a noncompensatory option under the characterization rule upon transfer of the noncompensatory option, but not upon transfer of an interest in the issuing partnership, because either type of transfer may change the analysis of whether there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the present value of the partners' and options holder's aggregate tax liabilities. The [Treasury] and the [Service] believe that the second and third measurement events are necessary to prevent avoidance of the characterization rule through the use of look-through entities.

Discussion and Recommendations. Each measurement event in the Final Regulations involves the NCO itself (or the partnership interest that would be issued upon exercise of the NCO). By contrast, each measurement event in the Proposed Regulations is an event that does not directly involve the NCO or the NCO holder itself. In the case of proposed new measurement events #1 and #3, the issuance, transfer or modification of any interest in the partnership that issued the NCO or of any interest in an upper-tier partnership that holds an interest in that issuing partnership would be a measurement event for *all* the NCOs issued by the issuing partnership. Proposed measurement event #2 arguably involves the NCO holder because it is an event that occurs with respect to an entity that is a direct or indirect owner of the NCO, but even this event could occur many tiers above the entity that owns the NCO and could occur without any participation on the part of that entity. Based upon the potentially sweeping scope of the proposed regulations, we considered whether it was inappropriate for an NCO holder to be subject to being retested upon an event that the NCO holder may have had no role in or no ability to cause or prevent.

In the case of proposed new measurement event #1, where the issuance, transfer or modification of any interest in the partnership that issued the NCO would be a measurement event for *all* the NCOs issued by the issuing partnership, we agree with the rationale expressed in the Preamble that this is an appropriate measurement event because such an event may change the analysis of whether there is a strong likelihood that the failure to treat an NCO holder as a partner would result in a substantial reduction in the present value of the partners' and NCO holder's aggregate tax liabilities. Even though the NCO holder may have had no involvement in the event, it seems fair to retest when the event involves an interest in the very partnership that has issued the NCO. This is particularly true since the Principal Purpose of Reduction Test also must be met. That is, not only must there be such a plan but in addition *this issuance, transfer or modification* must be *pursuant to* that plan.[14]

In the case of proposed new measurement events #2 and #3, both involve events occurring at upper-tier entities (*i.e.*, entities above the partnership that issued the NCO). We considered whether it might impose an undue burden on an issuing partnership or an NCO holder to monitor issuances, transfers and modifications taking place at such upper-tier entities. We also considered whether having these events be measurement events might mean that some issuing partnerships and NCO holders would face uncertainty as to whether they were receiving complete information from the upper-tier entities and upper-tier partners and might therefore be perpetually concerned about the occurrence of measurement events

[14] One idea we considered was that the "plan" not meet the test unless the NCO holder was aware of some or all of the plan. We rejected this idea because it could encourage taxpayers to purposefully exclude (or attempt to exclude) NCO holders from such plans. Not only would this be an incidence of a tax rule inappropriately motivating behavior, but the rule could have the opposite effect of what was intended (*i.e.*, (i) instead of protecting NCO holders who are unaware of the plan, the rules would (seemingly) enable other taxpayers to avoid the Characterization Rule by inappropriately not meeting a component of a measurement event, or (ii) unexpectedly cause harm to the NCO holder if the IRS were to apply general principles of tax law to recharacerize the NCO holder as a partner).

that they were unaware of. We considered whether there were any requirements that could be added to measurement events #2 and #3 that would limit their scope so that they applied only to cases where it was likely that the upper-tier entity was being used to avoid the Characterization Rule. We recognize that the Principal Purpose of Reduction Test must be met in each case and that it is a robust test that requires intention (*i.e.*, it would never be met "by accident"), but some of our members were still concerned that a test of that nature would mean that a taxpayer could never be entirely sure that it had not met the test.

We considered whether it might be appropriate for there to be a materiality threshold such that the event would not be a measurement event unless the event materially alters the economic consequences to the NCO holder. Similarly, we considered if there should be a *de minimis* exception that would apply if the interest issued, modified or transferred were of sufficiently small size relative to the partnership as a whole (perhaps the upper-tier partnership or perhaps the partnership that issued the NCO). We rejected these ideas because they would need to be accompanied by another rule providing for related events to be aggregated in testing if the threshold were met and the resulting set of rules would be more complex than appropriate in this context and would probably not provide the sought-after certainty.

A significant majority of our members believe that the Principal Purpose of Reduction Test is, as worded, a robust test that requires a significant amount of intentional action on the part of the parties involved and that it alone should properly separate events that are not appropriate triggers for retesting from events that are. This majority believes that the application of the test could be made more clear and some of the potential uncertainties in the test could be reduced, however, if the regulations provided a list of

relevant factors that should be considered in determining if the test is met in the case of events involving transfers, issuances or modifications of partnership interests in upper-tier entities. We believe that such a list would be helpful to both taxpayers and the Service in applying the regulations.

We suggest that the regulations' list of factors include: (i) whether the upper-tier entity is related (within the meaning of Section 267(b) or 707(b)) to the issuing partnership, (ii) whether the upper-tier entity has actual control over the issuing partnership, (iii) whether the upper-tier entity has significant assets other than its partnership interests and NCOs in the issuing partnership and, if so, whether those assets are relevant to the business or investment activities of the entity (other than assets acquired with a principal purpose of avoiding a measurement event), and (iv) whether a principal purpose of the use of the tiered arrangement is to avoid having a measurement event.

A minority of our members, however, believe that it would also be appropriate to minimize the burden and uncertainty posed by proposed new measurement events #2 and #3 by providing a safe-harbor whereby, if the following two requirements are met, measurement events #2 and #3 would not apply:

(i) substantially all of the value of the upper-tier entity's assets are attributable to assets other than partnerships interests and NCOs issued by the issuing partnership, and

(ii) the tiered arrangement was not used with a principal purpose of avoiding a measurement event.[15]

This safe-harbor is modeled after the rule in Treas. Reg. § 1.7704-1(h)(3)[16] which sets out requirements that must be met in order to take upper-tier partners into account in

[15] An alternative way to formulate this second requirement would be: the upper-tier entity was not formed or availed of with a principal purpose of avoiding the Characterization Rule.

determining the number of partners in a lower-tier partnership for purposes of the Section 7704 publicly traded partnership rules.

Technical Terminations. We also recommend that the regulations clarify that, in the event of a "technical termination" of a partnership under Section 708(b)(1)(B), that (i) the deemed events that occur pursuant to Treas. Reg. § 1.708-1(b)(4)[17] do not themselves give rise to a measurement event, and that (ii) those events do not include a deemed issuance or transfer of any NCO issued by the terminated partnership or any lower-tier partnership.

For example, if a transfer of an interest in an upper-tier partnership is not itself a measurement event under the Proposed Regulations (because the Principal Purpose of Reduction Test is not met), the deemed transfer of interests in the lower-tier partnership (occurring solely pursuant to Section 708(b)(1)(B) and Treas. Reg. § 1.708-1(b)(4)) should not be separately tested for whether they are a measurement event under the Proposed Regulations. However, if the events deemed to occur under Section 708(b)(1)(B) included a deemed issuance or transfer of an NCO issued by any of the entities involved, then that event might be a measurement event under the Final Regulations (where meeting the Principal Purpose of Reduction Test is not required in every case). Such an approach would permit a tax fiction (*i.e.,* the events that occur under Treas. Reg. § 1.708-1(b)(4)) to substantively alter

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[16] Treas. Reg. § 1.7704-1(h)(3) provides that for purposes of the 100-or-fewer partners exception from publicly-traded-partnership status, a person owning an interest indirectly through one of more flow-through entities is counted as a partner "only if –

> (i) Substantially all of the value of the beneficial owner's interest in the flow-through entity is attributable to the flow-through entity's interest (direct or indirect) in the partnership, and
>
> (ii) A principal purpose of the use of the tiered arrangement is to permit the partnership to satisfy the 100-partner limitation".

[17] Under Treas. Reg. § 1.708-1(b)(4), the terminated partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership, and the interests in that new partnership are deemed to be distributed by the terminated partnership to the purchasing partner and the continuing partners in liquidation of the terminated partnership.

the tax analysis of a transaction and would also substantially broaden the scope of the Proposed and Final Regulations. It is our view that if the transfer of the interest at the upper-tier entity did not amount to a measurement event, the deemed events that are treated (pursuant to Section 708(b)(1)(B)) as occurring as a result of that should not be a measurement event.

Notice. The Preamble requests comments on the appropriate procedures for notifying the issuing partnership and its partners upon the occurrence of a measurement event. We considered a requirement that partners and NCO holders notify the issuing partnership in the event of any transfer of the partnership interest or NCO that constitutes a measurement event, and a further requirement that the issuing partnership notify each of its partners and NCO holders of any measurement event. However, we believe the parties should provide for their own notification requirements and procedures without the regulations mandating what should occur. The issuance of NCOs likely involves taxpayers who are financially sophisticated and therefore do not need the Service to protect them by ensuring that notice be given to them. We believe partners and NCO holders should be permitted to negotiate these matters among themselves. Moreover, given how the tests work, it seems unlikely that partners and partnerships involved in transactions that are affected by these rules would be caught unaware.

Effective Date. We support the effective date in the Proposed Regulations. In some circumstances we might be concerned about an effective date prior to the promulgation of final regulations, but here we agree it is appropriate. The Proposed Regulations are intended as a back-stop to the Final Regulations (similar to an anti-abuse rule), and NCO holders and partnerships were put on notice of these proposed additional measurement events when the

Final Regulations were finalized and the Proposed Regulations were issued and announced at the same time.

B. Character of Gain or Loss to Grantor of an NCO That Lapses or Is Closed Out

The Final Regulations do not directly address the character of the income or loss recognized by the grantor partnership upon the lapse or other closing transaction[18] with respect to an NCO. The Proposed Regulations would provide that NCOs are subject to Section 1234(b) by providing in new proposed regulations under Section 1234 that the term "securities" as used in Section 1234(b)(2)(B) includes partnership interests. Thus, gain or loss recognized by the grantor (*i.e.,* the issuing partnership) of an NCO from a closing transaction, and gain recognized by the grantor upon the lapse of an NCO, would be treated as resulting from the sale or exchange of a capital asset with a short term holding period.

This was one of two approaches recommended in our 2002 Report.[19] The other approach would be to treat the lapse of an NCO essentially the same as an exercise of the NCO followed by the repurchase of the resulting equity interest.[20] The decision not to adopt this other approach is consistent with how the Final Regulations treat cash settled options.[21] We support the position in the Proposed Regulations.

III. Should Section 751(a) Apply to the NCO Holder Upon the Sale of the NCO

A. Background

Section 1234(a) provides that:

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[18] A closing transaction means any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option. Section 1234(b)(2)(A).

[19] *See* 2002 Report, at 27 – 32.

[20] *Id.*

[21] Treas. Reg. § 1.721-2(d).

> "gain or loss attributable to the sale or exchange of, or loss attributable to failure to exercise, an option to buy or sell property shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him)."

We said in the 2002 Report that we think that Section 1234(a) should apply to the sale or exchange of an NCO, and we still think that is appropriate.

As discussed in the Preamble, a partnership interest is a capital asset pursuant to Section 741, which provides

> In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items).

Thus, the sale or exchange of a partnership interest gives rise to capital gain or loss, subject to one exception. Under Section 751(a), a partner transferring a partnership interest must take into account a portion of the gain or loss recognized on the transfer as ordinary (rather than capital) generally to the extent the gain or loss is attributable to unrealized receivables and inventory items held by the partnership (so-called "hot assets"). In effect, Section 751(a) overrides Section 741 by applying the aggregate theory of partnerships (in part) and treating a transfer of a partnership interest as (in part) a transfer of a portion of the partnership's ordinary income assets.

It is not clear whether Section 1234(a), by its terms, requires (or, in the absence of regulations, permit) the application of Section 751(a) to a transfer of an option. Section 1234(a) provides that the gain or loss from the sale of an option "shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the option relates has in the hands of the taxpayer." A partnership interest is a capital asset. Section 751(a)

does not change the character of the partnership interest as a capital asset; nor does Section 751(a) treat the taxpayer as having sold the partnership's hot assets. Rather, Section 751(a) recharacterizes the character of the gain or loss upon the actual sale of the partnership interest**.** Under this reading of Section 751(a), gain or loss from the sale of an NCO would be treated entirely as capital.

Treating such gain or loss entirely as capital is consistent with other provisions of the Code that recharacterize all or a portion of the capital gain recognized on a sale or exchange of a capital asset as ordinary income, but do not extend this recharacterization treatment to gain recognized on the sale or exchange of an option on that same capital asset. For example, under Section 1248, a U.S. person's capital gain on a sale or exchange of stock of a controlled foreign corporation may be recharacterized as ordinary income. The purpose of Section 1248 is similar to that of Section 751(a), as both aim to tax economically accumulated (but previously untaxed) earnings as ordinary income upon a sale of an interest whose value is derived from those earnings. We are not aware of any authority that would treat a sale of an option on stock of a controlled foreign corporation as subject to Section 1248, by way of Section 1234(a) or otherwise. Similarly, we are not aware of any authority suggesting that a payment by a corporation in cancellation of an option on the corporation's stock as a dividend under Section 302. Significantly, we are aware of two Code provisions laying out special rules for sales of stock that explicitly provide that those special rules also apply to sales of options on such stock: the passive foreign investment company ("**PFIC**") rules under Section 1291 (see Section 1298(a)(4) (providing that, to the extent provided in a regulations, a holder of an option of PFIC stock will be treated as holding PFIC stock)). and the Section 306 stock rules (see Section 306(d)(1) (providing that, for purposes of Section 306, "stock rights shall be treated as stock")).

Both of these rules are provided for in the statute itself. There is no similar provision in Section 741 or Section 751 with respect to options on a partnership interest. Thus, it would appear that a sale of an NCO should not be subject to Section 751(a), even though a sale of the underlying partnership interest would be.

Alternatively, the language of Section 1234(a) could be read to provide that the sale of an option gives rise to gain or loss having the same character that the taxpayer would have recognized had he sold the underlying property directly, and that in the case of an NCO this means applying Section 751(a).

Nevertheless, for the reasons expressed below, we believe that the better answer, taking the purposes of Section 751 and Section 1234 into account, is to not apply Section 751(a) to sales or exchanges of NCOs. First, we acknowledge that failing to apply Section 751(a) to such transfers would allow holders to sell the NCOs that may have value attributable to the underlying partnership's hot assets,[22] and to have some income not taxed at ordinary rates, the ordinary income or loss from the sale of hot assets is not lost to the system; rather, it will be recognized (as ordinary income) by the partners at the time the hot assets are sold or at the time an actual partnership interest is sold. Thus, not applying Section 751(a) to the sale of an NCO does not reduce the total ordinary income recognized as a result of the partnership's hot assets.

Second, as demonstrated in our examples below, applying Section 751(a) to transfers of NCOs would actually cause those hot assets to be counted more than once in recharacterizing capital gain as ordinary income. In order to prevent this duplication of the impact of the hot assets, it would be necessary to construct an extremely complicated regulatory regime. When analyzing a similar character issue with respect to "corrective allocations" for NCOs, Treasury

[22] "Hot assets" include unrealized receivables of the partnership and inventory items of the partnership. *See* Sections 751(c) and (d).

and the Service concluded "the complexity that could arise from a character matching requirement would outweigh the potential benefit of obtaining a more precise tax result."[23]

Possible Approaches to Applying Section 751(a). While we believe there are a number of possible approaches to applying Section 751(a) to a sale of an NCO, we focus on the most straightforward approach which we believe is to treat the transferred NCO as having been exercised immediately before the transfer solely for purposes of Section 1234.[24] This approach (the "**Deemed Exercised Approach**") would work as follows:

(i) first, immediately before the actual sale of the NCO, treat the NCO holder as having exercised the NCO for cash, (ii) as a result of this deemed exercise, revalue the partnership capital accounts pursuant to the special rule in Treas. Reg. § 1.704-1(b)(2)(iv)(*s*) (which provides for revaluation immediately after the deemed exercise, instead of the normal approach of revaluation immediately before), and (iii) provide for a deemed sale of the partnership interest for an amount realized equal to the amount actually received plus the deemed exercise price. The deemed exercise and sale would give rise to ordinary income or loss under Section 751(a) to the extent that the NCO holder was allocated ordinary income or loss in the revaluation. Thus, the amount of capital gain or loss the NCO holder would recognize would equal the holder's gain

[23] Under the Final Regulations, to the extent that upon exercise of an NCO there is not sufficient "unbooked" appreciation to allocate to the capital account of the newly exercised option holder, the regulations provide that the partnership may make corrective allocations to that partner. Although the regulations attempt to provide such holder with its appropriate share of ordinary and capital income, in certain circumstances, there may be mismatching.

[24] Alternative approaches might construct some sort of a proxy to approximate the amount of gain or loss that should be taxed as ordinary income or loss (in place of a precise tracking via a deemed exercised approach). For example, the amount of gain or loss recharacterized as ordinary income or loss would equal the overall gain or loss multiplied by a fraction; the fraction could be based on the relative percentage of hot assets inside the partnership or relative percentage of ordinary income or loss that would be generated upon a hypothetical liquidation of the partnership at the time of transfer of the NCO. A rule based on values would be necessarily less precise than a rule based on the deemed exercise of the NCO, in the sense that asset value, rather than gain, is measured to determine the amount of the ordinary income to be included. A potentially desirable result of this rule would be that the ordinary income inclusion would be limited to the gain realized on the sale of the NCO. Although these fractions might provide an administratively easier method for which to measure ordinary income or loss upon a sale of an NCO, these alternatives do not alleviate the duplicate counting of the hot assets that would take place upon our deemed exercised approach.

or loss without regard to Section 751(a) minus any Section 751(a) ordinary income or plus any Section 751(a) loss recognized by the holder. This approach mimics the tax consequences that would occur if an NCO holder were treated as a partner upon a measurement event.

This approach could, however, create overinclusions or underinclusions of ordinary income or loss due to the lack of coordination between the tax treatment of holders of actual partnerships interests and holders of NCOs. The examples below illustrate this result.[25]

Deemed Exercise Approach Applied to Simple Sale of NCO by its Initial Holder.

> Example 1. Each of A, B and C own a one-third interest in the partnership. The partnership holds only hot assets. Each partner has an outside basis and capital account balance of $10, and the partnership assets have an aggregate inside basis and value of $30. The partnership issues to D for no consideration an NCO to acquire a one-fourth (25 percent) interest in the partnership for an exercise price of $10.
>
> Over the next 4 years, the partnership operates on a break-even basis and makes no distributions, but its hot assets appreciate to a value of $390. At the beginning of year 5, D sells its NCO to E for $90. Assume that all partners are U.S. individual taxpayers taxed at the highest marginal tax rates with no net operating loss or credit carryforwards. Accordingly, there is not a strong likelihood that the failure to treat D as a direct partner in taxing the sale would reduce the present value of the partners' tax liabilities, and, thus, we assume that the Characterization Rule would not recharacterize D's NCO as a partnership interest.

Notwithstanding that the NCO is not treated as a partnership interest under the Characterization Rule, the Deemed Exercised Approach would treat D as if the NCO were exercised (for its $10 exercise price) immediately before the sale,[26] and the partnership interest

[25] All examples assume that the holder of the NCO is not treated as a partner under either the Final Regulations or general principles of U.S. Federal income tax law. We recognize that the options in the examples are either in-the-money or at-the-money; however, we opted for examples that were simplest to highlight our conclusions. Further, although there are no specific examples regarding repurchases or lapses of NCOs, we believe that the same duplication issues would result without a basis adjustment mechanic.

[26] By analogy, *see* Treas. Reg. § 1.761-3(a)(3) which provides that if an NCO is treated as a partnership interest under the characterization rule in the Final Regulations, the recharacterization is deemed to occur immediately before the measurement event that gave rise to the recharacaterization.

was then sold for $100, recognizing $90 of gain – the same as the economic gain on the actual NCO sale. In the revaluation, the ordinary income that would have been allocated to D is equal to D's deemed 25% interest in the $360 partnership-level built-in-gain, which is $90. Since that exactly equals D's gain on the sale of his deemed partnership interest, all of his sale gain is taxed as ordinary income.

Up to this point, the result seems to be appropriate. At the time that D purchased the NCO, the partnership owned only hot assets and, as of the time of the sale, all intervening partnership asset appreciation has been attributable to only those assets. Therefore, ordinary taxation of D's gain on his NCO sale seems potentially appropriate and certainly reasonable.

However, when followed through to subsequent transactions, we see that this approach can inappropriately skew the tax liability of the partners and the other NCO holders. Unlike full recharacterization under the final Treasury Regulations, the purchaser of the NCO (E) would presumably be treated as the holder of an NCO, not as a partner (because the deemed exercise here was only for purposes of determining the character of the NCO seller's gain). Because of that, the $90 in ordinary income already taken into account by D would likely be required to be taken into account a second time, by one of the actual partners in the partnership (i.e, A, B, or C, and, possibly, E).[27]

Subsequent sale of partnership interest where NCO holder previously took into account the ordinary income.

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[27] The tax consequences in Example 1 are consistent with the application of the Final Regulations on exercise of an NCO. Under Treas. Reg. § 1.704-1(b)(2)(iv)(s), the holder's share appreciation in partnership property that accrues while an NCO is outstanding is generally reflected in the option holder's capital account immediately after the holder exercises the NCO. Assuming the appreciation is in inventory or unrealized receivables, the exercising holder will be taxed at ordinary rates upon the recognition events with respect to those items under the principles of Section 704(c). Of course, unlike the recharacterization of capital gain or loss as ordinary income or loss on the sale of an NCO if Section 751(a) were to apply, the recognition of that income will be deferred until the partnership-level recognition event. But, in either case, appreciation in ordinary assets ultimately would be taxable to the NCO holder as ordinary income.

Example 2: The facts are the same as in Example 1. After D sells its NCO to E, A sells his partnership interest to F for $100, recognizing a $90 gain.

Applying the rules of Section 751(a), A would recognize ordinary income to the extent that ordinary income would have been allocated to A on a sale of all of the partnership's assets. The assets, having a basis of $30 and a value of $390, would, if sold, result in the recognition of $360 of ordinary income by the partnership. Since E is still treated as a mere NCO holder rather than an equity holder, A's share is one-third (not one-fourth) of the total built-in-gain, notwithstanding that D was treated, in effect, as owning 25 percent of the partnership in the deemed revaluation that occurred in connection with his sale of the NCO.[28] Accordingly, on a sale of those assets, one-third of that gain ($120), rather than the proper amount ($90), would be allocated to A. Under Section 751(a), A would recognize ordinary income of $120 on the sale of its partnership interest with an offsetting capital loss of $30.[29] Effectively, this results in an overinclusion of ordinary income to A of $30.

In Example 1, D already recognized $90 of the $360 of ordinary income on his sale of the NCO to E. Therefore, E (in place of D) became economically entitled to $90 worth of the partnership assets. But E is not treated as a partner. Thus, his economic share is ignored for purposes of computing the result to A under Section 751. The subsequent sale of the partnership interest by A, therefore, gives rise to $120 of ordinary income to A under the Section 751 rules, $30 of which actually represents appreciation in E's economic share of the partnership assets

[28] If the $90 of ordinary gain already taxed to D were subtracted, A's one-third share times the remaining $270 of gain would result in $90 being taxed to A. However, there appears to be no mechanism to make such a subtraction. In fact, had D actually been a partner, E would have been entitled to the entire basis adjustment under Sections 754 and 743, and the partnership would have been entitled to nothing. However, if E were a partner, A's share of the $360 in built in gain would be the right percentage – 25 percent ($90).

[29] *See* Treas. Reg. § 1.751-1(g) *Example 1*. We understand certain practitioners believe, despite regulations indicating otherwise, that ordinary income recognized under Section 751 cannot exceed the total gross proceeds received by the seller on the transfer of his partnership interest.

previously taxed to D upon D's sale of the NCO to E. Strictly speaking, double income inclusion does not occur, since A's $30 in capital loss arithmetically counter-balances the taxation to A of $30 in previously taxed ordinary income. However, the resulting character mismatch may inappropriately increase A's net tax liability.

Sale of assets by partnership after transfer of NCO to new holder. A similar overinclusion of ordinary income would occur if the partnership sold all of its assets after the transfer of the NCO.

> Example 3: The facts are the same as in Example 1. After D sells his NCO to E for $100, the partnership sells all of its assets for $390.

The asset sale would give rise to $360 of ordinary income. A, B and C each would be allocated $120 of this ordinary income. If E does not exercise his option, then each of A, B and C receive the entire $120 in value and have no current offsetting capital loss. The $360 of ordinary appreciation has resulted in $450 of capital gain being recharacterized as ordinary income. (If Section 751(a) did not apply to D's transfer of the NCO, then A, B and C would still recognize $120 of ordinary income each upon the asset sale, and each would recognize $30 of capital loss upon a sale of the partnership interest, assuming that E exercised his option.) If E subsequently exercises his NCO, then each of A, B and C will have an interest worth $90, meaning that each will eventually recognize a $30 capital loss. This $30 of capital loss matches the $30 of ordinary income that each has taken into account that had also previously been taken into account by D, as the NCO holder. Thus, there is character and timing mismatch for A, B and C.

Exercise of NCO before sale of partnership assets. If E exercises his NCO before the partnership sells its assets, E would be required to include a proportionate share of the ordinary

income generated by the sale of the assets, which, without E's exercise, would have been borne by the historic partners (A, B and C) (as demonstrated by Examples 2 and 3).

> Example 4: The facts are the same as in Example 1. After D sells his NCO to E for $100, E exercises the NCO by transferring $10 to the partnership for a 25 percent interest. The partnership then sells all of its assets for $400 (*i.e.*, $390 plus the $10 contributed by E).

The asset sale would give rise to $360 of gain, all of which would be characterized as ordinary. A, B, C and E each would be allocated $90 of this gain.[30] E would recognize this ordinary gain notwithstanding the fact that E did not sustain any actual economic gain (ordinary or otherwise).[31] E's ordinary income would be offset by a capital loss at the time of his disposition of his partnership interest. In this sense, E's treatment is comparable to treatment of a partner that purchases a partnership interest when the partnership does not have a Section 754 election in place, so there is no duplication of tax. However, this example illustrates the duplication of the recharacterization of capital gain as ordinary income because D already recognized $90 of ordinary income and E will as well.

Subsequent transfers of same NCO. If the principles of Section 751(a) were to apply to a transfer of an NCO, there would be a need to decide how that rule would work in the event of subsequent transfers of the same NCO.

> Example 5: A, B and C are equal partners in the partnership. The partnership holds one capital gain asset and one hot asset. Each partner has an outside basis and capital account balance of $10, and each partnership asset has a basis and value of $15 (for aggregate inside basis and value of $30). The partnership issues to D for no consideration an NCO to acquire a one-fourth (25 percent) interest in the partnership for an exercise price of $10.

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30 *See* Treas. Reg. § 1.704-1(b)(2)(iv)(*s*).

31 If future regulations provided that holders of NCOs were permitted to apply the special basis adjustment rules under Section 743(b), E would not have had this result.

Over the next 4 years, the partnership operates on a break-even basis and makes no distributions, but its two assets equally appreciate to a value of $195 each (meaning that each has embedded appreciation of $180). D then sells its NCO to E for $90. D recognizes $90 of gain, D's 25 percent share of the hot asset appreciation is $45, so $45 of D's gain is treated as ordinary income.

Over the next 4 years, the partnership continues to operate on a break-even basis and makes no distributions, but the hot asset appreciates to a value of $215 (meaning the embedded appreciation is now $200) and the capital asset appreciates to a value of $615. E then sells its NCO to F for $200, recognizing a total gain of $110.

If Section 751(a) were applied to the sale by E to F of the NCO in the same way as it had been applied to o the sale by D to E of the NCO, then $50 of E's income would be being treated as ordinary (*i.e.*, 25 percent of the appreciation on the hot assets would be $50). This would occur despite the fact that D had already treated $45 of his gain as ordinary income upon its sale to E (and the additional appreciation in the hot assets between the two sales was only $5).

A way to prevent this double counting of Section 751 hot asset appreciation would be to account for the hot asset appreciation taken into account on prior transfers of the NCO. This could presumably be done by coordination between the sellers and buyers of NCOs or a deemed special basis adjustment mechanism similar to that under Section 743(b). The added complexity and the non-fungibility between previously transferred and non-previously transferred NCOs leads us again away from applying Section 751(a) in this case.

Ordinary income earned by partnership with outstanding NCOs. In any case, as shown by the following example, Section 751(a) cannot always ensure that the option holder takes into account as ordinary income gain derived on the NCO that is attributable to ordinary income recognized by the partnership.

Example 6: The facts are the same as in Example 1, except that after the NCO is issued, the partnership sells all its hot assets for $390, retains the cash, and recognizes $360 of ordinary income, bringing total value and basis of its assets to $390, all of which is in the form of cash. D then sells his NCO to E for $90.

The $360 of ordinary income is allocated equally to A, B, and C. If D sells his NCO, all $90 will be capital gain because the partnership has no hot assets, despite the fact that all of the appreciation in D's NCO is attributable to ordinary income earned by the partnership. One could argue that ordinary income has been shifted from D to A, B, and C – that NCO obtained value from the production of ordinary income, yet still did not recognize any ordinary income upon sale of its option. D is essentially selling the right to the cash, cash which as derived in the form of ordinary income, but D recognizes capital gain.

If Treasury and the Service are concerned about not applying Section 751(a) to sales of NCOs, we believe a better method of ensuring that holders take into account their appropriate share of ordinary income under Section 751(a) would be by using the Characterization Rule to treat an NCO holder as holding a partnership interest in appropriate circumstances. The Characterization Rule provides Treasury and the Service the authority to curtail abusive situations where NCOs were issued in order to avoid tax. We believe this result is preferable to attempting to apply Section 751(a) to transfers of NCOs which would result in potential overinclusions or underinclusions or require an extensive regulatory regime to reach the "correct" result. This is particularly the case because ordinary income in partnership assets will not be permanently eliminated. Instead, the historic partners will be subject to such tax.. Accordingly, we recommend that the Service rely on its carefully drafted Characterization Rule to ensure that holders of NCOs are treated as partners (subject to Section 751(a)) rather than option holders when appropriate.

Alternative approaches for coordinating Sections 751(a) and 1234(a). As these examples demonstrate, implementing Section 751(a) in coordination with Section 1234 is

complex.[32] There are multiple ways in which to effect such coordination. One approach is the deemed exercise mechanic described in the examples above. However, as discussed, there can be over-application of Section 751(a) under that mechanic both upon successive transfers of NCOs and transfers of the underlying interests, resulting in inappropriately overtaxing historic partners and/or NCO holders on ordinary income or loss. The over-application of Section 751(a) depends on the timing of exercise of the NCO, sale of the partnership assets and sale of partnership interests.

Regulations could include a basis adjustment mechanism (described below) to minimize these issues. However, it is unclear that such a regime would be consistent with general subchapter K principles as applied to NCOs. Under Sections 754 and 743(b), a partnership may adjust the basis of its property with respect to a particular partner upon the transfer of an interest in the partnership. Currently these rules do not apply on the transfer of an NCO. Inside basis is not affected by the transfer of an NCO regardless of whether the transfer results in current recognition of income or loss attributable to appreciation or depreciation of partnership assets to the NCO transferor. Income is therefore capable of being taxed more than once on a current basis, to be offset an indeterminate period of time later by the recognition of loss (or less gain) upon the sale of the partnership interests. A special Section 743-like regime that applied to NCO holders only in the case of sales of hot assets to avoid the double application of ordinary income in the case in which the sale of the partnership interest is preceded by a sale of an NCO would be inconsistent with this policy. Moreover, although this would solve E's problem, it would not

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[32] Although this Report does not discuss Section 751(b), we believe the Service would need to coordinate Section 751(b) with Sections 1234 and 751(a) if the Service were to apply Section 751(a) to transfers of NCOs. We believe that this would be similarly complex. Section 751(b) applies to disproportionate distributions of hot assets to prevent the shifting of ordinary income or capital gain income to certain partners. Section 751(b) requires a hypothetical sale of the disproportionate amount between the distributee partner and the partnership.

solve the overinclusion to A, B, or C, which stems from treating E as an option holder rather than as a partner while E owns the NCO before it has ever been transferred.[33]

It is unclear whether Treasury and the Service have authority to use such a regulation under the Code as currently drafted. Section 1234 applies only to the characterization of the gain or loss from the transfer or lapse of the option itself, and does not permit the alteration of the tax treatment of the recognition of gain or loss upon the sale or exchange of partnership property. Nor does Section 1234 grant general rulemaking authority to the Secretary to implement the purposes of Section 1234, unlike other provisions of the Code. We recognize, however, the general grant of authority provided by Section 7805(a).

If regulations were issued to coordinate Sections 751(a) and 1234(a), we believe that the best approach would be as follows:

1. The partners in the issuing partnership would take into account amounts that would be recognized by NCO holders under Section 751(a) when those partners calculate their shares of the partnership's ordinary income or loss under Treas. Reg. § 1.751-1(a)(2);

2. The partnership would take into account the amounts that would be recognized by NCO holders under Section 751(a) when the partnership calculates Section 743(b) basis adjustments (and allocates such adjustments in accordance with Section 755) for any partner; and

3. The partnership (and **successor** NCO holders) would take into account the amounts that actually have been recognized by prior NCO holders under Section 751(a) in determining how much is recognized by any such successor NCO holders under Section 751(a).[34]

[33] A common basis adjustment on D's sale would solve the A, B, and C overinclusion problem, but would be completely inconsistent with the current operation of Sections 743 and 734.

[34] This adjustment would also reduce the amount of capital gain or loss recognized by a successor holder.

Working together, these provisions would coordinate the recharacterization or ordinary income or loss among partners and NCOs holders, including successive buyers and sellers of each. We reiterate, however, that our recommendation is that Section 751(a) not be applied to transfers of NCOs.