NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE PROPOSED REGULATIONS RELATING TO PARTNERSHIP OPTIONS AND CONVERTIBLE SECURITIES

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I. Introduction

On January 22, 2003, the Treasury Department and the Internal Revenue Service issued proposed regulations (the "Proposed Regulations") providing guidance regarding the Federal income tax treatment of noncompensatory options and other rights to acquire a partnership interest (a "noncompensatory option").[2] The Proposed Regulations follow the issuance of Notice 2000-29[3], which previously requested public comment on the appropriate tax treatment of noncompensatory options as well as compensatory options. On January 29, 2002, the Tax Section submitted a report in response to Notice 2000-29 (the "First Report"). This report now provides comments on the Proposed Regulations. In addition, in response to the request in the preamble to the Proposed Regulations for additional comments with respect to compensatory options, the Tax Section is also submitting a separate report with respect to compensatory options.

The Proposed Regulations are substantially consistent with our recommendations in the First Report and therefore this report generally does not review the issues discussed

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[1] This report was prepared by members of the Committee on Partnerships of the Tax Section of the New York State Bar Association. The principal drafter was Andrew W. Needham, with substantial contributions from William B. Brannan, Patrick C. Gallagher and David H. Schnabel. Helpful comments were received from Andrew N. Berg, Kim Blanchard, Stephen P. Foley, Stuart L. Rosow, Joel Scharfstein and Linda Z. Swartz.

[2] REG-103580-02, Notice of Proposed Rulemaking, Noncompensatory Partnership Options, 68 Fed. Reg. 29-30 (Jan. 22, 2003).

[3] 2000-1 C.B. 1241.

in the First Report. Most of our comments are technical in nature. The primary exception relates to addressing the provisions in the Proposed Regulations dealing with corrective allocations. In the First Report, we recommended that the exercise of a noncompensatory partnership option generally be tax free to the holder of the option and the holder be taxed going forward on the "spread value" of the option under reverse Section 704(c)[4] principles. The Proposed Regulations generally adopt this recommendation, but they go on to require certain "corrective allocations" in some cases, which can produce immediate income to the holder. As discussed below, we support the use of corrective allocations as a reasonable approach to address the income shifting potential of partnership options. We do recommend certain technical changes designed to further limit corrective allocations to cases where the historic partners of the partnership have been "overtaxed" on partnership income.

As described below, we also generally support the approach taken in the Proposed Regulations for determining whether a noncompensatory option should be treated characterized as a current partnership interest. However, in addition to certain technical comments, we recommend deletion of the proposed rule that would require the characterization of a partnership option be retested upon each transfer of the option.

[4] All "Section" references herein are to the Internal Revenue Code of 1986, as amended to date (the "Code").

II. Summary of the Proposed Regulations

A. In General.

The Proposed Regulations address the Federal income tax consequences of the issuance, exercise and lapse of a noncompensatory option, both to the holder of the option and to the partners of the issuing partnership. First, the Proposed Regulations provide that the exercise of a noncompensatory option generally will not trigger recognition of gain or loss to either the issuing partnership or the option holder. Second, the Proposed Regulations provide rules governing the maintenance of capital accounts both before and after the exercise of a noncompensatory option and the effect of any capital account adjustments on allocations of income and loss by the partnership. Finally, the Proposed Regulations provide that, under certain limited circumstances, a noncompensatory option will be characterized as a current partnership interest for Federal income tax purposes.

B. Issuance, Exercise and Lapse.

Section 721(a) generally provides that no gain or loss is recognized by a partnership or any of its partners upon the contribution of property to the partnership in exchange for a partnership interest. Neither the statute nor the current regulations, however, address the tax consequences of the issuance, lapse or exercise of a noncompensatory option. The Proposed Regulations state that the general tax principles governing the treatment of options, rather than the principles of Section 721, should govern the issuance and lapse of a noncompensatory option. In general, therefore, the issuance of a noncompensatory option is treated as an "open transaction" for tax purposes. Accordingly, the partnership issuer recognizes no gain or loss upon the receipt

of cash or other property in exchange for a noncompensatory option. Similarly, the holder is treated as having made an investment and therefore recognizes no gain or loss upon the purchase of the option in exchange for cash. However, if the holder uses appreciated or depreciated property to pay the premium for the purchase of the noncompensatory option, the holder recognizes gain or loss in accordance with general tax principles. The Proposed Regulations do not alter the general tax principles governing the issuance of convertible debt or convertible equity, so the conversion right is treated as part of a single security rather than as separate item of property for tax purposes.

The Proposed Regulations also address the tax consequences of the exercise of a noncompensatory option. The Proposed Regulations treat the issuance of the partnership interest to the holder of the option as a transaction described in Section 721. Specifically, for Section 721 purposes, the Proposed Regulations treat the option holder as having contributed three discrete items of property in exchange for the partnership interest: the original option premium, the exercise price and the option privilege (i.e., the "spread value") of the noncompensatory option. Accordingly, the exercise of a noncompensatory option generally is not taxable to either the partnership or the holder of the option.

Finally, the Proposed Regulations clarify that Section 721 does not apply to the lapse of a noncompensatory option. Consequently, based upon general tax principles, the lapse of a noncompensatory option generally results in the recognition of gain by the partnership and the recognition of loss by the option holder.

C. Capital Account and Section 704(c) Issues.

In general, a new partner's initial book capital account for Section 704(b) purposes equals the amount of cash and the fair market value of any property contributed

by the partner to the partnership. Under the Proposed Regulations, upon the exercise of an option, the premium and exercise price paid in respect of the option are treated as contributions that increase the initial capital account of the holder. However, because the option terminates upon exercise, the option itself is not treated as having been contributed to the partnership.[5] However, when a holder of a noncompensatory option exercises the option, it usually acquires a partnership interest that has an entitlement to distributions, as measured on a liquidation basis, that exceeds the sum of the amount of premium and exercise price. This presents an issue of how to achieve the proper book capital account balances after exercise.

The Proposed Regulations achieve the proper book capital account result by first setting the option holder's initial capital account balance at an amount to equal the sum of any premium originally paid to the partnership to acquire the noncompensatory option plus the exercise price. The Proposed Regulations then require that the partnership "book-up" its assets immediately after exercise, allocating any unrealized gain first to the holder of the noncompensatory option, and then to the historic partners, to produce book capital account balances that reflect each party's share of the proceeds that would be available in a hypothetical liquidation of the partnership. In certain cases, however, the built-in gain inherent in the partnership's assets will not be sufficient to achieve the proper capital account balances, particularly where there has been an earlier book-up or the partnership has recognized income or gain. Under these circumstances, the

[5] This position is not consistent with the treatment of the option itself as property for Section 721 purposes. However, as noted in the First Report (see pp. 35-37 and 40-41), it does not seem appropriate to treat the option as contributed property for Section 704(b) or (c) purposes, because the option does not remain in existence after exercise.

partnership must reallocate capital from the capital accounts of the historic partners to the capital account of the former holder of the noncompensatory option to the extent necessary to produce the proper capital account balances. When it does so, the Proposed Regulations require the partnership to make offsetting corrective allocations of gross income for tax purposes to the holder of the noncompensatory option in the year of exercise (and, if necessary, in succeeding taxable years). This gross income allocation reduces the amount of income allocated to the continuing partners.[6]

As noted above, a noncompensatory option is not treated for Section 704(b) purposes as an asset contributed to the partnership upon exercise and therefore Section 704(c) would not operate to allocate any built-in gain inherent in the noncompensatory option to the holder. However, to the extent that the partnership allocates any unrealized gain to the holder of the noncompensatory option in connection with the book-up procedure described above, the holder will recognize that gain under reverse Section 704(c) principles as the partnership sells, depreciates or amortizes the revalued assets. This has the effect of substituting built-in gain inherent in the historic assets of the partnership for the built-in gain inherent in the noncompensatory option.

Finally, the Proposed Regulations provide an important valuation methodology for use in connection with any book-up of the capital accounts of the historic partners prior to the exercise of a noncompensatory option. Treasury Regulation § 1.704-1(b)(2)(iv)(f) provides that a partnership may adjust capital accounts to reflect a revaluation of partnership property after certain events, including the admission of a new

[6] Because such corrective allocations are for tax purposes only, they do not affect the Section 704(b) "book" capital accounts of the partners and, therefore, they cannot have any economic effect.

partner or the redemption of an existing partner. If a noncompensatory option is outstanding at the time of the revaluation, the Proposed Regulations require the partnership to set aside a portion of any book-up gain for future allocation to the noncompensatory option holder.[7]

D. Recharacterization Rule.

The Proposed Regulations generally respect the form of a noncompensatory option as an option for Federal income tax purposes. As a general rule, therefore, the Proposed Regulations do not treat the option holder as having a present equity interest in the issuer partnership until the holder actually exercises the noncompensatory option. Under certain circumstances, however, the noncompensatory option may provide the holder with "rights substantially similar to the rights afforded a partner". The Proposed Regulations apply a facts and circumstances test to determine whether a noncompensatory option provides such rights, including whether the noncompensatory option is reasonably certain to be exercised and whether the holder of the noncompensatory option has "partner attributes". The Proposed Regulations recharacterize a noncompensatory option with these rights as a present equity interest if, as of the date of issuance of the noncompensatory option (or the date of any later transfer or modification of the option), there is a "strong likelihood" that the failure to treat the holder as a partner would result in a substantial reduction in the present value of the aggregate tax liabilities of the historic partners and the option holder.

[7] Prop. Reg. §1.704-1(b)(2)(iv)(h)(2).

E. Effective Date.

The Proposed Regulations would be effective for noncompensatory options issued on or after the date on which final regulations are published.

III. Comments on the Proposed Regulations

A. In General.

The Tax Section commends the IRS and Treasury for issuing important and long-awaited guidance in an area plagued by uncertainty for decades. In general, the Proposed Regulations provide clear and sensible rules concerning the taxation of the issuer and the holder of a noncompensatory option upon issuance, exercise and lapse of the option, as well as the ongoing capital account and tax allocation issues associated with a noncompensatory option. The Proposed Regulations also generally strike an appropriate balance between the objective of accurately reflecting the income of the holder of a noncompensatory option and the historic partners during the life cycle of the noncompensatory option and the desire not to frustrate the economic expectations of the participants by recasting an arrangement in a manner that differs from its commercial form unless the arrangement is likely to result in tax avoidance.

Our support for the Proposed Regulations extends to what is probably the most controversial aspect of the regulations, namely, the limited use of corrective allocations of gross income after the exercise of a compensatory option in certain circumstances to achieve the proper capital account balances for the partners. While there is some tension between the corrective allocation approach, on the one hand, and general option tax principles and the nonrecognition rule of Section 721, on the other hand, we believe that the corrective allocation approach is a reasonable approach to the problem of potential income shifting. We do make some technical comments that, if taken, would scale back the requirement for corrective allocations in some circumstances.

We generally support the approach of the Proposed Regulations. Our principal comments and suggestions are as follows:

Issuance, Exercise, and Lapse

- Accrued but Unpaid Interest. The final regulations should clarify the treatment of the issuance of a partnership interest in exchange for the portion of a converted debt claim that represents accrued but unpaid interest; the tax treatment of any capital shift that results from the transaction should reflect the same principles that apply to the exercise of a compensatory option for a capital interest in a partnership.

- Options in Disregarded Entities. The final regulations should clarify the tax treatment of the exercise of an option to acquire an interest in a disregarded entity, making clear that general option principles apply if the issuer of option is the owner of the disregarded entity, but not if the issuer of the option is the disregarded entity itself. In the latter case, certain principles in the Proposed Regulations should apply to the exercise of such an option, subject to modification to avoid the possibility of immediate income recognition to the holder.

- Use of Property to Satisfy Exercise Price where Option Requires Cash. The final regulations should clarify that, while the holder of a noncompensatory option recognizes gain or loss if the holder uses property to pay any option premium, the holder does not recognize gain or loss upon the transfer of property to a partnership in payment of the exercise price of the noncompensatory option, whether or not the option by its terms allows an in-kind payment with property.

Corrective Allocations

- Clarify Computation of Capital Accounts When a Book-Up is Followed by a Reduction in Asset Value. The final regulations should provide that if an asset is booked-up while an option is outstanding and then declines in value, (i) the portion of the unrealized gain that is considered reflected in the partnership capital account should be adjusted for purposes of the special valuation rule applicable to partnership property revaluations and (ii) the partnership may elect to revalue its assets immediately before the exercise of the option.

Convertible Debt

- Initial Capital Account upon Conversion of Convertible Debt. The final regulations should provide that a partnership should credit the capital account of a holder of convertible debt with the adjusted issue price of the debt at the time of conversion, not the holder's adjusted basis in the debt.

Recharacterization Rule

- Confirm General Substance over Form Rules Continue. The final regulations should clarify that the recharacterization rule, which authorizes the IRS to recharacterize a noncompensatory option as a current partnership interest under certain circumstances, does not preempt a separate challenge to the status of a noncompensatory option as an option under general substance over form principles.

- Impact of Volatility. The final regulations regarding the recharacterization rule should clarify that the impact of the volatility of a partnership interest in determining the characterization of the option.

- Confirm Tax Consequences of Change in Characterization. If the final regulations retain the rule requiring that the characterization of a noncompensatory option be retested upon transfer, the regulations should (i) confirm that the determination is based on the facts relating to the transferee rather than the transferor and (ii) in cases where characterization of the option changes upon the transfer, clarify the tax treatment of the transfer to the transferor, the transferee and the partnership.

- Partner Attributes. The final regulations should clarify that the carve out in the recharacterization rule for partner attributes that a holder of a noncompensatory option possesses solely by virtue of owning a partnership interest (provided that such rights are no greater than the rights granted to other partners owning similar interests) should apply on a modified basis where the option holder has greater rights; we also believe that for purposes of both the basic definition of partner attributes and the carve out, the final regulations should take into account any rights attributable to any partnership interest held through an affiliate.

Eliminate Retesting of Characterization Upon Transfer Rule

- The final regulations regarding the recharacterization rule should exclude the mere transfer of a noncompensatory option as an occasion for retesting the noncompensatory option and should treat modifications to a noncompensatory option as testing dates only when the modifications are material.

Effective Date

- The final regulations should permit taxpayers to elect to rely on such regulations with respect to noncompensatory options issued prior to the date on which the final regulations are published.

B. Detailed Comments.

1. Issuance, Exercise, and Lapse Generally.

(a) Accrued but Unpaid Interest. The Proposed Regulations do not address the tax consequences of the conversion of a convertible partnership debt instrument with accrued but unpaid interest (including original issue discount). Instead, the preamble to the Proposed Regulations requests comments on the issue. Citing *Carman v. Commissioner*,[8] the preamble to the Proposed Regulations does acknowledge that the interest claim could be viewed as inseparable from the debt and therefore "property" for purposes of Section 721. Alternatively, the preamble notes that "it may be appropriate to require a partnership to recognize gain to the extent of the accrued but unpaid interest, because the issuance of the partnership interest satisfies a deductible (or capital) expense of the partnership". The basis for gain recognition would be Treasury Regulation § 1.721-1(b)(i), which provides that Section 721 does not apply to the extent that the other partners give up a right to be repaid their contributions "in satisfaction of an obligation" of the partnership.

One point that does seem clear in this area is that the holder and the partnership should recognize any interest income and expense not previously taken into account under their respective methods of accounting.[9] Thus, the real open issue in this area is whether the partnership should recognize gain. As described in the First Report, the proper treatment of an accrued interest claim in this context presents essentially the same

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[8] 189 F.2d 363 (2d Cir. 1951); but see Section 351(d)(3) (accrued interest on debt of transferee not "property" for purposes of Section 351).

[9] See the First Report, p. 49, N. 71.

income recognition question that arises when a partnership issues a capital interest upon the exercise of a compensatory option.[10] In either case, *if* the resulting capital shift to the holder of the option is characterized as a constructive sale of a portion of the assets of the partnership to the holder followed by a recontribution of those assets, the partnership would recognize gain or loss (and also recognize a deduction if the interest expense was not previously deducted). On the other hand, if the capital shift is instead characterized as a constructive payment of cash by the partnership to the holder followed by a recontribution of the cash to the partnership, the partnership should not recognize gain or loss (but again it may be entitled to a deduction).

In the First Report, we described both hypothetical constructs and the resulting tax consequences in the context of the exercise of a compensatory option for a capital interest in a partnership.[11] Although we did not express strong support for either construct, we did express a preference for the "circular cash flow" approach for a number of reasons. We expressed a similar preference for that approach in the accrued but unpaid interest context. Regardless of which construct the final regulations adopt for compensatory options, we recommend that they apply the same principles to the conversion of an accrued interest claim.

(b) Exercise of a Noncompensatory Option to Acquire an Interest in a Disregarded Entity. Although the Proposed Regulations apply to the exercise of a noncompensatory option to acquire an interest in a pre-existing partnership, they do not apply to the exercise of a noncompensatory option to acquire an interest in a disregarded

[10] See the First Report, p. 53.

[11] See the First Report, pp. 71-78.

entity. Immediately after exercise, however, the disregarded entity would become a partnership for tax purposes and the interest in the disregarded entity would become a partnership interest (assuming the noncompensatory option is not an option to acquire all the interests in the entity). In the preamble to the Proposed Regulations, Treasury and the IRS requested comments on whether they should extend the final regulations to the exercise of a noncompensatory option to acquire an interest in a disregarded entity.

We believe that the tax consequences of the exercise of a noncompensatory option in this context should depend upon the manner in which the disregarded entity converts to a partnership. In Revenue Ruling 99-5,[12] the IRS addressed two types of entity conversions. The first type involves a purchase of an interest in the disregarded entity directly from the owner, with the owner retaining the proceeds of sale. In this type of conversion, the ruling treats the owner as having sold a ratable portion of the assets of the disregarded entity to the buyer, followed by a joint contribution of the retained and the sold assets to a newly-formed partnership under Section 721. The second type of conversion involves a transfer of cash to the disregarded entity by the buyer in exchange for a newly-issued interest in the entity. In this type of conversion, the ruling treats the buyer and the owner as having jointly contributed cash and property to a newly-formed partnership under Section 721.

Under the reasoning of Revenue Ruling 99-5, the exercise of a noncompensatory option issued by the *owner* of the disregarded entity should be treated as the acquisition by the holder of a portion of the assets of the disregarded entity from the owner pursuant to an option to acquire those assets from the owner, followed by the contribution of the

[12] 1999-1 C.B. 434.

acquired assets to a newly-formed partnership with the owner. The general tax principles that apply to the taxation of options and the existing regulations under Sections 721, 704(b) and 704(c) already address the tax consequences of these transactions to the parties, so it would not seem necessary that the final regulations provide any additional guidance for that type of transaction (other than perhaps clarifying that the foregoing construct is correct).[13]

In contrast, if a noncompensatory option was issued by the disregarded entity itself, then the option exercise transaction should be treated differently. Under the rationale of Revenue Ruling 99-5 and assuming any option premium and the exercise price stay in the entity, the holder of the noncompensatory option should be viewed as contributing any option premium and the exercise price to the new partnership, whereas the original owner should be viewed as contributing to the new partnership all the other assets held by the disregarded entity. We believe this approach is appropriate because (i) neither party has disposed of property in a sale-like transaction, (ii) it avoids creating a disparity in tax treatment as compared to cases where the disregarded entity becomes a partnership before the option is exercised and (iii) if different rules were to apply depending upon interim changes in entity status, there would be an incentive to engage in tax-motivated status changes that serve no real business purpose. Accordingly, we recommend that the final regulations clarify that result.[14] In addition, because this type of conversion transaction is functionally similar to the exercise of a noncompensatory

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[13] We should also note that neither Notice 2009-29 nor the Proposed Regulations address in any context options issued by a partner in a partnership.

[14] The final regulations may wish to exclude cases where there is a fundamental change in the assets of the disregarded entity while the option is outstanding.

option for a partnership interest and presents many of the same policy issues, the final regulations should extend the applicable principles of the Proposed Regulations to the option holder and the owner of the entity.

In particular, we recommend that the final regulations address a peculiar capital account problem that arises in this context. In the absence of a special rule, the opening book capital accounts of the partners would rarely correspond to the business deal, because, as with a noncompensatory option issued by a partnership, the value contributed by the holder would usually be less than the initial book capital account it should have, whereas the original owner would be credited with the full fair market value of the assets it is deemed to contribute. Consequently, the partnership would have no built-in book gain to allocate to the holder in a post-exercise book-up.[15] The partnership would therefore always have to reallocate a portion of the original owner's capital account to the former holder of the noncompensatory option to give it the correct capital account balance, thereby triggering an immediate corrective allocation.[16] To avoid this inappropriate result, we recommend that final regulations allow the newly-formed partnership to apply the valuation principles of Proposed Regulation § 1.704-1(b)(2)(iv)(h)(2), which govern the revaluation of partnership property in connection with the exercise of a noncompensatory option issued by a partnership. Under those principles as applied in this context, the owner of the disregarded entity would be treated as having contributed assets to the newly-formed partnership with a value equal to their actual fair market value *less* the built-in gain attributable to the option. The difference in values

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[15] See Treas. Reg. § 1.704-1(b)(2)(iv)(b).

[16] See Prop. Reg. § 1.704-1(b)(4)(x).

would then be assigned to the opening capital account balance of the holder of the option, with Section 704(c) principles applying to the resulting difference in tax basis and fair market value to each partner.[17] Again, this result is appropriate because neither party has disposed of property in a sale-like transaction and because it avoids the creation of a disparity in tax treatment as compared to cases where the disregarded entity becomes a partnership before the option is exercised.

(c) Application of Section 721(b) to Investment Company Partnerships. As stated in the First Report, "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."[18] The Proposed Regulations extend Section 721 to the exercise of a noncompensatory option without expressly noting any exceptions to nonrecognition treatment.[19] Under Section 721(b), however, Section 721(a) does not apply to any gain realized upon the transfer of property to a partnership that would be treated as an "investment company" if it were a corporation. Final regulations should therefore clarify that if Section 721(b) does apply to the contribution of appreciated property in connection with the exercise of a noncompensatory option, the holder of the noncompensatory option who transfers the appreciated property in satisfaction of the exercise price should

[17] It seems inappropriate, however, to permit a shift of any unrealized gain arising prior the issuance of the option to the holder of the option. This could occur under the special capital accounting rules described above if the entity had undistributed taxable income while the option was outstanding. One potential way to avoid this result would be to further adjust the book value of the contributed assets to preserve the appropriate amount of section 704(c) again.

[18] See the First Report, p. 21.

[19] Prop. Reg. § 1.721-2(a).

recognize gain on the transfer. Under the bargain purchase doctrine generally applicable to option holders, however, the holder should not recognize the built-in gain inherent in the option itself.

(d) Use of Property to Satisfy Exercise Price Where Option Requires Cash. As noted above, under the Proposed Regulations, the holder of a noncompensatory option generally does not recognize gain upon exercise of a noncompensatory option for a partnership interest, either with respect to the gain inherent in the noncompensatory option or with respect to the gain inherent in any property transferred to the partnership upon exercise.[20] An example in the Proposed Regulations clarifies that Section 721 applies to both, at least if the holder of the noncompensatory option has a preexisting right to fund the exercise price either in cash or in property.[21] Accordingly, the holder will recognize gain on the contributed property during future periods under Section 704(c) as the partnership depreciates or sells the property.

As noted in the First Report,[22] if a noncompensatory option requires the holder to pay cash but the partnership later agrees to accept property, it would appear that Section 721 should still apply, even though the delivery of the property could theoretically be construed as a deemed sale of the property in satisfaction of a preexisting obligation to deliver cash. It would be helpful if the final regulations addressed this issue. As suggested in the First Report, we would recommend that the final regulations provide that Section 721 applies whether or not the option provides for a transfer of

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[20] Prop. Reg. § 1.721-2(a), -2(f).

[21] Id.

[22] See the First Report, p. 16, n. 13.

property in satisfaction of the exercise price. If the final regulations do not take that position, then a further issue would be what consequences result if the noncompensatory option does not provide for the use of property but it is modified by the parties prior to exercise to permit the use of property (both in terms of whether such modification would prevent gain recognition upon the transfer of the property and whether the modification itself would be a taxable event under Section 1001 principles).

(e) Taxation of Option Lapse or Repurchase. The Proposed Regulations state that Section 721 does not apply to the lapse of a noncompensatory option and that instead general option principles apply.[23] However, the Proposed Regulations do not expressly address the consequences of the issuing partnership's repurchase of the option for consideration. Under general option principles, for example, if the partnership repurchases an outstanding option for an amount exceeding the option premium, the partnership generally would have short-term capital loss under Section 1234(b). In contrast, if the holder exercises the option and the partnership then repurchases the resulting equity interest, under the Proposed Regulations the exercise of the option would be tax free, and under Section 731(b) the partnership would have no gain or loss upon the repurchase. The disparate tax treatment of the partnership from these two economically similar transactions, which in the corporate context led to the enactment of the second sentence of Section 1032(a), is further discussed in the First Report at II.C.2. The final regulations should clarify whether the general option principles applicable to the lapse of a noncompensatory option also apply to the partnership's repurchase of the option.

[23] Prop. Reg. §1.721-2(c) and Preamble.

2. Tax Accounting for Noncompensatory Options.

(a) Capital Account Adjustments Upon Exercise. The Proposed Regulations provide that upon exercise of a noncompensatory option with a built-in gain or loss, the capital accounts of the partnership will not be considered to be maintained in accordance with the rules of Treasury Regulation § 1.704-1(b)(2)(iv) unless the partnership credits the capital account of the exercising partner by (i) the consideration paid to the partnership to acquire the noncompensatory option (i.e., the option premium) and (ii) amount of cash and/or the fair market value of any property contributed to the partnership upon exercise.[24]

If the option holder's right to share in partnership capital exceeds the sum of the consideration paid by the holder to acquire the option and the amount paid upon exercise (as would usually be the case), the partnership must follow the following rules:

(1) In lieu of the normal type of revaluation under Treas. Reg. § 1.704-1(b)(2)(iv)(f), which would occur immediately *before* the exercise of the noncompensatory option, the partnership revalues its assets immediately *after* the exercise;

(2) The partnership allocates the resulting "book-up" gain first to the capital account of the former holder of the noncompensatory option to the extent necessary to reflect the holder's right to share in partnership capital under the partnership agreement and any remaining book-up gain is allocated to the historic partners;

(3) To the extent that the book-up gain is insufficient to cause the capital account balance of the former holder of the noncompensatory option to reflect the holder's right to share in partnership capital, the partnership must reallocate capital from the existing partners to the former holder of the noncompensatory option; and

(4) To the extent of any such capital reallocation, the partnership must make corrective allocations of gross income for tax purposes to the former holder of

[24] Treas. Reg. § 1.704-1(b)(2)(iv)(b); Prop. Reg. § 1.704-1(b)(2)(iv)(d)(4).

> the noncompensatory option in taxable years beginning with the year of exercise (which produces a corresponding tax benefit to the historic partners).[25]

The Proposed Regulations generally follow the recommendations of the First Report in determining how and when to account for the built-in gain in the noncompensatory option. To reduce or eliminate book-tax disparities following a capital account reallocation, however, the First Report had recommended the use of reverse Section 704(c) allocations with the additional possibility of using notional items rather than special allocations of gross income.[26] This method would have reduced the possibility of immediate income to the option holder and instead required the holder to recognize any built-in gain in the noncompensatory option under Section 704(c) principles as the partnership sold, depreciated or amortized its assets. The Proposed Regulations rejected this approach as "unduly complex," opting instead for immediate corrective allocations of gross income for tax purposes where book-up gain is insufficient to achieve the proper capital account balances.

The corrective allocation approach is somewhat inconsistent with the tax treatment of options in general and the application of Section 721, because the corrective allocation approach may force the option holder to recognize income upon exercise of the noncompensatory option. While other approaches may avoid this result,[27] we nevertheless support the adoption of the corrective allocation approach primarily because

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[25] Prop. Reg. § 1.704-1(b)(2)(iv)(s).

[26] The First Report at 96, Example 3(b).

[27] In the First Report, we recommended permitting a tax-free reallocation of capital, coupled with ongoing adjustments of tax allocations in accordance with Section 704(c) principles. See the First Report, pp. 39-40.

we believe it is a reasonable approach to address the income shifting potential of partnership options. Once an option is in the money, the holder has an economic interest in future income and gain. If this income or gain is realized before exercise the income or gain must be allocated to the other partners. It seems appropriate to reverse this over allocation to the historic partners once the option has been exercised.[28]

The same concern about income shifting is not present when a capital shift represents only a shift in unrealized appreciation. In this regard, we commend the special valuation approach contained in the Proposed Regulations applicable to revaluations when there are outstanding options. This approach addresses the concern we expressed in the First Report, that a post-exercise book-up may not be sufficient to produce the proper capital account balances for the partners because the built-in gain or loss inherent in the partnership's assets may already be reflected in the partners' capital accounts by reason of one or more pre-exercise book-ups or realization events.

Under the special valuation methodology prescribed by the Proposed Regulations, the fair market value of partnership property for purposes of a revaluation is reduced to reflect outstanding options, to the extent they are in the money. This leaves "headroom" to book up the option holder's capital account with unrealized appreciation upon a subsequent exercise, thereby avoiding a corrective allocation. This seems to work fine so long as the property does not decline in value after the revaluation. If the property

[28] We note that the Proposed Regulations do not eliminate every possible income shift. For example, if taxable income is earned prior to exercise and taxed to the partners, the option holder may still avoid a corrective allocation if there is sufficient unrealized gain at the time of exercise to put the holder's capital account in proper balance. In essence, the Proposed Regulations contain an implicit taxpayer favorable ordering rule, where the option holder may look first to unrealized gain at the time of exercise. As a result, the option holder may end up in a better situation, at least in terms of timing, by virtue of having held the option instead of a partnership interest.

declines in value, the optionholders' headroom may disappear. There may still be a substantial amount of unrealized tax appreciation in the partnership properties, but it may have already been allocated to the book capital accounts of the other partners.

One would think the situation described above could be remedied by revaluing the property once again to reflect the reduction in value. The problem, however, is that since the property was not booked up to full fair market value in the first case, the property may still be on the partnership's books at a value greater than its then fair market value. This could preclude a second revaluation from fixing this disappearing headroom problem, since it would require the property to be booked down below its fair market value, which the Proposed regulations do not seem to permit. We suggest herein that the Proposed Regulations be modified to permit such a book down, to the extent it reverses a prior book-up.

While booking down property below its fair market value may seem odd, it's no different than the special valuation rule already contained in the Proposed Regulations, which requires property to be revalued below its actual fair market value when an in the money option is outstanding. Moreover, permitting property to be booked down below its fair market value to reverse a prior book-up should result in putting the capital accounts largely in the same place they would have been had the first revaluation had not occurred.

The foregoing recommendation is implemented by two technical comments. One relates to the case of a downward revaluation that occurs subsequent to a greater upward revaluation. The other relates to revaluations in connection with the exercise of options

where there has been a decline in value since a prior revaluation event but there is still unrealized appreciation in the partnership's property for tax purposes.

The foregoing can be illustrated by the following examples:

> **Example (1):** Partnership has three partners, A, B and C, each with a one-third partnership interest. Partnership holds no depreciable assets. Each partner has a capital account balance of $10, and the partnership assets have a value of $30. Partnership issues to D for no consideration a noncompensatory option to acquire a 25% interest in the partnership for an exercise price of $10. Over the next four years, Partnership X operates on a break-even basis and makes no distributions, but its assets appreciate in value to $390. At the beginning of Year 5, D exercises the noncompensatory option.

Assuming no prior revaluations, a book-up of capital accounts upon the exercise of the noncompensatory option produces appropriate results. Partnership allocates the first $90 of its $360 of unrealized gain to D and the remaining $270 in equal amounts to each of A, B and C, producing capital account balances of $100 for each partner. However, the result in the foregoing simple example could have been frustrated by a prior book-up:

> **Example (2):** Assume that same facts as in Example (1) but that Partnership books-up the capital accounts before D exercises the noncompensatory option at the end of Year 4 in connection with the issuance of a small interest to a new partner in exchange for a contribution of property.

When a book-up precedes the exercise of a noncompensatory option, the Proposed Regulations require a partnership to earmark an appropriate portion of any unrealized gain in a suspense account for future allocation to the noncompensatory option holder. Accordingly, the Partnership in Example (2) would increase the book capital account balances of A, B and C to $300 rather than $390, leaving $90 of potential gain to allocate to D when D later exercises the noncompensatory option. The Partnership may therefore have sufficient unrealized gain to increase D's capital account from $10 to $100 even if the assets of the partnership do not appreciate in the interim. As a result, the

Partnership will not reallocate any capital from the historic partners to D upon exercise of the noncompensatory option and therefore no special allocation of gross income to D is necessary.

> **Example (3):** Assume that same facts as in Example (1) but that Partnership sells all of its assets shortly before D exercises the noncompensatory option, realizing a gain of $360.

Because D is not a partner on the date of sale, Partnership must allocate the entire $360 of gain to the historic partners, resulting in each partner having a capital account balance of $130. When D exercises the noncompensatory option, there is no book-up gain to allocate and, therefore, Partnership X must reallocate $30 of capital from each of the historic partners to D. This will trigger a corrective allocation of $90 of gross income to D. The logic behind requiring such allocation to D is to tax D on the portion of the gain economically allocable to D but previously taxed to A, B and C. This generates the equivalent of a deduction to the historic partners, which, subject to character and/or timing differences, effectively offsets the prior income inclusion.

We observe, however, that under the Proposed Regulations a book-up of partnership assets while a noncompensatory option is outstanding increases the likelihood that a corrective allocation will be required. If a book-up is followed by either (i) the recognition of taxable income by the partnership or (ii) a decline in the value of the booked-up assets the Proposed Regulations may require a corrective allocation where none would have been required absent the prior book-up.

> **Example (4):** Upon the formation of Partnership, A and B each contribute $10 in exchange for 10 units and C pays $0 in exchange for an option to acquire 10 units (with a $10 exercise price). Partnership buys non-depreciable Property Z for $20. At a time when Property Z has increased in value to $50, D contributes $20 in exchange for 10 units of Partnership. Upon the contribution, Property Z is booked-up to $40 ($50 actual value, less $10 value of partnership option), and A's and B's capital accounts are

> increased to $20 each. The cash contributed by D generates $10 of cash and taxable income (none of which is distributed) and then, when Property Z is still worth $50, C exercises its option.
>
> Upon the exercise of the option, Property Z is booked-up from $40 to $50 and the entire $10 of book gain is allocated to C. In addition, the Partnership reallocates $2.50 of capital to C from the book capital accounts and A, B and D and there is a $2.50 corrective allocation to C.

We support the use of corrective allocations in Example (4) because they result from the historic partners having been "overtaxed" on partnership income. In other words, A, B and D bore tax on the entire $10 of taxable income, even though 25% of that income was economically allocable to C.

However, as illustrated by Examples 5, 6 and 7, corrective allocations may result under the Proposed Regulations in cases where the historic partners have not been overtaxed if there is an increase in asset value that is followed by a book-up and then decline in asset value. The application of the corrective allocation in this context is attributable to two technical issues that arise under the Proposed Regulation. First, in cases where there has been a book-up in the value of a partnership assets while a partnership option is outstanding and the assets subsequently decline in value, a technical issue with the Proposed Regulations prevents the historic partner's share of the decline in value from being taken into account under the special rule for determining the book value of the partnership's assets. As a result, this loss will not be reflected in the historic partners capital accounts and this, in turn, can result in the application of corrective allocations to the option holder upon exercise. This issue is illustrated in Example 5. The second issue arises from the fact that the Proposed Regulations do not permit a revaluation of the partnership assets immediately before a partnership option is exercised. This is illustrated in Examples 6 and 7.

> **Example (5):** Upon the formation of Partnership, A and B each contribute $10 in exchange for 10 units and C pays $0 in exchange for an option to acquire 10 units (with a $10 exercise price). Partnership buys non-depreciable Property Z for $20. At a time when Property Z has increased in value to $50, D contributes $20 in exchange for 10 units of Partnership. Upon the contribution, Property Z is booked-up to $40 ($50 actual value, less $10 value of partnership option). The cash contributed by D generates no income and then, at a time when Property Z has declined in value to $46, E contributes $19 in exchange for 10 units and there is a revaluation of the Partnership's assets. Thereafter, C exercises its option.
>
> In computing the book-up resulting from E's contribution, the value of the Partnership's assets immediately before the contribution ($66, consisting of $20 in cash and $46 in Property Z) is reduced by the value of the partnership option ($9), but only to the extent of the unrealized gain (here $26) that has not already been reflected in the capital accounts previously ($20). Here, only $6 of the unrealized gain has not been reflected in the capital accounts and thus the value of Property Z is reduced by $6 rather than $9. Accordingly, Z is considered to have a value of $40 and there is no book loss, even though Property Z has declined in value. Upon the exercise of the option, Partnership allocates the remaining $6 of book gain to C and reallocates $3.00 of capital from the book capital accounts of A, B and D and there is a $3 corrective allocation.

The historic partners in Example (5) have not been overtaxed on their share of partnership income and therefore it does not seem necessary or appropriate to apply a corrective allocation upon the exercise of the option. As noted above, the corrective allocations in this example result from what we consider a technical issue with Prop. Treas. Reg. Section 1.704-1(b)(2)(iv)(h)(2) which prevents the full reduction in the value of property Z from being allocated to the historic partners when the partnership's assets are revalued upon E's admission to the Partnership. This occurs because, in determining the book value of property Z, the Proposed Regulations do not include a mechanism to reduce the amount of unrealized gain reflected in the capital accounts by the historic

partner's share of the decline in value of Property Z. We recommend that the regulation add a mechanism to correct this issue.[29]

We similarly recommend that a partnership be permitted to revalue its assets immediately prior to the exercise of a noncompensatory option to reflect any decline in the value of a partnership asset that was previously booked-up. Again, this would narrow the use of corrective allocations to cases where the actual partners of the partnership have been overtaxed on actual partnership income. In addition, it would avoid the creation of a disparity in treatment as compared with cases where there was an actual book event shortly before option exercise. Without this rule, there would be an incentive to engage in tax-motivated events that allow for a book-up but serve no real business purpose.

> **Example (6):** Upon the formation of Partnership, A and B each contribute $10 in exchange for 10 units and C pays $0 in exchange for an option to acquire 10 units (with a $10 exercise price). Partnership buys non-depreciable Property Z for $20. At a time when Property Z has increased in value to $50, D contributes $20 in exchange for 10 units of the Partnership. Upon the contribution, Property Z is booked-up to $40 ($50 actual value, less $10 value of partnership option). Thereafter, the partnership generates $0 of income and then, at a time when Property Z is worth $46, C exercises its option.

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[29] One way to alleviate the issue presented by Example (5) but stay within the framework of Prop. Treas. Reg. Section 1.704-1(b)(2)(iv)(h)(2) would be to modify the regulation so that, on the facts of Example (5), the amount of "unrealized income" treated as "reflected in the capital accounts previously" is reduced by the historic partner's share of the decline in value of property Z (i.e., reduce it by $3). Under this approach, the value of the Partnership's assets ($66, consisting of $20 in cash and $46 in Property Z) would still be reduced by the value of the partnership option ($9), but only to the extent of the unrealized gain ($26) that has not already been reflected in the capital accounts. However, the amount of unrealized gain reflected in the capital accounts would be reduced from $20 to $17 to reflect the historic partner's share in the reduction in value of Property Z. As a result, (i) there would be $9 (rather than $6) of unrealized gain not reflected in the capital accounts, (ii) the book value of Property Z would be reduced by $9 (rather than $6), and (iii) Z would be considered to have a book value of $37 (rather than $40) and (iv) when the $37 book value of property Z was compared with the previous $40 book value of property Z, there would be a $3 of book loss, which would be allocated among A, B and D. Upon the exercise of the option, C would therefore be allocated $9 of book gain and there would be no corrective allocations.

Under the current proposed regulation, the value of Property Z would not be adjusted prior to C's exercise of its option. Rather, upon exercise of its option, C would be allocated $6 of book gain and there would be a $3 corrective allocation.

Assume instead that the final regulations allow the assets of the partnership would be booked-down immediately prior to the exercise of the option. In computing the book-down, the value of the Partnership's assets ($66, consisting of $20 in cash and $46 in Property Z) would be reduced by the value of the partnership option ($9), but only to the extent of the unrealized gain (here $26) not already reflected in the capital accounts. Assuming that the issue identified in Example (5) is corrected, in determining the book value of property Z, (i) the unrealized income considered reflected in the capital accounts would be reduced from $20 to $17 (reflecting the historic partners' share in the decline in value of Property Z), (ii) $9 of the unrealized gain would be treated as not having been reflected in the capital accounts and (iii) the book value of Property Z would be reduced by $9. Accordingly, Z would be considered to have a book value of $37 and there would be $3 of book loss, which would be allocated among A, B and D. Upon the exercise of the option, C would be allocated $9 of book gain and there would no corrective allocations.

Example (7): Same as Example (6) except that after D is admitted and before C exercises its option the Partnership recognizes $4 of taxable income.

Assume again that the final regulations allow the assets of the partnership to be booked-down immediately prior to the exercise of the option. In computing the book-down, the value of the Partnership's assets ($70, consisting of $24 in cash and $46 in Property Z) would be reduced by the value of the partnership option ($10), but only to the extent of the unrealized gain (here $26) not already reflected in the capital accounts previously. Assuming that the issue identified in Example (5) is corrected, in determining the book value of property Z, (i) the unrealized income considered reflected in the capital accounts would be reduced from $20 to $17 (reflecting the historic partners' share in the decline in value of Property Z), (ii) $9 of the unrealized gain would be treated as not having been reflected in the capital accounts and (iii) the book value of Property Z would be reduced by $9. Accordingly, Z would be considered to have a book value of $37 and there would be $3 of book loss, which would be allocated among A, B and D. Upon the exercise of the option, C would be allocated $9 of book gain and there would be a $1 corrective allocation.

Even with the modifications noted above, a book-up while a noncompensatory option is outstanding will increase the likelihood that corrective allocations will be

required upon the exercise of the option.[30] In general, this will make partnerships more reluctant to do pre-exercise book-ups and will prompt holders of noncompensatory options to seek a contractual right to approve any book-ups prior to the time of exercise. However, assuming the adoption of the above modifications, the imprecision so often inherent in valuing privately-held businesses may render corrective allocations a largely elective regime in practice because in most cases there will be no definitive evidence of the fair market value of the partnership assets.[31] Instead, the parties will have a range of possible valuations available to them, each of which may be defensible under one or more appraisal methodologies and none of which may have any pre-tax consequence to the historic partners. In view of the potential tax consequences under the Proposed Regulations, the holder of the noncompensatory option will prefer a lower asset valuation upon a pre-exercise book-up and a higher asset valuation upon exercise so that there is enough book-up gain upon exercise to avoid a capital account reallocation while the historic partners will have the opposite incentives with respect to the valuations. Another consideration is that the holder of a noncompensatory option may be able to defer or avoid a capital account reallocation by deferring the date of exercise to allow for sufficient incremental appreciation in the value of the partnership's assets. In practice, therefore, we expect that capital account reallocations may tend to be fairly uncommon, except in cases where the book-up values needed to prevent a reallocation would create meaningful economic risk for one or more of the parties. Presumably, the government

[30] For example, the corrective allocations applicable in Example (4) would not be required if the Partnership's assets had not been booked-up upon D's admission to the partnership.

[31] Note that the fact that the option has been exercised will not directly establish the value of the partnership assets; it will merely establish, at least in the holder's view, that the noncompensatory option is "in the money" and thereby possibly establish a floor as to the value of the partnership's assets.

would have little to gain by challenging these valuations unless a gross income allocation to the noncompensatory option holder would result in a tax liability to the holder that differs materially from the aggregate reduction in tax liability to the historic partners attributable to the offsetting deduction.

Finally, because a capital account reallocation usually results from the historic partners having been "overtaxed" on partnership income, we believe that the final regulations should address the potential for character conversion that could result if the gross income that is specially allocated in connection with the capital account reallocation differs in character or other tax-favored status from the income on which the historic partners were overtaxed. Because the Proposed Regulations require that any corrective income allocation be effected using a pro rata share of the partnership's items of gross income for the applicable taxable year, so no matching principle applies.[32] While it would be difficult to cure this problem in all cases, we recommend that, at a minimum, the pro rata allocation rule in the Proposed Regulations be modified to provide that, to the extent a capital account reallocation is attributable to prior allocations of income, the resulting corrective allocation of income should be made using income of the same character or tax status as prior income to the maximum extent possible.[33] However, for administrative simplicity and in deference to the annual accounting system, it may be necessary to limit the scope of this rule to the year(s) during which the corrective allocations of income would otherwise occur. In other words, a partnership should not be able to defer a corrective allocation pending recognition of income of matching character

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[32] Prop. Reg. § 1.704-1(b)(2)(iv)(s).

[33] Cf. Treas. Reg. §§ 1.1245-1(e)(2) and 1.1250-1(f).

if other income items are available. This means that character conversions will still occur, but at least they should be minimized.[34] We recognize that some complexities may arise in identifying the specific items of income that have given rise to the need for a capital account reallocation, but the determination should be relatively straightforward in many cases.

(b) Mandatory Book-Up. To satisfy the capital account maintenance requirements of Treasury Regulation § 1.704-1(b)(2)(iv), the Proposed Regulations *require* a partnership to book-up the capital accounts of the partners upon the exercise of a noncompensatory option,[35] even though book-ups are otherwise permissive under the Section 704(b) regulations.[36] The reason book-ups are permissive in other contexts is that partners will very often find it to be in their economic interest to book-up and, in any event, profit and loss allocations can still have "substantial economic effect" even if the partnership does not book-up the capital accounts of the partners. Rather than booking-up, for example, a partnership may choose to specially allocate the gain inherent in the partnership assets not on the revaluation date, but on the date that the partnership actually

[34] To give a simple illustration of the potential conversion problem that could still occur, a partnership may be required to reallocate capital attributable to capital gains realized in prior years yet be forced to make the resulting corrective allocation of income using ordinary income if that is the partnership's only source of income for the taxable year during which the reallocation occurs.

[35] Prop. Reg. § 1.704-1(b)(2)(iv)(s)(x).

[36] Treas. Reg. § 1.704-1(b)(2)(iv)(f) (the taxpayer "may" upon occurrence of certain events book-up its capital accounts). The regulations further admonish that "if the capital accounts of the partners are not adjusted to reflect the fair market value of partnership property when an interest in the partnership is acquired from or relinquished to the partnership, paragraphs (b)(1)(iii) and (b)(1)(iv) of this section should be consulted regarding the potential tax consequences that may arise if the principles of section 704(c) are not applied to determine the partners' distributive shares of depreciation, depletion, amortization, and gain or loss as computed for tax purposes, with respect to such property." Id.

realizes the gain.[37] When a holder exercises an appreciated noncompensatory option, however, it generally acquires an interest in partnership capital that exceeds the amount of the option premium and the exercise price paid to the partnership. Because the disparity in capital accounts that would otherwise result cannot be corrected under traditional Section 704(c) principles, a mandatory book-up in this situation is not unreasonable. We therefore support mandatory book-ups upon the exercise of a noncompensatory option.[38]

(c) Use of Adjusted Basis Upon Conversion of Convertible Debt. The Proposed Regulations credit the capital account of the holder of convertible debt with the adjusted basis of the debt (plus any accrued but unpaid qualified stated interest) upon conversion of the debt into a partnership interest.[39] We recommend that final regulations instead credit the holder's capital account with the adjusted issue price of the convertible debt, which would reflect the original holder's initial cash payment to the partnership, as adjusted to reflect the accrual of any discount and any intervening cash payments (other than payments of qualified stated interest). Using adjusted issue price would avoid creating a different tax result as between cases where the debt is converted by the original holder and cases where there had been a prior transfer of the debt at a price that reflected

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[37] See, e.g., Treas. Reg. § 1.704-1(b)(5) (Example 14, part (iv)). This approach, of course, may create economic risk for one or more of the partners, because they will need to rely on future income allocations to cause their capital accounts to reach the right level.

[38] We also note that many (if not most) partnerships already book up their assets when permitted to do so. For partnerships that keep and liquidate in accordance with capital accounts this often occurs explicitly. For other partnerships (e.g., so called "distribution driven" partnerships), the revaluation of partnership assets is generally inherent in the economic deal and taken into account in determining the tax allocations.

[39] Treas. Reg. § 1.704-1(b)(2)(iv)(b) and Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(d)(4).

unrealized gain or loss attributable to the conversion right and/or changes in market interest rates.[40] This approach is inconsistent with the general approach of the Proposed Regulations to exclude the value of the option privilege in determining the initial capital account balance of the holder upon exercise of the noncompensatory option.

(d) Accounting for Cash Settlement. The Proposed Regulations generally apply to noncompensatory options that "may or must" be settled in cash or property other than a partnership interest.[41] Under general tax principles, the exercise of a cash-settled option is generally treated as a sale or exchange of the option,[42] although at least one commentator has suggested that a cash settlement might be alternatively treated as a deemed exercise of the option followed by an immediate sale of the underlying property.[43] We recommend that final regulations clarify that the cash settlement of a noncompensatory option be treated as a sale or exchange of the noncompensatory option rather than a deemed Section 721 exchange followed by a sale of the partnership interest. Unless the noncompensatory option is payable only in cash, any revaluation of the partnership assets that occurs while a cash-settled noncompensatory option is outstanding should earmark a portion of the book-up gain for future allocation to the noncompensatory option holder. If the option is payable only in cash, no such earmarking seems necessary because, upon settlement of the option, the partnership

[40] In addition, if this suggestion is adopted, Example 24 in Prop. Reg. § 1.704-1(b)(5) should be conformed by replacing the reference to "adjusted basis" with "adjusted issue price."

[41] Prop. Reg. § 1.721-2(e)(1).

[42] See Rev. Rul. 88-31, 1988-1 C.B. 302 (exercise of cash settlement option treated as sale or exchange of option).

[43] Dolan and DuPuy, "*Equity Derivatives: Principles and Practice,*" 15 Va. Tax Rev. 161, 173-74 (1995).

should have (subject to the discussion in III.1.e above) short-term capital loss equal to the settlement price less any option premium paid at issuance,[44] which in turn should cause appropriate adjustments to the historic partners' capital accounts.

(e) Partnerships Not Following the Capital Account Rules. As the foregoing discussion indicates, key elements of the Proposed Regulations, especially the mandatory capital account book-up procedure and corrective allocations, presuppose that the issuing partnership is maintaining capital accounts for its partners and otherwise complying with the "substantial economic effect" rules in Treasury Regulation § 1.704-1(b). However, many partnerships do not take that approach and instead rely on the partners' interests in the partnership theory to validate their tax allocations.[45] While it is true that many of these partnerships are less sophisticated and less likely to issue noncompensatory options than other partnerships, some of these partnerships are actually quite sophisticated and may issue noncompensatory options. We urge the IRS and Treasury to consider how the law regarding noncompensatory options should apply to such partnerships, including the practical issues such partnerships may face in applying the law.

3. Recharacterization Rule.

(a) Basic Rule. The Proposed Regulations treat a noncompensatory option as a partnership interest if, as of the date it is issued, or as of any subsequent date on which it

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[44] See Section 1234(b).

[45] See Treas. Reg. § 1.704-1(b)(3). The economics of many business deals is defined in terms of sharing of distributable cash. Modeling these complicated arrangements as profit and loss allocations is a difficult exercise. Liquidating in accordance with capital accounts in such cases imposes some economic uncertainty concerning whether the agreed business deal will be appropriately reflected in all possible circumstances. In such cases many taxpayers prefer to have economic certainty and forego the safe harbor of the 704(b) regulations. These taxpayers usually make profit and loss allocations in a manner consistent with the 704(b) regulations, but rely as a technical matter on these allocations being respected as in accordance with the partners' interests in the partnership.

is transferred or modified (a "trigger date"), the noncompensatory option meets the following conditions:[46]

1. The noncompensatory option (and any rights associated with it) provides the holder with rights that are "substantially similar" to the rights afforded to a partner and, if the noncompensatory option is "reasonably certain" to be exercised, this condition will be presumed satisfied;[47] and

2. As of the trigger date, there is a "strong likelihood" that the failure to treat the holder of the noncompensatory option as a partner would result in a "substantial reduction" in the present value of the partners' and the holder's aggregate tax liabilities.

We commend Treasury and the IRS for crafting a recharacterization rule that weighs not only the substantive rights of the noncompensatory option holder but the likely impact on the transaction as a whole of recharacterizing a noncompensatory option as a partnership interest. By requiring that there be a "strong likelihood" of a substantial reduction in tax revenues as a condition precedent to recasting a noncompensatory option as a partnership interest, the Proposed Regulations avoid applying the recharacterization rule in situations where the holder of the noncompensatory option and the historic partners each are subject to tax at substantially equivalent tax rates on the trigger date. Accordingly, we do not object to the first prong of the recharacterization rule, which applies a substantive analysis that apparently extends beyond what a traditional substance-over-form analysis would countenance. We believe that the requirement of significant tax avoidance potential overrides the otherwise legitimate concerns regarding the breadth of the substantive criteria. However, we would observe that the

[46] Prop. Reg. § 1.761-3(a).

[47] Prop. Reg. § 1.761-3(c)(1).

recharacterization rule does allow for the possibility that identical noncompensatory options in different entities, or even identical noncompensatory option in the same entity if owned by different parties, will constitute a partnership interest in some cases and a mere option to acquire a partnership interest in others.

In view of the targeted nature of the recharacterization rule, therefore, we recommend that final regulations clarify that general substance-over-form principles continue to apply to any noncompensatory option that represents, in substance, a current partnership interest.[48] For example, a penny warrant to acquire a valuable partnership interest, or an in-the-money warrant with respect to a partnership that holds short-term debt securities and that prohibits interim distributions, should not be immune from IRS challenge merely because it is unlikely that the aggregate tax liabilities of the participants would be reduced. If a noncompensatory option is, in substance, a current equity interest, the IRS should not be precluded from asserting substance-over-form merely because it has adopted a more targeted recharacterization rule.[49]

We also recommend that final regulations provide one or more examples involving a noncompensatory option that satisfies the "substance" prong of the recharacterization rule but does *not* satisfy the "strong likelihood" of tax avoidance prong. A possible source of authority is the "substantiality" regulations under Treasury Regulation § 1.704-1(b)(2)(iii). Under the substantiality regulations, allocations do not have substantial economic effect if (i) the allocations increase the after-tax economic

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[48] Mathew Lay, a principal drafter of the Proposed Regulations, has stated that they were not intended to alter existing law on the tax treatment of deep-in-the-money options. See Stratton, IRS Officials Discuss Partnership Option Guidance, reproduced at TNT Doc 2003-6191.

[49] See, e.g., Rev. Rul. 82-150, 1982-2 C.B. 110 (payment of $70,000X for an option to acquire stock with a value of $100,000X for a $30,000X exercise price treated as current purchase of shares).

consequences to at least one partner in present value terms relative to the consequences without the allocation; and (ii) a "strong likelihood" exists that the after-tax consequences to no other partner will be "substantially diminished" in present value terms. In determining after-tax consequences, the substantiality rule considers the relationship between the allocation and the tax position of the investors. Like the anti-abuse rule in the Proposed Regulations, therefore, the substantiality rule considers the relative tax brackets of the partners, the availability of net operating losses or other tax attributes and the tax-exempt status of one or more of the partners.[50]

(b) Cash-Settled Options. An option that "may or must" be settled in cash or property other than a partnership interest is included in the definition of a noncompensatory option under the anti-abuse rule. Specifically, the Proposed Regulations provide that an option "shall not fail to be treated as [a noncompensatory option] … merely because it may or must be settled in cash."[51] Although we agree that a cash settlement feature should not alone remove an option from noncompensatory option status, the final regulations should acknowledge that a cash settlement feature, in particular one that denies the holder the unilateral right to acquire the underlying partnership interest or any other rights associated with equity ownership, would not ordinarily be subject to recharacterization. The holder of such an option, whether exercised or not, will never hold a partnership interest.

(c) Relevance of Volatility. The Proposed Regulations list the volatility of a partnership interest that is the subject of an option as a factor in determining whether a

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[50] Treas. Reg. § 1.704-1(b)(5) (Examples 5 and 9).

[51] Prop. Reg. § 1.721-2(e)(1).

noncompensatory option to acquire that interest is reasonably certain to be exercised.[52] The Proposed Regulations include an example involving a real estate leasing partnership with stable expected cash flows that issues a slightly out-of-the-money noncompensatory option with a seven year term.[53] The partnership will not make any distributions while the option is outstanding. The example concludes that that the noncompensatory option is reasonably certain to be exercised, because the predictability of the cash flow, together with the fact that the partnership will not make distributions during the term of the option, ensures that the value of the noncompensatory option would ultimately exceed its strike price before it expires.

The point of this example seems to be to illustrate that low volatility will increase the likelihood of exercise when, taken together with the other facts and circumstances, it increases the probability that the value of the underlying partnership interest will exceed the strike price of the noncompensatory option. We note, however, that low volatility does not invariably suggest a reasonable certainty of exercise. For example, a noncompensatory option with respect to a partnership with stable cash flow is not necessarily reasonably certain to be exercised if the option is substantially out of the money on the date of grant or it permits interim distributions to partners. Indeed, high volatility would normally tend to increase the probability of exercise of a noncompensatory option, because it increases the chances the option will become in the money at some point, thereby making it economically advantageous for the holder to

[52] Prop. Reg. § 1.761-3(c)(2)(iv)

[53] Prop. Reg. § 1.761-3(d) (Example 2).

exercise.[54] Nevertheless, even high volatility should not, in and of itself, be a basis for recharacterizing an option as a current equity interest, particularly in cases where the holder is not readily able to disposed of the partnership interest. In fact, the holder of an option relating to a volatile partnership that cannot be readily sold has even less incentive to actually exercise it before maturity, since exercise would increase the holder's economic investment and thereby expose the holder to a risk of greater economic loss. It would be a strange rule indeed that would treat an option as a current equity interest when the value of the attribute that causes the result reflects the very fact that the holder will not bear an equity holder's risk until the option matures. We therefore recommend that the final regulations clarify the impact of volatility on the characterization of a noncompensatory option.

(d) Recharacterization Upon Transfer. Under the recharacterization rule of the Proposed Regulations, the status of a noncompensatory option as an option (as opposed to an actual partnership interest) for tax purposes must be retested upon a transfer of the noncompensatory option.[55] To our knowledge, this would be the first time that the tax law would seek to alter the tax character of a financial instrument after original issuance without any change in the terms of the instrument.[56] Although Sections 382, 1361 and

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[54] See J. Hull, *"Introduction to Futures and Options Markets,"* 189 Prentice Hall (1991).

[55] Prop. Reg. § 1.761-3(a), (c).

[56] The status of an obligation as debt, for example, is generally tested at the time of issue. See, e.g., Hutton v. United States, 501 F.2d 1055 (6th Cir. 1974) (rejecting the dividend treatment of retirement payment of T's notes sold by individual shareholders of T at a fraction of face value to the individual shareholders of P when P purchased T's stock; debt for federal income purposes when issued; notes retained their character upon transfer to P's shareholders). Similarly, no specific authority appears to exist for the proposition that an instrument issued as non-debt may become debt upon a subsequent transfer. See, e.g., Plumb, *"The Federal Income Tax Significance of Corporate Debt: a Critical Analysis and a Proposal"*, 26 Tax L. Rev. 369, 485 n.758 (1971). See also Treas. Reg. §1.1001-3 (treating a debt

1504 each provide for retesting of options upon a transfer, they do so for the limited purpose of determining whether the issuer or its owners may continue to enjoy a specific tax attribute (i.e., use of net operating losses, pass-through treatment and consolidation, respectively), rather than for the broader purpose of determining the tax character of the instrument itself for all purposes.[57]

We do not believe it is appropriate to automatically retest the status of a noncompensatory option as a partnership interest at the time of any transfer of the option. First, we believe that as a matter of general tax policy it is generally not appropriate to alter the characterization of an outstanding financial instrument absent a material modification of the instrument. Moreover, a rule requiring retesting upon transfer would impose a heavy burden on a partnership issuer to continually monitor changes in the identity of the holders of its options and reevaluate who its partners are for tax purposes so as to be able to properly allocate profit and loss among them. That burden would be imposed even if the partnership issued the noncompensatory option under non-abusive circumstances. In that connection, it should be noted that a noncompensatory option may be significantly in the money at the time of transfer due merely to the passage of time and normal appreciation in the value of the partnership's assets. We know of no precedent in any context for treating the transferee of an option as owning the underlying property solely by virtue of interim appreciation in the underlying asset. The tax avoidance effect requirement does help mitigate the effect of the recharacterization rule, but a partnership

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instrument as having been exchanged only upon a significant modification to its terms, not upon any mere transfer by the holder).

[57] Treas. Reg. §§ 1.382-4(d)(2)(i), 1.1361-1(l)(4), 1.1504-4(c)(1).

(to say nothing of the option holder) often will have significant uncertainties about the tax positions of its partners and, in any event, any tax avoidance effect may be unintentional.

Notwithstanding the foregoing, as suggested in the First Report, we share the government's concern that noncompensatory options might be transferred under circumstances where a tax avoidance effect could result. For example, a tax-exempt or foreign person might hold an option to acquire an interest in a partnership that conducts an active U.S. trade or business. Such a person could realize appreciation in the value of the business without ever having to pay U.S. income tax by selling the option. If that was the intent of the parties from the beginning, then the recharacterization rule, as applied to the issuance of the option, may appropriately have the effect of treating the option as an equity interest from the outset. In any event, we would encourage the IRS and Treasury to consider dealing with such tax avoidance concerns using targeted rules that would treat the gain from the sale of the option as unrelated business taxable income or effectively connected income, rather than dealing with such concerns with a more unwieldy recharacterization rule that may be difficult to apply in practice and may have a variety of unintended ancillary consequences.[58]

Finally, if the final regulations do not exempt transfers of noncompensatory options from retesting under the recharacterization rule, we recommend that they at least exempt transfers of noncompensatory options under specified circumstances where there should be no real potential for abuse. Possible candidates for exemption would include

[58] Compare the result in the FIRPTA area, where a foreign person holding an option issued by a partnership owning U.S. real property generally would be taxable on the sale of the option because it would be treated as a U.S. real property interest (without reliance on any recharacterization rule). Treas. Reg. § 1.897-1(d)(2)(ii)(B).

transfers of options with short remaining maturities, transfers upon death, transfers pursuant to a nonrecognition provision of the Code and transfers between parties who are subject to tax at substantially equivalent rates.[59] The Proposed Regulation should also clarify that only the transferred noncompensatory option is subject to retesting, and not all outstanding options.[60]

(e) Recharacterization Upon Modification. The Proposed Regulations also require a partnership to retest the status of a noncompensatory option after a modification.[61] We support retesting after a modification so long as the modification in question has real economic significance. We therefore recommend that the final regulations clarify that a modification of a noncompensatory option will not require a partnership to retest the noncompensatory option unless the modification would represent a material change to the option. The final regulations might also consider whether

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[59] For examples of such option safe harbors in other contexts, see Treas. Reg. §§1.382-4(d)(7) (Section 382 ownership change test), 1.1361-1(l) (S corporation one-class-of-stock requirement), and 1.1504-4 (affiliated group determination).

[60] We note that while the Proposed Regulation retest the characterization of a partnership option upon a transfer of the option, they do not rest the option upon a transfer of an interest in the partnership. In some cases this may frustrate the rule that generally prevents recharacterization of an option as a partnership interest unless there is a "strong likelihood" that the failure to so characterize would result in a "substantial reduction" in the present value of the partners' and the holder's aggregate tax liabilities. For example, suppose that a partnership that will invest in stocks and securities is formed between two individual taxpayers and a third individual is issued an option to acquire an interest in the partnership. Assuming the three individuals are similarly situated, the option generally would be respected as such. Nothing in the regulation would specifically require that the characterization be retested if, for example, the two individual partners transferred their partnership interests to a tax-exempt organization, unless (perhaps) the transfer was contemplated at the time of formation. We note that Treas. Reg. § 1.704-1(b)(2)(iii) generally tests for "substantiality" at the time an allocation becomes part of the partnership agreement and therefore suffers from a similar infirmity.

[61] Prop. Reg. §§ 1.761-3(a) and -3(c).

Section 1001 principles should be applied to cause such a change to be treated as a taxable event.[62]

(f) Tax Treatment of Status Changes from Noncompensatory Option to Partnership Interest. As described above, the recharacterization rule in the Proposed Regulations provides for the retesting of the tax status of a noncompensatory option upon its transfer, but we recommend that the final regulations not treat the mere transfer of a noncompensatory option as a retesting date. If the final regulations do not adopt this recommendation, we recommend that they confirm that the characterization determination is based on the facts relating to the transferee rather than the transferor. In addition, we recommend that the regulations clarify the treatment of the transfer and the change in characterization to the transferor, the transferee and the partnership. Our committee was split as to whether the option should (in effect) be treated as (1) transferred and then exercised in the hands of the transferee or (2) exercised in the hands in the transferor and then transferred. Factors favoring the first approach include: (i) it would be consistent with the original determination that the option should not be treated as a partnership interest in the hands of the transferor; (ii) it would be more consistent with the expectations of the transferor; and (iii) it is somewhat anomalous to treat the transferor as having exercised the option when the determination that the option should be treated as equity was based on facts related to the transferee rather than the transferor. The argument in favor of the second approach is that it would harmonize the tax

[62] For comments on this subject, see American Bar Association Comments in Response to Notice 2000-29 (January 28, 2002), 40-45, TNT Doc 2003-2099. See also Peaslee, *"Modifications of Nondebt Financial Instruments as Deemed Exchanges,"* 95 Tax Notes 737 (April 29, 2002); James S. Reily v. Comm'r, 53 T.C. 8 (1969) (period during which option may be exercised is "of the essence"); and Rev. Rul. 80-134, 1980-1 C.B. 187, *obsoleted by* Rev. Rul. 1986-9, 1986-1 C.B. 290 (gratuitous extension by writer of option not effective to defer recognition of premium).

treatment of the transfer of the option with the tax treatment of the transfer of an actual partnership interest and prevent certain option holders from escaping US tax, including by (i) potentially subjecting the transferor to tax under Section 512, 871 or 882 if the transferor were a tax-exempt organization or non-U.S. person and the partnership were engaged in business,[63] and (ii) allowing the transferee a Section 743 adjustment if the partnership has a Section 754 election in effect. We also recommend that the final regulations clarify that any recharacterization of a noncompensatory option resulting from a transfer or modification of the option be effective as of the applicable transfer or modification date, and not retroactive to the time of original issuance of the option.

Finally, we recommend that final regulations also clarify that a modification of a noncompensatory option that triggers a recharacterization under the recharacterization rule should be treated as a deemed exercise of the noncompensatory option immediately before the modification.

(g) Option Holder Also a Partner. In determining whether a holder of a noncompensatory option possesses "partner attributes," the Proposed Regulations disregard the rights that the holder possesses solely by virtue of owning a partnership interest and not by virtue of holding an option, provided that those rights are "no greater than rights granted to other partners owning similar interests in the partnership".[64] As drafted, therefore, this exception apparently would not apply if the option holder is the

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[63] See Section 512(c)(1); T.A.M. 9651001 (June 27, 1996) (applying Section 752 to determine portion of partnership debt allocable to tax-exempt partner); Rev. Rul. 91-32, 1991-1 C.B. 107 (sale of partnership interest by foreign partner generates effectively connected income where partnership engaged in U.S. trade or business).

[64] Prop. Reg. § 1.761-3(c)(3) (third sentence). It is unclear whether the qualification "for this purpose" limits the applicability of this sentence to the second sentence (control rights) or extends it to the entire paragraph (economic and control rights).

sole managing member or general partner of a partnership, which we believe is appropriate. However, even in other cases, the very flexibility of the partnership form to accommodate complex business arrangements will often deny partners the benefit of this exception, because there may not be any other partner with a sufficiently similar interest to provide a basis for the comparison of rights. Thus, the scope of this exception in its current form may be unduly limited in practice. One way to address that problem would be to provide that, in any case where the option holder does have rights in excess of those of other partners, the exception may still apply with respect to the regular rights and only the "excess" rights should be taken into account.

The final regulations should also clarify how this exception applies when the noncompensatory option is held by one person and the partnership interest is held by an affiliate. As drafted, a holder of a noncompensatory option that holds a partnership interest through an S corporation or other pass-through entity, or a corporate holder of a noncompensatory option that holds a partnership interest through a consolidated subsidiary, apparently would not be deemed to possess partner attributes by virtue of the holder's indirect ownership of a partnership interest. That result does not seem appropriate.[65]

Lastly, the final regulations should clarify how this exception applies to a holder of a preferred partnership interest that is convertible into a common partnership interest. Presently, it is unclear whether the equity rights of such a holder technically constitute

[65] We note that Prop. Treas. Reg. 1.761-3(c)(3) addresses some but not all of these concerns.

"rights in the partnership possessed by the option holder solely by virtue of owning a partnership interest and not by virtue of holding a noncompensatory option."[66]

(h) Convertible Debt and Convertible Equity Examples. The Proposed Regulations define noncompensatory options to include convertible debt and convertible preferred for purposes of the recharacterization rule.[67] If the recharacterization rule applies, it would apparently treat the entire instrument, and not just the conversion feature, as a partnership interest. It would be helpful if the final regulations included examples that illustrate how the rule would apply to such instruments. In particular, the final regulations should address the issue of whether, if convertible debt is recharacterized as a partnership interest, the interim accruals of interest on the debt become recharacterized on a retroactive basis as allocations of partnership income under Section 702 or as guaranteed payments.

4. Miscellaneous.

It may also be appropriate for the final regulations to discuss the issues under Sections 171 and 249 that were discussed in the First Report at III.A.1.b and III.A.3.b. In addition, it would be helpful if the final regulations discussed the impact of partnership mergers, divisions and technical terminations under Section 708 in cases where a noncompensatory option is outstanding. Finally, it would be helpful if the final regulations discussed the tax consequences that apply in the case of a taxable disposition

[66] Prop. Reg. § 1.761-3(c)(3), (b)(2).

[67] Prop. Reg. § 1.761-3(b)(2). Convertible debt that has very high probability of conversion could also be recharacterized as equity under the general debt-equity analysis rather than under substance-over-form principles. See Rev. Rul. 83-98, 1983-2 C.B. 40.

of a noncompensatory option, including the application of Section 1234 and whether it triggers the application of Section 751.

5. Effective Date.

As noted earlier, the Proposed Regulations would be effective for noncompensatory options issued on or after the date on which final regulations are published. Accordingly, the tax treatment of noncompensatory options issued prior to that date would remain uncertain. In order to reduce such uncertainty, we recommend that the final regulations include an election for taxpayers to apply the principles of the final regulations to noncompensatory options issued prior to that date, provided all the relevant parties have reported on a consistent basis. Any such election should require the consent of both the issuing partnership and the option holder.