The Triumph of Policy: The Proposed Partnership Options Regulations

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Kevin Thomason and John Maxfield examine the proposed partnership options regulations issued earlier this year and provide their perspective on what the regulations do and do not accomplish.

I'm back. Brought some backup this time. Smart guy. Good guy. John Maxfield of Holland & Hart.[1] Born in Wyoming, moved to Colorado, King Tut. Buried with a ...

Sorry—too much coffee. I'll let John into this rap in a minute. But first, a little solo crowing—and crow-eating.

I. Preamble: "That Was Really Good Flying, Right Up to the Part Where You Got Killed"[2]

In my prior article in this publication on this topic,[3] I waxed semi-eloquent on various issues related to the existence—or more precisely, the *non*-existence—of a taxable "capital shift" upon the exercise of an option to acquire an interest in a partnership (including LLCs taxed as partnerships). I keened that the attempts of various aggregate theorists to construct a recognized gain to the historic partners of a partnership upon the exercise of an option for a partnership interest in a partnership whose assets had appreciated while the option was outstanding exemplified both bad process and bad policy. *Bad process* because it approached the issue by first adopting the aggregate theory as the ascendant theory in all matters partnership, and then imposing that theory on every fact pattern that arises under subchapter K, an approach that is 180 degrees from that which I advocated, which was that the right result should first be divined by analyzing the applicable policy concerns and then adopting the appropriate partnership taxation theory, whether aggregate or entity (either of which appears, upon an

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analysis of the case law as done in Appendix A to the Comments of the Tax Section of the American Bar Association submitted on this topic,[4] to be readily available for such application as needed). *Bad policy* for the multitude of reasons set forth in that article,[5] the most compelling of which are that:

> [G]enerally, taxpayers are not taxed on realized gains when they have not actually terminated or liquidated their investments … [and] … generally, our system of taxation does not impose tax upon the admission of an owner to a business enterprise unless one of the prior owners becomes liquid in the process, and then only to the extent of such liquidity.[6]

Both the ABA Comments and the Comments of the New York State Bar Tax Section[7] decried the imposition of the aggregate theory on this fact pattern, the former explicitly and the latter by implication, but neither focused on the need for a policy support for that position, nor did either provide any such policy support. My rant about the importance of "why" began early,[8] has continued for years,[9] and reached its screeching zenith in the *Myth* and in my recent speech at the NYU program in San Diego.[10] I simply have never believed that the choice between the entity or aggregate theories (or some mutant variant of either of them) should be made on any basis other than the determination of which theory can best be grafted onto the correct result reached intuitively—that being, the result reached after answering the underlying policy question of, *"Is this an appropriate time, and is this an appropriate manner by which, to tax the historic partners of the partnership?"*

And the government apparently agrees. In the preamble to the Proposed Regulations recently issued by the Treasury and the IRS,[11] I think—I'm not sure, but I think—that the government states that ... well, read it for yourself:

> ... [M]ost commentators believe that §1.721-1(b)(1) should not cause the issuance of a partnership interest upon exercise of a noncompensatory option to be taxable. They assert that the exercise of such an option should be nontaxable to the holder and the partnership, both under general tax principles applicable to noncompensatory options and under the policy of section 721 to facilitate business combinations through the pooling of capital.
>
> Treasury and the IRS agree that, in general, the issuance of a partnership interest to the holder of a noncompensatory option should not be taxable to the holder or the partnership. Upon exercise, the option holder may be viewed as contributing property in the form of the premium, the exercise price, and the option privilege to the partnership in exchange for the partnership interest. Generally, this is a transaction to which section 721 should apply—a transaction through which persons join together in order to conduct a business or make investments. Accordingly, the proposed regulations generally provide that section 721 applies to the holder and the partnership upon the exercise of a noncompensatory option issued by the partnership.[12]

YeeeeeHaw! That sounds like a big one for the home team. I would have preferred a little tighter connection between the last sentence of the first quoted paragraph and the first and third ones of the second, but it looks like a great place to declare victory and head for the bar.

But I had to go too far. The previously cited quote from Top Gun finds me squarely in its "heads-up display"—*"That was really good flying, right up to the part where you got killed."* I quote me, in full flight:

> Anyway, I don't believe in capital shifts. They're myths.[13] ... I continue to be convinced that the capital shift at exercise that so captures the imagination of many tax theorists simply doesn't exist. It remains, in my mind at least, a powerful myth, but a myth nonetheless.[14]

I got lured.[15] Remember how Moe used to wind up, windmill-style, with his *right* and then *doink* Larry or Curly in a *left-handed eyepoke?!* Think of me as Curly. (Not so hard, is it?) While the aggregate theorists were attacking on all fronts[16] in an attempt to tax ephemeral capital shifts supposedly necessitated by the existence of *unrealized* gain in partnership assets as of the date of exercise (the windmill right), the "true" capital shift issue was the one arising when that gain or income had been either *recognized* prior to exercise and of necessity taxed to the historic partners or otherwise booked to the capital accounts of the historic partners (the *doink*). So, I was right—and I was dead wrong.

Luckily, although we ignored that issue in the ABA Comments, as did the New York State Bar Tax Section in the N.Y. Comments, Eric Solomon and his hardy band of intrepid Reg. Writers did not. As we will explain below, the Proposed Regulations deal with this capital shift in a pristine, although not question-free, fashion.

Now, for our feature presentation, let me invite onto the stage for what must be by now a duet to which he wishes he had never agreed—John Maxfield. Welcome, John.

II. The Proposed Regulations: A Review and Overview

On June 5, 2000, the Treasury and the IRS issued Notice 2000-29[17] inviting public comment on the income tax treatment of the exercise of an option to acquire a partnership interest, the exchange of convertible debt for a partnership interest and the exchange of a preferred interest in a partnership for a common interest in that partnership. Two major sets of comments, the ABA Comments and the N.Y. Comments, were forwarded to the Treasury and the IRS in late January 2002. On January 22, 2003, the Treasury and the IRS issued the Proposed Regulations.

Both the ABA Comments and the N.Y. Comments advocated, among other things, that (1) the issuance of a partnership option be given "open transaction" treatment, (2) such options generally be respected as such absent abusive situations, (3) there be no taxable gain or income recognized by the partnership or the historic partners upon the exercise of the options, (4) Code Sec. 1234[18] control the treatment of the lapse or repurchase of the options, and (5) rules be promulgated that would avoid, upon the occurrence of a "book-up" event (such as the entrance of a new partner while the option is outstanding), booking any unrealized gain to the capital accounts of the historic partners that is rightfully attributable to the outstanding option holder.[19]

The Proposed Regulations adopt most of these recommendations and further answer some of the questions left unanswered, and to some degree unasked, by the two sets of Comments. Specifically, the Proposed Regulations provide that:

- Noncompensatory options are those options, warrants, convertible debt and convertible preferred equity that are not issued in connection with the performance of services.
- Comments on compensatory options, specifically on the application of Code Sec. 83, in this context, and on how to coordinate the treatment of profits interests with that of compensatory options, are requested.
- These Proposed Regulations apply only to noncompensatory options for partnership interests.
- The issuance of noncompensatory options is taxed under general tax principles; thus, the issuance of a noncompensatory option is generally an open transaction to the issuing partnership and a mere investment by the optionee.
- If the optionee uses appreciated or depreciated property to acquire the option, he recognizes gain or loss at the time of such acquisition in accordance with the provisions of Code Sec. 1001.
- The conversion right embedded in convertible debt or convertible equity is taken into account as part of the underlying instrument.
- The exercise of a noncompensatory option does not cause recognition of gain or loss to either the issuing partnership or the option holder, with the optionee being deemed as contributing property in the form of the option premium, the exercise price and the option privilege to the partnership in exchange for the partnership interest.
- Comments are requested on the proper treatment of the exercise of convertible debt to the extent of accrued, but unpaid, interest, and the Proposed Regulations do not presently describe the tax consequences thereof.
- Code Sec. 721 does not apply to the lapse of a noncompensatory option, generally resulting in recognition of income by the partnership and loss by the former option holder.
- Certain modifications to the approved manner of maintaining partners' capital accounts are mandated, including precise provisions for revaluing partners' capital accounts while a noncompensatory option is outstanding in such a way as to take into account the fair market value, if any, of such outstanding option.
- Certain alterations in the computation of partners' distributive shares of partnership items are mandated, the most important of which have to do with the "true" capital shift described above, *i.e.*, the situation where economic gain or loss rightfully attributable to the optionee has been booked to the capital accounts of the historic partners and thus must be "shifted" to the exer-

cising optionee by way of gross income and deduction allocations similar in nature to Code Sec. 704(c) allocations, starting in the year of exercise and continuing thereafter as needed.

- Comments are requested regarding whether the nonrecognition rule described above should be extended to options, *etc.*, issued by an eligible entity, as defined in Reg. §301.7701-3(a),[20] that would become a partnership under Reg. §301.7701-3(f)(2) if the option were exercised.
- Although noncompensatory options generally are to be respected as such, in certain circumstances where the option provides the holder thereof with rights that are substantially similar to the rights afforded a partner, such holder will be treated as a partner and taken into account in allocating partnership income, but only when there is a strong likelihood that the failure to so treat such holder will result in a substantial reduction in the present value of the partners' and option holder's aggregate tax liabilities.
- The special rules for debt instruments convertible to stock set forth in Reg. §§1.1272-1(e), 1.1273-2(j) and 1.1275-4(a)(4) are extended to debt instruments convertible to partnership interests.

Written comments are requested by April 29, 2003, and we are both involved in an effort by members of various committees—primarily the Partnerships Committee of the Tax Section of the American Bar Association—to provide such comments. In addition, in recent discussions with representatives of the Treasury we were informed that the government's efforts are now turning to the preparation and issuance of guidance with respect to compensatory partnership options and that the Proposed Regulations will likely not be finalized until such guidance, most likely in the form of proposed regulations, is issued. Again, this same working group of the ABA Tax Section has organized and is meeting regularly to determine the advisability of making further comments on compensatory options[21] and, if so, the substance thereof.

III. Preliminary Matters: Preamble, Definitions, Policy and the Prelude to Guidance on Compensatory Partnership Options

A. Miscellaneous Issues Arising in the Preamble

1. Cash-Out Options. In the *Explanation of Provisions* section of the Proposed Regulations, several items bear special notice. First, it is made clear that these rules apply both when the asset to be obtained is a partnership interest and when such asset is cash or property having a value equal to the value of such interest. Thus, so-called "cash-out options," being options where the optionee is never intended to become a partner, but rather is to be paid a cash amount derived from the value of the partnership interest, however determined, as of the date of exercise, are covered by the Proposed Regulations.

2. Disregarded Entities. Next, note the carve-out from the "nonrecognition on exercise" regime for eligible entities, such as disregarded single-member LLCs, that would become partnerships upon the exercise of the option.[22] Inasmuch as the owners of such disregarded entities are treated as owning the assets of such entities directly, the option exercise does not occur wholly within subchapter K, but rather is one that transitions from a nonsubchapter K context to a subchapter K regime. (Note, however, that the recharacterization rules that may be invoked by the IRS to treat an option holder as a partner may also be used offensively by the IRS to create a partnership where the parties may have believed only a disregarded entity existed.)

3. Use of Appreciated/Depreciated Property to Purchase Option. In pronouncing open transaction treatment upon the issuance of a noncompensatory option, the foremost of the "Option Rulings," Rev. Rul. 78-172,[23] is cited. However, the discussion in the preamble clearly states that none of the available theories for nonrecognition—whether an extended application of Code Sec. 721 or the Option Rulings themselves—will rescue the optionee from Code Sec. 1001 gain or loss recognition treatment if appreciated or depreciated property is used to purchase a noncompensatory option.[24] In discussing this approach, the preamble also makes it clear that the Code Sec. 1001 rules remain circumscribed by all other generally applicable rules governing the allowance of losses, such as Code Sec. 707(b).

4. Misrepresentation and Dismissal of the Aggregate Theory. Interestingly, as the authors of the

Proposed Regulations set up the straw man of the aggregate theory/taxable capital shift approach in prelude to completely disregarding it, their summarization of that approach is so cursory as to be an inaccurate representation thereof.

5. Lapse and Repurchase of Options—No Guidance. Both the ABA Comments and the N.Y. Comments state, without equivocation, that Code Sec. 1234 should control the treatment of the lapse and repurchase of partnership options. Strangely, although the preamble and Proposed Reg. §1.721-2(c) clearly state that Code Sec. 721 does not apply to the lapse of a noncompensatory option, no affirmative statement regarding the application of Code Sec. 1234 (or addressing the multitude of tough questions regarding the necessity of overlaying some type of Code Sec. 751 treatment on Code Sec. 1234[25]) is made in the Proposed Regulations.

6. The Disappearing Option Privilege—Impact on Use of Code Sec. 704(c). Although later in this article we will delve more deeply into the workings of the Code Sec. 704(c)-like mechanism that the Proposed Regulations mandate upon the occurrence of a "true" capital shift, we wanted to note an interesting quirk that is highlighted in the preamble regarding the "nature" of the option.

The option issued in this context is clearly treated as a separate asset and the option issuance as a stand-alone investment transaction of the optionee, albeit an open transaction for purposes of determining the ultimate tax treatment of the option. A purchase of the option with an asset having a fair market value different from its basis will produce gain or loss under Code Sec. 1001. The option issuance transaction is specifically ruled to be outside the auspices of Code Sec. 721.

More interestingly, upon the exercise of the option, the "option privilege" is treated as part of the "property" being contributed in the Code Sec. 721 contribution transaction (although the fair market value of such privilege is expressly excluded from the computation of the fair market of the property contributed upon the exercise of the option[26]), and to the extent that there exists an inherent gain or loss in such option privilege upon exercise, the Code Sec. 704(c) regime is invoked. However, because the asset being contributed—that very option privilege—disappears upon exercise, the government, in order to fully use the Code Sec. 704(c) approach, was forced to make the conceptual leap that the built-in gain or loss in the other assets of the partnership would be those to which the Code Sec. 704(c)-like accounting adjustments would be made post-exercise.

> *The seeming simplicity of the definition of "noncompensatory option" obscures some important issues.*

B. Definitions—Issues Lurking Beneath the Surface

The seeming simplicity of the definition of "noncompensatory option" obscures some important issues. Proposed Reg. §1.761-3(b)(1) defines a noncompensatory option as "an option (as defined in paragraph (b)(2) of this section) issued by a partnership, other than an option issued in connection with the performance of services." So, first we must figure out what constitutes an "option." Proposed Reg. §1.761-3(b)(2) indicates that an option is "a call option or warrant to acquire an interest in the issuing partnership. ..." Moreover, such section provides that "convertible debt" and "convertible equity" are options for these purposes. Proposed Reg. §1.721-2(e)(2) states that "any indebtedness of a partnership that is convertible into an interest in the partnership" is convertible debt, and subparagraph (e)(3) of that same portion of the Proposed Regulations provides that convertible equity is "preferred equity ... that is convertible into common equity in that partnership." Preferred equity, just to round out the definitional merry-go-round, is deemed to be "any interest in the issuing partnership that entitles the partner to a preferential return on capital" and common equity is "any interest in the issuing partnership that is not preferred equity." As an interesting coda to this utilitarian set of definitions, as noted above, the Proposed Regulations provide that a contract that otherwise constitutes an option that may or must be settled in cash or property other than a partnership interest is still deemed to constitute an option for these purposes.

However, the weakness in the whole definitional structure may be the insistence that only two types of options exist—compensatory, the treatment of which is specifically not addressed by the Proposed Regulations, and all other options, which are defined as noncompensatory. The ABA Comments and other articles[27] note that a category that has been called "Rent Options," that being options granted *neither* for cash or other property *nor* in connection with services, but rather for the *use* of property, might require a third regime for taxation inasmuch as they bear a strong resemblance to compensatory options (being as they are given as a substitute for what would otherwise be consideration—rents and royalties—that would constitute ordinary income to the provider of the property and an ordinary deduction to the user of the property), but are not covered by Code Sec. 83. We believe that the government unnecessarily backs itself into a corner by so defining noncompensatory options and would be better served by defining noncompensatory options in a manner that does not foreclose a subsequent identification and analysis of Rent Options.

C. The Nod to Policy: The Importance of "Why"

As mentioned in Kevin's preamble to this article, the draftsmen and draftswomen of the Proposed Regulations come oh-so-close to citing policy considerations as at least one reason among equals for not imposing gain recognition treatment on the historic partners of a partnership upon the exercise of a noncompensatory option. Though the recommended nonrecognition treatment is clearly laid out in the preamble to the Proposed Regulations and is the undeniable result of Proposed Reg. §1.721-2(a)'s extension of Code Sec. 721 treatment to the exercise of noncompensatory options, we would sure like it if the government would just go ahead and say out loud that this underlying policy supports *and justifies* such treatment, both because it is so *and* because of the debate that is looming immediately ahead in the context of compensatory options, where Code Sec. 721 is arguably unavailable per the existing regulations thereunder.[28] The same policy rationale that supports nonrecognition in the noncompensatory partnership option context—that is, to use the government's language[29] *"to facilitate business combinations through the pooling of capital"*—supports similar treatment in the compensatory arena, and a statement of the efficacy of such policy to avoid recognition of gain to the historic partners upon exercise of a *noncompensatory* partnership option will make it easier for the government to reach a similar correct conclusion when it turns to publishing guidance for *compensatory* partnership options.

D. Questions and Foreshadowing Regarding Compensatory Options

Guidance on compensatory partnership options is coming—soon. The Proposed Regulations request input on that topic, and Treasury officials have told us that they're working on that guidance right now.

Specifically, the preamble to the Proposed Regulations asks for comments on the following matters that bear on, or which the Treasury deems to be related to, the treatment of compensatory partnership options:

- The application of Code Sec. 83 to the issuance of compensatory options and capital interests in connection with the performance of services
- The coordination of the tax treatment of partnership profits interests issued in connection with the performance of services[30] with the treatment of options to acquire partnership capital interests issued in connection with the performance of services
- The treatment of the exercise of convertible debt to the extent of accrued, but unpaid, interest (including original issue discount) on the debt, inasmuch as the preamble to the Proposed Regulations states that *"this issue is closely related to the tax treatment of the exercise of compensatory options"*[31]

It remains important to remember that many of the policy decisions that will ultimately drive the treatment of noncompensatory options will set the stage for the treatment of compensatory options—thus, our concern for issues like the *reason* for nonrecognition treatment on the exercise of noncompensatory options.

IV. The Search for Equilibrium: The Proposed Tax Treatment of Noncompensatory Options

The most effective way to illustrate the treatment of noncompensatory partnership options propounded by the Proposed Regulations is to go through the examples set forth therein. (These examples are included in Appendix A attached hereto and will not be set forth in full in the text hereof.) Step by step, such examples show the tax treatment, and the attendant tax accounting, mandated by the Proposed Regulations for the basic fact patterns that present themselves upon the issuance and exercise of noncompensatory options, convertible partnership debt and convertible partnership preferred equity.

First, however, let us show you the actual regulatory changes that have been proposed.[32]

A. The Proposed Amendments to the Regulations—A Summary

Attached to this article as Appendix A are excerpts of the Regulations under Code Secs. 704, 721, 761, 1272, 1273 and 1275, blacklined to show the proposed amendments thereto. Those proposed amendments can be summarized as follows:

1. Proposed Reg. §1.721-2 provides (1) for nonrecognition treatment upon the exercise of a noncompensatory option, (2) that such nonrecognition treatment does not apply upon the transfer of appreciated or depreciated property in exchange for the option, (3) that Code Sec. 721 nonrecognition treatment does not apply upon the lapse of a noncompensatory option, and (4) definitions of the key words and phrases used in this and other proposed regulations sections.

2. Proposed Reg. §1.704-1(b)(2)(iv)(*s*) provides for mandatory adjustments of capital accounts upon the exercise of a noncompensatory option, including adjustments for unrealized income, gain, deduction or loss attributable to the option holder and adjustments for "true" capital shifts with regard to income, gain, deduction or loss that has been booked to the historic partners prior to such exercise, but rightfully "belong" to the option holder.

3. Proposed Reg. §1.704-1(b)(2)(iv)(*d*)(*4*) provides rules for determining the fair market value of the property contributed on the exercise of a noncompensatory option (whether a stand-alone option or an option embedded in convertible debt or convertible equity of the partnership), a valuation that is necessary in order to make the adjustments required by Proposed Reg. §1.704-1(b)(2)(iv)(*s*). For a similar reason, Proposed Reg. §1.704-1(b)(2)(iv)(*f*)(*1*) and (*h*)(*2*) provides rules for determining the fair market value of the partnership's property.

4. Proposed Reg. §1.704-1(b)(4)(ix) provides that actual allocations of income must be made to match the adjustments for unrealized income, gain, deduction and loss that are the subject of the capital account adjustment rules of Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*2*), while Proposed Reg. §1.704-1(b)(4)(x) provides that actual allocations of income must be made to match the adjustments for previously booked income, gain, deduction and loss (those items that require a "true" capital shift), which are the subject of the capital account adjustment rules of Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*3*). Proposed Reg. §1.704-3(a)(6) specifically applies the principles of Code Sec. 704(c) to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues property under Proposed Reg. §1.704-1(b)(2)(iv)(*s*), *i.e.*, reverse Code Sec. 704(c) allocations.

5. Proposed Reg. §1.704-1(b)(5) has been amended by adding Examples 20 through 24.

6. Proposed Reg. §1.704-1(b)(1)(ii) has been amended to provide that the Proposed Regulations apply to noncompensatory options that are issued on or after the date final regulations ("the Final Regulations") are published in the Register.

Now, let's turn to the mechanics of how these valuation, adjustment and allocation provisions of the Proposed Regulations actually work.

B. Issuance

Proposed Reg. §1.721-2(f) sets forth the following example,[33] the first portion of which illustrates the basics of the issuance of an option for property having a basis different from its fair market value:

> *Example.* In Year 1, L and M form general partnership LM with cash contributions of $5,000 each, which are used to purchase land, Property D, for $10,000. In that same year, the partnership issues an option to N to buy a one-third interest in the partnership at any time before the end of Year 3. The exercise price of the option is $5,000, payable in either cash or property. N transfers Property E with a basis of $600 and a value of $1,000 to the partnership in exchange for the option. N provides no other consideration for the option. Assume that N's option is a noncompensatory option under paragraph (d) of this section and that N is not treated as a partner with respect to the option. Under paragraph (b) of this section, section 721(a) does not apply to N's transfer of Property E to LM in exchange for the option. In accordance with §1.1001-2, upon N's transfer of Property E to the partnership in exchange for the option, N recognizes $400 of gain. Under open transaction principles applicable to noncompensatory options, the partnership does not recognize any gain upon receipt of appreciated property in exchange for the option. The

> partnership has a basis of $1,000 in Property E. ...

The "paragraph (b)" referred in this passage is the following portion of Proposed Reg. §1.721-2:

> (b) ***Transfer of property in exchange for a noncompensatory option.***—Section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. For example, if a person purchases a noncompensatory option with appreciated property, the person recognizes income or gain to the extent that the fair market value of the noncompensatory option exceeds the person's basis in the surrendered property.

Note the Code Sec. 1001 gain treatment and the stand-alone treatment of the option purchase transaction, reinforcing the position that Code Sec. 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. Also, notice that the gain or loss is determined by comparing the basis of the surrendered property to the fair market value of the option, not the fair market value of the property. Although one would think that those values would, of economic necessity, be the same, the development of discount theories in the family limited partnership and other areas certainly supports the possibility that the fair market value of the option may be substantially less than the fair market value of the surrendered property.

Some would argue against this result on the theory that the tax treatment of the transfer of the appreciated property to the partnership in exchange for an option should be held "open" until it is known whether the option will be exercised or will lapse. Those in favor of open transaction treatment would argue that if the option is exercised, the in-kind property transferred as the option premium should be accorded tax-free exchange treatment under Code Sec. 721. According to this school of thought, gain or loss in connection with the transfer of such property to the partnership should be recognized by the holder only if the option lapses or is repurchased by the partnership.

Although this theory has technical merit, we agree with the approach taken in the Proposed Regulations that Code Sec. 721 does not apply (and thus, generally, gain or loss will be recognized) upon the transfer of appreciated or depreciated property to the partnership in payment of the option premium. The approach taken in the Proposed Regulations is a concession to the practical reality that in many, if not most, cases the partnership simply must know from the moment it receives the property whether it will have a carryover basis under Code Sec. 723 or a cost basis under Code Sec. 1012.

For example, suppose that in Year 1, the option purchaser transfers to the issuing partnership the following assets in payment of the premium to acquire a partnership option: (1) equipment with a fair market value of $10,000 and an adjusted tax basis of zero, (2) a building with a fair market value of $70,000 and an adjusted tax basis of $15,000, and (3) intellectual property with a fair market value of $20,000 and an adjusted tax basis of zero. Assume that the issuing partnership has five equal partners and that in exchange for payment of the option premium, the option holder will have the option to acquire a one-sixth interest in partnership profits, losses and capital for $1 million. Further assume that (1) at the end of Year 2 the partnership sells the equipment for $5,000, (2) at the end of Year 3, two of the original five partners sell their interests to a new partner, (3) at the end of Year 4 the partnership sells the building for $80,000 and sells the intellectual property for $50,000, and (4) at the end of Year 10, the option lapses unexercised. Because ultimately the option lapsed, Code Sec. 721 treatment was presumably never appropriate. We strongly believe that the failure to treat the conveyance of appreciated or depreciated property to the partnership in payment of the option premium as a taxable disposition of such property at the time the option is issued[34] will lead to only one certain result—a long trip to the psych ward for the tax accountant who is charged with sorting out the resulting mess.

C. Exercise

1. Use of Appreciated/Depreciated Property to Pay Exercise Price. The key distinction between the treatment of the optionee upon the issuance of the option and upon the exercise thereof is the applicability of Code Sec. 721, literally and in principle. Continuing the prior example:

> In Year 3, when the partnership property is valued at $16,000, N exercises the option, contributing Property F with a basis of $3,000 and a fair market value of $5,000 to the partnership. Under paragraph (a) of this section, neither the partnership nor N recognizes gain upon N's contribution of property to the partnership upon the exercise of the op-

> tion. Under section 723, the partnership has a basis of $3,000 in Property F ...

Here, the indicated controlling provision of the Proposed Regulations is Proposed Reg. §1.721-2(a), which reads as follows:

> (a) ***Exercise of a noncompensatory option.*** Notwithstanding §1.721-1(b)(1), section 721 applies to the exercise (as defined in paragraph (e)(4) of this section) of a noncompensatory option (as defined in paragraph (d) of this section) ...

Thus, the nonrecognition provisions of Code Sec. 721, while not available upon the issuance of the option, are fully effective to prevent recognition of gain or loss to the exercising option holder and the historic partners upon the exercise of a noncompensatory option where the optionee uses appreciated or depreciated property to pay his exercise price. There are no "open transaction" issues to delay the determinations of basis and holding period that theoretically could exist if the use of such property to purchase the option were deemed not to cause gain or loss recognition, and the tax accountant can sleep easily, knowing that carryover basis, tacked holding periods, Truth, Justice and the American Way are all intact and in place.

2. The Trigger Point: Lack of Economic Equilibrium at Exercise. It is extremely important to an understanding of the conceptual underpinnings of the Proposed Regulations to notice—and understand the importance of—the following mirror image preambles to the operative sections of the Proposed Regulations. Notice that the first sentence of the capital account adjustment provisions applicable in this context—Proposed Reg. §1.704-1(b)(2)(iv)(*s*)—is almost identical to the first sentence of the income allocation provisions of Proposed Reg. §1.704-1(b)(4)(ix):

> (*s*) ... A partnership agreement may grant a partner, on the exercise of a noncompensatory option ... a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid by the partner to acquire and exercise such option.

and

> (ix) ... A partnership agreement may grant to a partner that exercises a noncompensatory option a right to share in partnership capital that exceeds (or is less than) the sum of the amounts paid by the partner to acquire and exercise such option.

Guidance on compensatory partnership options is coming—soon. The Proposed Regulations request input on the topic, and Treasury officials have told us that they're working on that guidance right now.

In the former case, the Proposed Regulations require the book-up or book-down adjustments done upon the option exercise to take into account these disparities. In the latter case, the Proposed Regulations mandate that the ultimate income and deduction allocations mirror—by application of Code Sec. 704(c)-like principles—those adjustments and, where a "true" capital shift occurs, accelerate those allocations to correct such disparities. But the portal to both of these regulatory fixes is the reality that an option, although possibly granted in economic equilibrium (that is, where the sum of the premium and the exercise price would equal the exercising option holder's *pro rata* share of the liquidation value of the partnership's property post-exercise), undoubtedly will no longer be in such equilibrium upon exercise. That is the seminal fact that distinguishes option exercises from any other run-of-the-mill entry of a partner into a partnership. This phenomenon has been discussed in other articles we have written,[35] and we are not surprised at the prominent place such triggering fact has received in the Proposed Regulations.

3. The Base Case—Example 20: Lack of Equilibrium Due to Unrealized Gain in Partnership Assets. In Example 20 of the Proposed Regulations, in Year 1, (1) TM and PK[36] each contribute $10,000 to an LLC (so named) taxed as a partnership, (2) that $20,000 is used to purchase nondepreciable Property A, and (3) DH buys an option for $1,000 cash that gives her the right to buy in Year 2 an interest in LLC's capital and profits equal to that owned by each of the other two members for an exercise price of $15,000. A standard set of assumptions is made regarding the operating agreement of LLC.[37] In Year 2, when Property A has a fair market value of $35,000, DH exercises her option by paying LLC the exercise price of $15,000.

Proposed Reg. §1.704-1(b)(2)(iv)(d)(*4*) provides that DH's capital account will be credited, upon exercise, with the sum of the

$1,000 option premium and the $15,000 exercise price, or $16,000. However, it is apparent that, due to the terms of the option and the appreciation of Property A, at the time of DH's exercise there is a disequilibrium between her capital account and the amount of LLC's assets that DH would be entitled to receive upon liquidation, being one-third of $51,000, or $17,000. Inasmuch as DH would be entitled upon liquidation to $1,000 more of LLC's capital than her capital contributions to LLC, the capital account adjustment provisions of Proposed Reg. §1.704-1(b)(2)(iv)(*s*) apply. Here's how.

First, Proposed Reg. §§1.704-1(b)(2)(iv)(*s*)(*1*) and (*2*) require, using the standard revaluation rules of Reg. §1.704-1(b)(2)(iv)(*f*), that the capital accounts of DH, first, and then the historic partners be increased by the unrealized gain sitting in Property A.[38] The first $1,000 of the $15,000 of net unrealized gain is allocated to DH, with the remainder being allocated equally to the other two members, $7,000 apiece. Proposed Reg. §1.704-3(a)(6) requires that tax items for the revalued property, here Property A, must be allocated in accordance with Code Sec. 704(c) principles. Because there was sufficient unrealized gain to bring DH's capital account into equilibrium, no further capital account adjustments—specifically, no adjustments under Proposed Reg, §1.704-1(b)(2)(iv)(*s*)(*3*)—are needed, and no special allocations of income, gain, deduction or loss, other than the standard Code Sec. 704(c) allocations, are required under Proposed Reg. §1.704-1(b)(4)(x).

4. A "True" Capital Shift—Example 21: Lack of Equilibrium Due to Gain Booked Prior to Exercise. Using the same introductory facts and Standard Assumptions as are contained in Example 20, the alternative facts set forth in Example 21 illustrate a lack of equilibrium between the option holder's post-exercise initial capital account and her prospective share of LLC's assets upon liquidation which is caused by the recognition of gain in the LLC's asset—gain that is attributable in a true economic sense to the optionee—in a tax year prior to her exercise of her noncompensatory option. These alternative facts are that Property A is sold in Year 1 for $40,000, with the $20,000 gain being recognized upon such sale and allocated $10,000 apiece to the two original LLC members, thus increasing their respective capital account balances to $20,000 apiece. LLC then uses the $40,000 of proceeds from the sale of Property A to purchase nondepreciable Property B. At the beginning of Year 2, at a time when Property B has appreciated in value to $41,000, DH exercises her option, paying $15,000 to LLC upon exercise. This example also assumes that during Year 2, LLC has gross income of $3,000 and deductions of $1,500.

Again, DH's initial capital account balance is $16,000. Again, the asset revaluation rules of Proposed Reg. §1.704-1(b)(2)(iv)(*f*)(*1*), as seen through the portal of Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*1*), must be invoked. With the aggregate value of LLC's assets being $57,000 ($41,000 of Property B + $1,000 of option premium + $15,000 of exercise price) and DH's one-third share thereof being $19,000, the principles of Proposed Reg. §1.704-1(b)(2)(iv)(*s*) mandate a $3,000 increase in the capital account of DH. However, the adjustment made under Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*2*), that being the allocation to DH of the $1,000 of unrealized gain residing in Property B, is insufficient to bring DH's capital account into equilibrium. The shortfall is due to the recognition and reporting by the historic members of LLC in Year 1 a portion of the gain that was economically "owned" by DH while her option was still outstanding. The Proposed Regulations mandate that equilibrium be attained by forcing a "true" capital shift under the provisions of Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*3*), such shift literally being done by reducing the capital accounts of the two other members of LLC by $1,000 apiece and increasing the capital account of DH by that aggregate $2,000. But that's not the end of the story.

No longer will LLC simply wait, under the auspices of Proposed Reg. §1.704-3(a)(6), to apply normal Code Sec. 704(c) principles, deferring the allocation of gain to DH until the sale of Property B (or if Property B were depreciable, reallocating depreciation therefrom so as to eliminate the book/tax disparity with regard to such property). Nay, nay, Tax Breath. Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*4*) clearly states that LLC's capital accounts will not, from the get-go, be treated as being maintained in accordance with the requisite capital account maintenance rules of Reg. §1.704-1(b)(2)(iv) unless its LLC agreement requires that corrective allocations be made in accordance with Proposed Reg. §1.704-1(b)(4)(x). That provision mandates that where the Proposed Regulations have required a capital account reallocation—a "true" capital shift—in order to produce capital account equilibrium for the exercising option holder, the LLC must, beginning with the tax year of the exercise and in all succeeding tax years until the allocations required are fully taken into account, make "corrective allocations" so to take into account such capital account reallocation. "For these purposes, a 'corrective allocation' is an allocation (consisting of a pro rata portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item."[39] So how does that work in this example?

Here, the LLC needs to allocate, using the "corrective" method mandated by the Proposed Regulations, $2,000 of gross gain and income items, starting in Year 2 and continuing thereafter as needed, from the other members to DH in order to comply with this forced allocation rule. DH normally would be allocated $1,000 (1/3 of $3,000) of gross income for Year 2, with the remaining $2,000 being allocated to the other two members of LLC. The forced allocation of that $2,000 of gross income to DH satisfies the forced allocation provisions of Proposed Reg. §1.704-1(b)(4)(x). Meanwhile, the $1,500 of deductions will be allocated equally among the three members, including DH, for Year 2.

Some questions that we have regarding the forced allocation regime are these: The language of Proposed Reg. §1.704-1(b)(4)(x) quoted above speaks in terms of allocating "gross income and gain, or gross loss and deduction." Why must it be one or the other? Couldn't the forced allocation just as easily be accomplished with a *combination* of gross income and deduction allocations? And must the forced allocation be limited only to the use of a "corrective" method?

The application of this new "corrective method" is akin to Code Sec. 704(c)'s curative method[40] … on steroids. The curative method under Code Sec. 704(c) limits the allocations that are used to reduce book/tax differences to those types of income and deductions that are expected to have substantially the same effect on each partner's tax liability as the tax item limited by the ceiling rule.[41] In contrast, the corrective method mandated by the Proposed Regulations apparently makes no such distinction in the allocations used to bring the optionee into equilibrium, thus ignoring the capital gain versus ordinary income/capital loss versus ordinary loss distinctions that the existing Code Sec. 704(c) regulations rightly recognize.

The preamble to the Proposed Regulations notes that some commentators have suggested that the historic partners and noncompensatory option holders should be allocated notional tax items over the recovery period for partnership assets similar to the remedial allocations that are permitted under the regulations pursuant to Reg. §1.704(c)(1)(A).[42] However, the preamble concludes that, although such method would over time eliminate the book/tax differences created by the capital account adjustment regime of Proposed Reg. §1.704-1(b)(iv)(*s*), such a system would be unduly complex. We agree that such a notional (remedial) system would likely be complex. Moreover, from a tax policy standpoint it is difficult to argue with the application of the corrective method under the facts of Example 21 because in that example the $2,000 that was shifted from the capital accounts of PK and TM were amounts of gain that had actually been *recognized* and reported as taxable gain on the tax returns of PK and TM—a "true" capital shift. Moreover, such previously recognized gain was economically attributable to the option holder, DH. Hence, it seems difficult to quarrel with the corrective method to eliminate the book/tax disparity in DH's capital account, especially because after the true capital shifts and their attendant income allocations, PK and TM are left with book capital account balances that are $1,000 less than their respective tax capital account balances.

However, in Example 21, the capital accounts of PK and TM had to be reduced by the capital shifting allocations in a circumstance where the capital accounts of such historic partners did not have, at the moment of DH's exercise, book/tax differences—read that, unrealized gain—in amounts at least equal to the capital shifted away from them to DH. That phenomenon occurred due to the prior recognition of the gain on the sale of Property A. If, however, that shortfall existed due to a decline in that property's value subsequent to a prior book-up, then DH might be subject to the forced allocation provisions even though the historic partners have not actually recognized any gain that would justify such forced allocations.

For example, such a situation would exist under the facts of Example 21 if the facts were changed slightly to assume that Property A had not been sold, but that instead, pursuant to a permissible book-up event as specified in Reg. §1.704-1(b)(2)(iv)(*f*), due to an increase to $40,000 of the fair market value of Property A the capital accounts of PK and TM had been properly booked-up to $20,000 apiece. Then, further assume that Property A had subsequently declined in value so that the option was still

$3,000 in the money, and then DH exercised her option. In such a case, the same capital account adjustments set forth in Example 21 would be employed. However, in that case, PK and TM would be allowed to use the normal Code Sec. 704(c) principles with respect to their book/tax differences, whereas DH would be required to use the much more aggressive corrective forced allocation method. Although it is admittedly complicated, it would seem that a less aggressive method, perhaps one that is similar to the remedial method under the Code Sec. 704(c) regulations, might be appropriate in order to avoid a harsh result for DH, at least on an elective basis. Moreover, the draftspersons of the Proposed Regulations might consider making such alternative method mandatory in certain potentially abusive situations, such as where PK and TM are high marginal rate taxpayers and DH is a tax-indifferent party.

5. Convertible Preferred Partnership Interests—Example 23: More Disequilibrium Due to Unrealized Gain in Partnership Assets. The facts of Example 23 are as follows: Again, two members form LLC on the first day of Year 1, each making a $10,000 cash capital contribution for 100 units of common interest in LLC. Simultaneously, SR contributes $10,000 cash for a convertible preferred interest (CPI) in LLC, such CPI entitling SR to (1) an annual allocation and distribution of cumulative net profits of LLC equal to 10 percent of SR's unreturned capital, and (2) convert, in Year 3, such CPI into 100 units of common interest in LLC. The Standard Assumptions are in place, except that here the assumption is that SR's right to convert the CPI into a common interest qualifies as a noncompensatory option under the Proposed Regulations and that prior to the exercise of such conversion right, SR is not treated as a partner with respect to such conversion right.[43]

LLC uses the $30,000 obtained upon formation to purchase Property Z, which is depreciable on a straight-line basis over 15 years. In each of Years 1 and 2, LLC has net income of $2,500, comprised of $4,500 of gross receipts and $2,000 of depreciation. It allocates and distributes $1,000 of this net income to SR in each such year. Further, LLC allocates, but does not distribute, the remaining $1,500 of net income equally to the other two partners[44] in each of these two years.

Thus, by the beginning of Year 3, SR's capital account is still at $10,000, having been allocated and distributed $1,000 a year in Years 1 and 2, and the balances of the other two members' capital accounts are $11,500 apiece, having been allocated an aggregate of $1,500 apiece for Years 1 and 2, but having received no distributions. At the beginning of Year 3, when Property Z has a value of $38,000 and a basis of $26,000 and LLC has accumulated cash of $7,000 ($4,500 per year less $1,000 per year of preferred return on SR's capital), SR converts the CPI to the 100 units of common interest to which SR is entitled.

The analysis of the adjustments to be made upon the conversion of SR's CPI is really no different than that set forth in our discussion of Example 20. First, Proposed Reg. §1.704-1(b)(2)(iv)(*d*)(*4*) provides that "[w]ith respect to convertible equity, the fair market value of the property contributed to the partnership on the exercise of the option includes the converting partner's capital account immediately before the conversion." Proposed Reg. §1.721-2(e)(5) provides that the exercise price is "in the case of convertible equity, the converting partner's capital account with respect to that convertible equity, increased by the fair market value of cash or other property contributed to the partnership in connection with the conversion." Thus, SR's beginning capital account, upon conversion of the CPI owned by SR, is $10,000, which was SR's capital account in the CPI owned by SR as of the beginning of Year 3. The same revaluation of Property Z is done under the same sections of the regulations and Proposed Regulations, and because there is sufficient unrealized appreciation in Property Z to bring SR's capital account (which has a balance of $10,000, but needs to have a balance equal to its liquidation value of $15,000) into equilibrium, only the fairly benign capital account adjustment provisions of Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*2*), and not the more impactful capital account adjustment provisions of Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*3*) and its evil twin, the forced capital account adjustment provisions of Proposed Reg. §1.704-1(b)(4)(x), are activated. SR's capital account is booked up to $15,000, as are the capital accounts of the historic common interest owners, and the normal timing and application of the Code Sec. 704(c)-like principles are allowed to operate.[45]

6. Convertible Partnership Indebtedness—Example 24: More Disequilibrium Due to Unrealized Gain in Partnership Assets. The facts of Example 24 are as follows: Again, two members form LLC on the first day of Year 1, each making a $10,000 cash capital contribution for 100 units in LLC.

Simultaneously, JS loans $10,000 cash to LLC under the terms of a convertible debt instrument (CDI), such CDI entitling JS to (1) an annual interest payment of $1,000, (2) repayment of the principal of such debt in five years, and (3) convert, at any time during such five years, such CDI into 100 units in LLC. The Standard Assumptions are in place, except that here the assumption is that JS's right to convert the CDI into a common interest qualifies as a noncompensatory option under the Proposed Regulations and that, prior to the exercise of such conversion right, JS is not treated as a partner with respect to the convertible debt.

LLC uses the $30,000 obtained upon formation to purchase Property D, which is depreciable on a straight-line basis over 15 years. In each of Years 1, 2 and 3, LLC has net income of $2,000, comprised of $5,000 of gross receipts, $2,000 of depreciation, and interest expense on the CDI owned by JS of $1,000. It allocates, but does not distribute, this $2,000 of annual net income to the two members of the LLC in each of these three years.

Thus, by the beginning of Year 4, the balances of the two members' capital accounts are $13,000 apiece, having been allocated $1,000 apiece in each of Years 1, 2 and 3, but having received no distributions. At the beginning of Year 4, when Property D has a value of $33,000 and a basis of $24,000 and LLC has accumulated cash of $12,000 ($15,000 of gross receipts less $1,000 per year of interest on JS's loan), JS converts the CDI to the 100 units of common interest to which she is entitled.

The analysis of the adjustments to be made upon the conversion of JS's CDI is again basically the same as that set forth in our discussion of Example 20. First, Proposed Reg. §1.704-1(b)(2)(iv)(d)(4) provides that *"[w]ith respect to convertible debt, the fair market value of the property contributed to the partnership on the exercise of the option includes the adjusted basis and the accrued but unpaid qualified stated interest on the debt immediately before the conversion."* Proposed Reg. §1.721-2(e)(5) provides that the exercise price is *"in the case of convertible debt, the adjusted issue price (within the meaning of §1.1275-1(b)) of the debt converted, increased by accrued but unpaid qualified stated interest and by the fair market value of cash or other property contributed to the partnership in connection with the conversion."* Thus, the beginning capital account balance of JS, upon conversion of the CDI owned by her, is $10,000, which was her adjusted basis in the CDI she owned as of the beginning of Year 4. The same revaluation of Property D is done under the same sections of the Regulations and Proposed Regulations, and because there is sufficient unrealized appreciation in Property D to bring JS's capital account (which has a balance of $10,000, but needs to have a balance equal to its liquidation value of $15,000) into equilibrium, only the fairly benign capital account adjustment provisions of Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*2*), and not the more impactful capital account adjustment provisions of Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*3*) and the forced allocation provisions of Proposed Reg. §1.704-1(b)(4)(x), are activated. JS's capital account is booked up to $15,000, as are the capital accounts of the historic members, and the normal timing and application of Code Sec. 704(c)-like principles are allowed to operate.[46]

The most complex set of mechanics found in the Proposed Regulations applies when a capital account adjustment event, such as the entry of a new partner, occurs while a noncompensatory option is outstanding.

Notice that the original issue discount (OID) rules have been fully incorporated into the treatment of debt convertible into partnership equity. Proposed Reg. §1.1272-1 extends the OID inclusion rules of Code Sec. 1272 to debt instruments issued by partnerships. Similarly, Proposed Reg. §§1.1273-2(j) and 1.1275-4(a)(4) propose to make the rules regarding the determination of issue price and issue date for corporate debt, along with those regarding contingent payment debt issued by corporations, fully applicable to debt issued by partnerships.

Finally, the Proposed Regulations do not describe the tax consequences (to the partnership or the holder) of a right to convert partnership debt into an interest in the issuing partnership to the extent of any accrued but unpaid interest on the debt (including accrued original issue discount). Inasmuch as the Treasury and the IRS perceive this issue to be closely related to the tax treatment of the exercise of compensatory options, they have decided to consider this issue in the course of preparing guidance on compensatory options, requesting comments on such issue in the preamble to the Proposed Regulations.[47]

D. Book-Ups While a Noncompensatory Option Is Outstanding—Example 22

The most complex set of mechanics found in the Proposed Regulations applies when a capital account adjustment event, such as the entry of a new partner, occurs while a noncompensatory option is outstanding. As discussed in the ABA Comments, the N.Y. Comments and several articles,[48] the temptation under the existing regulations was to book to the capital accounts of the historic partners (and even the entering partner) unrealized appreciation rightly attributable to the economic interest of the option holder. Because prior to exercise, there is no real accounting mechanism for booking that appreciation to any kind of account referable to the option holder, one is faced with the knee-jerk response that (1) if you revalue the partnership's assets, the balance sheet must increase to the full fair market value of such assets, and (2) therefore, because assets must equal liabilities plus capital, an equivalent amount must be booked into the only capital accounts available, those being the capital accounts of the existing partners.

However, to do so completely ignores the economic realities of the bundle of rights owned by the optionee. Moreover, if such a book-up regime is followed, then upon the exercise of the option the amounts that were erroneously booked to the capital accounts of the historic partners must then be "shifted" to the exercising option holder's capital account, looking for all the world like a "capital shift" that must somehow result in a taxable event or a corrective allocation.

In the *Myth*, proper credit was given to the dynamic duo of one of your authors, Mr. Maxfield, and his intrepid colleague, Adam Cohen, for suggesting that we need not be slaves to the left-hand side of the balance sheet while seeking to do justice to the right-hand side thereof.[49] (Kevin here—I've just got to quote my *paean* to Batman and Robin, even though John doesn't want me to):

> The answer—a truly outside-the-box approach for an earth-bound misfit like myself—was provided by John Maxfield and Adam Cohen of the Holland & Hart firm in Denver. They suggested that we simply not book up the asset side of the balance sheet by any more than the aggregate amounts rightly allocable to the existing partners' capital accounts. ... My initial response to this approach was, I must admit, somewhere between negative and disrespectful. But with further thought and the gentle coaching of Messrs. Maxfield and Cohen, I came to appreciate the beauty and simplicity of this approach, and I hope that the Treasury will adopt it in its forthcoming guidance.

It did. As we work our way through Example 22, notice that the practical impact of the reductions in the value of the partnership's property mandated by Proposed Reg. §1.704-1(b)(2)(iv)(*f*)(*1*) and (*h*)(*2*) is nothing less than the adoption of the approach to this issue which was dreamed up by the aforementioned Coloradoans and adopted in the ABA Comments.

1. Example 22: The "Simple" Mechanics of the Book-Up. The facts of Example 22 are as follows: Again, in Year 1, two members form LLC with capital contributions of $10,000 apiece, obtaining 100 units apiece in LLC, which uses those funds to purchase nondepreciable Properties A and B for $10,000 apiece. In the same year, DR purchases, for a cash option premium of $1,000, an option to purchase 100 identical LLC units for an exercise price of $15,000 in Year 2. All of the Standard Assumptions are applicable in this example.

Prior to DR's exercise of his option, ML contributes $17,000 to LLC for 100 identical units in LLC at a time when Property A has a value of $30,000, Property B has a value of $5,000, and the fair market value of DR's option is $2,000. Now the fun begins—let's do the book-up!

The butler did it. We know, you hate it when we tell you how the mystery comes out before you slog through the whole whodunit. Sorry—we're just trying to help. Here's the thing—in doing the revaluation of partnership property, all the machinations take you to one simple result—the option is treated as if it doesn't exist. It's gone, it's outta here, it's *hasta la bye bye*. You get rid of the premium and you carve out the appreciation (or add back the depreciation) that would inure to the benefit (or burden the value) of the option, and you do the book-up with what's left. Here's how you technically do it, according to the Proposed Regulations:

- First, using the principles of Reg. §1.704-1(b)(2)(iv)(*f*), as they are proposed to be amended by the Proposed Regulations, you revalue the partnership's property. Starting with the "gross" fair market value of the LLC's property (here $36,000: $30,000 in Property A, $5,000 in Property B and the $1,000 option premium), this provision of the

Proposed Regulations would have you subtract from the value of the LLC's property the amount of the option premium. That reduction in value—a vaporization of the premium, if you will—goes directly to the $1,000 of cash, although the Proposed Regulations don't say so anywhere and are actually pretty confusing when it tries to take us through the computation. The Proposed Regulations also do not tell us what asset should be reduced if the partnership no longer has $1,000 of cash at the time of the revaluation.

- Next, Proposed Reg. §1.704-1(b)(2)(iv)(*h*)(*2*) tells you to do a computation that subtracts the consideration paid for the option, here $1,000, from the fair market value of the option. Mind you, the Proposed Regulations nowhere tell you how to compute the fair market value of the option.
- If the amount obtained above is a positive number, then the value of the LLC's property is reduced by that amount. And vice versa. If that amount is a positive number, that indicates the existence of unrealized appreciation in the LLC's assets that is economically "owned" by the optionee, and the reduction in the value of the LLC's assets that is necessary in order to reach invisibility for the option as a whole is to be allocated to those assets that have unrealized appreciation, here only Property A. And *vice versa*. (Wait'll you see how slick this computation works—it'll give you goose bumps!)
- Thus, the LLC's gross assets of $36,000 are reduced by $1,000 two different times (once to eliminate the premium and once to eliminate the appreciation attributable to the option), for these purposes, down to $34,000. The basis of the noncash[50] assets of the LLC is $20,000. Thus, there is $14,000 of unrealized appreciation in the noncash assets of LLC to be allocated equally to the capital accounts of the original two members, bringing each of their capital account balances up to $17,000—amazingly, the same as was paid by ML upon his admission.
- How did that happen? Well, it's a function of the fact that the Proposed Regulations apparently backed into the fair market value of the option—stated in the example to be $2,000—by simply subtracting the $15,000 exercise price from the amount a supposedly arm's-length purchaser of a partnership interest identical to that which the optionee would obtain upon exercise—that is, $17,000. So, you can see that if the fair market value of the option is *not* derived from the liquidation value of the partnership interest that would be obtained upon exercise of the option, then the math might not work so neatly. In such a case, we would be forced to return to the debate over whether the entering partner, here ML, may participate in a book-up triggered by his entry into the LLC. Some seem to think that Examples 14 and 18 of Reg. §1.704-1(b)(5) stand for the proposition that such an entering partner may not so participate, but we disagree, and have so in previous articles.[51] For example:

> I believe the only reason that the entering partner in the Examples did not participate in the book-ups illustrated therein is that such entering partner, as the facts are constructed, is always entering by making a fair market value contribution. That being the case, mathematically no book-up can apply to him, and rightly so inasmuch as the amount being contributed by such entering partner is the best evidence of what the value of the partnership's assets is at that time. ... Not so in the option exercise context. By the time an option is exercised, there is no particular linkage between the aggregate amount (premium and exercise price) that the exercising option holder/new partner will have paid for his partnership interest and the value of the partnership's assets at the exact moment of exercise. Though this is fodder for another article, I cannot imagine why an exercising option holder shouldn't participate in a book-up that occurs upon his exercise.[52]

The same rationale would support allowing ML to participate in the book-up occasioned by his entry into the LLC if, for some reason, the math doesn't work out quite as neatly as it has thus far in this example.

2. The "Ought" and "Is" of Book-Ups: Practice vs. Theory. The practical method long used by practitioners and partnerships for adjusting (aka "booking-up" or "booking-down") capital accounts upon the admission of a new partner[53] has long departed from what the words of the regulations seem to actually require. This divergence, the reason why it now matters, and some suggestions for clarifying the matter are set forth below.

a. What the Regulations Say. In relevant part, the regulations have long required that upon the admission of a new partner (or other adjustment event) the book capital accounts of the partners should be adjusted to reflect a revaluation of the partnership's property and that such revaluation must be "based on the fair market value of partnership property ... on the date of adjustment."[54]

b. What Happens in Practice. In practice, when a new partner is admitted to the partnership in exchange solely for a capital contribution of cash or other property, the revaluation of the partners' capital accounts under Reg. §1.704-1(b)(2)(iv)(*f*) seldom results in adjusting the partnership assets to an amount equal to their respective fair market values. Rather, the book-up or book-down, as the case may be, is generally reverse-engineered from the starting point of the capital contribution of the new partner. The effect of this approach is that the adjusted capital accounts of the partners are actually derived, not from the fair market value of the partnership's net assets, but from the fair market value of the new partner's partnership interest, *i.e.*, the amount that the partner and the partnership agreed would be the new partner's purchase price for such interest in a willing-buyer/willing-seller transaction.

This approach does not generally result in adjusting the partners' capital accounts to an amount derived from the fair market value of the partnership's assets,[55] because a partner who purchases a partnership interest from the issuing partnership presumably discounts the amount he is willing to pay for his partnership interest by an amount equal to applicable marketability, minority and other appropriate discounts that are applicable to such interest. Consequently, a book-up or book-down that is calculated by working backwards from the amount contributed to the partnership by the new partner in exchange for his interest generally is going to result in a valuation that is lower than a simple *pro rata* extrapolation from the fair market value of the partnership's assets on a liquidation basis.

For example, if equal partners A and B admit new partner C as an equal one-third partner in their partnership in exchange for \$100x, then as long as the capital accounts of A, B and C are all equal to \$100x immediately upon C's admission, the capital accounts reflect their economic arrangement, *i.e.*, that they are equal partners. Suppose that the net fair market value of the partnership's assets immediately before C's admission were \$350x (and thus immediately after C's contribution of \$100x, the net value of the partnership assets attributable to C's interest is \$150x (\$450x / 3)). Suppose further that the reason the partnership and C agreed to a purchase price of \$100x for C's one-third interest is because both parties recognized and took into account the fact that such partnership interest was devalued by transfer, control and liquidation restrictions contained in the partnership agreement and that these restrictions caused the fair market value of C's newly acquired interest to be worth only \$100x even though the liquidation value of the partnership's net assets attributable to C's interest was \$150x.

c. Why Does It Matter? As a practical matter, there is nothing wrong with reverse-engineering the amount of each partner's booked-up capital account based on the capital contribution of the new partner as long as the capital accounts of all partners are in sync with their economic deal. Such is the case if the capital accounts of A, B and C are adjusted to \$100x in the preceding example. However, potential problems can arise if the regulations and Proposed Regulations are not clarified to both (1) recognize that the fair market value of partnership assets that correspond to a partnership interest ordinarily will not equal the fair market value of such partnership interest; and (2) expressly provide that capital account book-ups and book-downs occasioned by the admission of a new partner may properly be determined with reference to the fair market value of the newly issued partnership interest.

Specifically, if the regulations mandate that upon the admission of a new partner (or other revaluation event) the partnership assets must be adjusted to an amount equal to their respective fair market values—in which case, the aggregate capital accounts must be adjusted to an amount that sums to the total net fair market value of the partnership's assets on a liquidation basis—then, in the preceding example, C would seemingly be required to have an opening capital account balance of \$150x, even though he only contributed \$100x in exchange for his one-third partnership interest. Moreover, in order to arrive at this adjustment, the partnership would be forced to make a determination (perhaps by way of costly appraisal) of such fair market values. In contrast, the reverse-engineered capital accounts of $100x for each of A, B and C does not require the partnership to obtain an appraisal and does not result in the counter-intuitive booking of C's capital account to an amount that is substantially higher than the amount he contributed in exchange for such account.

Further, adjusting the capital accounts based on the fair market value of the partnership's assets leads to confusion in the worlds of both compensatory transfers, under Code Sec. 83, and donative transfers. In the preceding example, if immediately after C's admission to the partnership, A transferred her one-third partnership interest worth $100x to E in exchange for services rendered by E to A, then E should have compensation income equal to $100x, not the $150x liquidation value of the partnership's net assets attributable to such partnership interest.[56] Similarly, if B gifted his one-third interest worth $100x to his daughter immediately after C's admission to the partnership, then the value of such gift for gift tax purposes should be $100x, not $150x.

d. What the Proposed Regulations Say. The Proposed Regulations seem to adhere to the false premise that the fair market value of the partnership's net assets attributable to a partnership interest are equal to the fair market value of such partnership interest. This is illustrated in Example 22. In that example, the newly admitted partner ML contributes to the partnership an amount that equals the amount that ML would receive from the partnership on a liquidation basis (after subtracting the fair market value of the outstanding option). The problem is that in practice ML will ordinarily discount the price he is willing to pay for his partnership interest (in relation to the underlying partnership asset values) to account for the fact that he does not have the unfettered ability to sell the partnership's assets and liquidate his partnership interest for cash. Basically, in Example 22, the amount ML pays for his interest in LLC is conceptually neat, but unrealistically high given the reality of the true value of minority interests in illiquid investments such as LLC. We are very curious to see if the mechanics of the Proposed Regulations dealing with intervening book-ups while a noncompensatory option is outstanding will work when the values being used are realistic, not merely neat. After a few suggestions on this point, we'll give them a test.

> *More precisely, a noncompensatory option that satisfies the five largely subjective [Anti-Abuse Rule] tests … will be treated as a partnership interest.*

e. Suggestions. It would be very helpful if the government would take this opportunity to clarify existing Reg. §1.704-1(b)(2)(iv)(*f*) by acknowledging that adjustments to the capital accounts that are based on the fair market value of a partnership interest issued to a partner are permissible even though the resulting adjustments will not necessarily cause the partnership properties to be adjusted to an amount equal to their fair market values. It would also be helpful if Example 22 could be similarly clarified to acknowledge that ordinarily the fair market value of the newly acquired partnership interest will not equal the amount that such new partner would receive if the partnership sold its properties at fair market value and then liquidated.

3. R-E-S-P-E-C-T. Let's just change the facts of Example 22 in one simple aspect. Everything else stays the same—we're just going to have ML buy in at the discounted price of $10,000. Let's do the math.

What's the fair market value of the option? If we start from the true value of the partnership interest that DR would receive upon exercise of his/her option, the best evidence of that amount is what ML just paid—$10,000. With the strike price being $15,000, that option doesn't appear to be worth much, if anything—it's out of the money. Although an out-of-the-money option may have some value, it does not, at the time of a book-up, share in previously unbooked appreciation in partnership assets. Therefore, we believe that if, as in this modified Example 22, the option is out of the money, it should be treated as having zero value. When we then subtract the price paid for the option, being $1,000, from the fair market value thereof, being zero, we get a negative $1,000. The Proposed Regulations contemplate that this might be a negative number and provide for an *upward* adjustment of the value of the partnership's assets in such a case.[57] Such increase is to be allocated only to properties with unrealized depreciation, in this case Property B.[58]

Now, before we finish—with a flourish—our mathematical gyrations, let's intuit what the capital accounts of the three members, AC, NE and ML, ought to be. With the option being out of the money, these three members, upon a liquidation of LLC, should equally split $46,000 ($30,000 for Property A, $5,000 for Property B, $10,000 from ML's capital contribution and the original $1,000 option premium), receiving $15,333.33 apiece. Now the grand finale.

The net unrealized appreciation in LLC's noncash assets is $16,000 ($36,000 of value—taking into account the $1,000 upward adjustment under Proposed Reg. §1.704-1(b)(iv)(*h*)(*2*)—less $20,000 of aggregate tax basis), which yields a book-up of $5,333.33 apiece, resulting in capital account balances of $15,333.33 apiece! Huzzah, huzzah, the Reg writers did it again!

If we understand the computational mechanics correctly (and we frankly aren't certain that we do), then so long as the fair market value of the option is determined with reference to whether it is in the money based on the price paid by the entering partner for its interest, *i.e.*, a value that has the same pressures and factors on it as does that value of the interest being purchased by the entering partner, the "right" answer will bubble to the top, just like ... never mind.

Observe, however, that under these computational mechanics, ML contributed $10,000 and has an opening capital account balance of $15,333.33. Yes, the capital accounts are in equilibrium (because each of AC's and NE's capital accounts are also $15,333.33), and yes, the partners' economic deal is preserved, but having ML start with a capital account ($15,333.33) which is quite different from his capital contribution ($10,000) seems a bit weird. Under the approach described above (under "2. The 'Ought' and 'Is' of Book-ups: Practice vs. Theory"), if ML paid $10,000 for this one-third interest, each of ML, AC and NE would have a $10,000 capital account balance. Either approach should, in theory, work. However, the approach that results in the entering partner (ML) starting with a capital account equal to his contribution ($10,000) is consistent with what usually happens in practice. In contrast, booking the partnership assets (and capital accounts) to their true fair market (and liquidation) values unnecessarily creates or exacerbates book-tax differences, even for an entering partner (ML, in the preceding modified Example 22) who pays a cash amount equal to the fair market value of his partnership interest ($10,000).

4. The Exercise. Returning to the facts of Example 22 as set forth in the Proposed Regulations, and having done the necessary book-up, now let's see what happens upon DR's exercise of his option. After the admission of ML, when Property A still has a value of $30,000 and Property B still has a value of $5,000, DR exercises his option, paying the $15,000 exercise price to LLC.

Now that there is no option outstanding, we need not hack through the jungles of the option-evaporating provisions of Proposed Reg. §1.704-1(b)(2)(*iv*)(*f*) and (*h*)(*2*). According to Proposed Reg. §.704-1(b)(2)(iv)(*b*)(*2*) and 1(*d*)(*4*), DR's capital account will be credited, upon exercise, with the sum of the $1,000 option premium and the $15,000 exercise price, or $16,000. However, it is apparent that because the total assets of LLC are now $68,000 ($30,000 to Property A, $5,000 to Property B, $17,000 from new member ML, $1,000 option premium and $15,000 option exercise price), at the time of DR's exercise there is a disequilibrium between his capital account and the amount of LLC's assets that DR would receive upon liquidation, being one-fourth of $68,000, or $17,000. Inasmuch as DR is entitled to $1,000 more LLC capital than his capital contributions to LLC, the capital account adjustment provisions of Proposed Reg. §1.704-1(b)(2)(iv)(*s*) apply.

"Yeah, yeah, yeah," we can hear you say. We know how to do this. The only question is, "Where is the $1,000 of unrealized appreciation? Didn't we use all of that unrealized appreciation when we did the book-up upon ML's entry into the LLC?"

Yes, we did, Ollie. But we took some back, remember, when we were vaporizing the outstanding option. The $1,000 that got backed out of the value of Property A, taking its value down to $29,000, is now available to be used for these purposes. That portion of unrealized gain, *i.e.*, the difference between the reduced value of $29,000 and the actual value of $30,000, is available to make the revaluation and capital account adjustment mandated by Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*2*). Because there is sufficient unrealized gain to bring DR's capital account into equilibrium, no further capital account adjustments—specifically, no adjustments under Proposed Reg. §1.704-1(b)(2)(iv)(*s*)(*3*)—are needed, and no special allocations of income, gain, deduction or loss, other than the standard Code Sec. 704(c)-like allocations, are required under Proposed Reg. §1.704-1(b)(4)(x).

V. "Are You Really an Option?"—The Proposed Anti-Abuse Rule: Certain Option Holders Treated As Partners

A. Overview

Proposed Reg. §1.761-3[59] ("the Proposed Anti-Abuse Rule") treats certain noncompensatory option holders as partners if the option provides the holder with rights that are substantially similar to the rights afforded to a partner and the failure to treat the option holder as a partner would economically whip-saw the government. More precisely, a noncompensatory option that satisfies the five largely subjective tests we will describe below will be treated as a partnership interest. It is safe to assume that if the government were not concerned about the potential for abusive partnership options, there would be no Proposed Anti-Abuse Rule. The heart of their concern is that partnerships with tax indifferent partners could issue options to high tax-bracket taxpayers who would hold their unexercised options for significant periods of time during which the partnership might be expected to have substantial taxable income.

An effective Proposed Anti-Abuse Rule must balance the following two competing concerns: First, absent the Proposed Anti-Abuse Rule and/or a similar rule under common law tax principles, an option holder would be free to defer any tax liability attributable to his economic share of partnership income during the time the option is outstanding, thus enjoying his share of the upside appreciation in the partnership while also suffering the downside risk of a partner to the extent of the amount invested as an option premium.[60] Second, treatment of an option holder as a partner is not a small matter, at least not in terms of complexity and administrative burden on the option holder, the partnership and the partners. All of these parties generally will have significantly different tax consequences if the option holder is treated as a partner, rather than as an option holder, prior to the exercise (or lapse) of such option. The stakes are even higher for an option holder that is highly sensitive to recognizing the type of partnership income that would be allocated to such holder if it were treated as a partner while the option remains unexercised, such as a tax-exempt organization, which may have a strong aversion to unrelated business taxable income.

The other partners are also impacted if an option holder is treated as a partner prior to his exercise of the option, primarily because such treatment would mean that the historic partners would recognize, in the aggregate, a different amount of income or loss than they would recognize absent application of the Proposed Anti-Abuse Rule. Similarly, the partnership itself faces a daunting task if it incorrectly treats an option holder as an option holder for a period of three years, only to find out later upon audit that the option holder should have been treated as a partner from the moment the option was issued. In such a case, presumably the partners' Schedule K-1s must be retroactively amended for all open years, which would also require the open tax returns of the historic partners to be amended and may ultimately reveal that tax or other distributions have been made in incorrect proportions.

If this sounds like fun, imagine the joy that all concerned will have if an option holder is treated as a partner under the Proposed Anti-Abuse Rule, only to have the option lapse unexercised many years later. If that were to occur, it would appear that upon such lapse, the option-holder-deemed-partner would be treated as though she had abandoned her partnership interest to the partnership as of the date that the option lapsed. Such abandonment treatment could have myriad implications including, to name a few, debt shifts and deemed cash distributions under Code Secs. 752 and 731, basis adjustments under Code Sec. 734 (if a Code Sec. 754 election has been made) and "hot asset" shifts pursuant to Code Sec. 751.

Given the potential for sheer havoc to all concerned, the drafters should strive to have the Proposed Anti-Abuse Rule satisfy two objectives: (1) to apply only where it is likely that the fisc will be economically whip-sawed by the failure to do so; and (2) to allow taxpayers to be able to predict with a high degree of certainty when it applies.

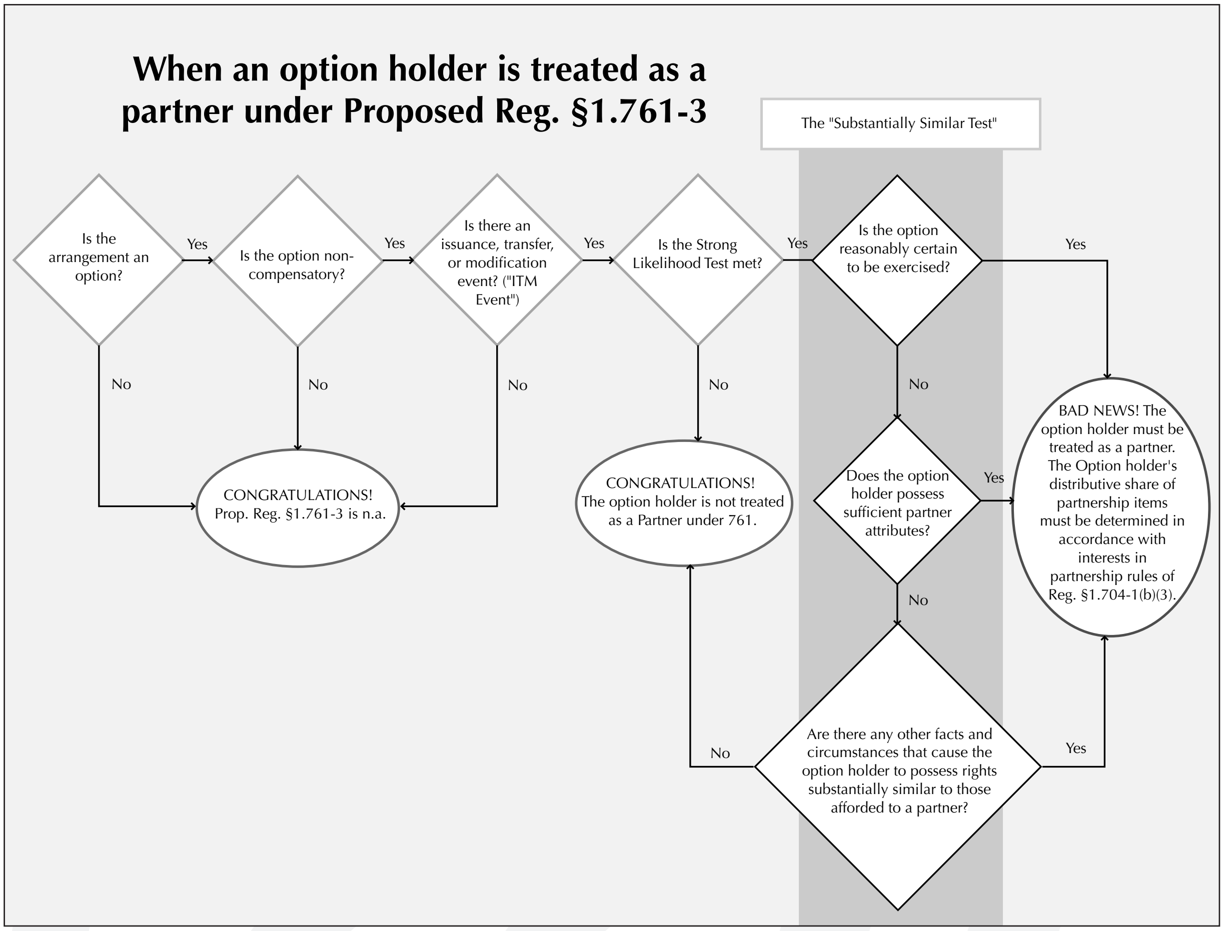
As discussed below, we believe that the Proposed Anti-Abuse Rule accomplishes the first objective but comes up short in accomplishing the second due to a lack of sufficient guidance with respect to when the Rule will be applied.

B. Mechanics

In order for a taxpayer to be treated as a partner under the Proposed Anti-Abuse Rule,[61] the following five questions must be answered in the affirmative:

Question 1: Is the arrangement with the taxpayer an option?

Diagram 1



Question 2: Is the option non-compensatory?

Question 3: Is there an event of issuance, transfer or modification with respect to the option ("an ITM Event")?

Question 4: Is there a strong likelihood that the failure to treat the option holder as a partner will result in a substantial reduction in the present value of the partners' and the holder's aggregate tax liabilities ("the Strong Likelihood Test")?

Question 5: Does the option (and any of the rights associated with it) provide its holder with rights that are substantially similar to the rights afforded to a partner ("the Substantially Similar Test")? The Substantially Similar Test appears to be satisfied if the answer to any one of the following three questions is "yes" at the time of the occurrence of an ITM Event:

- Is the option reasonably certain to be exercised?

or

- Does the holder possess "partner attributes"?

or

- Are there any other facts and circumstances that cause the holder to possess rights substantially similar to those afforded to a partner?

This test is depicted in Diagram 1.

If each of the five questions depicted above is answered in the affirmative, then the option holder and the partnership must treat the option holder as a partner even though the option remains unexercised. In that eventuality, the option holder's distributive share of partnership income, gain, loss and other partnership items will be determined in accordance with the vagaries of the "partner's interest in the partnership" rules contained in Reg. §1.704-1(b)(3).[62] Application of these rules could be problematic for partnerships and partners that are required for one reason or another to maintain capital accounts in accordance with the safe harbor capital account maintenance rules of Reg. §1.704-1(b), such as partnerships with tax-exempt partners that are relying on compliance with the so-called "fractions rule" in order to avoid unrelated business taxable income treatment on their distributive share of partnership income.

If any one of the foregoing questions is answered "no," then the option holder will not be treated as a partner.[63]

Question 1: Is the Arrangement an Option? If the arrangement is not an option, then the Proposed Regulations are not applicable. As set forth above, the term "option" is defined to include a call option or warrant to acquire an interest in the issuing partnership and is defined to include convertible debt, convertible equity and cash settlement options.[64]

This definition leaves room for considerable uncertainty. It is not clear whether certain arrangements styled as something other than an option, but which for economic purposes are tantamount to an option, will be regarded under the Proposed Regulations as an "option" under the Proposed Anti-Abuse Rule.[65] For example, there would seem to be little, if any, economic difference between the economic substance illustrated by the following two scenarios:

Scenario 1. Myrl and Bob are equal partners in Predictable PRS. The sole asset of Predictable PRS is a building that is 100-percent rented to corporate tenants with a mid-investment grade bond rating or better and is expected to remain so for the next 20 years. On July 1, 2003, Adam contracts to purchase from Predictable PRS a one-third partnership interest in Predictable PRS's profits, losses and capital for a purchase price of $100x. Pursuant to the purchase contract, Adam pays Predictable PRS a nonrefundable earnest money deposit of $30x. The closing date is July 1, 2006, or such earlier date specified by Adam. In the event Adam breaches his obligation to purchase said partnership interest, Predictable PRS's sole remedy is to retain the earnest money deposit.

Scenario 2. The facts are the same as in Scenario 1 except that instead of a purchase and sale agreement, Predictable PRS issues to Adam for an option premium of $30x an option to purchase the same one-third partnership interest in Predictable PRS for an exercise price of $70x.

It would seem that the nontax economics of Scenarios 1 and 2 are virtually identical. Scenario 2 clearly needs to run the five-question gamut of the Proposed Anti-Abuse Rule, and depending on additional facts, Adam may well be treated under the Proposed Anti-Abuse Rule as a partner at the time the option is issued (*i.e.,* on July 1, 2003).[66] If, in Scenario 2, Adam is treated as a partner as of July 1, 2003, it is unclear whether that same result would obtain under the facts in Scenario 1. It would seem that the result should not be able to be freely manipulated by merely relabeling the documents.

Question 2: Is the Option Noncompensatory? The Proposed Anti-Abuse Rule applies only to noncompensatory options.[67] Not surprisingly, a noncompensatory option is defined as "an option[68] issued by a partnership, other than an option issued in connection with the performance of services." An option issued in connection with the performance of services would appear to be any option governed by the provisions of Code Sec. 83.[69] The definition specifically treats convertible debt and convertible equity as noncompensatory options.[70] The broad scope of the definition of "noncompensatory option" also appears to include other options, such as so-called rent concession options, which, for example, might be issued by a tenant partnership in connection with a "rent concession" by the landlord pursuant to an office lease.

Question 3: Is There an ITM Event? Perhaps the scariest aspect of the Proposed Anti-Abuse Rule is the matter of *when* the option is tested for possible recharacterization of the holder as a partner. Few will be surprised by the requirement that the option be tested when it is issued. What might come as a surprise to some is that the option is also to be tested whenever it is "transferred" or "modified." Accordingly, a noncompensatory option, such as the one described in Example 1 of the Proposed Anti-Abuse Rule,[71] might pass muster when the option is initially issued, only to satisfy the Substantially Similar Test and the Strong Likelihood Test at a later date when the option is either deemed to be, or actually is, transferred or modified, thereby leading to a recharacterization of the option as a partnership interest as of the date of the transfer or modification.

For example, assume that three years after the option in Example 1 in the Proposed Anti-Abuse Rule[72] is issued, and while the option remains unexercised, the option holder sells the option. Further assume that at the time of such transfer the option is deep in the money and that, for reasons not unlike those articulated in Example 3 of the Proposed Anti-Abuse Rule,[73] the transferee-option holder at the time of such sale would be deemed to satisfy the Substantially Similar Test. Assume further that the transferee is an individual who pays tax at the highest marginal rates and that a majority-in-interest of the partners are tax indifferent. In this case, it would seem that the option transferee would be treated as a partner immediately upon receipt of the option, even though the option has not been exercised.

An even more interesting question is how the option transferor is treated.[74] Presumably, although the matter is not free from doubt, the option transferor would be treated as having transferred a partnership option, and the option transferee would be treated as having acquired a partnership interest, under an analysis somewhat analogous to that applied in *E.E. McCauslen*.[75] If so, the option transferor's treatment of the sale of the option appears to be governed by Code Sec. 1234(a), which provides that the gain or loss attributable to the sale of an option is considered gain or loss from the sale or exchange of property that has the same character as the property to which the option relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by him). Does this mean that the seller of a noncompensatory option has to look not only to Code Sec. 741, but also to the so-called "hot asset" rules of Code Sec. 751(a) to determine the character of her gain or loss in connection with such a sale? In light of this potential treatment, the partnership might be well-advised to restrict or, if permissible, prohibit the transferability of outstanding noncompensatory options. At a minimum, the option should require that the option holder provide the partnership with notice of any transfer.

Despite the multitude of consequences that may flow from such an event, the Proposed Anti-Abuse Rule does not provide guidance with respect to when an option will be deemed "transferred" or "modified." Some of the situations that might constitute an event of "transfer" or "modification"[76] subsequent to the initial issuance of the option are:

- termination of the partnership under Code Sec. 708(b)(1)(B);
- admission of a new partner;
- withdrawal of a partner;
- amendment of the partnership agreement;
- any amendments to the option agreement;
- death of the option holder;
- dissolution or liquidation of the option holder;
- bankruptcy of the option holder;
- state law merger of the option holder into another entity;
- conversion from one type of tax partnership to another (*e.g.*, partnership to limited liability company);
- transfer of the option pursuant to Code Sec. 332, 351, 368(a), 721 or 731;
- merger of the issuing partnership into another partnership; and
- division of the issuing partnership.

It would be helpful if the Final Regulations contained additional guidance as to which of the foregoing events are intended to be events of "modification" or "transfer," even if such guidance were qualified by the word "ordinarily" or "generally." Hopefully, such additional guidance will be drafted with a view that an ITM Event should not have such a hair trigger as the naked words "issuance," "transfer" or "modification" might otherwise connote. It does not seem that such a sensitive triggering mechanism is necessary in order to protect the government's interest.

Interestingly, a fairly similar analysis must be made in the "second class of stock" test imposed on a call option or warrant issued by an S corporation to acquire its shares. For that purpose, the test of whether the call option or warrant is a second class of stock depends on if it is "substantially certain to be exercised."[77] It is not clear whether the regulation drafters intend that the testing dates (*i.e.*, the ITM Event) in connection with a noncompensatory partnership option under the Proposed Anti-Abuse Rule be different from the testing dates set forth in the analogous S corporation regulations.

An interesting question is whether it is possible for the holder of an unexercised option that has multiple ITM Events to flip back and forth between partner and option holder status. It is unclear whether such alternating treatments are possible from ITM Event to ITM Event, or, alternatively, whether the Proposed Anti-Abuse Rule is intended to act in lobster-trap fashion—that is, that once an option holder is characterized as a partner, such treatment continues uninterrupted unless and until the option lapses unexercised, irrespective of any other ITM Events.

Question 4: Is the Strong Likelihood Test Met? The option holder will not be treated as a partner unless, as of the time of an ITM Event, there is a "strong likelihood" that the failure to treat the noncompensatory option holder as a partner would result in a substantial reduction in the present value of the partners' and the option holder's aggregate tax liabilities. Apparently, even if the option is deemed reasonably certain to be exercised and the option holder is deemed to possess substantially the same economic benefits and detriments that she would have possessed if she had acquired a partnership interest outright, the option holder will still not be treated as a partner under the Proposed Anti-Abuse

Rule unless the Strong Likelihood Test is met.

Example 1. PRS has two equal partners, CJM Corporation, a C corporation, and Nicholas, an individual. Both CJM Corporation and Nicholas have substantial net operating losses that are expected to offset all of the PRS income expected to be allocated to them for the next five years. PRS is expected to generate an average of $24x of annual taxable income over each of the next five years. PRS issues to Kathryn, for a premium of $18x, an option exercisable at any time during the next five years to acquire a partnership interest representing a one-third interest in PRS profits, losses and capital for an exercise price of $5x. For the foreseeable future, Kathryn is expected to pay tax on all of her income at the highest marginal rate. At the time the option is issued, the fair market value of such one-third interest in PRS is $20x. The option terms preclude PRS from making distributions or dilutive issuances of PRS equity while Kathryn's option is outstanding.

In this example, Kathryn will enjoy the upside potential of a one-third partner during the five-year option term, and she will also have downside risk to the extent of her $18x option premium, which is a substantial risk. Yet, if her option is not treated as exercised on the date of issuance, she will not be burdened with current tax liability with respect to what is effectively her one-third share of partnership taxable income as and when such income is earned. Instead, such income will be allocated to CJM Corporation and Nicholas, neither of whom will currently pay tax on such income by virtue of their NOLs. The fact that Kathryn enjoys this deferral benefit is not, by itself, enough to invoke the Proposed Anti-Abuse Rule. However, the fact that there appears to be a strong likelihood that Kathryn will enjoy this deferral benefit at the expense of the government (*i.e.*, taking into account the expected aggregate tax liabilities of Kathryn, Nicholas and CJM Corporation on a present value basis) is probably enough to recharacterize Kathryn as a partner under the Proposed Anti-Abuse Rule.

Apparently, a cornerstone of the Proposed Anti-Abuse Rule is that an option holder should be treated as a partner only if there is a strong likelihood that the failure to treat him as such will substantially reduce, on a present value basis, the taxes paid to the government by the aggregate of all of the partners and the option holder, computed on the assumption that the option holder exercised his option. Accordingly, the Proposed Anti-Abuse Rule seems to say that as long as the holder and the partnership have correctly concluded that there is not a strong likelihood that the fisc will be substantially short-changed by the failure to treat the option as a partnership interest, partnerships can issue, and an option holder can hold, noncompensatory options with confidence that the IRS will respect the option holder as an option holder prior to the exercise or lapse of the option.[78]

Example 2. Eva and Kanevul are equal partners in Daredevil PRS, which owns a business with a net asset value of $1,000x. Eva and Kanevul pay tax at the highest marginal individual tax rates. On July 1, 2003, Daredevil PRS issues an option to LowProfile Corporation to acquire a one-third interest in PRS profits, losses and capital for an option premium of $500x and an exercise price of a double-tall-soy latte (from you know where). The option may be exercised at any time prior to July 1, 2014. LowProfile is subject to governmental regulations that preclude it from owning a partnership interest in Daredevil PRS for state law purposes before 2014. Daredevil PRS, the applicable regulatory agency, LowProfile and their esteemed counsel all agree that the option does not cause LowProfile to be a partner for state law purposes.

Is LowProfile a partner for federal income tax purposes? In the absence of the Proposed Anti-Abuse Rule, it would appear that due to the high-option premium and nominal exercise price,[79] LowProfile would be treated as a partner under general tax notions of when an option holder should be treated as a partner.[80] However, if the Proposed Anti-Abuse Rule is adopted as is in the Final Regulations, it would appear that LowProfile would not be treated by the IRS as a partner because the government will not lose any revenues due to LowProfile being respected as an option holder. In such a case, it is not clear whether Daredevil PRS and LowProfile could elect against the chosen form (*i.e.*, option holder) and properly treat LowProfile as a partner for tax purposes. If Daredevil PRS unilaterally treats LowProfile as a partner for tax purposes without LowProfile's consent, the consequences become even murkier. In the absence of additional guidance on this issue, the parties would be wise to specifically address this issue in the written option agreement.

Example 3. UR Hyper, Inc. and Wired, Inc. (both C corporations) are equal partners in Tridecaf PRS, which owns a business with a net asset value of $1,000x. On July 1, 2003, Tridecaf PRS issues to Nightworkers Pension Fund, an exempt trust pursuant to Code Sec. 401(a), an option to acquire a one-third interest in the profits, losses and capital of Tridecaf PRS. The option premium is $500x and the exercise price is a vente mocha coconut frappacino with whipped cream and chocolate sprinkles. The option may be exercised any time prior to July 1, 2014. At the time the option is issued and for the foreseeable future, UR Hyper, Inc. and Wired, Inc. are expected to pay tax at the highest corporate tax rate. Tridecaf PRS is expected to generate substantial taxable income in each tax year, all of which if allocable to Nightworkers Pension Fund would constitute unrelated business taxable income, taxable at the highest corporate rate.[81]

Unfortunately, the Proposed Anti-Abuse Rule contains no examples of its own that apply [the Strong Likelihood Test], nor does it provide any further explanation as to when the Strong Likelihood Test will be met.

In the preceding example, it would appear that the Proposed Anti-Abuse Rule would not apply because there does not appear to be a strong likelihood that treatment of Nightworkers Pension Fund as a partner would increase the aggregate tax liabilities on a present value basis of UR Hyper, Inc., Wired, Inc. and Nightworkers Pension Fund. Accordingly, it appears that if the Final Regulations adopt the Proposed Anti-Abuse Rule as set forth in the Proposed Regulations, Nightworkers Pension Fund can comfortably assume that the government will not treat it as a partner prior to its exercise of the option.[82]

We make the following observations about this example:

- First, Nightworkers Pension Fund likely will pay substantially less tax on a present value basis if it is respected as an option holder rather than treated as a partner.
- Second, Nightworkers Pension Fund will be treated as an option holder if it does not pass the Strong Likelihood Test, *i.e.,* unless there is a strong likelihood that the government will lose out on substantial revenue.
- Third, because Nightworkers Pension Fund likely will pay substantially less tax on a present value basis if it is not treated as a partner while the option is outstanding, whether Nightworkers Pension passes or flunks the Strong Likelihood Test depends on the expected tax profiles of the historic partners of the partnership.
- Fourth, although the Proposed Anti-Abuse Rule is not clear on this point, it would seem that the tax liabilities of expected future partners must be taken into account in this analysis.
- Fifth, whether Nightworkers Pension Fund is to be treated as a partner prior to exercise is a test that is conducted not only when the option is "issued," but also when such option is "transferred" or "modified."
- Sixth, the Proposed Anti-Abuse Rule provides no guidance with respect to the frighteningly loaded terms "transferred" or "modified."
- Seventh, even if Nightworkers Pension Fund gets comfortable that it will not be treated as a partner when the option is issued, it may nonetheless lose sleep despite the mass quantities of caffeine ingested when the option is issued because the option's future may hold an event of "transfer" or "modification" that will necessitate a *de novo* test of whether Nightworkers Pension Fund will be treated as a partner at that time. This sleeplessness may worsen when Nightworkers Pension Fund tries to ascertain what possible future events might constitute an event of "transfer" or "modification."
- Eighth, the very act of carefully drafting an option agreement or partnership language that is designed to protect against these potentially troublesome events may in and of itself cause Nightworkers Pension Fund to be deemed to possess "partner attributes," which would constitute another demerit under the Proposed Anti-Abuse Rule.[83]

The wording of the Strong Likelihood Test in the Proposed Anti-Abuse Rule should have a familiar ring to those who wrestle with the tests in the Code Sec. 704(b) regulations for determining whether an allocation that has economic effect is "substantial."[84] This may give an advisor some comfort if the two tests are to be interpreted and applied in a similar manner, because there is quite a bit of commentary on this part of the substantial economic effect test.

Unfortunately, the Proposed Anti-Abuse Rule contains no examples of its own that apply this test, nor does it provide any further explanation as to when the Strong Likelihood Test will be met. Thus, taxpayers and their advisors will often have difficulty reaching a high comfort level. Consider the following possible scenarios where the Strong Likelihood Test may be met.

Example 4. Sam and Colleen are individuals who currently and for the foreseeable future are each expected to pay income tax at the highest rates and are equal partners in SC partnership, which is expected to both be highly profitable and to recognize the majority of its income as long-term capital gain for the next five years. SC partnership issues an option to High-tacks (a C corporation that currently and for the foreseeable future is expected to pay tax at the 35-percent rate) to acquire a one-third interest in the profits, losses and capital of SC partnership. Because High-tacks would pay tax at the 35-percent rate on capital gain income allocated to it if it were a partner and because Sam and Colleen will only pay tax on such gain at the 20-percent rate, it seems difficult to safely conclude that the Strong Likelihood Test will not be met when the option is issued, transferred or modified.

Example 5. Corporations Slikee and Buoy are both C corporations that currently and for the foreseeable future are expected to pay alternative minimum tax on all of their income at the 20-percent rate specified in Code Sec. 55(b)(1)(B). Slikee and Buoy are equal partners in Slikee-Buoy partnership, which issues an option to Heycede (a C corporation that is expected to pay tax at the 35-percent marginal rate for the foreseeable future) to acquire a one-third interest in profits, losses and capital of Slikee-Buoy partnership. Assuming Slikee-Buoy partnership is expected to generate substantial taxable income over the life of the option, it seems difficult to safely conclude that the Strong Likelihood Test is not satisfied when the option is issued, transferred or modified.

Example 6. Eldon, an individual, and Tiger Corp., a C corporation, are equal partners in ET PRS. Eldon is expected to pay tax at the highest applicable individual rates for the foreseeable future. Tiger Corp. has net operating losses that are expected to offset most or all of Tiger Corp.'s income for the foreseeable future. ET PRS conducts an active trade or business of the type that is expected to generate substantial taxable income over the course of the next five years. ET PRS issues an option (exercisable anytime during the next five years) to Max to acquire a one-third interest in partnership profits, losses and capital of ET PRS partnership. Max is an individual who expects to pay tax at the highest rates in each of the next five years. Again, it seems difficult to conclude with any degree of certainty that the "Strong Likelihood Test" is not satisfied at the time the option is issued, transferred or modified.

Situations in which a prospective option holder will be in a higher tax bracket than one or more of the historic partners should be somewhat common. Accordingly, if the Final Regulations do not provide additional guidance, taxpayers will need to wrestle with the vagaries of whether the Strong Likelihood Test is satisfied at the time of an ITM Event, *unless* the option is structured in a manner that does not provide the option holders with rights that are substantially similar to the rights afforded to a partner—a test that is fraught with many of its own uncertainties.

Question 5: Is the Substantially Similar Test Met? The holder of a noncompensatory option will not be treated as a partner if the option does not "provide the holder with rights that are substantially similar to the rights afforded to a partner." The Substantially Similar Test is generally met if any one of the following three subsidiary questions is answered in the affirmative as of the time of the ITM Event: First, is the option reasonably certain to be exercised? Second, does the option holder possess so-called "partner attributes"? Third, do other facts and circumstances indicate that the holder possesses rights substantially similar to the rights afforded to a partner?[85] These three constituent parts of the Substantially Similar Test are discussed below.

1. Reasonably Certain to Be Exercised. The Proposed Anti-Abuse Rule states that the following factors are relevant in determining whether at the time of the occurrence of an ITM Event the option is "reasonably certain"[86] to be exercised:

- The fair market value of the partnership interest that is the subject of the option[87]
- The exercise price of the option
- The term of the option
- The volatility, or riskiness, of the partnership interest that is the subject of the option
- The fact that the option premium and, if the option is exercised, the option exercise price will become assets of the partnership
- Anticipated distributions by the partnership during the term of the option
- Any other special option features such as an exercise price that declines over time or declines contingent on the happening of specific events
- The existence of related options, including reciprocal options
- Any other arrangements (express or implied) affecting the likelihood that the option will be exercised

At first glance, it is tempting to criticize the lack of specificity in the foregoing factors. Upon further reflection, we think we came to the same realization as did the drafters of the Proposed Anti-Abuse Rule—that is, that relatively few options to acquire an interest in a partnership that conducts a risky trade or business are "reasonably certain to be exercised" at the time they are issued, because of the inherent, undeniable, riskiness of most businesses. The Treasury's thinking on this issue is revealed in each of the three examples set forth in the Proposed Anti-Abuse Rule.

In Example 1, the holder paid an option premium equal to 50 percent of the fair market value of the optioned partnership interest when the option was issued and the exercise price was slightly out of the money when the option was issued. In Example 3, the holder paid an option price equal to 93.3 percent of the fair market value of the optioned partnership interest on the date the option was issued. The exercise price was only 40 percent of the fair market value of the partnership interest on the date the option was issued. Yet, in neither example was the option deemed reasonably certain of exercise. The primary rationale for this conclusion in both examples appears to be that the underlying nature of the business was inherently risky (*i.e.,* Example 1 deals with a telecommunications business and Example 3 deals with an Internet start-up venture). Accordingly, these examples seem to recognize the economic reality that an option with an exercise price equal to only 40 percent of the fair market value of the underlying partnership interest on the date the option is issued and which may be exercised at any time during a 10-year option period is not reasonably certain to be exercised if the business conducted by the partnership is risky.

In contrast to the risky businesses conducted by the partnerships that are the subjects of Examples 1 and 3, Example 2 provides a glimpse of a situation that the drafters of the Proposed Anti-Abuse Rule clearly consider to meet the "reasonably certain of exercise" test. Example 2 illustrates an option issued by a partnership that is deemed to have reasonably predictable earnings. When combined with the restrictions on the partnership's ability to make distributions, it is reasonably certain at the date the option is issued that the option will be in-the-money prior to its expiration. Therefore, the example concludes that it is reasonably certain that the option will be exercised. Because the option is deemed reasonably certain to be exercised, the option holder is deemed to possess rights that are substantially similar to the rights afforded a partner. Therefore, the example concludes that the option holder will be treated as a partner if the Strong Likelihood Test is also satisfied. In summary, it appears that the reasonably-certain-to-be-exercised standard will rarely be met by a garden-variety partnership that does not offer its partners a bond-coupon-clipping level of security.

We suggest that it would be extremely helpful if the Final Regulations could clarify in the text of the regulations (not just in the examples) that an option ordinarily will not be treated as though it is reasonably certain to be exercised as long as the optioned interest does not relate to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.[88]

2. Partner Attributes. In determining whether an option holder possesses "partner attributes" the Proposed Anti-Abuse Rule seems most concerned with the following three attributes: (1) the extent to which the option holder will share in the economic benefit of partnership profits (including distributed profits); (2) the extent to which the option holder shares in the economic detriment associated with partnership losses[89]; and (3) the existence of any arrangement (either within the option agreement or in a related agreement) that, directly or indirectly, allows the holder of a noncompensatory option to control or restrict the activities of the partnership.

The problem here is that the very nature of most options causes the holder to partake in some measure of all three of these "partner attributes." So, the question cannot be whether the holder possesses the above-described partner attributes, because in most cases he will possess all three of them. The question apparently is whether the holder possesses an impermissibly high measure of these (and perhaps other unstated) partner attributes. Unfortunately, other than the examples contained in the Proposed Anti-Abuse Rule, there is no explanation of how much is too much for this purpose.

Examples 1 and 3 in the Proposed Anti-Abuse Rule provide some guidance as to when an option holder will possess sufficient "partner attributes" to be treated as a partner at the time an ITM Event occurs. It is assumed in each such example that the relevant option agreement provides that the partnership cannot make distributions to its partners or issue partnership equity in a way that would dilute the optioned partnership interest while the option remains outstanding and that the option holders do not have any other significant rights to control or restrict the activities of the partnership. Each of the examples illustrates the application of aspects of the Substantially Similar Test to a particular fact pattern. However, as discussed below, additional examples, and one or more additional safe harbors, would be truly helpful to taxpayers who are attempting to fashion an option in a manner that gives all parties concerned a high degree of certainty that the option holder will not be treated as a partner.

Example 1 deals with an option issued by a partnership (PRS) engaged in the telecommunications business. In exchange for a premium of $8x, PRS issues an option to acquire a 10-percent partnership interest for an exercise price of $17x at any time during the immediately following seven-year option period. The fair market value of the optioned 10-percent interest at date of issuance is $16x. The example provides that due to the riskiness of PRS's business, the value of the optioned interest in seven years is not reasonably predictable on the issuance date, and therefore it is not reasonably certain that the option will be exercised. The example also reasons that although the option holder has substantially the same economic benefit of partnership profits as would a direct investment in PRS, the holder does not share in substantially the same economic detriment of partnership losses as would a partner in PRS. Example 1 concludes, based on these facts, that the holder does not possess rights that are substantially similar to the rights afforded to a partner. Therefore, because the Substantially Similar Test is not met, the option holder is not treated as a partner at the time the option is issued.

Example 1 in the Proposed Anti-Abuse Rules is helpful. In a nutshell, the example provides comfort that if the partnership conducts an inherently risky business (in this case, a telecommunications business), an option won't be deemed to possess too many partner attributes, even if it provides the option holder with substantially the same economic share of partnership profits as would a direct investment in the partnership. Further comfort is added by the fact that the holder paid a premium ($8x) equal to 50 percent of the fair market value of the optioned partnership interest at date of issuance ($16x). Consequently, to the extent of a 50 percent reduction in the net asset value of the partnership, the option holder would share in the downside risk with each of the partners. Despite the fact that the option holder possessed a significant measure of all three "partner attributes" listed in the Proposed Anti-Abuse Rule, Example 1 concludes that because the option holder did not share in substantially the same economic detriment of partnership losses as would a partner, the option holder did not possess sufficient partner attributes to satisfy the Substantially Similar Test. Because the option was neither reasonably certain to be exercised nor did it cause the option holder to share in "substantially the same economic detriment of partnership losses as would a partner in PRS," the unexercised option was not treated as a partnership interest.

We hope that the result obtained in Example 1 would not change if, on the date the noncompensatory option was issued, the partnership also issued a partnership interest to a partnership employee that qualified as a profits interest under Rev. Proc. 93-27.[90] In such a case, the profits interest partner would have no capital at risk in the partnership, whereas the option holder would have substantial capital at risk in the partnership. So, if the facts of Example 1 were slightly modified, it would no longer be possible to recite therein that the option holder does not share in substantially the same economic detriment of partnership losses as would a partner (at least not every partner), because a partner who has only a profits interest bears no economic detriment of partnership losses (other than perhaps having foregone a higher salary in order to receive a profits interest). Additional guidance with respect to this issue would be helpful.

Notably, the option in Example 1 is the only option described in each of the three examples that is not deemed to afford the option holder with rights that are substantially similar to the rights afforded to a partner. In the absence of additional examples that demonstrate options that are deemed to pass muster, taxpayers will be left with precious little guidance in their quest to draft terms for options that will not be treated as partnership interests. Options come in all shapes and sizes, and in many cases it will not be possible to conclude that the option affords the holder with less partnership rights than those afforded to the option holder in Example 1 of the Proposed Anti-Abuse Rules. For example, it is difficult to discern whether any one or more of the following additional or different option terms would be problematic:

- Longer option term (*e.g.*, 15 years)
- Option holder approval of any amendments to the partnership agreement
- Option holder's right to approve the sale or exchange of partnership assets other than in the ordinary course of business
- Option holder's right to approve any major refinancings
- Option holder's right to approve the partnership's conversion to a corporation
- Option holder's right to approve a voluntary partnership dissolution
- Option terms that reduce the exercise price on account of distributions made to partners while the option is outstanding
- Options that are in-the-money (but not deep in-the-money) at the time of the ITM Event (Notably, the option in Example 1 was slightly out-of-the-money at the date of issuance.)[91]

The government's concern about the potential for abusive option transactions is legitimate. Moreover, the Reg drafters' willingness in the Proposed Anti-Abuse Rule to treat an option holder as a partner only if the Strong Likelihood Test is passed evidences the government's intention to be as unobtrusive upon taxpayers' business arrangements as they possibly can be, as long as the fisc is not highly likely to be economically whip-sawed. Nonetheless, there are a great many circumstances in which both the Strong Likelihood Test will be satisfied (*i.e.,* where some or all of the partners are tax indifferent and the option holder is not tax indifferent) and where the option is issued in a nonabusive transaction in which the option holder and perhaps the partnership and/or historic partners need to know with a high degree of certainty whether the option holder will be treated as a partner. Hopefully, the Final Regulations will provide additional guidance to taxpayers in these circumstances without jeopardizing the government's legitimate concern about being whip-sawed.

In addition to more examples, it would be helpful if, consistent with Example 1, the Final Regulations could provide a safe harbor for partnership options issued by partnerships that predominantly conduct one or more active—and inherently risky—businesses if the exercise price at the date of the ITM Event bears a specified relationship to the fair market value of the optioned partnership interest at the date of the ITM Event, irrespective of whether the option contained any other "partner attributes." For example, such a safe harbor might be drafted to apply to an option that (1) has an exercise price of not less than 90 percent of the fair market value of the optioned partnership interest at the date the option is issued,[92] and (2) does not involve a partnership business that affords its partners with highly predictable income (*e.g.,* a Treasury bond, coupon-clipping-type of business). Such a safe harbor would be far more conservative than common law notions of when an option is deemed reasonably certain of exercise, yet it would allow taxpayers who need certainty on the often high-stakes question of whether the holder will be treated as partner prior to exercise a practical and reasonable means to attain a much higher degree of certainty (at least as of the issuance date) without seemingly jeopardizing the government's legitimate concern about being whip-sawed.

Example 3 contains two separate examples. In Part 1 of Example 3, a limited partnership engaged in an Internet start-up venture issued a noncompensatory option to acquire a five-percent interest in the partnership. The option premium was \$14x, the exercise price was \$6x, the fair market value of the optioned partnership interest on the date the option was issued was \$15x and the term of the option was 10 years.

Example 3 concludes that due to the risky nature of the partnership's business, the option is not reasonably certain to be exercised. Nonetheless, the example concludes that because the option holder has paid a $14x premium for a partnership interest that has a fair market value of $15x, the option holder has substantially the same economic benefits and detriments as a result of purchasing the option as the option owner would have had if the option holder instead purchased a partnership interest. Importantly, this example illustrates a circumstance in which an option is not reasonably certain to be exercised at the time of an ITM Event, but which nonetheless has sufficient "partner attributes" to cause the holder to be treated as a partner.

Support for the application of a partner attribute test to treat an option holder as a partner even though the option is not reasonably certain to be exercised can be derived from cases such as *W.O. Culbertson, Jr.*[93] and *H.M. Luna,*[94] both of which look at all the facts and circumstances to determine whether a partnership exists—and by extension, whether the parties to the arrangement are partners.

In *Culbertson,* the Court addressed a purported partnership formed by a father and his sons. The father contributed capital to the partnership, while the sons purchased an undivided 50-percent interest in the partnership in exchange for a note. The Tax Court held that a partnership was not formed due to the fact that none of the sons had contributed to the "partnership" either "vital services" or "capital originating with him." The Supreme Court determined that the focus placed upon the contributions by the Tax Court was improper:

> The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.[95]

In *Luna,* the taxpayer argued that payments received as commissions were actually received from a joint venture formed by the taxpayer with his employer, rather than payments received as an employee. The Tax Court rejected the taxpayer's arguments, finding that a joint venture had not been formed between the taxpayer and his employer. The Tax Court looked to the following factors:

> The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint ventures; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.[96]

The Tax Court determined that the contract was unambiguously an employment contract, that the parties' conduct with respect to the contract was clearly indicative of an employment contract and that a partnership was never discussed or contemplated. The court found that the taxpayer shared in neither profits nor losses with the employer, that the taxpayer had no control over the business, and that it had no proprietary interest in profits.

Further support for treatment of an option holder as the owner of the optioned property prior to the time that the option holder exercises the option can be derived from Rev. Rul. 82-150.[97] In Rev. Rul. 82-150, A paid B a $70x option premium to purchase all of the stock of a foreign corporation worth $100x, with an exercise price of $30x. The option arrangement was tax motivated. The revenue ruling applied the doctrine of "substance over form." Reasoning that the option holder had assumed the benefits and burdens of the ownership of the optioned stock, the ruling concluded that the sale of such stock to the option holder was completed when the option was issued. Because, in Part 1 of Example 3, the option holder paid an option premium equal to 93.3 percent of the fair market value of the optioned partnership interest at the date the option was issued, it is difficult to quarrel with the conclusion that the option holder should be treated as a partner on the date the option was issued.

The drafting of compensatory and noncompensatory options is fraught with many traps for the unwary, and life for the option draftsperson will not get easier under the Proposed Regulations.

Partnership lenders will no doubt pay particular attention to Part 2 of Example 3, in which the base facts of Part 1 are modified to provide that the option holder is a lender who transfers $150x to the partnership in exchange for a note from the partnership that matures 10 years from the date of issuance and a detachable warrant to acquire a five-percent interest in partnership for an exercise price of $6x. The warrant issued with the debt is exercisable at any time during the 10-year term of the debt. The example provides that the debt instrument and warrant comprise an investment unit within the meaning of Code Sec. 1273(c)(2), and that under Reg. §1.1273-2(h), the $150x issue price of the investment unit is allocated in accordance with the relative fair market values of the debt instrument and the warrant. The example assumes that the allocation is $130x to the debt instrument and $14x to the warrant. Because the detachable warrant in Part 2 of Example 3 has the identical features of the warrant in Part 1, such warrant is deemed to satisfy the Substantially Similar Test. Accordingly, the example concludes that if the Strong Likelihood Test is also satisfied, the warrant holder will be treated as a partner from the date of issuance.[98] In contrast to the separate valuation of detachable warrants issued as an investment unit, an option to acquire equity that is embedded in a debt instrument (*i.e.,* convertible debt) apparently is not separately valued for this purpose.[99] Accordingly, lenders who are sensitive to partner treatment during the time when an option is outstanding, and partnerships that are sensitive to such treatment, should consider using convertible debt rather than debt instruments with detachable warrants in situations where the treatment of the detachable warrant under the Proposed Anti-Abuse Rule cannot be ascertained with a high degree of certainty.

3. Other Facts and Circumstances. The Proposed Anti-Abuse Rule states that, in determining whether the Substantially Similar Test is met, "all facts and circumstances are considered, including whether the option is reasonably certain to be exercised ... and whether the option holder possesses partner attributes."[100] However, nowhere in the Proposed Anti-Abuse Rule is there any guidance with regard to what sorts of circumstances might be problematic in the absence of reasonable certainty of exercise and too large a measure of partner attributes. If the regulation drafters didn't really have a particular abuse in mind, we would suggest that the "all facts and circumstances" language be deleted. Alternatively, the Final Regulations could provide that, in the absence of reasonable certainty of exercise and sufficient partner attributes, the holder will "ordinarily not be treated as possessing rights which are substantially similar to a partner." If the regulation drafters do have "other facts and circumstances" in mind, it would be helpful if the Final Regulations would describe them.

C. Summary of Recommendations Regarding the Proposed Anti-Abuse Rule

In sum, the drafters of the Proposed Anti-Abuse Rule have faced a daunting task of protecting the government against an economic whip-saw and providing sufficiently clear guidance to enable taxpayers to structure "garden variety" options with some degree of certainty that the options will not be recharacterized. As discussed in the preceding pages, we would suggest that the objectives of providing sufficiently clear guidance to the taxpayers could be better achieved without jeopardizing the Treasury's objective of protecting against being economically whip-sawed by providing the following additional guidance in the Final Regulations:

- Provide a laundry list of events that ordinarily will, and ordinarily will not, constitute "transfer" or "modification" events (hopefully with a view to avoiding hair triggers).
- Provide that an option will not be regarded as reasonably certain of exercise so long as at

the time of the ITM Event the optioned partnership interest does not relate to a substantially certain and predictable stream of income from partnership assets, such as from high-quality debt securities or a high-quality net lease.

- Provide one or more safe harbors under the partner attributes test, *e.g.*, that an option will not be treated as having an impermissibly high level of partner attributes as long as the exercise price is more than a specified percentage of the fair market value of the optioned partnership interest at the time of the ITM Event or the option premium is less than a specified percentage of the fair market value of the optioned partnership interest at the time of issuance.[101]
- Provide examples of situations in which the Strong Likelihood Test will or will not be met.
- Consider deleting the "other facts and circumstances" portion of the Substantially Similar Test or, alternatively, state in the Final Regulations that the holder of an option that neither is reasonably certain of exercise nor has sufficient partner attributes will ordinarily not be treated as a partner prior to exercising the option.

VI. What the Proposed Regulations Don't Address

Given the seemingly endless number of tax issues with respect to partnership options, it would be unrealistic to expect that the Proposed Regulations could address them all. A few of the issues not addressed in the Proposed Regulations are set forth below:

- Compensatory options[102]
- Lapse of noncompensatory partnership options[103]
- Sale of noncompensatory partnership options[104]
- Repurchase of noncompensatory partnership options by the issuing partnership[105]
- The treatment of noncompensatory partnership options in partnership mergers and partnership-to-corporation conversions[106]

Each of these events presumably has tax consequences and, in many cases, raises unanswered questions. Our hope is that to the extent these issues are not addressed in the Final Regulations, the Treasury subsequently issues additional guidance in the form of one or more revenue rulings or revenue procedures.

VII. Selected Drafting Issues for the Option Scrivener

The drafting of compensatory and noncompensatory options is fraught with many traps for the unwary, and life for the option draftsperson will not get easier under the Proposed Regulations. The core reason for many difficulties is that some partnership option drafters pick up a corporate-style option or warrant and use it in a partnership without due consideration of the fundamental differences between how the economic pie is allocated among the owners of a corporation under state corporate law principles and how it is allocated among the owners of a partnership that follows the economic capital accounting principles prescribed in the regulations pursuant to Code Sec. 704(b).[107]

As a general proposition, the net assets of a corporation are allocated, upon liquidation, among the various classes of shares on a priority basis (*e.g.*, first to any classes of preferred stock in accordance with their relative priorities and the rest to the common). Then, the portion of the net assets allocated to each respective class of shares is allocated within such class on a share-by-share basis.

The world is quite different for partnerships, at least for those that choose to be governed by the capital accounting principles of Code Sec. 704(b). Rather than a corporate-style system that divides the net assets in accordance with relatively simple ratios among shareholders, each partner's share of the economic pie is a function of the balance in its capital account. Quite often, the balance in a partner's capital account (in relation to the other partners) is not proportionate with such partner's share of partnership profit. Indeed, many partnerships slice and dice partnership profits in such a fashion that it is a misnomer to simply describe a partner's share of partnership profits as an overall percentage (*e.g.*, "partner A has a 10-percent share of partnership profits").

By way of example, in new Partnership XY, X contributes $100 and is allocated a preferred return of 10 percent on her unreturned capital each year as a priority profits allocation. X also is allocated 50 percent of the remaining profits. Y contributes services and no cash or other property and is allocated 50 percent of the remaining profits. Distributions first are made to cover

X and Y's estimated taxes at an assumed tax rate, and second to X until X receives an amount equal to his capital contributions ($100) plus his preferred return. Thereafter, distributions are made 50/50. In this example, X and Y have differing profits interests at any given time (due to X's preferred return), and at any given time X and Y's capital accounts are not necessarily proportionate to their interests in profits. The drafter of an option issued to C by Partnership XY to acquire an interest in Partnership XY needs to account for these variables in accordance with the partners' intentions. Ascertaining the partners' intentions often entails walking the client (as well as the drafter) through several illustrations of how the economics of the option will play out under alternative scenarios.

For purposes of illustrating certain of the economic issues that arise in drafting partnership options, consider the following example.

Example. A and B form AB Partnership. Each contributes $50 and receives $50 capital account credit and 50 percent of the profits. The partnership agreement adopts the safe harbor capital accounting rules contained in Reg. §1.704-1(b). The partnership agreement also contains the fairly standard provision that, among other things, upon the issuance of a partnership interest to a new or existing partner in exchange for cash or other property, the partnership will adjust (*i.e.*, "book-up" or "book-down") the carrying values of its assets pursuant to Reg. §1.704-1(b)(2)(iv)(f). Simultaneous with the formation of AB partnership, the partners, in exchange for $20 from C, issue an option to C to acquire a one-third interest in the profits and losses of the partnership in exchange for an exercise price of $50. The option provides that the $20 option premium plus the $50 exercise price will be credited to C's capital account upon exercise. One year later, the partnership has earned $30 of profit (for capital accounting purposes) and its assets, net of its liabilities (including the $30 of taxable profit and excluding the $20 option premium) have appreciated to $230. At this point, C exercises his option.

A. Unbooked Appreciation

Presumably, A, B and C intended at the outset that if the partnership were to liquidate immediately after the option was exercised, A, B and C would each receive an equal liquidating distribution (*i.e.*, $100 each). However, it is debatable whether the above-described option actually produces this result. At least prior to the Proposed Regulations, arguably, the capital accounts of AB Partnership would be booked-up pursuant to Reg. §1.704-1(b)(2)(iv)(*f*) so that A's and B's capital accounts each would be equal to $115 immediately prior to C's admission, and that upon C's capital contribution, C would receive capital account credit of $70. The effect of this result would be to deny C the benefit of any appreciation that has accrued prior to the exercise of his option. This is illustrated by the fact that if the partnership were to sell its assets for $300 net of liabilities and selling expenses and then liquidate immediately after C's admission, A and B would each receive $115, and C would receive $70.

Perhaps the single largest historic trap for the unwary partnership option drafter has been the failure to take into account unrecorded appreciation in partnership assets (including goodwill) in the terms of the option document. The option should be drafted to expressly provide that, upon exercise and payment of the exercise price, C's capital account will contain one-third of the total partnership capital (irrespective of the option exercise price and premium), subject to proportionate dilution for subsequent issuances of partnership interests.

B. Restricted Distributions

In the preceding example, A and B could arguably diminish or eliminate the intended benefit (at least as far as C is concerned) of C's bargain by causing the partnership to make a distribution (*e.g.*, of $90) before C exercised his option. Consequently, the option drafter should consider whether the option agreement should restrict distributions, other than tax distributions by the partnership. The Proposed Anti-Abuse Rule provides that for purposes of applying the "partner attributes" component of the Substantially Similar Test, an option holder will be deemed to have partner attributes (although not necessarily an impermissible quantum of partner attributes) if he is allowed the right to control or restrict the activities of the partnership. Nonetheless, each of the three examples in the Proposed Anti-Abuse Rule assume that the partnership cannot make distributions while the option is outstanding. What is less certain, however, is whether an option will be considered to have too large a measure of partner attributes if, in lieu of prohibiting distributions, it permits distributions (or at least certain distributions) subject to a formula reduction of the option exercise price. Some thought should also be given to the impact of allowed distributions (for tax purposes or otherwise) on the terms of the option.

C. Dilution

The option generally should deal with prospective dilution issues. Presumably (although not necessarily), if Partnership AB admits D as a one-third partner in both profits and capital prior to C's exercise of his option, C would receive a one-quarter interest in profits, losses and capital upon exercise, not a one-third interest. In this regard, it would seem that the option drafter generally should include language to the effect that the interest received by C upon exercise of C's option will be self-adjusted proportionate with any dilution of A's and B's interest subsequent to the date that C's option was issued. Alternatively, the option might prevent any dilutive issuances, as is assumed in the three examples in the Proposed Anti-Abuse Rule.

D. Veto Rights

In contrast to the corporate model, a partner's deal is generally contained entirely in a written contract among the partners, *i.e.*, the partnership agreement. Consequently, C has a keen interest in ensuring, to the extent C has negotiating leverage, that the partnership does not substantially change the rules of the game before C exercises his option. For example, if D and C are arch-competitors, C may not be happy with his counsel if the option fails to give C a veto over D's admission to the partnership prior to (and after) the time C exercises his option. Beware, however, that the inclusion of these and other partner-like rights in the option may constitute a demerit for purposes of applying the Substantially Similar Test.[108]

E. Reverse Code Sec. 704(c) Allocations

Generally, the exercise of the option by C will give rise to, or create another layer of, book-tax disparities. The drafter should consider whether the option agreement should designate which Code Sec. 704(c) method for reducing such book-tax disparities will be employed.[109]

F. Execution of Partnership Agreement

Among other things, the option should condition the issuance of the interest to C upon his execution of the partnership agreement.

G. Buy-Out Provisions

A and B may want the partnership agreement to contain a provision for the purchase of C's interest or his/her option by one or more of A, B and the partnership upon the occurrence of certain events (*e.g.*, C's death).

H. Access to Information

Depending on the circumstances, it may be appropriate for option holders to have access to certain partnership information.[110]

I. Additional Provisions Occasioned by Proposed Regulations

The Proposed Regulations demand certain provisions be part of the partnership agreement to be deemed in compliance with the test for substantial economic effect. The option holder and the partnership should both ensure that the partnership agreement expressly provides that, on the exercise of any noncompensatory option, the partnership shall comply with the rules of Proposed Reg. §1.704-1(b)(2)(iv)(*s*). The option holder and the partnership should also ensure that all material allocations and capital account adjustments under the partnership agreement not pertaining to noncompensatory options are recognized under Code Sec. 704(b).[111] Because any event of issuance, transfer or modification triggers a full retesting of the option under the Proposed Anti-Abuse Rule, both the partnership and the option holder may be well advised to restrict (or if permissible, prohibit) the transferability of outstanding noncompensatory options and the ability of both parties to modify their terms. At a minimum, the option should require the holder to provide the partnership with notice of any transfer. Similarly, depending upon how the term "transfer" or "modification" is ultimately defined for this purpose, the option holder may wish to require that the partnership agreement contain provisions designed to preclude the partnership from triggering such event.

Beware, however, that under the Proposed Anti-Abuse Rule, the very act of carefully drafting the option agreement or partnership agreement language that is designed to protect against an ITM Event may in and of itself cause the option holder to be deemed to possess "partner attributes" under the Proposed Anti-Abuse Rule.[112] If it appears that the Strong Likelihood Test[113] will be satisfied, then the partnership and the option holder will need to pay close attention to the myriad features of the option that may cause it to be deemed either reasonably certain of exercise or to provide the holder with an impermissibly high measure of partner attributes.[114]

J. Conversion of the Partnership to a Corporation

The partnership agreement itself generally should permit a "reorganization" upon obtaining the requisite approval of the partners.

Warrants and options generally should contain provisions that permit this conversion without having to obtain the consent of the warrant or option holder. In the case of holders of warrants to acquire substantial partnership interests, it may be appropriate for the warrant holder to have a veto right. In the case of holders of compensatory options, it is generally not appropriate for the holder to have a veto right. In either case, however, the issue should be expressly addressed in the terms of the option itself.

K. Amendments to Partnership Agreement

Consideration should be given to the historic partners' ability to amend the partnership agreement both before and after exercise of the options or warrants. Generally, the historic partners will want the partnership agreement to permit amendments with a majority or super-majority vote, provided such amendments do not have a material adverse effect on the nonapproving partners.[115] The holder of a warrant to acquire a substantial partnership interest may be able to successfully negotiate for veto rights on any amendments to the partnership agreement.

L. Registration Rights

Although probably not appropriate for compensatory options, the holder of a warrant to purchase a substantial interest in the partnership may under certain circumstances want the ability to require the partnership to convert to a corporation and in such case may also want to have provisions dealing with such warrant holders' registration rights.

M. Securities Laws Compliance

Both federal and state securities laws are potentially applicable to the issuance of options.

VIII. Conclusion

The Treasury and the IRS did a remarkable job in preparing the Proposed Regulations, adopting many of the suggestions made in the ABA Comments and the N.Y. Comments and deftly dealing with technical issues unaddressed by either of those sets of input. Some technical issues remain to be fine-tuned, and some significant policy decisions remain to be made—and explained—in the process of finalizing the Proposed Regulations on noncompensatory options and in preparation for the issuance of proposed regulations on compensatory options. We look forward to the continued journey down this Yellow Brick Road, happy in the knowledge that our fellow travelers in the government have hearts, courage ... and BRAINS!

ENDNOTES

1 We both would like to express our appreciation to Adam Cohen of Holland & Hart LLP for his cheerful, insightful and witty assistance with this article.

2 Jester to Maverick, TOP GUN (Paramount Pictures 1986).

3 Kevin Thomason, *The Myth of the Capital Shift*, J. PASSTHROUGH ENTITIES, Sept.–Oct. 2002, at 49 (herein "*Myth*").

4 Comments in Response to Notice 2000-29, TAX LAW., Fall 2002 (herein the "ABA Comments").

5 *Myth*, at 51–52.

6 *Id.*

7 Comments in Response to Notice 2000-29, Jan. 29, 2002 (herein the "N.Y. Comments").

8 Thomason, Frost and Clifton, *Partnership Options*, 17th Annual Texas Federal Tax Institute, San Antonio, Texas, June 7, 1999 (herein "TexFed").

9 Speeches of Kevin Thomason before the Dallas Bar Association Tax Section, Dec. 5, 1999 ("Dallas"), and the Partnerships Committee of the ABA Tax Section, May 2002 ("ABA"); Kevin Thomason, *Partnership Options,* State Bar of Texas Advanced Tax Program, Houston, Texas, Sept. 2002 ("Houston").

10 Kevin Thomason, *Partnership Options and Related Instruments*, New York University 61st Institute on Taxation, Nov. 10–15, 2002, San Diego, California. (herein "NYU").

11 68 FR 2930–41 (Jan. 22, 2003) (herein "the Proposed Regulations").

12 Proposed Regulations, at 2931.

13 *Myth*, at 52.

14 *Id.,* at 54.

15 BULL DURHAM (Orion Pictures Corporation 1988). Millie to Annie Savoy regarding her pre-game clubhouse activities with Ebby Calvin "Nuke" LaLoosh in an early scene of the movie.

16 Lee A. Sheppard, *The Fairies, the Magic Circle, and Partnership Options,* 90 TAX NOTES 975 (Feb. 5, 2001); Sherwin Kamin, *Partnership Options—A Modified Aggregate Theory,* 91 TAX NOTES 975 (May 7, 2001).

17 Notice 2000-29, 2000-1 CB 1241.

18 All references herein to "Code Sec(s)." are to sections the Internal Revenue Code of 1986, as amended ("the Code").

19 For an in-depth summary of the ABA Comments and the N.Y. Comments, *see* NYU, *supra* note 10.

20 All references herein to "Reg. §" are to Treasury regulations promulgated to interpret the Code.

21 The ABA Comments and the N.Y. Comments both provided suggestions for the treatment of compensatory ("Service") options for partnership interests.

22 *See* Rev. Rul. 99-5, 1999-1 CB 434.

23 Rev. Rul. 78-172, 1978-1 CB 265.

24 *See also* Proposed Reg. §1.721-2(c).

25 *See* ABA Comments, N.Y. Comments and NYU.

26 Proposed Reg. §1.704-1(b)(2)(iv)(4).

27 TexFed, Dallas, Houston and NYU.

28 Reg. §1.721-1(b)(1).

29 Proposed Regulations, *supra* note 11, at 2931.

30 *See* Rev. Proc. 93-27, 1993-2 CB 343, as clarified in Rev. Proc. 2001-43, 2001-2 CB 191.

31 Proposed Regulations, *supra* note 11, at 2931.

32 This portion of the article will not deal with the recharacterization issues raised in the Proposed Regulations. *See* Section V of this article for a comprehensive discussion of that topic.

33 Proposed Regulations, *supra* note 11, at 2939.

34 Thus giving the partnership a cost basis in such property under Code Sec. 1012.

35 *Myth,* TexFed, Houston and NYU.

36 The initials of various personnel at the Treasury and the IRS were used in the examples. We applaud such usage (no doubt they earned it), but would suggest that the optionee in each example be given a consistent, and differently conceived, moniker (such as I, as used in the ABA Comments), simply to make it easier to remember who is the optionee when going through the explanations in the examples.

37 These assumptions (herein "the Standard Assumptions") are that (1) the LLC agreement

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requires that on the exercise of a noncompensatory option, LLC comply with the rules of Proposed Reg. §1.704-1(b)(2)(iv)(*s*); (2) all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under Code Sec. 704(b); (3) the option being discussed in the example is a noncompensatory option under Proposed Reg. §1.721-2(d); and (4) the optionee, here DH, is not treated as a partner with respect to the option.

38 Let us help you with what appears to be a confusing circularity in drafting, but is not. The proposed revision to Reg. §1.704-1(b)(2)(iv)(*f*)(*1*) would seem to require some complex calculations with regard to the option of DH. However, before you go down that path too far, note that the language that triggers the revaluation in the context of noncompensatory options, Proposed Reg. §1.704-1(b)(iv)(*s*)(*1*), provides that the revaluation, instead of theoretically occurring prior to the exercise (apparently feeling that the "conventional pre-exercise bookup" theory found in the N.Y. Comments had more validity than some had thought—*see Myth* and NYU), be done immediately after the exercise, in which case, in this simple example, there is no outstanding option to run through the meat-grinder of the proposed new language in Reg. §1.704-1(b)(2)(iv)(*f*)(*1*).

39 Proposed Reg. §1.704-1(b)(4)(x).

40 Reg. §1.704-3(c)(1).

41 Reg. §1.704-3(c)(3)(iii).

42 Reg. §1.704-3(d).

43 Apparently, under the right circumstances, SR could be both a holder of a preferred equity in the LLC and a holder of a separate common interest in such LLC, if the recharacterization provisions of the Proposed Regulations lead to such a conclusion. *See* Proposed Reg. §1.761-3 and Section V of this article.

44 SR's CPI gets no allocation or distribution prior to conversion, a fact pattern frighteningly close to a loan.

45 Proposed Reg. §1.704-3(a)(6).

46 *Id.*

47 Proposed Regulations, *supra* note 11, at 2931.

48 *Myth,* TexFed, Dallas, Houston and NYU.

49 *Myth*, at 55.

50 Example 22 appears to quantify the unrealized gain in the LLC's assets by reference only to the noncash assets thereof, presumably because cash always has a basis equal to its value. If, however, in searching for unrealized gain in the LLC's assets *via* a bulk computation of values of the LLC's assets and their aggregate bases is done, then one would have to reduce the basis of the vaporized cash premium to zero in order to reach the desired result.

51 TexFed, *Myth* and NYU.

52 *Myth*, at 53.

53 Among other events specified in Reg. §1.704-1(b)(2)(iv)(f).

54 *See* Reg. §1.704-1(b)(2)(iv)(*f*)(*1*).

55 Arguably, the existing regulations do not require the book-up or book-down to result in the partnership assets being adjusted to their fair market value, because Reg. §1.704-1(b)(2)(iv)(*f*) merely requires that "[t]he adjustments be *based on* the fair market value of partnership property …" (emphasis supplied). However, this issue is unclear.

56 *See* Code Sec. 83(a).

57 Proposed Reg. §1.704-1(b)(iv)(*h*)(*2*).

58 *Id.*

59 *See* Appendix A attached to this article for a full text of this portion of the Proposed Regulations.

60 As previously discussed, this problem appears to be primarily one of timing, which is largely addressed by virtue of the application of Code Sec. 704(c) principles to the book-tax differences resulting from exercising the option and becoming a partner. Proposed Reg. §1.761-3-(b)(2). Given the nature of partnerships, it is also possible to imagine that the tax stakes could also include character differences (*i.e.,* ordinary income versus capital gain) or perhaps even income-sourcing differences for non-U.S. taxpayers. *See also* Code Sec. 1234(c)(2) for the treatment of cash settlement options generally.

61 Proposed Reg. §1.761-3.

62 The preamble to the Proposed Regulations states: "For this purpose, the partner's interest in the partnership generally must reflect the economic differences between holding an option to acquire a partnership interest and holding the partnership interest itself. For example, unlike a partner, a noncompensatory option holder is not required initially to contribute to the partnership the full amount of the purchase price for the partnership interest. Instead, the noncompensatory option holder generally pays an option premium that is considerably smaller than the purchase price and may wait until the option is about to expire to decide whether to exercise the option and pay the exercise price. The computation of the noncompensatory option holder's share of partnership items should reflect this lesser amount of capital investment to the extent appropriate in a particular case. In addition, a noncompensatory option holder's cumulative distributive share of partnership losses and deductions may be limited under sections 704(b) and (d) to the amount paid by the holder to the partnership for the option." Preamble, at 2933.

63 If each of the first four questions is answered in the affirmative and the option is reasonably certain to be exercised, then the Proposed Regulations provide that the option holder will "ordinarily" be treated as a partner.

64 Proposed Reg. §1.761-3(b)(2).

65 For that matter, this lack of clarity has a broader impact than just that experienced in the context of the Proposed Anti-Abuse Rule. The definition of what constitutes an "option" is the portal through which one must go to determine whether any of the rules in the Proposed Regulations are applicable in a particular situation. *See* Proposed Reg. §1.704-1(b)(3)(b)(*1*).

66 *See* Proposed Reg. §1.761-3(d), Example 2.

67 Proposed Reg. §1.761-3(a).

68 As defined in Proposed Reg. §1.761-3(b)(ii), and as discussed above.

69 *See generally* Code Sec. 83 and Reg. §1.83-7(a); and Code Secs. 421 through 424.

70 Proposed Reg. §1.761-3(b)(ii).

71 Proposed Reg. §1.761-3(d), Example 1; Example 1 of the Proposed Regulations discussed below.

72 Proposed Reg. §1.761-3(d), Example 1.

73 Proposed Reg. §1.761-3(d), Example 3.

74 For an excellent analysis of this issue, *see* ABA Comments.

75 *E.E. McCauslen,* 45 TC 588, Dec. 27,889 (1966).

76 In the absence of additional guidance, it is possible that taxpayers, the IRS and the courts will look to common law notions of when a "modification" has occurred in other contexts. *See, e.g., Cottage Savings Ass'n,* SCt, 91-1 USTC ¶50,187, 499 US 554, 111 SCt 1503; and Reg. §1.1001-3 for analogous authority on the question of what constitutes a modification for this purpose.

77 Note the slight difference in the S corporation (second class of stock test) language from the "reasonably certain to be exercised" language contained in the Proposed Anti-Abuse Rule. *See* Reg. §1.1361-1(l)(4)(iii)(A), which states that the testing dates are "… the date that the call option is issued, transferred [by an eligible S corp shareholder to an ineligible S corp shareholder], or materially modified." Reg. §1.1361-1(l)(4)(iii)(A). This same regulation states further that, "For purposes of this paragraph (l)(4)(iii), if an option is issued in connection with a loan and the time period in which the option can be exercised is extended in connection with (and consistent with) a modification of the terms of the loan, the extension of the time period in which the option may be exercised is not considered a material modification."

78 Taxpayers should not assume that this rule will apply to other options outside the confines of subchapter K of the Code.

79 Although admittedly, the price of a double-tall-soy latte might cause one to rethink this conclusion, especially based on the value of the drink after an all-nighter of writing this article.

80 *See* Rev. Rul. 82-150, 1982-2 CB 110.

81 *See* Code Secs. 511(a) and 11.

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[82] For the same reasons articulated in Example 2, Nightworkers Pension Fund would be well advised to ensure that the option terms preclude Tridecaf PRSs from unilaterally treating Nightworkers Pension Fund as a partner during the pendency of the option.

[83] *See* Reg. §1.761-3(a)(3), which states, *inter alia* that "Partner attributes also include the existence of any arrangement ... that, directly or indirectly, allows the holder of a noncompensatory option to control or restrict the activities of the Partnership."

[84] Reg. §1.704-1(b)(2)(iii)(*a*) provides that one of the components of the substantiality test is whether "there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement." For an excellent discussion of the substantiality test and the strong likelihood test contained therein, *see* William S. McKee, William A. Nelson, and Robert B. Whitmire, Taxation of Partnerships and Partners (3d ed.), at ¶10.02[2][b].

[85] The Proposed Anti-Abuse Rule gives no indication of when these "other facts and circumstances" may exist.

[86] Interestingly, the similar term used in the S corporation regulations in connection with the analogous issue of whether a call option or warrant to acquire shares from the issuing S corporation is "substantially certain"—as opposed to "reasonably certain"—to be exercised. Reg. §1.1361-1(l)(4)(iii).

[87] *See* Rev. Rul. 82-150, *supra* note 80.

[88] *See* Rev. Proc. 93-27, 1993-2 CB 343.

[89] *See* Reg. §1.761-3(c) and (d), Example 3.

[90] Rev. Proc. 93-27, *supra* note 88.

[91] This issue will likely be of particular importance to option holders that are exempt organizations, such as qualified retirement plans or charities that face the threat of unrelated business taxable income if they are treated as partners, rather than option holders for tax purposes. Similarly, treatment of an option holder as a partner has immediate implications for the other partners, not only with respect to income and loss allocations, but also with respect to nonrecourse debt allocations under Code Sec. 752, partnership elections such as a Code Sec. 754 election, the determination of when a tax termination occurs under Code Sec. 708(b)(1)(B) and many other concerns under subchapter K. This mind-numbing complexity of treating an option holder as a partner prior to exercise may be exceeded by the task of unraveling such treatment in the event that the option ultimately lapses without being exercised. In such a case, one can only assume that the option holder who was treated as a partner, upon lapse, will be treated as though such holder's partnership interest were transferred to the partnership for no additional consideration, other than perhaps any deemed cash distributions to the former option holder/partner by virtue of nonrecourse debt reallocations under Code Sec. 752.

[92] *See, e.g.*, Reg. §1.1361-1(l)(4).

[93] *W.O. Culbertson, Jr.*, SCt, 49-1 USTC ¶9323, 337 US 733, 69 SCt 1210; *see also F.E. Tower*, SCt, 46-1 USTC ¶9189, 327 US 280, 66 SCt 532.

[94] *H.M. Luna*, 42 TC 1067, Dec. 26,967 (1964).

[95] *Culbertson*, *supra* note 95, 337 US, at 742.

[96] *Luna, supra note 96,* 42 TC, at 1077–78.

[97] *Supra* note 80.

[98] Contrast this result in Part 2, Example 3 of the Proposed Anti-Abuse Rule with the treatment of a call option with nominal exercise price ("penny option") that is issued to certain lenders by S corporations under Reg. §1.1361-1(l)(4)(iii)(B). In such case, the penny option to acquire S corporation shares is not deemed exercised.

[99] *See* the preamble to these Proposed Regulations; *see also* Reg. §1.1273-2(j).

[100] Proposed Reg. §1.761-3(c)(1).

[101] As noted above, such a safe harbor is provided in the S corporation regulations that govern whether a call option issued by a S corporation to acquire such corporation's stock will be treated as a second class of stock. Specifically, if the price of the call option is at least 90 percent of the fair market value of the underlying stock on the date the option is either issued, transferred by an eligible shareholder to an ineligible shareholder, or materially modified, then the option will fall within the safe harbor. The regulations further provide that "... a good faith determination of fair market value by the corporation will be respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable due diligence to obtain a fair value. Failure of an option to meet this safe harbor will not necessarily result in the option being treated as a second class of stock." Reg. §1.1361-1(l)(4). We see no reason why an analogous safe harbor is not appropriate here. It would certainly be helpful to those who are attempting to draft noncompensatory options with an often-required high degree of certainty that the option holder will not be treated as a partner.

[102] Reg. §1.83-3, -7(a). For an excellent discussion of compensatory partnership options and noncompensatory compensatory options *see generally*, ABA Comments, at 203 (Fall 2002). This includes the tax treatment of the grant, exercise, lapse and disposition of compensatory options, which entail different issues from the tax treatment of noncompensatory options. The distinction between compensatory and noncompensatory options stems from the fact that a compensatory option, unlike a noncompensatory option, generally is not treated as "property" for income tax purposes. Treasury officials have announced that they are working on proposed regulations dealing with the tax treatment of compensatory partnership options.

[103] *Supra* note 4, at 203–30 and 239.

[104] *Id.*, at 238.

[105] *Id.*, at 239.

[106] *Id.*, at 241.

[107] *See generally* Reg. §1.704-1(b).

[108] *See* Proposed Reg. §1.716-3(c)(3).

[109] *See generally* Reg. §§1.704-1(b)(2)(iv)*(d)*(*3*) and 1.704-3.

[110] Such a provision might read as follows: "***Availability of Information.*** So long as the Partnership shall not have filed a registration statement pursuant to Section 12 of the Exchange Act or a registration statement pursuant to the requirements of the Securities Act, the Partnership shall, at any time and from time to time, upon the request of any holder of Restricted Securities and upon the request of any Person designated by such holder as a prospective purchaser of any Restricted Securities, furnish in writing to such holder or such prospective purchaser, as the case may be, a statement as of a date not earlier than 12 months prior to the date of such request of the nature of the business of the Partnership and the products and services it offers and copies of the Partnership's most recent balance sheet and profit and loss and retained earnings statements, together with similar financial statements for such part of the two preceding fiscal years as the Partnership shall have been in operation, all such financial statements to be audited to the extent audited statements are reasonably available, provided that, in any event the most recent financial statements so furnished shall include a balance sheet as of a date less than 16 months prior to the date of such request, statements of profit and loss and retained earnings for the 12 months preceding the date of such balance sheet, and, if such balance sheet is not as of a date less than six months prior to the date of such request, additional statements of profit and loss and retained earnings for the period from the date of such balance sheet to a date less than six months prior to the date of such request. If the Partnership shall have filed a registration statement pursuant to the requirements of Section 12 of the Exchange Act or a registration statement pursuant to the requirements of the Securities Act, the Partnership shall timely file the reports required to be filed by it under the Securities Act and the Exchange Act (including but not limited to the reports under Sections 13 and

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15(d) of the Exchange Act referred to in subparagraph (c) of Rule 144 adopted by the Commission under the Securities Act) and will take such further action as any holder of Restricted Securities may reasonably request, all to the extent required from time to time to enable such holder to sell Restricted Securities without registration under the Securities Act within the limitation of the exemptions provided by (a) Rule 144 and Rule 144A under the Securities Act, as such rules may be amended from time to time, or (b) any other rule or regulation now existing or hereafter adopted by the Commission. Upon the request of any holder of Restricted Securities, the Partnership will deliver to such holder a written statement as to whether it has complied with such requirements."

111 Proposed Reg. §1.704-1(b)(4)(ix).

112 *See* Proposed Reg. §1.761-3(a)(3).

113 Proposed Reg. §1.761-3(a).

114 *See* Proposed Reg. §1.761-3(c).

115 A sample provision is as follows: "***Amendments.*** This Agreement may be amended only with the written agreement of Partners holding not less than ninety percent (90%) of the Voting Interests. No amendment that has been agreed to in accordance with the preceding sentence shall be effective to the extent that such amendment has a Material Adverse Effect upon one or more Equity Owners who did not agree in writing to such amendment. For purposes of the preceding sentence, "Material Adverse Effect" shall mean any modification of the relative rights to Distributions by the Partnership (including allocations of Profits and Losses which are reflected in the Capital Accounts). Without limiting the generality of the foregoing: an amendment that has a proportionate effect on all Equity Owners (or in the case of a redemption of Ownership Interests or issuance of additional Ownership Interests, an amendment that has a proportionate effect on all Equity Owners immediately after such redemption or issuance) with respect to their rights to Distributions shall be deemed to not have a Material Adverse Effect on Equity Owners who do not agree in writing to such amendment. Notwithstanding the foregoing provisions of this Section _____, no amendment shall be made to a provision herein which requires the vote, approval or consent of the Partners holding more than ninety percent (90%) of the Voting Interests, unless Partners holding such greater Voting Interests approve of such amendment."

Appendix A—Proposed Partnership Options Regulations

SECTION 1.704-1. PARTNER'S DISTRIBUTIVE SHARE.

(a) EFFECT OF PARTNERSHIP AGREEMENT. A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761(c).

(b) DETERMINATION OF PARTNER'S DISTRIBUTIVE SHARE—

(0) CROSS-REFERENCES.

(1) IN GENERAL—

***

(ii) EFFECTIVE DATES. The provisions of this paragraph are effective for partnership taxable years beginning after December 31, 1975. However, for partnership taxable years beginning after December 31, 1975, but before May 1, 1986, (January 1, 1987, in the case of allocations of nonrecourse deductions as defined in paragraph (b)(4)(iv)(a) of this section) an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner that is not respected under this paragraph nevertheless will be respected under section 704(b) if such allocation has substantial economic effect or is in accordance with the partners' interests in the partnership as those terms have been interpreted under the relevant case law, the legislative history of section 210(d) of the Tax Reform Act of 1976, and the provisions of this paragraph in effect for partnership taxable years beginning before May 1, 1986. In addition, paragraph (b)(2)(iv)(d)(4), paragraph (b)(2)(iv)(h) (2), paragraph (b)(2)(iv)(s), paragraph (b)(4)(ix), paragraph (b)(4)(x), and Examples 20 through 24 in paragraph (b)(5) of this section apply to noncompensatory options (as defined in _1.721-2(d)) that are issued on or after the date final regulations are published in the Federal Register.

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(2) SUBSTANTIAL ECONOMIC EFFECT—

(i) TWO-PART ANALYSIS. ***

(ii) ECONOMIC EFFECT—***

(iii) SUBSTANTIALITY—***

(iv) MAINTENANCE OF CAPITAL ACCOUNTS—

(a) IN GENERAL. ***

(b) BASIC RULES. ***

(c) TREATMENT OF LIABILITIES. ***

(d) CONTRIBUTED PROPERTY—

(1) IN GENERAL. The basic capital accounting rules contained in paragraph (b)(2)(iv)(b) of this section require that a partner's capital account be increased by the fair market value of property contributed to the partnership by such partner on the date of contribution. See Example 13(i) of paragraph (b)(5) of this section. Consistent with section 752(c), section 7701(g) does not apply in determining such fair market value.

(2) CONTRIBUTION OF PROMISSORY NOTES. ***

(3) SECTION 704(c) CONSIDERATIONS. ***

(4) Exercise of noncompensatory options. For purposes of paragraph (b)(2)(iv)(b)(2) of this section, the fair market value of the property contributed on the exercise of a noncompensatory option (as defined in § 1.721- 2(d)) does not include the fair market value of the option privilege, but does include the consideration paid to the partnership to acquire the option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the option. With respect to convertible equity, the fair market value of the property contributed to the partnership on the exercise of the option includes the converting partner's capital account immediately before the conversion. With respect to convertible debt, the fair market value of the property contributed on the exercise of the option includes the adjusted basis and the accrued but unpaid qualified stated interest on the debt immediately before the conversion. See Examples 20 through 24 of paragraph (b)(5) of this section.

(e) DISTRIBUTED PROPERTY—

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(f) REVALUATIONS OF PROPERTY. A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

(1) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, ~~and~~as determined under paragraph (b)(2)(iv)(h) of this section, reduced by the consideration paid to the partnership to acquire any outstanding noncompensatory options (as defined in § 1.721-2(d)) that are issued on or after the date final regulations are published in the Federal Register. See Example 22 of paragraph (b)(5) of this section. * * * * *

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(g) ADJUSTMENTS TO REFLECT BOOK VALUE—***

(h) DETERMINATIONS OF FAIR MARKET VALUE.

Appendix A—Proposed Partnership Options Regulations (cont'd)

(1) In general. For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that

(~~1~~i) such value is reasonably agreed to among the partners in arm's-length negotiations, and ~~(2)~~

(ii) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.

(2) Adjustments for noncompensatory options. The fair market value of partnership property must be adjusted to account for any outstanding noncompensatory options (as defined in 1.721-2(d)) at the time of a revaluation of partnership property under paragraph (b)(2)(iv)(f) or (s) of this section. If the fair market value of outstanding noncompensatory options (as defined in 1.721-2(d)) as of the date of the adjustment exceeds the consideration paid by the option holders to acquire the options, then the fair market value of partnership property must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. If the price paid by the option holders to acquire the outstanding noncompensatory options (as defined in 1.721-2(d)) exceeds the fair market value of such options as of the date of excess to the extent of the unrealized deduction or loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation.

(i) SECTION 705(a)(2)(B) EXPENDITURES— ***

(j) BASIS ADJUSTMENTS TO SECTION 38 PROPERTY. ***

(k) DEPLETION OF OIL AND GAS PROPERTIES—***

(l) TRANSFERS OF PARTNERSHIP INTERESTS. ***

(m) SECTION 754 ELECTIONS—***

(n) PARTNERSHIP LEVEL CHARACTERIZATION. ***

(o) GUARANTEED PAYMENTS. ***

(p) MINOR DISCREPANCIES. ***

(q) ADJUSTMENTS WHERE GUIDANCE IS LACKING. ***

(r) RESTATEMENT OF CAPITAL ACCOUNTS. ***

(s) Adjustments on the exercise of a noncompensatory option. A partnership agreement may grant a partner, on the exercise of a noncompensatory option (as defined in § 1.721-2(d)), a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid by the partner to acquire and exercise such option. Where such an agreement exists, capital accounts will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless—

(1) In lieu of revaluing partnership property under paragraph (b)(2)(iv)(f) of this section immediately before the exercise of the option, the partnership revalues partnership property in accordance with the provisions of paragraphs (b)(2)(iv)(f)(1) through (4) of this section immediately after the exercise of the option;

(2) In determining the capital accounts of the partners (including the exercising partner) under paragraph (b)(2)(iv)(s)(1) of this section, the partnership first allocates any unrealized income, gain, loss, or deduction in partnership assets (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner's right to share in partnership capital under the partnership agreement, and then allocates any remaining unrealized income gain, loss, or deduction (that has not been reflected in the capital accounts previously) to the existing partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date;

(3) If, after making the allocations described in paragraph (b)(2)(iv)(s)(2) of this section, the exercising partner's capital account still does not reflect that partner's right to share in partnership capital under the partnership agreement, then the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner's capital account does reflect the exercising partner's right to share in partnership capital under the partnership agreement (a capital account reallocation). Any increase or reduction in the capital accounts of existing partners that occurs as a result of a capital account reallocation under this paragraph (b)(2)(iv)(s)(3) must be allocated among the existing partners in accordance with the principles of this section; and

(4) The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made under paragraph (b)(2)(iv)(s)(3) of this section (see paragraph (b)(4)(x) of this section). See Examples 20 through 24 of paragraph (b)(5) of this section.

(3) PARTNER'S INTEREST IN THE PARTNERSHIP— ***

(4) SPECIAL RULES—

(i) ALLOCATIONS TO REFLECT REVALUATIONS.***

(ii) CREDITS. ***

Appendix A—Proposed Partnership Options Regulations (cont'd)

(iii) EXCESS PERCENTAGE DEPLETION. ***

(iv) ALLOCATIONS ATTRIBUTABLE TO NONRECOURSE LIABILITIES. ***

(v) ALLOCATIONS UNDER SECTION 613A(c)(7)(D). ***

(vi) AMENDMENTS TO PARTNERSHIP AGREEMENT. ***

(vii) RECAPTURE. ***

(ix) Allocations with respect to noncompensatory options. A partnership agreement may grant to a partner that exercises a noncompensatory option a right to share in partnership capital that exceeds (or is less than) the sum of the amounts paid by the partner to acquire and exercise such option. In such a case, allocations of income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding cannot have economic effect, because, if the noncompensatory option is exercised, the exercising partner, rather than the existing partners, may receive the economic benefit or bear the economic detriment associated with that income, gain, loss, or deduction. Allocations of partnership income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding will be deemed to be in accordance with the partners' interests in the partnership only if—

(a) The holder of the noncompensatory option is not treated as a partner under _1.761-3;

(b) The partnership agreement requires that, on the exercise of the noncompensatory option, the partnership comply with the rules of paragraph (b)(2)(iv)(s) of this section; and

(c) All material allocations and capital account adjustments under the partnership agreement not pertaining to noncompensatory options are recognized under section 704(b). See Examples 20 through 24 of paragraph (b)(5) of this section.

(x) Corrective allocations. If partnership capital is reallocated between existing partners and a partner exercising a noncompensatory option under paragraph (b)(2)(iv)(s)(3) of this section (a capital account reallocation), the partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the allocations required are fully taken into account, make corrective allocations so as to take into account the capital account reallocation. A corrective allocation is an allocation (consisting of a pro rata portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item. See Example 21 of paragraph (b)(5) of this section.

(5) EXAMPLES. The operation of the rules in this paragraph is illustrated by the following examples:

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Example 20. (i) In Year 1, TM and PK each contribute cash of $10,000 to LLC, a newly formed limited liability company, classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase a non-depreciable property, Property A, for $20,000. Also in Year 1, at a time when Property A is still valued at $20,000, LLC issues an option to DH. The option allows DH to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DH pays $1,000 to the LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under section 704(b). Also assume that DH's option is a noncompensatory option under § 1.721-2(d), and that DH is not treated as a partner with respect to the option. In Year 2, DH exercises the option, contributing the $15,000 exercise price to the partnership. At the time the option is exercised, the value of Property A is $35,000.

	Assets		Liabilities and Capital	
	Basis	Value	Basis	Value
Property A	$20,000	$35,000	TM $10,000	$17,000
Cash			PK $10,000	$17,000
Premium	$1,000	$1,000	DH $16,000	$17,000
Exercise Price	$15,000	$15,000		
Total	$36,000	$51,000	$36,000	$51,000

(ii) Under paragraphs (b)(2)(iv)(b)(2) and (b)(2)(iv)(d)(4) of this section, DH's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, DH is entitled to LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). Immediately after the exercise of the option, LLC's assets are cash of $16,000 ($1,000 premium and $15,000 exercise price contributed by DH) and Property A, which has a value of $35,000. Thus, the total value of LLC's assets is $51,000. DH is entitled to LLC capital equal to 1/3 of this value, or $17,000. As DH is entitled to $1,000 more LLC capital than DH's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(iii) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase DH's capital account from $16,000 to $17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section and allocating the first $1,000 of book gain to DH. The net gain in LLC's assets (Property A) is $15,000 ($35,000 value less $20,000 basis). The first $1,000 of this gain must be allocated to DH, and the remaining $14,000 of this gain is allocated equally to TM and PK in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(s)(2) of this section increases DH's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

Appendix A—Proposed Partnership Options Regulations (cont'd)

	TM		PK		DH	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	$10,000	$10,000	$10,000	$10,000	$16,000	$16,000
Revaluation amount		$7,000		$7,000		$1,000
Capital account after revaluation	$10,000	$17,000	$10,000	$17,000	$16,000	$17,000

Example 21. (i) Assume the same facts as in Example 20, except that, in Year 1, LLC sells Property A for $40,000, recognizing gain of $20,000. LLC does not distribute the sale proceeds to its partners and it has no other earnings in Year 1. With the proceeds ($40,000), LLC purchases Property B, a nondepreciable property. Also assume that DH exercises the noncompensatory option at the beginning of Year 2 and that, at the time DH exercises the option, the value of Property B is $41,000. In Year 2, LLC has gross income of $3,000 and deductions of $1,500.

	Assets		Liabilities and Capital	
	Basis	Value	Basis	Value
Property B	$40,000	$41,000	TM $20,000	$19,000
Cash	$16,000	$16,000	PK $20,000	$19,000
			DH $16,000	$19,000
Total	$56,000	$57,000	$56,000	$57,000

(ii) Under paragraphs (b)(2)(iv)(b)(2) and (b)(2)(iv)(d)(4) of this section, DH's capital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, DH is entitled to LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). Immediately after the exercise of the option, LLC's assets are $16,000 cash ($1,000 option premium and $15,000 exercise price contributed by DH) and Property B, which has a value of $41,000. Thus, the total value of LLC's assets is $57,000. DH is entitled to LLC capital equal to 1/3 of this amount, or $19,000. As DH is entitled to $3,000 more LLC capital than DH's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(iii) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase DH's capital account from $16,000 to $19,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating the $1,000 of book gain from the revaluation to DH. This brings DH's capital account to $17,000. Second, under paragraph (b)(2)(iv)(s)(3) of this section, LLC must reallocate $2,000 of capital from the existing partners (TM and PK) to DH to bring DH's capital account to $19,000 (the capital account reallocation). As TM and PK share equally in all items of income, gain, loss, and deduction of LLC, each member's capital account is reduced by 2 of the $2,000 reduction ($1,000).

(iv) Under paragraph (b)(2)(iv)(s)(4) of this section, beginning in the year in which the option is exercised, LLC must make corrective allocations so as to take into account the capital account reallocation. In Year 2, LLC has gross income of $3,000 and deductions of $1,500. The book gross income of $3,000 is shared equally by TM, PK, and DH. For tax purposes, however, LLC must allocate all of its gross income ($3,000) to DH. LLC's deductions ($1,500) must be allocated equally among TM, PK, and DH. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from Property B must be allocated in accordance with section 704(c) principles.

	TM		PK		DH	
	Tax	Book	Tax	Book	Tax	Book
Capital account after exercise	$20,000	$20,000	$20,000	$20,000	$16,000	$16,000
Revaluation						$1,000
Capital account after revaluation	$20,000	$20,000	$20,000	$20,000	$16,000	$17,000
Capital account reallocation		($1,000)		($1,000)		$2,000
Capital account after capital account reallocation	$20,000	$19,000	$20,000	$19,000	$16,000	$19,000
Income allocation (Yr. 2)		$1,000		$1,000	$3,000	$1,000
Deduction allocation (Yr. 2)	($500)	($500)	($500)	($500)	($500)	($500)
Capital account at end of year 2	$19,000	$19,500	$19,000	$19,500	$18,500	$19,500

Example 22. (i) In Year 1, AC and NE each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Under the LLC agreement, each unit is entitled to participate equally in the profits and losses of LLC. LLC uses the cash contributions to purchase two non-depreciable properties, Property A and Property B, for $10,000 each. Also in Year 1, at a time when Property A and Property B are still valued at $10,000 each, LLC issues an option to DR. The option allows DR to buy 100 units in LLC for an exercise price of $15,000 in Year 2. DR pays $1,000 to LLC for the issuance of the option. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under section 704(b). Also assume that DR's option is a noncompensatory option under § 1.721-2(d), and that DR is not treated as a partner with respect to the option.

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(ii) Prior to the exercise of DR's option, ML contributes $17,000 to LLC for 100 units in LLC. At the time of ML's contribution, Property A has a value of $30,000 and a basis of $10,000, Property B has a value of $5,000 and a basis of $10,000, and the fair market value of DR's option is $2,000.

(iii) Upon ML's admission to the partnership, the capital accounts of AC and NE (which were $10,000 each prior to ML's admission) are, in accordance with paragraph (b)(2)(iv)(f) of this section, adjusted upward to reflect their shares of the unrealized appreciation in the partnership's assets. Under paragraph (b)(2)(iv)(f)(1) of this section, those adjustments must be based on the fair market value of LLC property (taking section 7701(g) into account) on the date of the adjustment. The fair market value of partnership property ($36,000) must be reduced by the consideration paid by DR to the partnership to acquire the option ($1,000) (under paragraph (b)(2)(iv)(f)(1) of this section), and the excess of the fair market value of the option as of the date of the adjustment over the consideration paid by DR to acquire the option ($1,000) (under paragraph (b)(2)(iv)(h)(2) of this section), but only to the extent of the unrealized appreciation in LLC property ($15,000). Therefore, the revaluation adjustments must be based on a value of $34,000. Accordingly, AC and NE's capital accounts must be increased to $17,000. This $1,000 reduction is allocated entirely to Property A, the only asset having unrealized appreciation. Therefore, the book value of Property A is $29,000. The $19,000 of built-in gain in Property A and the $5,000 of built-in loss in Property B must be allocated equally between AC and NE in accordance with section 704(c) principles.

	Assets Basis	Value	Option Adjustment	704(c) Book
Property A	$10,000	$30,000	($1,000)	$29,000
Property B	$10,000	$5,000	0	$5,000
Cash	$1,000	$1,000	0	$1,000
Subtotal	$21,000	$36,000	($1,000)	$35,000
Cash contributed by ML	$17,000	$17,000	0	$17,000
Total	$38,000	$53,000	($1,000)	$52,000

	Liabilities and Capital	
	Tax	Value
AC	$10,000	$17,000
NE	$10,000	$17,000
ML	$17,000	$17,000
Option	$1,000	$2,000
Total	$38,000	$53,000

(iv) After the admission of ML, when Property A still has a value of $30,000 and a basis of $10,000 and Property B still has a value of $5,000 and a basis of $10,000, DR exercises the option. On the exercise of the option, DR'scapital account is credited with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, DR is entitled to LLC capital corresponding to 100 units of LLC (1/4 of LLC's capital). Immediately after the exercise of the option, LLC's assets are worth $68,000 ($15,000 contributed by DR, plus the value of LLC assets prior to the exercise of the option, $53,000). DR is entitled to LLC capital equal to 1/4 of this value, or $17,000. As DR is entitled to $1,000 more LLC capital than DR's capital contributions to LLC, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

(v) Under paragraph (b)(2)(iv)(s) of this section, the LLC must increase DR's capital account from $16,000 to $17,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section and allocating the first $1,000 of book gain to DR. The net increase in the value of LLC properties since the previous revaluation is $1,000 (the difference between the actual value of Property A, $30,000, and the book value of Property A, $29,000). The entire $1,000 of book gain is allocated to DR. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(s)(2) of this section increases DR's capital account to the amount agreed on by the members, the LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from Properties A and B must be allocated in accordance with section 704(c) principles.

	AC		NE		ML		DR	
	Tax	Book	Tax	Book	Tax	Book	Tax	Book
Capital account after admission of ML	$10,000	$17,000	$10,000	$17,000	$17,000	$17,000		
Capital account after exercise of DR's option	$10,000	$17,000	$10,000	$17,000	$17,000	$17,000	$16,000	$16,000
Revaluation								$1,000
Capital account after revaluation	$10,000	$17,000	$10,000	$17,000	$17,000	$17,000	$16,000	$17,000

Example 23. (i) On the first day of Year 1, MS, VH, and SR form LLC, a limited liability company classified as a partnership for Federal tax purposes. MS and VH each contribute $10,000 cash to LLC for 100 units of common interest in LLC. SR contributes $10,000 cash for a convertible preferred interest in LLC. SR's convertible preferred interest entitles SR to receive an annual allocation and distribution of cumulative LLC net profits in an amount equal to 10 percent of SR's unreturned capital. SR's convertible preferred interest also entitles SR to convert, in year 3, SR's preferred interest into 100 units of common interest. If SR converts, SR has the right to the same share of LLC capital as SR would

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have had if SR had held the 100 units of common interest since the formation of LLC. Under the LLC agreement, each unit of common interest has an equal right to share in any LLC net profits that remains after payment of the preferred return. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section, and that all material allocations and capital account adjustments under the LLC agreement not pertaining to noncompensatory options are recognized under section 704(b). Also assume that SR's right to convert the preferred interest into a common interest qualifies as a noncompensatory option under § 1.721-2(d), and that, prior to the exercise of the conversion right, SR is not treated as a partner with respect to the conversion right.

(ii) LLC uses the $30,000 to purchase Property Z, a property that is depreciable on a straight-line basis over 15 years. In each of Years 1 and 2, LLC has net income of $2,500, comprised of $4,500 of gross receipts and $2,000 of depreciation. It allocates and distributes $1,000 of this net income to SR in each year. LLC allocates, but does not distribute, the remaining $1,500 of net income equally to MS and VH in each year.

	MS		VH		SR	
	Tax	Book	Tax	Book	Tax	Book
Capital account upon formation	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
Allocation of income Years 1 and 2	$1,500	$1,500	$1,500	$1,500	$2,000	$2,000
Distributions Years 1 and 2					($2,000)	($2,000)
Capital account end of Year 2	$11,500	$11,500	$11,500	$11,500	$10,000	$10,000
Capital account end of Year 2	$11,500	$11,500	$11,500	$11,500	$10,000	$10,000

(iii) At the beginning of Year 3, when Property Z has a value of $38,000 and a basis of $26,000 ($30,000 original basis less $4,000 of depreciation) and LLC has accumulated undistributed cash of $7,000 ($9,000 gross receipts less $2,000 distributions), SR converts SR's preferred interest into a common interest. Under paragraphs (b)(2)(iv)(b)(2) and (b)(2)(iv)(d)(4) of this section, SR's capital account after the conversion equals SR's capital account before the conversion, $10,000. On the conversion of the preferred interest, however, SR is entitled to LLC capital corresponding to 100 units of common interest in LLC (1/3 of LLC's capital). At the time of the conversion, the total value of LLC assets is $45,000. SR is entitled to LLC capital equal to 1/3 of this value, or $15,000. As SR is entitled to $5,000 more LLC capital than SR's capital account immediately after the conversion, the provisions of paragraph (b)(2)(iv)(s) of this section apply.

Assets			Liabilities and Capital		
	Basis	Value		Basis	Value
Property Z	$26,000	$38,000	MS	$11,500	$15,000
Undistributed Income	$7,000	$7,000	VH	$11,500	$15,000
			SR	$10,000	$15,000
Total	$33,000	$45,000	Total	$33,000	$45,000

(iv) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase SR's capital account from $10,000 to $15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating the first $5,000 of book gain from that revaluation to SR. The net unrealized gain in LLC's assets (Property Z) is $12,000 ($38,000 value less $26,000 basis). The first $5,000 of this gain must be allocated to SR. The remaining $7,000 of that gain must be allocated equally to MS and VH in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(s)(2) of this section increases SR's capital account to the amount agreed on by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	MS		VH		SR	
	Tax	Book	Tax	Book	Tax	Book
Capital account prior to conversion	$11,500	$11,500	$11,500	$11,500	$10,000	$10,000
Revaluation on conversion		$3,500		$3,500		$5,000
Capital account after conversion	$11,500	$15,000	$11,500	$15,000	$10,000	$15,000

Example 24. (i) On the first day of Year 1, AK and JP each contribute cash of $10,000 to LLC, a newly formed limited liability company classified as a partnership for Federal tax purposes, in exchange for 100 units in LLC. Immediately after its formation, LLC borrows $10,000 from JS. Under the terms of the debt instrument, interest of $1,000 is payable annually and principal is repayable in five years. Throughout the term of the indebtedness, JS has the right to convert the debt instrument into 100 units in LLC. If JS converts, JS has the right to the same share of LLC capital as JS would have had if JS had held 100 units in LLC since the formation of LLC. Under the LLC agreement, each unit participates equally in the profits and losses of LLC and has an equal right to share in LLC capital. Assume that the LLC agreement requires that, on the exercise of a noncompensatory option, LLC comply with the rules of paragraph (b)(2)(iv)(s) of this section, and that all material allocations and capital account adjustments not pertaining to noncompensatory options are recognized under section 704(b). Also assume that JS's right to

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convert the debt into an interest in LLC qualifies as a noncompensatory option under § 1.721-2(d), and that, prior to the exercise of the conversion right, JS is not treated as a partner with respect to the convertible debt.

(ii) LLC uses the $30,000 to purchase Property D, property that is depreciable on a straight-line basis over 15 years. In each of Years 1, 2, and 3, LLC has net income of $2,000, comprised of $5,000 of gross receipts, $2,000 of depreciation, and interest expense (representing payments of interest on the loan from JS) of $1,000. LLC allocates, but does not distribute, this income equally to AK and JP.

	AK		JP		JS	
	Tax	Book	Tax	Book	Tax	Book
Initial capital account	$10,000	$10,000	$10,000	$10,000		
Year 1 net income	$1,000	$1,000	$1,000	$1,000		
Year 2 net income	$1,000	$1,000	$1,000	$1,000		
Year 3 net income	$1,000	$1,000	$1,000	$1,000		
Year 4 initial capital account	$13,000	$13,000	$13,000	$13,000	0	0

(iii) At the beginning of year 4, at a time when Property D, the LLC's only asset, has a value of $33,000 and basis of $24,000 ($30,000 original basis less $6,000 depreciation in Years 1 through 3), and LLC has accumulated undistributed cash of $12,000 ($15,000 gross receipts less $3,000 of interest payments) in LLC, JS converts the debt into a 1/3 interest in LLC. Under paragraphs (b)(2)(iv)(b)(2) and (b)(2)(iv)(d)(4) of this section, JS's capital account after the conversion is the adjusted basis of the debt immediately before JS's conversion of the debt, $10,000, plus any accrued but unpaid qualified stated interest on the debt, $0. On the conversion of the debt, however, JS is entitled to receive LLC capital corresponding to 100 units of LLC (1/3 of LLC's capital). At the time of the conversion, the total value of LLC's assets is $45,000. JS is entitled to LLC capital equal to 1/3 of this value, or $15,000. As JS is entitled to $5,000 more LLC capital than JS's capital contribution to LLC ($10,000), the provisions of paragraph (b)(2)(iv)(s) of this section apply.

	Assets			Liabilities and Capital	
	Basis	Value		Basis	Value
Property D	$24,000	$33,000	AK	$13,000	$15,000
Cash	$12,000	$12,000	JP	$13,000	$15,000
			JS	$10,000	$15,000
Total	$36,000	$45,000		$36,000	$45,000

(iv) Under paragraph (b)(2)(iv)(s) of this section, LLC must increase JS's capital account from $10,000 to $15,000 by, first, revaluing LLC property in accordance with the principles of paragraph (b)(2)(iv)(f) of this section, and allocating the first $5,000 of book gain from that revaluation to JS. The net unrealized gain in LLC's assets (Property D) is $9,000 ($33,000 value less $24,000 basis). The first $5,000 of this gain must be allocated to JS, and the remaining $4,000 of that gain must be allocated equally to AK and JP in accordance with the LLC agreement. Because the revaluation of LLC assets under paragraph (b)(2)(iv)(s)(2) of this section increases JS's capital account to the amount agreed upon by the members, LLC is not required to make a capital account reallocation under paragraph (b)(2)(iv)(s)(3) of this section. Under paragraph (b)(2)(iv)(f)(4) of this section, the tax items from the revalued property must be allocated in accordance with section 704(c) principles.

	AK		JP		JS	
	Tax	Book	Tax	Book	Tax	Book
Year 4 capital account prior to exercise	$13,000	$13,000	$13,000	$13,000	0	0
Capital account after exercise	$13,000	$13,000	$13,000	$13,000	$10,000	$10,000
Revaluation		$2,000		$2,000		$5,000
Capital account after revaluation	$13,000	$15,000	$13,000	$15,000	$10,000	$15,000

(c) CONTRIBUTED PROPERTY; CROSS-REFERENCE. ***

(d) LIMITATION ON ALLOWANCE OF LOSSES. ***

(e) FAMILY PARTNERSHIPS. ***

SECTION 1.704-3. CONTRIBUTED PROPERTY.

(a) IN GENERAL—***

(6) OTHER APPLICATIONS OF SECTION 704(C) PRINCIPLES—

(i) REVALUATIONS UNDER SECTION 704(b). The principles of this section apply to allocations with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to ~~section~~ § 1.704-1(b)(2)(iv)(f) or 1.704-1(b)(2)(iv)(s) (reverse section 704(c) allocations).

Appendix A—Proposed Partnership Options Regulations (cont'd)

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SECTION 1.721-1. NONRECOGNITION OF GAIN OR LOSS ON CONTRIBUTION.

(a) No gain or loss shall be recognized either to the partnership or toany of its partners upon a contribution of property, including installmentobligations, to the partnership in exchange for a partnership interest.

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§ 1.721-2 Noncompensatory options.

(a) Exercise of a noncompensatory option. Notwithstanding § 1.721-1(b)(1), section 721 applies to the exercise (as defined in paragraph (e)(4) of this section) of a noncompensatory option (as defined in paragraph (d) of this section). However, if the exercise price (as defined in paragraph (e)(5) of this section) of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the noncompensatory option, the transaction will be given tax effect in accordance with its true nature.

(b) Transfer of property in exchange for a noncompensatory option. Section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option. For example, if a person purchases a noncompensatory option with appreciated property, the person recognizes income or gain to the extent that the fair market value of the noncompensatory option exceeds the person's basis in the surrendered property.

(c) Lapse of a noncompensatory option. Section 721 does not apply to the lapse of a noncompensatory option.

(d) Scope. The provisions of this section apply only to noncompensatory options and do not apply to any interest on convertible debt that has been accrued by the partnership (including accrued original issue discount). For purposes of this section, the term noncompensatory option means an option (as defined in paragraph (e)(1) of this section) issued by a partnership (the issuing partnership), other than an option issued in connection with the performance of services.

(e) Definitions. The following definitions apply for the purposes of this section.

(1) Option means a call option or warrant to acquire an interest in the issuing partnership, the conversion feature of convertible debt (as defined in paragraph (e)(2) of this section), or the conversion feature of convertible equity (as defined in paragraph (e)(3) of this section). A contract that otherwise constitutes an option shall not fail to be treated as such for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(2) Convertible debt is any indebtedness of a partnership that is convertible into an interest in that partnership.

(3) Convertible equity is preferred equity in a partnership that is convertible into common equity in that partnership. For this purpose, preferred equity is any interest in the issuing partnership that entitles the partner to a preferential return on capital and common equity is any interest in the issuing partnership that is not preferred equity.

(4) Exercise means the exercise of an option or warrant or the conversion of convertible debt or convertible equity.

(5) Exercise price means, in the case of a call option or warrant, the exercise price of the call option or warrant; in the case of convertible equity, the converting partner's capital account with respect to that convertible equity, increased by the fair market value of cash or other property contributed to the partnership in connection with the conversion; and, in the case of convertible debt, the adjusted issue price (within the meaning of § 1.1275-1(b)) of the debt converted, increased by accrued but unpaid qualified stated interest and by the fair market value of cash or other property contributed to the partnership in connection with the conversion.

(f) Example. The following example illustrates the provisions of this section:

Example. In Year 1, L and M form general partnership LM with cash contributions of $5,000 each, which are used to purchase land, Property D, for $10,000. In that same year, the partnership issues an option to N to buy a one- third interest in the partnership at any time before the end of Year 3. The exercise price of the option is $5,000, payable in either cash or property. N transfers Property E with a basis of $600 and a value of $1,000 to the partnership in exchange for the option. N provides no other consideration for the option. Assume that N's option is a noncompensatory option under paragraph (d) of this section and that N is not treated as a partner with respect to the option. Under paragraph (b) of this section, section 721(a) does not apply to N's transfer of Property E to LM in exchange for the option. In accordance with § 1.1001-2, upon N's transfer of Property E to the partnership in exchange for the option, N recognizes $400 of gain. Under open transaction principles applicable to noncompensatory options, the partnership does not recognize any gain upon receipt of appreciated property in exchange for the option. The partnership has a basis of $1,000 in Property E. In Year 3, when the partnership property is valued at $16,000, N exercises the option, contributing Property F with a basis of $3,000 and a fair market value of $5,000 to the partnership. Under paragraph (a) of this section, neither the partnership nor N recognizes gain upon N's contribution of property to the partnership upon the exercise of the option. Under section 723, the partnership has a basis of $3,000 in Property F. See § 1.704-1(b)(2)(iv)(d)(4) and (s) for special rules applicable to capital account adjustments on the exercise of a noncompensatory option.

(g) Effective Date. This section applies to noncompensatory options that are issued on or after the date final regulations are published in the Federal Register.

SECTION 1.761-1. TERMS DEFINED.

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SECTION 1.761-2. EXCLUSION OF CERTAIN UNINCORPORATED ORGANIZATIONS FROM THE APPLICATION OF ALL OR PART OF SUBCHAPTER K OF CHAPTER 1 OF THE INTERNAL REVENUE CODE.

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§ 1.761-3 Certain option holders treated as partners.

Appendix A—Proposed Partnership Options Regulations (cont'd)

(a) In general. A noncompensatory option (as defined in paragraph (b) of this section) is treated as a partnership interest if the option (and any rights associated with it) provides the holder with rights that are substantially similar to the rights afforded to a partner. This paragraph applies only if, as of the date that the noncompensatory option is issued, transferred, or modified, 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. If the holder of a noncompensatory option is treated as a partner under this section, such partner's distributive share of the partnership's income, gain, loss, deduction or credit (or items thereof) is determined in accordance with that partner's interest in the partnership (taking into account all facts and circumstances) in accordance with § 1.7041(b)(3).

(b) Definitions—(1) Noncompensatory option. For purposes of this section, a noncompensatory option means an option (as defined in paragraph (b)(2) of this section) issued by a partnership, other than an option issued in connection with the performance of services. A noncompensatory option issued by an eligible entity (as defined in 301.7701-3(a)) that would become a partnership under § 301.7701-3(f)(2) of this chapter if the option holder were treated as a partner under this section is also a noncompensatory option for purposes of this section. If a noncompensatory option is issued by such an eligible entity, then the eligible entity is treated as a partnership for purposes of applying this section.

(2) Option. For purposes of this section, a call option or warrant to acquire an interest in the issuing partnership is an option. In addition, convertible debt (as defined in § 1.721-2(e)(2)) and convertible equity (as defined in 1.721-2(e)(3)) are options for purposes of this section. A contract that otherwise constitutes an option shall not fail to be treated as such for purposes of this section merely because it may or must be settled in cash or property other than a partnership interest.

(c) Rights taken into account. (1) In determining whether a noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner, all facts and circumstances are considered, including whether the option is reasonably certain to be exercised (as of the time that the option is issued, transferred or modified) and whether the option holder possesses partner attributes. For purposes of this section, if a noncompensatory option is reasonably certain to be exercised, then the holder of the option ordinarily has rights that are substantially similar to the rights afforded to a partner.

(2) Reasonable certainty of exercise. The following factors are relevant in determining whether a noncompensatory option is reasonably certain to be exercised (as of the time that the noncompensatory option is issued, transferred, or modified)—

(i) The fair market value of the partnership interest that is the subject of the option;

(ii) The exercise price of the option;

(iii) The term of the option;

(iv) The volatility, or riskiness, of the partnership interest that is the subject of the option;

(v) The fact that the option premium and, if the option is exercised, the option exercise price, will become assets of the partnership;

(vi) Anticipated distributions by the partnership during the term of the option;

(vii) Any other special option features, such as an exercise price that declines over time or declines contingent on the happening of specific events;

(viii) The existence of related options, including reciprocal options; and

(ix) Any other arrangements (express or implied) affecting the likelihood that the option will be exercised.

(3) Partner attributes. Partner attributes include the extent to which the holder of the option will share in the economic benefit of partnership profits (including distributed profits) and in the economic detriment associated with partnership losses. Partner attributes also include the existence of any arrangement (either within the option agreement or in a related agreement) that, directly or indirectly, allows the holder of a noncompensatory option to control or restrict the activities of the partnership. For this purpose, 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 are not taken into account, provided that those rights are no greater than rights granted to other partners owning similar interests in the partnership.

(d) Examples. The following examples illustrate the provisions of this section. For the following examples, assume that:

(1) Each option agreement provides that the partnership cannot make distributions to its partners while the option remains outstanding; and

(2) The option holders do not have any significant rights to control or restrict the activities of the partnership (other than restricting distributions and dilutive issuances of partnership equity).

Example 1. Active trade or businEss. PRS is a partnership engaged in a telecommunications business. In exchange for a premium of $8x, PRS issues a noncompensatory option to A to acquire a 10 percent interest in PRS for $17x at any time during a 7-year period commencing on the date on which the option is issued. At the time of the issuance of the option, a 10 percent interest in PRS has a fair market value of $16x. Due to the riskiness of PRS's business, the value of a 10 percent PRS interest in 7 years is not reasonably predictable as of the time the option is issued. Therefore, it is not reasonably certain that A's option will be exercised. Furthermore, although the option provides A with substantially the same economic benefit of partnership profits as would a direct investment in PRS, A does not share in substantially the same economic detriment of partnership losses as would a partner in PRS. Given these facts, the option to acquire a PRS interest does not provide A with rights that are substantially similar to the rights afforded to a partner. Therefore, A is not treated as a partner under this section.

Example 2. Option issued by partnership with reasonably predictable earnings. PRS owns rental real property. The property is 95 percent rented to corporate tenants with a mid-investment grade bond rating or better and is expected to remain so for the next 20 years. The tenants of the building are responsible for paying all real estate taxes, insurance, and maintenance expenses relating to the property. Occupancy rates in properties of a similar character are high in the geographic area in which the property is located, and it is reasonably predictable that properties in that area will retain their value during the next 10 years. In exchange for a premium of $6.5x, PRS issues a noncompensatory option to B to acquire a 10 percent interest in PRS for $17x at the end of a 7-year period commencing on the date of the issuance of the option. At the time the option is issued, a 10 percent interest in PRS has a fair market value of $16.5x. Given the stability of PRS's rental property, PRS can reasonably predict that its net cash flow for each of the 7 years during which the option is outstanding will be $10x ($70x over the 7 years), and that there will be no decline in the value of the property during that time. In light of the reasonably predictable earnings of PRS and the fact that PRS will make no distributions to its partners during the 7 years that

Appendix A—Proposed Partnership Options Regulations (cont'd)

the option is outstanding, it is reasonably certain that the value of a 10 percent interest in PRS at the end of the option's 7-year term will significantly exceed the exercise price of the option. Therefore, the option is reasonably certain to be exercised. Because the option is reasonably certain to be exercised, under these facts, B has rights that are substantially similar to the rights afforded to a partner. Therefore, if there is a strong likelihood that failure to treat B as a partner would result in a substantial reduction in the partners' and B's aggregate tax liabilities, B will be treated as a partner. In such a case, B's distributive share of PRS's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with B's interest in the partnership (taking into account all facts and circumstances) in accordance with 1.704-1(b)(3). Example 3. Deep in the money options. (i) LP is a limited partnership engaged in an internet start-up venture. In exchange for a premium of $14x, LP issues a noncompensatory option to C to acquire a 5 percent interest in LP for $6x at any time during a 10-year period commencing on the date on which the option is issued. At the time of the issuance of the option, a 5 percent interest in LP has a fair market value of $15x. Because of the riskiness of LP's business, the option is not reasonably certain to be exercised. Nevertheless, because C has paid a $14x premium for a partnership interest that has a fair market value of $15x, C has substantially the same economic benefits and detriments as a result of purchasing the option as C would have had if C had purchased a partnership interest. Therefore, the option provides C with rights that are substantially similar to the rights afforded to a partner (partner attributes). See paragraph (c)(3) of this section. If there is a strong likelihood that failure to treat C as a partner would result in a substantial reduction in the partners' and C's aggregate tax liabilities, C will be treated as a partner. In such a case, C's distributive share of LP's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with C's interest in the partnership (taking into account all facts and circumstances) in accordance with 1.704-1(b)(3).

(ii) The facts are the same as in paragraph (i) of this Example 3, except that C transfers $150x to LP in exchange for a note from LP that matures 10 years from the date of issuance and a warrant to acquire a 5 percent interest in LP for an exercise price of $6x. The warrant issued with the debt is exercisable at any time during the 10-year term of the debt. The debt instrument and the warrant comprise an investment unit with the meaning of section 1273(c)(2). Under § 1.1273-2(h), the issue price of the investment unit, $150x, is allocated $136x to the debt instrument and $14x to the warrant. As in paragraph (i), C has substantially the same economic benefits and detriments as a result of purchasing the warrant as C would have had if C had purchased a partnership interest. Therefore, the warrant provides C with rights that are substantially similar to the rights afforded to a partner. If there is a strong likelihood that failure to treat C as a partner would result in a substantial reduction in the partners' and C's aggregate tax liabilities, then C will be treated as a partner. In such a case, C's distributive share of LP's income, gain, loss, deduction, or credit (or items thereof) is determined in accordance with C's interest in the partnership (taking into account all facts and circumstances) in accordance with 1.704-1(b)(3).

(e) Effective Date. This section applies to noncompensatory options that are issued on or after the date final regulations are published in the Federal Register.

PROPOSED CHANGES TO SECTIONS 1.1272-1, 1.1273-2 AND 1.1275-4

Par. 6. Section 1.1272-1 is amended by adding a sentence at the end of paragraph (e) to read as follows:

§1.1272-1 Current inclusion of OID in income.

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(e) *** For debt instruments issued on or after the date final regulations are published in the Federal Register, the term stock in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

***

Par. 7. Section 1.1273-2 is amended by adding a sentence at the end of paragraph (j) to read as follows:

§1.1273-2 Determination of issue price and issue date.

***

(j) *** For debt instruments issued on or after the date final regulations are published in the Federal Register, the term stock in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

***

Par. 8. Section 1.1275-4 is amended by adding a sentence at the end of paragraph (a)(4) to read as follows:

§1.1275-4 Contingent payment debt instruments.

(a) ***

(4) *** For debt instruments issued on or after the date final regulations are published in the Federal Register, the term stock in the preceding sentence means an equity interest in any entity that is classified, for Federal tax purposes, as either a partnership or a corporation.

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