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ANALYZING THE NONCOMPENSATORY PARTNERSHIP OPTION PROPOSED REGULATIONS

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Early this year the IRS issued Proposed Regulations (REG-103580-02) providing guidance on the tax treatment of noncompensatory options issued by partnerships. This outline will review that guidance, contained in Prop. Reg. 1.704-1, 1.704-3, 1.721-2, 1.761-3, 1.1272-1, 1.1273-2, and 1.1275-4.

I. Growth in Use of Partnership Options and Convertibles -

The combination of the development of limited liability flow-through entities, particularly the limited liability company (LLC), and the high tech boom of the last decade combined to give birth to the use of partnership options and convertibles for use in both compensatory and noncompensatory situations. Young techies clamored for a piece of the action in the new dot.com companies, often structured as LLC's, as a part of their compensation packages. Hungry and competitive for investment dollars to fund their projects, the new ventures were anxious to provide incentives to venture capitalists to provide seed money to their companies. While the tech bubble may have burst, the use of LLC's as a preferred structure within which to do business has continued to work its way into the mainstream. With that, there remain a number of effective uses of noncompensatory options, including the following:

Interest sweetener to lenders in lieu of fixed interest

Encourage future investment by venture capital sources

Additional source of cash infusion

Upside return opportunity vehicle for preferred interests

Incentive for lenders to convert debt to equity

All of these uses could be met without creating immediate partner status for the holder of the option or convertible right. However, in contrast to corporate stock options and conversion rights, the tax treatment of partnership options and conversion rights was uncertain.

II. Scope of Regulations

- A. The proposed regulations describe certain of the income tax consequences of issuing, transferring, and exercising noncompensatory options.
- B. Apply only if the call option, warrant, or conversion right entitles the holder to the right to acquire an interest in the issuer, or to cash or property having a value equal to the value of such an interest.
- C. The rule providing for nonrecognition of gain or loss on the exercise of a noncompensatory option does not apply to any call option, warrant, or convertible debt issued by an eligible entity (i.e., disregarded entity), as defined in §301.7701-3(a), that would become a partnership under §301.7701-3(f)(2) if the option, warrant, or conversion right were exercised.
- D. Do not apply to compensatory options - (accordingly, unless otherwise specified, any reference to “options” in this material are intended to mean only noncompensatory options)
- E. The proposed regulations do not change the rules relating to the issuance of convertible debt or convertible equity. Under general tax principles, the conversion right embedded in the convertible debt or convertible equity is typically taken into account for tax purposes as part of the underlying instrument.

III. Issuance of Noncompensatory Option

- A. Proposed regulations do not generally contain rules for the treatment of the issuance of a noncompensatory option, nor do they treat it as a transaction to which §721 applies.
- B. Preamble to Proposed Regulations - Issuance treated under general tax principles
 - 1. open transaction to the issuer – income is not fixed or determinable until the lapse, exercise, repurchase or other termination of the option
 - 2. capital investment to the holder – neither taxable to nor deductible by the holder – Rev. Rul. 78-182 (1978-1 C.B. 265)
 - 3. if the holder uses appreciated or depreciated property to acquire the noncompensatory option, then gain or loss is recognized in accordance with the provisions of §1001, subject to the generally applicable rules governing the allowance of losses, such as §707(b)

IV. Lapse of Noncompensatory Options

- A. §721 does not apply to the lapse of a noncompensatory option – Prop. Reg. 1.721-2(c)
- B. Preamble provides that the lapse generally results in the recognition of income by the partnership and the recognition of loss by the option holder, consistent with general tax principles

V. Exercise of Noncompensatory Options

- A. Preamble - upon exercise, the holder of a noncompensatory option 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
- B. Prop Reg 1.721-2(a) – generally provides that Section 721 applies to the exercise of a noncompensatory option issued by the partnership
 - 1. if, however, the exercise price of a noncompensatory option exceeds the capital account received by the option holder on the exercise of the option, the transaction will be given tax effect in accordance with its true nature
 - 2. Section 721 does not apply to a transfer of property to a partnership in exchange for a noncompensatory option – Prop Reg 1.721-2(b)
 - 3. Does not apply to any interest on convertible debt that has been accrued by the partnership (including accrued OID)
- C. Definitions
 - 1. Noncompensatory Option – an option issued by a partnership, other than an option issued in connection with the performance of services
 - 2. Option – a call option or warrant to acquire an interest in the issuing partnership, the conversion feature of convertible debt, or the conversion feature of convertible equity
 - a) 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
 - 3. Convertible Debt – any indebtedness of a partnership that is convertible into an interest in that partnership

4. Convertible Equity – preferred equity in a partnership that is convertible into common equity in that partnership
5. Exercise – the exercise of an option or warrant or the conversion of convertible debt or convertible equity
6. Exercise Price
 - a) Call option or warrant – the exercise price of the call option or warrant
 - b) 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
 - c) Convertible debt – the adjusted issue price of the debt converted, increased by the 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

VI. Capital Account Maintenance Rules and Capital Shifts

A. General –

The proposed regulations also contain rules to assist partnerships in properly accounting for any shifts in capital that may result from the exercise of noncompensatory options. Generally, upon the exercise of a noncompensatory option, the option holder receives a partnership interest with a value that is greater or less than the aggregate value of the premium and exercise price that the option holder contributes to the partnership. In other words, the option privilege represents an asset with built-in gain or loss, i.e., an asset to which section 704(c) would apply. However, because the option privilege terminates upon its contribution to the partnership, the partnership cannot allocate gain or loss from the option privilege to the option holder under section 704(c)(1)(A). To address this problem, the proposed regulations generally allow partnerships to substitute built-in gain or loss in the partnership's assets for the built-in gain or loss in the option.

The proposed regulations achieve this result by providing that a noncompensatory option holder's initial capital account is equal to the consideration paid to the partnership to acquire the noncompensatory option and the fair market value of any property (other than the option) contributed to the partnership on the exercise of the noncompensatory option. The proposed regulations then require the partnership to revalue its property immediately following the exercise of the

noncompensatory option, when the holder has become a partner. Under the proposed regulations, the partnership must allocate the unrealized income, gain, loss, and deduction from this revaluation, first, to the noncompensatory option holder, to the extent necessary to reflect the holder's right to share in partnership capital under the partnership agreement, and, then, to the historic 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. To the extent that unrealized appreciation or depreciation in the partnership's assets has been allocated to the capital account of the noncompensatory option holder, the holder will, under section 704(c) principles, recognize any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated, or amortized.

In some cases, the built-in gain or loss in the option will exceed the unrealized appreciation or depreciation in the partnership's assets (that has not been reflected in the partners' capital accounts previously). In those cases, even after all of the unrealized appreciation or depreciation in the partnership's assets has been allocated to the option holder, a disparity may remain between the noncompensatory option holder's right to share in partnership capital and the value of money and other property contributed by the partner. The proposed regulations allow the partnership, in such situations, to shift capital between the historic partners and the noncompensatory option holder on the exercise of the noncompensatory option.

In the event of such a capital shift, the proposed regulations require that the partnership make corrective allocations of gross income or loss to the partners in the year in which the option is exercised so as to take into account any shift in the partners' capital accounts that occurs as a result of the exercise of a noncompensatory option. These corrective allocations are allocations of tax items that differ from the partnership's allocations of book items. If there are not sufficient actual partnership items in the year of exercise to conform the partnership's tax allocations to the capital shift, additional corrective allocations are required in succeeding taxable years until the capital shift has been fully taken into account.

The proposed regulations also provide rules for revaluing the partners' capital accounts while a noncompensatory option is outstanding. The proposed regulations modify §1.704-1(b)(2)(iv)(f) and (h) to provide that any revaluation during the period in which there are outstanding noncompensatory options generally must take into account the fair market value, if any, of outstanding options.

B. Capital Contribution Amount

1. Noncompensatory Option – FMV includes 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
 - a) Does NOT include the fair market value of the option privilege
2. Convertible Equity - FMV includes the converting partner's capital account immediately before the conversion
3. Convertible Debt - FMV includes the adjusted basis and the accrued but unpaid qualified stated interest on the debt immediately before the conversion

B. Capital Account Revaluations – the Prop Regs require that outstanding noncompensatory options be taken into account upon the revaluation of partner capital accounts

1. Basis of adjustment - the adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined below, reduced by the consideration paid to the partnership to acquire any outstanding noncompensatory options that are issued on or after the date final regulations are published in the Federal Register
2. FMV of option > consideration paid to acquire - 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).
 - a) reduction allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation
3. Consideration paid to acquire > FMV of option – fair market value of partnership property must be increased by that excess to the extent of the unrealized deduction or loss in partnership property (that has not been reflected in the capital accounts previously).
 - a) increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation

C. Adjustments on Exercise – where a partnership agreement grants 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, capital accounts will not be considered to be determined and maintained in accordance with the capital account maintenance rules all of the following requirements are met:

1. In lieu of revaluing partnership property, as generally permitted under the book-up rules, immediately before the exercise of the option, the partnership revalues partnership property immediately after the exercise of the option
 2. In determining the capital accounts of the partners (including the exercising partner) under step 1 above, 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 steps 1 and 2 above, 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), and
 4. The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made in step 3 above.
 - a) Corrective allocation – beginning with the taxable year of the exercise and in all succeeding taxable years until the allocations required are fully taken into account, the partnership must 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.
- D. Application of 704(c) Principles – the Prop Regs clarify that the principles of Reg. Section 1.704-3 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 the adjustments on exercise.

- E. Allocations in Accordance With Partners' Interests – the Proposed Regulations provide that if a partnership agreement grants 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, then 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—
1. The holder of the noncompensatory option is not treated as a partner under §1.761-3 (see recharacterization discussion below)
 2. The partnership agreement requires that, on the exercise of the noncompensatory option, the partnership comply with the rules regarding adjustments on exercise (see VI, D above)
 3. All material allocations and capital account adjustments under the partnership agreement not pertaining to noncompensatory options are recognized under section 704(b)

VII. Recharacterization

- A. General - the proposed regulations generally respect noncompensatory options as such and do not characterize them as partnership equity. However, the proposed regulations (Prop Reg 1.761-3) contain a rule that characterizes the holder of a noncompensatory option as a partner if the option holder's rights are substantially similar to the rights afforded to a partner. This rule 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 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.
- B. Definitions
1. Noncompensatory Option - for purposes of recharacterization, a noncompensatory option means an option (as defined below) 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. Option Holder Treated As Partner

1. Rights of a Partner - a noncompensatory option (as defined in VII.B.1. above) 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
2. Subject To - recharacterization 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
3. Partner's Distributive Share - if the holder of a noncompensatory option is treated as a partner under this rule, 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 §1.704-1(b)(3)
 - a) Option Must Be Considered – the Preamble indicates that, 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

3. Rights Taken Into Account - 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 this purpose, 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
4. Partner attributes
 - a) 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
 - b) 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
 - c) 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
3. Reasonable certainty of exercise - the Prop Regs list the following factors as 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):
 - a) The fair market value of the partnership interest that is the subject of the option
 - b) The exercise price of the option
 - c) The term of the option
 - d) The volatility, or riskiness, of the partnership interest that is the subject of the option

- e) The fact that the option premium and, if the option is exercised, the option exercise price, will become assets of the partnership
- f) Anticipated distributions by the partnership during the term of the option
- g) Any other special option features, such as an exercise price that declines over time or declines contingent on the happening of specific events
- h) The existence of related options, including reciprocal options
- i) Any other arrangements (express or implied) affecting the likelihood that the option will be exercised

VIII. OID Provisions

- A. Conforming Changes - the proposed regulations amend the OID provisions to treat partnership interests as stock for purposes of the special rules for convertible debt instruments.

IX. Effective Date

Applies to noncompensatory options that are issued on or after the date final regulations are published in the Federal Register

X. Potential Issues

The Proposed Regulations create an added level of complexity for partnerships that utilize noncompensatory options. As is typical with complex new provisions, there remain questions as to definitions, scope, practical application and administration. Many of these may be clarified prior to the release of Final Regulations (which Treasury apparently does not intend to release until it issues its Proposed Regulations relating to compensatory partnership options). Some areas that warrant further clarification might include:

- A. FMV of Option – the FMV of the option is relevant throughout the Proposed Regulations. Is this defined as the proportionate share of the underlying partnership assets? Or is it the true FMV taking into account such established factors as discounts for lack of marketability and minority interests?
- B. Option – How broad is the scope or definition of “option”?
- C. Noncompliance – What is the effect of noncompliance (e.g., a partnership fails to make the required amendments to the partnership agreement)?
- D. Recharacterization – Is it applicable to only Subchapter K, or to all Sections of the Code?

- E. Recharacterization - What do the terms “strong likelihood” and “substantial reduction” mean in quantifiable terms?
- F. Required Allocations – How will the potential allocations required under the Proposed Regs coordinate with allocation provisions of the partnership agreement, such as special allocations?
- G. Economic – the potential for option holders to be required to recognize taxable income (the gain inherent in the option at the time of exercise) faster than anticipated (faster, e.g., than an option holder in an S corporation) changes the value of the option right, and presumably the amount a purchaser would be willing to pay for such an option

XI. Conclusion

The Proposed Regulations represent a significant step forward in clarifying the treatment of noncompensatory options in the partnership environment. Treasury’s effort to apply the established concepts applicable to options generally is likewise a step in the right direction. Nonetheless, it seems taxpayers and advisors will want to consider even more carefully use of partnership options, given the added layer of complexity the Proposed Regulations create. Use of options may only be practical and cost effective for larger partnerships. Advisors, lenders, investors and the partnerships themselves will likely be motivated to seek alternative structures designed to avoid the complex areas of the Proposed Regulations.