Noncompensatory Partnership Options

Treasury and IRS Issue Final and Proposed Regulations on Noncompensatory Options, Warrants and Convertible Instruments Issued by Partnerships

SUMMARY

On February 4, 2013, Treasury and the Internal Revenue Service issued final and proposed regulations (the “Final Regulations” and the “Proposed Regulations”, respectively) governing the tax treatment of certain noncompensatory options, warrants and convertible instruments issued by partnerships (collectively referred to as “options”). These regulations apply only to options that are not issued in connection with the performance of a service; regulations governing options that are issued in connection with the performance of a service (for example, options issued to employees as compensation) were proposed in 2005 and were subject to additional comment in 2011, but have not yet been finalized. The Final Regulations modify and expand the proposed regulations issued January 22, 2003 (the “2003 Proposed Regulations”), discussed in our client publication dated January 30, 2003, entitled “Proposed Regulations Regarding Tax Treatment of Noncompensatory Options and Convertible Instruments Issued by a Partnership”.

The Final Regulations, similar to the 2003 Proposed Regulations, provide that the exercise of a noncompensatory option generally does not result in the immediate recognition of income or loss by either the issuing partnership or the option holder. The Final Regulations modify the Treasury regulations that govern the maintenance of partners’ capital accounts and the determination of partners’ distributive shares of partnership items, to account for exercised and outstanding noncompensatory options. The Final Regulations also provide a more comprehensive test, including multiple testing dates, to determine whether a noncompensatory option is treated as a direct interest in the issuing partnership.
SULLIVAN & CROMWELL LLP

The Proposed Regulations clarify that the lapse of a noncompensatory option would result in the recognition of income to the issuing partnership. The Proposed Regulations solicit comments from the public regarding whether the rule that recharacterizes a portion of a partner’s capital gain from the disposition of a partnership interest as ordinary income based on the proportion of “hot assets” of the partnership (described below) should be broadened to cover the sale, exchange or lapse of an option. The Proposed Regulations also list additional testing dates upon which a noncompensatory option must be evaluated to determine whether it should be treated as a partnership interest.

DISCUSSION

A. ISSUANCE, EXERCISE OR LAPSE OF A NONCOMPENSATORY OPTION

The Final Regulations adopt the approach of the 2003 Proposed Regulations to the issuance, exercise and lapse of a noncompensatory option issued by a partnership.\(^1\) The Final Regulations apply general tax principles to the issuance of a noncompensatory option, which provide that the issuance would generally be an open transaction for the issuer. The issuer’s income or loss would not become fixed and determinable until the lapse, exercise, repurchase or other termination of the option. For the holder of the option, the purchase would be an investment in the option – a capital expenditure that is neither taxable to nor deductible by the holder. If the holder transfers depreciated or appreciated property to acquire the option, however, the holder would recognize gain or loss under general tax principles as a result of the disposition of the property.

The Final Regulations provide that the nonrecognition rule applicable to contributions to a partnership applies to the holder and the partnership upon the exercise of an option issued by the partnership.\(^2\) Upon exercise, the option holder would be viewed as contributing the option premium and exercise price to the partnership in exchange for the partnership interest. Therefore, the issuance of a partnership interest to the holder upon an exercise of an option generally would not be taxable to the holder or the partnership. In the event of a termination or lapse of the option, however, the former option holder has not contributed property to the partnership in exchange for a partnership interest. Accordingly, under general tax principles, the lapse would result in the recognition of income by the partnership and the recognition of loss by the former option holder.\(^3\)

---

\(^1\) These rules do not apply to options issued by disregarded entities.

\(^2\) Section 721(a) of the Code provides that, with certain exceptions, no gain or loss is recognized to a partnership or any of its partners on the contribution of property to a partnership in exchange for an interest in the partnership.

\(^3\) Prior to the issuance of the Proposed Regulations, it was unclear whether the lapse of an option to purchase a partnership interest would result in the partnership’s recognition of gain under Section 1234(b) of the Code, because Section 1234(b) only applies to options in “property” and it was unclear whether partnership interests fell within the definition. The Proposed Regulations provide that, for (continued . . .)
The Final Regulations address two scenarios where the nonrecognition rule does not apply to the exercise of an option. First, the rule does not apply to the extent the option’s exercise price is satisfied with the partnership’s obligation to the option holder for unpaid rent, royalties or interest (including accrued original issue discount) that accrued on or after the beginning of the option holder’s holding period for the obligation. This special rule prevents option holders from converting a receivable that would generate ordinary income into a partnership interest, which is generally a capital asset. Second, the nonrecognition rule does not apply to an option that is cash-settled. An option holder that cash settles would be treated as having sold its option, rather than contributing its option to a partnership and then being redeemed. Under general tax provisions applicable to options, the character of the gain or loss attributable to the sale or exchange of an option has the same character as the sale or exchange of the property to which the option relates. Since a partnership interest is generally treated as a capital asset, this result is favorable to taxpayers. The Proposed Regulations have, however, solicited comments from the public regarding whether the sale, exchange or lapse of an option should be subject to the same rules that govern dispositions of partnership interests attributable to partnership “hot assets” (generally unrealized receivables and inventory items). If these rules were to apply, they would recharacterize a portion of the gain from the sale, exchange or lapse of an option attributable to partnership hot assets as ordinary.

B. CAPITAL ACCOUNT MAINTENANCE

The Final Regulations generally adopt the approach of the 2003 Proposed Regulations and treat the exercise of a noncompensatory option as a contribution of the option premium and exercise price to the partnership in exchange for a partnership interest. An option holder’s initial capital account would be equal to the consideration paid to the partnership to acquire the option plus the cash or the fair market value of any other property contributed to the partnership on the exercise of the option. Depending on the terms of the option, however, an exercising option holder may be entitled to a capital account that is greater than or less than that holder’s initial capital account. To account for this difference, the 2003 Proposed Regulations and the Final Regulations require the partnership to allocate built-in gain or loss in any option issued after the effective date of the Final Regulations, the term “property” includes partnership interests.

4 Section 751(a) of the Code.

5 The Proposed Regulations have also solicited comments from the public on how to calculate the amount of an option that is attributable to partnership hot assets, and how the calculation impacts partners’ shares of partnership hot assets.

6 The Final Regulations clarify that in the case of convertible debt, the value of the debt is equal to the adjusted issue price of the debt plus any accrued but unpaid qualified stated interest, and, in the case of convertible preferred equity, the value of the preferred equity is the capital account associated with the preferred equity.
the partnership’s assets to the option holder. The partnership would revalue its property immediately following the exercise of the option and allocate the unrealized gain or loss from the revaluation first to the option holder to the extent necessary to reflect the holder’s capital account entitlement (including the holder’s right to share in unrealized gain or loss) in proportion to the unrealized gain or loss in each of the assets, and then to the historic partners to reflect the manner in which the remaining unrealized gain or loss in the partnership property would be allocated among those partners if there was a taxable disposition of such property for its fair market value on that date. The Final Regulations clarify that this reallocation would take into account any special allocations or other economic arrangement of the partners. As long as there is sufficient built-in gain or loss in the partnership’s assets to properly account for the difference between the option holder’s initial capital account and its capital account entitlement, the transaction does not result in gain or loss in that tax year. To the extent that the unrealized appreciation or depreciation in the partnership’s assets is allocated to the option holder, however, the holder would recognize any income or loss attributable to that appreciation or depreciation as the underlying assets are sold, depreciated or amortized.

In the event that the difference between the option holder’s initial capital account and its capital account entitlement exceeds the unrealized appreciation or depreciation in the value of the partnership’s assets, the Final Regulations follow the 2003 Proposed Regulations and require that the partnership reallocate capital from the historic partners to the option holder to account for the shift in the partners’ capital accounts as a result of the exercise of the option. The partnership would be required to make corrective allocations of gross tax items in the current tax year or immediately succeeding tax years to reflect the capital account reallocation. As a consequence, the option holder would recognize income or loss to the

---

7 This can be illustrated by the following example: Assume A and B each contribute cash of $10,000 to P, a partnership, in exchange for 100 units of P. Under the partnership agreement, each unit is entitled to participate equally in the profits and losses of P. P uses the cash to purchase nondepreciable property, Property A, for $20,000. C pays P $1,000 for an option that allows C to buy 100 units of P for an exercise price of $15,000. One year later, C exercises the option by contributing $15,000 to the partnership when Property A is worth $35,000. Under the Final Regulations, C’s capital account equals $16,000, the purchase price of the option plus the exercise price. Under the partnership agreement, however, C is entitled to a capital account of $17,000, which is one third of P’s total assets consisting of $16,000 of cash and $35,000 of property. The Final Regulations require P to revalue its assets and allocate the first $1,000 to C, to increase C’s capital account to $17,000. P has total built-in gain in Property A of $15,000 ($35,000 value minus $20,000 basis). The first $1,000 is allocated to C, and the remaining $14,000 is allocated equally to A and B in accordance with the partnership agreement.

The Final Regulations recognize that such a revaluation could result in the allocation of built-in gain or loss arising prior to the issuance of the option to the new partner. To address such a result, the Final Regulations permit the revaluation of partnership property upon the issuance of a noncompensatory option.

8 The allocation would be based on the principles of Section 704(c) of the Code, which applies to contributions of appreciated or depreciated property to a partnership.
Noncompensatory Partnership Options
February 8, 2013

extent there are sufficient partnership items in the year of exercise to conform the partnership’s tax allocations to the capital shift and additional income or loss in succeeding taxable years until the capital shift has been fully taken into account. In addition, it is likely that the reallocated income or loss would be ordinary to the extent it stems from the partnership’s business, as opposed to the allocation of built-in gain or loss on partnership assets, which would generally result in a capital gain or loss upon the assets’ disposition.

The Final Regulations also adopt the approach of the 2003 Proposed Regulations requiring special capital account maintenance rules to take into account outstanding noncompensatory options in the event of revaluations of partnership assets. The revaluation rules take into account the contingent liability associated with the outstanding option by adjusting the built-in gain or loss in the partnership’s assets that is allocated to the partners’ capital accounts as part of the revaluation. If the fair market value of the option as of the date of the revaluation exceeds the consideration paid for the option, the value of the built-in gain in the partnership’s assets allocated to capital accounts as part of the revaluation would be reduced pro rata based on the built-in gain in the assets. Conversely, if the fair market value of the option as of the date of the revaluation is less than the consideration paid for the option, the value of the built-in loss in the partnership’s assets allocated to capital accounts as part of the revaluation would be reduced pro rata based on the built-in loss in the assets. The Final Regulations do not contain any guidance on determining the fair market value of the option, but the preamble and the examples utilize the liquidation value of the underlying partnership interests assuming the option is exercised.

C. OPTION CHARACTERIZATION

The Final Regulations follow the 2003 Proposed Regulations in distinguishing noncompensatory options from partnership interests. Under the Final Regulations, however, a noncompensatory option would be treated as a partnership interest if: (i) the option provides the holder with rights that are substantially similar to the rights afforded to a partner, and (ii) there is a strong likelihood that the failure to treat the holder of a noncompensatory option as a partner would result in a substantial reduction in the present value of the partners’ and option holder’s aggregate Federal tax liabilities.

The Final Regulations provide additional guidance with respect to both prongs of this test. An option grants holders rights that are substantially similar to the rights afforded to a partner if either: (i) the option is reasonably certain to be exercised, or (ii) the option holder possesses partner attributes. In

---

9  Treas. Reg. § 1.704-1(b)(2)(iv)/(f) provides that upon the occurrence of certain events (including the contribution of money by a new or existing partner), a partnership may increase or decrease the partners’ capital accounts to reflect a revaluation of partnership property.

10 Unlike the rules covering recognition of gain or loss on the exercise of an option, these rules also cover options issued by disregarded entities. Consequently, an option issued by a disregarded entity would cause the entity to be treated as a partnership for tax purposes if the option is treated as a partnership interest under these rules and is held by any person other than the sole owner.
determining whether an option is reasonably certain to be exercised, the Final Regulations employ a facts and circumstances test. Relevant factors include the fair market value of the partnership interest that is the subject of the option, the strike price of the option, the term of the option, the predictability and stability of the value of the partnership interest to which the option relates, and whether the partnership is expected to make distributions during the term of the option. The Final Regulations also provide two safe harbors under which an option would not be treated as reasonably certain to be exercised: (1) if the latest exercise date is within 24 months and the exercise price is equal to or greater than 110 percent of the current fair market value of the partnership interest to which the option relates, or (2) if the terms of the option provide that the exercise price is at least equal to the fair market value of the partnership interest on the exercise date or is based on a formula that was developed by the parties on the issue date of the option as a means of approximating the fair market value of the partnership interest on the exercise date and which is applied based on facts and circumstances on the exercise date.

Whether the holder possesses partner attributes is also determined based on all the facts and circumstances, including the extent to which the option holder can participate in the management of the partnership, has a current right to the income of the partnership or has undertaken obligations that are similar to the obligations undertaken by a partner to bear partnership losses. If the option holder also owns partnership interests, the rights granted by those interests generally would not be taken into account as long as they are similar to the rights granted to other similarly-situated partners that are not option holders. In determining whether an option holder possesses partner attributes, the option holder is treated as owning all the partnership interests and noncompensatory options issued by the partnership that are owned by any person related to the holder.

The second prong, whether there is a strong likelihood that the failure to treat the holder of an option as a partner would result in a substantial reduction in the present value of the partners’ and option holder’s aggregate Federal tax liabilities, is also evaluated based on all the facts and circumstances. Relevant factors include the interaction between the partnership allocations and the partners’ tax attributes (including attributes that are unrelated to the partnership), the absolute amount of the tax reduction and the relative tax reduction compared to the overall tax liabilities, and the timing of items of income or deduction. For purposes of evaluating the test, the Federal income tax consequences that result from the interaction between partnership allocations and the partners’ tax attributes must take into account: (i) in

---

11 The Final Regulations provide that rights that permit an option holder to control or restrict a partnership decision that could substantially affect the value of the partnership interest to which the option relates would not ordinarily be considered to convey partner attributes. In particular, an option may provide holders with the right to impose reasonable restrictions on partnership distributions or dilutive issuances of partnership equity or the right to choose the partnership’s Section 704(c) method for partnership properties without conveying partner attributes.

12 Related parties in this context are defined by reference to Sections 267(b) or 707(b) of the Code.
the case of a partner that is a passthrough entity, the tax attributes of ultimate owner of the entity, treating any intermediate passthrough entities as transparent, and (ii) in the case of a partner that is a member of a consolidated group, the tax attributes of the consolidated group and any other member with respect to a separate return year.

Options must be tested under the Final Regulations on any date on which a “measurement event” occurs. A measurement event occurs upon: (i) the issuance of the option, (ii) a modification of the terms of the option or the underlying partnership agreement, if the modification either materially increases the likelihood that the option may be exercised or provides the holder with partner attributes, or (iii) a transfer of the option if the option may be exercised more than one year after its issuance or the transfer is part of a plan a principal purpose of which is the substantial reduction in the present value of the partners’ and option holder’s aggregate Federal tax liabilities. The Proposed Regulations add certain additional events that would be measurement events if the additional events occur pursuant to a plan in effect at the time of issuance or modification of the option, a principal purpose of which is the substantial reduction in the present value of the partners’ and option holder’s aggregate Federal tax liabilities.

Because of the mechanics of these provisions, it is possible that the tax consequences to the transferor of an option could depend on the transferee. If a measurement event occurs as a result of a transfer of the option, the partner attributes of the transferee are taken into account. The conversion of an option into a partnership interest under these rules, however, occurs immediately prior to the occurrence of the measurement event. Consequently, if an option becomes a partnership interest based on the partner attributes of the transferee, the transferor would be treated as transferring a partnership interest, not an option.

Once an option is treated as a partnership interest on a measurement date, the option may never again be treated as an option, even if it fails any of the tests on a later measurement date. In addition, even though the Final Regulations provide detailed guidance regarding when an option would be treated as a partnership interest, the regulations are not intended to replace or supersede existing general tax

---

13 However, changes in the strike price of an option or the amount of partnership interests received upon exercise of the option do not result in a new measurement date, as long as the change is made pursuant to a bona fide, reasonable formula that has the intended effect of preventing the dilution of the interests of the option holder.

14 Transfers at death, to spouses or former spouses do not result in a new measurement date.

15 These events are: (i) the issuance, transfer or modification of an interest in, or the liquidation of, the issuing partnership, (ii) the issuance, transfer or modification of an interest in, or the liquidation of, any passthrough entity that owns directly or through any other passthrough entity, the option, or (iii) the issuance, transfer or modification of an interest in, or the liquidation of, any passthrough entity that owns directly or through any other passthrough entity, the issuing partnership.
principles that may, under certain circumstances, treat an option holder as directly holding the asset to which the option relates.\textsuperscript{16}

**D. EFFECTIVE DATE**

The Final and Proposed Regulations were published in the Federal Register on February 5, 2013 and are effective for noncompensatory options that are issued on or after that date.

\* \* \*

\textsuperscript{16} For example, in Rev. Rul. 82-150 (1982-2 C.B. 110) the Internal Revenue Service concluded that a holder of a deep-in-the-money option to purchase stock should be treated as a shareholder under substance over form doctrine.
SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jay Plum (+1-212-558-4049; plumj@sullcrom.com) in our New York office.

CONTACTS

New York

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eli D. Jacobson</td>
<td>+1-212-558-3645</td>
<td><a href="mailto:jacobson@sullcrom.com">jacobson@sullcrom.com</a></td>
</tr>
<tr>
<td>Andrew S. Mason</td>
<td>+1-212-558-3759</td>
<td><a href="mailto:masona@sullcrom.com">masona@sullcrom.com</a></td>
</tr>
<tr>
<td>David C. Spitzer</td>
<td>+1-212-558-4376</td>
<td><a href="mailto:spitzerd@sullcrom.com">spitzerd@sullcrom.com</a></td>
</tr>
<tr>
<td>David J. Passey</td>
<td>+1-212-558-3176</td>
<td><a href="mailto:passeyd@sullcrom.com">passeyd@sullcrom.com</a></td>
</tr>
<tr>
<td>Alan D. Kravitz</td>
<td>+1-212-558-7259</td>
<td><a href="mailto:kravitza@sullcrom.com">kravitza@sullcrom.com</a></td>
</tr>
</tbody>
</table>

London

<table>
<thead>
<tr>
<th>Name</th>
<th>Phone</th>
<th>Email</th>
</tr>
</thead>
<tbody>
<tr>
<td>S. Eric Wang</td>
<td>+44-20-7959-8411</td>
<td><a href="mailto:wangs@sullcrom.com">wangs@sullcrom.com</a></td>
</tr>
</tbody>
</table>