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Proposed Regulations on Noncompensatory Options: A Light at the End of the Tunnel

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Proposed Regulations on Noncompensatory Options: a Light at the End of the Tunnel

Walter D. Schwidetzky*

It has become increasingly common for partnerships to issue options.¹ There is a dearth of authority on the federal tax treatment of options to acquire interests in partnerships. In this context, there are two main categories of options, “services options” and “noncompensatory options.” Services options, unsurprisingly, are options to acquire partnership interests where the option is received in exchange for services. Noncompensatory options cover the rest of the waterfront.² The simplest version of the latter would be partnership analog to “normal” options found outside the partnership context: the option holder pays the partnership an “option premium” to acquire an option to purchase a partnership interest sometime in the future for a fixed price. A previous article by this author discussed services options,³ and this article serves as a companion piece, focusing

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² At the outset, the author must acknowledge his indebtedness to the “Options Group” composed of members of the Partnerships, Real Estate, and Employee Benefits Committees of the ABA Section of Taxation. The Options Group, of which the author was a member, submitted extensive recommendations to the Service on the taxation of partnership options generally, sexily entitled “Comments in Response to Notice 2002-29.” After the Service issued proposed regulations on noncompensatory options, the Options Group submitted a second set of extensive recommendations, with the equally sexy title, “Comments in Response to REG-1003580-02” (hereinafter “ABA Comments”). The author’s understanding of this area was dramatically improved by participation in this group of first-rate tax lawyers, whose efforts were headed by Paul Carman of Chapman and Cutler. Paul Carman’s command of detail and ability to connect the various pieces of the puzzle together can only be described as extraordinary. Also a thanks goes to my significant other, Bonnie Charon, and our cats, Lilly and Cleo, whose names are taken in vain in the examples.


primarily on the recently issued proposed regulations on the tax treatment of noncompensatory options. The article will describe and analyze the proposed regulations and offer alternatives. While the term "partnership" will be used throughout this article, the reader should recall that for federal income tax purposes it normally includes limited liability companies (LLCs) provided they have more than one member.

Background

The basic principles that apply to the taxation of the issuance and exercise of noncompensatory options have been clear for some time. They are contained in IRC Section 1234 and various pronouncements of the courts and the Service.

(i) Option contracts are generally treated as open transactions until exercise or expiration;
(ii) There is no federal income tax consequence on account of either the receipt or the payment of the option premium by either the issuer or the option holder until the option is exercised or terminated;
(iii) Under Section 1234(a), if the option goes unexercised, the option holder is treated as having a loss from the sale or exchange of property which has the same character as the property to which the option relates. Thus, if the option relates to a capital asset, the loss will be a long or short term capital loss depending on how long the option holder has held the option. Regardless of how long the option is outstanding, the option issuer’s gain on the lapse is short term capital gain under Section 1234(b).

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6 Reg. 301.7701-3(b), assuming the default rule applies and no election out is made. For a discussion of options to purchase an interest in a disregarded entity see ABA Comments, at IVF3.


8 An open transaction generally means that no tax consequences apply while it is open. In this context, there are usually no tax consequences until the option is exercised or lapses, thereby closing the open transaction.

9 This assumes the premium is paid in cash. If property is transferred in exchange for the option, IRC Section 1001 would require gain or loss recognition on the transfer. See ns. 19-20 infra and accompanying text.
(iv) Upon exercise, both the issuer and the option holder use the total of the option premium and the exercise price to determine the amount realized on the sale and the cost basis of the property acquired, respectively, and

(v) Exercise of an option at a time when the value of the relevant property had risen above the exercise price of the option does not cause the Option holder to have income. The Proposed regulations depart from this principle in a limited way, as will be discussed.9

If the option holder disposes of the option before exercise, it is treated like any other disposition of property. Gain or loss is recognized under Section 1001 unless an exclusionary rule applies.

When an entity issues interests in itself, it can raise tax issues in addition to those discussed above. Until the Service issued the proposed regulations, there was no guidance in the partnership context,10 but there has been guidance for some time with regard to corporations. Section 1032(a) provides that a corporation recognizes no gain or loss on the lapse or acquisition of an option to buy or sell its stock. The actual exercise of the option would not be taxable to the corporation either, as Section 1032(a) also provides that a corporation recognizes no gain or loss on the receipt of money or other property for its stock. The treatment of the option holder is covered by the regular rules discussed above.

Partnerships are very different tax (and nontax) creatures than corporations, and when they issue options they raise different tax issues. Most of the issues that arise relate to the fact that unlike C corporations, partnerships are not taxable entities, income is taxed to and losses are deducted by the partners. Appreciation in partnership property and undistributed income typically inures in part to the benefit of the option holder. How should the partnership keep track of that benefit? Since the economics of a partner’s investment in the partnership are generally measured by the partner’s capital account, a corollary question is how should capital accounts be kept when an option is outstanding? If a new partner acquires a partnership interest while an option is outstanding, how should the existence of the option be taken into account? There are times when an option holder should be treated as a partner. If there were no anti-abuse rules, taxpayers could give option holders so many rights that they would have all the economic benefits of being a partner without actually being treated as a partner. High bracket taxpayers would buy options, avoid taxable ordinary income on the partnership earnings, though the option economi-

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9 See discussion of corrective allocations infra.

10 Technically there is still no guidance as the regulations are in proposed form; however, it will doubtless inform the decision making process of tax practitioners.
cally benefit from undistributed earnings, and then sell the option at a long term capital gain and receive preferential tax rates. The proposed regulations address these and other issues.

Another piece of the puzzle is Section 721. It provides that no gain or loss is recognized to a partnership or its partners in the case of a contribution of property to the partnership in exchange for a partnership interest. A major question is when and how Section 721 applies in the options context. To the extent it does apply, the transaction becomes nontaxable, the tax equivalent of the promised land. In the typical, nonabusive case, the proposed regulations sensibly take the view that an option holder is not a partner. Accordingly, the issuance of the option is not within the purview of Section 721 (though the issuance of an option usually is still nontaxable). Section 721 usually literally applies to the exercise of the option, however, inasmuch as then a partnership interest is being received for cash or property.

A final issue involves the potential for capital account shifts between the partners. Indeed, there may be no single issue more important than this one. When an option holder exercises an appreciated option, it may be necessary to shift capital from the continuing partners to the option holder/partner to give him his appropriate interest in the partnership. The form of this would be a transfer of a portion of the capital account balances from the continuing partners to the option holder/partner. The fear has been that this “capital shift” could be seen as a taxable transfer of partnership property by the continuing partners to the option holder/partner in an amount equal to the value of the capital shift. If the continuing partners transferred 5% of partnership capital to the option holder/partner, could they have made a taxable disposition of 5% of the partnership assets and have to recognize the associated gain or loss? If so, it would obviously inhibit option (and other) transactions, at least where gain would be recognized. No case ever held that such a capital shift was a taxable transaction to the continuing partners, but academics and practitioners have spilled a lot of ink speculating on this possibility. The proposed regulations generally put the fear to rest in the partnership options context. A capital shift is not treated as a taxable transfer of the underlying partnership property, though there can be an income tax effect to the option holder/partner, as I will discuss.11

Scope of Proposed Regulations

The proposed regulations only cover noncompensatory options issued by partnerships.12 In addition to “standard” options, the proposed regulations

11 See discussion of corrective allocations infra; also see McDougal v. Comm’r, 62 TC 720 (1974) where a transfer was taxable where the court deemed the sequence to be the transfer of property to a service provider followed by the formation of the partnership.

12 Prop. Reg. 1.721-2(d); the proposed regulations do not apply to any interest on convertible debt that has been accrued by the partnership (including original issue discount). Id.
can also apply to warrants, convertible debt, and convertible preferred equity, though I will focus on traditional options.\(^\text{13}\) The final regulations will be prospective from the date they are promulgated.\(^\text{14}\) While the proposed regulations are technically of no legal effect, they do give taxpayers a sense of where the Service stands and that can be useful in planning.\(^\text{15}\)

The proposed regulations require that the capital account maintenance provisions in the partnership agreement comply with the proposed regulations. If existing capital account maintenance provisions incorporate the regulations by reference, as is commonly recommended, existing partnerships will not have to amend the partnership agreements to comply with the option regulations when they are finalized. If, on the other hand, an existing agreement recites the pre-option regulation capital account rules, the agreement will have to be amended to bring it up to date when the regulations are finalized.\(^\text{16}\)

**Issuance, Lapse, and Straightforward Exercise**

In line with the existing nonpartnership authority, it is apparent from the proposed regulations that the issuance of the option usually is treated as an

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\(^{13}\) Prop. Reg. 1.721-2(e)(1); it is clear from the preamble that the proposed regulations apply to "cash settlement options." These are options in which parties do not intend for the option holder ever to become a partner. Rather, on exercise, the option holder is to be paid a cash amount equal to the value of the partnership interest subject to exercise less the exercise price. See ABA Comments, at IVB3.

\(^{14}\) Prop. Reg. 1.721-2(g).

\(^{15}\) The Service has informally suggested that it sees the proposed regulations as applying to any provision that causes an adjustment to the partners' interests in the partnership. Partnership agreements commonly provide for contribution of additional capital either voluntarily or upon the occurrence of specific events. If "options" were to include these provisions, the scope of the regulations would be extraordinarily broad and make life much more complicated for partnerships and their partners, many of whom lack the sophistication to master regulations as complex as the ones being proposed. There are other circumstances that could lead to adjustments of partners' interests, such as redeeming a partner's partnership interest at a discount. Little purpose would seem to be served by such a broad interpretation of the regulations. When finalized the regulations should make clear that they apply to circumstances specifically covered by the regulations and no others, see ABA Comments, at IVB1.

\(^{16}\) Capital accounts, unlike tax basis, are designed to measure the liquidation value of a partner's investment, though they are often inaccurate as gain or loss inherent in partnership assets are often not reflected in the capital accounts until the interest is actually liquidated. Generally speaking, capital accounts are increased by the money and fair market value of property contributed by a partner as well as that partner's share of partnership income. Capital accounts are decreased by money and the fair market value of property distributed to a partner by that partner's share of losses, and any expenditures allocable to a partner that are neither deductible nor capitalized. See Reg. 1.704-1(b)(2)(iv)(b); see Willis, Pennell, Postlewaite, Partnership Taxation, 6th Edition, at ¶ 10.04(2) (hereinafter WPP); also see Richard M. Lipton and John D. McDonald, Noncompensatory Options: Prop. Regs. On Partnership Options Take a 'Friendly' slant. 70 Practical Tax Strategies 281 (May 2003) (hereinafter "Lipton & McDonald").
open transaction for the issuer (while outside the scope of Section 721). The option holder is seen as having made a capital expenditure to acquire an option that is neither taxable to the partnership nor deductible to the holder. The proposed regulations never explicitly state this, however, though there is language in the preamble and in an example to this effect.\textsuperscript{17} While it is probably clear enough, an explicit statement in the proposed regulations (as opposed to just the preamble) would be preferable.\textsuperscript{18}

The proposed regulations note that under general rules of taxation, if the holder exchanges property for the option, there has been a taxable disposition of the property. Gain or loss is recognized.\textsuperscript{19} This conclusion is not entirely inescapable. One could argue that following the general open transaction system applicable to options, the transaction should be held open until it is known whether the option will be exercised or not. If not, gain or loss should be recognized on the property transferred for the option. If the option is exercised, Section 721 should apply to give tax free treatment to the contribution of the property to the partnership. This approach definitely stretches current law, however. An option is in fact a property interest, and Section 1001 requires gain or loss recognition when properties are exchanged barring a trumping IRC section. There is no code section that trumps the property transfer by the option holder for the option, and therefore suggesting that Section 1001 does not require gain or loss recognition (again subject to the loss disallowance rules) requires a fair amount of imagination.

The proposed regulations provide limited coverage of the tax treatment of a lapse of an option. The regulations themselves merely state the obvious: That a lapse is outside the scope of Section 721.\textsuperscript{20} It would have to be outside the scope of Section 721 inasmuch as the erstwhile option holder has not contributed property to the partnership in exchange for an interest in the partnership. The preamble to the proposed regulations then observes that, consistent with general tax principles, the lapse of a non-compensatory option generally results in the recognition of income by the partnership and the recognition of loss by the former option holder. Under the general principles of Section 1234, there should be short term capital gain to the partnership in the amount equal to the option premium and a

\textsuperscript{17} Preamble; Prop. Reg. 1.721-2(b),(f) exp.

\textsuperscript{18} See ABA Comments, at IVB2 and “Shop Talk, Court Gives Legal Effect to Preamble to Proposed Regs!,” 80 J. Tax’n (January 1994).

\textsuperscript{19} Prop. Reg. 1.721-2(b); there are numerous loss disallowance rules in the Code. One example are the passive loss rules of IRC 469 which usually disallow passive losses to the extent the taxpayer does not have sufficient offsetting passive income.

\textsuperscript{20} Prop. Reg. 1.721-2(c).
(typically capital) loss of the same amount to the option holder. While admittedly it would be doing no more than restating current law, for sake of completeness it would be helpful if the regulations contained a section on lapses, including an example.

The proposed regulations generally apply Section 721 to the exercise of the option, making it a nontaxable transaction to the partners and the partnership. The option holder is viewed as contributing money or property in the form of the exercise price and option privilege to the partnership and receiving a partnership interest in exchange. Thus, if in the exercise of the option the option holder transfers property to the partnership, no gain or loss is recognized to the option holder or the partnership. The partnership takes a carryover basis in any contributed property under Section 723. The option holder takes a substituted basis in the partnership interest under Section 722.

The proposed regulations make good sense to this point. They are consistent with the general option rules of Section 1234 as well the rules for the exercise of option to acquire stock in a corporation. The reality is that the issuance of an option is an open transaction in fact. Usually it is unknown at the time of issuance what will ultimately occur, whether the option will be exercised, or allowed to lapse. Under these circumstances it makes sense to hold the transaction open until all the facts are in. These considerations led to the Service ruling in favor of open transaction status for options long ago and to Section 1234, and it only made sense for the Service to respect that history in promulgating the proposed regulations.

The proposed regulations contain some highly important rules for computing capital accounts. An option holder, not being a partner, has no capital account. When the option holder becomes a partner upon exercise of the option, the option holder’s initial capital account is equal to the option premium and option exercise price paid, including the fair market

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21 See discussion of background supra.

22 The proposed regulations do not discuss the tax consequences 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. The drafters felt there were arguments for and against income recognition at this point, and inasmuch as the area was closely related to the tax treatment of compensatory options, it deferred addressing the issue until the compensatory regulations are issued. See preamble.

23 See Section 1032(a).


25 This assumes the option holder does not also hold a partnership interest. It also assumes the recharacterization rules discussed later in the article do not apply.
Typically, the value of the partnership interest received will be different from the total amount paid by the option holder. Of course, what commonly induces an option holder to exercise an option is the belief that what she is receiving is worth more than what she is paying. This means that the option privilege itself has value inherent in it. Since the option exercise is a nontaxable event, the gain is not recognized on exercise (neither would be the loss in the less likely event the option holder exercises the option even though the exercise price exceeds the value of the option). In principle, the option privilege is an asset with built-in gain or loss that should be allocated to the option holder under Section 704(c). The difficulty is that the option privilege is not truly contributed to the partnership, but rather disappears on exercise. Accordingly, the value of the option privilege itself does not increase the capital account. To get to the right result, the proposed regulations generally substitute gain or loss inherent in the partnership’s assets for gain or loss inherent in the option privilege. This is done by first requiring the partnership to revalue its property immediately after the exercise of the option. Allowable revaluations have to date been optional. Under the proposed regulations, however, revaluations in this context are mandatory.

Any unrealized gain or loss from the revaluation is first allocated to the option holder to the extent necessary to reflect the holder’s right to share...
in partnership capital under the partnership agreement. Thereafter the gain or loss is allocated to the historic partners to reflect the manner in which the gain or loss would be allocated among them if there were a taxable disposition of the partnership property. Section 704(c) principles are then used to make sure that tax gain or loss is allocated properly. This is perhaps easiest to understand by way of an example.

Example 1. In Year 1, Lilly and Cleo each contribute cash of $10,000 to LLC, a newly formed limited liability company (that is a tax partnership) 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 Bonnie. The option allows Bonnie to buy 100 units in LLC for an exercise price of $15,000 in Year 2. Bonnie pays $1,000 to the LLC for the issuance of the option. In Year 2, Bonnie exercises the option, contributing the $15,000 exercise price to LLC. At the time the option is exercised, the value of Property A is $35,000.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Basis</th>
<th>FMV</th>
<th>Liabilities and Capital</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prop. A</td>
<td>20,000</td>
<td>35,000</td>
<td>Lilly</td>
<td>10,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Cash Prem.</td>
<td>1,000</td>
<td>1,000</td>
<td>Cleo</td>
<td>10,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Exercise Price</td>
<td>15,000</td>
<td>15,000</td>
<td>Bonnie</td>
<td>16,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Totals</td>
<td>36,000</td>
<td>51,000</td>
<td></td>
<td>36,000</td>
<td>51,000</td>
</tr>
</tbody>
</table>

Bonnie’s tax basis in the partnership interest is $16,000, the total amount she invested. Bonnie’s capital account initially is credited by $16,000 with the amount paid for the option ($1,000) and the exercise price of the option ($15,000). Under the LLC agreement, however, Bonnie 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 and Property A, which has a value of $35,000. Thus, the total value of LLC’s assets is $51,000. Bonnie is entitled to LLC capital equal to 1/3 of this value, or $17,000.

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31 See n. 27 supra.
32 This example is based on Prop. Reg. 1.704-1(b)(5), Example 20.
Thus, Bonnie is entitled to $1,000 more LLC capital than her capital contributions to LLC. Under the proposed regulations, LLC must increase Bonnie’s capital account from $16,000 to $17,000 by, first, revaluing LLC property and allocating the first $1,000 of book gain to Bonnie.33

The net “book” gain inherent 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 Bonnie, and the remaining $14,000 of this gain is allocated equally to Lilly and Cleo in accordance with the LLC agreement. These capital account adjustments have no immediate tax impact. Note that all of the partners, including Bonnie, are allocated their fair shares of the book gain. Some of the book gain is allocable to Bonnie because it economically belonged to her due to the increase in the value of her option privilege.

After the smoke clears, the tax and book account are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Lilly</th>
<th></th>
<th>Cleo</th>
<th></th>
<th>Bonnie</th>
<th></th>
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<tr>
<td></td>
<td>Tax</td>
<td>Book</td>
<td>Tax</td>
<td>Book</td>
<td>Tax</td>
<td>Book</td>
</tr>
<tr>
<td>Beg Cap</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
<td>10,000</td>
<td>16,000</td>
<td>16,000</td>
</tr>
<tr>
<td>Revaluation</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>7,000</td>
<td>1,000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>17,000</td>
<td>17,000</td>
<td>17,000</td>
<td>17,000</td>
<td>16,000</td>
<td>17,000</td>
</tr>
</tbody>
</table>

The disparity between the tax and book accounts must be allocated in accordance with Section 704(c) principles.34

Non-Straightforward Exercise

New Partner Enters While Option Outstanding

The proposed regulations provide rules for doing the revaluation math if a new partner enters the partnership while an option is outstanding.35 The fair market value of partnership property is adjusted for any outstanding options. There are two components to the adjustment.

The first component: The fair market value of partnership property is reduced by the option premium paid to the partnership.36 This reduction occurs because

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33 See n. 24 supra.
34 See n. 27 supra and Reg. 1.704-1(b)(2)(iv)(s)(1),(2); in this context this means that of the $15,000 of tax gain, $7,000 each must be allocated to Lilly and Cleo and $1,000 must be allocated to Bonnie, i.e. the tax gain effectively earned by them.
35 Logically these rules should apply even if a new partner is not entering the partnership but the partnership interests change due to additional capital contributions from some of the existing partners while an option is outstanding.
the value of the option premium in a sense belongs to the option holder, and he will be able to increase his capital account by the amount of the premium if he exercises the option.

The second component: If the fair market value of the outstanding option exceeds the premium paid by the option holder, then the fair market value of partnership property is reduced by the excess to the extent of unrealized income or gain in partnership property that has not previously been reflected in the capital accounts. The reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. This adjustment insures that gain economically attributable to the option holder is not allocated to the partners. If the option premium paid by the option holder exceeds the fair market value of the option, then the value of partnership property is increased by that excess to the extent of the unrealized deduction or loss in partnership property not previously reflected in the capital accounts. The increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation. This adjustment insures that a loss economically attributable to the option holder is not allocated to the partners. If the option ultimately lapses, as would be likely where the value of what is to be received is less than the option exercise price, Section 1234 will trigger short term capital gain to the partnership in the amount of the option premium and a corresponding loss to the option holder. At that point the adjustments discussed above would no longer be appropriate. The proposed regulations do not address this issue, but presumably the partnership would have to await a subsequent revaluation to get the numbers right again.

Example 2. In Year 1, Lilly and Cleo each contribute cash of $10,000 to LLC, a newly formed limited liability company that is a tax partnership, in exchange for 100 units in LLC. LLC uses the cash to purchase two nondepreciable 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 Bonnie for $1,000. The option allows Bonnie to buy 100 units in LLC for an exercise price of $15,000 in Year 2. Prior to the exercise of Bonnie’s option, Matt contributes $17,000 to LLC for 100 units in LLC. At the time of Matt’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 Bonnie’s option is $2,000. Upon Matt’s admission to the partnership, the capital

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38 This example is based on Prop. Reg. 1.704-1(b)(5) exp. 22.

39 Example 22 in the proposed regulations simply give this as a fact. This will be discussed in more detail below.
accounts of Lilly and Cleo (which were $10,000 each prior to Matt's admission) are revalued, thus reflecting their shares of the unrealized appreciation in the partnership's assets.

Under the proposed regulations, the fair market value of partnership property ($36,000) must be reduced by the option premium paid by Bonnie to the partnership to acquire the option ($1,000) and the excess of the fair market value of the option as of the date of the adjustment over the option premium paid by Bonnie to acquire the option ($1,000), 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 ($36,000 - $2,000). Accordingly, Lilly and Cleo’s capital accounts must be increased to $17,000.

The second $1,000 reduction is attributable to the “profit” inherent in the option premium (“the second component”) and is allocated entirely to Property A, the only asset having unrealized appreciation. Therefore, the book value of Property A is $29,000 ($30,000 - $1,000).40

<table>
<thead>
<tr>
<th>Assets</th>
<th>Tax Basis</th>
<th>FMV</th>
<th>Option Adjustment</th>
<th>Book</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property A</td>
<td>10,000</td>
<td>30,000</td>
<td>(1,000)</td>
<td>29,000</td>
</tr>
<tr>
<td>Property B</td>
<td>10,000</td>
<td>5,000</td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Cash</td>
<td>1,000</td>
<td>1,000</td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>Subtotal</td>
<td>21,000</td>
<td>36,000</td>
<td>(1,000)</td>
<td>35,000</td>
</tr>
<tr>
<td>Matt’s cash contribution</td>
<td>17,000</td>
<td>17,000</td>
<td>0</td>
<td>17,000</td>
</tr>
<tr>
<td>Total</td>
<td>38,000</td>
<td>53,000</td>
<td>(1,000)</td>
<td>52,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
<th>Tax</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lilly</td>
<td>10,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Cleo</td>
<td>10,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Matt</td>
<td>17,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Bonnie’s Option</td>
<td>1,000</td>
<td>2,000</td>
</tr>
<tr>
<td>Total</td>
<td>38,000</td>
<td>53,000</td>
</tr>
</tbody>
</table>

40 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 Lilly and Cleo in accordance with Section 704(c) principles. Reg. 1.704-1(b)(1)(iv)(f)(4).
After Matt becomes a member, and when the property values are unchanged, Bonnie exercises the option. On the exercise of the option, Bonnie’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, Bonnie 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 Bonnie, plus the value of LLC assets prior to the exercise of the option, $53,000). Bonnie is entitled to LLC capital equal to 1/4 of this value, or $17,000. As discussed above, the proposed regulations require a revaluation and capital account adjustments at this stage.

The LLC must increase Bonnie’s capital account from $16,000 to $17,000 by, first, revaluing LLC property and allocating the first $1,000 of book gain to Bonnie. 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 Bonnie.41

Obviously, these rules are highly complex. They accomplish one very useful objective. They hold out of the capital account adjustments the appreciation (and less importantly depreciation) attributable to the outstanding...

41 Again, IRC 704(c) principles must be followed in allocating tax gain and loss. Reg. 1.704-1(b)(2)(iv)(f)(4). See n. 27 supra.
ing option, as well as the option premium itself. If this were not done, the capital accounts of the continuing partners and entering partners would tend to be overstated upon a revaluation, assuming the partnership property had appreciated while the option was outstanding. That is because some of the increased value of the property would really “belong” to the option holder who would be allocated it as soon as the option was exercised. Moreover, the more appreciation there would be, the more likely it would be that the option would be exercised, making it increasingly pointless to allocate the appreciation to anyone other than the option holder. Further, if the option is ignored in these circumstances and upon a revaluation (while the option is outstanding) all of the value is allocated to the new and existing partners, when the option is exercised and a revaluation is again done, a portion of the capital accounts of the existing partners would have to be allocated to the option holder/partner. Prior to the promulgation of the proposed regulations, the concern would have been that capital shift could be seen as a taxable transfer of the associated partnership property by the existing partners to the option holder under Section 1001. Yet economically, the relevant gain belonged to the option holder all along. The proposed regulations solve this problem by pulling the appreciation attributable to the option holder—as well as the option premium—out of the revaluation equation (though the issue arises again for curative allocations, as I discuss below).

There is one practical problem with the approach of the proposed regulations. When doing a revaluation, both the proposed regulations and the existing regulations require the partnership to restate the book values of the partnership properties at their fair market at the time of the revaluation. The capital accounts of the partners are in turn also restated to their fair market values, that is what partners would generally receive if the partnership were liquidated. The practical problem is that the values of the partnership properties in real life in most instances will not be knowable with precision without going to the often great expense of an appraisal. In most cases that will not be an economically viable option.

Partnerships, when doing revaluations, commonly do not attempt to independently determine the fair market values of the partnership properties. Rather, they “reverse engineer” the value of the partnership properties based on the value of the cash and/or property contributed by the new

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42 For example, a 10% capital shift could be seen as a taxable transfer of 10% of the partnership property from the continuing partners to the new partners, though there is no authority directly on point. See McDougal v. Comm’r, 62 TC 720 (1974) and Schwidetzky I, n. 3 supra, at 111-113.


44 See Reg. 1.704-1(b)(2)(iv)(b).
partner and the percentage interest that partner will have in the partnership. Thus, if an entering partner pays $10,000 for a 10% interest, it is assumed that the partnership property (inclusive of the $10,000) is worth $100,000. Thus, ultimately the revaluation is not based on the value of the partnership property but on the value of the partnership interest being acquired.45

Typically, a reverse-engineered revaluation will yield book values of partnership properties that are less than the amount for which they could be sold and capital accounts that are less than the liquidation value of the partnership interest. This is because an incoming partner will often discount what he will pay for the partnership interest to take into account economic realities. These realities could include the facts that the interest is not marketable, that it represents a minority interest in the enterprise, and therefore does not have control, and/or other relevant discounting considerations.46 Thus in the example above, where the entering partner paid $10,000 for a 10% partnership interest, the actual value of the partnership property on a sale might be $120,000, but the entering partner might have discounted the value by 20% to take into account the lack of marketability and the fact that he is receiving a minority interest.

It would be best if both the existing and proposed regulations were amended to take this real-world approach into account. If it is not done and a partnership (perhaps foolishly given the low risk of audit) wanted to comply literally with the regulations, the results would be anomalous. In the example, upon the revaluation the entering partner arguably could be given a capital account of $12,000 notwithstanding the fact he only paid $10,000, which in addition to being aesthetically unpleasing, will cause a lot of confusion. Taxpayers will wonder why their capital accounts are different than their contribution, and many legal and accounting advisors will not understand the rules and make the capital account $10,000 regardless. Further, there is no real harm done by formally permitting the real-world approach as everything will come out in the wash on an actual liquidation. The regulations require the partnership to recognize any book gain or loss inherent in the assets at that time.47 Without a regulatory authorization, however, a less than wise IRS auditor might claim the partnership is not keeping capital accounts properly and launch a full-blown attack.

45 See ABA Comments, at IV2; this approach is most workable where a straight percentage is acquired. However, often a partner does not acquire a "10% interest," but instead acquires an interest that varies depending on partnership performance.

46 There is ample case law supporting the use of discounts. See, e.g., Gross v. Comm' r, 272 F.3d 333 (6th Cir. 2001); Church v. Comm' r, 268 F.3d 1063 (5th Cir. 2001); Estate of Strangi v. Comm' r, 115 TC 478 (2000), aff'd in part and rev'd in part 293 F.3d 279 (5th Cir. 2002), on remand TC Memo 2003-145. Some times a premium is paid for "going concern value."

47 Reg. 1.704-1(b)(2)(iv)(c)(1). This rule also requires book gain or loss to be recognized on a nonliquidating distribution of property.
on an otherwise allowable allocation regime. Further, it would create disjunctures with other rules. If the new partner gifts the interest, the gift will have a value of $10,000, not the $12,000 in the capital account. The same is true with regard to the amount realized on a sale.

The proposed regulations are internally inconsistent and do not base capital accounts on liquidation values in one important respect. As I discuss in the above examples, in calculating the capital accounts of the partners in the case of a new partner entering the partnership while an option is outstanding, an adjustment is made for the "fair market value" of the outstanding option. That fair market value is presumably the value an independent third party would pay for the option, not the "liquidation profit" that would be generated if the option were exercised and the partnership were immediately liquidated. Using the actual fair market value of the option can create unnecessary problems with the corrective allocations rules (that I discuss immediately below). By using the fair market value rather than liquidation profit to value the outstanding option, the proposed regulations will tend to overstate the capital accounts of the existing partners. This is because the fair market value of the option will likely be less than the liquidation profit due to economic realities associated with minority interests, lack of marketability, and other factors, considerations the proposed regulations otherwise ignore. When the option is exercised, if the continuing partners have overstated capital accounts, the option holder/partner will need a larger capital account than would otherwise be the case, increasing the chance that a corrective allocation will be necessary.

This problem is mooted if my recommendation is followed that the corrective allocation rules not be adopted. Still, for sake of consistency, flexibility, and real world realities, it would be preferable if the proposed regulations gave the partnership a choice. This unfortunately will complicate the regulations somewhat as there will need to be two regimes, but alas the alternative of leaving things they way they are creates larger problems. Either the partnership revalues using the actual values of the partnership properties and then the liquidation profit for the option or reverse engineers using the capital contribution of the entering partner, in which case it would be appropriate to use the actual fair market value of the option. It would not be appropriate to jump back and forth between the two systems as that would permit unduly easy manipulation of capital account balances. Case law suggests that the choice between the two systems would be a choice of an accounting method. A partnership is re-

48 In order to meet the "substantial economic effect" safe harbor for allocations of income and loss among the partners, capital accounts must be maintained as provided in the regulations, Regs. 1.704-1(b)(2)(ii)(b). -1(b)(2)(iv)(b).


50 In Prop. Reg. 1.704-1(b)(5) exp. 22, the proposed regulations assume the fair market value of the option is equal to the liquidation profit, but in real life that will not necessarily be the case.
quired to be consistent in its use of accounting systems, and that rule should prevent partnerships from alternating between the two systems. It would be best, however, if the final regulations stated this explicitly.

Corrective Allocations

In some cases the built-in gain or loss in the option will exceed the unrealized appreciation or depreciation in the partnership’s assets. As a consequence, a disparity will remain after all of the unrealized appreciation or depreciation in the partnership’s assets has been allocated to the option holder after the revaluation. In this case the proposed regulations still shift capital between the historic partners and the option holder so that the option holder has the economically correct capital account balance. In a controversial move the proposed regulations require the partnership to make corrective allocations of gross income or loss to the partners so as to take into account this disparity. This can mean, for example, that the option holder will incur taxable income on exercise of the option. Allocations under the partnership agreement will not be considered to have substantial economic effect, unless the agreement complies with these rules.

Example 3. Assume the same facts as in Example 1, 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 non-depreciable property. Also assume that Bonnie exercises the option at the beginning of Year 2 and that, at the time Bonnie 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.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities and Capital</th>
</tr>
</thead>
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<tr>
<td>Basis</td>
<td>FMV</td>
</tr>
<tr>
<td>Property B</td>
<td>40,000</td>
</tr>
<tr>
<td>Cash</td>
<td>16,000</td>
</tr>
<tr>
<td>Total</td>
<td>56,000</td>
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</tbody>
</table>

51 See Bank One Corporation v. Comm'tr, 120 TC No. 11 (2003) and Reg. 1.446-1(a); thanks goes to Paul Cauman, Esq. of Chapman and Cutler for pointing out the accounting system rules.


53 Prop. Reg. 1.704-1(b)(2)(iv)(s)(3)(ix). Meeting the “substantial economic effect” test can be crucial. To meet the regulatory safe harbor for allocations of partnership income or loss, they must have “substantial economic effect.” Reg. 1.704-1(b)(1)(i).

54 This example is based on Prop. Reg. 1.704-1(b)(5) ex. 21.
Bonnie'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, Bonnie 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 and Property B, which has a value of $41,000. Thus, the total value of LLC's assets is $57,000. Bonnie is entitled to LLC capital equal to 1/3 of this amount, or $19,000. Bonnie is thus entitled to $3,000 more LLC capital than her capital contributions to LLC.

Under the proposed regulations, LLC must increase Bonnie's capital account from $16,000 to $19,000. First, LLC revalues its property, allocating the $1,000 of book gain from the revaluation to Bonnie. This brings Bonnie's capital account to $17,000. There being no other book gain available, LLC must now reallocate $2,000 of capital from Lilly and Cleo to Bonnie to bring Bonnie's capital account to $19,000 (the capital account reallocation). As Lilly and Cleo have equal shares, each of their capital accounts is reduced by half of the $2,000 reduction, $1,000 each. 

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 Lilly, Cleo, and Bonnie. For tax purposes, however, LLC must allocate all of its gross income ($3,000) to Bonnie. Her normal share would have been one-third or $1,000. The extra $2,000 of income "offsets" the $2,000 allocated to her capital account. According to the proposed regulations, LLC's book and tax deductions ($1,500) are allocated equally among Lilly, Cleo, and Bonnie.

There is a conflict of sorts in the proposed regulations between the descriptive language of the regulation and the provisions in the example. The former provide that a corrective allocation is an allocation of "gross income and gain, or gross loss and deduction, that differs from the partnership's allocation of the corresponding book item." The example provides for the allocation of income only. The regulatory language suggests losses could be used instead (for example, by depriving Bonnie of her share of tax losses), or a combination of income and losses could be used. If the final regulations

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55 Since the proposed regulations attach no tax consequence to this stage, the implication is that this capital shift itself does not constitute a taxable event. Since many believe capital shifts to generally be taxable events, an explicit statement as to its nontaxable nature would be preferable. See letter to Commissioner from the Federal Taxation Committee of the Chicago Bar Association dated July 22, 2003 (hereinafter "Chicago Bar Letter"); see discussion of background supra.

56 Note that there are still book/tax disparities meaning that future tax items from Property B must still be allocated in accordance with Section 704(c) principles.

should stick with the corrective allocation approach (with which, as dis­
cussed below, I would disagree), they should clarify whether the partner­
ship has the discretion to allocate income or losses or whether the partner­
ship has to follow a set procedure.\textsuperscript{58} The former would generally
seem preferable as it would make it more likely that the partnership could
remedy some of the character mismatching that can occur (discussed be­
low), give the partnership more flexibility in addressing corrective alloca­
tions, and at least in partnerships with unrelated partners would not seem
likely to lead to abuse. The corrective allocation approach of the proposed
regulations likely does not match the typical option holder’s expectations.
Outside the entity context, if an option holder exercises a call option, it is
precisely because there has been appreciation in the asset subject to the
option. The fisc does not tax the option holder on it until the underlying
property is sold. In the examples, the option holder’s option is to purchase
the partnership interest. There has been no disposition of it and under tra­
ditional option principles it would seem premature to generate income
recognition. The problem with this perspective is that a partnership inter­
est does not truly represent a separate asset. Without once again beating to
death entity versus aggregate arguments on partnership taxation,\textsuperscript{59} what
makes the partnership interest worth more is what is going on inside the
partnership, a flow-through entity. The appreciation in Property A occurred
while Bonnie held the option, and due to the appreciation the option be­
came worth exercising. In a sense, given the existence and inevitability of

\begin{table}
\centering
\begin{tabular}{|c|c|c|c|c|c|}
\hline
 & Lilly & & Cleo & & Bonnie & \\
 & Tax & Book & Tax & Book & Tax & Book \\
\hline
cap acc. post exercise & 20,000 & 20,000 & 20,000 & 20,000 & 16,000 & 16,000 \\
re-valuation & & & & & 1,000 & \\
cap acc. after reval. & 20,000 & 20,000 & 20,000 & 20,000 & 16,000 & 17,000 \\
realloc. & & (1,000) & & (1,000) & 2,000 & \\
cap acc. after reall. & 20,000 & 19,000 & 20,000 & 19,000 & 16,000 & 19,000 \\
inc. alloc. & & 1,000 & & 1,000 & 3,000 & 1,000 \\
ded. alloc. & 500 & 500 & 500 & 500 & 500 & 500 \\
capital acc. end year 2 & 19,500 & 19,500 & 19,500 & 19,500 & 18,500 & 19,500 \\
\hline
\end{tabular}
\end{table}

\textsuperscript{58} See ABA Comments, at IVB7.

\textsuperscript{59} WPP n. 16 supra, at ¶ 1.04.
the exercise of Bonnie's option, when Property A was sold, Lilly and Cleo were taxed on Bonnie's share of the income. Accordingly, it makes some sense to find a way to tax Bonnie on that income when capital is shifted from Lilly and Cleo to Bonnie. The regulations accomplish this to some degree. They also expedite matching tax and book accounts, always a high priority in partnership taxation. Further, by shifting taxable income (but not book income) to Bonnie, Lilly and Cleo get the equivalent of a tax loss, appropriately offsetting the "extra" tax gain they received on disposition of the property.

The corrective allocation approach of the proposed regulations creates some problems, however. One is a potential character mismatch. Continuing with the example, the gain from the sale of Property A commonly would be capital or 1231 gain, whereas the income allocated to Bonnie typically would be ordinary income. This may give Lilly and Cleo an opportunity for tax arbitrage. They recognize capital gain on the sale of the Property A, pay tax on the gain at preferential rates (typically 15%), and then receive the equivalent of an offsetting ordinary tax loss when a portion of partnership income is allocated to Bonnie (reducing taxable income that can be taxed at up to a 35% rate). Under the right circumstances, Lilly and Cleo will actually be motivated to sell property while an option is outstanding. Given the near-term tax impact, Bonnie will probably see the option as worth less and will be less likely to exercise the option.60 Alternatively, Bonnie might cooperate with the tax arbitrage for Lilly and Cleo if she is tax-indifferent due, for example, to the fact that she has a net operating loss carry over.61

Further, a corrective allocation can be triggered even when the partnership has not sold property while the option was outstanding.

Example 4. Year 1: Lilly and Cleo form a LLC by contributing $1000 each. LLC purchases unimproved land (the "Property") for $2,000 and grants to Bonnie for $100 an Option to acquire an interest in LLC. This

60 The ABA Comments, at IVB7 note that the corrective allocation approach of the proposed regulations further exaggerates the differences with the way options are treated in the corporate context, where there are no corrective allocation. While there may be some arguments for greater consistency between the two regimes, at least with regard to C-corporations the difference can be justified. C-corporations are not flow-through entities, and thus an option to acquire stock really is an option to acquire an asset that is best seen as independent of the internal workings of the corporation. Of course, what goes on inside the corporation affects the value of the stock, but this seems more akin to general economic conditions affecting the value of nonentity related call options for property and less akin to call options for interests in flow through entities.

61 See ABA Comments, at IVB7. A tax exempt entity would not necessarily be tax indifferent. That is because income from a typical business partnership would be unrelated business taxable income and thus taxable to the tax exempt. See Sections 511 and 512.
option entitles Bonnie to no voting rights and a one-third interest in the capital and profits of LLC for $567. A one-third interest based on the value of the partnership assets should cost $900 assuming Bonnie gets credit for the option premium ($2000 + ($900 + $100)/3 = $1000). The “discount” is due to the facts that Bonnie will be a minority partner without control over partnership affairs and will hold an interest that is not very marketable. LLC has no income or loss in year 1.  

Year 2: On January 1, Bonnie exercises the Option at a time when the interest acquired has a fair market value of $667 (Bonnie’s Option price plus Option premium). In that year LLC has no net income, $222 of gross income and $222 of deductions. The value of the Property is unchanged at $2,000. Under the agreement, Bonnie’s share of partnership capital immediately upon exercise is $889, one-third of the total capital of $2,667. Under Prop. Reg. 1.704-1(b)(2)(iv)(s)(2), Bonnie’s capital account includes the sum of (i) the Option premium, (ii) Option price paid and (iii) built-in gain to the extent necessary to produce a capital account equal to Bonnie’s actual share of capital. Since there is no built-in gain, under the proposed regulations, Bonnie’s capital account would initially consist of (i) the option premium and (ii) option price paid, or a total of $667, $222 less than her actual share of capital.

Since there is no appreciation or depreciation in partnership assets, the proposed regulations require a capital account reallocation of $222 from Lilly and Cleo’s capital accounts to Bonnie’s capital account, and since there is no book gain, a corrective allocation. Under these facts that will mean an allocation of $222 of ordinary, taxable income to Bonnie and an allocation of $111 of tax deductions each to Lilly and Cleo.

This result makes no sense. There has been no appreciation in the asset. There is an economic gain inherent in Bonnie’s LLC interest that could only be recognized if the LLC liquidates. If Bonnie sells the interest to another, presumably the same discounting will apply and the interest will still have a value of $667. A corrective allocation would cause Bonnie’s tax basis to exceed the fair market value of her interest. Further, Lilly and Cleo are effectively allocated tax losses where they have had no economic losses.

Thus, while with corrective allocations of the proposed regulations address a legitimate concern, the cure may often be worse than the disease. The complicated nature of the corrective allocations will also mean that they will be a trap for the unwary. Many partnerships will lack the sophistication to comply. The Service has indicated informally it does not think corrective allocations will be common even under the regime of the proposed regulations. Given its complexity and the problems it can create,  

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62 This example is taken (in parts verbatim) from the ABA Comments, at IVB7.
if the problem is not going to be a common one, it is better to forgo the solution, at least as conceived by the proposed regulations. Accordingly, I suggest that the final regulations delete the corrective allocation rules. This may mean that the continuing partners have "extra income" and the option holder avoids some income, but this will normally be resolved on liquidation of the interests. Often partnership agreements provide that allocations of income and loss will be made so that a partner's capital account equals the amount distributed to that partner. Admittedly, waiting until liquidation to resolve the matter can mean a significant deferral for the option holder/partner, but as I discussed, and as Example 4 shows, using corrective allocations can mean allocating income to the option holder when that is not appropriate. Further there are other rules, in particular the recharacterization rules discussed below, to deal with truly abusive situations. If giving up on the corrective allocation rules entirely is more than the Service can stomach, the Service can replace the corrective allocation rule with a narrowly defined anti-abuse rule, allowing the Service to require corrective allocations when an active abuse is taking place.

Option Holder Treated as Partner

Generally, the proposed regulations treat an option as such and not as a partnership interest. Accordingly, the proposed regulations do not normally require the partnership to take an outstanding option into account when making partnership allocations of income and loss. There are exceptions, however, and they are necessary. If every option were blindly respected, it would be easy for high-bracket taxpayers to avoid partnership income while effectively owning an interest in the partnership. Rather than acquire a partnership interest, they would buy an option. The terms of the option and the partnership agreement can be written so they fully benefit from partnership profits. The terms might provide that the partnership may not make distributions or, more likely, only make limited distributions to cover partner tax liabilities. Since the profits will mostly stay in partnership solution, the option will increase in value, giving the option holder the benefit of partnership income without being taxed on it. Down the road the option holder could even sell the option at a capital gain, which typically would only be taxed at a 15% rate rather than ordinary income rates of up to 35% on a partner's share of operating profits. Further, had the option holder sold a partnership interest instead of the option, Section 751 would

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63 Some have suggested relying on Section 704(c) and its regulations in this context to get the capital accounts right. See Chicago Bar Letter, n. 55 supra. However, that will not always be possible. In this example, there is no basis for applying Section 704(c) since there is no book/tax disparity in the assets.

64 Sections 1(h), 1(i)(2).
have required him to recognize ordinary income to the extent of ordinary income inherent in partnership receivables and inventory.\textsuperscript{65} Even before the proposed regulations, the Service has ruled and the courts have held that under the right facts options can be viewed as ownership interests. The proposed regulations would have fallen far short if they had not addressed this issue.\textsuperscript{66}

The proposed regulations treat an option holder as a partner if two tests are met. The option holder's rights must be substantially similar to the rights afforded a partner ("substantially similar test").\textsuperscript{67} Additionally, as of the date that the option is issued, transferred, or modified, there must be 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 ("strong likelihood test").\textsuperscript{68}

If an 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.\textsuperscript{69}

The proposed regulations list a series of factors that are relevant in determining whether or not an option is reasonably certain to be exercised. I generally do not find these lists helpful since they are nonexclusive and consist of items that one would usually think of anyway—but nevertheless, here is the list:

(i) Fair market value of the partnership interest that is the subject of the option;
(ii) Exercise price of the option;
(iii) Term of the option;
(iv) Volatility, or riskiness, of the partnership interest that is the subject of the option;
(v) Fact that the option premium and, if the option is exercised, the option exercise price, will become assets of the partnership;

\textsuperscript{65} This problem is to some extent offset by the fact that any purchaser of the option is likely to discount the price paid for the option for the associated tax Section 751 tax liabilities he will be assuming on exercise of the option. Note that an IRC Section § 754 election could not solve this problem if the option is respected as an option since there has been no sale or exchange of a partnership interest.

\textsuperscript{66} Kwiat v. Comm'r, TCM 1989-382; Penn-Dixie, Steel Corp., 69 TC 837 (1978); Rev. Rul. 82-150, 1982-2 CB 110; also see Griffin Paper Company, TCM 1997-409, aff'd 180 F.3d 272.

\textsuperscript{67} Prop. Reg. 1.761-3(a).

\textsuperscript{68} These descriptive terms are borrowed from the ABA Comments, at IVE1. See Reg. 1.761-3(a).

\textsuperscript{69} Prop. Reg. 1.761-3(c)(1)
(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) Existence of related options, including reciprocal options; and
(ix) Any other arrangements (express or implied) affecting the likelihood that the option will be exercised. 70

The proposed regulations give some examples of when the rights given to an option holder do or do not cross the line to partner status. In one example an option holder pays $8 for a 7-year option to acquire a 10% partnership interest for $17. The relevant partnership interest is worth $16 at the time the option is issued. The business of the partnership is a risky one. Given the length of the term of the option and the fact that it is barely out of the money, the option holder is economically not very differently situated from a partner with a profits interest in the partnership. Under the facts, however, the option holder does not have the same risk of loss as a partner. Further, the riskiness of the business means that the value of a 10% interest in 7 years is not reasonably predictable. For these reasons the proposed regulations conclude that the option holder is not treated as a partner. 71

In another example, a partnership owns rental property. The property is 95% rented to good quality corporate tenants on triple-net leases and is expected to remain so rented for 20 years. Occupancy rates are high in the relevant geographic area and it is expected to stay that way for 10 years. The option holder pays $6.50 for a 7-year option to acquire a 10% interest in the partnership for $17. The value of a 10% interest at the time of issuance of the option is $16.5. Net cash flow is reasonably expected to be $10 per year for the next 7 years. Finally no distributions are allowed to be made to the partners during that time. Under these assumptions, some of which require an unusually good crystal ball, the value of the option can be expected to go up in value over the 7-year option term (as no distributions are being made), and the value of the option can be expected to be greater than the option exercise price—and of course it can be expected that the option will be exercised. Under these circumstances, the option holder has rights substantially similar to the rights afforded a partner. If there is also a strong likelihood that failure to treat the option holder as a partner would result in a substantial reduction in the partners' and the option holder's aggregate tax liabilities (because, for example, the option holder

70 Prop. Reg. 1.761-3(c)(2).
is in a high tax bracket and the partners in low tax brackets), the option holder will be treated as a partner.72

Options that are deep in the money73 raise similar issues. In one example in the proposed regulations a limited partnership is engaged in a risky internet start-up venture. (Is there any other kind?) The option holder pays $14 for an 10-year option to acquire a 5% interest for $6. A 5% interest has a fair market value of $15 at the time the option is issued. Given the riskiness of the venture, it is not certain that the option will be exercised, but what the option holder has paid as a premium, $14, almost equals what the corresponding partnership interest currently is worth, $15. Thus, if the business goes south, the option holder stands to lose almost as much as a partner. The option holder will also be able to participate the success of the partnership. Therefore, according to the proposed regulations, the option holder has similar economic benefits and detriments of a partner and therefore has rights similar to that afforded a partner. If there is a strong likelihood that the failure to treat the option holder as a partner would result in a substantial reduction in the partners’ and the option holder’s aggregate tax liabilities, the proposed regulations conclude that the option holder will be treated as a partner.74

If the option holder is considered to be a partner, he is allocated his share of partnership income or loss based on his interest in the partnership. Computing his interest in the partnership is the hard part. The regulations do not provide a lot of guidance in this regard beyond noting that an option holder may have contributed less than other partners, making his economic interest in the partnership smaller. Many different factors might go into calculating the allocable share, including the amount of the option premium paid, future rights to current profits if they cannot be currently distributed, and rights on liquidations, if any.

There are other complexities that can arise when an option holder is required to be treated as a partner. The biggest problems will occur when the partnership does not treat an option holder as a partner when it should have. Any audit that would detect the mistake will come years after the fact. In the interim, the other partners may have incurred too much income while the option holder may have incurred too little. That will all have to be undone, assuming the statute of limitations has not expired on the personal tax returns of the partners.75 The problem gets worse if, for example.

73 Meaning the exercise prices is well below the value of the partnership interest that will be acquired with the option.
75 The mitigation provisions of Section 1311-1314 may be relevant in this regard.
the option holder is a tax exempt organization with a strong aversion to partner status and its associated unrelated business taxable income. If any partners have come or gone during the involvement of an option holder that should-have-been-treated-as-partner-but-was-not, the complexities of setting it all right reach Kafkaesque proportions.

Those same problems exist in reverse if the option holder is treated as a partner only to discover he was not one. Another complication in this regard is if the option holder/partner who is considered a partner allows the option to lapse. Now what? Presumably it would be treated as an abandonment of the partnership interest, generating possible debt shifts and deemed cash distributions under Sections 752 and 731, basis adjustments under Section 734 if a Section 754 election is in effect, and hot asset problems under Section 751.

If things run amok here, no one, least of all the IRS agent in the field, is likely to put Humpty Dumpty back together again. Accordingly, while the Service undoubtedly needs to address the possibility of abuse, it should do so in a manner that is narrowly designed to catch the abusers (and, more importantly, discourage the potential ones), while leaving the rest of the tax world confident that it is free of the recharacterization ambit. The strong likelihood tests insure that only abusers will be drawn into the fold, but the rules as a whole do not insure that nonabusers will not be drawn in as well. The rules need some fine-tuning.

Under the proposed regulations, for purposes of determining whether the rights possessed by the option holder are substantially similar to those afforded partners, a key consideration with whether the option holder will share in the economic benefit of partnership profits and in the economic detriment associated with partnership losses. Also relevant is any arrangement that allows the holder of an option to control or restrict partnership activities. The difficulty here is that to some extent most options meet the first two of these tests, and may meet all three tests. If the business does well, the option will become more valuable and the option holder will be likely to exercise the option, and thus the option will share the economic benefit of partnership profits. Indeed, that is exactly what every

76 This income is taxed to the tax exempt organization at regular tax rates. See Section 511, 512.

77 See ABA Comments, at IVE1.

78 Rights in the partnership possessed by the option holder solely by virtue of owning a partnership interest are not taken into account in this regard, provided those rights are not greater than the rights granted to other partners owning similar partnership interests: Prop. Reg. 1.761-3(c)(3).

79 See ABA Comments, at IVE2e; also see Culbertson v. Comm’r, 337 U.S. 733 (1949) and Luna v. Comm’r, 42 TC 1067 (1964).
option holder in or outside the partnership context hopes for. If the business goes south, the option holder will likely not exercise the option and lose the value of his premium, thus to some extent sharing in the economic detriment associated with partnership losses. Admittedly, the maximum amount of loss is set by the premium, but that maximum may not be that different from losses likely to be incurred by partners. It is not unusual for partners, especially limited partners and LLC members, to have a maximum amount they can lose as well. Thus, all option holders will to some extent “share in the economic benefit of partnership profits and in the economic detriment associated with partnership losses.”

It is less common for option holders to have a major say in what the partnership can and cannot do, though economically strong option holders may have such right. If such rights exist, they will tend to be more indicative of partner status than the fact that an option holder ultimately shares in partnership profits and losses, but it should hardly by itself mean that the substantially similar test is met. For example, an option holder might have the power to prevent the partnership from expanding beyond its existing lines of business. But if there is no intention to make such an expansion, simply holding these veto rights would not seem sufficient to meet the substantially similar test. A well-advised option holder may ask for a variety of protections that in and of themselves should not be fatal. Examples include the right to veto admission of certain types of partners, which Section 704(c) method is used, exit strategies and buy back rights, the rights of the option holder in the event of the sale of partnership assets, right to veto a sale of substantially all of the partnership assets, access to partnership books and other partnership information, compliance with federal and state securities laws, and limitations on the partnership’s right to make distributions, and the manner in which they are made where not completely prohibited. It would be impossible for the Service to provide a list of all acceptable or unacceptable rights that could be given to an option holder. Further, rights that might be acceptable in some circumstances may become unacceptable in others. The examples give a better sense of things, but more guidance is needed. A solution would be for the regulations to exclude commercially reasonable provisions that look to

60 Once a revaluation is made, allocations of tax items have to be made in a manner that takes Section 704(c) into account. This could mean, for example, that existing appreciation in partnership assets has to be allocated to the continuing partners except to the extent the option regulations provide otherwise. Under the Section 704(c) regulations, three methods can be used to do this, the “traditional method,” the “traditional method with curative allocations,” and the “remedial method.” The tax impact of the three methods can vary dramatically. See Reg. 1.704-3.

61 See ABA Comments, at IVD2e. (Typically existing partners will at least want to receive distributions sufficient to pay their taxes.)
protecting the option holder’s investment in the option. This standard is hardly a model of precision, but it would be helpful to practitioners and is a large improvement on the current overly broad language that provides that partner attributes include the existence of any arrangement that directly or indirectly allows the holder of the option to control or restrict the activities of the partnership.\textsuperscript{82} The commercially reasonable standard adds some objectivity. The Service and taxpayers can look to the relevant industry to see what is in common usage. The regulations could also give examples of rights that do or do not cross the line. Thus, a right to veto entry into an improbable line of business might pass muster, but rights to regularly participate in management decisions would not.

One of the most problematic areas in the rules is the fact that the option is tested to determine whether or not it constitutes a partnership interest each time the option is issued, transferred, or modified (“ITM event”).\textsuperscript{83} Thus, not only is the option tested under the rules when it is issued, it is also tested upon a modification or transfer. It is not clear when a transaction qualifies as a modification or transfer. Modifications to the terms of options are not uncommon. It is important that the final regulations make clear what is a modification that triggers a recharacterization review and what is not, so that taxpayers have adequate guidance. This issue has arisen in other contexts. Regulation 1.1361-1(l)(4)(iii) considers whether an option should be classified as a second class of stock. One of the times the option can be so classified is when there has been a “material” modification of the option. Additionally, with regard to testing when corporations are part of a consolidated group based upon options, Reg. 1.1504-4(c)(4) defines the “measurement date.” A “measurement date” can be a date on which there are adjustments to the terms of the option. Adjustments are excepted that do not materially increase the likelihood that the option will be exercised. Also excepted are modifications that are determined by a bona fide, reasonable, adjustment formula that has the effect of preventing dilution of the interests of the holders of the option. Transfers by gift, at death, and pursuant to Section 1041\textsuperscript{84} among others, are excluded as well.

These rules provide helpful guidance. Obviously, the mere fact that there is an adjustment to a partnership option should not be enough to trigger a testing event to determine whether or not the option should be recharacterized as a partnership interest. The change should be substan-

\textsuperscript{82} Prop. Reg. 1.761-3(c)(3).

\textsuperscript{83} Again, this acronym is borrowed from the ABA Comments, at IVE2.

\textsuperscript{84} Section 1041 treats transfers between spouses while married or pursuant to a divorce as nontaxable transactions.
tial. Further, certain changes, even if arguably substantial, are inherently benign and thus should also not trigger a testing event. Typically the option holder is not going to be able to prevent all distributions. Partners are going to want at least enough distributed to meet their tax obligations. Consequently, many options have automatic adjustment provisions that adjust the exercise price for distributions that are made while the option is outstanding. Commonly, option agreements have provisions to prevent dilution or enhancement, providing that the interest received or the exercise price adjusts should the partnership issue partnership interests or redeem them while the option is outstanding. There are many other examples where adjustments may occur that are clearly benign in nature and not part of a subterfuge to give the option holder status equivalent to a partner. Some examples: Amendments to the partnership agreement not directly involving the option; an amendment to the option agreement not affecting the likelihood of exercise or the fundamental rights of the option holder; dissolution; liquidation or bankruptcy of the option holder; and taxable merger, reorganization, or division of the partnership or the option holder.85

What makes this all especially problematic is that a benign ITM event could trigger partner status due to changes in the underlying economics. For example, an option that at the outset would not meet the tests for partner status might later. Perhaps the business does especially well and now it is a virtual certainty that the option will be exercised. If the "substantially similar" test is not tightened as I recommend above, the option holder as of the later ITM event may have developed economic benefits and detriments sufficiently similar to a partner so that the substantially similar test could be met. If the strong likelihood test is also met, the option holder could suddenly become a partner, even where the ITM event was entirely benign and no subterfuge was involved.

Accordingly, I recommend that the final regulations follow the lead of the consolidated return regulations. The final regulations should provide that an ITM event is not triggered for modifications in the option agreement that do not materially increase the likelihood that the option will be exercised and adjustments that are determined by a bona fide, reasonable, adjustment formula that has the effect of preventing dilution or enhancement of the interests of the holders of the option.86

Just as certain changes to the terms of the option are benign and should not trigger a recharacterization review, certain transfers of the option are benign and should be similarly excluded. As the consolidated return regulations implicitly conclude, gifts, Section 1041 transfers, and

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85 See ABA Comments, at IVE2c.
86 See ABA Comments, at IVE2c, where the same recommendation is made.
transfers at death fall in the latter category and are not likely to be part of, or typically even able to, contribute to a tax-avoidance scheme. One can think of exceptions. A high-bracket donor might gift an interest to a low-bracket donee to make it less likely that the strong likelihood test will be met. But the gift tax rules would often take away the incentive for such a gambit, and it does not seem like it would be sufficiently common to justify the existence of a special rule. Other examples of tax free transfers that should not trigger an ITM event include termination of a partnership under Section 708; a state law conversion of the partnership;\(^{87}\) conversion into another entity where the conversion is tax free for federal income tax purposes;\(^{88}\) a tax-free merger, reorganization or division of the partnership or option holder; and tax-free transfers pursuant to Section 332, 351, 368(a), 721, or 731.\(^{89}\) Tax free transfers do not provide much of an opportunity for abuse (and usually none at all), and accordingly, I recommend that the final regulations exclude any tax free transfers from the definition of an ITM event.

It would also be helpful if the final regulations would clarify when the option is converted if a transfer indeed causes a recharacterization. Since the option presumably qualified as such prior to the transfer, logically the transfer should be viewed as a transfer of the option by the transferor. The recharacterization would then occur in the hands of the transferee.\(^{90}\)

The proposed regulations imply, but do not explicitly state, that treating an option holder as a partner is a one-way street. It would make life very complicated indeed, perhaps insurmountably so, if an option holder could be classified as a partner then, after another ITM, reclassified as an option holder. I would recommend, therefore, that the final regulations make the one-way nature of reclassification explicit.\(^{91}\)

Under the strong likelihood test, an option holder is treated as a partner if the failure to do so would result in a substantial reduction in the present value of the partners’ and the option holder’s aggregate tax liabilities. A similar, but not identical standard is contained in the substantial economic effect regulations. These regulations provide that the economic effect of an allocation is not substantial if on an after tax, present value

\(^{87}\) Many states permit state law partnerships to convert to LLCs by process of law. Effectively the partnership is designated an LLC. There is no need to liquidate the partnership or form an LLC.

\(^{88}\) An example would be the state-law conversion of a partnership into an LLC. See Rev. Rul. 95-37, 1995-1 CB 130.

\(^{89}\) See ABA Comments, at IVE2c.

\(^{90}\) See ABA Comments, at IVF1.

\(^{91}\) See ABA Comments, at IVE2f.
basis there is a strong likelihood at least one partner is better off and none of the partners are worse off than if the allocation were not in the partnership agreement. Both tests could take into account tax attributes of a partner unrelated to the partnership. Given that the substantial economic effect regulations have been in effect since 1985, both tax practitioners and the Service have developed a comfort level with them and they speak to the same issue. I would therefore recommend that the language in the proposed regulations be conformed as much as possible to the language in the substantial economic effect regulations. For example, under the substantial economic effect regulations, taxpayers do not have to look forward more than five years. Under the test of the proposed regulations, on the other hand, there is no five year limit and any future event that has a tax impact conceivably would have to be considered. It would be best if that test were adapted to correspond to the existing test contained in the substantial economic effect regulations to which taxpayers (or at least their tax advisors) are accustomed.

Given the highly problematic consequences to the partnership and the option holder if the option interest is recharacterized, it is going to be important to taxpayers to have reliable guidance in this regard. If taxpayers are uncertain about the status of an option, they are less likely to use options, creating economic inefficiencies. Consequently, the final regulations should contain an overarching safe harbor. Taxpayers who comply with the safe harbor will know that their option will be respected as such, without the need to analyze the substantially similar test. The ABA Comments recommend use of the same safe harbor that already exists in the S-corporation context. An option will not be treated as a second class of S corporation stock if the strike price is at least 90% of the fair market value of the underlying stock. That high of a strike price suggests that the option is legitimate and not a disguised ownership interest. The ABA Comments would except from the safe harbor partnerships with substantially certain and predictable income streams, as abuse could still occur here. Even if the 90% safe harbor were met, high-bracket individuals could avoid income by owning options in such partnerships—provided there was a sufficient limitations on distributions—and still be confident of the ultimate

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92 Regs. 1.704-1(b)(2)(iii)(b)(2) and (c)(2).
93 “Comfort” could be pushing it. Let’s say the parties have learned to tolerate them.
94 To same effect, see ABA Comments, at 1V2E2d.
95 See ABA Comments, at 1V2E2d.
96 Reg. 1.1361-1(l)(4)(iii)(C). Under this regulation, a good faith determination of fair market value by the corporation is respected unless it can be shown that the value was substantially in error and the determination of the value was not performed with reasonable diligence to obtain a fair value.
mate return. The ABA Comments' recommendations seem quite reasonable, and the fact that the safe harbor is in use in another area means that both taxpayers and the Service will be accustomed to its use. The logical time to apply a safe harbor would be on the date of an ITM event. It will be especially important to adopt the exceptions to an ITM event that I discuss above. Otherwise an option that met the safe harbor on issuance could, due to successful partnership operations, fail to meet the safe harbor on a subsequent, totally benign event—such as implementation of an anti-dilution clause in the option agreement. This would in turn undermine the whole purpose of safe harbors: To provide taxpayers with confidence that if they comply with a given set of rules they will be safe from undesired tax consequences.

Conclusion

Partnership options in general, and noncompensatory options in particular, are becoming increasingly common. Yet, anomalously, there was almost no guidance as to their tax treatment. The proposed regulations make an important first step in providing that guidance. On the whole the proposed regulations are taxpayer-friendly and make a cogent effort to provide the necessary guidance and prevent abuse. I have two main concerns. One relates to the fact that in some areas the target is too elusive to be hit squarely. Corrective allocations address a legitimate concern, but the response may create more problems than it solves. Some problems are best left unattended. In my view the problems corrective allocations are meant to address fall into this category. I would not cause the option holder to incur taxable income on the exercise of the option and thus would eliminate the corrective allocation provision of the proposed regulations. Second, some form of recharacterization rules is necessary, and the proposed regulations were quite right to create one, but I suggest it be honed more finely and give the taxpayers some safe harbors on which to rely. On the whole, however, the proposed regulations are fair and balanced and provide a solid start to developing the guidance the tax law needs in this area.

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97 See ABA Comments, at IVE3.