IRS Releases Final Regulations on the Tax Treatment of Noncompensatory Partnership Options

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On February 4, 2013, the Internal Revenue Service issued final regulations relating to the tax treatment of noncompensatory partnership options (the “Final Regulations”). These regulations apply only to options that are not issued in connection with the performance of services. As a general matter, the Final Regulations explain that the exercise of a noncompensatory partnership option does not cause the recognition of immediate income or loss by either the issuing partnership or the option holder. The Final Regulations also modify the regulations under Code Section 704(b) regarding the maintenance of partners’ capital accounts and the determination of the partners’ distributive shares of partnership items. In addition, the Final Regulations clarify when the holder of a noncompensatory partnership option is treated as partner for tax purposes.

I. BACKGROUND

The Internal Revenue Service issued proposed regulations relating to the tax treatment of noncompensatory partnership options and convertible instruments issued by a partnership in 2003 (the “Proposed Regulations”). The Internal Revenue Service received various comments regarding the Proposed Regulations. The Final Regulations generally incorporate the Proposed Regulations with certain modifications reflecting some of the comments received. The Final Regulations should provide taxpayers greater certainty as to the tax treatment of noncompensatory partnership options. Notable aspects of the Final Regulations are discussed below.

II. ISSUANCE, EXERCISE, LAPSE, REPURCHASE AND OTHER TERMINATIONS OF A NONCOMPENSATORY PARTNERSHIP OPTION

The Final Regulations apply to an option issued by a partnership other than an option issued in connection with the performance of services. For this purpose, an option is defined as a call option or warrant to acquire an interest in the issuing partnership, the conversion feature of convertible debt or convertible equity.

A. Issuance of a Noncompensatory Partnership Option

The Proposed Regulations provided that the exchange of property for a noncompensatory partnership option is generally treated as an open transaction that is not subject to taxation. The Final Regulations, similarly generally treat neither the exchange of property for a noncompensatory
partnership option as a taxable event nor the satisfaction of a partnership obligation with a noncompensatory partnership option as a taxable event. Thus, generally a holder of a noncompensatory partnership option is treated as making an investment (i.e., a capital expenditure that is not taxable nor results in a deductible expense to the holder). However, if the holder transfers depreciated or appreciated property to the partnership in exchange for the option, the holder would recognize gain or loss upon the disposition of the property under the general tax principles of the Code.

B. Exercise of a Noncompensatory Partnership Option

As a general rule, the contribution of cash or property to a partnership in exchange for an interest in the partnership is treated as a nonrecognition transaction. The Final Regulations provide that such general nonrecognition rule applies to the exercise of a noncompensatory partnership option, whether the exercise price is paid in property or cash. Upon exercise of a noncompensatory partnership option, an option holder will generally be deemed to contribute the option purchase price and exercise price paid to the partnership in exchange for a partnership interest in a nonrecognition transaction. Thus, the exercise of a partnership noncompensatory partnership option will generally be non-taxable to both the option holder and the partnership.

However, the Final Regulations provide two situations in which the general nonrecognition rule does not apply to transfers of partnership interests to a noncompensatory partnership option holder. Such exceptions are meant to prevent the conversion of ordinary income into capital gain. First, the general nonrecognition rule does not apply to the transfer of a partnership interest to a noncompensatory partnership option holder in satisfaction of the partnership’s debt for unpaid interest (including accrued original issue discount) on convertible debt that accrued on or after the beginning of the convertible debt holder’s holding period for the debt. Second, such rule does not apply to the extent that the 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. Under either scenario, the option holder is required to recognize the interest, rent or royalty income, but the partnership is not required to recognize any gain or loss.

C. Lapse, Repurchase, Sale or Exchange of a Noncompensatory Partnership Option

The Final Regulations provide that the lapse of a noncompensatory partnership option generally is a taxable event to both the partnership and the option holder. The partnership recognizes income and the option holder recognizes loss in an amount equal to the price paid for the option. Similarly, settlement of a noncompensatory partnership option (i.e., in which exercise is settled in cash or property other than the underlying interest in the issuing partnership) is treated as a taxable event. Under proposed regulations issued concurrently with the Final Regulations, gain or loss from such transactions will be treated as short-term capital gain or loss. However, the Internal Revenue Service is continuing to examine the character of gain or loss recognized by an option holder on lapse, settlement, sale or exchange of a noncompensatory partnership option.

III. ACCOUNTING FOR NONCOMPENSATORY PARTNERSHIP OPTIONS

The Final Regulations generally follow the Proposed Regulations in providing that the issuance of a noncompensatory partnership option (other than an option for a de minimis partnership interest) is a permissible revaluation event for tax purposes.
Upon exercise, the holder of a noncompensatory partnership option will have an initial capital account equal to the consideration paid for the option plus the exercise price paid to the partnership in exchange for the partnership interest. Depending on the terms of the noncompensatory partnership option and the partnership agreement, an exercising option holder may be entitled to a capital account that is greater than or less than the holder’s initial capital account. In such case, the partnership is required to revalue its property immediately following the exercise of a noncompensatory partnership option and allocate unrealized income, gain, loss and deduction from this revaluation, first to the noncompensatory partnership option holder on exercise to the extent necessary to accurately reflect the option holder’s right to share in partnership capital under the partnership agreement and second, to the historic partners. To the extent that unrealized appreciation or depreciation in the partnership’s assets is allocated to the option holder, the holder will recognize income or loss attributable to such appreciation or depreciation, as applicable, when the underlying assets are sold, depreciated or amortized under the general principles of Code Section 704(c).

Generally, as long as there is sufficient built in gain or loss in the value of the partnership’s assets to properly account for the difference between the option holder’s initial capital account and its capital account entitlement, the exercise should not result in recognition of gain or loss to the holder in the year of exercise. However, in the unlikely circumstance that the difference between the option holder’s initial capital account and the option holder’s capital account entitlement exceeds the unrealized appreciation or depreciation in the value of the partnership’s assets, the Final Regulations generally follow the Proposed Regulations and provide that the partnership must reallocate capital from the historic partners to the option holder. The partnership will then need to make “corrective allocations” of income or loss to the extent that there are sufficient partnership tax items at the time of exercise to conform the partnership’s tax allocations to the capital shift. The option holder would also recognize income or loss in ensuing tax years until such time as the capital shift is fully taken into account.

IV. CHARACTERIZATION RULE

The Proposed Regulations generally respect noncompensatory partnership options as such and do not characterize them as partnership equity. However, under the Proposed Regulations, holders of noncompensatory partnership options would be treated as partners if the option provided the holder with rights "substantially similar" to those granted to a partner and if, as of the date that the noncompensatory partnership option was issued, transferred or modified, there was a "strong likelihood" that the failure to treat the holder of the noncompensatory partnership option as a partner would result in a substantial reduction in the present value of the partners’ and the holder’s aggregate tax liabilities. The Proposed Regulations use a facts and circumstances test to determine whether a noncompensatory partnership option holder’s rights are substantially similar to the rights afforded to a partner.

The Final Regulations retain these rules with certain modifications that address the breadth of the language in the Proposed Regulations that provides that all facts and circumstances will be considered in determining whether a noncompensatory partnership option provides the holder with rights that are substantially similar to the rights afforded to a partner. Thus, the Final Regulations provide that a noncompensatory partnership option provides its holder with rights that are substantially similar to the rights afforded to a partner if the option is "reasonably certain to be exercised" or if the option holder possesses "partner attributes."
A. Substantially Similar Test

The Final Regulations determine whether an option holder’s rights are substantially similar to those of a partner by examining first, whether the option is reasonably certain to be exercised, and second, whether the holder has partner attributes. Failure of either test could result in the characterization of an option as a partnership interest.

1. “Reasonably Certain To Be Exercised” Test

The Final Regulations provide two safe harbors to determine whether a noncompensatory partnership option is reasonably certain to be exercised. The first safe harbor provides that a noncompensatory partnership option is not considered reasonably certain to be exercised if it may be exercised not more than 24 months after the date of the applicable measurement event and it has a strike price equal to or greater than 110% of the fair market value of the underlying partnership interest on the date of the measurement event. Under the second safe harbor, a noncompensatory partnership option is not considered reasonably certain to be exercised if the terms of the option provide that the strike price of the option is equal to or greater than the fair market value of the underlying interest on the exercise date. However, neither safe harbor applies if the parties to the option had a principal purpose of substantially reducing the present value of the aggregate tax liabilities of the partners and the noncompensatory partnership option holder.

Options that do not satisfy the safe harbors may still be treated as not reasonably certain to be exercised based on all the facts and circumstances. As in the Proposed Regulations, the Final Regulations provide a non-exclusive list of facts and circumstances that may be considered, including fair market value of the partnership interest that is the subject of the option, the exercise price and term of the option and the predictability and stability of the value of the underlying partnership interest.

2. “Partner Attributes” Test

Under the Proposed Regulations, partner attributes include the extent to which an option holder shares in the economic benefit and detriment of partnership income and loss and the extent to which the option holder has the right to control or restrict the activities of the partnership. The Final Regulations clarify this language by providing that the determination of whether a noncompensatory partnership option holder possesses partner attributes is based on all facts and circumstances, including whether the option holder, directly or indirectly, through the option agreement or a related agreement, is provided with voting or managerial rights in the partnership. Partner attributes do not generally include rights to significantly restrict or control a partnership decision that could substantially affect the value of the underlying partnership interest, including standard dilution provisions.

B. “Strong Likelihood” Test

The Final Regulations provide that all facts and circumstances should be considered in determining whether there is a strong likelihood that the failure to treat a noncompensatory partnership 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 liability. Such factors include (i) the interaction of the partnership’s allocations and the partners’ and the option holder’s tax attributes, (ii) the absolute amount of the federal tax reduction, (iii) the amount of the reduction relative to overall tax liability, and (iv) the timing of items of income and deduction. If a partner or an option holder is a look-through entity (such as a partnership or S corporation) or a member of a consolidated group, then the tax attributes
of that entity’s beneficial owners or consolidated group are taken into account in determining whether there is a strong likelihood of a substantial tax reduction.

C. Testing Events

The characterization of a noncompensatory partnership option is generally required to be tested upon issuance, transfer and modification of the option. Under the Final Regulations, the following events do not require testing of the characterization of the option: (i) transfer of a noncompensatory partnership option at death or between spouses or former spouses, (ii) a transfer as part of a transaction that is disregarded for tax purposes, (iii) a modification of the option that does not increase the likelihood that the option will be exercised or provide the option holder with partner attributes, (iv) a change in the strike price of a noncompensatory partnership option, or in the interests that may be issued under the option if such changes are made pursuant to a bona fide, reasonable adjustment formula that has the intended effect of preventing dilution of the interests of the option holder, and (v) any other event provided in Internal Revenue Service guidance.

In addition, to address potential abuse with respect to transactions involving look-through entities, the Internal Revenue Service issued proposed regulations under Code Section 761 concurrently with the Final Regulations that add three events that require testing of the character of an option: (i) issuance, transfer, or modification of an interest in, or liquidation of, the issuing partnership, (ii) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns the noncompensatory partnership option, and (iii) issuance, transfer, or modification of an interest in any look-through entity that directly, or indirectly through one or more look-through entities, owns an interest in the issuing partnership. These additional testing dates apply only if those events are pursuant to a plan in existence at the time of the issuance or modification of the noncompensatory partnership option that has as a principal purpose the substantial reduction of the present value of the aggregate tax liabilities of the partners and the option holder.

D. Timing and Effect of Characterization

The Final Regulations provide that characterization of an option as a partnership interest applies upon the issuance of an option, or immediately before any other measurement event that gave rise to the characterization. Once a noncompensatory partnership option is treated as a partnership interest, it may not be subsequently recharacterized as an option.

V. EFFECTIVE DATE

The Final Regulations are effective as of February 5, 2013, and apply to noncompensatory partnership options issued on or after February 5, 2013.
If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 References to the “Code” are to the Internal Revenue Code of 1986, as amended.

2 “Corrective allocations” are allocations of tax items that differ from the partnership’s allocation of book items. If the capital account reallocation is from the historic partners to the exercising option holder, then the corrective allocations must first be made with gross income and gain. If an allocation of gross income and gain alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross loss and deduction as to further take into account the capital account reallocation. Conversely, if the capital account reallocation is from the exercising option holder to the historic partners, then the corrective allocations must first be made with gross loss and deduction. If an allocation of gross loss and deduction alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of gross income and gain as to further take into account the capital account reallocation.